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RISK MANAGEMENT OF BOLI

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EXECUTIVE TAKE-AWAYS

- BOLI remains an attractive asset for a bank's balance sheet.
- BOLI carriers are not immune to the 2020 economic environment. A thorough evaluation of an existing or proposed carrier remains a critical element in BOLI program management.
- Interest rates have been historically low for a number of years and fell even further in early 2020. Many predict low rates to continue for the next few years, with some mild expectation for a return to a rising rate environment. BOLI crediting rates will generally lag the market, but without mark-to-market risk of other fixed income investments. A bank should understand how crediting rates are determined in order to set proper expectations.
- For existing programs, a bank can either make internal or external exchanges or look to make policy-level changes to improve yield. While rare, banks should periodically evaluate whether whole or partial liquidation of their BOLI is warranted. Every bank should understand the tax consequences of doing so and develop a strategy for effectively managing the process.

INTRODUCTION

After rising in recent years, economic contraction caused by the coronavirus has rapidly softened loan demand. While the PPP program from the SBA added billions in loans, the margin on PPP loans is extremely thin with an expected short life. During the pandemic restrictions, liquidity at many banks has increased from federal stimulus as well as depositors simply spending less. With 40 million becoming unemployed in just a 3-month period, many borrowers are expected to struggle to keep current on loan payments, affecting interest income and requiring increased reserves. Yields on traditional bank investments are at historically low levels, with Fed Funds near 0% and both the 5-year and 10-year US Treasury rates below 1%.

Yet the cost of employee benefits continues to rise, adding even more pressure to margin. As a result, banks are rediscovering the value of a well-designed Bank-Owned Life Insurance (BOLI) program.

Why? For almost 40 years, BOLI has been the preferred tool for banks to offset the cost of employee benefit programs. According to Call Report data from the FDIC website, at the end of 2019, sixty-five percent (65%) of banks reported BOLI holdings totaling $178.2 billion, compared to $122.8 billion a decade earlier.

BOLI generally provides a competitive tax-equivalent yield with little or no mark-to-market risk (which is very appealing for when we exit the low period of the interest rate cycle). The annual growth in policy values is included in noninterest income, which many banks are trying to improve. And, the death benefits in excess of cash value can serve three valuable purposes: offer a very efficient supplemental life insurance benefit to the insured employee, help the bank recover the cost of providing employee benefits, and protect the bank against the loss of key persons.

Before purchasing BOLI, however, a bank is required to conduct a thorough analysis of the BOLI marketplace. If a bank already has BOLI, it is required to do an annual risk assessment. Financial Institutions Letter 127-04 (FIL 127-04), the interagency statement on the purchase and ongoing management of BOLI, provides a clear roadmap for either analysis.

This paper will not address all of the elements of a thorough analysis. Rather it will focus on the insurance carrier, the product, and how a bank can make changes to either. These are particularly important in light of the recent crisis in financial services.

THE BOLI CARRIER

FIL 127-04 opines that carrier selection "is one of the most critical decisions" in the BOLI purchase process. This applies not only at initial purchase, but throughout the holding period of the BOLI.

Of over 800 life insurers in the U.S., there are approximately 30 carriers who have inforce BOLI policies, with perhaps 8-10 of those actively issuing new business. If a bank has BOLI from a carrier that does not actively issue new policies, the bank should understand how that may affect policyowner service and policy performance.

The 2020 economic crisis cause by the pandemic has not skipped over the insurance industry. Rating agencies such as S&P and Moody's have placed the entire industry on "outlook negative" in early 2020 as the industry grapples with low interest rates and underwriting concerns over the coronavirus. It's not unrealistic to expect that one or more of the carriers who have issued BOLI will be downgraded. A thorough review of a carrier's ratings history over multiple years is a necessary first step.

Ratings, however, are not the only source of information a bank should review. FIL 127-04 provides that a bank should "perform a credit analysis on [the] carrier in a manner consistent with safe and sound banking practices for commercial lending." Like a bank does with its call report, an insurer must file quarterly and annual statutory financial statements with its home state insurance department. These statutory filings are commonly called "blue books" due to their covers, and contain detailed information about the insurer's assets, liabilities, capital, and earnings. Most carriers provide their blue books free of charge, and a bank should review the blue books for the last two or three years. There are also subscriptions to 3rd parties who evaluate carrier financials over multiple years to identify trends and summarize their findings.

THE BOLI PRODUCT - GENERAL DESIGN

BOLI falls into one of three types of insurance: (a) general account (GA), (b) separate account (SA), or (c) hybrid separate account (HSA). The defining difference between these types is the level of risk the bank is taking in either the insurer, the assets that support the product, or both.

