NFP®

When Interest Rates Rise

What to Expect from your BOLI Asset

Since 2008, our economy has experienced significantly low interest rates in comparison to historical patterns. With the Federal Reserve now posturing interest rates to a "neutral" level, there has been some upward movement in rates. Using the 10-year Treasury as a proxy, yields have increased about 100bp over the past year and have been reflected in higher mortgage rates as evidenced by 30-year mortgages near the 5% level. Bankers may welcome the news as a step in improving net interest margin, but many are skeptical as to the impact on interest-rate-sensitive assets. Insurance companies may also welcome the news, as higher interest rates can relieve compression spread, particularly on insurance policies where interest rate guarantees are difficult to support at current investment portfolio yields.

But how will rising interest rates affect bank-owned life insurance (BOLI) assets held by a majority of banks? Interest rates that influence insurance carriers' portfolios have been declining since the early 1980s, when BOLI became an attractive and viable asset for banks to acquire. Over the last 30 plus years, there have been occasional interest rate blips up and down, but nothing has been as dramatic or impactful as the interest rate climate since 2008. Let's dive into the details of how interest rates have affected BOLI assets.

THE PREMISE OF BOLI

BOLI is an asset that accrues value (meaning cash values) over its life, from the date of purchase to an eventual maturity amount paid at the death of the insured. It's life insurance, not a bond, although can be viewed as a "zero coupon perpetual bond." The yearly rate of accrual changes are due to two primary factors: interest earnings and insurance charges. But the maturity value never changes unless it's increased to meet federal statutes on the definition of life insurance. While the BOLI asset accrues, the bank is able to recognize non-interest income on a tax-preferred basis with a final non-interest income amount attributed to the payment of maturity value at death.

So, how does the subject of rising interest rates – or, for that matter, any change in interest rates – influence the BOLI asset?

- BOLI is not a "mark-to-market" asset; it's always carried at book value.
- Rising interest earnings in BOLI improve non-interest income.
- Increased interest earnings can improve the long-term internal rate of return of the BOLI if they cause an increase in the maturity value.

HOW TO DETERMINE BOLI INTEREST EARNINGS

Generally, insurance carriers follow one of two methodologies for valuing their investment portfolios supporting BOLI contracts:

- **Book yield** is commonly followed for general account and hybrid separate account products. It's a consistent measure of the aggregate investment portfolio performance and translates well to the interest earnings for general and hybrid account products. Because the insurance carrier guarantees the value of the BOLI asset, the bank isn't subject to the investment risk and mark-to-market exposure.
- **Total return** is associated with the stable value accounting methodology for separate account products. It's a measure of the performance of the investment accounts underlying separate account products, as the valuation is not unlike that of a mutual fund. Although the carrying value of separate account products is at book value, the fact that the investment risk of the investment accounts remains with the bank exposes the bank to potential interest earnings and asset value volatility.

HOW TO DECLARE INTEREST EARNINGS

Insurance carriers follow one of two approaches for declaring the interest earnings for BOLI: **portfolio** method or **new money** method. The **portfolio** method is most commonly applied for BOLI contracts, as the carrier determines an aggregate portfolio book yield for declaring interest earnings for all policy owners regardless of the date of purchase. The **new money** method is an approach where the initial interest earnings of the BOLI purchase are based on the book yield of new investments. Each BOLI purchase can have its own series of interest earnings, as the new money is integrated into the aggregate portfolio over time.

- **Portfolio Method**

  Carriers will often say their portfolios turn over, on average, 10 percent per year. This is due to maturities, selling decisions and net positive cash flow for new investment purchases. As the reinvestments occur, the overall portfolio book yield is influenced by the direction of the change in book yields of the new purchases compared to the aggregate portfolio book yield. If the new purchase book yield is below the aggregate book yield, the aggregate will fall. If the new purchase book yield is above the aggregate, the aggregate will rise. This is where you hear the statement, "Crediting rates will lag going down in a falling market and will lag going up in a rising market." The statement describes why a difference may exist for portfolio-based crediting rates versus current new money: a timing difference.

- **New Money Method**

  You may ask, "What's the difference if the carrier follows the new money method?" These products will have interest earnings for new BOLI purchases based solely on the book yield of investments the carrier can acquire at the time of purchase, or may use a blend of new money and portfolio for new BOLI purchases. The future interest earnings will become a blend of the new money integrated into the aggregate portfolio over a period of years consistent with the investment portfolio turnover rate. With new money products, every purchase group has its own series of interest earnings rates due to the starting point and the blending rate.

  What's interesting about new money products is that if new money rates are below portfolio rates, the projected cash value performance of new money products isn't likely to meet the levels of portfolio products for many years into the future. This results from the premise most insurance companies invest similarly, which translates to similar aggregate investment returns on their portfolios, creating an upper threshold on ultimate interest earnings.

THE BOTTOM LINE

Rising interest rates are not a negative to BOLI. They can be positive. General and hybrid account products do not experience a mark-to-market issue when interest rates rise. The benefit of rising interest rates is evidenced in an improvement in the accrued non-interest income and perhaps the ultimate maturity value of the BOLI asset.

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