

Introduction

Banks commonly purchase life insurance on their employees as a long-term financing vehicle in connection with employee compensation and benefit plans (most often referred to as “BOLI”). Bank regulations have long provided guidance regarding permissible uses of BOLI, pre-purchase due diligence requirements, ongoing risk management for BOLI holdings and the amount of BOLI banks can own.

As of 3/31/2010, it is estimated that banks (including bank holding companies, thrift institutions, state banks and national banks) held total BOLI assets of approximately \$138 billion, representing about 8.54% of total bank capital.¹ The magnitude of BOLI holdings by banks makes it critical for banks to understand and evaluate the unique and complex risks associated with BOLI.²

Management at most banks has a basic understanding of the primary counterparty exposures from holding BOLI. This is generally true regardless of which genus of BOLI is owned: “general account” (GA) BOLI or “separate account” (SA) BOLI. Furthermore, most banks have developed reasonably effective policies and procedures to monitor their credit risk exposures on an ongoing basis, in large part due to regulatory requirements imposed on banks investing in BOLI.

Needless to say, there have been many recent unprecedented occurrences within the financial markets, including some that were presumed unthinkable only a short time ago. Major banks and insurers have received staggering sums of federal assistance, and, in some instances, balance sheets and capital and equity values have shrunk at an astonishing pace. Once venerable names have become severely tarnished or have vanished altogether.

Consequently, banks are rightly reexamining traditional counterparty exposures, but these developments also underscore the need to more rigorously examine counterparty exposures unique to BOLI, understand BOLI-related credit risk and uncover other risks that may arise from these exposures, fully appreciate the possible consequences of these exposures, and augment existing risk management policies and procedures accordingly. This paper is intended to identify some of the key counterparty risk exposures that banks may face with respect to their BOLI holdings and to explain under what circumstances those exposures might occur. The authors also enumerate potential risks and implications related to these counterparty exposures and summarize corresponding considerations and questions that may require additional review. To a limited extent, the authors also explore strategies for mitigating some risks.

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This paper is timely due to a number of common misconceptions regarding BOLI counterparty exposures. These misconceptions are hardly surprising given the inherently complex relationship between various state laws and jurisdictional issues, the number of credit-related exposures that apply to BOLI plans, the array of possible interplays between counterparties, and the often differing consequences of those interrelationships. Another contributing factor to numerous misunderstandings is that the number and quality of representations, warranties, and indemnifications offered by insurance companies and other BOLI counterparties vary widely, if not wildly, from one transaction to the next. This is frequently true even in situations involving a single insurance carrier, policy form, and similarly sized transactions.

¹ Sources: FDIC *Reports of Condition and Income* – i.e., “Call Reports,” OTS Thrift Financial Reports, and FRB Y-9C Reports.

² Although the focus of this paper is on banks, the discussion of risks is relevant to business-owned life insurance generally.

Life Insurance Company Insolvency

The Basics

Life insurance companies are not subject to federal bankruptcy laws. Instead, states follow either the Uniform Insurers Liquidation Act or the National Association of Insurance Commissioners' (NAIC) Insurers Rehabilitation and Liquidation Model Act. The former was promulgated in 1939 while the latter, which is more comprehensive, was promulgated in 1977³ and subsequently revised in 1995. More recently, in December 2005, the NAIC adopted the Insurer Receivership Model Act (IRMA) (neither the 1995 act nor the 2005 model act has been widely adopted to date). Whenever possible, the insurance company is placed under an order of rehabilitation or conservation to help it regain financial stability. Only when it is determined that the company cannot be rehabilitated is it declared insolvent and liquidated. The insurance company's domiciliary state (or home state) laws generally govern these events and procedures. Other counterparties, such as the stable value protection (SVP) provider, the custodian, and the sub-account investment manager, may be subject to either state or federal bankruptcy laws/proceedings.

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GA BOLI

Owners of GA BOLI plans should be familiar with the statutes governing the disposition of assets in the event their insurer is placed, by a court in its domiciliary state, under an order of supervision, liquidation, rehabilitation, or conservation. Most industries are subject to the federal Bankruptcy Code. In contrast, insurer insolvencies in nearly all states follow either the Uniform Insurers Liquidation Act or the Insurers Rehabilitation and Liquidation Model Act. Each state's insurance commissioner is responsible for monitoring and regulating insurance activity within the state, declaring when an insurer requires regulatory intervention, and subsequently seeking authority to seize the insurer's assets and assume control of its operations (i.e., pending rehabilitation or liquidation).

The insurance company's domiciliary state's laws spell out the priority of policyholders⁴ and other claimants in the event of insolvency. While policyholders are normally near the top of the list of creditors (generally, only the court-appointed conservator ranks higher), having a clear idea of any special classifications related to group or corporate-owned policies is prudent. Assuming there is a material shortfall in assets available to make good on policy provisions, one must understand potential protections and limitations from the applicable guaranty associations.

Guaranty Associations

All 50 states, as well as the District of Columbia and Puerto Rico, have established life and health guaranty associations (property and casualty guaranty associations are separately established on a state-by-state basis). Each state is responsible for establishing and maintaining its own guaranty association, which governs the degree of financial protection extended to various classes of policyholders. With few exceptions, all insurance companies licensed to write life and health

³ The act was intended to revise and replace the model Insurers Rehabilitation and Liquidation Act, which the NAIC first published in 1969.

