Bank Owned Life Insurance

BOLI: A Solution For Managing Employee Benefit Costs

NOLAN FINANCIAL

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BOLI

A viable tool for financing employee benefits

Bank-Owned Life Insurance (BOLI) is life insurance purchased by a bank on its key employees (typically limited to the top 35% most highly compensated employees). BOLI is a stable, low-risk source of financing that can generate gains to offset the rapidly rising cost of providing employee benefits, such as medical, group life, supplemental life, and qualified retirement plan expenses.

BOLI can also be used as a tool to informally fund nonqualified executive benefit plans. Typically, the bank pays the premiums and is the owner and beneficiary of the insurance policies. The death benefit proceeds can be used to defray the costs of overall health and employee benefits for the bank.

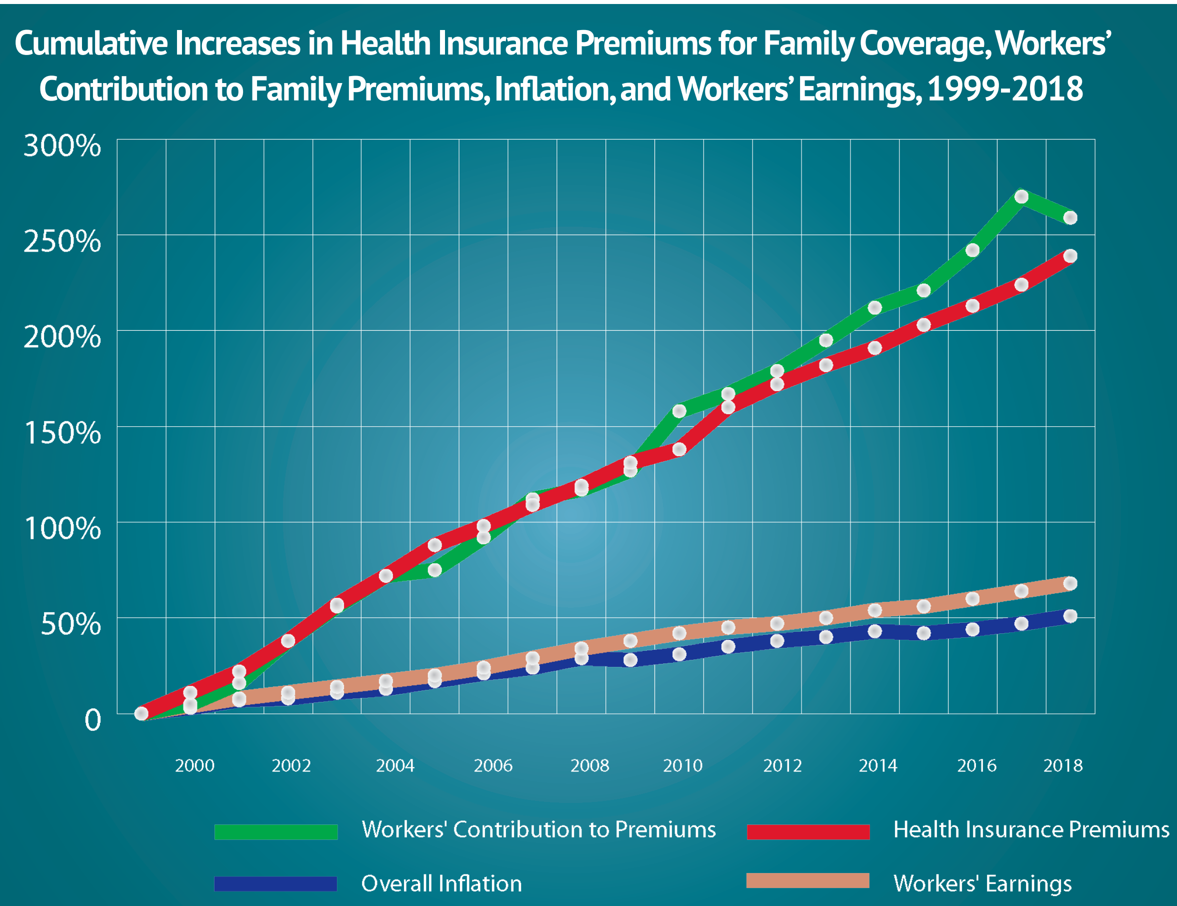
In general, life insurance policies are purchased with a single premium so as to yield a higher future death benefit. When properly utilized, life insurance holdings can serve a number of appropriate business purposes due to the income tax-free cash flows from a Bank Owned Life Insurance (BOLI) policy.

