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

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This article is the second 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, among other things, the "what," "where," "who," "how," and "why" of BOLI.

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While the intensity of this 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).

While there are certainly many reasons why a bank's decision-makers may have a taste for BOLI, 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."

Our first article, published in the Autumn 2023 issue of *Benefits Law Journal*, addressed the fundamental question, "What is BOLI?," by reviewing the three basic BOLI "flavors" as well as the modified endowment contract option, describing the advantages and disadvantages of each approach and reviewing the difference between experience-rated versus pooled mortality designs.

This second article reveals the remainder of the ingredients (i.e., the "where," "who," "how," and "why") for the recipe banks will need to determine if BOLI is right for their bank.

Future articles will cover such topics as COLI management strategies, actuarial issues, and provide a "due diligence" BOLI recipe that banks can follow to create a gourmet BOLI mix that blends well with their culture, objectives and other investments.

WHERE IS BOLI?

According to Federal Deposit Insurance Corporation (FDIC) data:

- There are currently over 4,100 insured commercial banks within the United States;

- Among the banks with assets less than $100 million, approximately 40% utilize bank-owned life insurance as an employee benefits funding or investment strategy; and

- Among the banks with assets equal to or more than $250 million, this percentage is anywhere between 70% to 80%.[1]

BOLI products are available from most of the major carriers, including but not limited to MetLife, MassMutual, Guardian, New York Life,

John Hancock, Lincoln National Corporation, Ohio National, and Prudential. When it comes to BOLI, such larger insurers are generally better equipped to purchase and provide exposure to a wider range of diversified assets, which contribute to the portfolio's yield and BOLI crediting rates that banks value. Smaller carriers may not necessarily have access to the wide range of investment asset classes and market opportunities relative to these larger carriers.

WHO ARE THE "INSUREDS" UNDER BOLI?

General Rules

- Banks looking to purchase BOLI must have an "insurable interest" in the lives of the person(s) to be insured.[2]

- While the determination of whether or not such interest exists is governed on a state-by-state basis, there are also federal statutes that must be considered to avoid adverse tax consequences.[3]

- Currently, BOLI, in one form or another, is permitted in all states; however, there are major differences with respect to the manner in which individual states define and limit "insurable interest" (e.g., some states, including California, prohibit "classes" of employer owned life insurance).

- One BOLI compliance rule shared by all states is that they each require that banks only need to have an insurable interest in the covered life at the time the policy issues.[4] This is an important feature because it means that such insurable interest does not have to remain after that time. As a result, a policy on an executive who retires or otherwise terminates employment with the bank can remain in force with the original owner. If this were not the case, it would eliminate much, if not all, of the appeal of using BOLI.

The Specific Details

Additional BOLI guidance arrived in 2006 with the COLI Best Practices Act (COLI BPA), which was signed into law as part of the Pension Protection Act of 2006 as an Amendment to Internal Revenue Code (IRC) Section 101(j) which includes the following requirements:

- *General Rule*

In the case of an employer-owned life insurance contract, the amount excluded from gross income of the policy owner may not exceed an amount equal to the sum of the premiums and other amounts paid by the policyholder for the contract.[5] If the law did not also provide conditions that could be met in order to create an exception to this rule, BOLI would have been much less appetizing for most banks. This rule also serves to illustrate why it is so essential for those banks who are BOLI consumers to ensure that they comply with the conditions described in (1) and either the conditions specified in (2) or (3) below:

(1) Notice and Consent Requirements: These requirements of this paragraph are met if, before the issuance of the contract, the employee –

a. is notified in writing of the bank's intention to insure the employee's life and of the maximum face amount for which the employee could be insured at the time the contract was issued (note: this notification must take the form of a direct communication to the affected employees – i.e., passive disclosures through employee handbooks or newsletters will not satisfy this requirement).[6]

b. provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment,[7] and

c. is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.[8]

Note: compliance with the federal requirement on consent may not necessarily ensure compliance with a state's requirement and vice versa. banks must be careful to be aware of both, comply with each and take measures to document such compliance.

Example #1: merely complying with a state's negative consent law requirement will not automatically ensure federal compliance because it would fail to meet the affirmative consent requirement of IRC Section 101(j).

Example #2: Alternatively, a bank could be in full compliance with the requirements of IRC Section 101(j) but fail to meet the applicable state requirements if it purchased an amount of insurance that fails to meet that state's definition of permitted coverage.

