STATE OF MICHIGAN
DEPARTMENT OF CONSUMER AND INDUSTRY SERVICES
OFFICE OF FINANCIAL AND INSURANCE SERVICES

Before the Commissioner of Financial and Insurance Services

IN THE MATTER OF: Request by Varnum Riddering Schmidt Howlett, LLP, for a declaratory ruling on limits applicable to holdings of separate account bank-owned life insurance

Ruling No. 05-43-BT

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Issued and entered
this 6th day of September, 2005
by
Linda A. Watters
Commissioner

DECLARATORY RULING establishing limits on the holding of bank-owned life insurance

I
BACKGROUND

Section 63[1] of the Administrative Procedures Act of 1969 allows an agency to issue a declaratory ruling, upon request by an interested person, as to how a statute administered by the agency would be applied to an actual state of facts. Section 2101[2] of the Banking Code of 1999[3] (Code) created a financial institutions bureau to "have jurisdiction over and administer the laws relating to financial institutions transacting business in this state" and named the commissioner of the financial institutions bureau as its head. Section 2204[4] of the Code authorizes the commissioner of the financial institutions bureau to issue orders and declaratory rulings. Executive Order 2000-4, effective April 3, 2000, transferred the powers of the Financial Institutions Bureau to the Office of Financial and Insurance Services and the powers of the Commissioner of the Financial Institutions Bureau to the Commissioner of Financial and Insurance Services.

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[1] MCL 24.263
[2] MCL 487.12101(1)
[3] MCL 487.11101 et seq.
[4] MCL 487.12204

Thus, the Commissioner of the Office of Financial and Insurance Services has authority to issue a declaratory ruling regarding the applicability of the Code to an actual state of facts. The June 1, 2004 and March 4, 2005 request letters set forth a statement of facts sufficient to enable the Commissioner to issue a declaratory ruling regarding the applicability of the Act to the stated facts.

II
FACTS

Independent Bank Corporation, Ionia, Michigan (IBC), is a Michigan corporation and bank holding company which owns four subsidiary banks that hold charters under the Michigan Banking Code of 1999. Each of the four subsidiary banks owns separate account bank-owned life insurance (BOLI) held with a single insurer, Prudential Insurance Company of America (Prudential). It is represented that the assets supporting these insurance policies are marketable securities eligible for direct investment by the banks.

The contract of insurance held by each bank for the subject BOLI states:

> "Prudential owns the assets of the Separate Accounts; it keeps them separate from the assets of its general account. As authorized by the terms of Section 17B:38-9(c) of the New Jersey Insurance Code, the assets held in the Separate Accounts shall not be chargeable with liabilities arising out of any other business of Prudential. For this purpose, "assets" means only those assets held in the Separate Accounts needed to satisfy Prudential's obligations under the contracts that participate in such Separate Accounts. Assets held in each investment option of VCA-GI-7 shall not be chargeable with liabilities arising in connection with any other investment option of VCA-GI-7."

Section 17B:38-9(c) of the New Jersey Insurance Code provides:

> "The investments held in a separate account and the liabilities chargeable against it shall at all times be clearly identifiable and distinguishable from the other investments and liabilities of the insurer. To the extent provided in the applicable contract or contracts, assets held in a separate account shall not be chargeable with liabilities arising out of any other business of the corporation."

A stable value protection (SVP) contract providing for payment in event of the surrender of the policy at the greater of fair market value or book value of the segregated separate account assets is associated with the policy. The SVP provider is a third party.

On March 12, 2002, the Office of Financial and Insurance Services (OFIS) issued an interpretive letter stating that:

- BOLI is permitted to Michigan banks as a funding device for employee benefit plans provided there is a strong correlation between the proceeds of the insurance and the combined costs of the insurance and benefit obligations;
- Regulatory comment may be made if the total of BOLI purchases from all insurers exceeds 25% of Tier 1 capital;
- BOLI purchases from all insurers aggregating in excess of 100% of Tier 1 capital likely will be subject to regulatory comment and/or criticism;
- BOLI purchases from a single insurer should not exceed the Code's legal limit on loans or extensions of credit to one person.[5]

On December 7, 2004, the four federal bank and thrift regulatory agencies issued guidance to depository institutions on purchasing and managing BOLI titled, "Interagency Statement on the Purchase and Risk Management of Life Insurance" (Interagency Statement). The Interagency Statement provides the following guidance to financial institutions regarding BOLI holdings:

> "Consistent with prudent risk management practices, each institution should establish internal policies and procedures governing its BOLI holdings, including guidelines that limit the aggregate CSV [cash surrender value] of policies from any one insurance company as well as the aggregate CSV of policies from all insurance companies. When establishing these internal CSV limits, an institution should consider its legal lending limit, the capital concentration threshold, and any applicable state restrictions on BOLI holdings. In this regard, given the liquidity, transaction/operational, reputation, and compliance/legal risks associated with BOLI, it is generally not prudent for an institution to hold BOLI with an aggregate CSV that exceeds 25 percent of the institution's capital as measured in accordance with the relevant agency's concentration guidelines. Therefore the agencies expect an institution that plans to acquire BOLI in an amount that results in an aggregate

