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UNDERSTANDING BOLI - BANK OWNED LIFE INSURANCE

Corporate Owned Life Insurance (COLI) owned by banks is often referred to as Bank Owned Life Insurance or **BOLI**. There are important distinctions, however, in how this term (BOLI) may be used that should be understood.

An Important Distinction

While *any* insurance owned by a bank can be referred to as BOLI, the term is most often applied to insurance marketing programs in which life insurance is offered to a bank specifically as an opportunity for the bank to take advantage of tax deferred cash value growth. This, of course, is done within the context of a legitimate business reason for a bank owning life insurance. However, with respect to this "BOLI marketed" insurance, it is the tax deferred investment elements of the life insurance product that are being emphasized and given a *primary* focus and which are expected to motivate the sale.

Alternatively, a bank may be approached (like any other corporation might be) to use insurance to offset the financial loss associated with, say, a key-person's death or to fund an employee benefit plan. In these situations the tax advantages of using life insurance to satisfy a business objective are an important *secondary* consideration and may give the use of life insurance a financial advantage over other available methods. The *primary* focus, however, is satisfying the business need. The life insurance products used in these situations will be bank-owned and, technically, BOLI. However, in design, purpose, and structure of the sale will typically supply the name by which these programs are known, as for any other business. For example: key-person; deferred compensation; split-dollar.

Although technically aimed at the same objective, the design of the products used in a "BOLI marketed" program versus a "business need" program will be dramatically different. The use of one type in the environment of the other may result in the specific objectives of the bank not being efficiently met or exposure to risk not contemplated. Therefore, banks must do a prudent analysis of life insurance they purchase and, in fact, are required to by the OCC to assure that insurance satisfies a legitimate business objective.

OCC Guidelines Apply

The Comptroller of the Currency (OCC) acknowledges that national banks may own life insurance for the same reasons that any other corporation may own life insurance. OCC Bulletin 2000-23 provides national banks with current guidance on this subject.

Banks may own life insurance if it is incidental to their banking function. Incidental uses which address a legitimate need of the bank are approved by the OCC. Such uses include:

- key-person insurance;
- insurance on borrowers;
- funding of employee compensation or benefit plans; and
- insurance taken as security for a loan.

Products Designed Specifically for the BOLI Market – "BOLI marketed" Insurance

The tax deferred build up of the cash value accumulations within a life insurance policy gives permanent cash value life insurance a distinct financial advantage over other forms of investment. In addition, income tax on the net investment gains earned on the values paid into a life insurance policy are avoided all together *if the life policy terminates as a death claim*.

When tax advantages are the focus of the sale as they are on BOLI marketed products, the products used are designed to emphasize and maximize the impact of the investment element. For example:

- BOLI marketed products are, typically, designed as <u>single premium</u> policies and are priced for <u>guaranteed issue</u>.

  The <u>single premium</u> structure recognizes the fact that banks make investment decisions immediately. That is, they do not make a current decision to invest a fixed amount for some number of years into the future (as would be required if an annual premium product were purchased). In fact, most BOLI sales are made near the end of the year as banks are considering what excess funds they may have available.

  A single premium also allows significant amounts to be "invested" relative to the death benefit and, therefore, minimizes the mortality charges (since the Net Amount at Risk is minimized in a single premium plan). Mortality charges, a necessary feature of a life insurance contract, reduce the cash value accumulation and are considered a cost which reduces the investment return of the product, a negative in a BOLI marketed product..

  The products are priced for <u>guaranteed issue</u> since the bank employees whose lives are insured are likely to receive no direct personal gain for allowing their lives to be insured as part of a BOLI program. As a result they may object to a full medical underwriting process. Under a guaranteed issue program the only thing they need to do is sign a consent form.

- Products designed specifically for the BOLI market are designed to "artificially" increase the early rate of return of cash value accumulations to meet some current objective.

