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Should Banks' Investment Menus Continue to Feature BOLIs in Light of the 2023 Crisis?

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This article is the first in a series that will provide the ingredients readers need to gather to reveal whether bank-owned life insurance (BOLI) is right for their bank. Over the series of articles, the authors will review this topic by examining the "what," "where," "who," "how," and "why" of BOLI.

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While the intensity of last spring's banking crisis may have lessened to the degree that it is no longer dominating the news cycle, many economic pundits remain concerned that it is premature to give the "all's clear" sign. Given the current economic and political climate (i.e., with financial markets remaining under stress in several sectors and policymakers and regulators weighing options to prevent similar crises in the future), now may be a prime time for banks to proactively review their operations and investments – including that familiar financial institution favorite, bank-owned life insurance (BOLI).

There certainly are many reasons a bank's decision-makers may have a taste for BOLI, but a careful analysis of many factors is needed to determine whether such investment will prove to be a savory piece of the bank's portfolio rather than a potential cause of "asset indigestion."

This article is the first in a series that will provide the ingredients readers will need to gather for a recipe to reveal whether BOLI is right for their bank. Over the series of articles, the series will serve readers with a review of this topic by examining the "what," "where," "who," "how," and "why" of BOLI.

This first article addresses the fundamental question: "What is BOLI?" In doing so, we will review the three basic BOLI "flavors" as well as the modified endowment contract option and describe the advantages and disadvantages of each approach. In addition, this article will review the difference between experience-rated versus pooled mortality designs.

WHAT IS BOLI?

BOLI is a type of permanent life insurance that banks may purchase on the lives of their key executives, board members, or other individuals in which the banks have an insurable interest. Frequently, though not always, banks use BOLI to help fund costs of providing employee benefits. For many years now, the majority of the nation's largest financial institutions have used BOLI. More recently, there has been a surge in BOLI use among midsize banks and thrifts as well as community banks throughout the country.

Although there are many flavors of BOLI contracts (discussed in more detail below), the defining characteristic of BOLI is that the policyowner and the insured life are different entities. The bank is the policyowner and beneficiary of the policy; the insured life is, as mentioned above, generally an employee, executive, or board member of the bank. Banks, therefore, have direct financial control over the cash flows of the policy. They control (within limits defined in the contract) when and how much premium is paid. They also control the use of any benefits, loans, or other proceeds paid from the policy. The benefits (or other cash flows) from the policy can be used to fund employee benefits, to directly cover costs associated with loss of key personnel, or to fund any other cash flow needs of the bank.

The U.S. Department of the Treasury's Office of the Comptroller of the Currency (OCC) has stated that banks can purchase BOLI in connection with employee compensation and benefit plans, key person insurance, insurance to recover the cost of providing pre- and post-retirement employee benefits, insurance on borrowers, and insurance taken as security for loans.[1] BOLIs allow for tax-free growth in cash value if held until the employee dies. Death benefits from BOLI are generally tax-free under Internal Revenue Code (IRC) Section 101(a).[2] However, IRC Section 101(j) was added by the Pension Protection Act of 2006 after companies were seen to be abusing the tax shelter benefits of company-owned insurance by insuring as many people as possible. Accordingly, IRC Section 101(j) generally requires insuring only officers, directors, or "highly compensated" employees[3] and obtaining insured consent in order for the death benefit to be tax-free.[4] Employer-owned life insurance is also subject to certain annual reporting requirements.[5]

BOLIs are accounted for under Financial Accounting Standards Board (FASB) Technical Bulletin 85-4, where the asset is recorded at the cash surrender value with annual changes in value recorded on the income statement as "other income."[6] Upon death, death benefits are treated as cash receipts and income on the balance sheet. Hence, BOLIs affect the corporate balance sheet and income statement, which are issues the company needs to take into account when considering the type of policy to adopt.

The use of BOLI benefits will be discussed in a subsequent article.

THREE BASIC BOLI FLAVORS

While there is a plethora of permanent life insurance options (e.g., whole life, universal life, variable life, indexed life, variable universal life), BOLI policies are typically served as one of the following: general account (GA), separate account (SA), or that "combo platter" known as a hybrid account.

