FEDERAL RESERVE BANK OF NEW YORK

at-10702(d)

May 6, 1994

Split-Dollar Life Insurance Arrangements

To the Chief Executive Officers of all State Member Banks and Bank Holding Companies, in the Second Federal Reserve District:

Last year, the Federal Deposit Insurance Corporation (the "FDIC") issued for its examiners extensive guidelines for the purchase of insurance, including split-dollar life insurance, by state nonmember banks; and the FDIC sent a letter to the chief executive officers of all state nonmember banks regarding their insurance practices. A copy of the FDIC's letter is printed herein for your information.

Split-dollar life insurance is a type of life insurance in which the purchaser of the policy pays the insurance premium and receives only a portion of the death benefit.

Split-Dollar Life Insurance Arrangements Between a State-Chartered Bank and Its Insiders

The FDIC guidelines were issued under section 24 of the Federal Deposit Insurance Act, which was enacted as part of the Federal Deposit Insurance Corporation Improvement Act of 1991 and became effective on December 19, 1992. Section 24 limits the activities and equity investments of all insured state-chartered banks to those activities and equity investments that are permissible for national banks. Under section 24, the FDIC has the sole responsibility for determining the permissible activities and equity investments of state-chartered banks; therefore, the FDIC guidelines apply to state member banks. In some instances, the purchase of life insurance by a state-chartered bank, including split-dollar life insurance arrangements, is one of the activities and equity investments governed by this statute.

The FDIC has concluded that participation in a split-dollar life insurance arrangement is a permissible activity for a state-chartered bank only if: (1) the policy meets the tests outlined in the Office of the Comptroller of the Currency's Banking Circular 249, a copy of which is also printed on the following pages; and (2) the benefits to the bank officer, director, employee, or principal shareholder for whom the insurance is purchased are reasonable.

The FDIC has determined that section 24 applies to all life insurance purchases made by state-chartered banks, including those made before December 20, 1992. Thus, if a state-chartered bank wishes to purchase an insurance policy that does not meet the FDIC's two standards set forth above, it must obtain the prior consent of the FDIC. The FDIC has further stated that a state-chartered bank presently holding an insurance policy that does not meet these standards -- whether or not such a policy was purchased before December 20, 1992 -- must obtain the FDIC's permission to retain the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A1 10702 (d)

insurance policy. Any state member bank holding an insurance policy that does not conform to the aforementioned FDIC standards must, under the FDIC's guidelines, obtain the FDIC's permission to retain the insurance policy.

In a recent revision to its guidelines, the FDIC has suggested that banks establish their own internal concentration limits for investments in split-dollar life insurance policies. These internal limits should not exceed the maximum allowable amounts, if any, that exist under applicable state laws or regulations. In addition, if the aggregate amount of a bank's investments in all of its insurance policies exceeds 25 percent of Tier 1 capital, it may be viewed as a concentration of credit.

In addition to the legal limitations placed on a state-chartered bank's participation in split-dollar life insurance arrangements as outlined in the FDIC's guidelines, such insurance arrangements at state member banks may also, in our view, constitute an unsafe and unsound practice involving the diversion of bank income or assets. When a state member bank purchases a split-dollar life insurance policy and arranges for one of its insiders, rather than the bank, to receive all or most of the benefits of the policy in excess of the amount of the premium paid, the state member bank, in effect, provides a significant economic benefit to its insiders. In those instances where the bank purchases life insurance in amounts that exceed the levels necessary to provide reasonable compensation benefits to the bank insider, the premium payments for such policies may be viewed as an inappropriate use of bank funds because the bank loses the opportunity to use its assets in a productive manner.[1]

Guidance on the standards of reasonable compensation as it applies to split-dollar life insurance arrangements can be found in the FDIC's August 18, 1993 memorandum to its Regional Directors and accompanying staff discussion paper, which is available from the FDIC upon request to its Office of Corporate Communications at (202) 898-8563. Specific questions on reasonable compensation as it applies to split-dollar life insurance arrangements should be directed to the appropriate FDIC Regional Office. You should also promptly contact this Reserve Bank in order to inform us that you are seeking the FDIC's permission to retain or enter into a split-dollar life insurance arrangement or to seek that agency's guidance concerning such an arrangement as part of a reasonable compensation package for a bank insider.

