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Opportunities and Objections to Insurance Company-Owned Life Insurance (ICOLI)

By Russell McMillan

The ever-extending low interest rate environment continues to present a significant challenge for insurance companies. Bond yields continue to decline and investment returns are hurting overall profitability. Investment managers have altered strategies within current risk mandates by reducing bond turnover and extending maturities. There has also been an increased exposure to lower quality, high yield bonds and private credit strategies as well as diversifying into less traditional alternative, Schedule BA, assets such as private equity and hedge funds.

Today's economy is compelling asset managers to investigate unfamiliar investments. While challenging and scary, this represents a real opportunity for the industry to diversify its holdings by incorporating non-traditional assets into its portfolio. Managers incorporating these new assets into their comprehensive allocation strategy and working within overall risk management mandates will see results.

Many of these new assets may offer margin opportunities but correspondingly come with potentially higher risk-based capital charges or illiquidity. Whether insurance companies contemplate investing in alternative assets or continue to stay the course with their traditional asset allocation approach, consideration should be given to place a portion of the portfolio within Insurance Company-Owned Life Insurance (ICOLI).

What is ICOLI?

- **ICOLI is life insurance purchased by an insurance company as a tax-efficient investment with potentially favorable risk based capital treatment**
- **ICOLI is an investment vehicle that helps insurance companies optimize risk adjusted returns**

ICOLI is an investment vehicle that helps insurance companies optimize their risk adjusted returns. ICOLI can enhance yields due to its tax favored status while simultaneously mitigating some risk capital hurdles. Companies can place almost any asset class within an ICOLI structure from fixed income to senior secured floating bank loans to equities to alternatives such as hedge funds. However, while all insurance companies can own ICOLI, not all should. There are many factors to consider, but, due to its many advantages, it's an opportunity worth exploring.

The ICOLI Opportunity

ICOLI is life insurance purchased by an insurance company as a tax-efficient investment with potentially favorable risk based capital treatment. The cash value growth in the policy is tax-deferred (tax-free if held until death) and the death benefits are tax-free.

The insurance company purchases the life insurance on a select group of key employees. The company is the owner and beneficiary, although some companies may opt to share a portion of the insurance proceeds with the insureds.

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Insurance companies may utilize ICOLI as a treasury asset or as an investment strategy to fund, or cost-offset, benefit programs in aggregate, including the high rise in healthcare costs and other group benefits. ICOLI may potentially reduce capital reserve requirements as there are generally no statutory "look through" requirements to underlying investments. The ICOLI statutory risk based capital treatment for a life company is 0% and for a P&C company it is 5%. There is also potentially favorable accounting treatment as income runs through operating earnings.

Companies typically purchase ICOLI for the following reasons:

- Potential for higher investment yields due to tax favored status
  - Tax efficient asset accumulation; the cash value growth in an ICOLI policy is tax-deferred (tax-free if held until death)
  - Protection of capital via tax-free death benefits
  - Does not create a tax deferred liability
- Access to a wide array of investment strategies/portfolios
  - Asset protection via bankruptcy remote separate account structure
  - Allocate to virtually any asset class
    - Strategies include tax inefficient assets and assets with high risk based capital charges (Equities and Schedule BA Assets)
  - Ability to re-allocate investments within ICOLI without incurring taxes
- Potential to reduce capital reserve requirements
  - NAIC RBC charge is 0% for life companies and 5% for property and casualty companies
- Clear regulatory and tax guidelines
  - ICOLI is an admitted asset
  - COLI Best Practices Act (Pension Protection Act of 2006; Internal Revenue Code 101(j))
  - IRS Revenue Procedure 2007-61—insurance companies eligible for beneficial tax treatment from ICOLI
- Income runs through operating earnings

ICOLI Product and Process

ICOLI is a tax efficient investment vehicle but it does come with associated costs. While ICOLI offers many benefits, including lowering risk-based capital charges and tax-free death benefits, the decision to buy ICOLI usually comes down to the significance of the tax savings versus the total insurance costs.