The overall trend of increasing employee retirement and welfare benefits costs is expected to continue.

One aspect of these costs relates to health insurance premiums, (as seen in the chart below). This graph illustrates the cumulative percentage increase in health insurance premiums from 1999–2018.[1] The dramatic increase in health insurance premiums affects employers and employees. The average premium for family health coverage through an employer was $19,616 in 2018, of which covered workers paid an average of $5,547.

As health insurance premiums continue to increase, managing employee retirement and welfare benefits costs can be the game changer.

1. Source: KFF Employer Health Benefit Survey, 2018; Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 1999-2017. Bureau of Labor Statistics, Consumer Price Index, U.S. City Average of Annual Inflation (April to April), 1999-2018; Bureau of Labor Statistics, Seasonally Adjusted Data from the Current Employment Statistics Survey, 1999-2018 (April to April).



BOLI

Plan management, administration and recordkeeping

As part of our best in class service, Nolan Financial offers BOLI management and oversight. Our BOLI knowledge and management combined with the recordkeeping and administration services of The Pangburn Group (TPG) offers our clients the added protection they deserve.

TPG services approximately 25% of all US banks that currently hold BOLI and reports on more than 26,500 policies per month with a total cash value of $7.45 billion. [2]

Nolan Financial's use of an independent, third party BOLI recordkeeper and administrator is a financially prudent strategy and is more consistent with the long-term nature of the BOLI transaction. For bank programs, Interagency Guidelines* suggest:

"... reliance solely upon pre-packaged, vendor-supplied compliance information does not demonstrate prudence with respect to the purchase of insurance." [2]

Benefits of BOLI

- Higher after-tax yield than traditional bank investments
- Tax-free earnings if policies are held until the death of the insureds
- Earnings flow through to P&L statement per FASB Technical Bulletin 85-4
- Tool to informally fund nonqualified executive benefit plans
- Policy growth potential
- Long-term stability
- Built-in rate guarantees
- Interest rate risk protection
- Strength of insurance company
- Predictable asset liability management
- Death benefit recovery
- Low front-end charges

2. Source: The Pangburn Group, BOLI tracker courtesy of the COLI Consulting Group. Numbers provided are as of December 31, 2016.

Regulations

BOLI regulatory framework specific to banks

Interagency Guidelines[3]

- Issued to remind national banks of safe and sound banking practices in connection with purchases of BOLI
- Under the Guidelines, banks are not allowed to purchase BOLI for:
  - Speculation
  - Repurchasing shares from deceased shareholder
  - Providing unreasonable estate planning benefits to insiders
  - Generating funds for normal operating expenses other than employee compensation and benefits
- It is generally not prudent for an institution to hold BOLI with an aggregate cash surrender value that exceeds 25% of the institution's Tier I capital
- To diversify credit risk according to the Lending Limits Guidelines of 12 C.F.R. Part 32.3(a), it is generally not prudent for an institution to purchase General Account BOLI in excess of 15% of its capital from any one insurance company.

"BOLI can help offset the rapidly rising cost of providing employee benefits."

3. Source: *Interagency Statement on the Purchase and Risk Management of Life Insurance; December 7, 2004 (OCC Bulletin 2004-56; FDIC FIL-127-2004; Federal Reserve Board Supervisory Letter SR 04-19)*

How BOLI Works

The mechanics of a typical BOLI purchase

Bank-Owned Life Insurance (BOLI) is a fairly straightforward life insurance program. A bank purchases life insurance policies on the lives of its consenting employees for purposes of utilizing the death benefit proceeds to defray the costs of overall health and employee benefits for the bank. The bank is the owner and beneficiary of the BOLI policies. Typically the life insurance policies are purchased with a single premium (structured as Modified Endowment Contract "MEC") so as to yield a higher future death benefit.

MEC policies have the lowest initial death benefit allowable in relation to the policy cash values, offering the highest yield on the bank's premium investment with higher future death benefits.

If MEC policies are surrendered or the cash value is accessed, the accrued earnings become taxable to the bank and there is an additional 10% penalty tax on the earnings.