(2) BOLI purchases must be limited to individuals who:

- Were employees of the policy holder at any time during the 12-month period before the insured's death,[9] or
- Were, at the time the contract is issued met any of the following conditions:
  - A director,
  - A highly compensated employee (HCE) within the meaning of Internal Revenue Code Section 414(q) (note: dollar amount threshold for this status is set as $150,000 for 2023 but is subject to future cost of living adjustments), or
  - A highly compensated individual who ranks in the top 35% of the bank's most highly compensated employees.[10]

(3) A separate exception is permitted for amounts paid to insured's heirs as follows:

Any amount received by reason of the death of an insured to the extent –

a. The amount is paid to a member of the family of the insured, any individual who is the designated beneficiary of the insured under the contract (other than the applicable policyholder), a trust established for the benefit of any such member of the family or designated beneficiary, or the estate of the insured,[11] or

b. The amount is used to purchase an equity (or capital or profits) interest in the applicable policyholder from any person described in (a).[12]

However, this exception is not always applicable as it would only apply to banks with BOLI investment strategies that

include providing such survivor benefits (i.e., as opposed to reserving all the death benefit proceeds for business purposes).

It should also be noted that in an effort to guard against noncompliance, the governing rules for BOLIs also require the following from banks adding BOLI to their investment menus:

- Maintenance of records necessary to prove the exemptions (e.g., that the employees to be covered meet the HCE definition, voluntarily provided written consent, etc.);[13]

- File Form 8925 with the bank's annual return,[14] and

- Rigorous due diligence, including board approval, before BOLI can be purchased.[15]

Accordingly, it is essential that banks, with assistance from their benefits consultants and legal advisors, determine the permissible population that can be insured, conduct a long-term benefit/cost analysis of the policies to be purchased to correctly estimate the total amount of insurance that can/should be purchased, and diligently obtain, document and maintain all written consents prior to completing the policy purchases.

WHAT ARE OTHER BOLI RULES AND REGULATIONS BANKS MUST CONSIDER?

Summary of Specific Rules and Governing Regulations

The lead federal regulator of BOLI is the Office of the Comptroller of the Currency (OCC), an independent bureau of the U.S. Department of the Treasury that charters, regulates, and supervises all national banks and federal savings associations as well as federal branches and agencies of foreign banks. However, several federal agencies have issued guidance on BOLI risk management and accounting. On December 7, 2004, the Board of Governors of the Federal Reserve System, along with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, issued OCC Bulletin 2004-56, an "Interagency Statement on the Purchase and Risk Management of Life Insurance" which expanded upon the interagency guidance previously issued in February 2004 (i.e., Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance).

OCC Bulletin 2004-56 provides a comprehensive update of supervisory guidance for BOLI which provides for two basic tests:

(1) Benefits-based test: the gains from BOLI cannot exceed the costs they are intended to offset.[16] Accordingly, banks considering BOLI should contact an independent employee benefit consulting firm to assist them in determining conservative parameters for such purchase.

(2) Capital-based test: As a general rule, a bank should not invest more than 25% of its Tier I capital plus 25% of the allowance for loan and lease losses in BOLI as a whole, and no more than 15% of its Tier I capital with any one company.[17]

OCC Bulletin 2004-56 also includes, but is not limited to, helpful information on the following topics:

- The legal authority under which banks may purchase BOLI[18] as well as BOLI accounting considerations;[19]
- A very detailed discussion of BOLI risk management considerations, which banks owning or contemplating the purchase of BOLI are encouraged to consider;[20] and
- An appendix that in addition to discussing insurance types and purposes also provides a glossary of insurance-related terminology.[21]

BOLI is also governed by FASB Technical Bulletin 85-4. This bulletin states that BOLI should be recorded on the balance sheet as an "other asset" and that both the cash surrender value growth and ultimate net insurance proceeds should be recorded as "other income."

HOW IS BOLI IMPLEMENTED AND USED?

General Summary

A bank purchases life insurance covering a select group of management including officers or other key personnel, after obtaining necessary written consent from such individuals.

- Bank's roles:
    - The owner of the policies,

- Payer of all premiums, and
- The beneficiary of the insurance proceeds.

Banks have the option of sharing a portion of these proceeds with plan participants; however, they are not required to do so and this option is not common in most cases except for those where they may be a separate business reason for providing enhanced survivor benefits to a specific key executive or director.

Course by Course Description of the BOLI Process

First Course: Bank meets with its benefit consultants and legal advisors to assess the financial and compliance issues that must be addressed before making any BOLI purchases. These meetings are needed to assess such factors as the Bank's projected benefit costs, current cash flow, budgetary constraints and thus determine not only if BOLI is a good fit for their financial future but also, if it is, which BOLI products would be most advantageous. Similarly, care must be taken to compliantly capture the covered group to be insured, effectively communicate the benefits of such coverage to this group (note: while this task may be easier if the group's survivors will be receiving at least some portion of the policy's death benefit, even if that is not the case, a well-crafted case for how the BOLI investment will improve the bank's bottom line may be sufficient to convince the key decision-makers that it will also be in their best interest to provide consent even without any portion of such proceeds earmarked for their survivors).