ICOLI is an investment-oriented life insurance product that is institutionally priced. The policy is typically a Private Placement Variable Universal Life Insurance (PPVUL) product and is designed to minimize up-front loads which can potentially create high early cash value and minimize insurance costs.

ICOLI cost components vary for each carrier and product. Carriers charge costs, often referred to as "policy drag" or "frictional costs," in exchange for insurance contracts. The various costs can normally be categorized as direct costs, financing costs or capital costs.

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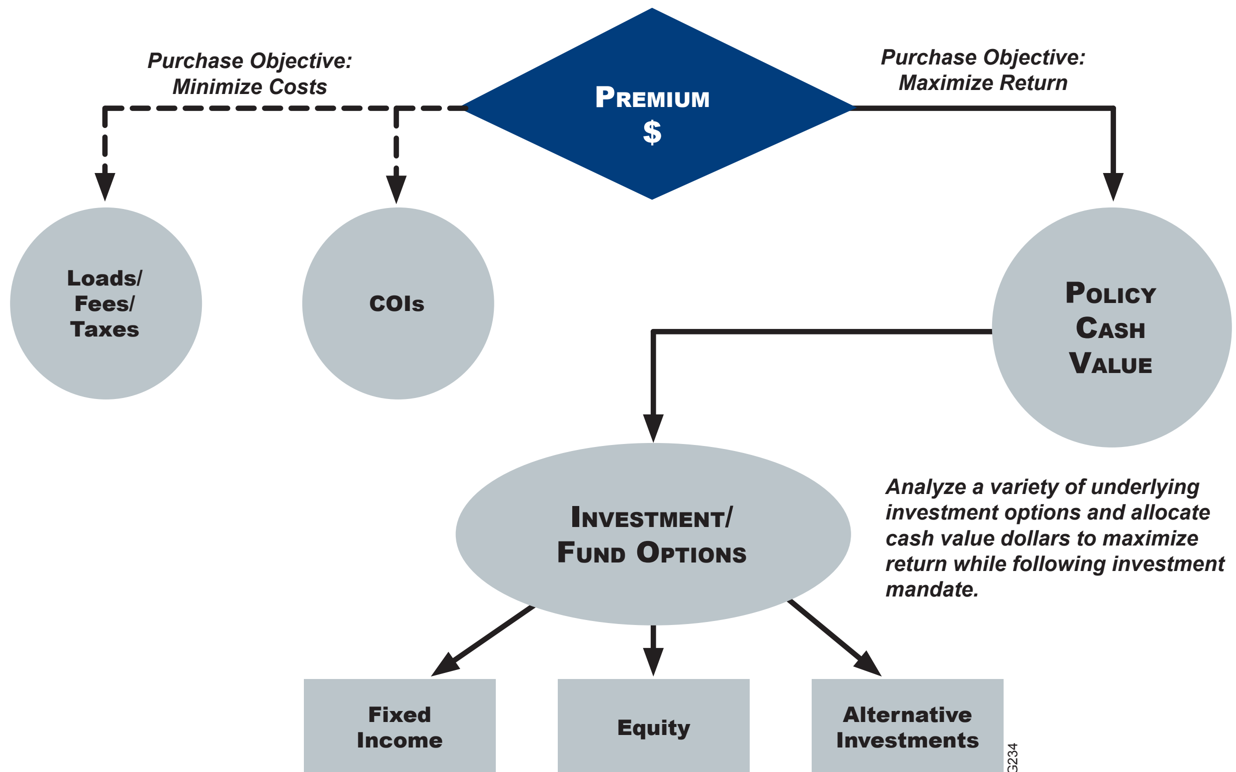
Direct costs incurred that are embedded into the product may include: premium tax, Deferred Acquisition Cost (DAC) tax, commissions/sales loads, Investment Management Fee, reinsurance premiums, and death claims. These costs characterize direct frictional costs and are charged against the premium or cash value. The direct charge may be immediate or may include a financing element. Financing costs are costs associated with the amortization of any direct cost that is normally charged in the first year.