⁴ "Policyholder" refers to the legal owner of a policy or contract; also referred to as the policy owner, policyowner, or contract owner. We use the term "policyholder" throughout this article because that term is used by the National Organization of Life & Health Insurance Guaranty Associations (NOLHGA).

insurance or annuities in a given state are, by law, members of that state's guaranty association.⁵ Guaranty association protection is generally provided to policyholders or certificate holders according to their state of residence at the time the insurer becomes impaired or is liquidated, even if that is not the same state in which the policy was purchased. In the case of corporate owners or policies held in trust, residency is usually defined as the principal place of business. It may be worthwhile to investigate this issue to be clear which state's guaranty association will apply. All guaranty associations enforce provisions to prevent duplicate coverage; if a person could be covered by the association of more than one state, whether as an owner, payee, beneficiary, or assignee, the protection is construed in conjunction with other state laws to result in coverage by only one association. Ambiguity regarding state of residence could conceivably devolve into a dispute regarding which association is responsible for providing coverage.

The laws governing the limits of protection and the types of policies covered vary by state. Typical protections are capped at \$300,000 in the case of death benefits and \$100,000 of policy cash surrender value per insured individual. Similar limits are stipulated for other types of coverage, including health insurance, disability insurance, annuities, and long-term care. Many states also impose an aggregate benefit limit on a single insured life (e.g., \$300,000). It appears that the intent

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of this overall cap is to limit the association's payment liability from all forms of insurance coverage to a single policyholder. It may also force multiple policyholders insuring the same individual to share in the aggregate limit, with each receiving a diminished benefit. For example, if an insured employee owns a personal life insurance policy with a death benefit of

\$500,000 (or health insurance policy or annuity contract) issued by the same troubled insurer that issued a \$1,000,000 BOLI policy to that insured employee's employer-bank, the available aggregate protection (e.g., \$300,000) may be apportioned among the two policyholders (the individual insured and the employer-bank), resulting in a smaller amount of protection for each policyholder. It is not clear whether or how the protection would be apportioned and results would no doubt vary from state to state.

Some states have identified and defined specific coverage limitations for employer- or corporate-owned life insurance. For example, Texas specifies an upper benefit limit of \$5,000,000 to one owner of multiple non-"group" policies, regardless of the number of life insurance policies owned. Thus, the normal per-policy protections may be greatly diluted.

The nuances of these laws differ significantly from state to state and should be carefully reviewed to determine likely application and corresponding implications. Banks and other corporate owners of life insurance can determine potential uncovered exposures for each tranche of policies they own according to the applicable state guaranty act. They can then formulate and adopt suitable internal policies and procedures well in advance of a given insurance company's financial impairment. Additionally, because guaranty association acts are subject to change, they should be monitored periodically so that exposures and internal policies can be updated correspondingly.

As discussed more fully below, there are several possible ways to reduce or potentially eliminate exposure to a given counterparty, but unfortunately there also seems to be a corresponding number of potential barriers.

⁵ In contrast to the ongoing assessment approach established by the Federal Deposit Insurance Corporation (FDIC) to provide protection to depositors, there are no advance assessments or reserves set aside by guaranty associations. States instead impose an assessment on solvent insurance companies after an insurer actually becomes impaired or insolvent.

SA BOLI

SA BOLI has an entirely different set of considerations and exposures than GA BOLI.

For starters, SA policies are afforded extremely limited protections under state guaranty associations. Most guaranty associations include within their definition of “non-covered contracts” language along the following lines: “any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policyholder or contract holder.” Insurance companies must guarantee a

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minimum death benefit to separate-account policyholders regardless of investment performance so that the policy complies with Internal Revenue Code (IRC) § 7702. Thus, this minimum death benefit should fall under the umbrella of the state guaranty association. Some separate-account policies allow for policy cash values to be allocated to the insurance company’s general account, but the vast majority of separate-account policy assets are not allocated in this manner. Policyholders therefore do not

rely primarily on the guaranty association’s protections with SA policies. Instead, they look to an insurer’s authority to establish separate accounts and the resulting insulation of the assets held within the separate accounts in the event the insurance company is placed under an order of rehabilitation or conservation or is declared insolvent. Rather than looking to the state of residence of the policyholder, one must instead be familiar with the statutes of the insurance company’s domiciliary state to understand the extent of protection. There are two relevant governing statutes: (1) the laws defining an insurance company’s authority to establish and operate separate accounts and corresponding products and (2) the priority of distribution of claims in the event the insurer is placed under an order of rehabilitation or conservation or is declared insolvent.

Most, if not all, state statutes related to variable life insurance and separate accounts can be traced to model legislation promulgated by the NAIC. The most relevant model laws are the Variable Life Insurance Model Regulation (Model #270) and the Model Variable Contract Law (Model #260). Even though most statutes are rooted in Model #270 and/or Model #260, states are not required to adopt any model bill and often adopt them in substantially modified form. Therefore, it is wise to carefully

review the applicable state’s statutes to determine the extent of protection. Statutory language generally provides that the assets of a separate account equal to the reserves and other contract liabilities with respect to such account are not chargeable with liabilities arising out of any other business of the insurance company. “Other business” typically includes business

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general account or under separate accounts other than the specific one in question. When the insurance company’s domiciliary state statutes mirror Model #270, it is generally believed that assets held in a separate-account policy will be free from the risk of attachment by a general creditor of the insurer, or creditor of another separate account, because such a creditor would be attempting to enforce a liability arising out of other business of the insurer.

