The Galbreath Group
Committed to Being a Valued Resource & Trusted Advisor

Q3 | 2015

The VAULT

The BOLI Blurb

Bank-Owned Life Insurance (BOLI): History and Why General Account is the Preferred Choice

Bank-Owned Life Insurance (BOLI) has been around for more than 30 years. In fact, the first transaction was made in 1982 when Western States Life Insurance Company, now part of Midland National Life Insurance Company, became the inaugural institution to provide BOLI. It wasn't until the mid-to-late 1990's that BOLI earned greater consideration and acceptance from the banking community throughout the United States. Today, approximately 59% of all banks and thrifts have BOLI holdings of some form. While approval has grown for this asset over time, it is still misunderstood by many including the entities that hold this investment.

BOLI is a single premium, investment weighted insurance product that grows tax-deferred and is ultimately received tax free via the death benefit. BOLI Contracts can be structured in three different ways: General Account, Separate Account, and Hybrid Account. For General Account contracts, the premium is placed into the insurance carrier's general investment account, which is managed by the insurance company. It affords access to broader investment asset classes that are not permissible to banks. This well diversified account includes investments such as real estate, private equity, and commercial mortgage loans, to name a few. The risk transfers to the insurance company with a guaranteed minimum yield. For Separate Account contracts, the premium is placed into a variable separate account limited to the investment classes that are allowable to banks by the regulators. The risk is maintained by the bank or thrift with the possibility of principal loss. The mortgage-backed security (MBS) implosion hit this BOLI structure particularly hard over the last several years because the separate account was heavily weighted in this area. Finally, Hybrid Account contracts are a combination of General Account and Separate Account.

The General Account is the easiest to understand of the three options, and it is the BOLI structure The Galbreath Group has always recommended. The Separate Account contract, on the other hand, is esoteric and voluminous, with a larger number of parties involved, making it more difficult to comprehend and manage by both the broker and the bank. Consequently, there is much greater risk associated with this option type. It started to become popular in the early 2000's because it was thought to provide higher yields for banks than General Account plans. Unfortunately, the performance hasn't played out that way with General Account BOLI out-pacing Separate Account BOLI in nine out of the last 10 years.[1] This could help explain why BOLI in the generic sense is misunderstood with misguidance in the marketplace helping perpetuate the perception that BOLI is not an attractive option for banks to explore. However, if structured the right way, through the right provider, and with the strongest insurance carriers, General Account BOLI remains an appealing asset that we continue to recommend highly to our clients.

[1] BOLITracker™ Report II, Net Interest Returns, Coli Consulting Group, LLC 2014

continued on page 2...

Basel III Implications to Separate Account BOLI

The third edition of the Basel Accords, Basel III, will undoubtedly have an impact on Separate Account BOLI held by banks. Although the actual risk weighting remains unclear, it is possible that Separate Account BOLI could have an associated weighting of 1,250%. This would significantly affect the amount of capital required by an institution to maintain this asset, which will be challenging for many to absorb. In addition, yield performance could decline further as insurance carriers look for ways to produce a lower risk weighting for their product. While the implementation of Basel III has been pushed out a few years, we think it is advisable to consider restructuring any Separate Account belongings ahead of this next installment. Doing so should alleviate any extra scrutiny or burden from regulators, reducing the amount of time and expense necessary to manage these requirements. We are experienced in these types of restructurings, and we would welcome the opportunity to guide you through this process.

Increase Earnings and Employ Capital through General Account Bank-Owned Life Insurance (BOLI)

Is increasing earnings a primary objective of your institution? Are you uncertain of the best way to use your capital? Perhaps you have been sitting on capital for a while waiting for the right time or opportunity to put it to work. Maybe you recently concluded a capital raising initiative, improving your position while generating greater flexibility and options. General Account BOLI is a great way to address both questions, and exploring it as part of the investment strategy is what we would recommend.

General Account BOLI is a very low risk, steady yield insurance product. BOLI yields flow directly to non-interest income, increasing a bank's financial performance. The investment, price, and credit risk in this structure transfers to the insurance company. Selecting carriers with the strongest ratings is paramount to a successful program. The bank is the owner and the beneficiary of the contract. BOLI is immediately accretive to earnings from day one, with 100% of the premium booked as an "other asset" on the balance sheet. Income from BOLI enables banks to recover the costs of benefit plans while also lowering the institution's effective tax rate. The cash value grows tax deferred and is received tax free as a death benefit assuming it is never surrendered. BOLI is designed to be held over a long time, and therefore, it is considered an illiquid asset. However, it can be surrendered if necessary at any time with taxes and a MEC (Modified Endowment Contract) penalty due on the gains only. Finally, the returns may be favorable to loans and other bank permissible investments.

BOLI might not be right for everyone. If your bank is profitable with growth desired, it may be a viable option. It is a means to diversify your portfolio, reducing your exposure and risk in any particular area. Guidelines allow for 25% of Tier 1 Capital to be invested in BOLI, with the top 35% of employees eligible as participants on the policy. Furthermore, no more than 15% of capital can be allocated to one insurance carrier although some institutions have a lower internal limit. Positioning capital and increasing earnings can be accomplished through General Account BOLI.

The Galbreath Group, headquartered in Abington, PA, advises financial institutions and corporations on Bank-Owned Life Insurance (BOLI) and BOLI portfolio management, design, implementation, and administration of BOLI and COLI plans; analysis of current BOLI and COLI plans; strategic planning and compliance analysis; and design, implementation, and administration of non-qualified deferred compensation plans. Regardless of whether you are an existing client, we would be happy to address any questions or needs you may have.

*For more information contact us at **www.TheGalbreathGroup.com***