Investing in BOLI & Establishing SERPs the "Right Way"

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When banks consider the purchase of bank-owned life insurance ("BOLI") linked to a BOLI-financed benefit decision, the bank makes two decisions: (1) investment in BOLI as an asset and (2) nonqualified deferred compensation established for senior executive officers and informally financed by BOLI.

Because the compensation decision often determines the amount of BOLI purchased, it is inconsistent with a bank's responsibilities under the Interagency BOLI Guidance for the bank to permit the insurance agent selling the BOLI to be the party that guides the bank's compensation decision making. A larger deferred compensation benefit can drive a larger BOLI purchase. To permit the BOLI insurance agent to be the advisor on the purchase of the BOLI linked to a compensation decision represents an abdication of the board's duties to oversee two separate decisions.

Concerns about bank due diligence and understanding of BOLI risks were the reasons why the banking agencies adopted the Interagency BOLI Guidance issued on December 7, 2004 establishing supervisory standards for banks to invest in BOLI. The Interagency BOLI Guidance provides that "Before an institution purchases insurance for the benefit of an officer, director, or employee, the institution should identify and quantify its compensation objective and ensure that the arrangement is consistent with that objective."

There are four steps in the process of implementing a salary continuation agreement, also known as a SERP: (1) deciding which executive officers should receive SERPs and the amount of the SERP benefit, (2) quantifying the cost of the proposed SERP benefits, (3) deciding if the bank will invest in BOLI to offset the nonqualified deferred compensation expense associated with SERPs, and (4) documenting a record of informed board decision making.

Identification of SERP Recipients and SERP Benefit Amounts

The process that ultimately concludes with implementation of a SERP begins with identification of the executives with whom the bank will possibly enter into a SERP. The size of a SERP retirement benefit is ordinarily determined through a shortfall analysis, an analysis that is routinely prepared as part of the process of putting salary continuation agreements and BOLI financing in place. It is directors' job to ask whether proposed SERP benefits are reasonable and how the benefit amounts were determined because SERP benefits generally entail significant projected benefit expense.

The usual goal – or target – in SERP design for community banks is to ensure that all executives have post-retirement income derived from employer-provided benefits that is approximately 60% of projected final base pay. The shortfall is the difference between the 60% income target and the estimate or projection of actual employer-funded retirement income. A SERP benefit is commonly established at the amount that precisely fills that shortfall.

Quantifying the Cost of SERP Benefits

When the shortfall analysis that yields the executives' desired retirement benefits is completed, the next step is to negotiate and prepare the SERP document. This drafting process has a number of variables of its own, including the question of whether vesting conditions should be imposed on early termination benefits, when should early termination or disability benefits actually become payable, and how the change-in-control benefit should be calculated. Some banks impose post-termination non-compete provisions as well. The way a SERP is drafted can affect the accounting expense for the SERP obligation.

Often banks with multiple SERP participants will vary the contract features and terms among the SERP participants. For example, the CEO might not be subject to vesting for the early retirement benefit but the chief lending officer could be subject to vesting for the entitlement to an early retirement benefit (the lesser deferred compensation retirement benefit if the executive does not stay until age 65). Also some but not all executives might receive an IRC § 280G gross up for parachute payment taxes arising at the time of change in control. Or some executives could receive single-trigger change-in-control benefits (benefits payable merely upon the occurrence of a change in control) while others receive double-trigger change-in-control benefits (benefits payable if a change in control occurs followed by involuntary employment termination or resignation for good reason).

Deciding Whether to Invest in BOLI as an Informal Financing Method to Offset Nonqualified Deferred Compensation Expense

A BOLI financing can be part of or separate from the SERP negotiation process. The BOLI-financing process operates on a schedule of its own which depends on the number of employees to be insured. A BOLI investment generally provides a tax-advantaged increase in bank earnings that offsets in whole or in part the nonqualified deferred compensation expense associated with SERP benefits. For that reason, BOLI financing and SERP preparation are often carried out together. Because a BOLI financing generally represents the largest single investment decision a community bank will make in a given year, bank management must be able to demonstrate that the decision to purchase BOLI was arrived at after carefully examining the types of BOLI products available, conscientiously weighing the features of the BOLI, and examining BOLI regulatory compliance, IRS compliance, and state insurable interest compliance.

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breach or security-related incident. Again, think of your service providers as if they were your own internal IT department, and write appropriate SLAs to demand the same level of security performance that you would expect internally.

