BOLI — AN INVESTMENT OR LIFE INSURANCE?

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. As its value accrues BOLI is 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 as if it were a bond. It's not a readily marketable asset, but it can be liquidated, subject to consequences. With all these attributes, 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.

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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 (the source) from which the pace of the accrual is determined. Insurance companies offer this choice through the structure of the BOLI product being issued.

General Account

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.

Separate Account

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.

Equity Index Account

Investment variations supported by the general account are referred to as **equity index accounts**. These accounts allow the policyowner to direct the **cash account** growth to be subject to a change in common equity market indices, such as the S&P 500. The performance of the index from point to point, generally a one year time frame, determines the pace of the **cash account** growth. At no time is the policyowner considered to be invested in the equity market defined by the index, thus there is no market risk. Rather, the insurance company is defining the attributable portion of its general account to acquire options against the index. Thus, the **equity index account** becomes another source of investment earnings within the general account.

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

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