APPENDIX

COMMON TYPES OF LIFE INSURANCE POLICIES

Life insurance can be categorized into two broad types, temporary insurance and permanent insurance. There are numerous variations of these products. However, basic life insurance provisions generally fall within one or a combination of the following categories.

Temporary Insurance

Temporary insurance consists of the various forms of term insurance. Term insurance provides life insurance protection for a specified time period. Death benefits are payable only if the insured dies during the specified period. If a loss does not occur during the specified term, the policy lapses and provides no further protection. All premiums are retained by the insurance company. Typically, term insurance premiums do not have a "savings component"; thus, term insurance does not usually create cash value.

Permanent Insurance

Permanent insurance is intended to provide life insurance protection for the entire life of the insured. Permanent insurance also differs from term insurance in that its premium structure includes a "savings component." Permanent insurance policy premiums have two components, the insurance cost (mortality cost,[1] administrative fees, sales loads, etc.) and the "savings component." The "savings component" typically is referred to as cash value. The policyholder may use the cash value to make the minimum premium payments necessary to maintain the death benefit protection, may access the cash value by taking out loans or making partial surrenders, or use any combination of these techniques. If permanent insurance is surrendered before death, a surrender charge may be assessed against the cash value. Generally, surrender charges are assessed if the policy is surrendered within the first 10 or 15 years. The amount of money a policyholder will receive upon surrendering a policy is referred to as the cash surrender value (CSV).

There are a variety of types of permanent insurance. Some of these include:

- Whole Life - A traditional form of permanent insurance designed so that fixed premiums are paid for the entire life of the insured. However, premiums may be paid from the CSV. Death benefit protection is provided for the life of the insured, assuming all premiums are paid.

- Universal Life - A form of permanent insurance designed to provide flexibility in

[1] Mortality cost represents the cost imposed on the policyholder by the insurance company to cover the amount of pure insurance protection for which the insurance company is at risk. With term insurance, the insurance company is generally exposed to risk of loss for the entire face amount of the policy. With permanent insurance, the net amount at risk for the insurance company is the difference between the policy's death benefit and the cash value,

premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a very high cash value. Alternatively, the policyholder can make minimal payments in an amount just large enough to cover mortality and other expense charges.

- General Account - form of whole or universal life insurance where the policyholder's cash value is supported by the general assets of the insurance company.

- Variable or Separate Account - form of whole life or universal life where the policyholder's cash value is supported by assets segregated from the general asset structure of the carrier. Theoretically, the cash value of a separate account insurance policy can go down to zero which would result in termination of the policy. The policyholder assumes all investment and price risk. The separate account is used solely for payment of policyholder benefits.

LIFE INSURANCE AS A FINANCING OR COST RECOVERY VEHICLE FOR BENEFITS PLANS

National banks may, as other corporations frequently do, use corporate-owned life insurance (COLI) as a financing or cost recovery vehicle for pre- and post-retirement employee benefits. In these arrangements, banks and other corporations insure the lives of certain employees to reimburse the corporation for the cost of employee benefits. The group of insured employees is often different from the group of employees who receive benefits. The corporation's obligation to provide employee benefits is separate and distinct from the purchase of the life insurance. The life insurance purchased by the corporation remains a corporate asset even after the employer/employee relationship is terminated. The employees, whether insured or not, have no interest in the insurance (other than their general claim against corporate assets arising from the corporation's obligation to provide the stated benefits). Permanent insurance is used for this purpose.

There are two common methods of financing or effecting cost recovery of employee benefits. The first is the cost recovery method. Under this method, the corporation sustains the cost of providing the employee benefits and the cost of purchasing the life insurance. The corporation holds the life insurance and collects the death benefit to reimburse the corporation for the cost of the benefits and the insurance.

The cost recovery method usually involves present value analysis. The corporation typically projects the dollar amounts of the expected benefits owed to employees and determines the present value of the benefits. Then, the corporation purchases a sufficient amount of life insurance on the lives of certain employees so that the gain (present value of the life insurance proceeds less the present value of the premium payments) from the insurance proceeds reimburses the corporation for the benefit payments.