[5] "Except as otherwise provided in this section or by order or declaratory ruling of the commissioner, the total loans and extensions of credit and leases by a bank to a person at no time shall exceed 15% of the capital and surplus of the bank, except that upon approval by 2/3 vote of its board of directors the limit may be increased to not to exceed 25% of the capital and surplus of the bank." MCL 487.14202(1)

CSV in excess of 25 percent of capital, or any lower internal limit, to gain prior approval from its board of directors or the appropriate board committee. The agencies particularly expect management to justify that any increase in BOLI resulting in an aggregate CSV above 25 percent of capital does not constitute an imprudent capital concentration. An institution holding BOLI in an amount that approaches or exceeds the 25% of capital concentration threshold can expect examiners to more closely scrutinize the risk management policies and controls associated with the BOLI assets and, where deficient, to require corrective action."[6]

III
ISSUE

The Commissioner has been asked to issue "a Declaratory Ruling that the separate account bank-owned life insurance ("BOLI") owned by IBC's subsidiary banks does not violate the lending limit set forth in Section 4202 of the Michigan Banking Code of 1999, as amended". Additionally, IBC asks that the Commissioner determine that its subsidiary banks are permitted to invest in separate account BOLI of a single issuer with cash surrender values in excess of the loan to one person limitation set forth in Section 4202(1) of the Code provided that the cash surrender value held by an investing bank does not exceed 25% of the bank's Tier 1 capital.

IV
ANALYSIS

In its March, 2002 interpretive letter, OFIS employed the Code's section 4202 limit on loans or extensions of credit to one person as a proxy for a safe concentration limit on BOLI investments from a single issuer.[7] Life insurance investments are not loans or extensions of credit; thus there is no question that a BOLI investment in excess of 25% of a bank's capital and surplus in life insurance policies from a single issuer does not violate Code Section 4202. Section 4202 may, however, be considered a statement of legislative parameters for prudent capital concentrations; unsafe concentrations may be subject to administrative action for engaging in an unsound practice under Code Section 2304.[8]

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[6] Interagency Statement on the Purchase and Risk Management of Life Insurance; December 7, 2004; Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision

[7] "The legal limit on loans or extensions of credit to one person is used to determine the limit per insurer for BOLI purchased by Michigan institutions." OFIS Interpretive Letter, March 12, 2002.

[8] MCL 487.12304

The instant request is for an exception from the Section 4202(1) limit where the assets underlying BOLI investments are segregated from the general accounts of the issuer, i.e., "separate account" BOLI.

The question remains whether the risks of separate account BOLI are sufficiently distinguishable from those of general account BOLI to warrant a higher investment limit on the former. It is appropriate in this context to re-examine whether it is necessary to limit investments in *any* form of BOLI from a single issuer to 25% of capital and surplus—or even whether it is appropriate to apply different limits on single-issuer vis-vis multiple-issuer BOLI investments—in order to prevent unsafe and unsound capital concentrations in a bank.

Life insurance is not an investment specifically authorized to banks by the Michigan Banking Code of 1999. The Code does, however, allow a Michigan-chartered bank to invest in other assets as authorized by order or declaratory ruling of the Commissioner[9]. In addition, Section 2204 of the Code grants the Commissioner authority to

> "issue declaratory rulings in accordance with the administrative procedures act of 1969, or issue orders on applications by 1 or more banks to exercise powers not specifically authorized by this act that will authorize banks to exercise powers appropriate and necessary to compete with other providers of financial services." MCL 487.12204

Section 2204(2) of the Code requires the Commissioner, in exercising authority to issue declaratory rulings authorizing powers, to "consider the ability of banks to exercise any additional power in a safe and sound manner, the authority of depository institutions operating under state or federal law or regulation, the powers of other competing entities providing financial services, and any specific limitations on bank powers contained in this act or in any other law of this state."

It is important to note that two of the principal purposes for which banks purchase life insurance, provision of employee benefits and protecting against loss of key executives, are incidental to the conduct of the business of banking. Ownership of life insurance exposes banks to a variety of

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[9] MCL 487.14303

risks. These are explored comprehensively in the Interagency Statement issued, it should be noted, subsequent to the 2002 OFIS Interpretive Letter. The risks, which may vary by type of insurance, are liquidity, transaction/operational, reputation, credit, interest rate, compliance/legal, and price risk. Most of the identified risks can be managed to some extent.

