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Should Banks' Investment Menus Continue to Feature BOLIs in Light of the 2023 Crisis? (Part III)

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This article is the third in a series that will provide the ingredients readers need to gather to reveal whether bank-owned life insurance (BOLI) is right for their bank. Over the series of articles, the authors will review this topic by examining, among other things, the "what," "where," "who," "how," and "why" of BOLI.

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The first article in the series presented an overview of key BOLI features, along with an exploration of the specific pros and cons associated with various BOLI product designs. The second article addressed regulatory issues and explained the processes banks undertake to implement a BOLI strategy. Together, the first two articles in this series make the case that BOLI can be an attractive investment opportunity if it suits the risk appetite of the bank and otherwise fits the investment policies and strategies of the bank.

In this third article, we begin to explore some of the actuarial issues associated with BOLI products. Specifically, this article explores how determination of a bank's risk appetite for BOLI warrants consideration of actuarial issues related to asset-liability management and in-force policy management.

ACTUARIAL SUITABILITY ANALYSIS: IS BOLI FOR YOU?

Banks routinely use BOLI to fund certain nonqualified deferred compensation plans (NDCPs). However, from an actuarial perspective, there is no "one flavor fits all" solution.

Not All Employee Benefit Plans Are Plain Vanilla

From an actuarial perspective, different types of employee benefit plans have markedly different risk profiles. Consider the following two extreme examples:

(1) On the one hand, a plan providing a death benefit if an executive dies prior to early retirement age

(2) On the other hand, a plan providing annuity benefits that begin at an executive's Social Security full retirement age.

In the first example, the actuarial risk is that the executive dies early (mortality risk). For instance, if the benefit coverage begins on January 1, 2024, and the executive dies on January 2, 2024, then the plan sponsor may need to pay a large benefit with little time to accumulate funding for the benefit. In the second example, the actuarial risk is that the executive dies "too late" (longevity risk) If the executive lives many years beyond expectation – say, beyond age 100 – then the plan sponsor may be obligated to pay annuity benefits accumulating to a potentially large sum.

In the first example, it is very clear how BOLI can be used to fund the benefit. If an NDCP provides a $1 million death benefit for an executive, a bank can directly fund (or hedge) that obligation by purchasing a whole life insurance policy with a $1 million face amount on the life of the executive. When the executive dies, the proceeds from the insurance policy are directly and immediately available to the plan sponsor to pay the benefit. The use of BOLI in this example is direct and transparent. Further, if the executive dies in the early years of participating in the benefit plan, then the plan sponsor can realize a large financial gain on the use of BOLI. For only a small amount of premium paid on the policy, the plan sponsor receives the full death benefit – the return on investment is large. In the case of early death, the purchase of life insurance results in a significant savings over the cost that would have been incurred by the plan sponsor if it were to pay that benefit directly from operating cash flows rather than purchase insurance.

In the second example, it is, perhaps, less clear how BOLI can be used to fund the benefit. It seems that BOLI protects against early death while the financial risk of the benefit plan lies in "late" death. How does one reconcile this apparent inconsistency? The answer, discussed in the following section, lies in the actuarial concept of asset-liability management.

Of course, employee benefit plan designs can be complex, falling anywhere along a continuum of the two extreme examples presented above. For example, certain NDCPs may feature lump sum payments at certain points in time or may offer secondary death benefits, complicating the risk profile.

The foregoing examples and discussion demonstrate that, when considering investments in BOLI, banks should begin with a consideration of the risks they are trying to fund or hedge. Not all benefit plans are created equal:

- BOLI policies may represent an optimal investment vehicle in some cases;
- In others, the suitability of BOLI is less obvious, requiring a thoughtful actuarial structure in place; and
- In yet others, BOLI may even be an ill-suited choice.

Consequently, prospective BOLI consumers should be aware that BOLI is not for everyone's risk appetite and not for every employee benefit plan. Accordingly, when designing a BOLI portfolio, it is prudent to consider whether and how the life insurance policies will be used to fund the types of benefits provided by the plan.

The next section explores in more detail how one can accomplish this.

