The International Journal of Banking and Finance, Volume 9 (Number 3) 2012: pages 15-26

BANK OWNED LIFE INSURANCE: A CRITICAL EXAMINATION OF BANKING STRATEGY

Leyuan You and Krishnan Dandapani
Texas State University and Florida International University, United States of America

---

Abstract

This paper is an investigation of a rampant insurance practice in the US banking sector, namely the permitted practice of employer-paid insurance policy. Under this policy, employee's life policy paid for by the employer, pays large sums as policy benefits to the employer not to the employee's family. Employers suggest that taking insurance covers the possible monetary loss value of an employee departing the firm, and hence the benefit is quite permissible, kosher. Our findings show its widespread occurrence in beefing up the earnings and even the capital base of the US banks. It calls into question if this practice, though legal, is socially responsible since an employee with such employer-paid policy would be deprived of tax deduction for his own self-paid policy cover, in most instances. Banking sector's prevalent use of this practice to cover even low-paid workers such as janitors brings into focus the ethics of this banking practice.

Key Words: Bank owned life insurance, Legal practice, Ethics in finance

JEL classification: G21

---

1. Introduction to BOLI

Great attention has been given to the Bank Owned Life Insurance (BOLI) recently in the United States (US). BOLI is the life insurance that a bank purchases on the life of its officers (or sometimes senior employees) whose lives Banks has a beneficial actuarial interest. Over the last decade, many banks have purchased BOLI to offset a variety of employee benefit obligations such as financing supplemental executive retirement, deferred compensation programs, health insurance, tuition reimbursement, and insuring against the risk of losing an important officer, all which constitute a major expense for most financial institutions.

In a typical case, the bank evaluates each employee by census information: age, sex, compensation, etc. to calculate the present value of benefit expenses. Then the bank buys an insurance policy on the life of a group or groups of key managers or employees and pays the premium.[1] Generally, the Bank is also the sole or joint beneficiary of the insurance. Thus, when an adverse event happens, the bank makes earnings minus the insurance charges that are paid till that date; most of the traditional bank investments generate taxable interest income. In contrast, due to favorable tax laws in force for insurance settlements, BOLI earnings produce no current income tax liability for banks. Two sources of BOLI's income are tax free: growth of the cash value in the policy and the death benefit received upon the death of the insured. By structuring the deal in a strategic fashion, the tax-deferred earnings can be used to offset employee benefit. The value of BOLI holdings is reported as "other asset", the earnings on the holdings are reported as "other noninterest income", and the death benefit is recorded as an extraordinary income by the bank.

Broadly, the BOLI can be categorized into two classes: the more typical case, permanent life insurance, provides life insurance for the entire life of the insured employee, and the temporary or term insurance, provides life insurance for a specified time period. Since the term insurance does not usually generate cash surrender, it is a less popular tool to offset costs.

1.1 What is BOLI and Why BOLI?

In the 1960s, U.S. companies have used corporate owned life insurance (COLI) to finance corporate liabilities. COLI have been so successful that some corporations have purchased them more for its investment value than for employee benefit. In the late 1980s and early 1990s, large banks started to follow suits by creating Banked Owned Life Insurance. During the past several years, many banks net interest margins and deposit growth have been under constant pressure due to competition and margins have been eroding. Banks have responded to this challenge by diversifying their source of income through non-traditional earning assets that can increase their non-interest income. BOLI has been the most popular strategy and it is proven to generate more returns and stability than even COLI.

[1] The bank has to get consent from the insured and in several states the insured employee has the right to cancel the insurance if he/she is leaving the position.

BOLI has proven to be a cost-efficient and effective medium for banks to offset rising employee benefit costs. BOLI is an attractive earning asset for community banks, yielding after tax returns of 200-300 basis points in excess of traditional bank investments. According to Meyer-Chatfield, a BOLI consultant company, BOLI provides historical ROAs of nearly 300 basis points and historical ROEs of 30% for Banks using this strategy.