Whether in the context of rehabilitation, liquidation, or a judgment debtor, there have been few cases testing these protections. One notable exception is *Rohm & Hass Company v. Continental Assur. Co.*, in which an Illinois appellate court held that funds deposited with an insurer in separate accounts which were properly maintained and administered by the insurer “are not chargeable with liabilities arising out of any other business the insurer may conduct to the extent that the assets of such accounts are equal to the reserves and other contract liabilities with respect to such accounts.” Since 1978, the year of Continental Assurance Co.’s insolvency, there have been numerous instances

when life insurance companies have been rehabilitated and/or liquidated, and in at least some of these instances the troubled carriers offered separate-account life insurance or annuities. Since no other *Rohm & Hass*-type challenges have been asserted, one might conclude that governing state statutes have been sufficiently clear regarding creditors' lack of standing to assert claims against SA assets so as to discourage any formal actions. One such example is Mutual Benefit Life (MBL), a New Jersey-domiciled life insurance company. On July 16, 1991, a New Jersey superior court order formally commenced the rehabilitation of MBL. At that time, MBL was the second oldest life insurance company in the United States. Among other things, the July 16 court order appointed the New Jersey Insurance Commissioner rehabilitator of MBL, granting the rehabilitator exclusive possession, control, and title of all MBL business, assets, contracts, bank accounts, funds, etc., and placing numerous constraints on policy loans and surrenders. However, the following language appeared in paragraph (15) defining such restraints and limitations: "Nor shall these restraints prohibit the payment on separate accounts in connection with variable annuities." Further clarification regarding variable life policies followed in a second court order issued on August 7, 1991: "The exception to the restraints in paragraph (15) which allows 'payment on separate accounts in connection with variable annuities' shall be deemed to refer to allowing 'payment from and withdrawal of funds invested in those variable annuities and variable life insurance policies which have been maintained separately and apart from Mutual Benefit's other assets and liabilities.'" No lawsuits challenging these exceptions were filed on behalf of MBL general account policyholders, other separate-account policyholders, or MBL creditors.

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One often overlooked question is whether and under what circumstances the separate account might fall short of the assets needed to satisfy claims of its policyholders. Although highly unlikely, a situation might arise due to fraud by an investment manager and/or the carrier or default by an SVP provider. In the event there is a deficiency in a separate account so that the claims secured are not fully discharged, the claimants may, depending on the statute in question, share in the carrier's general assets, but such sharing is generally deferred until certain other general creditors have been satisfied. This risk, albeit remote, underscores the importance of conducting continuous reconciliations of policy charges and values.

Assuming for the moment that the issue regarding the safety of assets held in SAs is resolved to one's satisfaction, that is not the end of the story with respect to carrier insolvency risks. For one thing, even with SA policies, it is not uncommon for modest percentages of policyholder assets to be held within the insurance company's general account. For example, some experience-rated policies maintain a reserve (often referred to as a contingency reserve) that is returnable to the policyholder in the event of full surrender. Other policies contain so-called "DAC" assets⁶ that are refundable over

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⁶ The DAC asset was invented to pass through the cost of DAC taxes to policyholders without the insurance company profiting or incurring cost with respect to the tax. DAC tax is a federal tax imposed on insurance companies that requires life insurers to capitalize a specified amount of their current deductions and amortize them over 10 years. In the case of BOLI policies, the specified amount is 7.7% of net premiums, but the net charge and corresponding DAC asset are closer to 4% of premiums. The DAC asset is structured as a noninterest-bearing notional account maintained on the books of the insurance company. The insurance company is contractually required to transfer the value of the DAC asset to the policyholder over the 10-year amortization period (amounts are transferred to the separate account while policies remain in force and directly to the policyholder in the event of death or surrender).

time, regardless of policy surrenders. Both of these items, when meeting contractual requirements, may be reflected on the policyholder's balance sheet (i.e., as part of the policy cash surrender value realizable upon surrender under TB 85-4). Some carriers have established SAs to hold mortality-related reserves, but it may not be clear that all courts will recognize their viability. The NAIC's Variable Life Insurance Model Regulation requires reserve liabilities for guaranteed minimum death benefits to be maintained in the general account of the insurer and defines minimal reserve requirements for such liabilities. While guaranteed minimum death benefits are clearly distinguishable from other mortality reserves, in the absence of a direct test by the courts, it may be difficult to become fully confident that such assets will enjoy the same treatment as other SA assets. In both instances, there is some uncertainty regarding asset safety in the event of rehabilitation or liquidation. For example, while one would seem to clearly have the ability to surrender the policies for cash or carry out an "IRC § 1035 exchange"⁷ to a financially sound carrier, it is not clear whether and to what extent contingency reserves or DAC assets remain at risk. Under these circumstances, one might be compelled, by either regulator or auditor, to account for these exposures in similar fashion to impaired securities.

