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SUPERVISORY MEMORANDUM

To: Montana State Chartered Banks

From: Melanie Hall, Banking Commissioner

Subject: Bank Owned Life Insurance

Date: December 12, 2012

Background

The Division of Banking has been asked if a state chartered bank may hold life insurance on a former employee.

Response

It depends. If the life insurance was key person insurance held to compensate the bank for the loss of the key person, the bank cannot hold the life insurance in excess of their risk of loss to be covered. So once the key person retires, resigns, is discharged or for any other reason the risk of loss is eliminated, the bank cannot hold key person insurance on that person. However, if the life insurance was held by the bank as a financing or cost recovery vehicle for pre- and post-retirement employee benefits such as individual or group life, health, dental, or vision insurance or tuition reimbursement, deferred compensation, and pension benefits, the life insurance can be held by the bank even after the employer's relationship with the insured employee is terminated.

Analysis

The Montana wildcard statute, Mont. Code Ann. § 32-1-362, allows Montana charters to engage in any activity that a national bank could engage in, that is not expressly prohibited by state law, and if the power is allowed to national banks and if the Montana charter has requested and received permission from the Division. So the question becomes, can a national bank hold life insurance on a retired employee.

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision have

issued guidance to national banks and federal savings associations in the form of an Interagency Statement on the Purchase and Risk Management of Life Insurance, December 7, 2004 (Interagency Statement). The Interagency Statement distinguishes between two types of insurance: key person insurance and insurance to finance or recover costs of pre- and post-retirement employee benefits.

Key person insurance is insurance to protect against the loss of key persons whose services are essential to the continuing success of the institution and whose untimely death would be disruptive to the institution. The institution may hold insurance on key persons to ensure against their loss.

Montana law also provides that an institution may insure key persons. Montana law provides that:

> Any individual of competent legal capacity may procure or effect an insurance contract upon the individual's own life or body for the benefit of any person. However, a person may not procure or cause to be procured any insurance contract upon the life or body of another individual unless the benefits under the contract are payable to the individual insured, to the individual's personal representatives, or to a person having, at the time when the contract was made, an insurable interest in the individual insured.

Mont. Code Ann. § 33-15-201(1). So key person insurance is allowable both under federal and state law.

However, national banks and federal savings associations may not hold life insurance in excess of their risk of loss or cost to be recovered. For example, once an individual no longer qualifies as a key person because of retirement, resignation, discharge, change of responsibilities, or for any other reason, the risk of loss has been eliminated. "Therefore, national banks and federal savings associations may be required to surrender or otherwise dispose of key person life insurance held on an individual who is no longer a key person. Typically, term or declining term insurance is the most appropriate form of life insurance for key person protection." (Emphasis added.) The Interagency Statement prohibits national banks and federal savings associations from holding insurance in excess of the risk of loss or cost to be covered. However it is unclear what "may be required" to surrender means.

Institutions often use life insurance as a financing or cost recovery vehicle for pre- and post-retirement employee benefits, such as individual or group life insurance, health insurance, dental insurance, vision insurance, tuition reimbursement, deferred compensation, and pension benefits. In these arrangements, an institution insures the lives of directors or employees in whom it has an insurable interest to reimburse the institution for the cost of employee benefits. The group of insured individuals may be different from the group that receives benefits. The institution's obligation to provide employee benefits is separate and distinct from the purchase of the life insurance. The life insurance purchased by the institution remains an asset even after the employer's relationship with an insured employee is terminated. The employees who receive benefits, whether insured or not, have no ownership interest in the insurance (other than their general claim against the institution's assets arising from the institution's obligation to provide the stated employee benefits).

National banks and federal savings associations may hold equity-linked variable life insurance policies (that is, insurance policies with a return tied to the performance of a portfolio of equity

securities held in a separate account of the insurance company) only for the purpose of economically hedging their equity-linked obligations under employee benefit plans. To be permissible, the national bank or federal savings association must demonstrate that:

- it has a specific, equity-linked obligation; and
- both at the inception of the hedge and, on an ongoing basis, changes in the value of the equity-linked variable life insurance policy are highly correlated with changes in the value of the equity-linked obligation.

If a national bank or federal savings association does not meet these requirements, the equity-linked variable life insurance holdings are not permissible. The use of equity-linked variable life insurance holdings as a long-term hedge against general benefit costs is not permissible because the life insurance is not hedging a specific equity-linked liability and does not meet the "highly correlated" requirement.

Conclusion

State chartered institutions would be allowed to hold life insurance to finance the costs of pre- and post-retirement benefits on the same terms as national banks, as long as the state charter complies with the Montana wild card statute, Mont. Code Ann. § 32-1-362.