Separate account BOLI mitigates some, but not all, of the risks associated with holding general account BOLI. The risk assumed by an institution owning separate account BOLI is the credit risk of the assets held in the separate account, not the direct credit risk of the carrier. A stable value protection (SVP) contract associated with a separate account BOLI policy reduces price risk and earnings volatility by protecting the policy owner from declines in the value of the separate account assets due to interest rate changes. In the instant situation, the policy owner is protected by SVP guaranteeing a policy surrender value of the greater of fair market or book value of the segregated assets supporting the policy.

Separate account BOLI is not without risk. Like general account BOLI, separate account policies are highly illiquid. Deferred acquisition costs credited to an institution in connection with a separate account policy represent a general account credit exposure. The protected status of separate account assets is largely untested in the courts, and there is potential that the Internal Revenue Service may characterize a separate account policy as an actively managed investment. SVP contracts do not protect separate account policy holders against default risk in the underlying assets.

The quality of pre-purchase evaluation and post-purchase monitoring contribute to the overall level of risk assumed by a BOLI investor, whether the investment is separate account or general account or from a single or multiple issuers. The Interagency Statement sets forth comprehensive standards for pre-purchase analysis and effective assessment, management, monitoring and controlling of risks associated with BOLI investment.

The requester's proposed limit on investment in separate account BOLI (25% of the investing bank's Tier 1 capital) is within the parameters set forth in the Interagency Statement, which additionally contemplates that a bank's aggregate investment in BOLI may exceed the general standard with appropriate justification and board approval.

The FDIC established a capital concentration guideline of 25% of Tier 1 capital for aggregate BOLI investments. The Office of Thrift Supervision allows federal thrifts to invest up to 25% of total capital in BOLI, and makes provision for exceptions with prior regulatory approval.[10] Still other bank regulators have chosen to establish higher limits for investments in separate account than general account BOLI. National banks are permitted separate account BOLI investments up to "25% of a bank's capital structure", which is inclusive of Tier 1 capital and the allowance for loan and lease losses.[11] New York state-chartered banks may invest up to 25% of their total capital in separate account BOLI products from a single issuer.[12] In Texas, if the bank determines that the issuer controls on separate acccount assets are sufficient to prevent misuse of assets in underlying investments, the bank may look to the underlying assets instead of the general limit on single-issuer BOLI of 25% of capital and surplus .[13]

Michigan law does not elsewhere prohibit or limit the volume of bank purchases or holdings of life insurance policies.

In conclusion, purchase and holding of life insurance can be managed safely and soundly in conformance with the standards set forth in the federal Interagency Statement on the Purchase and Risk Management of Life Insurance. Separate account BOLI investments, like general account BOLI investments, carry risk. While separate account BOLI may mitigate certain risks, badly managed separate account BOLI investments may represent greater risk to an institution than well-managed general account BOLI investments. There is no evidence that limiting a Michigan state-chartered bank's holdings of BOLI acquired and managed in accordance with the Interagency Statement, whether issued by a single provider or by multiple providers, to 25% of Tier 1 capital would threaten the safety and soundness of the policy holding institution or otherwise be harmful to the public. In fact, some competing financial institutions are permitted to hold larger amounts of single-issuer separate account BOLI than the current Michigan standard permits to the state's state-chartered banks.

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[10] OTS regulatory handbook, 250A.5
[11] Interagency Statement, OCC Bulletin 2004-56
[12] Industry Letter, 1/6/03
[13] Supervisory memorandum 1010

V
RULING

IT IS MY RULING that a Michigan state-chartered bank that has established and utilizes a comprehensive risk management process for purchasing and holding bank-owned life insurance in accordance with the Interagency Statement on the Purchase and Risk Management of Life Insurance issued on December 7, 2004 may purchase and hold bank-owned life insurance. The amount of BOLI purchased should be closely correlated to the institution's estimated employee benefit obligation or risk of loss to be covered. BOLI may not be purchased for speculative purposes.

The aggregate cash surrender value of a bank's holdings of BOLI should not exceed 25% of the Tier 1 capital of the bank. The BOLI investments may be with a single issuer or multiple issuers and may be separate account or general account in form. Institutions that plan to hold BOLI with aggregate cash surrender values in excess of 25% of Tier I capital are expected to:

1. gain prior approval by the board of directors or the appropriate board committee of increases in bank-owned life insurance; and
2. document that any increase in bank-owned life insurance resulting in aggregate cash surrender value in excess of 25% of Tier 1 capital does not constitute an imprudent capital concentration.

Examiners will closely scrutinize the risk management policies and controls associated with bank-owned life insurance holdings exceeding 25% of an institution's Tier 1 capital. BOLI purchases from all insurers aggregating in excess of 100% of Tier 1 capital likely will be subject to regulatory comment and/or criticism. A bank may be asked to divest BOLI holdings that are deemed to represent an unsound concentration of capital.

Linda A. Watters

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Commissioner