# Bank-Owned Life Insurance:
## Frequently Asked Questions

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# Introduction

**BOLI: A highly effective financing tool**

Banks and related financial institutions have had the opportunity to avail themselves of this unique funding opportunity for a number of years. There are a large percentage of banks throughout the United States that have already taken advantage of this opportunity.

For those financial institutions that have yet to take advantage of this extraordinary benefit, we have prepared a series of frequently asked questions that the decision-maker may find helpful in their deliberations to introduce Bank Owned Life Insurance (BOLI) to their financial institution.

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, BOLI 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.

*“BOLI is an excellent vehicle for financing the cost of employee benefits.”*

# BOLI Overview

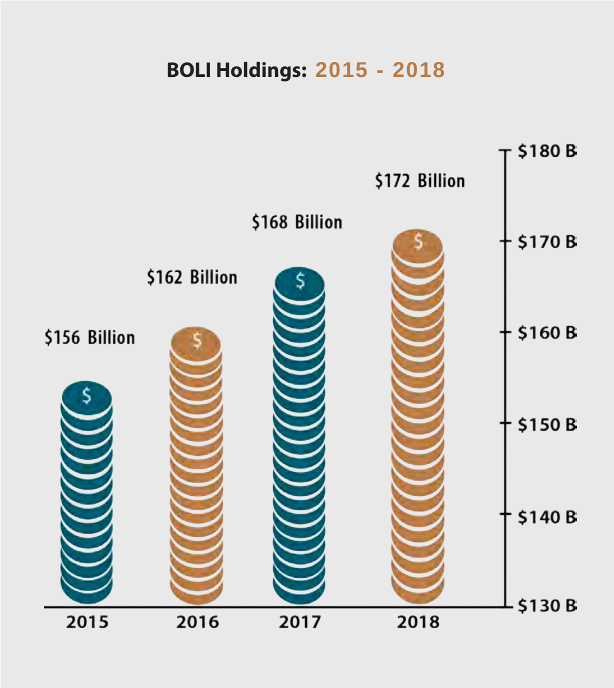
**BOLI is a fairly straightforward life insurance program**

### Q: How does 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.

> *"Typically limited to the top 35% most highly compensated employees."*




### Q: Why do financial institutions buy 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 BOLI widely used?

A: At the end of 2018, there were approximately 5,406 banks and institutions in the United States and 64% reported holding BOLI assets. More community banks than before are investing a portion of their Tier 1 capital in BOLI.

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*"Well-designed Bank Owned Life Insurance can provide higher after-tax returns."*


# Why BOLI?

**There are many reasons to utilize BOLI**

**Q: Why is 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 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: 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.

Oftentimes, the employer may be willing to allow the employee, while still employed, to name a beneficiary for part of the insurance proceeds if the employee dies while still employed by the employer.

# BOLI & Employees

**Typically, 90% or more of potential participants agree to the purchase of BOLI on their lives**

### Q: Does the financial institution need to communicate with its employees about BOLI?

A: Insurable interest laws vary by state. However, written consent is required from every employee to be insured. Section 101(j), which was added to the Code by § 863(a) of the Pension Protection Act of 2006, specifically defines the required consent requirement that the employer must obtain prior to insuring the life of a covered employee and to which the employer is the owner and beneficiary.

### Q: How do potential plan participants react to 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. Nolan Financial 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: 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. Nolan Financial 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 future tax-deferred growth of that contract.

# BOLI Products

**There are three basic categories of BOLI products**

**Q: What kinds of BOLI products are available?**

A: Because of our conservative approach, Nolan Financial typically recommends diversification when making BOLI purchases. There are three basic categories of BOLI products:

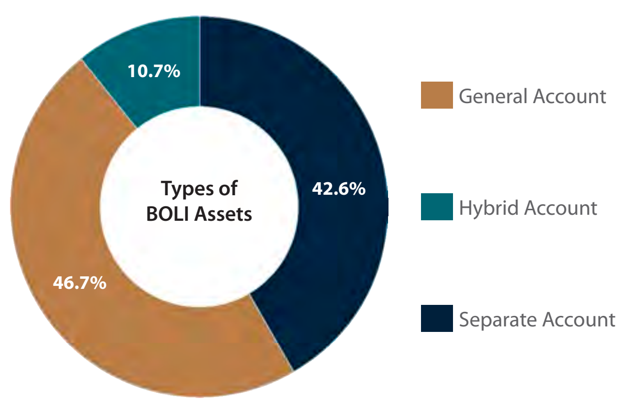
**General Account**: These products typically provide minimum interest rate guarantees. Current interest rates are typically determined on a quarterly or annual basis. The net rates credited reflect the overall earnings of an insurance company's general account, as well as any expenses associated with 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 policy owner bears the risk of default of assets in the separate account.

