In this Alert, we bring you up to date on the current environment of bank-owned life insurance, or BOLI. Willis has long recognized the value of BOLI and other executive benefit strategies for our Financial Institutions (FI) clients. Tom Lobaugh, Senior Vice President and the leader of our Executive Benefits Practice, has partnered with Peter Dinardi of NYLEX to create a concise and highly informative analysis of the recently promulgated Bulletin 2004-56 from the Office of the Comptroller of the Currency (OCC). This interagency bulletin was issued jointly by the three major regulators of banks in the US: the OCC, the Board of Governors of the Federal Reserve System and the Office of Thrift Supervision.

Tom and Peter provide a roadmap through the new regulations. It is useful information for all banks — those that currently buy BOLI and those that never have. The piece explains what BOLI can be used for and how to implement a BOLI program in the most efficient manner. It also discusses the unfavorable perception that has stigmatized BOLI in the past and how these new regulations might change that. We hope that you find the material useful and we encourage you to look further into this and other Executive Benefits issues. We would be glad to offer our assistance.

For the Willis FI practice, 2005 has started out at a rapid pace that continues to accelerate. We have added a number of new clients to our family, and are continuing to proudly serve those of you that have been with us for a long time. We always look forward to our opportunities to see you, and thank you for your continued support.

As always, please call me if I can be of service in any regard.

— John Bayeux, FI Industry Practice Leader

### Bank-Owned Life Insurance Revisited

**By**

Peter L. Dinardi, CPA, MBA

CAO, NYLEX Benefits

and

W. Thomas Lobaugh, CLU, ChFC

SVP, Willis Employee Benefits Practice

**Overview**

Bank-owned life insurance (BOLI) encompasses all life insurance that a bank purchases and either owns or in which it has a beneficial interest. For many years, banks have been purchasing life insurance on the lives of directors, officers and employees with the banks as the owners and beneficiaries of the policies. These policies have been typically acquired to recover all or a part of the costs of the bank’s employee compensation and benefit programs.

BOLI is most commonly designed as a single premium life insurance contract structured to earn tax-free income. BOLI’s tax-free income is generated by the increase in cash value of the policy and insurance proceeds paid to the bank when an insured dies.

Most traditional bank investments create taxable interest income. In contrast, BOLI results in no current income tax liability for the earnings generated each
Earnings are sheltered inside the life insurance contract and are therefore tax-deferred. When a death occurs, the bank receives life insurance proceeds tax-free. By reinvesting funds from traditional portfolio investments into BOLI, a bank can typically increase its yield by 100 to 350 basis points depending upon marginal tax rates, the size of the transaction, the type of policies selected and the demographics of the key employees to be insured.

New Regulatory Guidance

Recently issued guidance from federal banking regulators reasserts the fact that BOLI can “serve a number of appropriate business purposes” and specifically that “BOLI can provide attractive tax-equivalent yields to help offset the rapidly rising cost of providing employee benefits.” The referenced guidance is a joint interagency statement, OCC Bulletin 2004-56 (also cited as FIL 127-2004). Issued on December 7, 2004 by the federal banking regulators¹, the bulletin and first formal interagency statement on BOLI replaced and rescinded the previous guidance, OCC Bulletin 2000-23.

Like its predecessor, the recent bulletin discusses the risks associated with a BOLI purchase and establishes the supervisory expectations of both a pre-purchase analysis and the continuing post-purchase risk assessment. The guidance with respect to pre-purchase analyses of life insurance applies to all BOLI contracts entered into after the issue date of the bulletin (December 7, 2004). BOLI contracts entered into on or before that date are subject to the prevailing guidance from an institution’s supervisory agency. The new post-purchase risk management guidance applies to all holdings of life insurance regardless of when the insurance was purchased.

Risk Evaluation and Pre-Purchase Analysis

Bulletin 2004-56 introduces eight risk categories associated with BOLI including the newly identified “reputation risk,” the risk to earnings and capital arising from negative publicity surrounding the public perception of institutions owning or benefiting from life insurance on employees. The guidance suggests that an insured’s informed consent prior to the bank’s purchasing BOLI as well as the bank’s monitoring of the amount of insurance purchased on any one individual will mitigate this risk.

Management actions that the bulletin recommends for an effective pre-purchase analysis include:

- Identifying the need for insurance, the economic benefits and the appropriate type of insurance
- Quantifying the amount of insurance appropriate for the institution’s objectives
- Assessing vendor qualifications
- Reviewing the characteristics of the available insurance products
- Selecting a carrier
- Determining the reasonableness of compensation provided to the insured employee if the insurance results in additional compensation
- Analyzing the associated risks and the bank’s ability to monitor and respond to those risks
- Evaluating alternatives
- Documenting the bank’s decision

Post-Purchase Risk Assessment

The current bulletin asserts that “BOLI can be an effective way for institutions to manage exposures arising from commitments to

¹ OCC Bulletin 2004-56 was issued by the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (FRB), and the Office of Thrift Supervision (OTS).
provide employee compensation and pre- and post-retirement benefits.” Once BOLI is implemented, management and the board of directors should continue to manage the life insurance holdings in a manner consistent with safe and sound banking practices.

The guidance identifies the risks which management and the board of directors should evaluate, including liquidity, transaction/operational, reputation, compliance/legal and price risk. In the ongoing assessment of risk, Bulletin 2004-56 directs bank management to review the performance of the institution’s insurance holdings with its board of directors at least annually. Such post-purchase review would include at a minimum:

- A comprehensive assessment of risks discussed in the guidance
- Identification of employees who are insured
- Assessment of death benefit amounts relative to employee salaries
- Calculation of percentages of insured persons still employed by the institution
- Evaluation of material changes to BOLI risk management policies
- Assessment of the effects of policy exchanges
- Analysis of mortality performance and impact on income
- Evaluation of material findings from internal and external audits and independent risk management reviews
- Identification of the reason for, and tax implications of, any policy surrenders
- Peer analysis of BOLI holdings

Assessment of Vendor Qualifications

Vendors generally represent banks in the vast majority of BOLI purchases as acknowledged by Bulletin 2004-56. The guidance reaffirms the importance of careful vendor selection. In choosing a vendor, consideration should be given to the adequacy of the vendor’s services, and its reputation, experience, financial soundness and long-term commitment to the BOLI marketplace. In addition, the guidance stresses the importance of “the vendor’s ability to honor its long-term commitments” and “the vendor’s commitment to investing in the operational infrastructure necessary to support BOLI.”

Future Outlook for BOLI

BOLI continues to be an important financial tool for banks offering competitive employee benefits and looking to recover or efficiently offset those costs. As a sophisticated financial strategy, it requires banks to manage the associated risks in a safe and sound manner. The interagency bulletin provides crucial supervisory guidance, including the regulatory expectations for a bank pursuing a BOLI purchase. Assistance is also available through qualified risk professionals.

*This article is for informational purposes only and is not intended as legal, accounting or tax advice. Clients should consult with their own professional advisors as to how this material may apply to their own specific circumstances.*

**Contacts**

John J. Bayeux  
Executive Vice President  
Industry Leader – Financial Institutions  
Willis Risk Solutions  
212 837 0739  
john.bayeux@willis.com

Tom Lobaugh  
Senior Vice President  
Employee Benefits Practice  
516 740 3114  
tom.lobaugh@willis.com

**Previous FI Alerts**

**Issue 1 – Basel II**

**Issue 2 – Cyber Liability**

**Issue 3 – Executive Risks Marketplace for FIs**

For more information or to download these issues, please visit www.willis.com.