

THE NORTHWESTERN MUTUAL LIFE INSURANCE COMPANY

# THE ABCs OF BOLI

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This article is intended to provide a basic understanding of bank-owned life insurance (BOLI) and how it can become a contributing asset to your financial institution's performance. In addition, this article addresses the unique features of The Northwestern Mutual Life Insurance Company's (Northwestern Mutual) BOLI product.

### ***What is BOLI?***

Any life insurance policy owned by a bank is BOLI. The life insurance policy may be one that was specially designed for the BOLI marketplace or it may be one available to the general public. In this article, the term "BOLI" refers to any life insurance policy owned by a bank, unless stated otherwise.

### ***Why do banks purchase BOLI?***

Banks purchase life insurance to informally finance executive benefit liabilities, post-retirement medical coverage, and other post-retirement employee benefits such as group term life insurance. These employee benefit obligations may be tied to existing programs or the bank may be considering implementing one or more new plans.

BOLI allows a bank to record favorable after-tax yields through cash value accumulation and death proceeds. Because the increases in cash value are tax-deferred and death proceeds are generally income tax free, BOLI offers banks a good choice for financing long-term employee benefit obligations. Note, however, that the Alternate Minimum Tax (AMT) could apply in some situations.

BOLI policies also can protect the bank from the monetary loss associated with the death of a key management employee.

### ***How are BOLI purchases treated by insurance and bank regulators?***

First of all, banks must have an insurable interest in all BOLI insureds and such insurable interest must be evaluated under applicable state regulations and insurable interest laws.

In addition, most financial institutions find their guidance regarding supervisory considerations for BOLI purchases in OCC Bulletin 2004-56, Interagency Statement on the Purchase and Risk Management of Life Insurance, dated December 7, 2004. This Bulletin was issued jointly by the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRS), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS).

All life insurance policies owned by banks are affected by Bulletin 2004-56. The guidance pertaining to the pre-purchase analysis of life insurance applies to all policies purchased by banks after December 7, 2004. The guidance pertaining to the ongoing risk management of BOLI applies to all BOLI, regardless of the date of purchase. The rules of the Bulletin apply to all life insurance sales, not just products designed specifically for banks.

OCC Bulletin 2004-56 specifies that “national banks and federal savings associations may *not* purchase life insurance:

- for speculation;
- to provide funds to acquire shares of stock from the estate of a major shareholder upon the shareholder’s death, for the further purpose of controlling the distribution of ownership in the institution;
- as a means of providing estate-planning benefits for insiders, unless the benefit is part of a reasonable compensation package; or
- to generate funds for normal operating expenses other than employee compensation and benefits.”

### ***What “due diligence” is needed with a BOLI purchase?***

OCC Bulletin 2004-56 stresses repeatedly that it is the responsibility of the financial institution to do the appropriate due diligence and understand all the issues, especially those pertaining to risks associated with BOLI. The Bulletin emphasizes the importance of following “safe and sound banking practices” in any purchase of BOLI as well as the need for ongoing post-purchase risk assessment.

Financial institutions that purchase BOLI policies must thoroughly document their analysis prior to the purchase. This pre-purchase analysis must include an evaluation of the insurance and business need, the appropriate product, the vendor’s qualifications, and the insurance carrier, including evaluation of the available alternatives.

The Bulletin also stresses the need for ongoing risk management. “A prudent risk management process includes:

- effective senior management and board oversight;
- comprehensive policies and procedures, including appropriate limits;
- a thorough pre-purchase analysis of BOLI products; and
- an effective ongoing system of risk assessment, management, monitoring, and internal control processes, including appropriate internal audit and compliance frameworks.”

Specific guidance regarding the pre-purchase analysis and ongoing risk assessment is detailed in the Bulletin.

### ***How much BOLI can a bank purchase?***

Once the bank has analyzed and determined its need for life insurance, the amount of BOLI a bank can purchase is limited by its Tier 1 capital plus loan loss reserves (referred to by the OCC as the “bank’s capital structure” but called “Tier 1” by the industry). Tier 1 capital (or core capital) is the capital that can absorb losses without a bank being required to cease trading, and includes equity capital and disclosed reserves. Allowance for loan/lease losses are general valuation allowances that have been established through charges against earnings to absorb losses on loans and lease financing receivables.