Appropriate solutions can really vary when it comes to vendor management, and your procedures for initial vendor selection and oversight should be tailored to your institution's specific risk appetite. Schneider Downs has industry specific experience to advise financial institutions on their third-party risk management programs, and we are standing by to assist.

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Bank Regulatory Considerations and Board Record of Informed Decisionmaking

Although a SERP benefit would not be considered an incentive compensation arrangement for purposes of the Federal banking agencies' Guidance on Sound Incentive Compensation Policies [65 Federal Register 36395 (June 25, 2010)], any bank that is considering adoption of SERPs must be conscious of the Federal regulators' greatly increased focus on compensation arrangements.

A record of informed decision making is necessary to address bank regulatory expectations. A thorough written record of board approval benefits the SERP executive recipient because a comprehensive record of informed board decisionmaking makes it less likely that shareholders or bank regulators will challenge the legitimacy of the SERP benefit decision. A thorough written record of board approval is as important to the executive recipient as the quality and clarity of the SERP contract itself.

M&A Preparedness

As a bank reviews compensation arrangements including the establishment of SERPs, it is best that an adviser consider change-in-control and tax law issues incident to all compensation and benefit programs. Management and the board should consider strategies to lessen the impact of §280G (the parachute payment excise tax on so-called excess parachute payments) so that the executives have a manageable state of affairs insofar as exercise of the executives' fiduciary duties in a merger scenario and receipt of the executives' change-in-control benefits. Ensuring that senior management compensation issues are satisfactorily addressed in any merger and acquisition scenario requires foresight and planning long before an acquisition offer arrives. For banks interested in careful §280G M&A planning and avoidance of the loss of deductibility for payment of excess parachute payments, analysis that models total executive compensation in a change-in-control context (acceleration of unvested options, severance payments under an employment agreement and the change-in-control payment under a SERP) permits management to understand executive compensation packages by reviewing executives' §280G "base amount" and change-in-control benefits provided under both employment and SERP agreements. Executive compensation M&A preparedness planning involves consideration of the company's interest every bit as much as the executive's interests are considered.

Advisors skilled in BOLI bank regulatory compliance, IRS compliance, state insurable interest law compliance and most importantly well-conceived executive compensation planning are indispensable when implementing the comprehensive pre- and post-purchase BOLI risk assessment process.

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Just as Jack and his team were starting to enter a phase of managing a stable function, the rapid changes in the industry standards (and regulatory expectations) were causing their partner servicing areas to be in a state of constant change. Frequent changes in servicing operations, ongoing processing delays, lost loan modification opportunities, dissatisfied customers – it was a perfect storm. Jack's management team worked hard to keep pace with changes and volumes. Jack requisitioned for more employees, but couldn't get the capex approvals. Not only did workload increase on Jack's team to unmanageable levels, their relationships with the partner servicing departments became very tenuous. Quality of customer service deteriorated. Employee morale suffered and attrition accelerated. In an attempt to improve responsiveness to customers, his team started loading more cases per CS staff and tightening the QA process, which further exacerbated the problem. Being the face of the bank for customer interactions, Jack and his team caught a lot of flak (and stress) for the worsening customer experience. The quality of people in Jack's department became a common target of ridicule across all business areas.

Rarely is a problem isolated to a single factor of an employee issue or a process flow. When we were engaged to help, we took a comprehensive approach. Talent was certainly an issue, but the overall context was key. We needed to help Jack find that balance between effectiveness and efficiency. We worked with his management team to conduct time-motion studies to analyze activities for each role. Building upon that activity analysis, we created a Utilization model that helped them monitor / assign case load within the defined thresholds of efficiency and effectiveness. This also helped create a business case for additional staffing, which Jack was then able to get approved. Armed with activity analysis, we worked on better defining roles and responsibilities (and accountability) and creating a more appropriate performance management framework. This enabled the staff to understand better what they will be measured on. We also designed ways of redeploying staff to more suitable roles and contain attrition. We refined the sources of incoming talent and the attributes important to look for during the interview process. A more structured (and measured) training program during onboarding and for ongoing improvement improved the staff's chances of being successful. Finally, we set in place methodical communication practices that improved morale within the CS function as well as relationships with other partner areas.

The bank, their CS function and Jack are enjoying sustainable success today because they agreed to the comprehensive approach instead of quick band-aids.

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Under his leadership, FNB has increased earnings five consecutive years, has increased dividends to our shareholders, and is 5 Star Bauer Rated.

Our other officers and staff are individuals who volunteer their time in numerous avenues in our community including church groups, food pantry service, coaching youth sports, the county fair and various boards including library, school, county, and the local Chamber of Commerce.