



Bank Owned Life Insurance (BOLI)

Bank Owned Life Insurance (BOLI) is defined as a company owned insurance policy on one or more of its key employees that will informally fund the financing of employee benefits programs. Done properly, BOLI may offset the current and future costs of pre- and post-retirement medical coverage, group life, retirement and many other benefits offered to bank employees. Because of how BOLI is accounted for, it is an ideal asset that can be matched against future liabilities while possibly providing a higher current net after-tax yield on the bank's existing assets than what the bank may be able to invest in today's environment.

Why do financial institutions buy BOLI?

Financial institutions face a wide range of ever-increasing benefit costs. These benefit plans range from qualified plans such as pensions to group health benefit plans and supplemental benefits designed to attract and retain key personnel. BOLI provides a tax-efficient tool to help offset these benefit costs.

Is BOLI widely used?

Yes, in fact almost 67% of the largest financial institutions (top 50) in the nation own BOLI as of 6/30/07. And as a whole, 44% of all banks have more than 3.5% of their Tier 1 assets in BOLI. (Source:FDIC)

How does BOLI work?

The bank purchases life insurance on a select group of management including officers or other key personnel. The bank is the owner of the policies, pays all premiums and is the beneficiary of the insurance proceeds. As part of the transaction, the bank may provide a pre-retirement survivor income benefit as a

way to entice the employee to allow the bank to insure the executive.

What type of Bank is best suited to do BOLI?

While all banks may have a need for BOLI, it is usually the bank that has one of the following or a combination of the following:

- Consistently rising benefit costs
- Retention problems of key executives because of a lack of benefits
- Large Deposits and a Low Loan percentage in relation to those deposits
- Unfunded post retirement obligations (i.e. benefits)
- A deferred compensation program for key employees

Does the financial institution need to communicate with its employees about BOLI?

While most states require disclosure, there is a new law, called the COLI Best Practices Bill that will require disclosure of the insurance, how much it is, the fact that the company will maintain the policy after the employee has left the bank, and what the policy is being used for. It is has been the practice of Schiff Benefit Group employees to fully disclose all insurance at the time of application.

How do potential plan participants react to BOLI funding of employee benefit programs?

While not every employee who is asked to participate in the insurance pool participates, because of the structure of the insurance, primarily as an informal

funding tool for a benefit plan that is either already in existence or a new one that the insured is going to receive as part of being insured, most employees opt to allow the bank to insure them.

Are employees required to participate?

Participation in the insurance plan is optional. But if bank decides to tie a benefit to the insurance, they have that right if offering a new discriminatory benefit.

What are the underwriting requirements for BOLI?

Depending on the carrier and the amount of the premium, in most cases there is no evidence of insurability. The policy would be issued on a guaranteed to issue basis after answering three or four health questions. In smaller community banks full underwriting will be required and depending on the results of the underwriting, the bank will have the option not to place any insurance on a “rated” employee. In this case, the premium would be spread across the remaining insurable participants.

What happens when a participant retires?

The bank retains the policy on the retiree's life since the economics of BOLI are most effective when BOLI is held for the long-term. By tracking the Social Security numbers of plan participants Schiff Benefits Group will be able to assist the bank with the administration of retiree policies. When an insured dies, this tracking system provides information necessary to gather appropriate documents from the bank in order to file a death claim with the insurance company. As an alternative, the bank may offer a nominal deductible death benefit in the form of normal income to the insured's beneficiary. When the insured dies, the beneficiary would then receive a tax deductible income and the bank would receive the tax free proceeds.

Does the bank benefit from the death of its employees?

Most BOLI plans are designed to be a zero sum program. BOLI is designed to offset costs of benefits for both those insured and the rank and file employees. By designing the plans properly at the outset the bank will be able to follow the strict rules of the regulating organization while providing a meaningful benefit to those involved.

What kinds of BOLI products are available?