Second Course: The bank then purchases life insurance policies (ideally from carriers with good credit quality) on the individuals identified above and not only remains the policy owner but also typically the designated beneficiary. The BOLI is purchased as permanent life insurance and thus includes a savings account component (i.e., its cash value). The Cash Surrender Value (or CSV) is the cash value minus any applicable surrender charges.

Accordingly, the bank treats this CSV as an asset on its books and periodic changes in the carrying value are recorded in earnings. Since the interest earned on the cash value of the BOLI is tax-deferred, a portion of this inside growth offsets the insurance risk cost (a/k/a cost of insurance or COI) within the policy. This COI is generally based upon the difference between the amount payable upon death and the account value and is referred to as the net amount at risk, or NAR. There is an ongoing requirement for banks to report such economic

facets of their BOLI programs in their quarterly statements of financial condition (i.e., call reports).

Third Course: BOLI policies are a sophisticated investment, which requires ongoing management to maximize the value to the policyowner and beneficiaries. For instance, many BOLI policies have a flexible premium design. Within certain parameters, the policyholder has discretion regarding amount and timing of premium payments. Certain premium strategies may be preferred over others in the sense that they maximize the lifetime value of the policies. Additionally, banks may want to consider how the cash flows of the insurance policy are matched with the cash flows of the employee benefit plan(s) the policies are intended to support, if any.

Fourth Course: Upon the death of an individual covered by a BOLI policy, that policy's death benefit, offset by any outstanding policy loan balances, is payable in full by the insurance company. Depending upon the policy's mortality design, the NAR portion of the benefit is either paid from a special type of reserve owned by the policyholder, or from the insurance company's reserves/surplus. The former design results in a payment that will be revenue neutral to the bank's P&L while the second result produces incremental P&L earnings in the reporting period equal the NAR paid. In addition, some policies are designed to reach maturity without the insured dying (i.e., a process known as endowing). For example, when the Cash Surrender Value equals the death benefit, the IRS definition of a life policy requires that this occur by a specified age (typically from age 95 to 100) but the exact details depend on when the policy was originally issued among other factors. However, there are circumstances that may occur which will preclude such events from coming into play because the policy might not last until it endows or results in a death claim if the policy owner elects to surrender it for the cash value, converts the policy CSV into an annuity or allows the policy to lapse.

Why Do Banks Buy BOLI?

As with any other employers, banks have many ongoing and future costs of employee benefits and liabilities for both their general employee population as well as their executives and directors. Most employees will be covered by programs such as general welfare employee benefits programs (e.g., medical plans, group life, qualified defined contribution and/or defined benefit plans). In addition to participating in these programs, the bank's top decision-makers may be eligible for supplemental nonqualified deferred compensation, long-term incentive plans and other executive perks. Such supplemental

benefits often serve an integral role in recruiting and retaining key personnel. These employee benefit obligations generally have longer average durations than many other liabilities. One attraction of BOLI is that it can serve as an efficient, though long-term, means to finance, hedge, or recover some of these benefit obligations. Since a properly designed BOLI program is accretive to earnings, it can serve as an appetizing addition to the balance sheet. BOLI also possesses attractive accounting characteristics. For example, most employee benefit obligations have longer average durations than many other liabilities. However, with a strategically structured BOLI policy, the timing of BOLI cash in-flows (tax free death benefits) is favorable for offsetting long term benefit liabilities.

SUMMARY OF MAIN BOLI PROS

- Effective investment to offset the rising costs of employee benefits.

- Consistent and competitive tax-preferred yields from high credit quality insurance carriers:

  - Tax-deferred build-up in the cash value of the policies as long as the bank does not surrender the policy prior to insured's death; and

  - Bank receives net life insurance proceeds tax-free.

- Enhanced ability to offer competitive compensation plans.

- If desired and need exists, banks can use BOLI to offer life insurance to its executives with the possibility of there being little or no net cost to either the bank or the executives (i.e., the ultimate cost to the bank will depend on a number of factors, including but not limited to the actual mortality of the covered group compared to the life expectancy assumptions used to establish the premium payments.

  - Banks can use a portion of the proceeds it receives as beneficiary of the life insurance contract to provide a pre-retirement death benefit to the insured.

  - If the insured dies while employed at the bank, the bank receives the life insurance proceeds and then pays the insured's beneficiary the pre-determined amount.