With GA BOLI, the cash values are part of the insurer's general account assets. This means the bank has direct credit risk exposure to the insurer, but not to underlying assets themselves. If the insurer invests in a fixed income asset that declines in value or defaults, the bank is not directly impacted. Because the insurer is the risk, FIL 127-04 provides that GA BOLI is risk-weighted at 100%. If a bank has GA BOLI from a carrier with recent downgrades, especially multiple downgrades, it should strongly consider either an alternative carrier or an alternative product, discussed below.

A bank should understand how much of an insurer's general account supports its GA BOLI, as that can have a large influence on crediting rates. For example, a carrier may look to its entire general account portfolio (for example, with a whole life chassis), or it may segment its general account (for example, with a universal life chassis).

With SA BOLI, the cash values are allocated to or among various portfolios that invest in bank-eligible securities. The portfolios are in an entity that is statutorily separate (hence, separate account) from the carrier, so that carrier's credit risk is reduced (although not eliminated). However, the bank takes on the credit risk of the underlying investments. FIL 127-04 allows a bank to "look through" to the underlying assets when risk-weighting SA BOLI (subject to a floor of 20%).

To reduce mark-to-market volatility that can occur with exposure to holdings of such assets, most SA BOLI includes a Stable Value Wrapper (SVW). With a SVW, the bank pays the insurer or a third party an annual fee, and in return the SVW provider offers a sort of "shock absorber" to the bank. (The value of the SVW is risk-weighted at 100%.) However, the SVW has limits on how much market value fluctuation it can absorb, as many banks with SA BOLI discovered in the Great Recession and years following it. The result for some was write-downs to SA BOLI holdings; for others, rapid reduction in crediting rates as the portfolio was reallocated to money market investments. Due to the reduced appetite for banks to invest in SA BOLI, as well as the reduced interest from carriers and SVW providers to offer the product, there were few SA BOLI transactions from 2009-2019.

Nevertheless, a bank with or considering SA BOLI should insist on stress tests, showing a large, rapid change in underlying values (both increasing and decreasing). A bank should clearly understand how it might exit a SA BOLI design.

SA BOLI is typically sold through private placement and is a complex financial instrument (the private placement memorandum and supplements can be as long as 100 pages). It was initially designed for large money center banks, but was pushed down market in the early- to mid-2000s so that it was available to most community banks. FIL 127-04 provides that before purchasing SA BOLI, "management should thoroughly review and understand the instruments governing…[the policy]." Because of this heightened oversight, most community banks avoided separate account, often because they lacked internal resources. Instead, community banks who wanted some of the advantages of separate account opted for the hybrid separate account design.

With HSA BOLI, the cash values are allocated to or among various separate accounts, similar to SA BOLI. However, the insurer offers minimum guarantees and acts as the "backstop" for market value fluctuations. There is no need for a stable value wrapper/provider, and HSA BOLI is not offered through a private placement. Unlike with SA BOLI, however, a bank is not allowed to look-through to the underlying assets for risk-weighting and HSA BOLI is weighted the same as GA BOLI.

A bank with or considering HSA BOLI should clearly understand the investment philosophy of the separate accounts and understand how the insurer will respond if market value falls below book value. Moreover, a bank should clearly understand the limitations of re-allocating among the separate accounts.

THE BOLI PRODUCT – INTEREST CREDITING

Once a bank understands the risks and rewards of the three product types, it also needs to understand how the carrier determines the crediting rate. GA BOLI policies, and some HSA BOLI policies, generally use either the "new money" or "portfolio" method.

Under the new money method, the carrier sets the initial policy interest rate based on what it can earn on the BOLI premium when first invested. Renewal rates are generally based on then-current market rates. Under the portfolio method, the carrier sets the policy interest or dividend rate based on what it earns on the portfolio of assets it uses to support its BOLI.

It is important to recognize that both methods generally lag movements in market rates, whether the market increases or decreases. In the declining rate environment of the past decade, BOLI rates have declined slower than traditional bank investments. When we enter a rising rate environment, as many predict, one should expect BOLI rates to increase slower than those other investments (although GA and HSA BOLI do not have the mark-to-market risk of those other investments that is inherent in a rising rate environment). At any given time, one of the methods will generally project higher current yield than the other; however, over the long holding period for BOLI, differences in the timing of the two methodologies should generally be minimized.