Split-Dollar Life Insurance Arrangements Between a Bank Holding Company and Its Subsidiary Bank

It should be noted that split-dollar life insurance arrangements may exist between a bank holding company and its subsidiary bank. Under such an arrangement, generally, the subsidiary bank owns the insurance policy, pays all or substantially all of the premiums, and is reimbursed for the premium payments only when the policy is cashed in or the death benefit is paid. The bulk of the insurance proceeds are paid to the bank's parent holding company or its insiders, and not to the bank. Such arrangements may violate sections 23A and 23B of the Federal Reserve Act because the payment of the entire insurance premium by a subsidiary bank -- without its concomitant receipt of all of the death benefit -- may represent an impermissible unsecured extension of credit to the bank's parent

---

[1]It should be noted that an individual who is a principal shareholder of a state member bank and holds no office at the institution is generally not entitled to compensation and, therefore, should not be a party to a split-dollar life insurance arrangement.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A+ 10702(d)

holding company, and because the subsidiary bank may not receive a favorable return on its investment. Such split-dollar life insurance arrangements may also constitute an unsafe and unsound banking practice because the arrangements may involve an improper diversion of bank income.[2]

In the event that you have any questions regarding split-dollar life insurance arrangements between a bank holding company and its subsidiary bank or you need to notify us about your contact with the FDIC concerning a split-dollar life insurance arrangement, please contact Donald E. Schmid, Manager of our Domestic Banking Department, at (212) 720-6611.

CHESTER B. FELDBERG
Executive Vice President

---

[2]Again, it should be noted that an individual who is a principal shareholder of a bank holding company and holds no office at the institution is generally not entitled to compensation and, therefore, should not be a party to a split-dollar life insurance arrangement.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

At 10702(d)

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Office of the Director
Division of Supervision

FIL-60-93
August 31, 1993

BANK PURCHASES OF LIFE INSURANCE

TO: CHIEF EXECUTIVE OFFICER

SUBJECT: Supervisory Considerations Relating to Purchases of Life Insurance by Banks

An increasing number of state nonmember banks have purchased various forms of life insurance contracts covering key employees. The policies are generally purchased as either a compensation benefit for the employee, or as key-person protection for the bank. In certain instances, the policies provide a benefit to executive officers who are also majority stockholders.

Many of these policies are structured as whole life, universal life, or other cash value policies that require large single premiums or periodic premiums of a substantial amount. These premiums may result in the build-up of significant cash surrender/investment values that cannot be easily liquidated without adverse tax consequences.

Various supervisory concerns arise when banks engage in these insurance activities. During the course of safety and soundness examinations, several broad areas of possible supervisory concern may be evaluated by FDIC examiners when considering the appropriateness of a state nonmember bank's involvement in these insurance arrangements.

To assist FDIC examiners in analyzing insurance policies purchased by state nonmember banks, the FDIC Division of Supervision issued a memorandum to its Regional Directors on August 18, 1993 (Transmittal No. 93-125). Attached to the memorandum is an August 1993 staff discussion paper that addresses the following subjects as they relate to bank purchases of life insurance: (1) Impermissible activities, (2) Reasonableness of benefits, (3) Compliance with laws and regulations, (4) Concentrations and other risk considerations, and (5) Accounting considerations.

