

## Bank Owned Life Insurance (BOLI) Q & A

### **Bank Owned Life Insurance (BOLI)**

Bank Owned Life Insurance (BOLI) is an excellent vehicle for financing the cost of employee benefits. 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. In addition, Bank Owned Life Insurance is a highly effective financing tool and offers a higher after-tax yield than most other investments. BOLI is an effective asset that helps diversify a portfolio and enhances the balance sheet. Furthermore, it has tremendous advantages as an asset-liability-matching tool.

### **Q: Why do financial institutions buy Bank Owned Life Insurance (BOLI)?**

A: 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.

### **Q: Is Bank Owned Life Insurance (BOLI) widely used?**

A: Most of the largest financial institutions in the nation have used BOLI for many years. More recently thousands of banks and thrifts as well as community banks throughout the country have purchased BOLI to help finance benefit costs.

### **Q: How does Bank Owned Life Insurance (BOLI) work?**

A: 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. Some banks may choose to share a portion of these proceeds with plan participants.

### **Q: Why is Bank Owned Life Insurance (BOLI) attractive?**

A: Well-designed BOLI can provide higher after-tax returns to the financial institution than other high quality asset alternatives. BOLI can help diversify a bank's portfolio and has tremendous advantages as an asset-liability matching tool.

### **Q: What is the primary economic benefit of Bank Owned Life Insurance (BOLI)?**

A: During the life of the policy, the growth of the cash surrender value is tax-deferred. Ultimately upon mortality, the death proceeds are received tax-free. This combination of economic benefits makes BOLI an excellent tool to offset a variety of existing or new benefit costs.

### **Q: Does the financial institution need to communicate with its employees about Bank Owned Life Insurance (BOLI)?**

A: Insurable interest laws vary by state. However, The Executive Benefits Network advocates obtaining positive, written consent from every employee to be insured even if doing so is not required by law.

### **Q: How do potential plan participants react to Bank Owned Life Insurance (BOLI) funding of employee benefit programs?**

A: As BOLI usage has become more common, many bank officers have become aware of the viability of this financing option, and realize the value BOLI provides to help the bank manage its benefit costs. The Executive Benefits Network can assist you in designing enrollment materials that may help ensure understanding and participation. Historically, 90% or more of potential participants agree to the purchase of BOLI on their lives.

**Q: Are employees required to participate?**

A: Employees are never required to participate. We believe that the more an employee understands about the uses and benefits of BOLI, the more likely they are to participate. There is no cost to the employees, and for larger plans there typically is no medical underwriting.

**Q: What happens when a participant retires?**

A: 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. The Executive Benefits Network will track the Social Security numbers of plan participants. 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.

**Q: Does the bank benefit from the death of its employees?**

A: The greatest value of a BOLI plan is the tax-deferred growth of the cash surrender value. While the bank receives death proceeds when an employee dies, it loses the potential tax-deferred growth of that contract. In addition, many banks choose to share a portion of the ultimate death benefits as an additional benefit to employees' beneficiaries.

**Q: What kinds of Bank Owned Life Insurance (BOLI) products are available?**

A: Because of our conservative approach, The Executive Benefits Network typically recommends diversification when making BOLI purchases. There are two basic categories of BOLI products:

*General Account:* These products typically provide minimum interest rate guarantees. Current interest rates are typically credited on a quarterly or annual basis. The net rates credited reflect the overall earnings of an insurance company's general account, as well as any expenses associated with the policies. The policies are backed by the general account of the insurance company; therefore the credit quality of a potential carrier is a critical issue to potential buyers.

*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 policyowner bears the risk of default of assets in the separate account.

**Q: Which insurance companies underwrite the products?**

A: Most of the major insurance carriers have BOLI products. Like its industry peers, The Executive Benefits Network has access to most major insurance carriers.

**Q: Do all general account products work the same way?**

A: There are two primary interest crediting methods used by carriers. "New money" product returns reflect current interest yields available at plan inception. Over time, the underlying assets, or a proxy portfolio that reflects them are tracked to determine future crediting rates. "Portfolio" products typically reflect the returns of assets backing a

broad group of policies and provide the same rate for all policies. The differences in renewal crediting rates between the two crediting philosophies can be substantial in early plan years, but tend to diminish over time.

**Q : Is Bank Owned Life Insurance (BOLI) liquid?**

A: BOLI can be surrendered at any time for its cash surrender value. However, 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.

**Q: What are the tax consequences of surrendering Bank Owned Life Insurance (BOLI)?**

A: Any gain above the premium that the bank paid would be taxed at the normal rate. In addition, most BOLI policies are classified as Modified Endowment Contracts. These types of policies allow for the most efficient cash surrender value growth possible, but any gain is subject to an additional 10% penalty tax if the policies' cash values are accessed. However, even with this penalty tax, the net BOLI returns may compare favorably to other financing alternatives over the same time period.

**Q: Bank Owned Life Insurance (BOLI) is a long-term asset. How can I manage credit risk?**

A: The bank should do a thorough review of the credit worthiness of any potential carrier as part of its due diligence. The Executive Benefits Network can provide you with updated credit information over the life of your BOLI coverage.

**Q: What happens if the tax treatment of Bank Owned Life Insurance (BOLI) changes?**

A: 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.