There are two basic categories of BOLI products:

- **General Account:** The policies are backed by the general account of the insurance company and the financial strength of the carrier is a primary concern for the bank when selected the carrier. Since the cash value is at risk with the specific carrier, the assets are considered to be 100% risk base weighted. The advantages of these products are that they normally provide minimum interest rate guarantees in the range from 2.5% to 3.5%. The current interest rates are usually guaranteed for the first year, credited monthly and reset on a quarterly or annual basis after the first anniversary. These products might have a “new money rate” or a “portfolio rate”, but over time, the products perform on a relatively equal basis.
 - **New Money Rate:** Interest is credited to the policy based upon what the carrier is able to get in the market at the time of issuance or anniversary
 - **Portfolio Rate:** Interest is credited to the policy based upon the overall portfolio of the insurance carrier which may be better or worse than what the bank is able to do in the market. Most policies that are designed this way have a 5 to 7 year

turnover rate on the underlying assets.

- **Blended Rate:** This is a hybrid of a New Money Rate policy and a Portfolio policy. In the early years, the crediting rate is based upon the rate that the carrier is currently getting and then “steps into” the portfolio rate over time.
- **Separate Account:** The returns of these policies reflect assets in a segregated account that are not subject to the general creditors of the insurance company. Plan returns are subject to market fluctuations. With a separate account product, the policy owner bears the risk of default of assets in the separate account.

Which insurance companies underwrite the products?

Most of the major insurance carriers have BOLI products. Like its industry peers, Schiff Benefits Group has access to these major insurance carriers. As part of the BOLI purchase we will help the bank analyze the differences between the credit qualities of the carriers versus the performance of their products. Ultimately, it is the banks choice as to what type of blended performance that the bank would like to implement. (Source: A++ A.M. Best, Aaa Moody's Investor Services, AAA Fitch, AAA Standard & Pours)
Is BOLI liquid?

Most BOLI products do not have surrender charges built into their product. As such, the policies can be surrendered at any time for its cash surrender value. However, if the bank surrenders any policy, or all of them, doing so may cause adverse tax consequences to the bank. Therefore, in order to receive the full economic benefits of BOLI, it should be considered a long-term asset.

What are the tax consequences of surrendering BOLI?

Since most BOLI plans are established as Modified Endowment Contracts under IRC Section 7702, any withdrawal or surrender of funds in excess of the original premium will have an additional 10% penalty tax. This is true if there is a partial surrender of one of the policies or a complete surrender of all the policies. In the case of a single policy surrender, the IRS assumes that all of the gains from the complete BOLI program are earned in the first policy surrender and therefore are taxable out of the proceeds. In that regard, partial surrenders should be strongly avoided.

BOLI is a long-term asset. How can I manage credit risk?

The bank should do a thorough review of the credit worthiness of any potential carrier as part of its due diligence. In addition to the carriers, regulators have also stated that you should choose your vendor, the firm that will search for the insurance products, first and then choose that carriers. A firm that has strong financial support and support services can help provide updated credit information over the life of your BOLI coverage.

What happens if the tax treatment of BOLI changes?

BOLI's current tax benefits have been unsuccessfully challenged over the years. There are strong bank regulatory guidelines for proper use of BOLI. If the tax treatment is changed, existing plans may be grandfathered. However, if existing policies are not grandfathered, they may be surrendered for their cash surrender values.

BOLI Accounting Treatment

How is the income earned and recorded?

The Bank earns income in a BOLI arrangement from two sources. The first is from the growth of the cash value of the policy under FAS

Technical Bulletin 85-4. While the full cash value works for the company, the company records as an asset the cash surrender value (the full cash value less any applicable surrender charges in the event the contract is surrendered in the year being recorded). The cash value increases each year as the insurance carrier credits interest. The second source of income comes from the insurance proceeds paid to the Bank when insured employees die. The accounting treatment for a typical BOLI plan can be summarized as follows:

- BOLI purchase is reflected as an OTHER ASSET in the call report.
- Earnings (increases to cash surrender value) will be recorded as an after tax credit to an income account (OTHER INCOME).
- Receipt of the net-at-risk portion of death proceeds are also reflected as an after tax credit to an income account (OTHER INCOME).

How is BOLI regulated?