For example, in reviewing life insurance policies for impermissible activities, examiners will evaluate a bank's compliance with Section 24 of the Federal Deposit Insurance Act (FDI Act). Section 24, in part, prohibits FDIC-insured state banks from engaging as principal in any activity that is not permissible for a national bank unless the bank is in compliance with the applicable capital standards and the FDIC determines that the activity will not pose a significant risk to the deposit insurance fund. The Office of the Comptroller of the Currency's Banking Circular 249 provides

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

AH 10702(d)

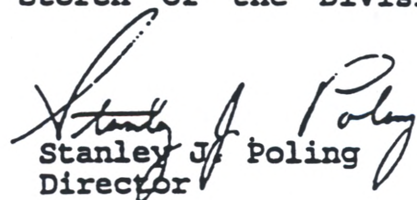
general guidelines for national banks to use in determining whether such banks may legally purchase a particular insurance product. Thus, if an insured state bank plans to purchase an insurance product that does not meet the guidelines contained in Banking Circular 249, the bank will need to obtain the FDIC's prior consent under Section 24 of the FDI Act.

Insured state banks holding insurance products acquired prior to December 20, 1992, that do not meet the guidelines contained in Banking Circular 249, or that have purchased such products without prior approval since that date, must obtain the FDIC's permission under Section 24 of the FDI Act to retain the insurance product. Any requests to purchase or retain a nonconforming insurance product should be addressed to the appropriate FDIC Regional Director. In evaluating whether to approve such a request, the FDIC will consider the safety and soundness of the activity as one of the factors to be assessed in determining whether the activity may involve a significant risk to the insurance fund.

The appendices to the August 1993 Division of Supervision staff discussion paper contain suggested examination procedures for reviewing insurance arrangements, a copy of OCC Banking Circular 249, and regulatory guidance issued by other federal agencies. For example, one of the appendices provides supervisory guidance issued by the Federal Reserve Board's Division of Banking Supervision and Regulation on the applicability of Sections 23A and 23B of the Federal Reserve Act to split-dollar life insurance arrangements between bank holding companies and their subsidiary banks.

Examiners have been directed to consider the supervisory concerns and suggested examination procedures addressed in the staff discussion paper when reviewing the appropriateness of a bank's purchases of life insurance. In order to ensure that those involved in such purchases are also aware of the FDIC supervisory guidance on these matters, the August 18 memorandum to Regional Directors and the accompanying staff discussion paper are available to state nonmember banks and other interested parties upon request from the FDIC's Office of Corporate Communications (202-898-8563).

State nonmember banks with specific supervisory questions concerning their particular insurance policies are encouraged to contact their appropriate FDIC Regional Office. However, general questions may be directed to Examination Specialist Stephen G. Pfeifer or Section Chief Robert F. Storch of the Division's Accounting Section at 202-898-8914.



Stanley J. Poling
Director

Distribution: FDIC-Supervised Banks (Commercial and Savings)

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

AI 10702(d)

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: Bank Purchases of Life Insurance

TO: Chief Executive Officers of all National Banks, Department and Division Heads, and all Examining Personnel

PURPOSE

This circular provides general guidelines for national banks to use in determining whether they may legally purchase a particular life insurance product.

BACKGROUND

In the past, bank purchases of term life insurance and traditional forms of permanent life insurance have raised few legal questions or supervisory concerns. Recently, however, the OCC has become concerned about bank purchases of insurance products with a significant investment component, such as single premium life insurance. In some cases, those purchases have raised serious questions about whether the bank has made an illegal investment in the cash surrender value (CSV) of life insurance. The OCC is also concerned because the unsecured cash surrender value of these policies has sometimes constituted a significant percentage of the bank's capital.

LEGAL AUTHORITY FOR PURCHASING LIFE INSURANCE

The authority for national banks to purchase and hold an interest in life insurance is found in 12 U.S.C. S 24(7). The law provides that national banks may exercise "all such incidental powers as shall be necessary to carry on the business of banking." The OCC has further delineated the scope of that authority through regulations, interpretive rulings, and letters addressing the use of life insurance for purposes incidental to banking. Those purposes include: key-person insurance, life insurance on borrowers, life insurance purchased in connection with employee compensation and benefit plans, and life insurance taken as security for loans. There is no authority under 12 U.S.C. S 24(7) for national banks to purchase life insurance for their own account as an investment.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

AH 10702 (d)

BC - 249 (Rev.)