The second method of financing employee benefits is known as cost offset. With this method, the corporation projects the annual employee benefit expense associated with the benefit plan. Then, the company purchases life insurance on the lives of certain employees. The amount of insurance purchased is great enough so that the income earned on the CSV offsets the benefit expense. The collection of death benefits may further enhance the company's return.

SPLIT-DOLLAR INSURANCE ARRANGEMENTS

National banks may, as many other corporations do, use split-dollar life insurance arrangements to provide retirement benefits and/or death benefits to certain employees. Under split-dollar arrangements, the employer and the employee share the rights to the policy's CSV and death benefits. The employer and the employee may share premium payments. If the employer pays the entire premium, the employee must recognize the economic value of the insurance as taxable income each year. Typically, split-dollar arrangements are set forth in written contracts that specify the terms and conditions of the agreement between the employer and employee.

Split-dollar arrangements may be structured in a number of ways. However, there are three basic types of split-dollar arrangements.

Endorsement Split-Dollar

In endorsement split-dollar arrangements, the employer owns the policy and controls all rights of ownership. The employer provides the employee an endorsement of the death benefit provided to the employee under the plan agreement. The employee may designate a beneficiary for the designated portion of the death benefit.

Under this arrangement, the employer typically holds the policy until the employee's death. At that time, the employee's beneficiary receives the designated portion of the death benefits, and the employer receives the remainder of the death benefits.

Collateral Assignment Split-Dollar

The employee owns the policy and controls all rights of ownership. Under these arrangements, the employer usually pays the entire premium or a substantial part of the premium. The employee assigns a collateral interest in the policy to the employer that is equal to the employer's interest in the policy. The employer's interest in the policy usually is equal to the premium paid by the employer or the premium plus a return on the premium.

Under this arrangement, the employee upon retirement usually has an option to buy the employer's interest in the policy. The employee usually withdraws money from the cash value or borrows against the cash value to purchase the policy. Sometimes, the employer may give the employee a bonus to purchase the employer's interest in the policy, or the employer may simply give the employee the corporation's interest in the policy as a bonus. This transfer of the employer's interest to the employee is typically referred to as a "roll-out."

If a "roll-out" is not provided or exercised, the employer does not receive its interest in the policy until the employee's death. Upon the employee's death, the employer would receive an amount equal to the premium paid or the premium plus a return on the premium. The employee's beneficiary would receive the remainder of the death benefits.

If the employee dies before reaching retirement age, the insurance policy's death benefit may be divided a number of ways. For example, the employer may receive an amount equal to the premium paid or the premium plus a return on the premium, and the employee's beneficiary would receive the remainder of the death benefit. As an alternative, the employer may retain the policy's entire death benefit.

Reverse Split-Dollar

Reverse split-dollar arrangements are very similar to collateral assignment split-dollar. The employee owns the policy and the employee provides the employer with an endorsement of part of the death benefit. The employer's interest in the policy is usually equal to or closely related to the pure insurance protection and used as “key-person” insurance. The employer's share of the premium is equal to the economic value of the pure insurance protection. The employee's interest in the policy is typically equal to or closely related to the cash value of the policy. The employee pays the remainder of the premium. This type of split-dollar arrangement is not frequently used in banks.

Split-Dollar Insurance Arrangements Used for Estate Planning Purposes or to Fund Buy-Sell Agreements

National banks may use split-dollar insurance arrangements as an estate planning tool for insiders or to fund buy-sell arrangements between the bank and insiders. However, such arrangements should be part of a reasonable compensation program. As stated in part VII of the pre-purchase analysis, national banks should combine the additional compensation provided to the insured by the split-dollar arrangement with all other compensation provided to the insured. Furthermore, national banks should ensure that total compensation provided to the insured is not excessive. Excessive compensation is prohibited as an unsafe and unsound practice. Guidelines for determining excessive compensation can be found in Appendix A to 12 CFR Part 30-Interagency Guidelines Establishing Standards for Safety and Soundness.

Typically, shareholders and other insiders who are not bank employees or directors do not provide goods or services to the bank and do not receive compensation. Therefore, national banks should only participate in such arrangements as a means of providing compensation for goods or services provided by insiders.

