



BY FRANCIS X. GRADY
MANAGING PARTNER,
GRADY AND ASSOCIATES

Bank and Business Split-Dollar Plans

2008 GAAP Change Requiring Expense Recognition for Split Dollar Life Insurance Makes Year End Planning Critical for Banks

On October 9, AALU members Francis X. Grady and Jim Foyt, presented “Bank and Business Split-Dollar Plans: Maintain, Revise or Eliminate” as part of AALU’s Educational Webinar Series. In this article, Mr. Grady takes an extended look at the topics he discussed during that webinar. If you would like to purchase this or any previous AALU Educational Webinar, please use the form on page 38.

Recent Accounting Developments

Banks and other employers use split dollar life insurance arrangements to provide retirement and death benefits to employees. These arrangements are commonly structured as either “endorsement” split dollar arrangements or “collateral assignment” split dollar arrangements. In general, the difference between endorsement and collateral assignment split dollar life insurance arrangements is based on ownership and control of the life insurance policy. In an endorsement split dollar arrangement, the employer owns the insurance policy and controls all rights of ownership. Conversely, in a collateral assignment split dollar arrangement, the employee owns the policy and controls all rights of ownership. Although these two types of split dollar life insurance arrangements have existed for years, there was a significant diversity in accounting practices with respect to the deferred compensation and post-retirement benefit aspects of these arrangements. Consequently, on September 20, 2006, and March 28, 2007, the Financial Accounting Standards Board (“FASB”) ratified Emerging Issues Task Force (“EITF”) Issues No. 06-4 and No. 06-10, respectively, to eliminate the diversity in accounting practices associated with endorsement and collateral assignment split dollar arrangements. EITF No. 06-04 applies to endorsement split dollar arrangements, while EITF No. 06-10 applies to collateral assignment split dollar arrangements.

Under these two EITF consensuses, if the employer has effectively agreed to maintain a life insurance policy during the employee’s or director’s retirement, the cost of the insurance policy during post-retirement periods must be accrued in accordance with FASB Statement No. 106, *Employers’ Accounting for Postretirement Benefits Other Than Pensions* (“FAS 106”), or Accounting Principles Board Opinion No. 12, *Omnibus Opinion – 1967* (“APB 12”). Similarly, if the employer has effectively agreed to provide the employee with a death benefit, the employer should accrue, over the service period, a liability for the actuarial present value of the future death benefit as of the employee’s expected retirement date in accordance with either FAS 106 or APB 12. The liability for the post-retirement benefit obligation must be recognized in accordance with FAS 106 if “in substance” a postretirement benefit plan exists, or alternatively, with APB 12 if the arrangement is “in substance” an individual deferred compensation contract. To determine the substance of an arrangement, all available evidence should be considered, including the explicit written terms of the arrangement, communications made by the employer to the employee, the employer’s past practices in administering the same or similar arrangements, and whether the employer is the primary obligor for the postretirement benefit.

The effects of applying the relevant EITF consensus for the type of split dollar agreement entered into by the employer should be recognized through either (i) a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or (ii) a change in accounting principle through retrospective application to all prior periods. Employers must start accruing costs and liabilities for the postretirement benefits provided by endorsement and collateral assignment split dollar arrangements for fiscal years beginning after December 15,

2007. The AALU estimates that over 1,000 banks maintain postretirement split dollar life insurance benefits.


Bank Regulatory Considerations

The Interagency Statement on the Purchase and Risk Management of Life Insurance issued on December 7, 2004, by the federal bank regulators provides general guidance for banks regarding supervisory expectations for the purchase and risk management of bank-owned life insurance or "BOLI." The interagency BOLI guidance states that banks should have a comprehensive risk management process for purchasing and holding BOLI. Banks must also monitor BOLI risks on an ongoing basis by performing an annual review of their BOLI assets. As noted in the summer 2007 edition of the FDIC's Supervisory Insights, "the EITF's two recent consensuses are of sufficient significance as to warrant a review outside of the annual cycle." The review should enable bank management to (i) understand and evaluate the accounting consequences of the EITF consensuses, (ii) ascertain the impact of the EITF consensuses on equity capital on the effective date and on earnings thereafter, and (iii) determine the actions needed, if any, to remedy the effects of applying the EITF consensuses beginning in 2008. Banks should also consider whether eliminating or reducing the postretirement benefits provided under the split dollar arrangements is appropriate taking into consideration any relevant tax consequences from such modifications.

