



Improving BOLI Yield

transcript

Scott Richardson at IZALE hosts.

Good morning

Welcome to our webinar today on improving BOLI yields. This was sent out to CBAI members, so we appreciate the opportunity to have a quick conversation with you today.

Today's roadmap, we're going to talk a little bit about what drives BOLI yield. Just so you understand the different elements that make that up. Give a quick overview of where the current BOLI offerings are. I think that helps put context of existing portfolios and some of the conversations that are occurring. Talk about in-force BOLI and what you can do from surrendering it to easy adjustments to any exchanges and ultimately potentially repurchasing if that's your path.

I saw this data earlier this week when I was at a board meeting and it just kind of took me by surprise. So as of September 30th, the industry collectively reported over \$60 billion of mark to market losses in the quarter. That was actually the largest quarterly change in three years. The middle and long term rate run up in late August into September, I think is what drove most of that. But the losses are up almost 25% from quarter two. So clearly this is putting some pressure on balance sheets, driving a lot of conversation about existing BOLI portfolios, but not a single penny of that \$68.4 billion came from BOLI.

So just a stark contrast.

It's frustrating, no doubt, when BOLI crediting rates are lagging, when you can see you can get cash at the Fed, for example, more than a lot of existing BOLI programs. That's frustrating, but that's how BOLI works. And we'll have a reminder of that in a second. Rates are not designed to go up as quickly as the Fed moves, nor did they go to zero when the Fed went to zero.

So what does drive BOLI yields? There are four primary elements. The biggest one, of course, is the crediting rate. Carriers, you give your money to the insurance company with the expectation that they invest it with their other assets and get a better return. Or a different type of return. Better and different. They have a broader basket of assets on their general accounts than you can just legally purchase on your own. So most of what an insurance company, in the general account arena anyway, most of what they invest in is fixed income assets like you might be familiar with. But they also have preferred equity. They have private equity. They do so very little common equity because it's not in their risk profile either, but they just do things differently.

They also are very good at investing longer because their liabilities go longer. They have some liabilities that might go 20, 30 years. So insurance companies very routinely buy fifteen, twenty-year maturity assets, and that's better for them in the sense that they don't have GAAP accounting as much as statutory accounting, which doesn't force them to do mark to market issues every quarter. Obviously, if they have to sell those assets for surrenders and claims and those things, that real mark to market issues impact them, but not on an ongoing basis.

So that's why you get the insulation from the mark to market risk when you buy their products is, they don't have that issue. Short term swings in interest rates like we've seen don't have much of an impact on in-force policies, which we'll talk about in a second, but it does on new purchases because carriers respond and put out, you know, new money rates that are more responsive to where we are in the current environment. Second thing that impacts the yield is what I call age and gender.

So generally speaking, a 45 year old insured executive is going to have a lower cost of insurance for that dollar amount than somebody who's 55 or 65. Females are less than males. You also have underwriting that comes into play, such as do you use tobacco or not use tobacco?

What kind of underwriting did you use to implement the program? Is it regular issue? In our industry we use the initials RI, but that's full underwriting. So if you've ever been underwritten for life insurance, it's the same drill exam fluids, lab records all those things versus guaranteed issue.

Guaranteed issue is a very short, Guaranteed issue is a very short, almost two questions from the insurance company beyond tobacco use. And so there's not a lot of deep inspection, if you will, and the carriers And so there's not a lot of deep inspection, if you will, and the carriers price for that accordingly.

All else being equal, your guaranteed issue yields will be slightly less than the regular issue yields. Over time, those tend to average out. But there is a point in time where one looks better than the other. So understanding what you have and where you got it is a big part of that. And lastly, this thing called the net amount at risk or NAR.

And that's just simply the difference between the cash surrender value or I should say, the death benefit and the cash surrender value. So that's the gain, the one time gain that's available should a bad day occur. The NAR, the net amount at risk is generally at its highest in the first policy year, maybe the first two policy years. And then as cash surrender value grows, the total death benefit grows as well, but not as fast.

And that net amount of risk actually declines and eventually will be zero. All you'll have is cash surrender value. After The maturity date At age 95 for a few carriers age 100 and whatnot, but generally speaking, they tend to get more efficient over time. And there was a fairly significant change to this Internal Revenue Code section called 7702.

That's the section that defines life insurance. The last big change was in the mid 1980s and there was one a couple of years ago. And for new policies, anything issued after 2021 that the ratio, the amount of top line death benefit that you have to have relative to the premiums dropped anywhere from 40 to 50%.

That made these policies, new policies, that much more efficient from a cash surrender value growth. So sometimes comparing new to old. Yes, there's higher crediting rates available on new, but it's also a more efficient policy.

So you got to be careful about where we are in new purchases. Carriers generally look at one of two methods to set their interest rates and sort of reset them. There's what we call new money, and that's where

the carrier bases their current crediting rate on assets they can basically acquire today. Portfolio is a little bit longer look back period. It's the crediting rate is based upon assets they might have acquired five or ten years ago and it's the average of the portfolio.

Well, as you can imagine, in a declining rate environment that we saw over the last several years, especially into the pandemic. Portfolio looked much better. Rates went to zero. Carriers had a higher performing assets that propped up that rate. In a rising rate environment. New money always looks better.

But the key is, is over time, after five, six years of being in force, even new money tends to become portfolio as those assets mature and get reinvested. So there's a point in time that one will always look better than the other, but over time they're generally going to perform similarly.

Again, we talked about this in the last slide, this IRC 7702 change. The real driver here is, again, the lower net amount at risk that has to be there to still qualify as life insurance means that it is at a lower cost of insurance that takes away from the crediting rate and yield gets better.

So what we're seeing today is carriers, not all carriers, but a handful of carriers are offering net yields after mortality costs anywhere from 4.5% to almost 6%. Obviously, the higher numbers, depending upon larger purchase sizes and whatnot, underwriting impacts that in those things.

But that's considerably better than where we were even 18 months ago.

So if you have enforce BOLI, the question was how do I go from here to there? Because that new stuff looks awfully shiny. Well, as a reminder, BOLI was never designed to respond to 300, let alone a 500 basis point increase by the Fed in such a short time frame. It didn't go to zero when the Fed went to zero. It's not going to go to five and a half. When the Fed goes up five and a half, it's a slower moving ship.

And again, even new money carriers get there. The portfolio carriers that were so attractive two and three years ago and even earlier than that, they are starting to increase rates. But that portfolio has to turn over and every carrier is slightly different, but it's estimated that it's about 15% of that a year. So you know, if you think about that it takes five or six years to turn over that full portfolio and capture the new money rate.

And we are seeing increases. We saw a few carriers do 10 to 15 basis point increases last year, more carriers increased anywhere from 15 to 45 basis points this year. And those were some of the same carriers to increase last year. So cumulatively we've seen 25 to 50, 60 basis points for some carriers. And the expectation is that those increases will continue for the next two or three years, assuming we stay at the current rate environment on the longer end of the curve, not on the short end where the Fed is, but on that 5 to 10 year duration. So 15 to 30, 15 to 35 basis point increases each of the next two or three years is not unrealistic to assume.

So I heard this the other day and it stuck with me. Hopefully it doesn't strike the wrong chord, but if you want the rainbow you put up with the rain. And the rain is sometimes you've got to be a little bit more patient on this.

Fully acknowledging, though, the rapid rise in rates has caused some other issues with bond portfolios being so far underwater Deposits, while I think there's a lot more confidence in what you have, there's still the stress on that. And it just begs the question, well, what else can you do, especially if you've got inforce BOLI?

Well, the scorched earth approach is first just surrender it. You have an ongoing put to sell your BOLI back to the insurance company for book value. So not a single dime of a surrender charge is hidden or anything

like that. The carrier will give you cash surrender value. The difference is that will trigger the recognition of all the gain you've recorded over the years, all the prior earnings. So if you've had BOLI for ten or 15 years, you recorded those earnings over ten or 15 years with no provision for tax expense because the intent was hold it to maturity when it's income tax free.

Well, surrendering is going to trigger all that recognition this year. It is reported and should be recognized as ordinary income. And the gain amount is also subject to a 10% excise tax if you have a modified endowment contract, which about 99% of BOLI that's out there is a modified endowment contract.

Now strategically, you might look at your bond portfolio and say, Man, could I harvest, purposely sell and make a paper loss into a real loss for tax purposes? Sure, you can offset BOLI gains against the losses. You can never offset the excise tax on that issue. That's always going to be there. The challenge is for accounting purposes, even though when you file your income taxes, you may be able to offset the gain, You still have to record the expense on the P&L basis, which can have some impact on financials.

So just if you're going to go down the road to say, hey, I want to surrender it, I really understand that. And really the big consideration is if you're going to surrender or interested in surrendering is do you want to keep anything that you have or potentially acquire more in the short term or even than the intermediate term?

That's a real big issue because if you retain some, the question is: will your auditor require you to start accruing a deferred tax expense for the next potential surrender? You just showed that you have the ability to surrender early. So the intent to hold to maturity not be argument, may not be as strong. So it's really important that you check with your auditor on that. That's not a BOLI carrier or BOLI vendor decision to make. It's between you and your auditor.

Short of surrender, there are some things you can do to try to improve your very first steps, and these are ministerial steps. I would say for the most part, don't require you to change carriers or anything like that.

The first one is can you lower that net amount at risk? These policies when they're first issued have that optimal relationship, the minimum relationship between the death benefit and the cash surrender value. But in this low rate environment that we had been in, oftentimes policies sort of lost that optimum ratio and you actually have more death benefit than you need to still qualify as life insurance.

So we can spot this with a two second look at carrier illustrations. It's something that we do for all of our clients every year. And it's just a simple request to the carrier to say, Hey, show me a reduced face analysis or illustration, and then we can compare the before and after. You generally will pick up current yield a few basis points initially that gets a little bit more each year as a trade off to forgoing some gain. So as you can imagine, six months from now, if that person has their bad day, everyone can look in the mirror, say,

Wow, I wish I wouldn't have done that. We would have gained more. Rarely is BOLI purchased for the gain expectation. It's about maximizing yield and cash surrender value. So having that conversation generally has been positive for folks to just again pick up some yield. And the reduction in the death benefit hasn't been significant. It's sometimes been \$5,000 to \$10,000 to \$15000. It's amazing how fine tune these policies can be in other areas.

Check your risk class. Has it changed or gotten better? So if you if the risk class of the insured has improved and we can go to the insurance company and say, hey, we'd like this reconsidered. So this obviously requires the insured to participate. So somebody who is retired or left employment of the bank, not much motivation. Sometimes it was adversarial, so there's never a motivation to help you to do that. But

it can be things like, again, if they were tobacco use and they're no longer, certifying that they're no tobacco use and perhaps doing a mouth swab for nicotine, sometimes it's a urinalysis for nicotine checks.

Fully underwritten cases. If you had some of those, perhaps somebody had a health issue that has been stable enough or just has gotten better. So that's a process to look at too. Third one is does the carrier have an internal exchange program? You know, carriers offer and create new generations of products from time to time. And occasionally they'll say, hey, we want to encourage you or not stop you from moving from the old to the new.

And so what can be done? There's a question of whether the insured that you have is active versus inactive, which I'll comment on that whole issue in the second slide here. But some carriers when they have an internal, aren't interested in moving the inactives for insurable interest issues.

And it's really challenging today for the carriers to do it, for some carriers to do it, in that even though it's all within the same family, they may have a bucket of assets, of portfolio assets that's supporting the old product and a brand new bucket of assets that supports the new. And so they would physically have to sell those assets, repurchase them in the new product.

Well, they're no different than you when they physically have to sell assets, are they underwater or not? So some of those portfolios may be stressed in that surrender situation. A sell scenario. So they're not really inclined to do a lot of internals. So again, it's worth asking the question, is there an internal exchange program? But it's a little bit more challenging today than it was a few years ago.

The next option is, well, what about a 1035 exchange? Banks are familiar with 1031 exchanges more frequently because of properties in the lending world. with life insurance and annuities. So you get a tax free exchange from carrier A to carrier B. As we start to think about this, understand that all the BOLI that's been issued in at least the last 20 years, no exceptions to this, they have had no charges for cash surrenders, but they all have contingent charges for 1035 exchanges. And the thought process from the insurance company is, is if you want to get out of the game, we'll give you all your coins back.

If you want to move to another one, they're going to get their, at least recover some of their, startup expenses that they wouldn't get on otherwise. Those 1035 periods range anywhere from 9 to 19 years. So where are you in that schedule? And even if you have a one or two or a few years left, is the charge that the carrier would impose, can you recapture that at a new carrier with a higher yield? What's the crossover or break-even point, if you will?

Second consideration is not all carriers are willing to accept an exchange from another carrier. Sometimes the carriers will look at where it might be coming from. And if that carrier A, for example, that you want to leave is still in the BOLI business, they're still they've been showing that they're increasing rates, maybe not as fast as you'd like or what new money is, but if they're committed in that sense and there's a subjectivity to that, I get that. But they may look at those carriers and say, We're not interested in disrupting that.

There are other carriers who have demonstrated that they're not so committed to the product that they're willing to accept, though. So understanding, you know, what carrier you have to be willing to accept, it is another part of it.

A lot of conversation about this, the idea of active versus inactive insurers. So there are two prongs to this conversation. So clearly when somebody is actively working for you or serving as a director even, there's a current and ongoing insurable interest and you can do an exchange without concern.

But what about the folks who left service, retired or otherwise, one, five, ten years ago? For federal income tax law The internal Revenue Code section that's applicable is called 101(j) and within 101(j). It requires employers who want to buy a policy on someone to give them proper notice and to get consent in order to get all the best tax benefits from this. Well, there is an exception in 101(j) that says if you have a 1035 exchange that you don't have to get notice and consent

And there's a little bit of a gray area around that. So earlier this year, Treasury introduced a proposed regulation that would clarify. I don't think it changes, but it does clarify it. And so there's a lot of chatter about, hey, we can do more exchanges on inactive people. That presents some concerns for the insurance company who might be taking that business. For example, they don't want because you can't go to those people and consent. You know someone who's gone from you, you're not going to maybe not even know where they're at. So there's some risk that they're taking when they take this inactives. So they're going to put some restrictions on how many people of an inactive group they can exchange, what the age is. Maybe it's only 70 and under. For example, they may require you to, you know, add some new premium as part of it. So there's an art and a science to it. But even if you can get comfortable with the insurance company and the federal income tax treatment, you still have to comply with state insurable interest law. And not all states are like in Illinois which has got one of the more progressive or favorable statutes here. But Illinois insurable interest statute says that employers have an interest in former employees and retirees, but it's a negative consent requirement under state statute. You have to tell them, we're going to do this and only if they object to you. Stop. So I don't know how applicable and helpful that's going to be here in the state of Illinois.

Other states don't have that negative consent thing. So inactives there's a lot of rocks we have to navigate around before we can think about that.

Next question that you think about. And when you do the exchanges, well, what kind of underwriting do you have to do? Even if you did guaranteed issue on the original placement and now you want to go to a new carrier, Well, do you have enough people to exchange to qualify for the new carrier's guaranteed issue program, or do you have to default to regular issue?

Those considerations come into play and again, it might be a combination of grabbing five or six former People, policies on former employees, to exchange adding new premium with four or five new people to meet the new carrier's guaranteed issue requirements.

So understanding what you have to deal with in the new one. This goes back to the Internal Revenue Code 7702. change the new product will have a lower death benefit than the current one when you do an exchange. I've not seen anything any illustrations that that that looked the same. It's always lower which means you're going to have less total return. Now total talking about by life expectancy, you're at the mortality event which could be decades down the road, but it could be two years down the road.

So there's an unknown element to that. Just understand that you're giving up something, a future Just understand that you're giving up something, a future gain to get more current yield on the balance sheet. We ran this for another client and it was only 13 people and there was a \$4.5 million reduction in the net amount at risk in those 13 people.

And the break even point on the illustration was 16 years. So they got higher yield on current on a current basis. But the total return break even was 16 years. That may or or may not be what you're looking for. So just make sure you do the proper analysis. And what about any existing benefits?

Oftentimes, people have a supplemental life insurance benefit for the insured person while you have that policy. Well, if you go to a new product that's got a substantially lower death benefit is going to impact your ability to provide that? Obviously, any time you do an exchange, it's just like a new purchase. So you restart the standard policy terms for contestability and suicide and fraud and all those things and you're going to have new 1035 restrictions. So again, that that that 9 to 19 year cycle is going to start anew.

Now it's 9 to 15 is what I see new products have. You're going to have lower guarantees. The old products might have had a 3%, 3.5% minimum crediting rate guarantee. The new one is 1% to 1.5%. There's one carrier who's still at 2%, but much, much lower guaranteed minimum crediting rate. So be careful what you give up. And you might even have some surrender restrictions. We've seen some crawl out provisions, meaning that instead of surrendering the new policies for 100% at one time, you might have to crawl out every six months, which means you get a five year period.

You should continue to earn, you continue to have life insurance, but you can't liquidate it as quickly. So be careful on the surrender, crawl out restrictions.

Last question. This comes up and we've seen a couple of public filings on this. So maybe you've seen this, maybe not. But is okay, we've cleaned up our BOLI portfolio, surrendered everything, but now we want to repurchase pretty quickly. What does that look like?

Well, one, understand that some carriers may not be interested in being your partner anymore if you recently surrendered BOLI. Surrenders can harm carriers, especially in the current environment. And so their thought process is you did it once, you're going to do it again. And I don't want to be on the other side of that. So there two or three carriers that are willing to accept new business when there's been a recent surrender, maybe even in purposeful step one, step two, if you will, but expect that different terms. You're going to have perhaps a different fee structure, a rate structure, you might have crawl out provisions. They're trying to protect themselves. Just understand if that works. I said this earlier, but the same thing is ask your auditor, are they going to ask you to accrue a DTL for the next potential surrender? You just demonstrated that you might not hold BOLI to maturity whether it will be income tax free so are they going to force you to start accruing something?

I've seen a few auditing firms who have been careful what they're comfortable not accruing, but I know of one or two I've heard of. I guess I haven't personally run into them, but I've heard of one or two who are not installed deals.

So if the idea of repurchasing some BOLI after you surrender, whether it's all or any all or none, I guess all are one really. Start here. Talk to your auditors first. Get comfortable where they're going to have you start tax treatment before you get down that path. And we've even seen some carriers in conjunction with the surrender when you might have that tax expense, Rear its head for the P&L basis, they were are willing to offer a day one bonus month one is a better way to say it. To offset the P&L impact so you might get a bonus of that's put into the structure to offset the large P&L. So it a very attractive first year yield in BOLI.

But it's all about accounting offset and that bonus is not an unrestricted right. There are some, you know, potential clawbacks to that bonus. So again, you're going to want to make sure your auditors would be comfortable with the way the language is written, so they allow you to record it as income or otherwise it's

not even worth chasing it down. And if you're going to get those bonuses, the carriers are going to recover those over time.

Your yield maybe in years two, three and four might be a little lower than it otherwise would be. So they're effectively front loading the policy on that. So creative approaches really depend upon how your auditors play into that thing. Because back to that theme again and again.

And obviously notice and consents still apply. That's the nice thing about a surrender or I guess a surrender/repurchase you know that everyone you repurchase on is actively you know committed to the organization is actively in service anyway. But you still have to give notice, you still have to get their consent for everything going forward.