- Potential improvement in bank's earnings.
  - Cash value of a BOLI policy is booked on a monthly basis as non-interest income;
  - Asset appreciates according to the net yield on the policy;
  - Such accretion can enhance the overall earnings of the bank when factoring in tax-preferred status of the BOLI asset.
- Diversification to a bank's asset portfolio.
- "Key Person" protection
  - Individuals covered are the bank's "VIPs" (i.e., very important personnel); and
  - If any of them die while still actively employed and serving a key role with the bank, the policy pays the bank a tax-free death benefit that it can use to recruit a new executive and/or to assist with other financial needs.
- Some insurance carriers offer book value accounting, which can stabilize earnings for banks that own BOLI.
- An accretive asset from inception.
  - Interest begins to accrue as soon as the initial premium is received.
- Even in the event of an insurer's insolvency, death benefits are protected up to specified levels guaranteed by state insurance guaranty funds.
- Medical underwriting may not be required.
  - Provided that that the bank's covered group falls within the previously described parameters set forth under Internal Revenue Code Section 101(j) and all required consents are obtained, if such covered group consists of 10 or more lives, it could qualify for Guaranteed Issue (GI), which requires no medical underwriting.

SUMMARY OF MAIN BOLI CONS/RISKS

As is the case prior to any major purchase/investment, a bank's directors and executive team and board of directors should review the applicable BOLI cons/risks compared to the potential benefits to the bank before proceeding with the implementation of any BOLI strategy. This level of due diligence is particularly important because bank examiners will consider such BOLI investments when auditing the bank's overall financial condition and risk profile and when assigning supervisory ratings.

Credit Risk

- BOLI products present a potential credit risk to the earnings and capital of the bank arising from the insurance company failing to pay amounts due under the contract.[22]

- Accordingly, to the extent a policy's death benefit exceeds the levels guaranteed by state insurance guaranty funds, benefits are contingent on the financial condition of the insurance company (i.e., such company's ability to honor the payment terms of the contract).

- Such financial condition and ability to pay must be reviewed regularly over the life of the contract.

- This risk, while manifesting differently can exist under either a general account (GA) or separate account (SA).

- Such risk can depend upon compliance with regulatory capital concentration thresholds, state legal lending limits, and any applicable state restrictions on BOLI holdings.

Interest Rate Risk

- BOLI products present an interest rate risk to the earnings and capital of the bank arising from movements in interest rates.[23]

- If GA product is in effect, such risk is tied to the policy's credited interest rate which will typically be longer term and thus the value of such investments may be subject to dramatic fluctuations in the event long-term interest rates change.

- SA products may also expose the institution to interest rate risk, depending on the types of assets held in the separate account. (i.e., if the SA assets consist solely of U.S. Treasury securities).

Liquidity Risk

- BOLI products can generally be considered a liquid asset. They can be readily surrendered for the cash surrender value of the policy at any time. However, BOLI products can carry transaction costs, including primarily the surrender charges that apply in early policy durations. In this sense, BOLI may pose financial risks to the bank. If cash flow demands arise during the period when BOLI values are depressed due to the application of a surrender charge or separate account volatility (for SA products with stable value protection), it may be undesirable for the bank to access the value of the BOLI policy during these times. Some banks may view this situation as creating a liquidity risk for BOLI products since they cannot always be sold without incurring transaction costs in the form of surrender charges.[24]

- Regardless of whether a GA or SA approach is used, due to the potential surrender costs, the BOLI's cash surrender value may not always be the most financially advantageous method to access liquidity.

- Banks generally may not receive any cash flow from these policies until the insured individual dies without incurring the costs discussed in this section.

- If the Bank's experiences cash flow issues, it could extract liquidity from a BOLI policy before the death of the insured by either surrendering the policy or borrowing against the policy; however, either option may result in adverse tax consequences and surrender charges.

Price Risk

- BOLI products present a price risk to the earnings and capital of the bank as a result from changes in the value of portfolios of financial instruments.[25]

- Generally, SA products provide that the policyholders assume the risk associated with investments within the separate account.

- In order to mitigate the price risk of an SA product, an institution may want to purchase a stable value protection (SVP) contract designed to ensure that in most cases the that the amount that will be realized from the policy is in excess of the cost basis of the policy.

- If a SVP contract is not purchased, monitoring and reporting systems should be established to recognize changes in valuation of assets.

