BUSINESS-OWNED LIFE INSURANCE

Preliminary Observations on Uses, Prevalence, and Regulatory Oversight

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Why GAO Did This Study

Business-owned life insurance is held by employers on the lives of their employees, and the employer is the beneficiary of these policies. Unless prohibited by state law, businesses can retain ownership of these policies regardless of whether the employment relationship has ended. Generally, business-owned life insurance is permanent, lasting for the life of the employee and accumulating cash value as it provides coverage. Attractive features of business-owned life insurance, which are common to all permanent life insurance, generally include both tax-free accumulation of earnings on the policies’ cash value and tax-free receipt of the death benefit.

To address concerns that businesses were abusing their ability to deduct interest expenses on loans taken against the value of their policies, Congress passed legislation to limit this practice, and the Internal Revenue Service (IRS) and Department of Justice pursued litigation against some businesses. But concerns have remained regarding employers’ ability to benefit from insuring their employees’ lives.

This testimony provides some preliminary information from ongoing GAO work on (1) the uses and prevalence of business-owned life insurance and (2) federal and state regulatory requirements for and oversight of business-owned life insurance.

What GAO Found

GAO's preliminary work indicated that no comprehensive data are available on the uses of business-owned life insurance policies; however, businesses can purchase these policies to fund current and future employee benefits and receive tax advantages in the process. Federal bank regulators have collected some financial information on banks' and thrifts' business-owned life insurance holdings, but the data are not comprehensive and do not address the uses of the policies. The Securities and Exchange Commission (SEC), the IRS, state insurance regulators, and insurance companies told GAO that they generally have not collected comprehensive data on the sales or purchases of these policies or on their intended uses, because they have not had a need for such data in fulfilling their regulatory missions. In an effort to collect comprehensive data, GAO considered surveying insurance companies about their sales of business-owned life insurance. However, based on a pretest with six insurance companies, GAO determined that it would not be able to obtain sufficiently reliable data to allow it to conduct a survey. GAO found, however, that some insurers have voluntarily disclosed information about sales of business-owned policies and that some noninsurance businesses have included examples of their uses in annual financial reports filed with SEC.

As part of their responsibility to oversee the safety and soundness of banks and thrifts, the federal bank regulators have issued guidelines for institutions that buy business-owned life insurance. Also, they told GAO that they have reviewed the holdings of many institutions with significant amounts of business-owned life insurance and concluded that major supervisory concerns do not exist. SEC officials said that the agency has not issued specific requirements for holders of business-owned life insurance, relying instead on its broadly applicable requirement that public companies disclose information material to investors in their financial statements; SEC did not have investor protection concerns about public firms holding business-owned life insurance. The IRS had some requirements related to the tax treatment of business-owned life insurance and expressed some concerns about compliance with these requirements. State laws governing business-owned life insurance differed; the four states’ regulators that GAO interviewed described some limited oversight of the policies, and these regulators and NAIC reported no problems with them.
Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the preliminary results of GAO’s work on business-owned life insurance, done at the request of Senators Akaka and Bingaman. Business-owned life insurance—including corporate-owned, bank-owned, and trust-owned life insurance—is held by employers on the lives of their employees. The employer is the beneficiary of these policies. Some of this insurance protects against the loss of key executives—called key-person insurance—while some of it covers larger groups of employees and is called broad-based insurance. Unless prohibited by state law, businesses can retain ownership of these policies regardless of whether the employment relationship has ended. Generally, business-owned life insurance is permanent rather than term life insurance, lasting for the life of the employee and accumulating cash value as it provides coverage. Attractive features of business-owned life insurance, which are features common to all permanent life insurance, generally include both tax-free accumulation of earnings on the policies’ cash value and tax-free receipt of the death benefit.

To address concerns that businesses were abusing their ability to deduct interest expenses on loans taken against the value of their policies, Congress passed legislation to limit this practice, and the Internal Revenue Service (IRS) and Department of Justice pursued litigation against some businesses. But concerns have remained regarding employers’ ability to benefit from insuring their employees’ lives—specifically, whether (1) employers should be considered to have an insurable interest in employees’ lives that allows them to hold business-owned life insurance, (2) employers’ insurable interest should continue after the employment relationship ends and, if so, under what circumstances, (3) employers should be required to obtain their employees’ consent before purchasing business-owned life insurance, and (4) businesses should be allowed to receive tax advantages from owning these policies. Proponents of business-owned life insurance point out that, among its other purposes, businesses use these policies to fund broad-based benefits for their employees, including pre- and postretirement health care.