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: Bank Purchases of Life Insurance

POLICY GUIDELINES

A national bank may purchase or take an interest in life insurance for a purpose incidental to the business of banking. The amount of such insurance must closely approximate the bank's risk of loss or obligation arising from its relationship with the insured. National banks may not purchase life insurance as an investment.

A life insurance policy will be considered to be purchased and held for non-investment purposes if it satisfies either of the following tests:

(A) When the bank purchases life insurance to indemnify itself against the death of an individual (as in the case of key-person insurance or insurance purchased on a borrower), the amount of insurance coverage must closely approximate the risk of loss. For purposes of measuring insurance coverage, the OCC considers the amount of insurance to be the total death benefit to be received upon the death of the insured. This includes the face amount of the policy, any premium to be returned, and accrued interest and/or dividends.

or

(B) When the bank purchases life insurance in conjunction with providing employee compensation or benefits, or when the insurance constitutes all or part of the benefit (as in so-called "split dollar" or other life insurance plans), the following condition must be satisfied:

Based upon reasonable actuarial benefit and financial assumptions, the present value of the projected cash flow from the policy must not substantially exceed the present value of the projected cost of the associated compensation or benefit program liabilities. The bank may include the insurance premiums paid and the associated time value of money in its calculation of the total cost of the liabilities.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

At 10702 (d)

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: Bank Purchases of Life Insurance

The following sections provide more detailed guidance on the specific purposes for which national banks may purchase life insurance.

KEY-PERSON INSURANCE

Interpretive Ruling 7.7115 (Insuring lives of bank officers), 12 C.F.R. § 7.7115, addresses those situations in which a national bank may obtain life insurance to protect itself against the loss of "key persons" in bank management. The ruling allows a national bank to purchase insurance on the life of an officer whose death would be of such consequence to the bank as to give it an insurable interest in his or her life. Interpretive letters have expanded the scope of this ruling to recognize the possibility that certain directors of the bank may also be key persons.

Key-person insurance must comply with non-investment test (A) of these guidelines. The bank's board of directors must adequately document the basis on which it determines an officer or director to be a key person. Similarly, the board of directors must adequately document the basis for determining the amount of insurance needed to indemnify the bank against the death of each key person. Interpretive Ruling 7.7115 does not authorize the purchase of life insurance on an individual who is not demonstrably a key-person. Nor does the Ruling permit the purchase of life insurance in an amount that is not reasonably related to the bank's potential loss.

The bank's authority to hold life insurance on a key person lapses if the individual, because of retirement, resignation, discharge, change of responsibilities, or for any other reason, is no longer a key person for the bank. The desire to obtain the return of the premium paid, interest, or dividends on the policy does not provide an independent basis under 12 U.S.C. § 24(7) and Interpretive Ruling 7.7115 for retaining life insurance on an individual who no longer qualifies as a key person. Therefore, the economic consequences of terminating the insurance, or the ability to transfer the coverage to another key person, should be considerations in selecting a key-person insurance policy.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

AH 10702(d)

LIFE INSURANCE ON BORROWERS

State law generally recognizes that a lender has an insurable interest in the life of a borrower to the extent of the borrower's obligation to the lender. Interpretive Rulings 7.7495 (Debt cancellation contracts), 12 CFR § 7.7495, and 12 CFR § 2.6(c) and (f) (Methods of selling credit life insurance) are relevant for national banks. They recognize that national banks may protect themselves against the risk of loss from the death of a borrower. That protection may be provided through self-insurance in the form of debt cancellation contracts, or by the purchase of life insurance policies on borrowers.

