October 19, 2012

The Honorable Thomas J. Curry, Comptroller
Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 2-3
Washington, DC 20219

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

RE: Comments on Standardized Approach NPR – Impact on Bank-Owned Life Insurance

Ladies and Gentlemen:

On August 30, 2012, a series of capital proposals were published in the Federal Register for public comment. One of the proposals, Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements (the “Standardized Approach NPR”) includes proposed changes to the general risk-based capital requirements for determining risk-weighted assets (RWA).

Once finalized, the Standardized Approach NPR will apply to all banking organizations that are currently subject to minimum capital requirements (including national banks, state member banks, state nonmember banks, state and federal savings associations, and top-tier bank holding companies domiciled in the United States). Collectively, these types of financial institutions own approximately $150 billion of Bank-Owned Life Insurance (BOLI). Current call report instructions require institutions to report the amount of BOLI they own as well as the type. There are three types of BOLI: general account (GA), separate account (SA), and hybrid.

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1 Total BOLI holdings are the sum of BOLI reported by bank holding companies in Y-9C reports and BOLI reported by standalone banks and S&Ls in call reports. Values are as of 6/30/2012.
As of 6/30/2012, approximate aggregate BOLI holdings by category were as follows:

<table>
<thead>
<tr>
<th>Category</th>
<th>BOLI Holdings ($ Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Account</td>
<td>55,811</td>
</tr>
<tr>
<td>Separate Account</td>
<td>82,510</td>
</tr>
<tr>
<td>Hybrid</td>
<td>12,527</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$150,848</strong></td>
</tr>
</tbody>
</table>

Established in 1992, MB Schoen & Associates, Inc. provides consulting and administrative services specifically related to BOLI. Our clients include community banks, large regional banks and banks that are among the largest in the world. We presently provide administrative services for more than $18 billion of BOLI assets. We appreciate the opportunity to provide comments on this important rule proposal. Please note that our comments are limited to the proposed rules' implications on BOLI programs. We are in no way expressing opinions regarding the underlying proposed rules' or their broader impact on financial institutions.

**Background Discussion of Existing Risk-Weighting Rules for BOLI**

The existing general risk-based capital rules do not explicitly address the applicable risk-weighting of BOLI. However, Interagency Guidance for BOLI issued December 7, 2004 ("BOLI Guidance"), provided some instruction for determining RWA for BOLI. In general, the BOLI Guidance applied elements of the general risk-based capital rules. Direct exposures to insurance companies (e.g., GA BOLI) were assigned a 100% risk-weight. SA policies were treated as an indirect holding of a pool of assets. Banks owning SA BOLI were allowed to choose between two distinct look-through RWA treatments: 1) apply the highest risk weight for a permitted asset to the entire carrying value; or 2) apply a pro-rata look-through approach based on the investment guidelines.

On December 7, 2007, the agencies published the final rule implementing the Basel II Advanced Approaches. While the Advanced Approaches did not provide explicit instruction regarding risk-weighting BOLI, it is our understanding that the following classifications are generally applied:

- GA BOLI is treated as a wholesale exposure but is generally risk-weighted 100% in accordance with the BOLI Guidance; and
- SA BOLI is treated as an equity exposure to an investment fund. There are four distinct look-through approaches for investment funds under the Advanced Approaches, including a guidelines-based (Alternative Modified Look-Through Approach) and a full look-through approach.

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Like previous capital rules, the Standardized Approach NPR does not explicitly address the applicable risk-weighting of BOLI. Nevertheless, we assume that banking organizations will be required to apply the Standardized Approach rules for risk-weighting BOLI when the rules are finalized and become effective. The remainder of this letter raises questions in need of clarification regarding the RWA treatment of BOLI under the Standardized Approach NPR.

GA BOLI under the Standardized Approach NPR

GA BOLI would appear to be risk-weighted 100% as a corporate exposure (section 32 of subpart D). Please confirm or clarify this treatment.

SA BOLI under the Standardized Approach NPR

Consistent with treatment under the BOLI Guidance and the Advanced Approaches, SA BOLI would appear to be classified as Equity Exposures to Investment Funds in the Standardized Approach NPR. If so, there are three available look-through approaches:

1. Full Look-Through Approach;
2. Simple Modified Look-Through Approach; and

Is this the intended classification for SA BOLI?

The Full Look-Through Approach requires an institution to risk-weight each underlying exposure held by the investment fund and to compute total RWA based on the institution’s proportional share of the investment fund. The other two look-through approaches continue to be based on defined investment limits.