We currently have work underway, and today, I will provide some preliminary information on (1) the uses and prevalence of business-owned life insurance and (2) federal and state regulatory requirements for and oversight of business-owned life insurance.

To obtain this information, we analyzed the financial reports that banks filed with their regulators as well as the corporate annual financial
statements that publicly traded insurers and noninsurers filed with the Securities and Exchange Commission (SEC). In addition, we interviewed officials of the IRS, SEC, the federal bank regulators, four state insurance departments, the National Association of Insurance Commissioners (NAIC), two life insurance associations, and six life insurance companies. We began our work in February 2003, and it is still ongoing.

Summary

Based on our preliminary work to date, no comprehensive data are available on the uses of business-owned life insurance policies; however, businesses can purchase these policies to fund current and future employee benefits and receive tax advantages in the process. Federal bank regulators have collected some financial information on banks’ and thrifts’ business-owned life insurance holdings, but the data are not comprehensive and do not address the uses of the policies. SEC, the IRS, state insurance regulators, and insurance companies told us that they generally have not collected comprehensive data on the sales or purchases of these policies or on their intended uses, because they have not had a need for such data in fulfilling their regulatory missions. In an effort to collect comprehensive data, we considered surveying insurance companies about their sales of business-owned life insurance. However, based on a pretest with six insurance companies, we determined that we would not be able to obtain sufficiently reliable data to allow us to conduct a survey. We found, however, that some insurers have voluntarily disclosed information about sales of business-owned policies and that some noninsurance businesses have included examples of their uses in annual financial reports filed with SEC. As part of their responsibility to oversee the safety and soundness of banks and thrifts, the federal bank regulators have issued guidelines for institutions that buy business-owned life insurance. Also, they told us that they have reviewed the holdings of many institutions with significant amounts of business-owned life insurance and concluded that major supervisory concerns do not exist. SEC officials said that the agency has not issued specific requirements for holders of business-owned life insurance, relying instead on its broadly applicable requirement that public companies disclose information material to investors in their financial statements; SEC did not have

1“Banks and thrifts,” as referred to in this testimony, are the commercial bank and thrift institutions regulated by the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and/or the Office of Thrift Supervision. However, our testimony does not cover bank holding companies and foreign banks with domestic branches.
investor-protection concerns about public firms holding business-owned life insurance. The IRS had some requirements related to the tax treatment of business-owned life insurance and expressed some concerns about compliance with these requirements. State laws governing business-owned life insurance differed; the four states' regulators that we interviewed described some limited oversight of the policies, and these regulators and NAIC reported no problems with them.

Neither federal nor state regulators collected comprehensive data on the uses and prevalence of business-owned life insurance. Although no comprehensive data were available on the uses of such policies, businesses may purchase life insurance to ensure recovery of losses in the event of the untimely death of key employees and to fund pre- and postretirement employee benefits. Accounting standards require that the future costs of postretirement benefit plans be recorded as liabilities at their present value on current financial statements. The accounting standards do not require that such liabilities be directly offset with specified assets. However, businesses may choose to fund such future costs using life insurance, thereby becoming eligible for tax-free policy earnings and tax-free death benefit payments on the policies.\(^2\) When businesses use nonqualified plans to provide postretirement benefits, they avoid the funding and other restrictions of tax-preferred qualified plans, while retaining control over the plan assets.\(^3\)

Federal bank regulators did not collect comprehensive data on the uses and prevalence of business-owned life insurance by banks and thrifts, although they collected some financial information on such policies as part of monitoring the safety and soundness of individual institutions. Regulatory officials said that they collect this information to support their supervision of individual institutions. For supervisory purposes, banks and

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\(^2\)If a business owns life insurance policies, the earnings and death benefit proceeds are among the factors that could make the business subject to the alternative minimum tax. In general, the alternative minimum tax is based on a corporation's regular taxable income adjusted for certain tax preference income items, such as exclusions, deductions, and credits. The amount due is the amount by which the tax computed under this system exceeds a corporation's regular tax.

