Asset/Liability Management (ALM) Analysis of Bank-Owned Life Insurance

Life insurance purchases can serve a number of appropriate business purposes. For example, federal and state banking regulators have recognized that BOLI can be a useful product to recover costs associated with providing employee benefits. However, the purchase of Bank-Owned Life Insurance (BOLI) must be consistent with safe and sound banking practices. The Interagency Statement on the Purchase and Risk Management of Life Insurance describes supervisory expectations for a thorough prepurchase analysis and a sound risk control framework used to address BOLI exposures on an ongoing basis.

Financial institutions should analyze the following Asset/Liability Management (ALM) concerns prior to the purchase of any asset, including BOLI.

1. Effect on Capital

One major issue to consider in contemplating the purchase of BOLI versus an alternative bank investment (e.g., a government agency bond) is the effect on the financial institution's capital ratios. If an institution owns a general account insurance product, it should apply a 100 percent risk weight to its claim on the insurance company for risk-weight capital purposes. Applicable regulatory guidance on BOLI provides an alternative "look-through" approach for certain investments in separate account BOLI assuming the funds in the separate account are insulated from the creditors of the insurance carrier.

2. Effect on Liquidity

The Interagency Statement notes that bank management should recognize the illiquid nature of permanent insurance and ensure that the institution has the financial flexibility to hold the asset in accordance with its expected use. Institutions generally do not receive cash flow from a BOLI program until death benefits are paid upon the maturity of a policy. Depending upon the age of the insured population, it is possible that an institution that insures a small number of employees may not receive cash flow from the insurance for many years.

Many insurance carriers in the BOLI market allow an institution to surrender its BOLI policies without incurring a surrender charge; however, adverse tax consequences may result from surrendering the policies. This is particularly true with a BOLI product that qualifies as modified endowment contract (MEC) for tax purposes. MECs are popular in the BOLI market because they are efficient and allow an institution to obtain a higher yield than non-MEC products. Financial institutions generally have a lower cost of funds than other non-bank corporations; thus, they are generally better able to invest dollars in a MEC contract and obtain their liquidity from other sources.

3. Interest Rate Sensitivity

Two types of risk that should be addressed as part of a prepurchase analysis are price risk and interest rate risk. Although BOLI has some inherent interest rate risk and price risk, in many ways it is less sensitive to changing interest rates than other bank investments. With fixed-income securities such as bonds, the value of the investment decreases as interest rates rise and vice-versa. If an investment's value is heavily affected by a change in interest rates, the investment is said to be "interest rate sensitive." Interest rate sensitive investments can result in volatile earnings if they are not properly managed. For example, available-for-sale bonds must be "marked-to-market" if interest rate changes affect the value of the bond portfolio. General account BOLI does not have to be marked-to-market. Mark-to-market risk in a general account product is borne by the insurance carrier, not the policyholder. Separate account BOLI products are subject to mark-to-market risks, but the risk can be mitigated by the use of a stable value protection (SVP) contract.

General account BOLI products tend to be less interest rate sensitive than comparable investments in bonds of similar duration. An institution with a general account BOLI product has an investment in the insurance carrier's investment portfolio. This may include non-fixed-income securities (e.g., equity securities) that are less interest rate sensitive than typical

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bank-eligible securities. The interest rate risk associated with a general account BOLI product is generally a function of the maturities of the assets in the carrier's investment portfolio, which often range from 4 to 8 years. These longer maturities tend to smooth the interest crediting rate on general account BOLI products over time reducing the risk of short-term interest rate and earnings volatility.

4. Tax Treatment

A significant advantage of BOLI over alternative bank investments is its tax-favored treatment. As long as BOLI policies are held to maturity, cash value accumulations and death benefits are tax-free to the policyholder. The tax-free build-up of cash value provides tax-free earnings to an institution in a manner similar to that of municipal bonds. However, there are no TEFRA interest expense deduction disallowances for BOLI, and cash value accumulation is tax-free for both state and federal tax purposes.

Tax-free life insurance death benefits are another advantage of BOLI over an investment in bonds. Under a typical BOLI program, the institution is the sole owner and beneficiary of the policy. This means that the bank receives the full life insurance death benefit when an insured officer dies.

5. Asset Quality

A financial institution should thoroughly analyze the quality of assets it intends to purchase, especially if an asset will be held long-term. This is true whether the institution is buying BOLI, a bond, an office building, or making a loan.

With BOLI, credit risk arises from the insurance carrier's contractual obligation to pay the cash surrender value upon the surrender of the policy. Before purchasing BOLI, an institution should conduct an independent financial analysis of the insurance company and continue to monitor its condition on an ongoing basis. Third party ratings of insurance carriers are readily available from Moody's, Standard & Poor's, AM Best, and Fitch. These agencies use specialized knowledge and extensive information to compile their ratings that are similar to the ratings assigned to bonds. Financial institutions contemplating a BOLI purchase should focus on highly rated carriers to minimize credit risk. With any purchase of a separate account BOLI product, an institution should fully understand the underlying assets in the separate account(s).

Not all insurance companies are equal. A financial institution contemplating a BOLI purchase should conduct a thorough comparison of the available carriers. Key differences arise in the following areas:

- Third party ratings from Moody's Investors Service, Standard & Poor's, Fitch Credit Rating Company, and The A.M. Best Company
- Size of the insurance carrier (admitted assets)
- Type of company (stock vs. mutual)
- Average portfolio yield including capital gains and losses
- Expenses compared to premium
- Lapse ratio (an indicator of policy owner satisfaction)
- Mortality ratio (an indicator of claim's experience)
- Product guarantees (cash value and death benefit)

No single ratio or category tells the complete story when comparing insurance carriers. All factors should be compared to arrive at the ultimate decision.

To learn more:

For more information on how BOLI can positively impact your bank, contact Mark Gurley, CLU, ChFC, CLTC, CAP with Legatus Memoria® at 616-451-0783 or mark@giftcoli.com

1 - OCC Bulletin 2004-56 issued December 7, 2004. This bulletin has been adopted by the Office of the Comptroller of the Currency, The Federal Reserve Board (SR 04-19), The Federal Deposit Insurance Corporation (FIL-127-2004), and the Office of Thrift Supervision (TB 84).

2 - OCC Bulletin 2004-56, p. 16.

3 - It should be noted that, unlike bonds, "highly-rated" does not imply "low yield." The inverse relationship between risk and return present in the fixed income securities market does not govern insurance policy performance. In general, highly rated insurance carriers do a better job of managing expenses, mortality, lapses, and portfolio yield. Accordingly, policies issued by highly rated carriers tend to perform better than policies issued by their lower rated peers.

Legatus Memoria : : 55 Campau NW, Suite 400 : : Grand Rapids MI 49503 : : 616.451.0783 : : Mark@GiftCOLI.com : : GiftCOLI.com