

Bank Owned Life Insurance

Using BOLI to Increase Bank Profitability

Today's competitive environment requires community banks to be increasingly innovative in their approach to traditional business activities to continue being profitable and independent. One of the best ways to increase bank profitability and value is through the use of a well-designed BOLI plan. When designed properly, BOLI is an investment that provides community banks with increased annual income that can be used to offset the costs of current bank benefit plans or provide new a benefit plan to bank executives.

What is BOLI and How Does it Work?

BOLI is an investment into a specially designed institutional insurance policy. The policy is paid for typically with a single up-front premium, which enables it to produce positive income in the first year. These policies are placed on the lives of key bank executives and to ensure the tax advantage of the BOLI, these policies should be held until the death of the executive. Upon the death of the executive, the bank will receive a tax-free death benefit.

An Example of Repositioning Assets

<u>Traditional Bank Investment</u>		<u>BOLI Investment</u>	
◆ Fed Funds	\$2,000,000	◆ Investment	\$2,000,000
◆ Income	\$ 60,000 (3.00%)	◆ Income	\$109,800 (5.49%)
◆ Taxes	\$20,400 (34%)	◆ Taxes	- 0 -
◆ Net Income	\$39,600 (1.98%)	◆ Net Income	\$109,800 (5.49%)

Additional Net Income: \$70,200 (3.51%)

Simply gaining tax deferred income at a rate of 5.49% gives the bank \$70,200 or 3.51% of additional income. While we used a crediting rate in this example of 5.49%, the rate on a BOLI contract will continually reset to the market thus keeping the spread of 3.51% fairly consistent.

Many view BOLI plans strictly as a method of providing supplemental benefits to bank executives. While it is true that many BOLI plans have been designed to

meet the retirement needs of community bank executives, the real power of a BOLI plan is best illustrated when you view BOLI as an investment. BOLI is a balance sheet strategy designed to enhance the banks profitability. This is accomplished by repositioning taxable investments into these institutional insurance policies, which provide tax-deferred income. There are some restrictions, which we will discuss later, that prevent a bank from using BOLI solely to enhance operating income.

Benefits of a BOLI Plan

The benefit of BOLI is simple; ***BOLI generates an additional of 150 to 200 basis points in after-tax investment yield depending on tax rates.***

Community Banks may find it advantageous to utilize BOLI strategies to achieve a competitive advantage in the next decade. Owners and Directors expect to achieve a sustainable competitive advantage by positioning their community bank to earn superior long-term profits regardless of changes in the environment. They like to maintain:

- An ever-increasing annual return on equity
- An ever-increasing book value per share
- An ever-increasing share price for the bank or bank holding company stock.

A key word that summarizes owners and directors expectations is MORE. However, there are historical trends that run contrary to the owners and directors expectations. Some of the reasons why the future profit forecast curve declines over time include:

- The narrowing net interest margin
- Salary and benefits constitute the second largest overall expense and the largest operating expense
- Banks give annual increases in fixed salaries
- Increases in benefit costs are tied to fixed salary increases

A well-designed BOLI plan can address any of the above issues. The spread between the current taxable investment income and the BOLI's tax-free income will provide increased ROE, ROA and can substantially increase the value of a bank. In our above example, using the additional net income provided by the BOLI plan of \$70,200 would result in a direct reduction in the costs of current plans. This cost reduction in turn flows straight to the bottom line. If we assume that the bank in our example has Net Income of \$1,500,000 and if this bank were valued at 10x earnings, the \$70,200 would equate to an additional \$702,000 in value or a 4.68% increase in bank value.

Optional Uses of BOLI

In today's increasingly competitive market place attracting and retaining key executives is vital and if this is your focus, BOLI provides your bank with a cost

efficient method of rewarding key employees. The additional income produced by a BOLI plan can be used in many fashions. As illustrated above, it can offset current plan costs or it can be used to enhance current benefits of bank executives. A brief description of six types of non-qualified plans for bank key executives is described below. These may help to understand plan characteristics and financial commitments to the bank. Understanding the various compensation arrangements are often useful in determining which one best suits the banks objectives.