BOLI is classified as an "other asset" in financial statements and provides other noninterest income, which is considered important to most investors. The cash surrender value of life insurance (CSVLI) has become a significant asset for several institutions, and in some cases approaching 20 per cent of Tier 1 capital. It can generate large returns because the cash value grows tax deferred and death benefits are tax-free insurance policies that are held to maturity according to the insurance banks. The cost the earnings, the insurance company's charge on the policy, is the least expensive term insurance rate. When properly implemented, there is no loss of deductible funding cost as with municipal bonds. Besides, the credit risk for BOLI is very low as the crediting rate is generally better than rates of other investments like T-bills. According to the General Accounting Office, in a 2004 report, by the end of 2002 at least one third of banks and thrifts in the U.S. held BOLI. This number increased to 41% by the end of 2004 according to a leading BOLI provider. In a recent survey, BOLI assets hit $126.1 billion in 2008, this increased by 5 per cent from 2007 for 880 top tier bank holding companies and 7,495 commercial and savings banks. When BOLI is designed properly, it is more than insurance for the Bank; it has become a sound investment strategy.

1.2 Regulatory History

There are four regulators for financial institutions in the U.S.A. - the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS) and the Office of the Comptroller of the Currency (OCC). While the OCC pioneered the supervisory standards to BOLI, the FDIC and OTS have implemented new regulations regarding BOLI purchases and standards in the last several years.

Prior to 1991, during the evolutionary days of BOLI there were common rules with regard to BOLI. Regulators evaluated the BOLI plan submitted by banks and an after study and appraisal informed the banks if it was approved. Then, in June 1991, Office of Comptroller of

Currency (OCC) released Banking Circular 249, the first several formal regulations which basically limit the life insurance for non-investment purposes. It initiated a set of standards of the BOLI purchasing: insure against loss of key employees, insure the life of a borrower, as a security for a loan, and finance employee benefits. Later, in August 1993, the FDIC issued a set of its own guidelines which adopted and expanded on the previous circular 249. It required the board of directors of the Banks to ensure the soundness of BOLI in several areas such as reasonableness of benefits, concentration and other risk considerations, and accounting issues.

In September 1996, the OCC issued another set of rules, Bulletin 96-51, which provided general guidelines to ensure that the purchase of BOLI is consistent with safe and sound banking practice. These rules details include a pre-purchase analysis of life insurance in very specific issues. Bulletin 96-51 provides more flexibility for banks to structure BOLI, allowing the bank to have more applications of life insurance as long as they have valid business reasons. In July 2000, OCC replaced the 96-51 with a revised circular 2000-23. This set of rules remains largely the same but expand to other areas such as price risk.

Additionally, in May 2002, OCC released 2002-19 to provide supplemental guidance and reinforce the legitimateness of life insurance. In August 2002, OTS issued regulatory bulletin 32-26 applicable to OTS regulated federal and state thrifts. In December 2004, bank regulators[2] issued the interagency statement that sets forth supervisory expectations for senior management and boards of directors to understand and mitigate the risks associated with BOLI. Basically, it outlined elements of "prudent risk management process" which include the following four major areas:

1. Effective senior management and board oversight, making sure those directors understand the risks which include:

- Liquidity risk –BOLI is not a highly liquid investment. The longer the time elapse between the purchase of the insurance and the death of the insured, the greater the tax free income to the bank.

[2] OCC Bulletin 2004-56 was issued by the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (FRB), and the Office of Thrift Supervision (OTS).

- Transaction/operational risk –the risk to earnings or capital arising from problems with service or product delivery. Understanding and appropriate monitoring is needed to make sure it is properly implemented.

- Tax and insurable interest implications risk - Consultation with professionals is essential to make sure it is done right or the consequences can be dire.

- Reputation risk – The newly defined risk in 2004-56, failure of the insurance company providing BOLI could affect the ability of institution to meet its obligations. Also, failure to establish BOLI in a proper manner (employees insured without their consent) can reflect poorly on the institution.

- Credit risk – the risk arising from an obligor’s failure to meet the terms of a contract. Generally, the carriers have high credit ratings while BOLI has low credit risk.

- Interest rate risk - the risk arising from movement in interest rates. Banks do not have much control over interest rate risk-BOLI interest rates fluctuate after the first year and these annual "resets" reduce interest rate risks, but boards should review the past performance over business cycles.

- Compliance/legal risk – the risk arising from violation and non-conformance with laws rules and regulations. Failure may involve regulatory and liability consequences.

2. Comprehensive internal policies and procedures including cash surrender value (CSV) should not exceed its legal lending limit nor in the aggregate exceed 25% of its tier 1 capital.