OCC guidelines, in Bulletin 95-7, limit banks to allocate up to 25% of Tier 1 to life insurance. In addition no more than 60% of the maximum BOLI limit can be purchased from any one carrier. Stated another way, no more than 15% of the bank’s capital structure

can be placed with a single carrier. This guideline limit applies to all cash value life insurance that a bank carries; it does not apply to each individual BOLI purchase.

**Keep in mind that the institution's capital structure is a fluctuating amount.** Financial institutions should continually monitor their cash value growth relative to their Tier 1 growth and changes in loan loss reserves. Because of the regulatory nature of the financial industry, institutions that retain excess amounts of cash value life insurance could be subject to adverse actions. On page 2 of the interagency statement, the agencies express concern that "some institutions have committed a significant amount of capital to BOLI without having an adequate understanding of the full array of risks it poses...." They caution that institutions can expect close scrutiny by examiners in situations where the aggregate cash values approach or exceed the guideline limit.

### ***How does a BOLI purchase impact the bank's balance sheet?***

The accounting required for BOLI policies is the same regardless of carrier or type of policy. Under Generally Accepted Accounting Principles (GAAP), accounting for BOLI policies is based on the guidelines of FASB Technical Bulletin 85-4 and the Emerging Issues Task Force (EITF) Issue No. 06-5. Premiums paid are a non-tax-deductible expense. Cash Surrender Value (CSV) is recorded as an "other asset". The increase in CSV over time is booked as "other non-interest income".

Income and death benefits provide an attractive tax equivalent return and the financial justification to buy an insurance policy over other financing alternatives. BOLI earnings will be reported on the income

statement and thus can contribute to increased net worth and earnings per share.

Generally there is no initial change in a bank's balance sheet due to a BOLI purchase. The policy is carried on the balance sheet as an earning long-term asset. The bank typically sells Treasuries or other securities as a fund source for the BOLI purchase, thereby trading one asset for another. The Modified Endowment Contract penalty is not usually an issue since surrender or borrowing from the policy by the bank is not anticipated. If the BOLI purchase is for the purpose of providing new nonqualified benefits for the participating employees, the bank must also account for the benefit liability in addition to the policy values.

### ***What are the best types of life insurance for a bank to own?***

Banks have an array of life insurance products from which to choose, ranging from term coverage to variable universal life. The Appendix to Bulletin 2004-56 discusses the various types of insurance: term vs. permanent; whole life vs. universal life; general account vs. separate account.

Typically banks purchase permanent life insurance with a single premium on a select group of key employees. The bank pays the premium, owns the policy and its cash value, and is the policy's sole beneficiary. Since these contracts are typically Modified Endowment Contracts (MECs), the bank holds the insurance until the death of the insured and, under current tax law, receives income-tax-free death proceeds.

Most insurance carriers use a universal life chassis through either their general account or a separate account. There is no superior type of account to be in; they each have their

strengths and weaknesses. The interest rate methodology range from those set weekly to annually and those that move after the sale monthly to changing annually.

### ***How does Northwestern Mutual's BOLI product compare?***

Unlike other carriers, Northwestern Mutual's BOLI product is a Single Premium Life (SPL) general account, participating whole life insurance contract. The contract is a MEC. Northwestern Mutual's contract provides

competitive guaranteed death benefit and guaranteed cash values compared with typical universal life contracts. NM's investment, mortality, and expense experience has led to a long history of strong policyholder value.

The Northwestern Mutual BOLI product is one of a number of products available to a bank. If the bank has a need for a non-MEC product, then any of the Northwestern Mutual non-variable products can be used. Keep in mind that any life insurance purchase counts toward the bank's Tier 1 limit.

### ***Summary***

When a bank considers its employee benefit obligations and the value of its key employees, it makes sense for it also to consider the long-term benefits that a Northwestern Mutual policy can offer. Northwestern Mutual has consistently maintained the best possible insurance financial strength ratings from all four major ratings agencies (Standard & Poors, A.M. Best, Moody's Investors Service and Fitch Ratings). Its financial strength along with the diversification of the general account assets and the active management of the investment portfolio help to protect its policyowners against market volatility and unexpected events. The commitment of Northwestern Mutual to provide its policyowners with superior value, while maintaining exceptional financial strength, will stand the test of time – just as it has for the past 150 years.

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