In addition to the look-through approaches identified in the proposal, we recommend that the agencies consider adding additional approaches that are suitable. One example might be to allow investment funds to be risk-weighted based on the actual amounts allocated to given asset sectors. This would likely result in overall risk-weights that are highly similar to the Full Look-Through Approach but could meaningfully reduce the administrative burden that arises from first obtaining and then processing each underlying holding. Additionally, if the investment manager provides a report detailing the proportion of portfolio allocations to specific sectors (e.g., Treasuries, U.S. government agencies, government-sponsored enterprises, corporate credit, non-agency securitizations, etc.), it could reduce concern regarding violations of Investor Control (see pages 6-7 for further discussion of Investor Control).

Similar to the current capital rules, both the Simple Modified and the Alternative Modified Look-Through Approaches state that a banking organization may exclude derivative contracts held by the fund that are used for hedging rather than speculative purposes and do not constitute a material portion of the fund’s exposures. Will there be written guidance regarding what uses qualify as hedging rather than speculative? For example, if a portfolio manager uses derivatives to help manage to a targeted duration of an investment...
fund subject to a constraint of +/- 0.5 years of the fund’s defined benchmark, would such use qualify as hedging? Also, will there be guidance regarding what amounts of such exposures would constitute a material portion of a fund’s exposures?

If an investment fund contains any exposures that the banking organization is unable to classify for risk-weighting purposes, how would the exposures be risk-weighted (e.g., what risk-weight would be assigned if applying the Full Look-Through Approach)? Might the treatment differ depending upon the materiality of such exposures? For example, if a bank is able to risk-weight a defined minimum percentage (e.g., 95%) of an investment fund’s exposures, it would seem acceptable to risk-weight the remaining exposures at either the weighted average risk-weight of the balance of the investment fund or some other reasonable risk-weight.

To the extent that SA BOLI includes direct exposures to the issuing insurance company (e.g., certain policyowner mortality reserves and DAC assets), such assets would be risk-weighted 100% as a corporate exposure. Please confirm or clarify this treatment.

To the extent that SA BOLI includes a direct exposure to a stable value protection (SVP) provider, such exposure would be risk-weighted at either: 1) 20% if the SVP provider is a banking institution; or 2) 100% if the SVP provider is not a banking institution. Please confirm or clarify this treatment.

**Hybrid BOLI under the Standardized Approach NPR**

Like SA BOLI, hybrid BOLI utilizes an insurance company separate account to insulate the cash surrender value from the insurance company’s general creditors. The assets in the separate account must be invested in accordance with defined investment limits. Hybrid BOLI is distinct from SA BOLI in that the insurance company retains significant risk associated with investment performance. For example, the policy provides a minimum guaranteed crediting rate, and the insurance company typically retains some discretion in resetting the crediting rate. In contrast, SA BOLI’s investment performance must reflect the actual market performance of the fund’s underlying investment exposures.footnote 3

In some instances, insurance companies that provide hybrid BOLI do not provide the underlying data necessary to monitor the degree of direct credit exposure to the insurance company (e.g., the proportional relationship between the cash surrender value and the underlying market value of investments in the separate account).

Should hybrid BOLI be risk-weighted similarly to SA BOLI (i.e., as an exposure to an underlying investment fund)? How should hybrid BOLI be risk-weighted when available data is insufficient to determine the relationship between the cash surrender value guaranteed by the carrier and the market value of the investments in the separate account, including proportional interests therein (i.e., how much should be risk weighted

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footnote 3: Some SA BOLI utilizes a SVP feature to reduce the period-by-period volatility by using a contractually defined, formulaic crediting rate. Even so, the underlying market value of the investment fund continues to reflect the actual performance of the holdings.
as an exposure to the insurance company versus the underlying assets held in the separate account)?

Additionally, provided that the insurance company sufficiently assumes interest rate risk, credit risk and market risk (i.e., through operation of the policy’s minimum guaranteed crediting rate), we believe the overall risk-weight of hybrid BOLI should be no greater than that of GA BOLI. Confirmation or clarification of this point would be helpful.