3. A thorough pre-purchase analysis to identify the need of BOLI and its benefit, to assess vendor qualification, and to analyze risk and alternatives.

4. An effective, ongoing system of risk assessment, monitoring and internal control including appropriate frame works for internal audit and compliance.

This new economic phenomenon also results in social problems, such as moral and tax issues. In the next section, we take a look at the economic effect of BOLI. Specifically, how and how much does the BOLI benefit the banks and what are the issues of BOLI.

2. Empirical Analysis: Data and Analysis

We chose the top 10 largest banks in the U.S. to analyze the impact of BOLI. We obtained the data of these banks from the FDIC official website. This website also provides balance sheets

and other financial reports of its member banks. Since life insurance is reported under "Other Assets", and the earnings from it is reported under the "Other Noninterest Income", this is not required to be reported elsewhere, therefore, the information on life insurance is not reported in the regular annual report given to investors. Banks not insured by the FDIC do not have this information on FDIC's website. As of September 10, 2008, the link to obtain the information on life insurance can be found at the following link: https://cdr.ffiec.gov/public/ManageFacsimiles.aspx.

Typically, information for BOLI is obtained from "Call Reports and Thrift Financial Reports". The FDIC updates its reports every three months.

Table 1: BOLI and its earnings $ 0000 for Bank of American, December 31, 2002

From the Balance Sheet		
Total assets (sum of items 1 through 11 in Table 2)	RCFD 2170	565,382,000
From The explanation for the "other asset" item in the balance sheet		
Cash surrender value of life insurance	RCFD C009	9,650,000
From the income statement		
a. Net income (loss) (sum of items 10 and 11 in Table 2)	RIAD 4340	8,216,000
From The explanation for the other Non interest income in the income statement		
b. Earnings on/increase in value of cash surrender value of life insurance	RIAD C014	510,000

An illustration is given in Table 1. It provides the value of BOLI asset, the total asset, the earnings from BOLI and the total net earnings for Bank of America, Charlotte, on December 31, 2002. The value of the life insurance for Bank of America in 2002 is $9.65 billion, 1.7 per cent (consider banking tier 1 capital is merely 4%) of the total assets, which is $565 billion. The earnings of the life insurance given the income statement are $510 million, 6.21 per cent of the $8.216 billion total net income. With 1.7 per cent of the assets making 6.21 per cent of the net income, this shows that earnings on life insurance can be very profitable. But the earnings cannot be realized every year; most of the time the cash value of the life insurance does not change.

We obtain the most recent quarterly report in 2008 for the seven banks, found on the reports of June 30, 2008. We then compared it to the third quarter report in 2007, 2006, 2005 and 2004.

Table 1: Top Ten Largest Banks in U.S. in 2008

Rank	Name (city, state)	Information Provided	Consolidated Assets (in millions of U.S. dollars)
1	Citigroup (New York, N.Y.)	NO	$2,199,848
2	Bank of America Corp. (Charlotte, N.C.)	3510	1,743,478
3	J. P. Morgan Chase & Company (Columbus, Ohio)	628	1,642,862
4	Wachovia Corp. (Charlotte, N.C.)	33869	808,575
5	Taunus Corp. (New York, N.Y.)	NO	750,323
6	Wells Fargo & Company (San Francisco, Calif.)	34075	595,221
7	HSBC North America Inc. (Prospect Heights, Ill.)*	57890	493,010
8	U.S. Bancorp (Minneapolis, Minn.)	NO	241,781
9	Bank of the New York Mellon Corp. (New York, N.Y.)	639	205,151
10	SunTrust, Inc. (Atlanta, Ga.)	867	178,986
11	Citizens Financial Group, Inc. (Providence, Rhode Island) **	NO	161,759

NOTE: As of May 30, 2008. *Source:* Federal Reserve System, National Information Center. *HSBA USA is used instead of HSBC North America since the latter is not found in FDIC website. ** The Eleventh Bank is shown for comparison purposes.

Panel A in Table 3 gives the value and the earnings of life insurance for the seven banks for the third quarter in every year from 2004 to 2008. Total assets and net income are provided; the life insurance value and earnings on life insurance are also expressed in percentages of total assets and net income respectively. Panel B of Table 3, shows the average values over the five quarter periods of the value and earnings on BOLI in percentages of total assets and net income.

