Regulators Offer Roadmap to BOLI

By William D. Chatfield

The use of bank-owned life insurance as a cost recovery tool for community banks has soared in popularity in recent years.

"BOLI can provide attractive tax-equivalent yields to help offset the rapidly rising cost of providing employee benefits," said the federal banking regulators in a recently issued interagency statement regarding the supervisory expectations and risk management guidelines for BOLI.

While the statement said that "BOLI can be a useful product to recover costs associated with providing employee benefits," the regulators also cautioned that they "are concerned that some institutions have invested a significant amount of capital in BOLI without an adequate understanding of the full array of risks it poses."

The regulators have formed a three-step process to guide bankers in utilizing BOLI. Step one is a thorough pre-purchase analysis. Step two is implementing a sound risk-control framework. Step three is using this framework on an ongoing basis to monitor the BOLI asset. Some major points referenced in the new bulletin are as follows.

Risk management process. "Before entering into a BOLI contract, institutions should have a comprehensive risk-management process for purchasing and holding BOLI," the interagency statement said. The process entails development of a detailed BOLI investment policy describing, at a minimum:

- Senior management and board oversight of the BOLI investment.
- The single insurer and aggregate insurer BOLI investment limits established by the institution.
- The institution's pre-purchase analysis of BOLI products and alternatives.
- The institution's risk assessment, management, monitoring, and internal control processes, as well as the appropriate internal audit and compliance functions.
- An annual post-purchase review of BOLI, including the 10 key components that were itemized by the regulators.

> The interagency guidance may necessitate changes to an institution's management of an existing or contemplated BOLI program.

BOLI accounting. The Financial Accounting Standards Board's Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance" concerning the carrying value of insurance on the balance sheet, is generally appropriate for all forms of BOLI. According to the 1985 bulletin, only the amount that could be realized under an insurance contract, net of the surrender charges, as of the balance sheet date, is reported as an asset.

Institutions should also be aware that the accounting for deferred compensation plans is separate and distinct from the accounting for BOLI.

Separate-account BOLI. With separate-account BOLI, the insurance carrier owns the asset, but maintains the asset beyond the reach of general creditors in the event of the insurer's insolvency. The guidance asserts that many institutions buy separate-account BOLI without fully understanding all the relevant risks. The regulators concluded that this particular type of insurance design is rather complex and that, depending on the internal capabilities of bank personnel, outside counsel may be required for proper implementation.

Separate-account policies have additional risks that result from accounting requirements and the limitation and costs associated with the stable value protection. The risk-weight look-through availability of separate account BOLI is addressed at length.

MEC vs. non-MEC BOLI policies. A modified endowment contract, or MEC, is a type of life insurance policy that is described under Internal Revenue Code Section 7702A. There are distinct advantages and disadvantages to both MEC and non-MEC policy designs. Institutions needs to understand the ramifications of each structure and choose according to the needs and risk profile.

Vendor selection. Purchasing BOLI from a vendor that only offers one type of insurance product may not be the best practice, since institutions are required to choose the BOLI design that is the "best fit" for the institution. Also, choosing an agent of an insurance carrier as the vendor raises additional regulatory concerns because the institution is driven to purchase only those policies offered by the carrier.

Commission splitting with BOLI broker essentially prohibited. For the first time, the regulatory agencies also discuss in the BOLI guidance the notion of "fee-splitting," meaning the splitting of BOLI commissions between a vendor and the institution's own subsidiary or affiliate insurance agency. The insurance laws of most states prohibit the payment of inducements or rebates to a person as an incentive to purchase life insurance. Regulation W issues were also referred to for the first time.

Tax and insurable interest implications. The BOLI guidance also discusses the tax and insurable interest implications associated with BOLI. To benefit from the favorable tax treatment of life insurance, a BOLI policy must be a valid insurance contract under state insurance law and applicable federal tax law. Issuing large levels of insurance without employee knowledge or consent becomes problematic.

The guidance affirms "reputation risk" as a category of risk to be managed. The risk is to earnings and capital arising from negative publicity that relates to an institution's business practices.

It is important to recognize that many of these post-purchase tasks and responsibilities are already performed as a function of the normal administrative services provided by BOLI vendors and administrators such as Meyer Chatfield Corp. and Meyer Chatfield Administrative Services.

Although the interagency BOLI guidance may necessitate changes to an institution's management of an existing or contemplated BOLI program, BOLI remains a very useful cost-recovery tool to finance benefit costs. Banks must improve the documentation when they purchase BOLI. To ensure ongoing compliance, a bank should retain qualified advisors skilled in BOLI regulatory compliance, IRS compliance, state insurable interest compliance, and well-conceived executive-compensation planning when benefits are linked to BOLI.

While the new BOLI guidance may seem overwhelming to some, the primary purpose of the guidance is to assist bankers in viewing BOLI as they would any other valuable asset.

All opinions expressed are solely those of the author. William D. Chatfield is president of Meyer Chatfield Corp., an ACB Business Partner.

The ACB/Meyer-Chatfield partnership delivers optimally structured BOLI strategies to ACB members with significant member-advantages, including pricing enhancement and dedicated education resources. Meyer-Chatfield specializes in BOLI transactions, and has a long history of helping community banks realize the full potential of these assets as a part of the bank's overall portfolio.

For more information about the ACB/Meyer-Chatfield partnership, contact ACB's Helen Sullivan at (202) 857-3157 or hsullivan@acbankers.org.

ACB Business Partners offers a complete menu of business solutions in mortgage, technology and payments, and financial and capital markets. Visit www.AmericasCommunityBankers.com/Partners *to learn more.*