**Questions on Application of Look-Through Approaches for SA BOLI**

Investment guidelines specify objectives and constraints for SA BOLI investment funds (also known as sub-accounts or divisions), including permitted investments, non-permitted investments, concentration and diversification requirements, credit quality requirements and duration parameters, among others. Underlying investment exposures most often include some combination of the following asset classes:

- U.S. sovereign exposures (e.g., U.S. Treasury and agency securities);
- Foreign sovereign exposures;
- U.S. government sponsored enterprises (e.g., FNMA, FHLMC, GNMA);
- Senior and super-senior tranches of asset-backed securities (ABS), including:
  - Credit cards,
  - Autos, and
  - Student loans;
- Senior and super-senior tranches of commercial mortgage-backed securities (CMBS);
- Non-agency mortgage-backed securities (MBS);
- CDOs and CLOs;
- TBAs and other OTC and exchange traded derivatives;
- Municipal bonds; and
- Corporate notes and bonds.

The applicable RWA treatment of many of these exposures is sufficiently clear under the Standardized Approach NPR. However, the treatment of certain ABS, CMBS and non-agency MBS securities appears less clear.

**Securitizations (ABS, CMBS, CDOs, non-agency MBS)**

As listed above, certain holdings in SA BOLI investment divisions represent securitization positions, generally senior or super-senior tranches of ABS, CMBS, CDOs and non-agency MBS. Most BOLI investment guidelines further require such holdings to be rated either AA or AAA by NRSROs. We understand that Dodd-Frank Section 939A requires the agencies to remove references to external ratings from regulations. Likewise, the Standardized Approach NPR does not allow for risk-weighting these exposures based on credit ratings.
The Standardized Approach NPR requires banks to demonstrate a comprehensive understanding of the features of a securitization exposure that would materially affect the performance of the exposure. Failure to demonstrate a comprehensive understanding of a securitization exposure would result in a 1250% risk-weight. The proposed rules would require a banking organization to conduct and document an analysis of the exposure “prior to acquisition and periodically thereafter.” The proposal also identifies specific elements of such an analysis.

How are these rules expected to apply to exposures within an investment fund when the decision to acquire securities is the sole responsibility of an external investment manager and influencing such manager’s investment decisions is prohibited? Do these due diligence requirements apply irrespective of the look-through approach a bank selects? Would it be possible to satisfy the due diligence requirements in the form of investment guideline requirements (or representations by the investment manager) specifying the structure and other key aspects of permissible holdings?

Some of the data required to fulfill the due diligence analysis requirements has historically not been available for SA BOLI holdings.

The Standardized Approach NPR provides two methods for computing the RWA amounts for securitization exposures: (1) the simplified supervisory formula approach (SSFA), or (2) a gross-up approach. A banking organization would be required to apply either approach consistently across all of its securitization exposures. Does this requirement to apply the same approach extend to indirect interests in investment funds like SA BOLI? If so, the requirement is problematic. For example, relatively immaterial exposures arising from investment fund exposures under the purview of external portfolio managers could preclude a bank from applying the desired approach for its direct ownership interests in securitization exposures (e.g., if the gross up approach is required for BOLI holdings due to data limitations, a bank might be precluded from applying the SSFA approach to its direct holdings).

Additionally, both the SSFA and the gross-up approach require inputs that may be difficult to obtain. For example, the SSFA requires explicit values relating to a securitization exposure’s attachment point (A), detachment point (D), percentage of underlying exposures that are more than 90 days past due or subject to other forms of impairment (W), and a determination of the weighted average risk-weight of the underlying assets within the securitization ($K_G$). If a bank is unable to perform the computations under the applicable approach (e.g., due to unavailability of one or more of the input parameters), it would be required to assign a 1250% risk-weight to the exposure. We are working with insurance companies that underwrite SA BOLI to better understand the availability of the data required. However, in nearly all instances, requiring a 1250% risk-weight for these highly rated exposures appears punitive. We would strongly encourage the agencies to consider more appropriate alternatives for these types of securities held within SA BOLI. It is also worth noting that SA BOLI policyowners need to be diligent not to violate the “Investor Control Doctrine.” The IRS’s stated position is that if the owner of a variable life
insurance contract (e.g., SA BOLI) retains "significant incidents of ownership" or retains "excessive control" over the investments in the separate account, the policyowner, not the insurance company, will be treated as the owner of those assets for federal income tax purposes. Such a finding would have devastating repercussions on the policyowner. In Revenue Ruling 2003-91, the IRS identified some safe harbors to avoid violating the Investor Control Doctrine. These include:

- [Policyowner] cannot select or recommend particular investments or investment strategies.
- [Policyowner] cannot communicate directly or indirectly with any investment officer of Insurance Company or its affiliates or with Advisor regarding the selection, quality, or rate of return of any specific investment or group of investments held in a Sub-account.