“KEY-PERSON” INSURANCE

A national bank may obtain life insurance to protect itself against the loss of “key-persons.” As such, a national bank may purchase insurance on the life of an employee whose death would be of such consequence to the bank as to give it an insurable interest in his or her life. Certain directors of the bank may also be “key-persons.”

The purpose of “key-person” insurance is to indemnify the bank against a potential loss of net income that may result from the untimely death of the insured employee. The determination of whether an individual is a “key-person” does not turn on that individual's status as an officer, but on the nature of the individual's economic contribution to the bank.

The first step in indemnifying a bank against the loss of a “key-person” is to identify the “key-person.” In essence, a “key-person” is anyone whose absence for an extended period of time

would result in a significant loss of net income for the bank. The next and possibly most difficult step is estimating the value of the "key-person." The value of the employee is an estimate of the potential loss of net income that the bank may incur from the untimely death of the "key-person." This value should be an estimate of the impact on net income from the loss of revenues, increased expenses, loss of operating efficiency, or other profit reductions that may result from the untimely death of the "key-person." This estimate of loss should represent a significant amount of the bank's profit or profit potential.

Determining the value of a "key-person" is not easy. Also, the most appropriate method for determining the value of a "key-person" is dependent upon the individual circumstances that created the "key-person" status. For these reasons, the OCC has not established a formula nor a specific process for estimating the value a "key-person" brings to a bank. Instead, the OCC affords bank management the opportunity to consider and analyze all relevant factors, and use their judgment to make the decision.

Additionally, "key-person" life insurance should not be used in place of, and does not diminish the need for, adequate management or "key-person" succession planning. Indeed, if a bank has an adequate management or "key-person" succession plan, its reliance on a "key-person" should decline as the person gets closer to retirement. Since a bank's reliance on a "key-person" declines as the individual moves toward retirement, the potential loss of net income which may result from the death of a "key-person" also should diminish.

As previously stated, holding permanent insurance in an amount in excess of the bank's risk of loss may be an unsafe and unsound practice.[2] Once an individual, because of retirement, resignation, discharge, change of responsibilities, or for any other reason, is no longer a "key-person" for the bank, the bank's risk of loss has been eliminated. Therefore, national banks may be required to surrender or otherwise dispose of life insurance held on a former "key-person." For this reason, the economic consequences of terminating the insurance should be considered in selecting the type of insurance and in structuring the policy. Typically, term or declining term insurance may be the most appropriate form of life insurance for "key-person" protection. It also may be appropriate to use permanent insurance that allows the substitution of insureds to provide for this protection.

LIFE INSURANCE ON BORROWERS

State law generally recognizes that a lender has an insurable interest in the life of a borrower to the extent of the borrower's obligation to the lender. In some states, the lender's insurable interest may equal the borrower's obligation plus the cost of insurance and the time value of money. Furthermore, national banks may protect themselves against the risk of loss from the death of a borrower. That protection may be provided through self-insurance in the form of debt cancellation contracts, or by the purchase of life insurance policies on borrowers.

National banks can take two approaches in purchasing life insurance on borrowers. First, a.

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[2] See part (II), Quantification of the Amount of Insurance Needed, of the pre-purchase analysis on page 4 of the bulletin.

national bank can purchase life insurance on an individual borrower for the purpose of protecting the bank specifically against loss arising from that borrower's death. Second, a national bank may employ a cost recovery technique similar to that used in conjunction with employee benefit plans. Under this method, the bank insures a group of borrowers in a homogenous pool of loans for the purpose of protecting the bank from loss arising from the death of any borrower in the homogenous pool. Examples of homogenous pools of loans include consumer loans that have distinctly similar characteristics such as automobile loans, credit card loans, and residential real estate mortgages.