**Hybrid Account**: This product combines certain features of General and Separate Account products.

Hybrid products offer a minimum guaranteed interest crediting rate, which eliminates the need for a stable value wrapper. Policy assets are held in separate accounts, so they are protected from the credit risk of the insurance company.




Although General Account and Separate Account policies hold similar amounts of assets, **a significantly greater number of banks hold General Account BOLI**: 96.9% General Account, 35% Hybrid Account and 12.3% Separate Account.

# Considerations

**A closer look at BOLI**

### Q: Is 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: Which insurance companies underwrite the products?

A: Most of the major insurance carriers have BOLI products. Like its industry peers, Nolan Financial 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. Current "Best in Class" BOLI products provide for underlying investments that are market reactive. We work closely with the bank to be certain that market rate sensitivity is addressed and resolved.

**Let Us Help You**

Nolan Financial works closely with banks to be certain that market rate sensitivity is addressed and resolved.

### Q: What are the tax consequences of surrendering 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

*"A pre- and post-purchase analysis must be performed for BOLI."*

# BOLI

**Bank Owned Life Insurance is a long term asset**

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: BOLI is a long-term asset. How can I manage credit risk?**

A: There is an OCC Pre-Purchase Analysis that all banks must conduct. One of Nolan Financial's roles is to help the bank complete this pre-purchase analysis. The bank should do a thorough review of the credit worthiness of any potential carrier as part of its due diligence. Nolan Financial can provide you with updated credit information over the life of your BOLI coverage.

In some instances, Nolan Financial may suggest multiple carriers to spread the risk, if the amount of the BOLI purchase warrants this type of diversification. Nolan Financial will only work with highly-rated insurance companies, whose COMDEX ranking is in the 90th percentile.

During their review, bank regulators will more than likely want to review the pre-purchase analysis that the bank was obliged to complete.

**Q: What happens if the tax treatment of 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.

# Regulations

**Nolan Financial is here to guide you through the process**

> "We can help you determine the appropriate amount of coverage."

### Q: How is BOLI regulated?

A: The regulations governing 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 over time. 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 state chartered 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.

**Thrifts**: On July 21, 2011, the Office of Thrift Supervision became part of the Office of the Comptroller of the Currency. The most recent guidelines largely follow the parameters of OCC Bulletin 2004-56. Nolan Financial 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 BOLI a bank can purchase?

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

# BOLI Risks

**The OCC requires that a bank evaluates 6 specific pre-purchase risks**

**Q: What other limitations exist to the purchase of 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 benefit costs they are intended to offset.

Nolan Financial can help you in determining conservative parameters for the purchase of BOLI. In addition, the OCC states that as a general rule, a bank should not invest more than 25% of its Tier 1 capital in BOLI, and no more than 15% of its Tier 1 capital with any one insurance company in General Account BOLI.

**Q: What risks do banking regulators say need to be evaluated when buying 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. Nolan Financial can assist you in documenting the purpose of your purchase, which is typically to offset a variety of benefit expenses.

**Risks**

Nolan Financial can help you in determining conservative parameters for the purchase of BOLI and we can assist you in documenting the purpose of your BOLI purchase.

# Accounting for BOLI

**BOLI is recorded on the balance sheet as an "other asset"**

**Investor Control**: This issue is primarily related to separate account plans. A bank may not exercise undue control of the product's underlying investments. Nolan Financial 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. Nolan Financial does not advocate using this technique in any potential BOLI purchase.

### Q: How do I account for 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."

*If you have additional questions or would like to proceed with the purchase of BOLI for your financial institution, contact Nolan Financial.*

## Recognizing Performance

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