That is, when insurance products are *normally* priced, life insurance company *acquisition costs* are charged off early meaning that it will take a number of years for significant policy cash values to develop. "BOLI marketed" products will, first, reduce acquisition costs by reducing agent compensation as a percent of premium. However, since BOLI marketed sales typically involve very large single premiums, the agent makes it up on volume. A "BOLI marketed" product may also need to *defer the recovery* of acquisition costs in the pricing analysis and provide more early year cash value than would ordinarily be provided. Typically, these products will target a first year cash value to be equal to the single premium accumulated at a relevant current rate of interest, say 5%. Later policy values may be affected by this deferral.

If the product is a Universal Life design with explicit mortality cost charges, these explicit mortality charges may be set to zero for the first few policy years, effectively deferring mortality charges. This would allow banks to look at the cash value accumulation within the contract on an interest only basis for the first few years. This design feature will enhance and allow simpler comparisons to alternative investment opportunities.

A bank which purchased such a BOLI marketed product would be able to show from policy year 1 a ***tax deferred*** return of, say, 5% on their single premium "investment" versus an ***after tax*** alternative of, say, 3%. Marketing materials, in this example, could illustrate that for every $1,000,000 the bank places in the product, an annual tax leveraged gain of $20,000 could be realized falling directly to the bank's bottom line. In some marketing approaches this savings would be shown as offsetting the bank cost of an employee benefit program.

- Because they are single premium designs, a BOLI marketed product is a Modified Endowment Contract (**MEC**) per §7702A of the Internal Revenue Code.

  This shouldn't matter because in a BOLI marketed sale the policies are intended to be held until they mature as death claims. The tax treatment of proceeds paid *on the death* of the insured is unaffected by the fact that the contract is a MEC. As a result, "BOLI marketed" insurance is offered with the expectation that it will be kept in force until death. Banks should realize that there can be a significant cost to the owner if the contract is surrendered or borrowed against before the insured's death.

Satisfying OCC Requirements

OCC Bulletin 2000-23 allows a bank to own life insurance if it is incidental to the business of banking. In other words, banks would not be allowed to purchase insurance strictly as an investment. While the tone of the guidance provided to banks indicates that the investment element contained in cash value life insurance can be a consideration by banks, there must be another reason for a bank to purchase life insurance.

Therefore, the sale of BOLI marketed products must be associated with a bank's legitimate business need for insurance. Of the needs recognized by the bulletin the ones most likely to be addressed by insurance companies or their agents are *key-person insurance* or the *funding of employee compensation or benefit plans with insurance*.

Key-person & "BOLI marketed" Design

A ***single premium*** BOLI marketed design would be a poor choice for providing insurance in connection with a key-person insurance program. These BOLI marketed designs are intended to be held until they mature by death because they are MECs and early surrender subjects cash values to tax and penalties that could wipe out or, at least, significantly reduce, any tax leveraged investment gains. Typically, in any corporation key-person insurance would be kept in force only for so long as the identified key-person remained employed or remained a "key" employee. That is, retirement, resignation, discharge or a change in responsibilities would eliminate the need for the insurance.

In addition to the fact that terminating key-person insurance when the need for it is gone makes good business sense, it may be required for banks per OCC guidance. With respect to banks, holding permanent insurance in excess of the bank's risk of loss could be considered an unsafe and unsound practice per the OCC Bulletin. It is highly likely that banks will lose key people as employees long before they die. Therefore, if *key-person* were the insurance need being covered by a BOLI marketed product, it is highly likely that the insurance would need to be terminated prior to death. This would trigger an unavoidable and undesirable taxable event.

Funding Employee Benefits & "BOLI marketed" Design

Single premium BOLI marketed products are more appropriately used to fund the employee deferred compensation or benefit plans of the bank. This is a typical use of life insurance. When using insurance to fund these types of plans the group of employees insured is often not identical with the group of employees who are to receive benefits. Quite often only a few lives are required to be insured in order to satisfy the funding objectives of the plan. And, since the funding is not directly related to the specific lives insured, the continuation of any insured life's employment with the bank is unimportant and coverage can be kept in force until death. This is in keeping with the use of life insurance to fund these types of plans in other types of corporations.