Table 3 shows that of the seven banks, all except Wells Fargo have BOLI. Of the of six banks using BOLI, only Bank of America and Wachovia have positive earnings on BOLI in our sample period, the former in 2008 and the latter from 2004 to 2007 .

Table 3: Summary of BOLI for the Large Seven Banks from 2004-2008

Panel A Historical Pattern of BOLI for the Seven Banks for the past Five Years

	Bank of America	JP Morgan Chase	Wachovia	Wells Fargo	HSBC	Bank of New York	SunTrust	Average Across Banks
6/30/2008								
BOLI assets	16,501	7,561	14,575	NA	213	1,820	611	5,897
Total assets	1,350,269	1,378,468	660,496		176,606	130,062	168,683	552,083
BOLI/Total assets	**1.22%**	**0.55%**	**2.21%**	NA	**0.12%**	**1.40%**	**0.36%**	**0.84%**
Earnings on BOLI	328,146	0	0		0	0	0	0
Net income (loss)	3,391,859							
Earnings/Net income	**9.67%**	**0**	**0**		**0**	**0**	**0**	**1.61%**
6/30/2007								
BOLI assets	14,131	7,327	13,430	NA	206	1,755	584	5,348
Total assets	1,264,470	1,252,369	525,811		164,881	95,641	175,010	496,883
BOLI/Total assets	**1.12%**	**0.59%**	**2.55%**	NA	**0.12%**	**1.83%**	**0.33%**	**0.94%**
Earnings on BOLI	0	0	279,000		0	0	0	0
Net income (loss)			3,193,000					
Earnings/Net income	**0**	**0**	**8.74%**		**0**	**0**	**0**	**1.46%**
6/30/2006								
BOLI assets	13,614	6,993	10,728	NA	196	1,690	553	4,825
Total assets	1,145,895	1,150,905	480,134		165,593	93,466	179,265	459,323
BOLI/Total assets	**1.19%**	**0.61%**	**2.23%**	NA	**0.12%**	**1.81%**	**0.31%**	**0.89%**
Earnings on BOLI	0	0	219,000		0	0	0	
Net income (loss)			3,065,000					
Earnings/Net income	**0**	**0**	**7.15%**		**0**	**0**	**0**	**1.19%**
6/30/2005								
BOLI assets	13,160	0	9,848	NA	0	1,690	0	3,528
Total assets	1,067,486	0	452,786		141,452	93,466	0	250,741
BOLI /Total	**1.23%**	**0.00%**	**2.17%**	NA	**0.00%**	**1.81%**	**0.00%**	**0.75%**

assets								
Earnings on BOLI	0	0	231,000		0	0	0	
Net income (loss)			3,055,000					
Earnings/Net income	**0**	**0**	**7.56%**		**0**	**0**	**0**	**1.26%**
6/30/2004								
BOLI assets	10,125	0	7,349	NA	NA	1,690	0	3,194
Total assets	706,888	654,641	368,871			93,466	0	303,978
BOLI/Total assets	**1.43%**	**0.00%**	**1.99%**			**1.81%**	**0.00%**	**0.87%**
Earnings on BOLI	0	0	199,000	NA	NA	0	0	
Net income (loss)			2,229,000					
Earnings/Net income	**0**	**0**	**8.93%**	**NA**	**0**	**0**	**0**	**1.49%**

Panel B BOLI Statistics Averaged Across Last Five Years

Values Averaged over 5 Years	Bank of America	JP Morgan Chase	Wachovia	Wells Fargo	HSBC	Bank of New York	SunTrust	Average Across Banks
BOLI	13,506	4,376	11,186	0	154	1,729	350	4,472
Life Insurance/Total Assets	1.24%	0.35%	2.23%	0	0.09%	1.73%	0.20%	0.83%
Earning	65,629	0	185,600	0	0	0	0	35,890
Earnings /Net Income	1.93%	0.00%	6.47%	0	0	0	0	1.20%

Note: The total assets are in unit of million and the earnings in unit of thousand.