Regardless of which approach is used, national banks should adhere to part 11 of the pre-purchase analysis. That is, banks should determine the risk of loss and ensure that the amount of insurance purchased is not excessive in relation to that estimate. When purchasing insurance on individual borrowers, bank management should, given the facts and circumstances known at the time of the insurance purchase, take reasonable efforts to ensure that the expected insurance proceeds match the expected repayment terms of the debt. To accomplish this, management should estimate the risk of loss over the life of the loan and match the anticipated insurance proceeds to the risk of loss. The insurance policy should be structured so that the expected death proceeds never substantially exceed the risk of loss. Generally, the risk of loss will be closely related to the outstanding principal of the debt. To properly structure the insurance policy, consideration should be given to the repayment terms of the debt. For example, for amortizing credit, banks should typically choose declining term insurance where the death proceeds are decreasing in amounts that match the loan amortization.

As previously stated, holding permanent insurance in an amount in excess of the bank's risk of loss may be an unsafe and unsound practice.[3] Once a credit is repaid, otherwise satisfied in full, or charged-off, the bank's risk of loss has been eliminated. Therefore, national banks may be required to surrender or otherwise dispose of life insurance on individual borrowers under these circumstances. For this reason, the economic consequences of terminating the insurance should be considered in selecting the type of insurance and in structuring the policy. Typically, term or declining term insurance is the most appropriate form of life insurance for insuring the lives of individual borrowers.

When purchasing life insurance on borrowers in a homogenous pool of loans, bank management should, given the facts and circumstances known at the time of the insurance purchase, take reasonable efforts to match the insurance proceeds on an aggregate basis to the total outstanding loan balances. If allowed by state law, national banks may match the insurance proceeds to the outstanding loan balances plus the cost of insurance on either a present value or future value basis. This relationship should be maintained throughout the duration of the program. When using this aggregate or group concept, it is acceptable for banks to continue to hold policies on the lives of borrowers that have been charged-off. However, loans in the homogeneous pool cannot include loans that have been charged-off. This will help ensure that national banks using this approach do not hold life insurance once the risk of loss has been eliminated.

The purchase of life insurance on a borrower is not an appropriate mechanism for effecting a

[3] See part (II), Quantification of the Amount of Insurance Needed, of the pre-purchase analysis on page 4 of the bulletin.

recovery on obligations that have been charged-off, or are expected to be charged-off for reasons other than the borrower's demise. In the case of charged-off loans, the purchase of life insurance does not protect the bank from a risk of loss since the loss has already occurred. Since the insurance does not protect the bank from a risk of loss, the bank does not need the insurance. Holding insurance the bank does not need may subject the bank to unwarranted risks, an unsafe and unsound banking practice. In the case of loans the bank expects to charge-off for reasons other than the borrower's demise, the risk of loss is so pronounced that the purchase of life insurance by the bank would be purely speculative and an unsafe and unsound banking practice.

LIFE INSURANCE AS SECURITY FOR LOANS

National banks may take an interest in an existing life insurance policy as security for a loan. National banks also may make loans to individuals to purchase life insurance, taking a security interest in the policy. As with any other type of lending, extensions of credit secured by life insurance should be made on terms that are consistent with safe and sound banking practices. For instance, the borrower should be obligated to repay the loan according to an appropriate amortization schedule.

Generally, a national bank may not rely on its security interest in a life insurance policy to extend credit on terms that excuse the borrower from making interest and principal payments during the life of the borrower with the result that the bank is repaid only when the policy matures at the death of the insured. Lending on such terms is generally speculative and an unsafe and unsound banking practice.

Frequently, banks acquire ownership of life insurance policies through debts previously contracted (DPC). That is, banks invoke their security interest in a policy after a borrower defaults. Life insurance policies do not have a secondary market. National banks should surrender or otherwise dispose of permanent life insurance acquired through DPC within a short time frame, generally 90 days, of obtaining control of the policy. It is possible that a national bank may find a means to dispose of permanent life insurance acquired through DPC which would require a longer holding period. Therefore, a national bank may request an extended holding period from its supervisory office. In order to receive an extension, the bank should have a well-documented plan that is reasonably certain to allow the bank to dispose of the policy through means other than speculating on the death of the insured. Additionally, the extended holding period should be in the best interest of the bank.

National banks may retain temporary insurance until the next renewal date or the next premium date, whichever comes first. National banks may not continue to make premium payments on term insurance acquired through DPC. This activity is speculative and an unsafe and unsound banking practice.