An even more nuanced question revolves around whether some portion of the amount payable upon the death of an insured employee is at risk. When an individual claim is paid, the policy death benefit or face amount comprises two components: (1) the policy cash value (or, in the case of a group policy, the portion of the aggregate cash surrender value held within the separate account attributable to a given individual certificate), plus (2) the policy term life insurance or risk component, known as the net amount at risk (NAR). State guaranty associations do not cover NAR exposures under SA policies to the extent they exceed the guaranteed minimum death benefit, which may represent a fraction of the NAR. What is more, the guaranteed minimum death benefit can still exceed guaranty association coverage limits, as discussed previously. An overriding question remains whether the rehabilitator/liquidator will pay the full death benefit due when claims are submitted. It is most likely in the best interest of the rehabilitator/conservator to pay the full amount due, the policy cash surrender value plus the NAR, notwithstanding any limits imposed by the guaranty association. Failure to pay the full death benefit will likely foster an immediate stampede of IRC § 1035 exchanges and/or surrenders. By removing any ambiguity regarding this point, the rehabilitator improves the odds that SA policyholders will retain the policies or at least defer the surrender/exchange decision. The policy may continue to operate as it did prior to the carrier becoming financially compromised, and eventually, as was the case with Mutual Benefit Life and Confederation Life, the entire block of COLI⁸/BOLI business can be sold to a more financially sound carrier under an assumption reinsurance transaction.⁹ This produces a far better result for remaining policyholders and claimants because the rehabilitator retains revenues and profits from the books of the SA business and may ultimately profit from its sale to another carrier. And, as described more fully below, from the policyholder's perspective, there are several important advantages to the policies transferring to a new carrier via assumption reinsurance versus through IRC § 1035 exchanges.

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Questions regarding the entirety of the death benefit are extremely important; consequently, it may prove worthwhile to pose "what if" questions to the applicable insurance departments before an actual problem manifests.

⁷ IRC § 1035 exchanges are explained in more detail under Remedies and Mitigation Strategies.

⁸ Corporate owned life insurance (COLI) is similar to BOLI only it is more commonly used to finance or hedge non-qualified executive benefits than general welfare benefits.

⁹ Further explanation regarding assumption reinsurance is provided under Remedies and Mitigation Strategies.

Other Counterparty Exposures and Considerations with SA Policies

Stable Value Protection

Most banks that own SA BOLI plans use stable value protection, also referred to as stable value wraps, redemption value wraps, and similar terms. SVPs may be offered by the issuing insurance company or an independent third party such as a commercial bank. A detailed discussion regarding the attributes of SVPs is beyond the scope of this article. However, in short, as the name implies, SVPs are used to produce relatively stable earnings for reporting purposes. The SVP provider contractually provides a crediting rate, which applies to the initial policy cash surrender value, and simultaneously establishes a policy book value (BV), which does not fluctuate daily as does the market value (MV) of the underlying SA portfolio. The crediting rate is based on the underlying yield to worst of the portfolio. It formulaically resets (generally, quarterly). It smoothes earnings by amortizing changes in MV through the crediting rate formula. If the policyholder surrenders its SVP policies during a period when MV is below BV, the SVP provider is obligated to pay the difference. Thus, the amount the policyholder realizes upon surrender is the policy BV, which is the amount reflected on its balance sheet each reporting period. There are a number of provisions within SVPs designed to reduce the provider's risk of loss due to policy surrenders, including a number of required representations by policyholders upon surrender (a "conforming surrender"¹⁰). Again, providing a detailed discussion of these provisions would be overreaching the intent and bounds of this article. Although the actual stable value agreement (SVA) is a contractual arrangement between the insurance company (not the policyholder) and SVP provider, policyholders should have a detailed understanding of its terms.

Recognizing the nature of SVP counterparty exposure inherent with use of SVPs, bank regulatory guidelines¹¹ require BOLI policyholders to risk weight any negative difference between MV and BV "at the risk weight applicable to the insurer or the SVP provider, as appropriate." Banks are indeed exposed to default risk in the event the SVP provider becomes insolvent at a time coincident with an attempted policy surrender (i.e., if at the time of attempted surrender, MV is below BV and all requisite policyholder representations can be affirmed).

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Here again, there are several convoluted issues that arise in relation to counterparty exposure. Should the SVP provider become financially distressed, what accounting implications might the policyholder be subjected to? What recourse does the policyholder have under these circumstances? Is the policyholder dependent on the carrier to take action or does the policyholder have any rights to compel appropriate actions be taken? Does the carrier have the right to demand collateral or remove the SVP provider without any cost inuring to policyholders? If the SVP provider is terminated, is there a suitable replacement SVP provider willing to step into the shoes of the exiting counterparty (i.e., preserve existing BV)? Conversely, if the carrier is downgraded, might there be SVP-related consequences to policyholders? For example, if the stable value agreement extends a reciprocal right to terminate the SVA if the carrier has fallen below a defined financial ratings threshold, the SVP provider could elect to walk away from the transaction with no exposure to loss (only the loss of future SVP fees). On the surface, such a provision may seem desirable to the SVP provider, but it may actually work against its best interests. If a carrier's financial strength ratings are dropping, but have

¹⁰ A typical BOLI policyholder representation is that it has been adequately capitalized and will remain adequately capitalized for a defined period within the surrender request date.

