Your Annual BOLI Review: What You Should Know

Banks are expected to conduct a review of their bank-owned life insurance (BOLI) portfolio annually under the guidance of the Interagency Statement of 2004. This supervisory oversight responsibility assures regulators that a bank's risk management processes for BOLI are consistent with safe and sound banking practices. Due to the nature of the insurance information, most vendors assist their clients through the process, but this review is often only a snapshot in time of the BOLI portfolio. What should be included in the review for the bank to be assured that expectations are being met and risks are identified?

THE BOLI ASSET

BOLI is a long duration asset, often expected to be held for 30 – 40 years. In one sense, BOLI can be considered as a "zero coupon perpetual bond." Despite not being an actual bond, it has many attributes of a bond. These attributes include:

- A stated maturity value (death benefit), with a promise to pay guaranteed by an insurance company (the "issuer") – yet, with an unknown maturity date
- An accrued value, referred to as cash value, determined by the issuer's assessment of mortality expectations, expenses and interest earnings
- A fair market value, the cash surrender value, available upon redemption prior to maturity

While the annual review process generally assesses the current state of the "bond", this process should further consider two questions:

1) What is the present and projected **return <u>on</u> the money invested** for the "bond" (the premium)?
2) What are the potential risks to the **return <u>on</u> and return <u>of</u> the money invested**?

Each of these questions can be examined in the annual review process. After all, the BOLI "bond" was acquired for the earnings to be a long-term financing strategy for employee benefit and compensation plans and for the maturity value to meet certain benefit obligations such as survivor income and split-dollar benefits. Guiding the board and bank management through this assessment necessitates an additional step in the review process: insurance company projections to reveal the future outlook of the maturity value of the "bond."

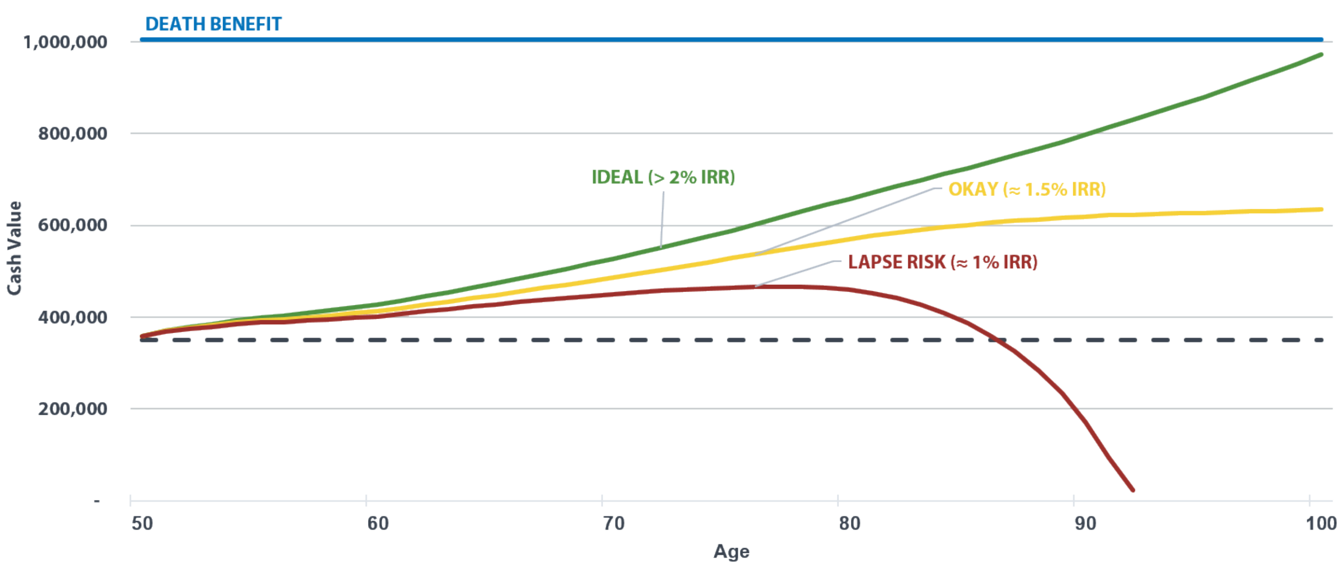
THE CRITICAL ELEMENT

Interest earnings credited to BOLI policies are the most dominant factor in the cash value growth, and are the most significant contributor to the annual earnings recognized as non-interest income each year. Unlike a zero coupon bond where the interest rate (discount rate) is set at purchase, the interest rate for the BOLI "bond" floats with the underlying investment portfolio of the insurance company supporting the BOLI. Even though the earnings are tax-favored, a bank generally looks to the present value predicated on the current credited interest rate to assess whether the BOLI is a good/bad/indifferent performing asset.

Depending on when the BOLI was acquired, the present interest rate scenario can range 100-400 bps below the rate at purchase. The level of future earnings from the BOLI under today's interest rate scenario can be significantly less than original projections. If the BOLI is intended to be a cost offset financing strategy, anticipating the direction of future BOLI earnings can measure its ability to meet forecasted expenses. Requesting re-projections of in-force policies at current crediting rates can provide a bank with an awareness of the BOLI policies' present and future earnings capability.

Because interest rates are vital to the performance of the carrier's underlying investment portfolio, the conversion of the investment portfolio performance to the credited interest earnings in the BOLI policy can forecast the success or risk of lapse of the BOLI program. Success can be measured by the cumulative cash value growth to date, and by the forecast of future cash value growth illustrated in inforce projections. The in-force projections can predict the sufficiency of the cash value to support the ultimate payment of the death benefit proceeds.

The following chart illustrates what should be the basic standard of cumulative cash value growth to forecast the success of the BOLI policy or identify potential lapse risk.



THE ASSESSMENT OF RETURN

The BOLI purchase is often predicated on two cash flow events:

- The money applied (cash out) to purchase the BOLI
- The money realized (cash in) from the maturity value — the death benefit

As the chart demonstrates, the assessment of BOLI should indicate how well the **return on the money** is capable of delivering the **return of the money**. Recognizing that the maturity value (death benefit) is often three to four times the premium invested, the cumulative cash value and the future pace of its growth is correlated to the final realization of the maturity value.

The risk in BOLI, particularly with present levels of interest rates, is observed in the chart through the three scenarios of **return on the money**. If the cumulative cash value is indicative of the Ideal green line, great! Yet, if the value indicates a trajectory more like the Lapse Risk red line, **both return on and return of the money** is in jeopardy.

ANNUAL REVIEW

The annual review process should be more than just meeting the regulators' expectations. Expanding the review to assess the projected results from BOLI can provide a bank with a broader assessment of its BOLI asset's ability to meet the original death benefit expectations. Acting on the following recommendations with the guidance of NFP executive benefits consultants and account executives provides a more thorough BOLI risk management process:

- Periodically include insurance projections into the process.
- Consider the characteristics and performance of the underlying investment portfolios supporting your BOLI.
- Understand what actions are available to mitigate risks in your BOLI's ability to meet original expectations.

With this knowledge, you can manage the expectations of the regulators and stay informed by ensuring that your BOLI is meeting the original goals and objectives of the bank.

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.

All guarantees are subject to the claims-paying ability of the issuing insurance company.

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