Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter 1030
June 2005
12 USC 24(7)

May 26, 2005

Subject: **( )**, (“Bank”) Investment in Bank-Owned Life Insurance (“BOLI”)

Dear **( )**:

This is in response to your inquiry whether the Bank may continue to hold a separate account BOLI investment that in turn holds interests in instruments with characteristics of debt securities and a rate of return, a portion of which is linked to equity securities. For the reasons set forth below, we conclude that the Bank’s investment, as described herein, may be permissible, provided the Bank’s Examiner-in-Charge (“EIC”) has no supervisory objection.

Background

The Bank’s predecessor purchased a separate account policy from **( )** Insurance Company, which later merged with **( )** (“***Co.***”). The book value of the Bank’s separate account policy was approximately $4.6 billion, as of March 31, 2005. In January 2002, the Bank reallocated nearly $900 million (amounting to $946 million as of March 31, 2005) in the separate account policy to four issues of structured notes (“Structured Notes” or “Notes”).

The Structured Notes

The separate account consists of four issues of Structured Notes and bank-eligible securities. Bankruptcy-remote special purpose entities (“SPEs”) issued the Structured Notes under SEC

Rule 144A.[1] All four issuances share essentially the same structure. The Bank's separate account holds roughly 80 percent of each issuance.

The Structured Notes have a maturity of 10 years and bear a coupon of either 1.75 or 2.25 percent, for a blended rate of approximately 2 percent, plus a potential or contingent, cumulative coupon of approximately 10 percent, payable at maturity, depending on the performance of assets in the SPE. At issuance, the Structured Notes were rated Aa3 (Moody's), and AA (S&P). The ratings apply to the principal and 2% assured interest, but not the cumulative interest. The assets of each SPE consist of a Balanced Portfolio and a Protection Agreement.

Balanced Portfolios

Balanced Portfolios hold two types of assets, the **( )** ("***BS***") and, when appropriate, fixed income instruments. **(*BS*)** represent five specific hedge fund strategies applied by 50 hedge fund managers. Rather than hold a basket of hedge funds, **(*Co.*)** may simply invest the Structured Note proceeds in mirror securities issued by a **(*Co.*)** affiliate that synthetically track the performance of the selected hedge fund categories. If a hedge fund manager performs poorly, assets under the control of that manager are reallocated into fixed income instruments. The fixed income instruments consist of notes issued by a **(*Co* .)** affiliate, up to a maximum of 25% of the principal value of the Structured Notes. Should it be necessary to reallocate additional assets to the fixed income instrument class, those assets must be invested in U.S. Treasury Securities. Reallocation to fixed income instruments allows **(*Co.*)** to assure that the SPE assets will be sufficient to meet **(*Co.*)**'s obligations at maturity to assure repayment of principal and the 2% coupon on the Notes.

Protection Agreements

Protection Agreements are contracts between the SPEs and either **( )** ("***Co.A***") or **( )** ("***Co.B***") that guarantee the holders of the Structured Notes repayment of principal and a coupon of either 1.75 or 2.25 percent. **(*Co* .)** has issued a surety bond to back the performance of its subsidiaries under the Protection Agreements, up to $3 billion. If either entity is downgraded to A- (S&P) or A3 (Moody's), **(*Co.*)** has 90 days either to find a replacement credit protection provider or collateralize the exposure with Treasury securities.

Stable Value Protection

A stable value protection ("SVP") policy protects the Bank's separate account in an amount equal to the difference between the book value and the market value of the separate account. The SVP in effect reduces the earnings volatility of the separate account for mark-to-market accounting purposes, but does not provide an effective, economic hedge. To realize the economic benefits of the SVP, the Bank must surrender the separate account policy, which would trigger tax liability for the cumulative earnings of the policy, thus negating one of the principal advantages of BOLI, tax deferral of earnings.

[1] 17 C.F.R. 230.144A.

Discussion

Life Insurance

National banks may purchase and hold life insurance under 12 U.S.C. § 24 (Seventh), which provides that national banks may exercise "all such additional powers as shall be necessary to carry on the business of banking." The OCC has found purchases of life insurance to be incidental to banking in several situations, for example in connection with employee benefit plans, key person insurance protection, recovering the cost of providing employee benefits, obtaining coverage on borrowers, and as security for loans. The OCC may approve other uses for insurance on a case-by-case basis. The OCC has indicated that national banks may not purchase life insurance for speculative purposes, to acquire shares from the estates of shareholders in order to control who owns the bank, or as an estate planning benefit to insiders (unless the benefit is part of a reasonable compensation).[2]