1 The Bank

The bank purchases institutionally-priced life insurance products designed for the BOLI market on a group of employees.

2 COLI/BOLI Best Practices

The insured group is limited to the top 35% of the bank's employees by compensation in order to comply with IRC 101(j) regulations.

3 Owner & Beneficiary

The bank is the owner and beneficiary of the BOLI policies.

4 Policies

Policies are typically purchased with a single premium, structured as Modified Endowment Contracts ("MEC").

5 Tax-Deferred Basis

Cash value accumulates on a tax-deferred basis and the earnings are reported as "other income" on the P&L statement (FASB Technical Bulletin 85-4) to help offset benefit expenses.

6 Death Benefits

If the policies are held until the death of the insureds, the death benefits are paid to the bank on a tax-free basis to provide additional income to offset benefit expenses.

"BOLI policies may be maintained on employees who retire or leave the bank."

BOLI Products

There are three types of BOLI products

General Account

- The policy cash values are held in the General Account of the insurance company.
- Insurance company sets the crediting rate based on the General Account portfolio yield and offers a minimum guaranteed crediting rate.
- The crediting rate may be based on a new money rate or a portfolio rate.[4]
- Since the policy values are part of the insurance company's General Account, the bank is a general creditor and exposed to the credit risk of the insurance company.
- The policy assets carry a risk-based weighting of 100%.

Separate Account

- Typically private placement with policy cash values allocated among variable investment options and subject to market fluctuations.
- The bank chooses from the available investment options and may reallocate periodically.
- Does not have a minimum guaranteed crediting rate, but may be structured to include a stable value wrap for an additional fee.
- Assets are protected from the general creditors of the insurance company. However, the bank takes on the credit risk of the underlying investments.
- The policy assets may carry a risk-based weighting of 20% to 100%, depending on the underlying investments.

Hybrid

- Combines certain features of General Account and Separate Account products.
- Policy assets are held in separate accounts, so they are protected from the creditor risk of the insurance company.
- Typically offer 2-3 investment portfolio options and the insurance company sets the crediting rate for each portfolio based on its projected yield.
- Hybrid products offer a minimum guaranteed crediting rate, eliminating the need for a stable value wrapper.
- The policy assets carry a risk-based weighting of 100%.

4. Crediting methods: The insurance company may determine the interest crediting rate on a General Account product based on a new money rate or a portfolio rate. Some products start with a new money rate that blends into a portfolio rate over a number of years. At any given time, one method will generate a higher yield than the other. But over the long term given periods of increasing and decreasing interest rates, the differences between the two method should generally be minimized impact on income.

New Money Rate

- *The insurance company sets the interest crediting rate based on the interest rate it can earn on new BOLI policy premiums that it invests. The renewal rates in subsequent years are generally based on then current market rates.*

Portfolio Rate

- *The insurance company sets the interest crediting rate based on the interest rate of the entire portfolio of assets in its General Account.*

> *"A pre-purchase analysis* **examines the risks** *associated with BOLI."*

Pre-Purchase

Comprehensive risk management process analysis

1 Identify the need for insurance & determine the economic benefits and appropriate insurance type.

- An institution should determine the need for insurance by identifying the specific risk of loss to which it is exposed or the specific costs to be recovered.

2 Quantify the amount of insurance appropriate for the institution's objectives.

- An institution should estimate the size of the employee benefit obligation or the risk of loss to be covered and ensure that the amount of BOLI purchased is not excessive in relation to this estimate and the associated product risks.
- When using BOLI to recover the cost of providing employee benefits, the estimated present value of future net cash inflows from BOLI, should not exceed the estimated present value of the expected after-tax employee benefit costs.

3 Assess vendor qualifications.

- Depending on the role of the vendor, the vendor's services can be extensive and may be critical to successful implementation and operation of a BOLI plan.

4 Review the characteristics of the available insurance products.

- An institution should understand the product it is considering purchasing, and select those with the characteristics that best match the institution's objectives, needs, and risk tolerance.

5 Select carrier.

- Management should review the product design, pricing, and administrative services of proposed carriers and compare them with the institution's needs.
- Management should also review the insurance company's BOLI experience, ratings, and reputation.