General Account (GA)

These were the first institutional BOLI products to attain mass portfolio appeal and they remain a very popular choice today. Under this approach, the entire policy's cash surrender value (CSV) is held within the insurance carrier's general account (i.e., the principal and interest are direct obligations of the insurer) and the carrier makes all investment decisions. These types of policies assume the general assets of the insurance company will support the policy's CSV. The CSV grows over time in a reliable and predictable way. For traditional whole life products, the CSV grows with interest and premium in a manner contractually defined in the insurance policy. For other policies (e.g., universal life), the account value may grow with premium and credited interest and is reduced for cost of insurance charges and other expenses. Some GA products provide for flexible premium payments (within certain defined limits), bringing an element of investor discretion or flexibility to the product, even though the insurer retains direct control over investment of the assets. In most or all cases, GA policies contain loan provisions, which allow the owner to extract value from the policy before the death is paid or the policy matures.

Most carriers' GA portfolios typically consist of high-quality corporate bonds and collateralized mortgages. Fairly clear-cut and reasonably easy to understand, these products typically provide minimum interest rate guarantees generally credited on a quarterly or annual basis. The net rates credited reflect the overall earnings of an insurance company's general account, as well as any expenses associated with the policies. Because these policies are backed by the general account of the insurance company, potential buyers should exercise due diligence by checking the credit quality of potential carriers before selection. At the same time, however, general account insurance contracts are backed by state guaranty associations, which provide protection, up to a certain dollar limit that may vary by state, to the policyowner (in this case, the bank) in the event of an insurer insolvency. The guaranty association protection is similar in many ways to deposit insurance provided by the Federal Deposit Insurance Corporation (FDIC).

From the perspective of the insurance company, the interest rate spread – i.e., the difference between the return the insurer earns on assets backing the product and the interest return credited to the policyowner's account – constitutes a substantial source of profit to the carrier. Insurers, therefore, in an effort to maximize interest spread while still controlling investment risk, carefully manage how they credit interest to policyowner accounts, subject to any minimum guarantees specified in the insurance contract. The two primary methods for crediting interest to policyowners under the GA selection are as follows:

(1) "New money" product returns reflect current interest yields available at plan inception. Over time, the underlying assets, or a proxy portfolio that reflects them, are tracked to determine future crediting rates.

(2) "Portfolio" product typically reflects the returns of assets backing a broad group of policies and provides the same rate for all policies.

The differences in renewal crediting rates between these two crediting philosophies can be substantial in early plan years, but typically diminish over the life of the policies.

GA Pros

- Insurance companies take most of the associated risks (i.e., credit risk on assets backing the insurance policy, interest rate risk, and default risk), with the portfolio of investments supporting the policy CSV.

- The policyowner (the bank) has broad discretion over how to use the benefits or other cash flows from the policy.

- GA policies generally feature interest rate guarantees – that is, the interest credited to the cash surrender value can never drop below the guaranteed level stated in the contract. This provides a reliable source of return on investment, even in volatile capital markets.

- The value of the life insurance policy to the owner (the bank) is reported at the CSV of the policy. For traditional life products, CSVs are formulaically determined and locked in at the inception of the contract. They are not subject to change due to underlying capital market conditions – e.g., interest rates. For universal life policies, the CSVs follow defined rules for interest crediting and cost of insurance charges, making the CSV relatively stable and predictable over time. Banks can, therefore, account for the policy CSV without any profit and loss (P&L) volatility from reporting period to reporting period.

- Banks have broad discretion over how the benefits or other cash proceeds from the policy can be used.

GA Cons

- Banks accept a long-term credit exposure to a single counterparty (to the extent the face amount of the policy exceeds the coverage provided by state guaranty associations) while having very little influence over the policy's economic performance.

- The CSV is an unsecured obligation of the insurance company and is available to the general creditors of the insurance company in the event of bankruptcy.

- GA policies are not a fully liquid investment in the sense that there is little secondary market for buying and selling insurance protections. Access to liquidity is provided in the form of policy loans (which must be repaid or else the insurance protection of the contract is eroded), surrender of the policy, or death of the insured life.

- Banks have little or no direct control over how the assets backing the policy are invested.

Separate Account (SA)

With this option, the issuing insurance carrier establishes an account that is legally segregated from its general account. Premiums are invested in the separate account in investments managed by fund managers and the policyowner bears some of the investment risks, subject to certain guarantees that may be provided by the insurer (for example stable value protection (SVP), which is described in greater detail under the SA Pros section below). Policyowners exercise a large degree of discretion over how much is paid in premium (subject to tax qualification and other limits discussed later) and how the assets are invested.

