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Topic: Final Volcker Rule Preserves Exception for Bank Owned Life Insurance

CITE: *AALU Letter to FSOC (Nov. 5, 2010); AALU Letter to Financial Regulators (Feb. 8, 2012)*

SUMMARY: On December 10, 2013, the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Securities and Exchange Commission, and Commodity Futures Trading Commission issued final rules (“final rules”) to implement the so-called Volcker Rule, which was enacted by Congress in section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Volcker Rule added a new section 13 to the Bank Holding Company Act of 1956 (“BHC Act”) that generally prohibits any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund (“covered fund”), including issuers that would be investment companies under the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act.

As urged by the AALU and a variety of other organizations and consistent with the proposed rule issued in October of 2011, the final rule includes provisions that allow banking entities to utilize life insurance products supported by an

unregistered separate account of an insurance company (“BOLI separate accounts”) without violating the prohibitions of the Volcker Rule. We note that the Volcker Rule prohibitions did not apply to general account life insurance products, nor to registered separate account life insurance products that do not rely upon the section 3(c)(1) and 3(c)(7) exemptions.

ANALYSIS OF BOLI EXCEPTION:

The preamble of the final rule clarifies that:

When made in the normal course, investments by banking entities in BOLI separate accounts do not involve the types of speculative risks section 13 of the BHC Act was designed to address. Rather, these accounts permit the banking entity to effectively hedge and cover costs of providing benefits to employees through insurance policies related to key employees. Moreover, applying the prohibitions of section 13 to investments in these accounts would eliminate an investment that helps banking entities to efficiently reduce their costs of providing employee benefits, and therefore potentially introduce a burden to banking entities that would not further the statutory purpose of section 13. The Agencies expect this exclusion to be used by banking entities in a manner consistent with safety and soundness.

Section __.10(c) of the final rule states:

[U]nless the appropriate Federal banking agencies, the SEC, and the CFTC jointly determine otherwise, a covered fund does not include:

(7) Bank owned life insurance. A separate account that is used solely for the purpose of allowing one or more banking entities to purchase a life insurance policy for which the banking entity or entities is beneficiary, provided that no banking entity that purchases the policy:

(i) Controls the investment decisions regarding the underlying assets or holdings of the separate account; or

(ii) Participates in the profits and losses of the separate account other than in compliance with applicable supervisory guidance regarding bank owned life insurance.

The language above—specifically, that “the separate account that is used solely for the purpose of allowing one or more banking entities to purchase a life insurance policy . . .”—appears to require that the insurance company separate accounts supporting unregistered BOLI support *only* BOLI and is therefore not permitted to also support COLI (corporate-owned life insurance) or TOLI (trust-owned life insurance).

To the extent that there are life insurance company separate accounts which do not solely support unregistered BOLI, we note that while the effective date of the final rule is April 1, 2014, banking entities have until July 21, 2015 to comply with the prohibitions on proprietary trading and covered funds.

The limitation that a banking entity may not participate in the profits and losses of the separate account “other than in compliance with applicable supervisory guidance regarding bank owned life insurance” would appear to have no effect on BOLI used for deferred compensation purposes in which the employee, not the banking entity, bore the consequences of the investment performance of the asset.

In addition, if BOLI is used to fund employee benefits more generally and the banking entity bore the consequences of the investment performance of the asset, that BOLI still would qualify for the exclusion from the definition of “covered fund”, provided that “applicable supervisory guidance” permitted the banking entity to participate in the profits and losses of the investment in such circumstances. The final rule appears to contemplate that scenario, in view of the fact that the preamble above states that a key justification for the exclusion of BOLI from the definition of “covered fund” is its use to provide employee benefits.

HOW FINAL RULE DIFFERS FROM PROPOSED RULE

The text of the final rule differs from the corresponding section of the proposed rule, section __14(a)(1), which provided:

(a) The prohibition contained in §_.10(a) does not apply to the acquisition or retention by a covered banking entity of any ownership interest in or acting as sponsor to:

(1) Bank owned life insurance. A separate account which is used solely for the purpose of allowing a covered banking entity to purchase an insurance policy for which the covered banking entity is

the beneficiary, provided that the covered banking entity that purchases the insurance policy:

- (i) Does not control the investment decisions regarding the underlying assets or holdings of the separate account; and
- (ii) Holds its ownership interest in the separate account in compliance with applicable supervisory guidance regarding bank owned life insurance.

As a general matter, the proposed rule excepts a banking entity's BOLI investment from the prescribed prohibitions on banking entities' investment activities. By contrast, the final rules except BOLI from the term "covered fund"—that is, those hedge funds or private equity funds that banking entities are prohibited from sponsoring or holding an ownership interest in. The significance of this modification is not entirely clear, but the final rules could be read to shift focus from the investment activities of the *banking entity* to the *fund* itself. Such an interpretation would place greater emphasis on the characteristics of the fund—including any conditions attached to an exception from the Rule's prohibitions.

With respect to the conditions attached to the BOLI exception, the revision to the respective subsection (ii) from the proposed rule to the final rule is notable and could be read either as less or more restrictive. The focus of this subsection was shifted as follows:

Proposed: Banking entity must hold its ownership interest in the separate account in compliance with applicable supervisory guidance regarding bank owned life insurance.

Final: No banking entity that purchases the policy may participate in the profits and losses of the separate account other than in compliance with applicable supervisory guidance regarding bank owned life insurance.

Under the less restrictive reading, the final rule may provide that while failure to comply with BOLI supervisory guidance in ways that do not relate to participation in profits or losses may have regulatory consequences, such noncompliance would not necessarily cause a banking entity to violate the Volcker Rule.

The more restrictive reading of the final rule is based not on its text, but on the fact that it chooses to focus on a criterion—participation in the profits and losses of the

separate account—that was not identified by the proposed rule as having particular significance. That new emphasis suggests that improper participation in the profits and losses has greater consequences than previously contemplated.

TAKEAWAY

As urged by the AALU and a variety of other organizations and consistent with the proposed rule issued in October of 2011, the final rule clearly permits banking entities to utilize unregistered separate account BOLI without running afoul of the Volcker Rule. However, as noted above, the exclusion from the definition of “covered fund” is not absolute and requires banking entities to comply with certain conditions when investing in BOLI. It is therefore important to examine any potential implications arising from the requirements of the final rule, including potential differences in the requirements of the proposed rule as compared to the final rule, to ensure that the BOLI exception is available.

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