

# **The ABC's of BOLI; Bank Owned Life Insurance**

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The financial crisis that has plagued banks for over a year is starting to hit one of the more opaque corners of the balance sheet: bank-owned life insurance, or BOLI. The hit could be worse than most people expect, especially for small banks. Because BOLI assets represent about 1% of the \$13.8 Trillion of total assets held by FDIC insured banks, any shortfall “surprise” means that tangible capital could be adversely affected.

The top 20 banks are believed to hold primarily separate account BOLI, which typically resets the crediting rate each quarter, compared to general account BOLI, which resets the crediting rate annually. Regional banks are thought to have roughly equal amounts of separate account and general account BOLI. Smaller banks predominately hold general account BOLI.

Separate account BOLI is an insurance contract structure in which the assets are held separately from the insurer's general funds, and the policyholder looks to the assets themselves rather than the general credit of the insurer for payment of policy benefits (particularly cash surrender proceeds). With general account policies, the insurer does not segregate the assets in its general investment portfolio that support its contractual BOLI obligations, and the policyholder looks to the insurer itself for payment of policy benefits.

Separate account policies differ from general account in another significant way: general account policies guarantee a minimum BOLI cash surrender value and a minimum BOLI crediting rate typically from 3% to 4% (before policy expenses such as mortality charges) In contrast, separate account policies have no guarantees for cash value, principal or interest. Consequently, separate account policies use an additional policy feature called a stable value wrap, whereby the stable value counterparty guarantees to make up any difference between accreted book value of the separate account assets and their current market value. The typical stable value wrap agreement defines book value and interest accretions using a quarterly formula that looks to the separate account assets, starting with the current market yield, and adjusting by subtracting two factors: an expense factor, and a factor that amortizes the market-to-book difference over the duration of the assets.

Because of this separate account/stable value structure, large-bank BOLI yields are more sensitive to current performance of the underlying assets than the general account yields of smaller banks. The relative sensitivity of separate account policies to changes in crediting rate, mainly because of the quarterly reset, creates an expectation that the performance of large-bank BOLI will occur ahead of small bank BOLI.

BOLI has been an attractive asset for banks in recent years for two reasons: the income on BOLI cash values is generally not taxed, and BOLI offered relatively high crediting rates. In fact, BOLI performance is better when rates are relatively high, because the cost structure of the life insurance policies is typically constant. This means that when crediting rates drop, BOLI expenses stay the same, and therefore BOLI yields see a disproportionate reduction.

With general account policies, the problem is made worse because banks are more likely to surrender underperforming BOLI, and the cost of policy lapses (i.e., any crystallized portfolio losses to meet surrender cash demands, plus the unamortized portion of policy acquisition costs like premium tax and commissions) typically gets shared among the policyholders who keep their BOLI. In contrast, separate account policies are structured to insulate the bank from lapse costs of BOLI surrenders by other policyholders.

Small banks without the internal resources of larger banks may be more likely to experience a “surprise” shortfall in BOLI performance relative to their expectations, because they tend to rely on vendors for information about policy performance and trends.

This is often the case in spite of explicit regulatory guidance in FIL-127(December 7, 2004), *Interagency Statement on the Purchase and Risk Management of Life Insurance*: “An institution should be aware that the vendor's financial benefit from the sale of insurance may provide the vendor with an incentive to emphasize the benefits of a BOLI purchase to the institution without a commensurate explanation of the associated risks. Therefore, reliance solely upon pre-packaged, vendor-supplied compliance information does *not* demonstrate prudence with respect to the purchase of insurance.”

In this unprecedented climate, bank officials should again familiarize themselves with the regulatory guidance on BOLI, which can be accessed at the following link: <http://www.fdic.gov/news/news/financial/2004/fil12704toc.htm>. The prudent banker needs to take the time to gain a complete understanding of the full spectrum of options for their BOLI portfolios (restructuring, surrender, exchange etc) from an *unbiased* third party, with the risks, benefits and costs of each option analyzed.

For more information about a multi-discipline fee based BOLI analyses go to the EBA website: [www.effronburke.com](http://www.effronburke.com) or call Carmen Effron at 203.226.2645.