Bulletin 2004-56

The OCC's current guidance on purchases of life insurance by national banks is contained in Bulletin 2004-56.[3] National banks may purchase life insurance for a purpose that is incidental to banking, but not purely as an investment.[4] One of the purposes that the OCC has found to meet that standard is in connection with employee compensation or benefit plans. National banks may purchase life insurance to fund or recover the cost of compensation or benefits for their employees, officers or directors. However, if the separate account contains equity securities, the OCC has imposed a further limitation; the equities in the account must effectively hedge the bank's liability under the compensation or benefit plan that the insurance is intended to fund.[5] "An effective economic hedge exists when changes in the economic value of the liability or other risk exposure being hedged are matched by counterbalancing changes in the value of the hedging instrument."[6]

> Such a relationship would exist where the obligation under an insured institution's deferred compensation plan is based upon the value of a stock market index and the separate account contains a stock mutual fund that mirrors the performance of that index. . . . If the insurance cannot be characterized as an effective economic

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[2] *See* Interpretive Letter No. 926 (Sept. 7, 2001) and Interpretive Letter No. 878 (Dec. 22, 1999).

[3] Dec. 7, 2004 ("Bulletin"), issuing the Interagency Statement on the Purchase and Risk Management of Life Insurance ("Interagency Statement").

[4] *See* Interpretive Letter No. 926, *supra.*

[5] As long as the separate account holds debt, however, the holding is permissible and there is no inquiry concerning the adequacy of the hedge that the separate account is intended to provide.

[6] Interagency Statement at 18.

> hedge, the presence of equity securities in a separate account is impermissible, and the agencies will require institutions to reallocate the assets unless retention of the policy is permitted under federal law.[7]

The Bank bases its purchase of Notes on the authority of a national bank to purchase life insurance. The Bank's business purpose in holding the separate account policy is to defray the costs of employee benefits such as active employee and retiree medical benefits and funding 401(k) company match and long-term disability payments. These are permissible purposes for purchasing BOLI.

Generally one does not examine the assets in an insurance policy in reviewing permissibility issues, in part because life insurance is considered a general obligation of the insurer. The exception to this approach is when the bank holds a separate account policy. One looks through the policy to the underlying assets in the account, if those assets are equity securities, to determine whether the securities effectively hedge the liabilities the insurance is intended to hedge. There is no hedging requirement under the OCC's current guidance, however, if the Notes are deemed to be debt securities. The debt securities in the separate account still must qualify as bank permissible investments under 12 C.F.R. Part 1 or some other authority.

Debt v. Equity

Certain substantive characteristics distinguish common stock from debt securities.[8] Common stock usually is perpetual with broad voting rights, while debt securities generally have a limited life and few, if any, voting rights. Common stock provides an ownership interest and appreciation in the market value of the issuer and dividends. In contrast, debt securities offer investors fixed or fluctuating periodic interest payments, and return of principal at maturity. With debt securities, if the issuer should fail, the claims of the common stockholders are subordinate to the debt holders'. Rating agencies may assign credit ratings to debt securities, but typically do not rate equity instruments.

In this case, the separate account holdings more closely resemble debt than equity securities. The Structured Notes possess the following characteristics typically associated with debt securities. The Notes have a fixed maturity, pay regular periodic interest payments at a blended rate of 2 percent, and return principal at maturity. The holders of the Notes have superior claims to those of the SPE's common stockholders. The Notes do not have voting rights. The Notes are rated by rating agencies and are considered debt instruments for federal tax and accounting purposes.

The Notes resemble equities in only one respect. In addition to the blended 2% coupon, the Notes can pay a coupon of up to 10 percent, depending on the return of hedge fund assets held by

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[7] *Id*.

[8] *See, e.g., Landreth Timber Co. v. Landreth,* 471 U.S. 681, 686-87 (1985); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 850-51 (1975); R. Hamilton, *Fundamentals of Modern Business* (1989).

the SPE that issued the Notes. The variable portion of the return is more similar to the return of shares of an investment company invested in hedge funds or equities, although we note that debt obligations may have variable returns. Altogether the Notes more closely resemble debt in sufficient respects to be classified as debt rather than equity.

Part 1

An investment security means a marketable debt obligation that is not predominantly speculative in nature. A security is not predominantly speculative in nature if it is rated investment grade. When a security is not rated, the security must be the credit equivalent of a security rated investment grade.[9] These requirements apply to both the principal and interest payable on the debt security. The Structured Notes held in **(*Bank*)**'s BOLI separate accounts may qualify as investment securities under Part 1. The Notes were issued under SEC Rule 144A and thus are marketable.[10] The principal and blended 2% assured interest portions of the Structured Notes bear investment grade ratings and thus meet the quality requirements of Part 1.[11] The unrated portion of the interest on the Notes may qualify as the credit equivalent of investment grade, as discussed below.