A carrier also incurs capital costs that are costs associated with the risk capital that the carrier must allocate to support the business. The carrier must dedicate a certain amount of capital and surplus to each insurance contract and must follow regulatory requirements as to how they can invest these funds. If a carrier can't meet earnings demands due to these investment restraints, it may obtain the earnings from the contract, adding to the policy drag.

ICOLI sounds complicated but, with the proper guidance, it can be simplified. The overall purchase goals should be to minimize the costs and maximize the return working within the parameters of the insurance company's investment mandate (see chart below).

ICOLI—Process at Purchase



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To illustrate the how ICOLI generates additional profits, the following shows a comparison between a hypothetical ICOLI investment and an insurance company investment outside ICOLI given the same net yields.

	Taxable Investment	Hypothetical ICOLI
Net Yield (net of all fees/costs)	6.00%	6.00%
Less: Insurance Expense	0.00	0.90
Pretax Return	6.00	5.10
Less: 40% Assumed Tax Rate	2.40	0.00
After-tax Return	**3.60**	**5.10**
Tax Equivalent Return	**6.00%**	**8.50%**

The chart illustrates the effect of the income tax characteristics of life insurance on after-tax results by assuming, hypothetically, that each alternative generates the same pretax rate of return. This chart incorporates hypothetical values that, while believed to be accurate, are not guaranteed nor are they a representation of post or future results. Actual results will vary.

The above example shows an after-tax improvement of 150 bps due to the reduction of tax drag being larger than the added insurance costs, or policy drag.

ICOLI becomes an attractive investment option due to the potentially substantial incremental income created by a small reallocation to ICOLI as well as the additional benefits of reducing capital requirements, wide range of investment options and possible income statement advantages.

ICOLI Objections

Despite the multiple benefits, there are attributes of ICOLI to consider before a purchase. There are some common objections, or possible misconceptions, to owning ICOLI. Companies may also not prove a good fit with ICOLI due to their financial condition or other specific, subjective, considerations that cause reluctance to invest.

The following lists some of the more common objections to ICOLI.

Fear of the Unknown

ICOLI is foreign to most insurance companies. Insurance company investment officers feel more comfortable owning an unfamiliar asset if it's a known quantity. This is understandable as it gives the investor a level of comfort knowing they are in good company if many of their peers already own the asset.

While it is true that a minority in the overall insurance industry hold ICOLI, insurance companies have owned ICOLI for many years. At the end of year 2016, it is estimated that ICOLI holdings totaled more than $22 billion. Not surprisingly, a higher percentage of larger companies own ICOLI compared to smaller companies. An estimated 35% of insurance companies with greater than $10 billion in assets own ICOLI and over 19% of companies with greater than $1 billion in assets own ICOLI. These overall ownership numbers drop dramatically in smaller companies as 6.2% of companies with greater than $100 million and less than $1 billion in assets own ICOLI.

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However, growth in recent years is strong as the number of companies that have ICOLI holdings has increased approximately 58% and ICOLI cash surrender value has increased an estimated 32% since 2012.[1]

This growth pattern follows a similar path as seen in the bank market. Bank-Owned Life Insurance (BOLI) was owned and enjoyed for years by the large banks. It took a few years to trickle down to the smaller, community bank, level and today is viewed as a prized asset on the balance sheet as 62% of all banks own BOLI.[1]

It is prudent to view the new and unfamiliar with increased skepticism. However, as more companies add it to their holdings, ICOLI will become more familiar and understood for what it is, a tax-favored and risk efficient investment vehicle.

Complex Purchase Process

ICOLI is a simple concept and not an overly complex asset. However, the purchase process can appear daunting. The purchase typically involves several departments beyond investments such as tax, legal, accounting and human resources. Companies making their first purchase must go through a learning curve.

A Chief Investment Officer (CIO) may be drawn to the benefits of ICOLI but may not feel it's worth the effort, as there may be more steps to purchase than a typical investment. However, while an initial purchase may be time consuming, it is not necessarily difficult to achieve and will be marshalled by the ICOLI consultant. Once the first ICOLI purchase is implemented, the process is in place and subsequent purchases are relatively easy and uneventful.