\(^3\)Nonqualified employee pension benefit plans, unlike qualified plans, are not subject to the requirements of the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 as to who can participate, the amount of benefits provided, and how the plan is funded. Further, in contrast to qualified employee benefit plans, the assets of nonqualified plans are not beyond the reach of a business's creditors in bankruptcy proceedings.
thrifts are only required to disclose the cash surrender value of business-owned life insurance and earnings from these policies in their quarterly financial reports to the regulators if the amounts exceed certain thresholds. For example, the Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board, and Office of the Comptroller of the Currency (OCC) require the institutions they regulate to disclose the cash surrender value of policies worth more than $25,000 in aggregate and that exceed 25 percent of “other assets,” which include such items as repossessed personal property. The Office of Thrift Supervision (OTS) requires the thrifts it supervises to report the cash surrender value of policies if the value is one of the three largest components of “other assets.” In addition to the banks and thrifts that meet a disclosure threshold, other institutions sometimes voluntarily provide data on their business-owned life insurance policies.

Our preliminary results indicated that about one-third of banks and thrifts, including many of the largest institutions, disclosed the value of their business-owned life insurance holdings as of December 31, 2002, either voluntarily or because they met the reporting threshold. The remaining two-thirds either did not meet the reporting threshold or did not own business-owned life insurance. We found that 3,209 banks and thrifts (34 percent of all institutions) reported the cash surrender value of their policies at $56.3 billion. Twenty-three of the top 50 banks and thrifts—ranked by total assets—reported owning policies worth $36.9 billion, or 66 percent of the reported total of all banks and thrifts. Overall, 259 large banks and thrifts—those with assets of $1 billion or more, including those among the top 50—held 88 percent, or $49.4 billion, of the total reported cash surrender value of business-owned life insurance.

The quarterly reports that commercial banks and FDIC-supervised thrifts submitted did not require them to categorize business-owned life insurance policies according to their intended use. OTS-supervised thrifts, in contrast, were required to report the value of their key-person policies and the value of business-owned life insurance policies held for other

4FDIC, the Federal Reserve Board, and OCC regulate commercial banks, and FDIC regulates some thrifts.

5The data do not include bank holding companies or foreign banks with domestic branches. The Federal Reserve Board started collecting data on business-owned life insurance from bank holding companies in 2003, but the data were not available at the time of our analysis. The federal bank regulators did not collect business-owned life insurance data on foreign banks with domestic branches.
purposes as separate items, if they met the reporting threshold. However, since the disclosure threshold applied separately to the two categories, OTS-supervised thrifts could be required to report on only one type of policy, rather than the total value of their business-owned life insurance holdings, even if they held both key-person and other policies.\(^6\)

According to SEC, agency regulations do not specifically require public companies to disclose the value or uses of business-owned life insurance in the financial statements submitted to the agency. The federal securities laws that SEC administers are designed to protect investors by requiring public companies to disclose information that is “material” to investors in their financial statements—that is, according to SEC, information that an investor would consider important in deciding whether to buy or sell a security or in making a voting decision related to a security that the investor owns. SEC officials said that for most companies, business-owned life insurance holdings are not likely to be material to the company’s financial results, and therefore would not be subject to SEC reporting requirements.

IRS officials told us that the agency has not collected comprehensive information on the value of or income from business-owned life insurance policies, and agency officials said that they do not need this information. Specifically, businesses are generally not required to include the earnings or death benefits from business-owned life insurance in their taxable income. Businesses that are subject to the alternative minimum tax include income from death benefits and earnings from insurance when calculating the tax, but they are not required to list the insurance-related values or the uses of the policies on the alternative minimum tax form. Also, businesses that are required to complete Schedule M-1, Reconciliation of Income (Loss) per Books with Income per Return, as part of their Form 1120, U.S. Corporation Income Tax Return, would report earnings on business-owned life insurance as part of the income recorded on their books but not on the tax return. However, according to IRS officials, these earnings might not be separately identified as they are often “lumped” with other adjustments.