¹¹ Enumerated within the most recent BOLI-related Interagency Guidelines, OCC 2004-56.

not yet breached the applicable threshold, or its financial health is otherwise suspect, the presence of such a clause might fuel selected policy surrenders (e.g., policies with MV well below BV; ironically, no such compulsion would likely manifest for policyholders with healthy MV/BV ratios). Even with such a provision in place, the SVP provider may elect not to terminate the SVP agreement because there is a strong probability that the policies will continue to operate as intended. Unlike when an SVP provider is downgraded, when a carrier is downgraded there is little change in the SVP provider's exposure to losses (e.g., it generally has adequate protection in place in the event of §1035 exchanges). But if the SVP provider terminates the agreement, the policyholder might suffer an immediate write-down of BV to MV along with possible mark-to-market volatility during subsequent reporting periods. Finding and inserting a suitable replacement SVP under such circumstances could prove difficult if not impossible. Can the SVP provider discontinue the SVP if the carrier defaults under non-financial terms of the SVA? What explicit rights, if any, does the policyholder have under such circumstances? Clearly, these are important questions to answer to pursue improvements in the present situation and/or to formulate a suitable internal policy.

Another important question regarding SVP-related counterparty exposure is: In the event of a conforming surrender, does the stable value agreement stipulate that funds flow directly to the separate account or through the carrier's general account? If funds flow through the carrier, and the carrier is in rehabilitation, is there a danger that funds could be subject to the discretion of the rehabilitator? The SVP payable is generally accounted for as an asset of the separate account by carriers and it is highly likely that the funds would be deemed legally owned by the separate account. However, it is conceivable that a rehabilitator may take a different view. It may be wise to ask carriers to obtain written clarification on this point from the relevant department of insurance to avert controversy at a later date.

Impaired Securities

Most SVPs require an immediate adjustment to BV in the event an underlying portfolio contains any securities that become impaired. Unlike temporary changes in the market value of portfolio securities, impairment generally means the loss suffered is permanent; hence the unwillingness of the SVP provider to amortize the loss. Fortunately, such write-down events have been extremely rare and have had minor impact due to such modest positions. In fact, until the notable demise of Lehman Brothers in September 2008 and Washington Mutual (WaMu) later the same month, carriers, SVP providers, and policyholders never experienced such events. There were some valuable lessons

One positive takeaway from the Lehman, WaMu, et al. situations is that most separate-account BOLI policies operated as intended – they minimized counterparty exposure through diversification.

taken from these recent instances. Carriers learned the hard way that ascertaining and verifying which securities fell under the category of impaired was far more difficult than anticipated. Some of the bonds (e.g., securitizations) with the Lehman moniker were found not to be direct obligations of the bankrupt entity and were unimpaired. Others, with no reference to Lehman whatsoever,

turned out to be direct Lehman exposures and were indeed impaired. Sorting out which securities fell into which category required work with the investment manager and the added input and consensus of the SVP provider. This process took time, in at least one instance enough time to delay delivery of accurate month-end carrier reports.

One positive takeaway from the Lehman, WaMu, et al. situations is that most separate-account BOLI policies operated as intended – they minimized counterparty exposure through diversification. We performed a brief, admittedly non-comprehensive, survey of direct exposure to Lehman's bankruptcy (i.e., impaired securities) within separate-account investment divisions with performance benchmarked to the Lehman Aggregate Index (now, the Barclay's Aggregate Index). The survey

contained both passively and actively managed investment divisions and collectively covered approximately \$10 billion of BOLI assets. As of August 1, 2008, the Lehman Aggregate Bond Index had 0.27% exposure to Lehman securities. By September 15, 2008, when Lehman filed for bankruptcy, the exposure had decreased to 0.09%. Exposures to impaired Lehman securities for passively managed investment divisions were generally very close to the benchmark's exposure (0.085%-0.095%), while actively managed investment divisions ranged between 0.00% (two managers) to as much as 0.60% (more than six times the benchmark's exposure). Even though some active managers contained significantly higher exposures than passive divisions and the underlying benchmark, Lehman-impaired securities represented very small percentages of policy values that were written down due to SVP requirements, averaging 0.4% of division assets. Note that the above exposures exclude indirect exposures managers might have encountered due to Lehman's role as counterparty to derivative transactions. Our research indicated that the net exposure (receivables in excess of payables to Lehman) within the same investment divisions averaged less than 0.03%. Also, we did not attempt to quantify the degree or extent of potential losses emanating from exposures other than impaired securities (e.g., downgraded mortgage-backed securities (MBSs)). Although these exposures in many instances eclipsed impaired securities as a percentage of assets, SVPs typically do not require book value write-downs unless a security actually becomes impaired. Therefore, SVP providers, much like GA BOLI carriers do with their BOLI clients, effectively deflect the bulk of MBS-related market losses from hitting the profit and loss statements of banks. Many viewed SVPs within BOLI as merely an accounting gimmick; however, thanks primarily to the fallout of the sub-prime collapse, it has become painfully clear to many, not the least of which are the SVP issuers themselves, that there is real risk of loss at stake.

Investment Manager and Custodial Exposures

Does the policyholder incur any exposure if either the investment manager or account custodian becomes insolvent or enters bankruptcy? Once again, these are knotty issues which may, depending on the specific structural approach taken by the carrier and the nature and domicile of the various entities involved, engage interplay between state laws and/or federal banking statutes. In most cases, policy assets remain the property of the customer (the insurance company) and do not become the property of the custodian, who holds them in a fiduciary capacity. Because assets are held separately from the custodian's assets, creditors should not have a legal basis to assert liens or claims against securities held in custody. However, the insolvency of a custodian can raise other counterparty-related concerns, including the custodian's ability to settle trades in a timely manner. It may therefore be prudent to find out which custodian(s) your carrier uses and to obtain a detailed explanation regarding the specific structure deployed.

