GRADY & ASSOCIATES
ATTORNEYS & COUNSELORS AT LAW

20950 CENTER RIDGE ROAD, SUITE 100
ROCKY RIVER, OHIO 44116-4307

(440) 356-7255
Fax (440) 356-7254
www.gradyassociates.com
www.boliattorneys.com

BOLI Investment Policy & Annual Post-Purchase Risk Assessment: New Bank Regulatory BOLI Compliance Obligations

by Francis X. Grady & Scott M. Puglise

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Overview. On December 7, 2004, 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 issued the "Interagency Statement on the Purchase and Risk Management of Life Insurance." Thirty pages long, the new interagency BOLI guidance is very comprehensive and clarifies the federal bank regulatory agencies' expectations regarding BOLI program implementation, operation, and ongoing risk assessment. For new BOLI purchases, the interagency BOLI guidance requires that financial institutions have a comprehensive risk management process for purchasing and holding BOLI. Moreover, financial institutions that currently hold BOLI must now complete an annual assessment of their BOLI investments as described in the "Risk Management of BOLI" section of the interagency BOLI guidance. Given the breadth of the interagency BOLI guidance, this article only discusses the need for a BOLI investment policy and the requirements for conducting an effective annual BOLI post-purchase assessment.

BOLI Investment Policy. The interagency BOLI guidance states that "before entering into a BOLI contract, institutions should have a comprehensive risk management process for purchasing and holding BOLI." This process necessarily entails development of a detailed BOLI investment policy that describes, at a minimum –

1) senior management and board oversight of the BOLI investment,
2) the single insurer and aggregate insurer BOLI investment limits established by the institution,
3) the institution's pre-purchase analysis of BOLI products and alternatives, and
4) the institution's risk assessment, management, monitoring, and internal control processes, as well as the appropriate internal audit and compliance functions.

In other words, the BOLI investment policy serves to establish the guidelines under which a financial institution will manage its BOLI investment. If a financial institution fails to establish effective controls over its BOLI investment as required by the guidance, the guidance notes that the appropriate bank regulatory agency may take supervisory action against the institution, including requiring divestiture of any affected policies, regardless of the potential adverse tax consequences.

Annual BOLI Post-Purchase Assessment. In addition to conducting a risk assessment as part of a thorough pre-purchase analysis, financial institutions must also monitor BOLI risks on an ongoing basis.

The interagency BOLI guidance provides that an institution should review the performance of its BOLI assets with the board of directors at least annually. More frequent reviews are appropriate if there are significant changes to the BOLI program, such as additional purchases, a decline in the financial condition of the insurance carrier(s), anticipated policy surrenders, or changes in tax laws or interpretations that could have an impact on the BOLI's performance.

This annual BOLI post-purchase assessment should include, but is not limited to, the following elements –

1) a comprehensive assessment of the liquidity, transaction/operational, tax and insurable interest, reputation, credit, interest rate, and compliance/legal risks associated with the BOLI investment,
2) identification of employees who are or will be insured,
3) assessment of death benefit amounts relative to employee salaries,
4) calculation of the percentage of insured persons still employed by the institution,
5) evaluation of the material changes to BOLI risk management policies,
6) assessment of the effects of policy exchanges,
7) analysis of mortality performance and impact on income,
8) evaluation of material findings from internal and external audits and independent risk management reviews,
9) identification of the reason for and tax implications of any BOLI policy surrenders, and
10) peer group analysis of BOLI holdings.

The requirement that institutions perform an annual review of their BOLI assets is a significant compliance obligation that must be planned for.

It is important to recognize that many of these post-purchase tasks and responsibilities are already performed as a function of the normal administrative services provided by BOLI vendors and administrators. In reality, the only aspect of post-purchase compliance that is new is the express requirement that all this information be aggregated on an annual basis and reviewed by the board of directors.

Conclusion. While the new interagency BOLI guidance may seem overwhelming to some, the primary purpose of the guidance is simply to assist bankers in viewing BOLI as they would any other valuable asset. Certainly, one of the most important aspects related to the adoption of the guidance is the establishment of corporate governance best practices. A recent wave of business scandals involving the likes of WorldCom, Enron, and the Walt Disney Co. have placed a higher importance on board oversight responsibilities. As a result, directors are now expected to take a more active role in shaping and controlling a financial institution's business operations and risks. By creating a detailed BOLI investment policy, and conducting a thorough BOLI post-purchase annual assessment, senior management and the board of directors will now be able to effectively identify and manage the risks associated with a BOLI investment. Financial institutions would also be wise to seek the counsel of qualified advisors skilled in BOLI regulatory compliance, IRS compliance, state insurable interest compliance, and well-conceived executive compensation planning when designing, developing, and implementing a comprehensive pre- and post-purchase BOLI risk assessment process.

All views expressed in this article are the authors. Francis X. Grady, a former attorney for the Federal Deposit Insurance Corp., is the founder of Grady & Associates, a Cleveland, Ohio law firm specializing in the representation of banks and thrifts, BOLI-financed executive compensation plans, and bank merger transactions. Scott M. Puglise is an associate with Grady & Associates.

One of the nation's only banking law firms with an active BOLI compliance practice niche, Grady & Associates is familiar with BOLI bank regulatory issues and state insurable interest law affecting state-chartered commercial banks, savings associations, and savings banks under the laws of nearly 40 states.

Grady & Associates
20950 Center Ridge Road, Suite 100
Rocky River, Ohio 44116-4307
(440) 356-7255
Fax (440) 356-7254
www.gradyassociates.com
or
www.boliattorneys.com
fgrady@gradyassociates.com