The returns of these policies reflect assets in a segregated account that is not subject to the general creditors of the insurance company. Plan returns are subject to market fluctuations (again, subject to any guarantees provided by the insurer on the account value of the policy), but can also generally generate a higher return than is available on GA products. With a separate account product, the policyowner bears some of the risk of default of assets in the separate account.

SA Pros

- Policy expenses are more transparent and generally lower for SA than GA BOLI.

- Because the SA funds are separate from the insurer's GA, these funds are protected from the general creditors of the insurance company.

- Offers bankers the opportunity to utilize diversification or targeted strategies by providing them with several asset class choices, the ability to diversify their assets within the same product, and transfer assets between SAs (albeit typically with some restrictions as to the amount and timing for transfers).

- Greater product transparency because of the manner in which the product is built and its securities disclosure regulations (i.e., a banker is able to get a better understanding of not only where the bank's money is being invested, but also what charges are deducted from the investment).

- As mentioned above, SA policies may come with an SVP wrap baked into the policy, which reduces investment volatility in SA BOLI by "smoothing" the returns of the underlying portfolio. In general, under an SVP contract, the provider sets an initial crediting rate based on the yield to worst of the underlying portfolio(s), which is reset periodically (monthly or quarterly) according to a contractually set formula. Under the terms of these contracts, the SA policyowner is paid any shortfall between the fair value of the separate account assets when surrendering the policy and the cost basis of the separate account to the policyowner, thereby enabling the policyowner to account for BOLI at book value. SVP contracts are most often used to mitigate price risk in connection with fixed-income investments.

SA Cons

- SAs are more complex to manage because, when accounting for them, the bank must carefully review the policy to determine the market value of the actual investments held in the SA. As a result, interest rate risk causes market value fluctuations daily, resulting in P&L volatility (unless utilizing a stable value wrap). Because BOLI must be carried at the amount that could be realized under the insurance contract as of the balance sheet date, if any contractual provision related to costs, charges, or reserves creates uncertainty regarding the realization of a policy's full CSV, governing agencies will require an institution to record the BOLI net of those amounts. Accordingly, as part of an effective prepurchase analysis, an institution should thoroughly review and understand how the accounting rules will apply to the BOLI policy it is considering purchasing. Failing to do so could result in the institution having to restate its earnings because of contractual provisions in its policies that were ambiguous with respect to the amount of the CSV available upon surrender of the policy.

- While providing some measure of protection, the inclusion of SVP will increase the above-referenced added complexity of the SA.

- Unlike most GA policies, some SAs don't have a minimum guaranteed interest rate and are often invested in long-term investments that may not be suitable for all investors because they are subject to fluctuating values of the underlying investment options and entail risk, including the possible loss of principal. On the other hand, some SA products do offer "secondary guarantees" that provide some level of protection to the policyowner in the event of adverse market movements.

- If there is a third-party stable wrap provider, the stable wrap portion has credit risk associated with the third-party wrap provider. SA policies may also offer lower risk-based weighting account options (as low as 20%), which solidifies a bank's risk-based capital (RBC) ratio and frees up capital for other purposes.

Hybrid Account

Combining certain features of both the GA and SA policies, hybrids are non-variable products invested in a duly established separate account with the objective of reducing direct counterparty/credit risk. The aim of these hybrid policies is to provide the creditor protection and investment choice of a separate account BOLI with the minimum guaranteed rate of a general account BOLI. The crediting rate is based on the underlying yield of the assets held in the overall portfolio. Hybrid products do not have a stable value wrap, are not classified as securities products, and offer a minimum guaranteed interest rate. Similar to SA options, hybrid products typically have various investment portfolios to choose from, and each invests in securities and other assets according to specific investment objectives and guidelines.

Hybrid Pros

- Because they have separate accounts to hold funds, in the event of carrier bankruptcy the assets would be protected from the credit risk of the carrier.

- Many hybrid products offer lower RBC weightings and have greater product transparency when compared to GA products.

Hybrid Cons

- The insurance carrier establishes and periodically adjusts a crediting rate and there is generally little, if any, ability to adjust allocation objectives over time.

