

Back to the Basics

Why BOLI? Why Now?

by James Corbin

This is Part II of a two-part series.



Regulatory and Administrative Advances

In late 2004, the Office of the Comptroller of the Currency (OCC) issued Bulletin 2004-56, "Interagency Statement on the Purchase and Risk Management of Life Insurance." This statement was issued to clarify and remind financial institutions that the purchase and risk management of BOLI

must be consistent with safe and sound banking practices. While BOLI can be a useful product to recover costs associated with providing employee benefits, the agencies expressed concern that some institutions had invested significant amounts of capital in BOLI without an adequate understanding of the full array of the risks it poses.

The statement described supervisory expectations for a thorough pre-purchase analysis and a sound risk-control framework to address BOLI exposures on an ongoing basis. The statement also recommended that financial institutions develop and implement comprehensive BOLI policies for the ongoing management of the BOLI program.

To assist banks in meeting the pre-purchase and ongoing regulatory requirements, administrative services supporting BOLI programs have also made significant advances. Through some BOLI providers, administrative services are available online to give real-time access to the Annual Review, Client Service Requirements, Benefit Administration, Insurance Administration, Carrier Due Diligence and Regulatory issues.

Why BOLI, why now?

To reiterate, the incremental income that BOLI's tax-

advantaged yields produce can offset the costs of a myriad of employee benefit plans. Many banks use this to help finance nonqualified executive and director benefit plans that, when properly designed, can help recruit, retain and reward key people, as well as help a bank achieve its strategic goals.

BOLI gains may also directly result in an increase in Net Income, Return on Assets (ROA) and Return on Equity (ROE). While general account and hybrid policies do have guaranteed minimum crediting rates, VUL policies have a risk of potential loss or negative returns depending on market performance. The example below illustrates this concept: a sample bank purchases \$10 million in a BOLI product that currently has a net yield of 4.6%. We also assume the bank uses a 2.5% opportunity cost (or what the bank was earning on that money prior to the BOLI purchase) and has a 40% tax rate.

Hypothetical Impact of BOLI on Fiscal Performance

This is a hypothetical illustration to show Separate Account BOLI (VUL) and is not indicative of the performance of any particular investment.

1 Item #	2 Call Report Item Description	3 Actual	4 Modified	5 Change
5	Securities	22,745,000	12,745,000	(10,000,000)
7	Net Loans and Leases	346,042,000	346,042,000	0
13	All Other Assets	8,415,000	18,415,000	10,000,000
38	Average Assets	394,779,000	394,779,000	0
107	Average Equity	35,986,000	35,986,000	0
45	Tier 1 Capital	34,698,000	34,698,000	0
65	Pre-Tax Net Operating Income	4,640,000	4,390,000	0
66	Securities Gains (Losses)	99,000	99,000	0
	Taxable Income	4,739,000	4,489,000	(250,000)
	Plus Additional Non-Taxable Income	0	464,250	464,250
67	(Less Applicable Income Taxes)	(1,594,000)	(1,494,000)	100,000
69	Extraordinary Gains (Losses)	0	0	0
70	Equals Net Income	3,145,000	3,459,250	314,250
85	Return on Assets	0.80%	0.88%	0.08%
87	Return on Equity	8.74%	9.61%	0.87%
	BOLI as percent of Average Assets	0.00%	2.53%	2.53%
	BOLI Earnings as percent of Net Income	0.00%	13.42%	13.42%

Note: The chart above is used for sample purposes only and does not reflect actual illustration. Assumes a \$10M BOLI purchase with a 4.64% net yield. Assumes the bank uses a 2.5% opportunity cost and has a 40% tax rate. Please refer to the Important Disclosures at the end of this article for additional information regarding variable life insurance.

As a result of the purchase, the bank produces an incremental gain to shareholders of \$314,250, improves ROA by 8 basis points and improves ROE by 87 basis points.

Some BOLI products with lower risk-weightings can also improve a bank's Risk-Based Capital Ratio. The better a bank's ratio, the more capital it frees up for other purposes, such as additional loans.