While welcome and helpful, the safe harbors set forth in Revenue Ruling 2003-91 are far from exhaustive; ambiguities remain. For example, they do not address what types of data and reporting are permissible or impermissible.

Unless an alternative approach (e.g., allowing a bank to rely upon representations by the money manager regarding underlying attributes of the holdings) or a limited exemption to the Standardized Approach NPR is provided, policyowners would either need insurance companies to provide additional, granular information for each securitization exposure and/or they would need to research such holdings directly.

Most SA BOLI insurance companies are generally satisfied that periodically providing security holdings reports to policyowners will not constitute a violation of Investor Control. Nevertheless, supplying ever more granular data on fund holdings, as would be required for risk-weighting securitization exposures under the Standardized Approach NPR, will likely cause insurance companies concern over the amplified potential for inadvertent violations of Investor Control (especially in the absence of specific clarification from the IRS). For example, an individual within a bank, armed with security level fund data, yet unfamiliar with internal protocols regarding Investor Control, could conceivably attempt to influence a money manager's investment decisions.

The legal, tax, regulatory and risk departments within banks owning SA BOLI will likely share heightened concern regarding compliance risk arising from the availability of more granular data on investment securities. Oftentimes, banks are contractually bound by insurance companies to adhere to specific instructions relating to Investor Control (generally based on Revenue Ruling 2003-91). Prior to providing more detailed reporting, some insurance companies may require an understanding of how a bank has augmented existing Investor Control protocols and procedures.

**Non-Securitized Mortgage Pass-Throughs**

If the SA BOLI investment fund owns any residential mortgage pass-through securities that are not backed by government sponsored enterprises (e.g., FHLMC or FNMA) and do
not involve the tranching of credit risk, they would be subject to the RWA treatment for residential mortgages. Under the Standardized Approach NPR, residential mortgages are first classified as either Category 1 or Category 2 and then are risk-weighted based on the underlying loan-to-value ratios.

At present, the specific granular data needed to determine the applicable RWA for some assets within SA BOLI investment funds is not available.

If investment guidelines explicitly require that all such holdings meet Category 1 mortgage exposures criteria, would banks be able to apply a 100% (worst-case) risk-weight to those exposures?

Investment Funds with Greater than Immaterial Leverage

The Standardized Approach NPR would require banking organizations to assign a 600% risk-weight to an equity exposure to an investment firm, provided that the investment firm 1) would meet the definition of a traditional securitization were it not for the primary federal supervisor's application of paragraph (8) of that definition and 2) has greater than immaterial leverage. Paragraph (10) of the referenced definition states (emphasis added) that "The transaction is not (i) an investment fund..." The interrelationship between paragraphs (8) and (10) appears to raise ambiguities regarding whether and how they might apply to a leveraged investment fund.

Would certain investments in leveraged investment funds meet the classification requiring a 600% risk-weight or would they be exempt from this classification because of Paragraph (10) of the definition of traditional securitization? It would be helpful if the agencies clarified these aspects of the proposed rules and provided examples of securities and transactions that would be assigned the 600% risk-weight.

How do the agencies determine the amount of leverage that would be deemed "greater than immaterial" within an investment division?

Relationship between BOLI Guidance and the Standardized Approach NPR

Do the agencies intend for the proposed rules in the Standardized Approach NPR to replace the risk-weighting rules in the BOLI Guidance? More specifically, will the 20% minimum weighted average risk-weight for an SA BOLI policy continue to apply? If it continues to apply, please confirm that it applies at the level of the SA BOLI policy (i.e., a particular investment division, such as U.S. Treasury-only, may qualify for a risk-weight less than 20%) provided that the total for the applicable SA BOLI policy is no less than 20%.

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4 Paragraph (8) states: "The [AGENCY] may determine that a transaction in which the underlying exposures are owned by an investment firm that exercises substantially unfettered control over the size and composition of its assets, liabilities, and off-balance sheet exposures is not a traditional securitization based on the transaction's leverage, risk profile or economic substance."
Will a banking organization be able to utilize the Full Look-Through Approach as described in the Standardized Approach NPR or will organizations need to continue applying the look-through approaches that are currently described in the BOLI Guidance?

Again, we appreciate the opportunity to submit comments on this important rule proposal.

Sincerely,

Tradyn Foley
Vice President