Asset-Liability Management: Two Sides of the Same Sirloin

Let's begin with a basic actuarial premise: an effective way to manage risk is to ensure an appropriate "match" (i.e., correlation) between a liability (e.g., a bank's obligation to pay benefits under an employee benefit plan) and an asset (e.g., the funds the bank will use to pay that obligation). Simply put, the assets backing a liability should bear some reasonable relationship to the liabilities they fund. In a perfect (here, meaning risk-free) world, assets will be available in the exact amount and at the exact time that you need them to pay your liabilities. In other situations, assets and liabilities may be considered "matched" without a perfect one-to-one correspondence between the cash flows of the two. If the assets provide an appropriate hedge for the liabilities under various stress scenarios (for instance, changes in capital market conditions and/or actuarial assumptions, such as mortality, which impacts both the liability cash flows and the asset cash flows under a portfolio of BOLI policies), then the assets and liabilities may be considered "matched." Assessing the asset-liability match of BOLI policies to the benefits they are intended to fund is an important step in assessing the suitability of a BOLI program. It requires actuarial analysis of the projected cash flows of the BOLI policies and the employee benefit plan, including stress testing the actuarial and investment assumptions under a range of plausible scenarios. At a minimum, this type of due diligence should be completed at the inception of a BOLI plan; however, prudent management of an in-force BOLI program also involves periodic, ongoing assessment of the actuarial aspects of the structure.

The two examples described in the previous section provide good context for illustrating how asset-liability management plays a role in assessing the suitability of a BOLI portfolio for a bank. Begin with the simple example of an employee benefit plan offering a death benefit in the event that an executive dies before early retirement, funded by a BOLI policy with a death benefit matched to the employee benefit plan. In this case, the asset-liability match is immediately evident. As discussed briefly earlier, there is essentially no mortality or longevity mismatch risk because, at the time of the executive's death, the full value of the death benefit under the employee benefit plan is immediately funded by the death benefit payable under the BOLI policy. Therefore, there is no mismatch but instead a perfect one-to-one correspondence.

Of course, the absence of "actuarial risk" (e.g., uncertainty in mortality assumption) does not imply the complete absence of any risk. There may be, as one example, balance sheet risk caused by imperfect correlation of the asset and liability values under changes in market interest rates. If the employee benefit obligation is reported on the bank's financial statement at fair/market value, which is subject to volatility in capital market conditions, and the value of the insurance policy is reported at its cash surrender value which may or may not correlate with volatility in the benefit obligation, then the funded status of the plan may fluctuate. This creates an accounting risk, even if the cash flows are perfectly matched.

Additionally, the foregoing discussion relates only to the death benefits of the vehicles in play (i.e., the benefit plan and the BOLI policy). A complete actuarial analysis extends beyond just the death benefits to also consider the total costs of the vehicles.

For the BOLI policy, one should consider the amount and timing of premium payments required to keep the policy in force (as discussed later in this article, there may be considerable flexibility in the premium payments, which warrants understanding before proceeding with a BOLI program).

For the employee benefit plan, one should consider the accounting accrual for the value of the benefit, along with how such an accrual correlates to the premium payment design.

Mismatch between the accounting accrual for the cost of the benefit and the premium payments of the BOLI (essentially an accounting accrual for the cost of acquiring the asset) may create additional income statement volatility. Actuarial analysis, coupled with a BOLI policy that has a sufficiently flexible premium design, may help mitigate this type of volatility.

Now, consider the more complex example of a benefit plan providing annuity benefits beginning at an executive's Social Security full retirement age. This example introduces actuarial risk. There is no longer a one-to-one correspondence between the benefit payments of the employee benefit plan and the benefits of the BOLI policy. In fact, the actuarial profiles of the two vehicles are, in some sense, completely mismatched. The actuarial risk on the benefit plan (late death) is the opposite of the actuarial risk on the life insurance policy (early death).

Fortunately, this is not an unreconcilable problem. The key to success lies in crafting an appropriate premium payment strategy for the BOLI portfolio, coupled with policy loan management (i.e., knowing when and how to draw on the cash value buildup of the policies by borrowing from the cash value of the policy) and a thoughtful reinvestment strategy (i.e., knowing when and how to reinvest BOLI benefits that are paid before they are needed to fund the liabilities of the benefit plan). Although not an unreconcilable problem, having

the appropriate structure in place requires actuarial analysis at the inception of a plan and periodically throughout the life of the BOLI portfolio.