\(^6\)OTS has proposed requiring all the thrifts that it supervises to report the value of both their key-person and other business-owned life insurance policies, beginning in 2004. “Proposed Agency Information Collection Activities; Comment Request—Thrift Financial Report,” OTS, 68 Fed. Reg. 3318 (Jan. 23, 2003).
State insurance regulators, concerned with state requirements, rates, and solvency issues, have collected extensive financial information from insurers, but not at the level of detail that would describe the uses or prevalence of business-owned life insurance policies. State insurance regulators use insurers’ financial statements to monitor individual companies’ solvency, and aggregate information on business-owned life insurance has not, in state regulators’ views, been necessary for such monitoring. Insurers’ financial statements list the number of all policies in force and premiums collected during the reporting period, but broken out only by individual and group policies, not by whether businesses or individuals owned the policies.

In an effort to compile more comprehensive data on business-owned life insurance, we worked with the representatives of six insurance companies and the American Council of Life Insurers (ACLI) to develop a survey of the uses and prevalence of business-owned life insurance sales. Although the insurance companies’ representatives cooperated in a pretest of the survey, and ACLI representatives said that they would encourage their members to participate in the survey itself, the results of the pretest led us to conclude that we would not be able to obtain sufficiently reliable data to allow us to conduct the survey. These representatives told us that they do not have a business need to maintain the comprehensive data on business-owned life insurance that we needed for the survey. They said that insurers do not routinely summarize information on the numbers of policies and insured individuals, cash surrender value of policies, and uses of business-owned life insurance. They explained that various factors made it difficult to obtain summary information, including that individual businesses may own multiple policies; that the same individuals may be insured under multiple policies; and that when purchasing policies, businesses may state multiple policy uses or policy uses may change over time. They also explained that extensive efforts would be required for insurance companies to obtain information from their computer systems and, in some cases, paper files to identify business-owned policies on employees where the business is also the beneficiary.

7In commenting on this testimony, New York state insurance regulators said that while they did not collect detailed information on the prevalence or uses of business-owned life insurance, information about insurers that have a high volume of business-owned life insurance sales would be useful to them in conducting market conduct examinations. They also referred to survey data that they have collected since 2000 on business-owned life insurance, and we have requested this information from them.
Our preliminary review of the financial statements of 32 life insurance companies that filed 10-K annual reports with SEC and that were among the 50 largest such companies ranked by assets, disclosed some information on business-owned life insurance. Although SEC did not require insurance companies to identify business-owned life insurance sales in their annual statements to the agency, nine insurers reported over $3 billion in business-owned life insurance premiums from 2002 sales. Five of the insurance companies also reported that total premiums from 2002 business-owned life insurance premiums ranged from 10 to 53 percent of each company’s 2002 total life insurance sales premiums. In addition, three insurance companies reported the value of their business-owned life insurance assets as totaling about $28 billion as of December 31, 2002.

Insurance companies have also reported business-owned life insurance sales in response to industry surveys. CAST Management Consultants, Inc., conducts research on business-owned life insurance and, in a summary report, estimated 2002 annual business-owned life insurance premiums of $2.1 billion, based on the survey responses of 20 insurance carriers increased by CAST adjustments. CAST representatives declined to provide us any information about the complete survey, which is available only to “qualified market participants.” We could not, therefore, determine whether CAST was able to collect the information we sought to obtain by conducting our own survey. In addition, a representative of the A.M. Best insurer rating company said that the company collects information on business-owned life insurance, but does not currently report the data. A.M. Best reported aggregate premiums from business-owned life insurance for 1998 (the last year for which it reported data) as more than $10 billion for 20 large insurers.

Some businesses included anecdotal information about how they intended to use business-owned life insurance in the annual financial statements they filed with SEC. Our preliminary analysis of 100 randomly selected Fortune 1000 public companies’ financial statements filed with SEC showed that 15 of the selected businesses referred to owning such policies, including 11 that provided information about their intended uses of the policies. The most commonly cited use of business-owned life

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insurance was to fund deferred executive compensation. One business reported using policies to help fund postretirement health care benefits, and another reported using the policies to help fund an employee benefit plan for management employees as well as executives.