In the aftermath of the Madoff scandal, one must also be mindful of potential losses stemming from fraud or the insolvency of the investment manager. The managed account structure deployed with many SA policies can help mitigate some of these risks because, with few exceptions, securities are held by a custodian, not the investment manager. As noted, there are exceptions, and obtaining an understanding of the particulars applicable to each investment manager/division on one's SA BOLI platform is highly recommended - prior to making an allocation.

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Exposure to loss as a consequence of fraud or theft by either custodian or money manager should be muted significantly as long as the insurance company remains financially sound. Assets held in the separate account of a variable life policy are owned by the insurance company, not the policyholder or the separate account. Unlike mutual funds in which shareholders own a proportionate share of actual assets, variable life policyholders have the right to be paid benefits according to the policy contract, regardless of whether the assets underlying the policy are actually there. The insurance

company's responsibility to fulfill its contractual obligations survives even if separate-account assets have been stolen. Consequently, insurance companies are given proper incentive to use caution in selecting custodians and appointing and monitoring external investment managers. State rules regarding the selection of the custodian of separate accounts are typically quite exacting, reflecting the commissioner's concern for liabilities that might arise in the event of insolvency.

Remedies and Mitigation Strategies

It may be more apt to title this section "Remedies, Mitigation Strategies, and Their Respective Limitations." What can one do to effectively deal with counterparty risks? The answers tend to differ depending on whether the action is taken as a preemptive measure or in response to real-world developments.

IRC § 1035 Exchanges

One possible remedy to consider when the exposure to a given insurance carrier becomes unacceptable is tax-free exchanges of policies under IRC § 1035. When conducted in accordance with the applicable regulations and available guidance, such exchanges are undertaken on a tax-free basis. The cost basis¹² of the prior policy is carried over to the new policy, policy cash value growth continues to be tax deferred, and death benefits are payable without taxation. However, there are costs associated with all § 1035 exchanges, and they are usually significant. In most instances, a federal deferred acquisition cost tax (the DAC tax) is imposed on the entire cash value at the time of exchange.¹³ This cost, which generally equates to a hard-dollar expense of approximately 1.25% (on a net present value basis) of the policy cash surrender value, is assessed regardless of whether the policy is exchanged internally (the incumbent carrier remains the issuing carrier) or externally (the successor policy is issued by a different carrier).¹⁴ In addition to the DAC tax, external exchanges are typically subject to state premium taxes on the entire cash value at the time of exchange. State premium taxes generally are not assessed in the case of internal exchanges, a significant advantage relative to external exchanges. Premium tax varies according to the state of residence of the insured but averages approximately 2%. State premium taxes and the DAC tax were of course already incurred when the original policy was purchased, generally assessed as a percentage of gross premium. Thus, incurring these taxes again upon exchange usually means more than re-incurring the original cost (because the second time around, they are computed on the original premium plus any policy cash value growth).

Presumably, one would only pursue an internal exchange if the replacement policy provided the safety of a separate account.

Now for the impediments; there are several complex hurdles to traverse before consummating §1035 exchanges. Especially challenging obstacles exist in the case of policies covering the lives of former

¹² Cost basis has historically been computed as the accumulated premiums paid to date minus amounts of cash withdrawn. Due to recent Internal Revenue Service (IRS) published guidance, cost basis may be more challenging to compute.

¹³ The DAC tax refers to the requirement that life insurers capitalize a specified amount of current deductions and amortize them over 10 years. In the case of BOLI policies, the specified amount is 7.7% of net premiums. In an IRC § 1035 exchange, the value of the contract (typically, its cash value) is treated as a premium paid to the new carrier. The cost to the carrier of deferring current tax deductions over a 10-year period is referred to as the DAC tax, which carriers generally seek to pass on to policyholders.

¹⁴ An "internal" IRC § 1035 exchange does not incur a DAC tax in this situation if the new contract does not involve a change in the interest, mortality, or expense guaranties present in the original contract. However, in this context there would be little point in undertaking an internal exchange if there were no change in any of these items.

employees (e.g., retired or terminated employees). One must first navigate applicable state insurable interest statutes. Does the state in question require you to reestablish insurable interest? If so, can you? Do you have to obtain new employee consents? Most state insurable interest statutes are silent on exchanges (Delaware is a notable exception, having well-crafted exchange provisions which thoughtfully balance protections for employees with a reasonable path for policyholders to follow to consummate exchanges on former employees).

Assuming you can adequately resolve these state-related questions, you now turn to a review of the possible impact of IRC § 264(f), the interest disallowance or “proration” rule.¹⁵ The Internal Revenue Service (IRS) has taken the position that a policy is “newly issued” at the time of an exchange requiring retesting under § 264(f) (see PLR 200627021, issued July 7, 2006). If the IRS prevails with this position, the policyholder will suffer ongoing interest disallowance for all policies covering former employees at the time of the exchange. Without delving into the specifics of the disallowance computation, suffice it to say that the added cost, in many instances, cripples the economic performance of the policies. The only exception is when the overall ratio of policy cash value attributable to former employees is fairly low.

...there are costs associated with all § 1035 exchanges, and they are usually significant.