The structured note in this situation raises the question of the permissibility of a debt instrument that has a non-rated interest component. Because of the structured nature of the security, the Bank may collect none, some, or all, of the contingent coupon. As a prudential matter, where a part of the return on a debt security is not rated, and the bank seeks to demonstrate that it is the credit equivalent of investment grade, the bank must document, through its own financial analysis, that there is a high probability that the security will produce a reasonable investment return over the life of the investment. For example, based upon an analysis of historical hedge fund returns, the bank could simulate a probability distribution of future performance. Through this analysis, the bank might be able to document that there is a high probability that the structured note will have an investment return (including the 2% rated portion) equal to or greater than the return for a similarly rated corporate exposure, with an appropriate spread premium for security structure risk, of the same maturity. Whether the unrated portion of a security may qualify as the credit equivalent of investment grade will depend on the facts and circumstances of each case.

Moreover, where part of the investment return is unrated and based on equity returns, the bank must also establish to the satisfaction of the bank's EIC the adequacy of the bank's reviews of the investment and risk management controls, and limit the total amount of any securities acquired under Part 1 with unrated, equity-based returns, to no more than 10 percent of the

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[9] *See* 12 C.F.R. 1.2(e).

[10] *See* 12 C.F.R. 1.2(f)

[11] *See* 12 C.F.R. 1.2(e).

bank's capital and surplus.[12] Accordingly, the Bank must establish, to the satisfaction of the Bank's EIC, that the contingent portion of the interest on the Notes meets these criteria.

Safety and Soundness

As Bulletin 2004-56 makes clear, in addition to credit and interest rate risks, BOLI exposes national banks to liquidity, transaction, reputation, and compliance risks, which often are difficult to measure and control. National banks that acquire BOLI must undertake a thorough prepurchase analysis and have a sound risk control framework to assess BOLI exposures on an ongoing basis. National bank purchasers of BOLI should develop and implement comprehensive policies that articulate their tolerance for the risks that BOLI presents. Bank management should conduct an analysis to support that acquisitions of BOLI do not give rise to imprudent capital concentration. Also, bank management should obtain approval from the board of directors or a designated board committee prior to the acquisition of BOLI beyond established limits or the capital concentration threshold.

The BOLI described herein presents a very complex transaction that is appropriate only in a well-diversified portfolio for institutions with superior credit and investment expertise, as well as sophisticated risk management processes. Where the separate account holds complex instruments with unrated, equity-based returns, review of the specific instruments by the OCC will be needed in order to determine that the holding is consistent with Bulletin 2004-56. Because of the complexity of the instruments, an appropriate level of diligence will be expected of the bank, and supervisory non-objection from the bank's EIC should be obtained. An appropriate exercise of due diligence should include:

- A review by outside counsel of the legal documents involved in the transaction.
- An initial assessment and ongoing monitoring of the performance of the underlying hedge funds, so that the bank will know at all times its credit exposure under the SVP policy.
- A review of BOLI holdings by an independent control or risk management unit to ensure compliance with OCC Bulletin 2004-56.

In addition, the bank should establish a compliance process to determine and monitor bank compliance with the supervisory conditions contained in this Letter.

Conclusion

We conclude that the Bank's investment in BOLI, as described herein, may be permissible as an investment in life insurance under section 24(Seventh). The separate account holdings more closely resemble debt than equity securities so the hedging accuracy standards for equity holdings in separate account BOLI do not apply. The Notes have a limited term, are rated, have

[12] *See* 12 C.F.R. 1.5, which requires that a national bank adhere to safe and sound banking practices as well as the specific requirements of Part 1 in purchasing and holding investment securities.

a fixed coupon, offer holders claims superior to common shareholders, and do not provide voting rights. Although the Notes' contingent coupon may resemble the return on an investment in equity securities, the Notes more closely resemble debt in sufficient respects to be classified as debt rather than equity.

Where, as here, the separate account holds complex instruments with unrated, equity-based returns, the Bank should conduct an appropriate level of due diligence, provide the OCC an opportunity to review the specific instruments to determine that the holding is consistent with Bulletin 2004-56 and obtain supervisory non-objection from the Bank's EIC. If you have questions concerning this matter, please contact Donald Lamson, Securities and Corporate Practices Division, at 202-874-5210 or Kurt Wilhelm, NBE, Treasury and Market Risk Division, at 202-874-5670.

Sincerely,

/s/ *Daniel P. Stipano*

Daniel P. Stipano
Acting Chief Counsel