The next section discusses the ongoing management of in-force BOLI policies in more detail.

MANAGING A PORTFOLIO OF BOLI POLICIES

BOLI policies are not a passive investment vehicle. They require ongoing management throughout the life of the portfolio, especially when the policies are intended to fund a specific liability stream. This section highlights some of the key considerations for managing a portfolio of policies.

Liquidity Through Policy Loans

As noted briefly at the conclusion of the preceding section, the use of policy loans may be an effective remedy when there is an imperfect actuarial match between the BOLI policies and the employee benefit plan they are intended to fund. Policy loans taken against BOLI policies can satisfy near-term liquidity needs. Indeed, loans may be a necessary part of a successful BOLI program.

Consider, for instance, a scenario in which employees live longer than anticipated in the original setup of the BOLI program. In this case, the death benefit proceeds from the policies may fall short of anticipated benefit cash flows. It may be appropriate to access the value of the BOLI policies (in the form of inside buildup of the cash value of the policies) through policy loans; that is, create liquidity from the policies without fully surrendering those policies.

While loan management can be, and often is, a successful strategy, the use of loans should be carefully balanced against the long-term implications for the lifetime value of the policies. Some BOLI policies impose rather large interest charges to the policy owner (the bank) on outstanding policy loans, especially relative to today's historically low interest rates (notwithstanding recent increases in Treasury rates). Policy loans must ultimately be repaid with interest, or the contractual death benefit of the policy may be eroded, potentially creating downstream impacts for its intended use to fund employee benefits in later years. BOLI portfolio management calls for analyzing the implications of different policy loan and repayment strategies and terms on the values of the policies, allowing for identification of the optimal loan balance to carry, as well as the specific policies from which to extract those loans. This is very much an active

investment strategy, warranting periodic (generally annual) review of the loan balances.

Reinvestment Strategy

Consider, now, the opposite situation from the one discussed immediately above – that is, a scenario in which employees covered by the BOLI policies die earlier than anticipated in the original setup of the BOLI program and also earlier than needed to fund the liability payments under an NDCP. (Note: there is no requirement for the employees covered by BOLI policies to be identical to the employees participating in the benefit plan the policies are intended to fund. Banks have broad discretion regarding how the proceeds of the BOLI policy are used in practice.) In this scenario, the positive cash flows from the BOLI policies exceed those needed to fund benefits under the NDCP.

As part of a portfolio management strategy, plan sponsors may want to proactively consider how future positive cash flows will be reinvested. Rolling the positive cash flows into new BOLI policies may be a viable option. However, the financial attractiveness of such a strategy will depend on the demographic profile of the employees eligible to be covered by BOLI policies. If the employee base has aged, insurance protection will become more expensive and may not provide the most attractive returns.

Additionally, plan sponsors may consider dump-in premiums (one-time, sizeable premiums) to existing policies or repayments on outstanding loans as uses of positive cash flows. Or, as a complete alternative to BOLI, plan sponsors may want to consider alternative investment options such as fixed income securities or equities. Because of this, a decision to invest in a BOLI portfolio is rarely as simple as selecting a single asset class (e.g., the life insurance policies). Instead, plan sponsors should be prepared to consider how the BOLI portfolio fits within a larger, diversified asset portfolio and how positive cash flows will be reinvested into those assets or redeployed to other asset classes.

Policy Loans Versus Policy Surrenders

As already discussed, policy loans may provide a viable source of liquidity from a portfolio of BOLI policies. However, given consideration of the interest costs associated with such loans (as previously discussed), loans may not always represent the financially optimal source of liquidity in a life insurance policy. Policy surrenders (i.e., terminating

the policy and forgoing any future death benefits in exchange for the policy's then-current cash surrender value) may be an optimal strategy in certain cases. When the cash surrender value of the policy exceeds the actuarial value of the policy, plans sponsors may optimize their financial returns of a BOLI portfolio through policy surrender(s). The actuarial value of a policy measures the extent to which the present value of future death benefits of the policy exceeds the present value of future premium payments and other policy expenses.