The regulations governing BOLI depend on the structure of the financial institution:

- **National Banks:** The OCC acts as the primary authority for BOLI usage for national banks. It has updated its guidelines for BOLI usage periodically in recent years. Its most recent declaration is OCC Bulletin 2004-66. This document outlines the ways in which banks. It has updated its guidelines for BOLI usage periodically in recent years. Its most recent declaration is OCC Bulletin 2004-56. This document outlines the ways in which BOLI can be used, as well as the risks that must be addressed prior to plan inception and over the life of the plan.
- **State Banks:** Part 362 of the FDIC's regulations provides the authority for state chartered banks' use of BOLI. These guidelines

largely defer to the parameters outlined in OCC Bulletin 2004-56, although exceptions may be permitted. In addition, state banks must make sure that any BOLI transactions fall within specific guidelines that may be issued by their state banking department.

- **Thrifts:** The most recent pronouncement regarding BOLI usage issued by the OTS is RB 32-26. This document is an update to the prior guidelines, OTS-250. The most recent guidelines largely follow the parameters of ODD Bulletin 2004-36, although some differences do exist.
- Regardless of a given institution's primary regulator, Schiff Benefits Group can assist you in designing and administering a BOLI program that is in full compliance with all relevant authorities.

Beyond banking regulations, are there limits on how much BOLI a bank can purchase?

Regardless of an institution's charter, any BOLI program must comply with state insurable interest laws. Schiff Benefits Group can advise you in determining appropriate amounts of coverage based on state law and the composition of a potential insured group

Currently there is a bill in congress called the "COLI Best Practices Bill" that will limit the percentage of insureds in any company, including banks. Carriers on the whole have already adopted these practices, but with the help of insurance organizations like National Association of Insurance and Financial Advisors (NAIFA) and Association of Advanced Life Underwriters (AALU).

What other limitations exist to the purchase of BOLI?

The OCC has been the lead regulator in this area. There are two basic tests: one based on benefits and one based on capital. The OCC has indicated that the

gains from BOLI cannot exceed the costs they are intended to offset. Schiff Benefits Group can help you in determining conservative parameters for the purchase of BOLI. In addition, the OCC says that as a general rule, a bank should not invest more than 15% of its Tier I capital with any one company and no more than 25% of its Tier I capital plus 25% of the allowance for loan and lease losses in BOLI as a whole. The OCC views these as guidelines, while the OTS regards them as stricter limitations.

What risks do banking regulators say need to be evaluated when buying BOLI?

The OCC requires that a bank evaluate six specific risks in its pre-purchase analysis: transaction risk, credit risk, interest rate risk, liquidity risk, compliance risk, and price risk. While the bank is ultimately responsible for its due diligence process, we can assist you in evaluating and documenting the analysis of each of these risks.

Are there additional risks that need to be evaluated?

Some areas that could potentially increase the tax risk of BOLI and invite IRS scrutiny include:

- **Borrowing:** A bank cannot directly borrow to fund BOLI or it will lose the interest deductions on the funds that were borrowed to do so. A bank should make clear in its documentation that the source of BOLI funding is not direct borrowings.
- **Business Objective:** A bank must have a valid business purpose for its purchase of BOLI. Schiff Benefits Group can assist you in documenting the purpose of your purchase, which is typically to offset a variety of benefit expenses.
- **Investor Control:** This issue is

primarily related to separate account plans. A bank may not exercise undue control of the product's underlying investments. Schiff Benefits Group can assist in designing a BOLI purchase that complies with this guideline, and negotiate documentation from the insurance company that the investment control is in compliance with the Code in this area.

- **Transfer of Risk:** In some plans with large groups of participants, a technique known as experience rating is used to relate mortality costs to a specific case, rather than a broad group. Depending on the particular structure, the IRS could argue that the BOLI policies are not life insurance since no risk has actually been transferred to the insurance company.

Schiff Benefits Group, LLC

712 Broadmoor Dr.
Blue Bell, PA 19422
(610) 292-9330

info@schiffbenefitsgroup.com

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Investment Advisory Services Offered Through ValMark Advisers, Inc. a
SEC Registered Investment Advisor
130 Springside Drive, Suite 300, Akron, OH 44333-2431* 1-800-765-5201
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