Life insurance purchased on borrowers must comply with non-investment test (A) of these guidelines. For borrowers who are in good standing, a bank's potential loss is generally the principal balance of the borrower's obligations to the bank, including the maximum amount that could be borrowed under a line of credit, at the time the insurance is purchased. That amount would, therefore, be the maximum insurance coverage the bank could purchase on the borrower.

The purchase of life insurance on a borrower is not an appropriate mechanism for effecting a recovery on obligations that have been (or are expected to be) charged-off. Such life insurance purchases are not incidental to banking within the meaning of 12 U.S.C. § 24(7) because the insurance does not protect the bank against a risk of loss. In the case of charged-off loans, the bank has already realized the loss, and the purchase of life insurance more closely resembles an investment to recover on that loss.

LIFE INSURANCE PURCHASED IN CONNECTION WITH COMPENSATION AGREEMENTS AND BENEFIT PLANS

Under 12 U.S.C. § 24(5) and 12 CFR § 7.5220, national banks may enter into employment agreements with their officers and employees upon reasonable terms and conditions. It is the responsibility of the board of directors to establish and be able to justify the reasonableness of the compensation provided to bank employees under these agreements.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

At 10702 (d)

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular   Subject: Bank Purchases of Life Insurance

A national bank may provide life insurance benefits to its employees through individual or group policies for which the bank pays all or part of the premium. A national bank also may provide deferred compensation and retirement programs for bank employees. Similarly, a national bank may establish programs that permit directors to defer payment of all or a portion of their director fees.

Interpretive letters have established that a national bank may protect itself against its contractual obligations under such agreements through the purchase of life insurance. However, except as part of a reasonable compensation agreement or benefit plan, a national bank may not purchase life insurance as an estate management device for the benefit of officers, directors, or employees who are also controlling shareholders of the bank.

Life insurance purchased in connection with compensation agreements and benefit plans must comply with non-investment test (B) of these guidelines. Such policies may be held for as long as the bank continues to have any liability under the compensation or benefit plans for which the policies were initially purchased. A bank may, therefore, purchase insurance on a group of persons and continue to hold the insurance as long as it has any liability under the associated compensation or benefit plan.

LIFE INSURANCE AS SECURITY FOR LOANS

National banks may take an interest in an existing life insurance policy as security for a loan. National banks may also make loans to individuals for the purpose of purchasing life insurance, taking a security interest in the insurance policy. As with any other type of lending, extensions of credit secured by life insurance must be made on terms that are consistent with safe and sound banking principles. For instance, the borrower must be obligated to repay the loan according to an appropriate amortization schedule.

Generally, a national bank may not rely on its security interest in a life insurance policy to extend credit on terms that excuse the borrower from making interest and principal payments during the life of the borrower with the result that the bank is repaid only when the policy matures at the death of the insured. Lending on such terms

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

AH 10702(d)

BC - 249 (Rev.)

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: Bank Purchases of Life Insurance

may be treated as an illegal investment in life insurance under 12 U.S.C. § 24(7) since the bank would be looking to the life insurance benefits as its sole return on the funds it advanced.

OTHER CONSIDERATIONS

Life insurance death benefits and cash surrender values are unsecured obligations of the insurance company. Cash surrender value of insurance should be reported as an "Other asset" on the bank's financial statements.

Before purchasing a life insurance policy, the bank should evaluate the financial condition of the insurance company and continue to monitor its condition on an ongoing basis. The bank should consider the effect of any significant holdings of this ordinarily long-term asset on the bank's capital and liquidity. It should also determine the tax and other economic consequences of surrendering the insurance before the death of the insured should that become necessary.

APPLICATION OF THE GUIDELINES

Examiners will evaluate all current holdings and future purchases of life insurance by national banks in light of the guidelines in this circular.

ORIGINATING OFFICE

Questions about this circular should be directed to the Office of the Chief National Bank Examiner (202) 447-1164.

Donald G. Coonley
Chief National Bank Examiner

Date: May 9, 1991

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis