BOLI & EXECUTIVE BENEFITS —

Two Peas in a Pod

Scott Richardson, President and Founder, IZALE Financial Group

Could the spike in deposits have come at a worse time? Loan yields are down, loan demand has not kept pace with deposit growth, and returns on permissible investments are near historical lows. Yet the cost of retaining and rewarding all employees continues to grow. It puts incredible pressure on earnings. What's a bank to do?

Since the early 1980s, bank-owned life insurance or BOLI has been the go-to strategy for banks to offset the cost of executive and employee benefits. At the end of 2020, more than 3,200 banks reported owning $184.3 billion — more than 10% of bank capital — in cash surrender value. In Illinois, 234 banks owned $6.9 billion. Over $3 billion was purchased in the 4th quarter of 2020 alone. What makes BOLI work so well?

BOLI is an institutional life insurance policy insuring bank officers (and sometimes directors). Unlike the typical life insurance policy we buy as individuals, BOLI is engineered to provide the least amount of death benefit gain and maximum amount of growth in cash surrender value (CSV). The growth in CSV is recorded monthly as "other non-interest income," and is accrued without any provision for taxes. When held to "maturity" — in other words, the death of the insured — BOLI offers tax-equivalent yields nearing 4%. With increasing chatter from Washington, D.C., about raising the federal corporate tax rate, the equivalent yield will be even higher, if that happens.

While BOLI can be surrendered to the insurer at any time for its cash surrender value, doing so triggers recognition of the previously accrued earnings as ordinary income. In most cases, there is also a 10% Modified Endowment Contract or MEC excise tax on the gain over the initial purchase. BOLI works best if the bank holds the policy until maturity, when all proceeds should be income-tax-free. This makes BOLI a long-term, illiquid asset.

Despite the long-term holding period, the crediting rate on BOLI can adjust at least annually. The crediting rate history shows BOLI moves in the general direction of broader interest rates, albeit more slowly and with a lag. Unlike directly-held fixed-income investments, however, general account BOLI has no market-to-market risk — something to consider as interest rates begin to rise. If the current fixed-rate BOLI is not appealing enough, you should consider whether "indexed BOLI" is right for you. With Indexed BOLI, the crediting rate is not merely declared by the insurer — it measures the change to an external index like the S&P 500™, but with a minimum and a maximum crediting rate. It is critical to note that the CSV is

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never exposed to the S&P500™ — CSV is still always backed by the insurer.

Recent changes to the tax code make BOLI more attractive. Buried in the 5,000-page appropriations bill that was signed by former President Trump in late December 2020 was a small but significant change to IRC Sections 7702 and 7702A. These code sections define life insurance and MECs, basically as a ratio of the death benefit to cash surrender value.

It will take a few months for insurers to revise their product portfolios to capture this change, however, BOLI carriers have already acted. Simply put, for policies issued after January 1, 2021, the death benefit required for a given BOLI purchase is 35%–55% lower than under the old code language. This means lower cost of insurance charges to drag down the yield on CSV, as well as the ability to structure a purchase with significantly lower reputation risk.

While nearly all BOLI has been a single-premium policy, these code changes could result in more competitive annual pay products becoming available to banks. This could eliminate the MEC excise penalty and provide for more liquidity.

Regulators have long-required banks to follow interagency guidance on purchasing and monitoring BOLI. This includes a thorough pre-purchase analysis as well as an annual risk assessment. It includes vendor due diligence, which is why it's important to partner with a provider that can provide technical and compliance support, such as IZALE Financial Group. The Community BancService Corporation, Inc. (CBSC), the business services subsidiary of CBAI, recently entered a strategic partnership with IZALE Financial Group, a premier provider of executive and director benefits plans, as its exclusive Preferred Partner for bank-owned life insurance (BOLI) and executive and director non-qualified benefit plans.

The interagency guidance also requires a bank to quantify the ability to buy BOLI by measuring the cost of employee benefits. This is where some confusion comes into play. Often BOLI is co-presented with an executive or director benefit and it is mistakenly viewed as one and the same. Offering a benefit and buying BOLI are two distinct decisions that can certainly work together but are nonetheless distinct. Even if your bank does not purchase BOLI, it may still be prudent to offer supplemental benefits to key people.

One of the first steps to evaluating whether supplemental executive benefits are appropriate is to do a Retirement Income Analysis or RIA. The RIA takes a snapshot of current benefits, (401(k), profit sharing, pension, social security, etc.) projects them to retirement age and calculates the percentage of final income that could be replaced by current benefits. The projected replacement ratio can then be compared to a targeted replacement ratio, thereby offering a rational and defensible starting point for quantifying a benefit amount.

Once your bank has targeted a benefit amount, it should then compare the three common approaches to delivering a benefit:

(i) Supplemental executive retirement plan or SERP — This is a mere promise by the bank to pay a benefit at a future date. Accounting rules require the bank to incur current annual expenses that build a liability for the expected benefit on the balance sheet. No specific asset is required; the bank will generally make payments from cash on hand. The bank receives a tax deduction when benefits are paid, and the executive recognizes the benefit as ordinary income when received. Early vesting provides an opportunity to recognize the benefit for FICA purposes, perhaps eliminating the self-employment tax exposure in retirement.

(ii) Restricted executive bonus agreement or REBA— This uses a life insurance policy owned by the executive (this is not BOLI!). Premiums are designed to accrue enough cash value on a tax-deferred basis so that at the designated date or age the executive can structure income-tax-free distributions to supplement income. The premiums are current tax-deductible expenses to the bank and reported as current ordinary income by the executive, and there is generally no accrual for any post-retirement obligation. Compared to a SERP, a REBA can offer savings to the bank of 20%–30% while providing the executive with greater benefit security.

(iii) Split-dollar loan arrangement or SDL — Like the REBA, SDL uses a life insurance policy owned by the executive. Instead of treating the premiums as a current expense to the bank and income to the executive, they are expected to be repaid in full by the policy cash

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"We believe now is an excellent time for bankers to consider adding more BOLI to their balance sheet," said Doug Parrott, CBSC vice chairman and president and CEO of State Bank of Toulon. "The favorable tax-equivalent yields available through BOLI can be used to offset the ever-increasing employee benefit costs." He cautioned, "Banks that fail to properly implement and monitor a BOLI policy face serious risks of regulatory scrutiny and incurring a tax liability that can impair bank earnings and capital and disappoint retiring bank executives."

value or death benefits and are therefore treated for income tax purposes as a loan. Federal Reserve guidance permits this without Reg O treatment, provided certain conditions exist. (Note: because of the Sarbanes-Oxley Act, SDL is generally unavailable to SEC-filers.)

Each benefit type offers its own advantages. For example, REBA and SDL may not be viable if there are underwriting concerns for the executive. The SERP provides the bank with greater control as the tradeoff to absorbing the largest expense of the three. After careful consideration and modeling, the bank should choose the one or ones — yes, you can do different things for different executives — that best match the bank's objectives.

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CBSC President Mike Kelley said, "Our due-diligence confirmed that during the past several years, many bankers had engaged IZALE to conduct BOLI and benefit plan reviews. Those reviews revealed design and administration flaws that had been overlooked." He concluded, "IZALE proved to CBSC leadership during our own plan review that they are among the best executive benefit and BOLI plan advisors in the country."

BOLI is a compelling tool that a bank can use to improve earnings. Whether you already own BOLI or it has been a while since you have considered it, market forces present strong reasons for a fresh look. Supplemental benefit plans for key people are also tools that help you attract, retain, and reward the key people driving shareholder value. Even if you have had a SERP for years, it should be reviewed, and other structures considered that might be more powerful for both the bank and the executive/director. ■

IZALE Founder and CEO Scott Richardson helped develop the interagency guidance for BOLI, and the IZALE team has designed and implemented over 1,100 benefit plans. Drawing on his service as a director of an Illinois community bank, Richardson stresses the importance of a consultative approach that provides rational and defensible analyses that lead to customary and reasonable solutions.

To receive a complimentary Retirement Income Analysis, to get a second opinion on your BOLI or to see how additional BOLI can help your bank, or to learn more about the different ways to structure executive benefits, contact IZALE Financial Group today.

IZALE is the BOLI and Executive Benefits Preferred Service Provider of Community BancService Corporation (CBSC), a for-profit subsidiary of CBAI. Inquiries about IZALE and its services should be directed to Phil Aderton at phil@izalefg.com, 630/561-9071.