Most community banks are using a model prepared by a BOLI vendor to quantify expense recognition for postretirement split dollar life insurance benefits. Office of the Comptroller of the Currency Bulletin 2000-16 and similar guidance on the part of the other federal bank regulatory agencies requires banks to have effective model validation procedures. Validation procedures test the integrity of model inputs, outputs, and reporting. Consequently, bank management must understand the full array of assumptions implicit in any BOLI vendor model illustrating liability recognition for postretirement split dollar arrangements. A bank should understand how the model was designed, including the logic behind the model and the model's key elements and assumptions. A failure to validate or a lack of understanding of the BOLI vendor's model could be an unsafe or unsound practice that negatively impacts a bank's management rating in a safety and soundness examination.

Because federal bank regulators do not want to receive amended quarterly Call Reports, banks are not permitted to implement the change in accounting principle through retrospective application to prior periods. Consequently, a bank would recognize the effects of applying the EITF consensuses through the cumulative effect adjustment to retained earnings. The initial recognition of a liability for postretirement benefits would reduce both the bank's equity capital and regulatory capital. Subsequent expense would be recognized over the remainder of the employees' required service periods until the employees' full eligibility dates for the postretirement split dollar life insurance benefit.

Conclusion

The EITF consensuses create a change in accounting principles that requires employers to recognize a liability at the beginning of fiscal 2008 for any split dollar life insurance benefits provided to employees or directors that extend to postretirement periods. Accordingly, an employer's first step is to quantify the benefit liability. Because most community banks are using a BOLI vendor illustration of *pro forma* liability recognition for postretirement split dollar life insurance arrangements, quantifying the benefit liability necessarily includes understanding the fact that changing certain assumptions such as the discount rate, mortality age, what actually comprises the cost of insurance in the vendor liability recognition model, the accrual methods (unit credit or simple interest) and the vesting conditions (immediate eligibility, for example, versus cliff vesting entitlement at age 65) could significantly impact the size of the reduction to retained earnings as of January 1, 2008, and the magnitude of expense recognition in future periods. Second, the employer will need to determine whether to maintain, eliminate or revise the postretirement benefit. Decisionmaking in the remaining months of 2007 represents the last opportunity for banks to apply the EITF consensuses through the cumulative effect adjustment to retained earnings. In contrast, if calendar year banks or other employers wait until January, 2008 to establish new postretirement split dollar life insurance benefits, more expense will be recognized on future income statements. Because a one-time charge to retained earnings increases future net income dollar for dollar, many, if not most, banks will find it far superior to recognize the financial statement consequences of the EITF consensuses as a reduction to retained earnings (i.e., capital) and minimize expense recognition in subsequent periods. 

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ABOUT THE AUTHOR

Francis X. Grady is the managing partner of Grady & Associates, a Cleveland, Ohio-based boutique banking law firm that provides bank regulatory counsel to 250 banks and thrifts across the county. Mr. Grady combines both government and private practice experience, as an attorney with the Federal Deposit Insurance Corporation in Washington, D.C. and as an attorney in private practice in Washington, D.C. and Cleveland.

One of the nation's only banking law firms with an active BOLI compliance practice niche and a concentration in BOLI-financed executive compensation, Grady & Associates is familiar with federal and state BOLI bank regulatory issues and state insurable interest laws under the laws of nearly 40 states.

Mr. Grady can be reached at: fgrady@gradyassociates.com