**Q: How is Bank Owned Life Insurance (BOLI) regulated?**

A: The regulations governing Bank Owned Life Insurance (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 2004-56. 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 statechartered 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.

*Thriffs:* 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 OCC Bulletin 2004-56, although some differences do exist. Regardless of a given institution's primary regulator, The Executive Benefits Network can assist you in designing and administering a BOLI program that is in full compliance with all relevant authorities.

**Q: Beyond banking regulations, are there limits on how much Bank Owned Life Insurance (BOLI) a bank can purchase?**

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

**Q: What other limitations exist to the purchase of Bank Owned Life Insurance (BOLI)?**

A: 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. The Executive Benefits Network 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.

**Q: What risks do banking regulators say need to be evaluated when buying Bank Owned Life Insurance (BOLI)?**

A: 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.

**Q: Are there additional risks that need to be evaluated?**

A: 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. The Executive Benefits Network 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. The Executive Benefits Network 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. The Executive Benefits Network does not advocate using this technique in any potential BOLI purchase.

**Q: How do I account for Bank Owned Life Insurance (BOLI)?**

A: BOLI is governed by FASB Technical Bulletin 85-4. This bulletin states that BOLI should be recorded on the balance sheet as an "other asset" and that both the cash surrender value growth and ultimate net insurance proceeds should be recorded as "other income."

## Corporate Owned Life Insurance (COLI) Q & A

### **Q: What is Corporate Owned Life Insurance (COLI)?**

A: Corporate Owned Life Insurance (COLI) is a common funding vehicle for non qualified deferred compensation plans. COLI is a life insurance policy owned by the corporation that insures the lives of one or more employees. COLI is used in conjunction with several different types of Non Qualified Deferred Compensation Plans.

The main reasons COLI is attractive to fund Non Qualified Plans are:

- They provides actual assurances to employee plan participants that their benefits under the non qualified plan will not be endangered by the employer's cash flow demands
- They ensure the employer that assets will be available for distribution to participating employee's, thereby reducing or eliminating a financial strain on the employer when it is time for distributions to occur.
- They provide tax-deferred buildup of cash value and tax free distribution of benefits.

### **Rabbi Trust**

### **Q: What is a Rabbi Trust?**

A: A Rabbi Trust is a trust established by an employer to provide a source of funds which may be used to satisfy the employer's obligation to executives under a non-qualified executive benefit plan. The trust is referred to as a Rabbi Trust because the first IRS letter ruling with respect to this type of trust involved a rabbi whose congregation had made contributions to such a trust for his benefit. The ruling stated that the rabbi would not be taxed on the funds in the trust until the funds were actually distributed to the rabbi or his beneficiary upon his death, disability, retirement or termination of employment.

Typically, the Rabbi Trust is established as an irrevocable trust. The employer must give up all rights to the assets in the trust and may not terminate the trust. The trust is also usually considered a grantor trust, with income being taxed to the grantor, usually the employer.

The primary purpose of the Rabbi Trust is to offer some limited level of security to the employee with respect to their nonqualified benefits. This is especially true for a Nonqualified Deferred Compensation Plan (NQDC) where the employee defers compensation with only the contractual promise of the employer to pay the benefits. Employee deferrals may be placed in the rabbi trust as deferrals are made. If a rabbi trust is "locked", funds placed in the trust may not revert back to the employer until all benefit obligations have been satisfied.

### **Q: How much security is really provided?**

A: A key important feature of any Rabbi Trust is that the assets in the trust must be subject to the claims of the employer's creditors at all times. If the employer becomes insolvent, all trust assets become available to the employer's creditors, including the NQDC participants. In other words, if insolvency or bankruptcy occurs, the NQDC participants stand in line with other employer unsecured creditors. The security offered by the rabbi trust is for " Change of mind: The employer may not access the assets in the trust once they have been contributed. " Change in control: A friendly or unfriendly takeover will not affect the assets in the trust. Some rabbi trusts have a trigger that requires full funding of designated benefits upon a change in control.

### **Q: What is the IRS's Position on Rabbi Trusts?**

A: The IRS has ruled that the establishment of a Rabbi Trust would not in itself cause a nonqualified plan to be considered funded for tax purposes since the assets are subject to the claims of creditors, and are not set aside solely for the benefit of participants. In Rev. Proc. 92-64, the IRS stated specific criteria that are necessary to obtain a

Favorable ruling on a rabbi trust used in connection with nonqualified plans. The Revenue Procedure contains a model rabbi trust that is intended to serve as a Safe Harbor for taxpayers who adopt and maintain the model trust in connection with nonqualified plans.

**Q: How does ERISA effect Rabbi Trusts?**

A: The Department of Labor (DOL) has ruled that the establishment of a Rabbi Trust will not in itself cause a nonqualified plan to be considered funded for ERISA purposes. Not would the transfer of assets cause the plan to be considered funded. The consequences of a plan being considered funded for ERISA purposes are that the plan would have to satisfy all the requirements of Title 1 of ERISA with cover participation, vesting, funding, fiduciary and enforcement requirements.

**Q: What is the Taxation of Rabbi Trusts?**

A: A Rabbi Trust is considered a grantor trust for income tax purposes. Any trust income is taxed to the employer who established the trust. Contributions to the trust are not income tax deductible by the employer. However, the employer may deduct the full amount of the benefit payment as the trust makes payments to the plan participants.