And the last section here is just a reminder of the product types that you can consider for for new or repurchases, if you will. We have general accounts, most of what's out there in the community bank space. Basically, you buy the balance sheet of the insurance company, right. MassMutual, you know, Midland National, Protective, whatever the carrier is, you're buying their big broad balance sheet that's been built up over decades and you get a little sliver of it. It's stabler

So the crediting rate, again, doesn't move very much from year to year. So it's more predictable. It's easier for budgeting. You don't have control over the assets, right? The carrier's making the assets decision. So you kind of get a feel for how they do it. You can look into their history and see where they generated return in. Because you don't control the assets. It's 100% risk weighted. Always has been. There's hybrid separate account, a handful of carriers do this and frankly, it's not as attractive as it was maybe ten or 15 years ago. These are where the assets are managed by the carrier might be the same assets they buy in their balance sheet, their general account balance sheet, but it's segregated. There's a separate account that's segregated from their regular balance sheet.

The intent is to give you some insulation from a credit exposure. But again, the carriers still managing it. They're still providing life insurance. So it's not as much insulation as you might think, but you can allocate to different accounts. There's maybe an account that's only focused on treasuries and agencies, an account that's only on corporates, etc. So that will drive the your investment return. But the regulators have said because the insurance company's acting as the backstop for everything, it's still risk weighted 100% like general account. So that's why it's less attractive.

There was a time we got look through risk weighting treatment that was appealing. They took that away. And lastly, separate account. Separate account is think of your 401k plan. You've got a menu of things you can allocate to. Same concept here. You're going to have a few accounts that you can allocate to, but they're still bank eligible, right? If you can't buy it directly on your balance sheet, you really can't buy it within the insurance wrapper.

So again, 1 to 3, 1 to 4 different accounts managed not by the insurance company often, but sometimes by a well-known external manager who is really good at fixed income investing. So you have a little bit more control over the profile and the manager but still don't get to choose the assets. That would violate some other tax issues. The key here is the risk weighting can be as low as 20%, right? If you go into a treasuries and agencies, while that would be 0% risk weighted if you bought them directly, regulators have said it can be as low as 20% only within a BOLI concept because again, there's some insurance carrier involvement here.

So if risk-based capital is a concern, this is a way to dial it down a little bit. Current separate account yields are pretty attractive. We're seeing 5.5% to 6%, even close to 7%, in some of these assets. But I'll tell you, they were not attractive at all for about ten years. So it's much, you know, those assets are much more responsive to what happens in the interest rate environment.

So it's more - I hate the word volatile – variable, so the yields can change much more frequently than general account. Monthly for some of them and quarterly for others. You're protected from the mark to market swings of the underlying assets that back them up. When you do what's called a stable value wrapper, you basically pay a third party to get an accounting treatment on that. So these are not for the faint of heart. These are private placement transactions. The documents run from 80 to 100 pages.

And so it's really important to understand the limits of the stable value wrapper that would be involved or the crawl out restrictions for many of the investment options you choose. And there are minimum purchase requirements. So one carrier's \$20 million, others are \$10 million. So it's generally not really suitable for most community banks because of the size of and the complexity. But understand it's an option. And where we are sitting here in November of 2023, the yield is attractive, but it may not be in a year or two years from now as attractive compared to other.

So eyes wide open.

So as we wrap up here, I wanted to say current optics notwithstanding, I think BOLI remains a very attractive asset on your balance sheet. You know, we got conservative, relatively predictable returns that are tax advantaged. Obviously with separate account you can get more favorable treatment and maybe a little bit higher current yield all of that without any mark to market risk and even the separate account, it's not the zero mark to market risk, but it's managed to that wrapper. It's a shock absorber.

There are limits to the stable value wrappers for separate account. If market values fall outside the tolerance, you'll write down your asset or go into money market like yield. So be careful of that. And that is still life insurance. And while that may not be the primary motivation here, the life insurance element does play a very important role to either help you support the families of your key people who might have their bad days or protect the bank's profitability through key personal relationships.

So, it can do both of those things but there aren't really any of their assets that does all of that in one thing. We welcome the opportunity to help you sort of guide through those discussions. If you are considering more or want to look at your existing portfolio, really going to have your auditors involved early on.

I want to thank you for participating. Be safe this weekend and I wish you all

a very happy Thanksgiving.

Take care.