General Suitability & "BOLI marketed" Design

A bank ought to conduct a pre-purchase analysis for any life insurance purchase as a sign of good business practice as well as because of the fact that it is required per guidance provided by the bulletin. Careful consideration should be given to all of the items highlighted in the bulletin. In particular, attention should be directed to the adverse tax consequences of surrendering or borrowing from a single premium BOLI marketed product and the impact this might have on the bank's liquidity.

A typical non-regulatory rule-of-thumb which has been applied in the presentation of BOLI marketed plans is that no more than 1 – 2% of a banks assets should be "invested" in ***single premium*** BOLI marketed type products.

General Marketing Focus of "BOLI marketed" Products

Insurance companies and vendors have, by now, fairly well saturated the market for a BOLI marketed product in large banks.

In the last few years (since about 1998) the focus has shifted to smaller community banks.

Corporate Owned Life Insurance – by Banks

A business need marketing approach would be built upon insurance products dramatically different from BOLI marketed products.

The insurance products typically used to provide key-person insurance or to fund employee deferred compensation or benefit plans are <u>annual</u> premium (not single premium) plans of insurance priced for full underwriting (not guaranteed issue). The use of these types of products anticipates a commitment by the corporation to fund these programs on an ongoing basis over a long period of time. Since the products are used to provide benefits from which the involved employees might benefit, the inconvenience they might experience in undergoing a life insurance underwriting process is more easily accepted by them.

The products used in these markets may be specifically designed or enhanced through the use of riders to emphasize the cash value accumulation within the product. The insurance companies that offer products in this market recognize the corporation's need to minimize the impact of installing such programs on the corporation's net gain. However, unlike the "BOLI marketed" product design, first year cash values are hardly ever more than 100% of the initial total premium payment. Therefore, installing a program which utilizes an annual premium product design will result in some cost being shown on the banks books in, at least, year 1. Another consideration is that, since the net amount at risk is larger relative to the policy value, the mortality cost is relatively higher than it would be in a single premium BOLI marketed design which can negatively affect the net cash value accumulation rate over the long term.

Annual premium plans provide the same tax advantaged cash value accumulation as do BOLI marketed plans. But, these more traditional annual premium products are designed, illustrated, and sold to avoid classification as a MEC per IRC §7702A. Therefore, these products would have none of the disadvantages with respect to the availability of cash value and liquidity as a single premium BOLI marketed design.

Conclusion

Banks are allowed to purchase life insurance to satisfy their legitimate business objectives. Life insurance cannot be purchased by a bank as an investment. However, the tax deferred investment income received through an "investment" in a life insurance contract is a principle characteristic of life insurance that is routinely exploited in the sale of life insurance products. Banks, when they purchase life insurance to satisfy legitimate business objectives, can receive a benefit because of this advantage. This seeming incompatibility of purpose requires banks to give careful consideration to their purchase of insurance. OCC Bulletin 2000-23 provides guidance to national banks as to how they can ensure that their purchase of life insurance is consistent with safe and sound banking practices.

Bank Owned Life Insurance, BOLI, is a form of Corporate Owned Life Insurance, COLI. There are <u>two generic types</u> of life insurance products available to banks.

One type, the single premium "BOLI marketed" plan, places the most emphasis an insurance product can on the investment element contained in life insurance. This is a COLI product type that is usually <u>only</u> made available to banks.

The second type is the more traditional *annual premium* products designed for use in the broader COLI market. These products are equally available to banks or non-banks and, therefore, a bank considering the use of life insurance to protect against a financial loss associated with the death of a key-person or to fund an employee benefit plan also has these products available to it. However, while these plans, by design, may have enhanced early year cash values, the acquisition of such policies to provide for key-person of employee benefit needs would likely reduce bank earnings in the years after these programs are initiated.

In general, cash value life insurance does provide a tax deferred build up of value within the contract. This feature can be useful to the bank in reducing the costs of any benefit programs it decides to implement.