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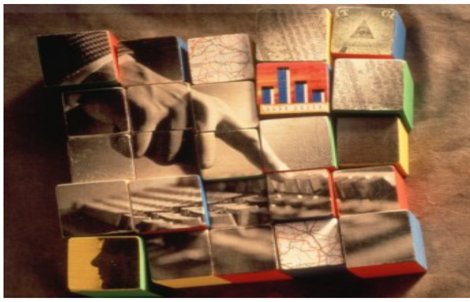


Bank-Owned Life Insurance Revisited

By Peter L. Dinardi, CPA, MBA[1]

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 typically have been acquired to indemnify against the loss of a key person or to recover all or a part of the costs of the bank's employee compensation and benefit programs.

BOLI is most commonly a single premium life insurance contract specifically designed 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 year. 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 potentially 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.

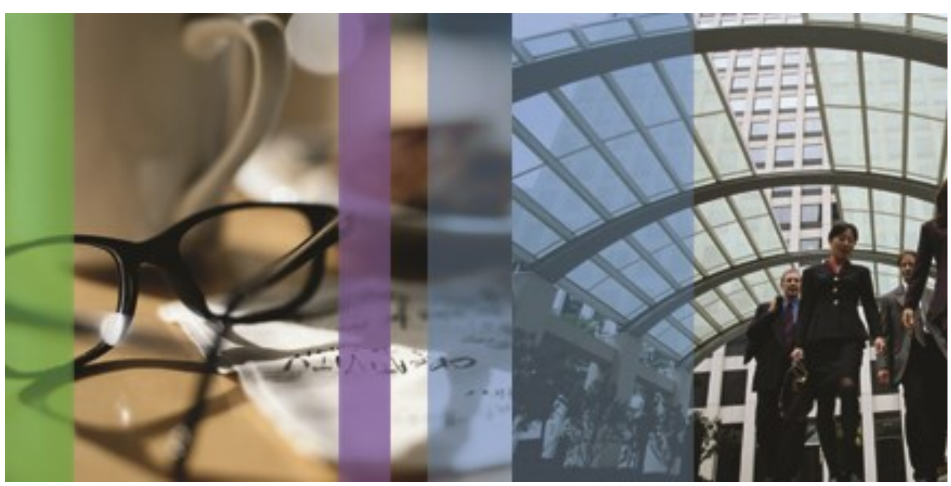
REGULATORY GUIDANCE

Guidance from federal banking regulators asserts 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." This guidance is contained in a joint interagency statement, OCC Bulletin 2004-56 (also cited as FIL 127-2004, FRB SR 04-19, and OTS TB-84). Issued on December 7, 2004 by the federal banking regulators[2], the bulletin and first formal interagency statement on BOLI replaced and rescinded the previous guidance, OCC Bulletin 2000-23.

Like its predecessor, OCC 2004-56 discusses the risks associated with a BOLI purchase and establishes the supervisory expectation of both a pre-purchase analysis and the continuing post-purchase risk assessment. The guidance from OCC 2004-56 with respect to pre-purchase analysis of life insurance applies to all BOLI contracts entered into after the date of the bulletin (December 7, 2004). BOLI contracts entered into on or before December 7, 2004, would be subject to the prevailing guidance from an institution's supervisory agency. The post-purchase risk management guidance of OCC 2004-56 applies to all holdings of life insurance regardless of when the insurance was purchased.

RISK EVALUATION AND PRE-PURCHASE ANALYSIS

OCC 2004-56 introduces eight risk categories associated with BOLI including the newly identified "reputation risk" or the risk to earnings and capital arising from negative publicity surrounding the public



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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.

The guidance identifies the risks which management and the board of directors should evaluate including liquidity, transaction/operational, reputation, compliance/legal and price risk.

Management actions which OCC 2004-56 recommends for an effective pre-purchase analysis include:

- Identifying the need for insurance and determining the economic benefits and appropriate insurance type
- Quantifying the amount of insurance appropriate for the institution's objectives
- Assessing vendor qualifications
- Reviewing the characteristics of the available insurance products
- Selecting 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

OCC 2004-56 asserts that "BOLI can be an effective way for institutions to manage exposures arising from commitments to provide employee compensation and pre- and post-retirement benefits."

Once 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.

In the ongoing assessment of risk, OCC 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 or will be 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 OCC 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 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 statement provides the necessary supervisory guidance and the regulatory expectations for a bank pursuing a BOLI purchase.

CONSULTATION

Peter Dinardi and Jeff Marsh of BOLI Strategic Partners are available for consultation on any issues and compliance needs related to BOLI or

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bank executive plans.

Peter L. Dinardi, CPA, MBA

Founder and Principal

BOLI Strategic Partners

ABOUT BOLI STRATEGIC PARTNERS

In early 2013, the BOLI business of NYLEX Benefits was transitioned to BOLI Strategic Partners. We focus on developing cost-effective practical solutions for community banks throughout the country.

Our services are designed to assist clients at all stages in the adoption and operation of their Bank-Owned Life Insurance programs and include:

- Initial assessment
- Plan design
- Funding
- Plan implementation
- Ongoing administration coordination with the Pangburn Group

BOLI Strategic Partners utilizes internal resources of New York Life through the Nautilus Group and Advanced Markets Network and also works closely with independent third parties in the following professional disciplines: all dedicated to supporting our clients' programs, processes, systems and services:

- Accountants
- Actuaries
- Attorneys
- Benefit specialists
- Insurance specialists

We take great care to assure that client programs are practical and that they are designed to achieve our clients' strategic and operational goals.

For more information, call us at (800) 584-9114 or visit www.bolistrategicpartners.com

[1] *Peter L. Dinardi , is a Principal and founder of BOLI Strategic Partners. He is the former Chief Financial Officer and Director of BOLI Operations for NYL Executive Benefits LLC (NYLEX Benefits). Mr. Dinardi was formerly the Executive Vice President and Chief Financial Officer of River Bank America, an FDIC insured and New York State chartered savings bank.*

[2] *The joint interagency Statement on BOLI (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).*

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