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DEPARTMENT OF FINANCIAL AND PROFESSIONAL REGULATION

DIVISION OF BANKING

BUREAU OF BANKS AND TRUST COMPANIES

COMMERCIAL BANKING

BANK PURCHASE OF LIFE INSURANCE

A state bank is authorized to purchase and hold life insurance policies for noninvestment purposes. This includes life insurance on borrowers, life insurance taken as security for loans, key-person life insurance and life insurance purchased in connection with employee compensation and benefit plans. In each situation, the amount of the insurance must closely approximate the bank's risk of loss or obligation.

Life Insurance on Borrowers

The Agency has taken the position that, incidental to the business of banking, a state bank may purchase insurance on the life of a borrower. The maximum amount of insurance coverage should not exceed the principal balance of the borrower's obligation. Similarly, a bank may either take an interest in an existing policy as security for a loan or make a loan to an individual to purchase life insurance, and then take a security interest in the policy. However, when a bank makes a loan for or takes a security interest in an insurance policy, it should not look to the life insurance benefits as its source of repayment for the funds it advances.

Key-person Insurance

A key-person insurance plan is one whereby the bank is the owner and beneficiary of a policy protecting the bank against financial hardship resulting from the death of a valued director, officer or employee. If a state bank wishes to purchase key-person insurance, it must justify the expenditure as a legitimate insurance need because the death of the director, officer or employee would be of such a consequence as to give the bank an insurable interest in his or her life. The policy may only be purchased in an amount that would closely approximate the business loss of the insured's death would cause the bank. The amount of insurance is the total death benefit to be received upon the death of the insured.

It is also important to realize that once the key-person retires, resigns, is discharged, or, because of a change in responsibilities, is no longer considered a key-person, the bank's authority to hold the insurance policy lapses. The bank must then take action to remove the insurance plan or to transfer the key-person insurance policy to the covered person's compensation or benefits plan. Therefore, when selecting a key-person insurance policy, it is necessary to consider the economic consequences of terminating the insurance and to determine if it is possible to transfer the policy to another key-person or to the covered person's compensation or benefits plan.

It is essential that the bank and its board of directors document the basis for their determination that a director, officer or employee is a key-person and the basis for their determination of the amount of insurance necessary to indemnify the bank against loss from the death of the key-person. During a bank's examination, this documentation will assist the examiners in determining whether the insurance policies are filling an insurance need or if they are actually used by the bank for investment purposes.

Life Insurance Purchased in Connection with Compensation Agreements and Benefit Plans

A bank may purchase life insurance in conjunction with providing employee compensation or benefits or when the insurance benefit is paid in part to the bank and in part to the employee (referred to as split dollar insurance). In a split dollar insurance arrangement, the bank would pay for life insurance on an officer or director until his or her retirement or resignation. At that time, the officer or director must assume responsibility for future premiums. Upon the officer's or director's death, the bank receives that portion of the proceeds equal to its premium investment plus accrued interest and the balance of the proceeds is paid to the officer's or director's beneficiary. A bank may also purchase life insurance in connection with employee compensation and benefit plans, and this practice usually consists of a lump sum payment or salary continuation plan paid to the director, officer or employee upon his or her retirement or to a beneficiary upon his or her death. As with any employee benefit program, if a state bank purchases a split dollar insurance policy or other insurance policy as part of an employee benefit, Section 5 of the Illinois Banking Act requires that the funding of the plan must be reasonable. Before purchasing a life insurance policy, a bank must also determine that the projected cash flow from the policy will not substantially exceed the projected liabilities to fund the compensation or benefit program. Such life insurance policies may be held only for as long as the bank continues to have any liability under the associated compensation or benefit plan.

Other Considerations

There are other factors a bank must consider when purchasing life insurance. In order to mitigate safety and soundness concerns, a bank also should: (1) consider the effect significant holdings of life insurance policies will have on the bank's capital and liquidity; (2) examine the financial condition of the insurance company before purchasing a policy; and (3) at all times have access to a recent financial statement of the insurance company.

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