Some businesses have also provided survey responses on their uses of business-owned life insurance to fund executive benefit plans. Clark/Bardes Consulting conducts an annual executive benefits survey and reports on the uses of business-owned life insurance by companies to fund nonqualified deferred compensation plans and supplemental executive retirement plans. In the 2002 results from its survey of Fortune 1000 corporations, Clarke/Bardes reported that 65 percent of those companies that fund nonqualified deferred compensation plans and 68 percent of those that fund nonqualified supplemental executive retirement plans do so using business-owned life insurance.

Finally, the federal government estimated that the current tax exclusion of earnings on the cash value of business-owned life insurance results in over a billion dollars in foregone tax revenues annually—these estimates do not reflect the exclusion of additional income from death benefit payments. In its “Estimates of Federal Tax Expenditures for Fiscal Years 2003-2007,” the Joint Committee on Taxation estimated that the foregone tax revenues resulting from the tax exclusion of investment income on life insurance for corporations would total $7.2 billion for 2003 through 2007. Similarly, the Office of Management and Budget, in its fiscal year 2004 budget “Analytical Perspectives,” estimated foregone tax revenues of $9.3 billion for 2003 through 2007 resulting from the tax exclusion of life insurance.

SEC requires companies to disclose information pertaining to the compensation of top officers. Therefore, the fact that companies most frequently disclosed the use of business-owned life insurance to fund executive compensation does not mean that this is necessarily the most common use of such policies.
Regulators Had Guidelines or Requirements Applicable to Business-Owned Life Insurance but Did Not Identify Significant Regulatory Concerns

The federal bank regulators, SEC, the IRS, and state insurance regulators had guidelines or requirements applicable to business-owned life insurance but did not identify significant regulatory concerns. The federal bank regulators had guidelines for purchases of business-owned life insurance by banks and thrifts. OCC and OTS guidelines describe the permissible uses of business-owned life insurance and require national banks and OTS-supervised thrifts to perform due diligence before purchasing policies and to maintain effective senior management and board oversight. According to agency officials, FDIC and the Federal Reserve Board follow OCC’s guidelines. The guidelines that are common among the regulators state that banks and thrifts can only purchase life insurance for reasons incidental to banking, including key-person insurance, insurance on borrowers, and insurance purchased in connection with employee compensation and benefit plans. Before purchasing policies, a bank’s or thrift’s management must conduct a prepurchase analysis that should, among other things, determine the need for insurance, ensure that the amount of insurance purchased is not excessive in relation to the estimated obligation or risk, and analyze the associated risks and the bank’s or thrift’s ability to monitor and respond to those risks. The guidelines also state that a bank or thrift should consider the size of its purchase of business-owned life insurance relative to the institution’s capital and diversify risks associated with the policies. The guidelines require banks and thrifts to document their decisions and monitor their policies on an ongoing basis. In addition, banks and thrifts using business-owned life insurance for executive compensation should ensure that total compensation is not excessive under regulatory guidelines.

The federal bank regulators we spoke with said that their risk-based examination programs target any aspect of banks’ and thrifts’ purchases of business-owned life insurance that would raise supervisory concerns. The regulators monitor institutions’ safety and soundness through their risk-based examinations, which they said assess banks’ and thrifts’ compliance with guidelines on business-owned life insurance on a case-by-case basis. For example, all of the regulators said that if the value of the policies exceeded 25 percent of the regulator’s measure of the institution’s capital, they would consider whether further supervisory review or examination of

these holdings was warranted. The regulators said that additional review or examination would be likely if the policies were held with one or very few insurers.

As of December 31, 2002, 467 banks and thrifts reported business-owned life insurance holdings in excess of 25 percent of their tier 1 capital. We asked the bank regulators to explain their oversight of 58 institutions with the largest concentrations, all in excess of 40 percent of tier 1 capital. Bank regulatory officials said that their agencies were monitoring these institutions’ levels of holdings, had conducted preliminary reviews or detailed examinations, and concluded that major supervisory concerns do not exist.