Apart from insurable interest and IRC § 264(f), do you have to comply with IRC § 101(j), the COLI Best Practices Act, which became effective August 17, 2006? This provision, in very general terms, requires corporate policyholders to provide written notice of coverage to employees and to obtain their prior written consent to it. These requirements apply to contracts “issued” after August 17, 2006. According to the IRS, an IRC § 1035 exchange gives rise to a newly issued contract as of the date of the exchange if any of the terms of the original policy are materially changed, other than certain permitted changes.¹⁶ These permitted changes include a change in the identity of the carrier, increases in death benefit that are the result of IRC § 7702 (or which occur by the existing terms of the contract), purely administrative changes, a change from a general account contract to a separate account contract (and vice versa), or changes in terms that occur pursuant to the exercise of an option or right granted under the contract as originally issued. If an IRC § 1035 exchange or other change in contract terms causes a contract to become subject to § IRC 101(j), then meeting the notice and consent requirements may be difficult in the case of former employees.

Assuming for the moment you have resolved all of these issues, and have done so before the insurance carrier in question has become insolvent, there is at least one final potential hurdle to clear. Historically, some state insurance regulators have intervened to curtail policy surrenders (including exchanges) before a carrier is formally placed in rehabilitation or insolvency. In one notable case during the early 1990s, a state’s insurance commissioner, attempting to forestall the demise of a troubled COLI-issuing carrier, contacted contemporaries within selected insurance departments and asked them to persuade insurance companies domiciled within their states to reject § 1035 exchanges. In turn, department commissioners obliged that commissioner by contacting leading BOLI/COLI carriers domiciled within their respective states and conveying that they would not look favorably upon carriers hastening the demise of the troubled carrier (i.e., by accepting § 1035 exchanges). Although not legally bound to follow these edicts, carriers nevertheless did so.

¹⁵ Subsection (f) of IRC § 264 was added in June 1997 in response to concerns about large COLI transactions covering non-employees (e.g., borrowers).

¹⁶ IRS Notice 2009-48.

Internal Conversion to Separate Account or Hybrid Policy

If the policies in question were specifically filed and approved by the applicable states with a provision or endorsement granting the policyholder the right to convert the policy to another offered by the insurer, and if the insurer makes available a suitable policy whereby policy cash values are, subsequent to the conversion, held in a separate account, then exercising such conversion right may be worth serious consideration. However, the policy is not a variable policy in the normal sense; cash value growth is still based on a declared interest crediting rate. As stated previously, almost all state statutes governing an insurer's authority to establish separate accounts and offer variable life products are rooted in the Variable Life Insurance Model Regulation (Model #270). The Investments by The Separate Account section of Model #270 states: "The transfer, whether into or from a

It is advisable to confirm, in advance, that the proposed policy has been granted explicit segregated asset account treatment by the domiciliary insurance department.

separate account, is made by a transfer of cash; but other assets may be transferred if approved by the commissioner in advance." Thus, subject to prior approval of the commissioner, assets (other than cash) held in the general account of the carrier may be segregated from other assets, transferred to a separate account, and subsequently extended the same protections as other separate account assets—namely, not chargeable with liabilities arising out of any other business of the insurance company. These policies thus straddle the line between general account and

traditional variable life policies, and for this reason they are often referred to as "hybrid" policies. It is advisable to confirm, in advance, that the proposed policy has been granted explicit segregated asset account treatment by the domiciliary insurance department. To that end, it seems reasonable to require a legal opinion from the insurance company's external counsel and/or written affirmation from the department of insurance. Written representations and warranties from the insurer would likely not suffice since they may prove ineffectual with the rehabilitator or in court in the event of insolvency or conservatorship.

There are other important points to consider. It is conceivable, especially in those instances where a conversion privilege is absent in the original policy, that the IRS may take the position that the conversion involves a "material change" to the original policy or is a "deemed exchange." If the IRS were to prevail in either position, then many, if not all, of the state insurable interest and IRC § 264(f) interest disallowance considerations previously discussed may come into play with potentially disastrous consequences. At a minimum, one should consider obtaining a legal opinion regarding the potential impact of a conversion. Ideally, the carrier will provide some type of indemnification to the policyholder in the event the transaction is challenged by the IRS.

At a minimum, one should consider obtaining a legal opinion regarding the potential impact of a conversion.

Some final notes regarding conversions: It is highly unlikely that a conversion provision or endorsement will specifically state that the owner may convert to a separate-account policy. This is because a right or option to purchase a security is generally considered a security in its own right and, as such, the original policy would be subject to securities laws in addition to state insurance laws (e.g., sold via prospectus or specifically exempted from such requirement under Regulation D, in which case accompanied with alternate suitable documentation). In the event the original policy was filed without a conversion privilege, one might still be able to become comfortable that the transaction does not constitute a deemed exchange or contain material changes. Central to this position is the notion that the successor policy will not differ materially from the original (i.e., same minimum guaranteed interest rate and guaranty of principal along with policy expense levels, etc). Maintaining the desired equivalency is a complex issue. A not so obvious question that occurs to the authors is: In the event the change from general account to separate account results in

cost savings, which party, insurer or policyholder, should receive the savings? In other words, does keeping the policy expenses and crediting rates the same produce equivalency when, as a consequence of the change, it enriches the insurer? A strong case may be made that any such savings should inure to the policyholder, especially if the existing policy structure allows for excess interest or is a participating policy (eligible for dividends). There are ample instances and means (e.g., dividends, experience credits, excess interest) of passing along favorable experience or earnings to life insurance policyholders. We believe that state insurance departments may be well disposed to this view.