The insurance company must take care to select an ICOLI provider that adheres to best practices when it comes to administration, reporting and systems as well as financial stability and long-term commitment to the marketplace. This type of company will offer robust systems, web access for reporting purposes and administration capabilities to assist with any ongoing asset, regulatory or compliance concerns.

ICOLI Liquidity

A common objection is the perception that ICOLI is illiquid. Insurance companies normally purchase COLI using surplus and companies concerned with liquidity may have alternative plans with their capital such as stock buy-backs, dividends, acquisitions, internal growth or new business lines. With that in mind, it's good to analyze ICOLI in terms of return on capital just as a company would with its other options. Note that of U.S. companies that do own ICOLI, the average holding as a percent of adjusted capital is 7.4%. Such a small amount of capital allocated to ICOLI should not hinder any other major strategic uses for capital.

ICOLI is intended to be a long-term asset. ICOLI gains are tax-deferred (tax-free if held until death) if policies are kept in-force and not surrendered. If surrendered, gains are subject to income tax and may also be subject to an additional 10% excise tax. Although there are many disincentives to surrender, the policies are still considered liquid and funds are available relatively quickly, assuming there are no lockup provisions with underlying funds. An insurance company should always perform a surrender analysis prior to purchase to ascertain the value of the investment if the insurance company did need to liquidate the policies in the future. Once the analysis is completed, typically companies are comforted that the returns are meaningful, despite incurring taxes and potential tax penalties.

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Other Tax-Deferred Investments Available/Municipal Bonds

Insurance companies already have a tax-favored option in municipal bonds. This asset class is obviously well established and well utilized. However, tax-deferral growth is really one of the only things municipal bonds and ICOLI have in common. In addition to tax-deferred growth, ICOLI provides a tax-free death benefit. Another difference is that virtually any asset class can be placed in an ICOLI structure and the buyer can allocate within multiple funds. The risks associated with municipal bonds, depending on the type of bond, such as call risk, price and interest rate risk don't totally translate to ICOLI. The flexibility of ICOLI allowing for investments in fixed income or emerging markets or hedge funds, or a combination of asset classes differentiates itself from municipal bonds.

ICOLI and municipal bonds are often put into the same broad tax-deferred asset class bucket. In reality, these are totally different and unique asset classes.

Compliance and Regulatory Concerns

Because insurance companies are unfamiliar with ICOLI, many may assume that there is additional associated regulatory scrutiny or risk. However, the tax, accounting and regulatory treatment are clear:

- ICOLI is an admitted asset (SSAP 21)
- COLI Best Practices[2] lays out clear and simple guidelines to owning ICOLI
- Tax treatment is straight forward
  - Internal Revenue Code Section 264 (f)
  - Revenue Procedure 2007-61
- Accounting
  - GAAP (ASC 325)
    - Balance Sheet: ICOLI reported as "Other Asset"
    - Income Statement: ICOLI gains as "Other Income"
  - Statutory
    - Balance Sheet: ICOLI reported within "Aggregate write-ins other than invested assets"
    - Income Statement: ICOLI gains reported within "Aggregate write-ins for miscellaneous income"

From a regulatory and compliance stand point, ICOLI it is not complicated. An argument can be made that is actually less onerous and less scrutinized than typical investments that appear on relevant investment schedules.

Conclusion

The stagnant low rate environment poses a significant challenge to insurance companies. With portfolios producing insufficient yield, companies are having difficulty meeting liability responsibilities let alone producing excess profits. A larger concentration of portfolio assets are being placed in higher yielding, less liquid and more volatile asset classes. This is outside historical norms and behavior. The industry is changing and can't rely on investment strategies that worked well over the last 30 years. Change is difficult, but inevitable. New strategies will emerge with new opportunities for success, such as ICOLI.

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NOTES

[1]*Data Source: SNL Financial LLC. Contains copyrighted and trade secret material distributed under license from SNL. For recipient's internal use only.*

[2]*COLI Best Practices was codified by the Pension Protection Act of 2006 in Internal Revenue Code 101(j).*

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To learn more about ICOLI and how M Benefit Solutions can help your insurance company, please contact Russell McMillan at 503.414.7307; russell.mcmillan@mben.com.

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