Addressing the Philosophical Objection of BOLI

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Bank-Owned Life Insurance (BOLI) has existed for nearly three decades and serves an important role in the banking industry as an efficient tax favored asset used to finance employee benefit programs. Currently, over 57% of all U.S. banks own BOLI and over 73% of U.S. banks with over $250 million in assets own BOLI. Total BOLI assets currently exceed $145 billion. In 2004, Regulators issued interagency guidance (OCC 2004-56), providing banks a definitive roadmap to follow as to the purpose of BOLI and purchase instructions. This regulatory blessing was again affirmed in Dodd Frank's Volcker Rule section in 2010. Given today's prevalence of BOLI and regulatory backing, objections to owning this popular asset still exist.

Objections to owning BOLI is puzzling given its merits. BOLI has an extensive track record of outperforming similar bank eligible investments such as municipal bonds, US treasuries, and mortgage-backed securities. The credit quality of most BOLI is excellent as insurance carriers offering the product are generally rated highly by agencies such as S&P, Moody's and AM Best. BOLI offers investment diversification and a consistent, non-volatile, return while potentially mitigating interest rate risk. The administration and accounting of BOLI is also simple and straightforward. The cash surrender value is booked as an "Other Asset" and the period-to-period increase in cash surrender value is recorded as "Other Non-interest Income."

The general objections to BOLI are typically either based on the perception of BOLI's liquidity or philosophical in nature. Banks that are concerned with liquidity usually have current strong loan demand or have strategic plans to utilize its capital for branch expansion or acquisition goals. To maximize return, BOLI is intended to be held long-term as BOLI gains are tax deferred (tax-free if held until death). Banks are reluctant to surrender BOLI as gains are subject to income tax and a 10% excise tax. A surrender analysis should be completed prior to a BOLI purchase to determine if BOLI is still a good investment if the bank ultimately has liquidity needs and must surrender. This analysis typically demonstrates BOLI having an incremental return to other available investments even upon early surrender. However, if the bank has liquidity issues or their strategic plans require greater liquidity, they might be reluctant to invest in BOLI.

The more pervasive objection to BOLI is philosophical in nature and generally relates to the discomfort of receiving death benefit payments on the lives of current or former employees. This creates a misconception that the bank is profiting on the death of an executive. While reputation risk must be considered, a proper understanding of BOLI is warranted. It is designed as an institutional product, providing maximum cash value and minimal excess death benefit but there still needs to be an amount at risk to the insurance carrier so that it qualifies as life insurance and retains its tax favored attributes. OCC 2004-56 Interagency Guidance states *"Life insurance holdings can serve a number of appropriate business purposes. Because the cash flows from a BOLI policy are generally income tax-free if the institution holds the policy for its full term, BOLI can provide attractive tax-equivalent yields to help offset the rapidly rising cost of providing employee benefits."*

BOLI providers also adhere to COLI Best Practices, codified in the Pension Protection Act of 2006. This requires positive written consent of all individuals being insured, may insure only highly compensated employees and coverage is limited to key persons (management or officer level). Employees uncomfortable being insured can simply decline to consent to be insured, which occurs from time to time. Most banks explain to employees that the BOLI program in which they are being asked to participate is designed to accomplish three objectives. First, BOLI helps the bank increase earnings in order to offset either a specific benefit program the employee is participating in or overall annual increases in employee benefit programs such as health insurance or pension cost. Second, BOLI provides key person life insurance coverage in the event of a key employee's untimely death. This benefit reimburses the bank for lost skills and knowledge and helps to fund the search and replacement cost of finding new executives. Many banks undervalue the fiscal impact of losing an experienced executive. Third, BOLI may provide a death benefit payment to the insured employee's named beneficiary.

A bank has the choice of whether or not to share a portion of the death benefit with the executive. If a bank opts to share a portion of the death benefit, it must decide whether to provide this benefit exclusively during employment or to extend the benefit into retirement. If the bank provides the benefit postretirement it must accrue an expense for the postretirement death benefit liability according to accounting rules (ASC 715). Due to this expense, it is typical for a bank to provide shared death benefits only while the insured individual is employed in order to maximize the incremental income to the bank's bottom line thus accomplishing BOLI's objective to effectively offset employee benefit costs.

As an insured under a BOLI program, executives should understand that ultimately the bank will receive a death benefit payment on their life. They should also understand that this allows the bank to increase profitability, benefiting all employees via profit sharing or expanded benefits. Most executives recognize this trade off and are willing participants in a properly designed BOLI program.

The fact that the bank can choose to only share death benefits during employment, or not share any death benefit at all, contributes to the philosophical objection some banks and bank Boards have with BOLI. However, fundamentally, BOLI's death benefits result from years of investment gains on the policies which were implemented to finance the bank's employee benefit costs. The death benefit proceeds are part of the overall financing strategy, ultimately providing the bank with recovery of costs incurred. Banks that object to BOLI still have employee benefit costs that must be paid and an alternative asset or investment must be employed to offset those costs. BOLI offers a more effective asset that allows banks to free up resources to expend on other important objectives such as additional loans, growth via expansion or acquisition, reinvestment into the community under the Community Reinvestment Act (CRA) or expanded shareholder dividends.

About the Author

John has almost thirty years of experience in the executive benefits area and bank- and corporate-owned life insurance. From 1997 through 2004 he was the President and Chief Executive Officer of a nationally recognized executive benefit organization. Since that time he has been a consultant to banks as part of the M Benefit Solutions - Bank Strategies group of banking advisors, the endorsed provider of executive benefits and BOLI for the ICBA. His expertise in the review of the legal, actuarial and financing of executive benefits and life insurance programs as well as timeline control and presentation ability to board committees has been obtained through completion of hundreds of corporate engagements and board presentations. John is a registered representative with M Holdings Securities, Inc. He is a current member of AALU. John is a member of ABA, ICBA and various state banking associations as well as The Financial Managers Society.

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