Assumption Reinsurance

Assumption reinsurance is not actually reinsurance, but rather is a term used to describe the sale of a block of business (policies) from one insurance company, the seller or “ceding” company, to another, the buyer or “assuming” company. The assuming insurance company effectively steps into the shoes of the ceding carrier, becoming legally bound by the terms of the policies. While the policyholder now looks to the assuming carrier to fulfill contractual obligations under the policy, generally, the contract’s terms and conditions remain unaltered as a consequence of assumption reinsurance transactions.¹⁷

From the perspective of the policyholder, there are several possible advantages to assumption reinsurance versus § 1035 exchanges or policy conversions. During the 1980s and 1990s, the IRS issued a series of private letter rulings regarding assumption transactions which concluded, in essence, that policies would not be treated as reissued (i.e., affect the date the contract was originally issued or cause a policy to lose its grandfathered status). The implication of such treatment is that, in contrast to policy exchanges or material changes, the peril of reestablishing insurable interest, re-incurring premium tax, and/or the application of IRC § 264(f) may be averted.

From the perspective of the policyholder, there are several possible advantages to assumption reinsurance versus § 1035 exchanges or policy conversions.

Selected banks have procured contractual rights to invoke an assumption reinsurance transaction if certain triggering events occur. These rights, generally embodied in a letter of understanding (LOU) which supplements the underlying policy and private placement memorandum (PPM), vary considerably from one carrier to another and even from case to case with the same carrier. Some typical events giving rise to the right to invoke an assumption are financial ratings downgrades below defined thresholds, changes in control, and failure to perform agreed-upon administrative services. Other lesser known, yet equally important, triggering events may be included. Enforceability of the right to invoke an assumption is highly variable, hinging on the triggering events specified and, in the case of service-related lapses, the precision with which service standards and deliverables have been defined. Also, even when successful in enforcing one’s contractual right to invoke an assumption, there is no way to guarantee that a suitable replacement carrier will be found; and if the ceding carrier is subject to regulatory intervention, the assumption will be subject to regulatory approval prior to being finalized.

BOLI Administrators/Vendors

The degree of importance of this risk is linked to how vital the service provider is to the bank’s BOLI risk management regime—that is, the extent of its role and services, especially in support of mission-critical BOLI tasks. With that in mind, insolvency is the most obvious form of counterparty risk exposure banks have with respect to BOLI service providers. However, some risks may arise

¹⁷ In a sale of a block of policies in a rehabilitation or liquidation context, the assumption reinsurance transaction may involve changes in policy terms.

regardless of whether the service provider remains in business. Fortunately, concrete measures can be implemented to mitigate the bulk of these potential vulnerabilities.

Identifying Vulnerabilities

Does the service provider possess key or sensitive documents (e.g., proof of consent, original closing documents, personal identifying information)? Do you depend on the service provider for mission-critical tasks (e.g., reconciling policy charges and values, BV/MV testing, performing risk weight computations, securities reconciliations)? Loss of certain documents and/or untimely interruption of services would be equally devastating regardless of the cause (e.g., bankruptcy, natural or other disaster). One might gauge the relative importance of documents, data, and services through a serious inquiry into the likely impact of loss or sudden disruption of services and/or data. Identifying all mission-critical tasks and services performed by the provider and all documents and sensitive data is a logical first step in the evaluative process. A review of the existing service provider's statement of work and deliverables should help in this regard. Be certain to identify any services that have been undertaken since the last time the administrative services agreement and statement of work were reviewed. Some vulnerability may already be addressed through the vendor's business continuity, data security, and disaster recovery plans (as evidenced periodically through SAS 70 Type II audits). Some issues may require special attention. For example, if you depend on a vendor for work product generated on the vendor's proprietary software system, you should obtain an agreement granting clear rights to its use and access to user codes in the event of the vendor's bankruptcy. This right must be accompanied by protocols for fulfillment in extreme situations (e.g., code and data deposited with a third party quarterly). Many of the vulnerabilities identified above are inherently present in the bank's relationship with its carriers, too. Prudent measures deployed in connection with vendors may therefore help to minimize similar exposures to carriers.

If you depend on a vendor for work product generated on the vendor's proprietary software system, you should obtain an agreement granting clear rights to its use and access to user codes in the event of the vendor's bankruptcy.

Ancillary Considerations

Implications of Reinsurance

Some may wonder whether the existence of reinsurance transmits protection to the policyholder against insolvency risk. Reinsurance generally does not provide any direct protection to policyholders. A reinsurer's obligations to a primary insurance company (the reinsured) do not abate if the reinsured becomes insolvent (enters receivership). Instead of making payments to the reinsured, the reinsurer makes payments to the receiver/liquidator and payments are considered part of the insolvent insurance company's estate. Policyholders generally have no grounds for asserting claims directly to the reinsurer. Note though that the insolvency of a reinsurance company or its failure to honor its agreement in no way relieves the primary insurance company of its obligations to policyholders.

Reinsurance generally does not provide any direct protection to policyholders.

Conclusion

Recent unprecedented market turmoil has revealed an entirely new and formidable reality relating to all forms of counterparty risk, and it is painfully clear that BOLI is no exception. Whether a bank owns general account, separate account, or hybrid BOLI, or a combination thereof, identifying and managing BOLI-related counterparty risk is a demanding, multifaceted task requiring rigorous inquiry and input from a diverse, interdisciplinary team. Dynamic, fluid risk management frameworks are better suited to the task than rigid, fixed regimes.