Determining the intrinsic actuarial value requires carefully informed selection of key actuarial assumptions related to mortality rates and interest rates, among other factors. Periodic assessment of the policies relative to the cash flow needs of the benefit plans they fund is an important part of ongoing portfolio management. The actuarial analysis should balance the immediate liquidity needs of the plan with the long-term cash flow needs of the benefit plan. Actuarial projections can help plan sponsors assess those competing needs and actively rebalance the asset portfolio on a periodic basis. In addition, it is essential to remember that no assessment is complete without consideration of the tax consequences of any changes to the portfolio. Surrendering a life insurance policy may generate a taxable event, requiring legal counsel or accounting advice.

Premium Payment Strategies

Some life insurance policies used as BOLI (e.g., universal life or variable universal life policies) offer flexible premium payment designs. Although these policies may have a planned level premium structure over the life of the policy, they allow the policy owner some discretion with respect to the amount and timing of premium payments within certain boundaries. Any premium payments over and above the planned level amounts will increase the value of the account and, therefore, the cash surrender value of the policy. However, such increase in value may not be dollar for dollar due to loads or charges embedded in the policy. In some cases, premium payments less than the planned level amounts may be allowed, particularly if the account value has previously accumulated to a significant sum.

In many cases, from the perspective of maximizing the intrinsic actuarial value of the policy, the financially optimal premium payment strategy may not be the same as the planned or specified premium. The optimal premium payment may be less than the planned premium, allowing the policy owner to improve short-term cash flows through reduced premium payments.

If the insured individuals die during this "premium holiday," then the plan sponsor maximizes its return on the policies. Of course, if the

insured individuals survive beyond the premium holiday, then future premium payments required to keep the policy in force may exceed the planned level amounts.

In other cases, the optimal premium payment may be more than the planned premium, allowing the policy owner to build up investment value of the policies at attractive yields to fund liability payments due years in the future. The financially optimal premium payment strategy again requires an actuarial analysis, reflecting actuarial assumptions related to mortality for the life insurance policies combined with actuarial projections of the employee benefit cash flows.

In some cases, particularly when BOLI has been purchased for a small set of key executives, it may be prudent to consider the insureds' known health conditions when setting actuarial assumptions to inform a premium payment strategy. For instance, a financially optimal premium payment strategy may want to minimize premium payments on policies covering insureds known to have terminal illnesses and resultingly high expected mortality rates.

Policy Replacements and Conversions

Traditionally, in our experience, universal life and/or variable universal life policies have been the most popular choice for BOLI portfolios. As discussed throughout this article series, these policies combine valuable insurance protection with investment features that result in a potentially attractive design for banks. Some banks, on the other hand, have invested in traditional whole life insurance (or, in limited circumstances, term life insurance). There may be good reasons for this. Traditional life insurance policies are less complex instruments than universal life policies when purchased as investment vehicles. For one thing, because traditional, non-participating life insurance policies generally do not feature flexible premium designs, there is no need for banks to spend time or money developing a financially optimal premium payment strategy. For another, banks may choose those policies because their actuarial analysis suggests they provide the optimal match to the benefits they are funding or the risk exposures they face.

Banks holding portfolios of traditional life insurance policies or term life insurance policies may want to conduct a portfolio review to determine whether the policies could be converted to universal life types of policies. There may be opportunities to enhance the value of the portfolio and/or improve the actuarial asset-liability match through an alternative portfolio design. In some sense, the exercise required for such a review is analogous to a bank starting a completely new BOLI program. The steps, from an actuarial perspective, are materially similar to those discussed in the early sections of this article. In

another sense, however, this type of review could be a part of ongoing portfolio management. As the liability profile of the benefit plan changes over time, the optimal structure of the BOLI portfolio may also change.

CONCLUSION

This article highlights some of the key actuarial considerations associated with designing, implementing, and managing a portfolio of BOLI policies. The steps may seem complicated, and they are. However, the returns on the investment generally justify the effort. Careful consideration of the key actuarial issues can help a bank structure the BOLI portfolio in a way that maximizes its return on investment. Through actuarial analysis, a bank can improve the match of the BOLI assets to the benefit liabilities they are intended to fund, reducing financial risk and mitigating balance sheet volatility. These are all key ingredients of a recipe for a successful BOLI program, well-positioned to meet the needs and risk appetites of the key stakeholders of the bank.

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