BOLI — AN INVESTMENT OR LIFE INSURANCE?

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Bank-owned life insurance (BOLI) is a long-duration accrual asset with no stated maturity date, yet it has a present and future maturity value. At purchase, a stated maturity value is known, which over time may increase to be paid at an undetermined maturity date. It's accretive to earnings, albeit accrual earnings rather than cash earnings. BOLI has no stated coupon rate; however, monthly there's a valuation of the asset, and income is recognized. It's not a readily marketable asset, but it can be liquidated, subject to consequences. In this sense, BOLI could be defined as a "zero coupon perpetual bond."

So with these attributes in mind, do we view BOLI as an investment? We certainly describe it as an earning asset, recognize its value as an asset on the balance sheet and compare its performance to other investments. We even cite an annualized yield as we do with an investment. We presume it has a credit quality like a debt instrument, attributed to the issuer.

But the fact is that BOLI is life insurance, and all it does from the date of its acquisition to the day it matures is accrue the asset value toward an eventual maturity value. All the activity in the interim takes on the perception that BOLI is an investment. However, it's not the BOLI asset itself that's the investment; rather, the investment relates to the attributes of the investments underlying the BOLI asset. It's these investments that become the source contributing to the pace of accruing the BOLI asset. Thus, the BOLI acquirer should be more attentive to these attributes, as they represent the investment nature of BOLI.

BOLI AS LIFE INSURANCE

BOLI – life insurance by definition – is the sum of two elements: a cash account and an insurance benefit in excess of the cash account. The insurance benefit must exist for the BOLI holder to derive the favorable tax preferences BOLI delivers: tax-deferred growth of the cash account and tax-free receipt of the sum of the cash account and insurance benefit at maturity (i.e., the death of the insured). If liquidated prior to maturity, the tax-deferred benefits are foregone. BOLI must exist via an insurance company, as it's the only authorized source of BOLI, and the tax preferences' companion to BOLI (meaning life insurance) are defined by federal statute.

How fast will the cash account grow? The cash account growth is subject to the performance of certain assets held by the insurance company and to the level of deductions the insurance company imposes to cover its risks and expenses. As a rule, the faster the growth of the cash account (the pace), the better the BOLI is perceived. That growth can be skewed to the early years or later years, depending on how the insurance company determines when and by how much it wants to be compensated for its risk and expenses. Also, that pace of growth can contribute to the amount paid at maturity. However, there's a limit to the growth: the performance of the investments defined by the insurance company backing the BOLI (the source).

INVESTMENT SIDE OF BOLI

When we speak of the source, the acquirer of BOLI is presented with a choice of investment structures to determine the pace of the accrual. Insurance companies offer this choice through the structure of the BOLI product being issued.

One choice is commonly referred to as general account, whereby the BOLI performance is predicated on a diversity of investments totally under the management control of the insurance company. The insurance company declares a notional rate of performance to be applied to the cash account, stating that it's attributed to the investments in their general account. The acquirer of a BOLI product of this genre cannot directly ascertain whether this notional rate is good, bad or neutral. Yet it would be prudent for the acquirer to exercise due diligence in the structure and performance characteristics of the investments, rather than just accepting the notional rate at face value. The acquirer, as well, can only view this form of BOLI as a general obligation of the life insurance company and as one of many purchasers in a similar position. Security behind this general obligation is not the "financial strength" rating of the insurance company, but rather the quality of the investments acquired by the insurance company to meet its obligations.

An alternative source of investments is found in a product made up of separate accounts, whereby the insurance company creates segregated accounts specifically for those acquirers of BOLI who prefer to have direct control of which investments define the performance of the cash account. There are guidelines surrounding the structure of these segregated accounts, which we won't detail here, but, needless to say, these accounts generally hold investments considered to be bank-eligible. With these segregated accounts, the acquirer is subject to performance risk of the investments in the accounts. The cash account, which these segregated accounts support, is subject to a change in value based on the performance of the segregated accounts. To mitigate this value fluctuation, an accounting arrangement is often entered into for these segregated accounts to translate the fluctuating investment performance into a notional rate. In the case of private placement products, this is done through a "stable value arrangement." With hybrid products (guaranteed separate accounts), the product terms automatically provide "stable value accounting." In either case, the acquirer is permitted to state the value of the cash account based on the "stable value accounting" approach, mitigating exposure to profit and loss variability.