SEC officials said that the agency’s regulations for public companies do not specifically address business-owned life insurance; rather, SEC has relied on its broadly applicable disclosure requirements to surface any investor protection concerns. SEC requires public companies to prepare their financial statements in accordance with generally accepted accounting principles (GAAP), which would require them to disclose information about business-owned life insurance policies when such information is material. According to SEC officials, however, following GAAP would rarely require purchases of and earnings from business-owned life insurance to be shown as separate line items because they typically are not financially material to the company. SEC officials also said that the agency would have an oversight concern if it became aware of a public company’s failure to disclose material purchases of or earnings from business-owned life insurance, or if problems developed in accounting for these policies. However, they said that, to date, such problems have not arisen, and they have not had investor-protection concerns about public companies holding such insurance.

The IRS had some requirements related to the tax treatment of business-owned life insurance. The Internal Revenue Code defines life insurance for tax purposes and sets out the current limitations on permissible tax deductions that businesses can claim for the interest on policy loans against life insurance policies. Federal laws and IRS regulations have changed some aspects of the tax treatment of business-owned life insurance.

The ratio of cash surrender value to tier 1 capital illustrates the institution’s overall exposure to risk, including credit risk (the risk of counterparty default), since tier 1 capital is a measure of the equity cushion that banks have available to absorb loss, including credit losses from their holdings of business-owned life insurance.
insurance. While policy owners may access the cash value of their policies by borrowing against them, policy owners’ ability to deduct the interest on such loans was limited by the Tax Reform Act of 1986 and further limited by the Health Insurance Portability and Accountability Act (HIPAA) of 1996, which amended Internal Revenue Code section 264.\(^\text{13}\) Before these limitations, some businesses were leveraging their life insurance ownership by borrowing against the policies to pay a substantial portion of the insurance premiums. Known as leveraged business-owned life insurance, these arrangements created situations where businesses incurred a tax-deductible interest expense while realizing tax-free investment returns.\(^\text{14}\) Various sources have reported that HIPAA curtailed new sales of leveraged policies, although such policies that were purchased in the past remain part of the life insurance policies currently in force. However, IRS officials expressed concern that HIPAA did not eliminate the tax arbitrage opportunities available through business-owned life insurance and that banks and other highly leveraged financial institutions may be indirectly borrowing to purchase policies on employees.\(^\text{15}\) IRS officials said that the agency is also concerned that banks are using separate account policies to maintain control over investments in a way that is inconsistent with the Internal Revenue Code.\(^\text{16}\) These

\(^{13}\)The limit on interest deductibility does not apply to policies purchased before June 20, 1986.

\(^{14}\)In addition to the legislation addressing leveraged business-owned life insurance plans, the IRS and Department of Justice prevailed in three cases involving the proper treatment of loan interest related to such plans. These plans covered over 55,000 employees. The courts found that the leveraged plans lacked economic substance, making the interest deduction unallowable. See In re C.M. Holdings, Inc., 301 F.3d 96 (3rd Cir. 2002); Am. Elec. Power v. United States, 326 F.3d 737 (6th Cir. 2003); Winn Dixie Stores v. United States, 254 F.3d 1313 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002). The taxpayer prevailed in a fourth case. See Dow Chemical Co. v. United States, 250 F Supp. 2d 748 (E.D. Mich. 2003).

\(^{15}\)The Congressional Research Service has reported that businesses could use overall indebtedness to indirectly support tax-preferred investment in business-owned life insurance. Since debt is fungible and businesses can deduct interest expenses to support investments, some businesses may borrow for purposes unrelated to life insurance and thereby have funds available to purchase these policies. Under such circumstances, it would be difficult to distinguish debt that is used to finance business-owned life insurance from that which is not. Congressional Research Service, The Library of Congress, Corporate-Owned Life Insurance: Tax Issues (Washington, D.C.: updated June 26, 2003). Congressional Research Service, The Library of Congress, Taxation of life Insurance Products: Background and Issues (Washington, D.C.: July 18, 2003).