BOLI Analysis

Risk categories that must be analyzed

6 **Determine the reasonableness of compensation provided to the insured employee if the insurance results in additional compensation.**

- Before an institution enters into a split-dollar arrangement or otherwise purchases insurance for the benefit of an officer, director, or employee, the institution should identify and quantify its compensation objective and ensure that the arrangement is consistent with that objective and that the insured's total compensation, including the compensation provided by the split-dollar arrangement, is not excessive.

7 **Analyze the associated risks and the ability to monitor and respond to those risks.**

- The Interagency Guidelines suggest that institutions can control compliance and reputation risks by obtaining informed employee consent and limiting death benefit amounts to a reasonable multiple of an employee's salary.
- Institutions can control credit, interest rate, liquidity, and transaction risks by limiting the aggregate CSV of policies from any one insurance carrier, as well as limiting the aggregate CSV of policies from all insurance carriers.

8 **Evaluate alternatives.**

- An institution should analyze the risks and benefits of acquiring BOLI compared to alternative methods for recovering the costs associated with the loss of key persons, providing pre- and post-retirement employee benefits, or providing additional employee compensation, as appropriate.

9 **Document decision.**

- An institution should maintain documentation supporting its comprehensive pre-purchase analysis, including an analysis of both the types and design of products purchased and the overall level of BOLI holdings.

> *"A pre- and post- purchase analysis* **must be performed** *for BOLI."*

Monitoring Risks

BOLI risks should be monitored on an ongoing basis

In addition to the pre-purchase analysis, the Interagency Guidelines also require the monitoring of BOLI risks on an ongoing basis.

Management of an institution should review the performance of the institution's insurance assets with its board of directors at least annually. This review should include:

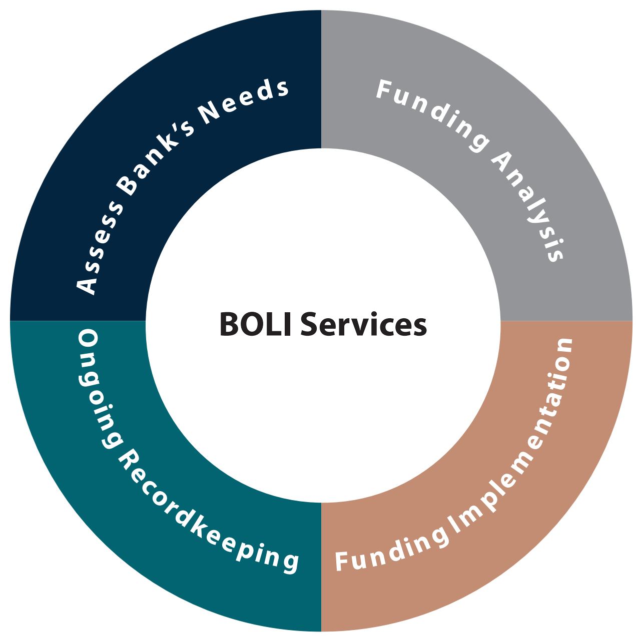
- A comprehensive assessment of the specific risks associated with BOLI.
- Identification of which employees are, or will be, insured (e.g., vice presidents and above, employees of a certain grade level).
- Assessment of death benefit amounts relative to employee salaries.
- Calculation of the percentage of insured persons still employed by the institution.
- Evaluation of the material changes to BOLI risk management policies.
- Assessment of the effects of policy exchanges.
- Analysis of mortality performance and impact on income.

The review should also include the following:

- Evaluation of material findings from internal and external audits and independent risk management reviews.
- Identification of the reason for, and tax implication of, any partial surrenders.
- Peer analysis of BOLI holdings.

Nolan Financial works with The Pangburn Group to provide comprehensive ongoing recordkeeping and risk monitoring as required by the Interagency Guidelines.

Nolan Financial's goal is to stay fully informed of changes in tax laws, government regulations, and business environments to offer our clients the most comprehensive and competitive BOLI programs available.



Steps In A Typical BOLI Case

Step 1

Bank expresses interest in BOLI solution and Nolan Financial reviews the BOLI capacity of the Bank

Step 2

Discussion is held with Bank to discuss BOLI capacity

Step 3

Bank provides Census data on proposed insureds & Nolan Financial procures BOLI quotes on behalf of bank

Step 4

Nolan Financial prepares analysis of BOLI products and quotes

Step 5

Pre-purchase analysis is completed

Step 6

Implementation and ongoing Administration

Although every case is different, there are six primary steps Nolan Financial follows to meet client needs

In developing BOLI solutions, Nolan Financial takes a consultative, prescriptive approach to ensure optimum solutions. We spend considerable time evaluating the bank's BOLI funding objectives to ensure that they fit with the overall financial and philosophical objectives.