In a recent poll of its members by the Independent Community Bankers of America (ICBA), 36% of respondents answered that their RBC Ratio had been affected by a downgrade in the credit agency rating of trust-preferred or mortgage-backed securities in their portfolio.¹

The example below summarizes the effect of investing \$10M in BOLI in a product with a 100% risk-weighting versus a

1 Item #	2 Call Report Item Description	After BOLI at certain risk weightings	
		100% RBC Weighting	20% RBC Weighting
45	Tier 1 Capital	35,231,000	35,231,000
47	Total Risk Weighted Assets	363,307,000	355,307,000
103	Tier 1 Risk Based Capital Ratio	9.70%	9.92%

Note: above chart is used for sample purposes only and does not reflect an actual purchase.

product with a 20% risk-weighting. In this example, the 20% risk-weighted product improves the RBC Ratio by 22 basis points.

While BOLI may not have as many uses as a Swiss Army knife, it comes close. It can both effectively offset benefit costs and ultimately help increase the value of the bank.

BOLI – a beacon for banks during the economic storm

This economic crisis has devastated the financial markets and tarnished the reputation of the financial industry, but community banks continue to weather the storm and stand tall. "Bank" was fast becoming the latest four letter word. However, the public is beginning to understand that community banks are, for the most part, still healthy and thriving and shouldn't be categorized with the too-big-to-fail crowd.

Community banks are not invulnerable to the economic conditions, as their profits are down and access to capital remains a concern. However, there are opportunities to be seized. Community banks are becoming more and more liquid. The personal savings rate in the U.S., as a percentage of disposable personal income, was 6.2% for May 2009,² a significant change from a rate of 0.6% for 2007 and 1.8% for 2008.³ This has led to an average increase in deposits of almost 34%⁴ with the average bank liquidity ratio rising almost 87%⁴ this past year.

This appears to be a major behavioral change for the population; it's logical to believe this will continue to lead to increased deposits in the coming years. Deposits aside, healthy banks also have access to cheap money. The Fed Funds effective rate was 0.17% as of July 2, 2009.⁵ This credit easing gives banks more flexibility and the necessary room to make competitive loans with more profitable margins than by the use of more expensive deposited funds.

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Banks are becoming more liquid, and the challenge is to leverage their inexpensive borrowings and increased deposits into profitable investments, so they can keep competitive savings rates while being as risk averse as possible. Their choices are limited. However, BOLI pre-tax net yields are currently ranging from 4-4.5% (tax-adjusted, using a 38% tax rate, the net yield ranges from 6.5-7.3%). These yields can vary depending on the BOLI product type (general account, hybrid or VUL) and if VUL is selected, upon the selection of the investment strategy for the bank assets. The life insurance

industry has also weathered the economic storm admirably due to strong reserve standards set by each state as well as conservative, long-term investment strategies.

Community banks are surviving based on sound banking principles. The life insurance industry also stands strong based on sound, long-term investment principles and substantial liquid reserves. Given today's volatile economic

environment, BOLI makes sense—a sound, stable asset with tax-advantaged yields that can offset benefit expenses and increase net income, while assisting banks to retain and reward their executives. Now is the right time for community banks to explore their needs and research available BOLI options and opportunities.

Important Disclosures

This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice.

¹ Independent Community Bankers of America (ICBA) Quick Poll conducted on June 15, 2009. Results found at <http://www.icba.org/qowresults.cfm?itemnumber=59748>.

² U.S. Department of Commerce; Bureau of Economic Analysis; National Economic Accounts, "Personal Income and Outlays" Report, May 2009.

³ U.S. Department of Commerce; Bureau of Economic Analysis; "Comparison of Personal Savings in the NIPAs with Personal Savings in the FFAs" Table, updated as of June 25, 2009.

⁴ SNL Database; information from FDIC Call Reports as of March 31, 2009.

⁵ Federal Reserve Statistical Release H.15 (519) Selected Interest Rates; July 6, 2009.

Variable life insurance products are long-term investments and may not be suitable for all investors. An investment in variable life insurance is subject to fluctuating values of the underlying investment options and entails risk, including the possible loss of principal.

The policy values are hypothetical for illustration purposes only and may not be used to project or predict investment results. Policy values will vary based on the actual performance of sub-account investments selected, actual insurance charges over the life of the plan and the timing of the premium payments.

Product guarantees, including the death benefit, are subject to the claims-paying ability of the issuing insurance company. Loans and partial withdrawals will decrease the death benefit and cash value and may be subject to policy limitations and income tax.

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