- Stable value wrap is not available.

ADDITIONAL BOLI CONSIDERATIONS

To MEC or Not to MEC

Permanent whole life insurance can be purchased either as a modified endowment contract (MEC) or as non-MEC. Each has significantly different death benefit, liquidity, and tax treatment characteristics.

Generally speaking, a MEC is viewed by tax authorities as being primarily an investment vehicle, not insurance protection. MECs are generally policies where the cumulative premium paid exceeds certain limits under the IRC and usually has the premium paid in a single premium up-front rather than having annual premiums.[7]

MECs are not subject to the same degree of favorable tax treatment as non-MECs. While death benefits for MECs are tax-free, loans or distributions upon surrender of the policy prior to age 59 1/2 are taxable and subject to a 10% penalty similar to early distributions from an IRA.[8]

In determining such tax, all MEC policies issued in the same calendar year from the same insurance carrier to the same policyholder are aggregated.[9] Nevertheless, there are some tax advantages and certain

FIGURE 1: RELATIVE TAX TREATMENT

Life Insurance (non-MEC)	Modified Endowment Contracts
Tax-free growth of interest and dividends	Tax-deferred growth of interest and dividends
Tax-free use of growth of cash value	Growth of cash value is taxed when used prior to age 59 1/2
Tax-free policy loans	Taxable policy loans
Tax-free retirement income	Taxable retirement income
Income tax-free death benefit	Income tax-free death benefit
Estate tax-free death benefit	Estate tax-free death benefit

other benefits that may make these contracts appealing depending on the purchaser's goals.

Figure 1 shows a quick side-by-side comparison of the relative tax treatment of each approach.

A non-MEC, on the other hand, is considered to be an insurance vehicle and generally qualifies for favorable tax treatment. A non-MEC usually entails a substantially lower up-front cost, which should be attractive to companies with liquidity issues, and does not have the tax penalties for loans or early distributions of cash value.

The responsibility for maintaining a life insurance product's qualification as a non-MEC generally falls on the insurance company (not the bank/policyowner). However, banks should carefully consider the design of the policy – e.g., MEC versus non-MEC – when deciding which BOLI policies to purchase.

MORTALITY DESIGNS: EXPERIENCE-RATED VERSUS POOLED MORTALITY

In pooled mortality or "non-experience-rated" plans, the carrier retains all of the mortality risk charge, commonly referred to as a cost of insurance (COI) charge, and thus must pay the portion of the death benefit exceeding CSV (excess over CSV) from its general assets. When a claim paid to a bank includes any such excess over CSV, it results in incremental earnings for the bank during that reporting period.

Experience rating allows banks to benefit directly from favorable mortality experience in their business. Thus, a company may use an "experience-rated" policy if it thinks its mortality experience will be better than the general mortality pool used in non-experience-rated plans. Under "experience-rated" policies, virtually all of the COI is accumulated in a mortality reserve used to pay claims. Because this reserve is an asset of the bank as policyowner (i.e., not the insurance company), when a claim is paid there is rarely a measurable increase in the bank's P&L earnings.

However, some people have questioned whether experience-rated arrangements do not have sufficient transfer of risk to qualify as insurance and have the tax benefits of insurance under the IRC.[10]

NOTES

1. https://www.investopedia.com/terms/l/loan.asp; see OCC 2004-56, December 2004.

2. See IRC Section 101(a).

3. See IRC Section 101(j). "Highly compensated" employee is as defined under IRC Section 414(q), including independent contractors, or a highly compensated individual within the meaning of IRC Section 105(h)(5), substituting "35%" for "25%".

4. Ibid.

5. See IRC Section 6039I(a). See Notice 2009-48 for additional guidance on disclosure requirements.

6. See FASB Technical Bulletin 85-4, Accounting for Purchases of Life Insurance.

7. See IRC Section 7702 for the rules that make a policy a MEC.

8. See IRC Section 7702 and 72.

9. See IRC Section 72(e)(12).

10. See "Effects of Experience Rating of COLI/BOLI Programs," June 2020, Society of Actuaries Product Matters!, and "A Primer on Corporate-Owned Life Insurance Including Rabbi Trust-Owned Life Insurance," Aon Consulting, 2008, for detailed discussions of "experience-rated" and "non-experience-rated" plans.

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