
# Bank-Owned Life Insurance Presents a Window of Opportunity

**By Francis X. Grady**

Bank-owned life insurance, or BOLI, is a single premium life insurance contract specially designed for banks to earn tax-free income.

With the specter of new federal legislation being enacted that would make BOLI financings slightly more difficult to implement, BOLI deserves a closer look for banks interested in taking advantage of these tax benefits.

BOLI's tax-free income comes from two sources: growth of the cash value in the policy, and insurance proceeds paid to the bank when the insured dies.

Most traditional bank investments generate taxable interest each year. In contrast, BOLI earnings produce no current income tax liability for the bank. Earnings stay sheltered inside the life insurance contract and therefore are tax-deferred. By reallocating funds from traditional portfolio investments into BOLI, a bank can increase its yield by 100 to 350 basis points depending on marginal tax rates, the size of the transaction, and the type of policies selected.

BOLI transactions are unique and represent activities that differ greatly from the main business activities of most financial institutions. It is not uncommon for a bank's initial purchase of BOLI to be an amount equal to 10-25 percent of capital. BOLI policies cover the lives of executive officers who, along with all other employees, participate in a variety of benefit plans, including—but not limited to—medical benefit plans, employee stock option plans, and 401(k) plans. BOLI policies, however, are not directly tied to any promised benefits.

According to testimony given by the U.S. General Accounting Office at an October, 2003 Senate Finance Committee hearing on business-owned life insurance, about one-third of FDIC-insured banks and thrifts disclosed BOLI holdings as of Dec. 31, 2002, with in-force BOLI by those 3,209 banks and thrifts totaling $56.3 billion. Overall, 259 banks and thrifts with assets of $1 billion or more held 88 percent, or $49.4 billion, of the total reported cash surrender value of BOLI.

While the Office of the Comptroller of the Currency pioneered the supervisory standards applicable to bank purchases of life insurance, the Office of Thrift Supervision has implemented new BOLI purchase standards in the last several years that may foreshadow future revisions by the OCC.

The other federal financial institution supervisory agencies, including the Federal Reserve Board, the Federal Deposit Insurance Corp., and the OTS, have followed the lead of the OCC on the subject of BOLI, essentially applying guidance from OCC Bulletin 2000-23 to BOLI investments by financial institutions subject to their respective jurisdictions. OCC Bulletin 2000-23 represents the current BOLI purchase standards applicable to banking institutions at the federal level, subject to several more restrictive nuances set forth in OTS Regulatory Bulletin 32-26 applicable to the 940 OTS-regulated federal and state thrifts.

Regulators expect banks to invest in BOLI with top tier investment grade insurance companies, maintain financial data on those insurance companies, and monitor the insurers' financial condition. The investment in cash surrender value of insurance must be reasonable in relation to the bank's capital accounts.

Bank management should be able to demonstrate that the decision to purchase BOLI was not reached solely by relying on outside consultants, but rather was arrived at after carefully examining the types of BOLI products available, conscientiously weighing the features of the BOLI, and examining any applicable laws.

With approximately 70 percent of the nation's FDIC-insured banks and thrifts being state-chartered entities, compliance with state bank regulatory standards can be just as important as a bank's efforts to satisfy federal bank regulatory BOLI supervisory purchase standards inherent in OCC Bulletin 2000-23 or the similar counterpart applicable to OTS-regulated thrifts.

Approximately one-third of the states provide more restrictive BOLI purchase standards than OCC Bulletin 2000-23, including restrictions on the creation of executive officer and director compensation plans, an important consideration for community banks where BOLI is often used as an informal financing mechanism for new director and officer nonqualified compensation and benefit obligations.

An essential element in all BOLI programs is that there be an underlying business purpose to the transaction. Given the heightened interest of the IRS and the plaintiffs' bar in COLI (the corporate version of BOLI for nonbanks) and insurable interest, the method by which an institution determines both the existence and extent of insurable interest in its employees should be thoroughly reviewed, documented, and capable of clear articulation by bank management.

State law requires that the purchaser of a life insurance contract have an insurable interest in the insured at the time the contract is issued. Historically, insurable interest related to a family's dependency on an individual and a business' risk of financial loss in the event of the death of a key employee. Judicial case law and state statutes determine under what circumstances a purchaser of insurance has an insurable interest and, if such an interest exists, to what extent insurance may be purchased on the life of the insured.

Two states' insurable interest law affords an insured employee the right to cancel a BOLI policy at the time the employee terminates job services. Failure to recognize quirks of state insurable interest law (such as the method prescribed to solicit employee participation in a BOLI program or limits upon the death benefit commensurate with the loss to the insured upon the insured employee's death) could seriously undermine the effectiveness of a BOLI financing, whether through exposing the bank to litigation risk from the insured's heirs claiming the policy death benefit or through unanticipated and adverse federal tax treatment applicable to premature surrender of a BOLI policy.

A pending Congressional bill aims to place new limitations on COLI, in response to popular outrage stirred by media coverage presenting a grossly distorted picture of COLI as "dead peasants' insurance" and as a corporate windfall.

The Bingaman Amendment passed by the Senate Finance Committee would have required companies that purchase life insurance policies on employees after Sept. 17, 2003, to pay taxes on the death benefits the companies collect from those policies if the insured employee has not worked for the company within the year preceding death.

Senator Bingaman's amendment, which would reverse long-standing federal tax and public policy regarding the tax-free treatment of death benefits paid from life insurance policies, was modified by the Senate Finance Committee on Oct. 1, 2003, to move back the effective date of the COLI proposal. The Sept. 17, 2003, effective date that was initially adopted had the effect of freezing a significant segment of the insurance marketplace and frustrating in-process business benefit planning.

The decision by the Senate Finance Committee to make any COLI legislation effective no earlier than the date of enactment presents a window of opportunity for banks to buy BOLI before any tax law changes become effective. Adverse insurable interest legislative initiatives are also brewing in several statehouses across the country. A bank should retain qualified advisors skilled in advising banks regarding BOLI regulatory compliance, IRS compliance, state insurable interest compliance, and well-conceived executive compensation planning.

*All views expressed in this article are the author's. Francis X. Grady, a former attorney for the Federal Deposit Insurance Corp., is the founder of Grady & Associates, a Cleveland law firm specializing in the representation of banks and thrifts, BOLI-financed executive compensation plans, and bank merger transactions.*

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