White Paper: Capital Treatment of BOLI

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You have asked us to prepare a white paper summarizing the capital treatment of bank owned life insurance ("BOLI") under several different regulatory regimes, including the Basel Committee on Banking Supervision’s Second Basel Accord (“Basel II”)\(^1\), as implemented in the United States; the Basel Committee on Banking Supervision’s Third Basel Accord (“Basel III”)\(^2\), as currently proposed; and the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)\(^3\).

I. BASEL II

Under Basel II (which the United States has never fully adopted), banks are given a fair amount of latitude but are required to risk weight banking book exposures for purposes of calculating their capital requirements. Banks are required to risk weight corporate claims, which include “claims on insurance companies,” based on the credit rating of the particular company.\(^4\) We believe that BOLI would be considered as assets that are “claims on insurance companies.” Therefore, the cash surrender value (“CSV”) of a BOLI policy issued by insurance companies with credit ratings of AAA to AA-, A+ to A-, BBB+ to BB-, and below BB- would receive risk

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4 Basel II para. 66.
weightings of 20%, 50%, 100%, and 150%, respectively. The CSV of BOLI issued by insurance companies that do not have a credit rating would acquire a 100% risk-weighting.

Basel II does not directly address the extent to which, if at all, banks may include the CSV of a BOLI policy as part of their calculation of available Tier 1, Tier 2, or Tier 3 capital; however, BOLI does not appear to fit into any of the categories of capital that Basel II states may be considered Tier 1, Tier 2, or Tier 3.

The United States banking agencies have adopted a risk-weighting approach for BOLI that differs from the Basel II approach. Pursuant to the 2004 Interagency Statement on the Purchase and Risk Management of BOLI (“Interagency Statement”), a bank holding a General Account BOLI policy “should apply a 100 percent risk weight to its claim on the insurance company for risk-based capital purposes.” Unlike Basel II, the Interagency Statement does not allow banks to apply different risk weights depending on the credit rating of the issuer of the General Account BOLI policy.

A bank that owns a Separate Account BOLI policy may, however, assess the policy’s risk weight through a “look-through” approach, provided that the bank is able to demonstrate that the Separate Account BOLI assets are protected from the insurance company’s general creditors in the event of the insurer’s insolvency. In applying the look-through approach, the bank may either 1) apply the highest risk weight for an asset permitted in the separate account to the entire CSV of the Separate Account BOLI policy, or 2) use a pro-rata approach to risk weight the separate assets that may be held in the separate account. The look-through approach would apply the risk weights to assets found in the OCC’s regulation on risk-
based capital standards. In no case may the risk weight for a Separate Account BOLI policy be less than 20 percent.

Like Basel II, the Interagency Statement does not directly address the extent to which, if at all, banks may include BOLI as part of their available Tier 1 or Tier 2 capital.

II. BASEL III

Basel III, which has yet to be fully spelled out and has not yet been adopted in the United States, does not mandate any change in the capital treatment of BOLI. Basel III also does not specifically address the risk-weighting that the CSV of BOLI should receive. Basel III also does not appear to include BOLI in its definitions of both Tier 1 and Tier 2 capital.

Basel III does, however, establish two additional ratios that banks may be required to follow in the future: a liquidity coverage ratio (“LCR”) and a net-stable funding ratio (“NSFR”). The goal of Basel III is to introduce the LCR on January 1, 2015 and the NSFR by January 1, 2018. Under the LCR, a bank is required to have a stock of “high-quality liquid assets” that is no lower than 100% of the total net cash outflows for a 30 day period. The CSV of BOLI, however, will likely not qualify as a high-quality liquid asset. Under the NSFR, a bank must have an “available amount of stable funding” that is more than 100% of its “required amount of stable funding.” Pursuant to Annex 2, 100% of the CSV of a bank’s BOLI policy would likely be required to be included in the bank’s required stable funding because it would likely be included in the bank’s “all other assets.”

III. DODD-FRANK ACT

Like Basel III, the Dodd-Frank Act does not mandate any change in the capital treatment of BOLI. However, given the recent increased emphasis on risk management and focus on Tier 1 capital in both the Dodd-Frank Act and Basel III, it is foreseeable that there will be increased regulatory attention to board and management oversight of BOLI carriers and their creditworthiness, as well as the types of BOLI portfolio investments that may be chosen, e.g., de-emphasis of certain portfolios of securitized assets, etc. Further, the Dodd-Frank Act removes

14 12 C.F.R. Part 3, Appendix A.
15 Interagency Statement at 19-20.
16 Although the Interagency Statement and capital treatment regulations do not specify inclusion of BOLI as Tier 1 capital, it is our understanding that some financial institutions include the increase in the CSV of their BOLI portfolio as retained earnings, and therefore, include the increased value as Tier 1 capital, and that outside auditors have become comfortable with such capital treatment.
17 See Basel III Resilient Banks, paras. 49-61.
18 Basel III Liquidity, para. 9.
19 Id. para. 17.
20 Id. paras. 41-42.
21 Id. para. 121.
22 Id. Annex 2.
reliance on credit ratings for financial institutions. This may mean that any separate account portfolios that rely on credit ratings for risk-weighting or other purposes may require increased risk analysis by banks on both a forward-looking as well as backwards-looking basis.

IV. CONCLUSION

Currently, banks must place a 100% risk-weighting on the CSV of their General Account BOLI and may apply a look-through approach to Separate Account BOLI. Although the Dodd-Frank Act and Basel III do not explicitly mandate different capital treatment for BOLI, regulations implementing each may eventually have an impact on how banks purchase and maintain BOLI from a risk management and perhaps, a capital treatment perspective. We will continue to evaluate changes required by those emerging rules to see how they might impact BOLI. Please do not hesitate to contact Brian W. Smith at (202) 637-2288 or brian.smith@lw.com, Melissa R.H. Hall at (202) 637-2292 or melissa.hall@lw.com, or Evan R. Thorn at (202) 637-2150 or evan.thorn@lw.com if you have any questions.