For these reasons, it's just as important, if not more so, for the acquirer to exercise prudent due diligence over the structure and performance characteristics for these segregated accounts as for an insurance company's general account. The acquirer of a separate account product in this instance can look to the segregated account for the security of its cash account, but continues to have a general obligation to the insurance company for the insurance benefit. The acquirer of a general account product, however, looks to the full death benefit (cash account plus insurance benefit) as a general obligation of the insurance company.

THE BOTTOM LINE

Returning to the original question, BOLI is life insurance but with investment attributes. As life insurance, BOLI provides advantageous tax preference features of tax-deferred growth of the cash account, becoming federal and state income tax-free at maturity along with the insurance benefit. Like an investment, the cash account and, ultimately, the maturity value are incumbent on the direction the acquirer chooses for its pace and source of growth. For that reason alone, the acquirer should take a more proactive view of the investment nature of BOLI.

BANK-OWNED LIFE INSURANCE — AND A WHOLE LOT MORE

At NFP Corp., our solutions and expertise are matched only by our personal commitment to each client's goals. We're a leading insurance broker and consultant that provides employee benefits, property & casualty, retirement, and individual insurance and wealth management solutions through our licensed subsidiaries and affiliates.

NFP has more than 3,800 employees and global capabilities. Our expansive reach gives us access to highly rated insurers, vendors and financial institutions in the industry, while our locally based employees tailor each solution to meet our clients' needs. We've become one of the largest insurance brokerage, consulting and wealth management firms by building enduring relationships with our clients and helping them realize their goals.

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Insurance products: 1) are not a deposit or other obligation of or guaranteed by any bank or bank affiliate; 2) are not insured by the FDIC or any other federal government agency, or by any bank or bank affiliate; and 3) may be subject to investment risk, including possible loss of value.

Guarantees are subject to the claims paying ability of the issuing insurance company.

Withdrawals made during the first 15 years could result in unfavorable LIFO taxation under IRC Section 7702(f)(7) "force-out" rules. Withdrawals in excess of cost basis may be taxable. Lapsing a policy with an outstanding loan results in the loan, and any accrued interest, being treated as a distribution, which may be taxable. Modified endowment contracts (MECs) are taxed differently and are not suitable for this program if surrenders or loans are anticipated. Please check policy illustrations to see if the policies being considered are MECs. Certain changes to a non-MEC policy could result in the policy becoming a MEC. Professional tax advisors should be consulted. Any loans, withdrawals or partial surrenders will reduce cash values and death benefits.

Internal Revenue Code 7702A defines an MEC as a life insurance policy that has had cumulative premium payments made during the first seven years that exceed the sum of net level premiums (the 7-pay test). Net level premiums are determined by each insurance company and reflect the premiums required to "pay up" the contract during the first seven years. The carrier must assume guaranteed cost of insurance charges and guaranteed minimum interest rates for "7702" testing which determines the net premium.

Disbursements from MEC policies, other than at death, are taxed on a Last In, First Out (LIFO) basis, accessing cash value buildup first and owner's basis last. Disbursements from non-MEC policies, other than at death, are taxed on a First In, First Out (FIFO) basis, accessing owner's basis (premiums paid) first and cash value buildup last.

Before investing, investors should carefully consider the investment objectives, risks, charges and expenses of the variable product and its underlying investment options. The current contract prospectus and underlying fund prospectuses provide this and other important information. Please contact your representative or the Company to obtain the prospectuses. Please read the prospectus carefully before investing or sending money.

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