Through 30 years of experience, Nolan Financial has been recognized as a specialist in the design, funding, implementation, and recordkeeping of selective nonqualified executive benefit programs. Our team of professionals specializes in nonqualified executive benefits helping Banks implement BOLI plans from start to finish.

> *"The following* **scenario** *illustrates the BOLI concept."*

Case Analysis

Funding Scenario for a hypothetical

A sample XYZ Bank's capacity for the purchase of BOLI was estimated to be the following:

- Tier I Capital: $40,000,000
- 25% of Tier I Capital: $10,000,000 (max total BOLI holdings)
- 15% of Tier I Capital: $6,000,000 (maximum General Account BOLI holdings from any single insurance carrier)

The sample illustration is based on a General Account BOLI product offered by a very highly rated insurance company. Many banks may prefer a General Account BOLI product due to the complexities associated with the private placement transactions of Separate Account products and the additional investment risks involved. As part of its BOLI services, Nolan Financial conducts a thorough review and analysis of the most competitive products available for purchase by a bank. The initial crediting rates offered by the various insurance companies can change as often as weekly, so it is important to review the current rates offered by all carriers to determine the most competitive product at a given time.

Sample Illustration: Projections based on $5,000,000 of BOLI premium insuring the life of a sample 45 year-old male:

	PREMIUM	CASH VALUE	DEATH BENEFIT	CUMULATIVE IRR ON CASH VALUE	CUMULATIVE IRR ON DEATH BENEFIT	ANNUAL P&L IMPACT	CUMULATIVE P&L IMPACT
1	(5,000,000)	5,193,950	17,451,700	3.88%	249.03%	193,950	193,950
2		5,383,000	17,494,700	3.76%	87.05%	189,050	383,000
3		5,569,400	17,543,650	3.66%	51.96%	186,400	569,400
4		5,753,950	17,549,500	3.57%	36.87%	184,550	753,950
5		5,935,800	17,510,600	3.49%	28.49%	181,850	935,800
6		6,113,850	17,485,550	3.41%	23.20%	178,050	1,113,850
7		6,297,000	17,442,750	3.35%	19.54%	183,150	1,297,000
8		6,484,800	17,379,300	3.30%	16.85%	187,800	1,484,800
9		6,677,900	17,295,700	3.27%	14.79%	193,100	1,677,900
10		6,875,700	17,258,050	3.24%	13.19%	197,800	1,875,700
11		7,078,000	17,270,350	3.21%	11.93%	202,300	2,078,000
12		7,285,550	17,193,950	3.19%	10.84%	207,550	2,285,550
13		7,498,600	17,171,800	3.17%	9.96%	213,050	2,498,600
14		7,718,550	17,212,350	3.15%	9.23%	219,950	2,718,550
15		7,945,950	17,163,200	3.14%	8.57%	227,400	2,945,950
16		8,177,800	17,173,350	3.12%	8.02%	231,850	3,177,800
17		8,413,450	17,163,400	3.11%	7.52%	235,650	3,413,450
18		8,651,700	17,216,900	3.09%	7.11%	238,250	3,651,700
19		8,892,950	17,163,400	3.08%	6.71%	241,250	3,892,950
20		9,136,950	17,177,450	3.06%	6.37%	244,000	4,136,950
21		9,384,050	17,172,800	3.04%	6.05%	247,100	4,384,050
22		9,634,050	17,244,900	3.03%	5.79%	250,000	4,634,050
23		9,888,800	17,206,500	3.01%	5.52%	254,750	4,888,800
24		10,147,400	17,250,550	2.99%	5.30%	258,600	5,147,400
25		10,410,550	17,281,500	2.98%	5.09%	263,150	5,410,550

Values based upon non-guaranteed current declared interest crediting rates and mortality & expense assumptions. Actual interest crediting rate may be more or less than that illustrated. All non-guaranteed elements are subject to change at the discretion of the insurance company. This is a hypothetical illustration. Actual results will vary.

Recognizing Performance

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