A non-qualified plan is a legal agreement between an employer and key executive employees to provide income at a future date. It maybe a general obligation of the employer and may provide death/disability benefits to replace future income. The bank deducts the retirement benefits when paid and the income is taxable to the retiree. There are several types of non-qualified plans.

- Deferred Pay Arrangements
- Salary Continuation Plan (SERP)
- Index Retirement Plan
- Incentive Compensation Plans
- Phantom Stock Plan
- Group Life Carve-Out Plans.

Compliance

The Office of the Comptroller of the Currency issued Bulletin 2000-23, dated July 20, 2000, which provides general guidelines for national banks to help ensure that bank purchases of life insurance are consistent with safe and sound banking practices. Often state regulatory authorities follow OCC guidelines. It replaces Bulletin 96-51, dated September 20, 1996, which is hereby rescinded. The authority for national banks to purchase and hold an interest in life insurance is found in 12 USC Section 24 (Seventh). The law provides that national banks may exercise “all such incidental powers as shall be necessary to carry on the business of banking.” Purchases of life insurance that the OCC has found to be incidental to banking include: key-person insurance, life insurance on borrowers, life insurance purchased in connection with employee compensation and benefit plans, and life insurance taken as security for loans. However, a purchase of life insurance must address a legitimate need of the bank for insurance. Life insurance may not be purchased to generate funds for the bank’s normal operating expenses, for speculation, or for the primary purpose of providing estate-planning benefits for bank insiders unless it is part of a reasonable compensation package. In addition, the purchase of life insurance is subject to

supervisory considerations, and life insurance holdings must be consistent with safe and sound banking practices.

The safe and sound use of bank owned life insurance depends on effective senior management and board oversight. Regardless of the bank's financial capacity and risk profile, the board must understand the role bank owned life insurance plays in the overall business strategies of the bank. The board's role in analyzing and overseeing bank owned life insurance should be commensurate with the size, complexity, and risk inherent in the transaction. Although the board may delegate decision-making authority related to bank purchases of life insurance to management, the board remains responsible for ensuring that purchases of life insurance are consistent with safe and sound banking practices. The objective of the pre-purchase analysis is to help ensure that the bank understands the risks, rewards, and unique characteristics of bank owned life insurance.

At a minimum, the pre-purchase analysis should consider the following standards:

- I. *Determination of the Need for Insurance*
- II. *Quantification of the Amount of Insurance Needed*
- III. *Vendor Selection*
- IV. *Carrier Selection*
- V. *Review the Characteristics of the Available Insurance Products*
- VI. *Analyze the Benefits of Bank Owned Life Insurance*
- VII. *Determine the Reasonableness of Compensation Provided to the Insured Employee if the Insurance Results in Additional Compensation*
- VIII. *Analyze the Associated Risks and the Bank's Ability to Monitor and Respond to those Risks*
- IX. *Evaluate Alternatives*
- X. *Document Decision*

National banks should follow generally accepted accounting principles for financial reporting and call report purposes. Financial Accounting Standards Board Technical Bulletin 85-4, "Accounting for Financial Purchases of Life Insurance" discusses how to account for investments in life insurance.

The task of implementing and administering a BOLI plan can seem daunting. Even so, a properly designed and administered plan is a vital component in a bank's portfolio. This is where APB Financial Group, LTD. comes in. We will put our 25 years of experience to work for you in determining the need for BOLI, designing the plan and communicating the plan design to board members and other key decision makers. As part of our ongoing commitment to your bank, we will provide plan documentation and regulatory assistance and support.

For more information, please contact Mero Capo, Vice President, APB Financial Group, LTD at 1-800-480-5190 or at MeroC@APBFinancial.com.