\(^{16}\)In separate account life insurance, an asset account is maintained independently from the insurer’s general investment account. This arrangement permits wider latitude in the choice of investments, particularly equities.
officials said that the agency is continuing to study these business-owned life insurance issues at selected banks. Finally, in September 2003, the IRS issued final regulations on the tax treatment of split-dollar life insurance policies—policies in which the employer and employee generally share costs and benefits. Under the regulations, corporations cannot provide tax-free compensation to executives using split-dollar policies.

State law requires that one party have an insurable interest in another to be able to take out a life insurance policy on that person and defines the conditions for one party to have an insurable interest in the life of another person. Historically, insurable interest related to a family’s dependency on an individual and a business’s risk of financial loss in the event of the death of a key employee. The significance of employers having an insurable interest in their employees is illustrated by the 2002 decision of a federal district court in Texas. The court found that Wal-Mart did not have an insurable interest in employees’ lives under Texas law, given the nature of the policies taken out on each of 350,000 Wal-Mart employees, and that under Texas law, Wal-Mart could not collect on the death benefits paid under policies covering deceased employees.17

NAIC, a membership organization of chief state insurance regulators that helps promote coordination among the states, initially developed model guidelines for business-owned life insurance in 1992 and revised them in 2002. The 1992 guidelines suggested that states consider including in their laws provisions that recognize employers’ insurable interest in employees, including nonmanagement employees who could expect to receive benefits. The 2002 revision added a recommendation for states to consider requiring employee consent to be insured and prohibiting employers from retaliating against employees who refused to grant their consent.

Since NAIC adopted the revised guidelines, several states have passed legislation requiring employers to obtain employees’ written consent before taking insurance on them. In some states consent provisions apply to life insurance policies in general, while in others these provisions specifically address business-owned life insurance. Our preliminary analysis indicated that, as of July 31, 2003, more than 30 states required written consent, including several states with provisions specific to

17Mayo, et al., v. Hartford Life Insurance Company, et al., 220 F. Supp.2d 794 (2002). Texas law on insurable interest was changed after Wal-Mart purchased the policies in question to grant an insurable interest to third parties who take out life insurance on those giving informed consent.
business-owned life insurance. However, most of these states exempted group life insurance policies from consent requirements. Also, in some states consent requirements were satisfied if an employee did not object to a notice of the employer’s intent to purchase a policy. Additionally, at least one state required employers to notify employees when purchasing business-owned life insurance, but did not require employee consent.

Officials of NAIC and four state insurance departments—California, Illinois, New York, and Texas—stated that, in recent years, some state legislatures adopted laws broadening the definition of employers’ insurable interest to include broader groups of employees in order to permit using business-owned life insurance to finance employee benefit programs, such as current employee and retiree health care. The officials said that such laws responded in part to Financial Accounting Standard 106, which took effect in 1992 and requires businesses to report the present value of future postretirement employee benefits as employees earn them. Also, our preliminary analysis showed that several states limit the aggregate amount of insurance coverage on nonmanagement employees to an amount commensurate with the business’s employee benefit liabilities. In addition, a few states recognize an employer’s insurable interest in employees, provided that businesses use the proceeds solely to fund benefit programs.

Insurance department officials from the four states also told us that they primarily address compliance with their respective laws through a review of the proposed policy forms that insurers must submit for approval before marketing policies in their states. For example, in New York, the insurance department developed a checklist of items that must be included on forms that will be used for business-owned life insurance policies to ensure that the forms comply with the state’s notification, consent, and other requirements. While NAIC officials said that state insurance regulators would generally have the authority to review policies currently in force for compliance with any state requirements, the officials from the four states said that they had not examined policies sold to confirm that employees consented to be insured or, where applicable, to test whether the amounts of coverage were appropriate. Officials in the four states said that their departments would investigate business-owned life insurance sales through their market conduct examinations of insurers
if they observed a pattern of consumer complaints about such sales.\footnote{New York insurance department officials said that other factors might also cause the department to investigate an insurer. For example, they said that the department would investigate, as part of its market conduct examinations, insurers that sell a significant amount of business-owned life insurance.} However, the officials said that generally they had not received complaints about business-owned life insurance. Also, NAIC officials told us that the organization maintains a national database of consumer complaints made to state insurance regulators and that business-owned life insurance has not been a source of complaints.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have at this time.
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