Another crediting method for GA BOLI that has become available in the past year or two is an "indexed" method. Under the indexed method generally, the 12-month change in the S&P 500 is measured solely to determine the crediting rate – BOLI cash values remain general account assets and are never invested in the S&P itself. If the change is 0% or less, the crediting rate that month is 0%. This is the floor rate, usually before cost of insurance is deducted, and some carriers offer a floor higher than 0%. To offset the risk to the carrier of offering the guaranteed floor rate, there is a maximum or cap rate. For example, if the cap rate is 8%, then a change in the S&P 500 of 8% or more results in a crediting rate that month of 8%. While indexed BOLI has more variability in the monthly return, it offers greater upside potential in a low fixed crediting rate environment without mark-to-market risk.
A bank should insist on detailed projections of BOLI yields, not only at issue but at each policy anniversary. This is imperative for inforce BOLI programs that support an executive benefit (such as a split-dollar arrangement or even a SERP) as even a small decrease in crediting rates can have a dramatic effect on the long-term benefits.

When reviewing projections, it is important to focus not just on the first year or even the first five years, but on the total expected return. Some carriers have designed policies that have lower early year expenses with higher later year expenses. The bank should also insist that those projections show not only the cumulative return, but the year-by-year return. This allows the bank to clearly see if a carrier is "frontrunning" the product at the expense of longer-term performance.

(SA BOLI generally uses the "yield-to-worst" method and HSA BOLI can use either the "portfolio" or "book yield" methods. Both yield-to-worst and book yield methods are formulaic, and the stress test recommended above should help the bank clearly understand how crediting rates will respond to market changes.)

MAKING CHANGES TO AN EXISTING PORTFOLIO

If a bank determines that the existing carrier or the existing product design is no longer desired, alternatives should be evaluated. Beyond holding the policy until maturity, the bank generally has two options: change the carrier/product or liquidate.

As a general rule, any changes to a carrier or to the underlying product will require the bank to re-establish insurable interest under state law. Therefore, the first step is knowing which insureds are still actively-employed by (or serve as directors of) the bank. The second step is knowing whether there are any restrictions from the carrier on the existing policies.

Under IRC Section 1035, a life insurance policy can be exchanged without causing the built-in gain to be recognized for income tax purposes. (Conceptually, this operates like IRC Section 1031 for property exchanges, something familiar to most bankers.) Once a bank has identified those policies on the active insureds, it must then determine whether an "internal" or an "external" exchange is warranted. (See the discussion below about IRC Section 101(j) for issues relating to exchanges on inactive insureds.)

An internal exchange is where the bank (with the consent of the insured) changes the underlying product but remains with the same insurer. (Not all carriers offer an internal exchange program, or one that is easily implemented.) Most of the time, this can be done without medical underwriting. The most frequent internal exchange is from a carrier's GA BOLI to its HSA BOLI. This allows the bank to reduce—not eliminate—credit risk of the carrier.

If an internal exchange is not available or desirable, the bank should consider an external exchange. An external exchange is where the bank changes the insurer (again, with the consent of the insured). Before initiating any external exchange, the bank must consider whether the current BOLI has any restrictions, such as crawl outs, surrender charges in general or charges specific to an external exchange. The existence of those restrictions should not preclude an external exchange but do impact the economics of the transaction and must be considered into the overall evaluation.

For an external exchange, where there is one or a handful of policies, medical underwriting will be required; for larger groups it may be possible to implement on a guaranteed issue basis.

A bank should be mindful of the impact of internal or external exchanges to any existing benefit plans. For example, if a policy is part of a split-dollar arrangement that is grandfathered from the 2003 final split-dollar regulations, it is likely that exchanging (internal or external) is a "material modification" of the arrangement that results in loss of grandfathering. This could result in a change to the imputed income the split-dollar participant is required to report each year. On the flip side of that, policies issued after 2019 are required to use a new mortality table that generally results in *higher* death benefits initially, potentially providing greater benefits to certain split-dollar participants.

When a vendor proposes either internal or external exchanges to a bank's current portfolio, a bank should understand how the vendor will be compensated. Generally, an external exchange results in significantly higher first-year commissions than an internal exchange (servicing commissions are often the same and may be even lower). While this should not deter a bank from pursuing an appropriate exchange, the bank should understand the motivations of the vendor's recommendation.

Attractive as they may be, a bank may not able to take advantage of the internal or external exchange options. Generally, that is due to one or both of the following: (a) lack of insurable interest on inactive insureds, or (b) inability to satisfy the requirements of IRC Section 101(j).

As noted above, a bank is generally required to re-establish insurable interest under state law in order to do an exchange. While a state may permit a bank to acquire a policy on a retired employee, most require consent (positive or negative). The longer a bank has held BOLI, or if it acquired its BOLI through acquisition, the more likely that bank's insureds are no longer employed. Some states may allow a bank to rely on the initial consent an insured provided, however, that is the exception.