Transaction/Operational Risk

BOLI products present a transaction/operational risk to the earnings and capital of the bank arising from problems caused by the institution's failure to fully understand or to properly implement a transaction.[26] Transaction/operational risk can arise due to the complex provisions which may be included in these products. Accordingly, purchasing banks should enlist the assistance of experienced advisors to ensure management clearly comprehends all the contractual language and options available to them for managing the cash flows of the policy. Failure to do so places the bank at risk with respect to its ability to (1) accurately assess whether or not the policies provide the expected benefits, and (2) comply with any conditions set forth in the policies.

- While GA policies may be less complicated than SA or hybrid BOLI (i.e., only two parties to the contract; fewer variables, etc.), they may contain potentially complex factors (e.g., interest-crediting rate, expense charges, and mortality costs).

- Alternatively, SA policies typically feature several complex provisions, including, but not limited to, third parties (i.e., the SA investment manager and any SVP wrap provider), terms of the SVP wrap, CSV provisions, and options regarding investments and mortality.

- Recently the issue of missing participants in qualified retirement plans has become a hot topic as plan sponsors have struggled keeping in touch with employees who terminate employment without immediately commencing their plan

benefits (i.e., whether by operation of the plan terms, their affirmative election to defer receipt or their failure to make an election to commence). Since a considerable amount of time may elapse between the date that a BOLI-covered employee leaves the bank and such employee's death, the policy holder bank will need to take proactive measures to regularly track the status such former employees to ensure that it is aware when such deaths occur and able to gather appropriate documents necessary to file a death claim with the insurance company.

Legal Risk

- BOLI products present a legal risk to the earnings and capital of the bank arising from violations of, or nonconformance with, laws, regulations and other guidance.

- Generally, life insurance is a complex product that is subject to a whole host of both federal and state laws including state insurable interest laws; the Employee Retirement Income Security Act of 1974 (ERISA); Federal Reserve Regulations O and W (12 CFR 215 and 223, respectively); the Interagency Guidelines Establishing Standards for Safety and Soundness; and the requirements OCC 2004-56.[27] Since BOLI adds the additional element of the insurance being purchased by a bank on the lives of its employees, there are also employment law, tax law, and reporting considerations. Consequently, banks considering BOLI or already utilizing BOLI should seek counsel from their accountants and/or attorneys to assist them in successfully navigating the various legal and regulatory issues and thereby minimize their risk exposure in these areas.

Reputational Risk

- BOLI products present a reputational risk to the earnings and capital of a bank from negative publicity.[28]

- No matter how it may be described as a prudent investment to help ensure the long-term financial viability of a bank and thus "trickle-down" economic benefits to its employees, there is no escaping the fact that BOLI is a product that enables banks to reap a significant tax-free benefit from the death of its employees or former employees.

- Accordingly, ideally before investing in this product, banks should proactively establish a plan for managing and mitigating any potential perception issues that such purchases may create.

BOLI: PORTFOLIO PIÈCE DE RÉSISTANCE OR TOO RICH FOR A BANK'S TASTE?

The answer to this question depends on many factors and varies from bank to bank.

While a well-prepared BOLI investment strategy can serve as an excellent addition to the portfolio menu of a bank, it can be expensive to manage and is certainly not without risk. The purchase of BOLI or any other insurance product should be aligned with the objectives of bank management, director-approved risk guidelines, and the bank's risk profile. Accordingly, before making a final decision, a bank's management should identify, quantify, and understand both the benefits and risks of this product so that it is satisfied the benefits outweigh such risks and with its ability to actively manage such risks. Given the inherent complexity of BOLI, the bank's decision-makers should seek qualified tax, insurance, employee benefit consulting and legal advice when considering such purchases.

NOTES

1. https://www.fdic.gov/bank/statistical/.
2. OCC Bulletin 2004-56, pg. 6 (December 7, 2004).
3. Id. 13-14.
4. See IRC Section 101(j)(3)(B)(ii).
5. See IRC Section 101(j)(1).
6. See IRC Section 101(j)(4)(A).
7. See IRC Section 101(j)(4)(B).
8. See IRC Section 101(j)(4)(C).
9. See IRC Section 101(j)(2)(A)(i).
10. See IRC Section 101(j)(2)(A)(ii).
11. See IRC Section 101(j)(2)(B)(i).
12. See IRC Section 101(j)(2)(B)(ii).
13. See IRC Section 60391.
14. Id.

15. OCC Bulletin 2004-56, at 5, 6-9.
16. Id. at 7.
17. Id. at 5.
18. Id. at 2.
19. Id. at 4.
20. Id. at 10-19.
21. Id. at 22-28.
22. Id. at 15-16.
23. Id. at 16.
24. Id. at 11-12.
25. Id. at 17-19.
26. Id. at 12-13.
27. Id. 17.
28. Id. at 14.

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