Even if a bank can re-establish (or maintain) insurable interest, it still must comply with IRC Section 101j, which applies to all employer-owned policies issued after August 17, 2006. Under 101(j), employers have certainty of the tax-free receipt of death benefits (and therefore the tax-free buildup of cash value) if the insured (i) was given proper notice, (ii) consented to the purchase, and (iii) was a director or among the top 35% of employees ranked by compensation. For policies issued prior to August 17, 2006, an exchange may result in the loss of grandfathering under IRC Section 101(j). While there is an exception in 101(j) that would appear to exclude 1035 exchanges from the notice, consent, and compensation tests, any policy that has a "material modification" to it as a result of the exchange is not eligible for the exception. Given that it is unsettled what constitutes a material modification, few carriers are willing to accept an exchange on an inactive insured and those that do require the employer – your bank – to indemnify the carrier against the tax risk of losing the exception.

If a bank cannot or does not want to maintain its current level of BOLI, it can liquidate the policies by surrendering them—at book value for GA BOLI and HSA BOLI—to the insurer for cash. Generally, the surrender proceeds will be sent to the bank within 10-30 days. However, because the BOLI is not held until maturity, it loses the tax benefits, and the entire gain is recognized as ordinary income. (In all likelihood, no accruals have been made for this potential tax liability, the primary reason that regulators consider banks "illiquid.") While some banks may have sufficient tax-loss carry forwards to offset the reportable income, all banks are required to pay any Modified Endowment Contract (MEC) excise tax applied to the gain. Surrendering only some BOLI may result a bank's tax advisor requiring a tax expense accrual on your remaining BOLI, therefore, it is critical to consult with your tax advisor before initiating any surrender.

A bank must also pay special attention to the anti-abuse rule in the tax code that applies to MECs (the "MEC aggregation rule"). Under that rule, all MECs issued by the same carrier in same calendar year to the same owner are treated as one policy. In effect, the policy level basis is ignored. An example is the best way to illustrate this:

Assume a bank purchases ten MEC policies from Carrier A in 2010, each with an initial premium of $100,000 (aggregate basis of $1,000,000). In 2020, each policy has a cash surrender value of $160,000, or aggregate cash surrender value of $1,600,000. Under the MEC aggregation rule, the bank is required to recognize as ordinary income the first $600,000 (the aggregate gain) that is surrendered, regardless of how many policies are surrendered, even though each policy has its own basis. In addition, the 10% MEC excise tax would apply to the amount of gain recognized.

The MEC aggregation rule has generally served to limit a bank's ability to partially liquidate its BOLI by surrendering one or a few policies. However, a favorable Revenue Ruling from 2007 (Rev. Rul. 2007-38) allows a bank to separate policies that are exchanged from those that are not when applying the MEC aggregation rule. For a bank desiring to reduce its BOLI holdings, one strategy to consider is to exchange policies where insureds are active, wait the appropriate amount of time, then surrender those that were not exchanged.

Continuing the example above, assume six of the initial ten employees are still active. If the bank exchanged those six policies, it would retain four policies with $640,000 of aggregate cash surrender value and $400,000 of aggregate basis, for an aggregate gain of $240,000. By strategically exchanging policies, the bank could liquidate the remaining four policies and avoid recognizing $360,000 of ordinary income (keeping in mind the caution above about the potential tax expense accrual requirement).

SUMMARY

BOLI remains a strong, strategic asset-liability management tool for banks, especially given the current economic climate. In mid-2020, the yields over traditional bank investments are compelling, and if rates increase BOLI rates should reset higher (although with some lag), without mark-to-market risk that exists with traditional fixed income alternatives.

Carrier selection remains a key indicator of program success. Ratings are one component a bank should review, however, more important are statutory financials over multiple years to identify credit risk and select appropriately.

Product changes have given banks more options, but banks should take extra care to make sure those options are worthwhile or even desirable for their profile.

Every bank should understand the consequences of liquidating – in whole or in part – their BOLI holdings. Where appropriate, the bank should take steps to do so, but in a manner that provides the greatest flexibility.

While monthly recordkeeping and general policy service are important parts of a BOLI program, working with a vendor who can provide the bank with experienced face-to-face relationships may be critical to the successful operation of the program.

ABOUT THE AUTHOR

Scott Richardson has worked extensively with federal and state bank regulators over the years and the team at IZALE Financial Group has helped design and implement over 1,100 of nonqualified benefit plans and BOLI programs. He is a shareholder in community banks and serves as a board member of a community bank.

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