When the qualified event occurs, the earnings on BOLI make up a considerable percentage of net income. For example, with 1.22 per cent of total assets invested in BOLI, the earnings on BOLI account for 9.67 per cent of net income in the third quarter of 2008for Bank of America. The BOLI assets increased from an average of $3,194 to $3,528 in 2005, $4,825 in 2006, $5,348 in 2007, and $5,897 million in 2008. The average quarterly earnings grew from $39,800 thousand to $54,690 thousand in 2008, however, it does not grow at a steady rate. Panel B shows that the average value of the BOLI is $4,472 million for the six banks over the last five years, which accounts for 0.86 per cent of the banks total assets, and the average 3rd quarter earnings on BOLI over the last five years is $35,890,000, accounting for 1.4 per cent of the net income. In general, Table 3 shows that BOLI can be profitable to banks.

4. Regulatory Implications: How BOLI affect CAMEL Rating of Banks

The CAMEL methodology was originally adopted by North American bank regulators to evaluate the financial and managerial soundness of U.S. commercial lending institutions. The CAMEL reviews and rates five areas of financial and managerial performance: Capital adequacy, Asset quality, Management, Earnings and Liquidity. Take Bank of America, National Association at Charlotte for example, BOLI accounts for 1.7 per cent of the total assets on Dec 2002. This number increased to almost 16.67 per cent in March 2004. It greatly improves the capital adequacy for the bank. The earnings of BOLI accounts for 5.29 per cent of the total net income on March 2002, it increases to 6.02 per cent in 9 months.

4.1 Other issues

Capital Adequacy, Basle and Regulation Issue:

Before 1991, there were no regulations addressing the issues around BOLI. The first several regulations came out around May 1991. They generally require that there are only 4 purposes of BOLI: insure loss of key employee, insure the life of a borrower in an account equal to the bank's exposure to loss, as a security for a loan, and finance employee benefits. Later on the OCC loosened the rules. Still possible regulatory review of BOLI products can occur if not implemented properly.

Federal Tax Issue:

The increasing audits by IRS show that BOLI has also become a hot issue with respect to tax. Under applicable law, the bank must have an "insurable interest" in order to qualify for tax free insurance proceeds. Even though the insurance meets the OCC requirements, it may not qualify for insurable interest requirement for tax purposes. The IRS can challenge whether the bank is entitled to the favorable tax treatment based on the information it collected. It requires exhaustive details on BOLI and inquiries into all aspects of BOLI. If the bank doesn't provide adequate documents to show its legitimate purpose of the insurance, the IRS can invalidate the contract as insurance.

The IRS has expressed its concerns about banks that purchase policy coverage that far exceeds the risk of loss may use it for business purpose. Recent cases on COLI, though different from BOLI, rendered some lessons for banks. In order to enjoy tax deferred build up of the BOLI cash value, the insurance policies must be under the ownership of the insurer, not the bank, meaning the cash values are not controlled by the bank. The IRS has established some criteria for separating accounts for BOLI. However, it is highly dependent on specific circumstances.

Social, Moral and Ethical Issue

Making profit out of insurance on people's lives is a controversial issue. Social commentators have argued that it is the banks not the employees who are being insured and their family who get the benefits. While Banks do have an actuarial interest in the lives of employees, many controversial practices necessitate a clear and pre-defined path for banks to follow. Although these issues may be beyond the scope of this paper here, it needs to be investigated.

5. Conclusion

BOLI can benefit banks with present regulations and tax rules. It increases bank earnings, and helps to improve the ratings of banks within the CAMEL context. It also produces risks and social issues. But because BOLI is a relatively new product, it needs to be further studied and possibly regulated to avoid implicit conflict of interest with the personal welfare of the insured employee.

Author Information: Leyuan You is a faculty member in the Department of Finance and Economics, McCoy College of Business Administration, Texas State University San Marcos, Texas, 78666, United States of America. Her contact detail: Email ly17@txstate.edu. Krishnan Dandapani is a professor at the Department of Finance and Real Estate, Florida International University, Miami, Florida, 33199, United States of America. He may be contacted at E-mail: Dandapan@fiu.edu.

References

Brew, Jay, (2007). Taxes: the forgotten piece of bank profits, *American Bankers Association. ABA Banking Journal*. 99: 22-24.

Collins, Patrick J., Dieter, Jurkat, (2005). The decision to replace trust owned life insurance policies, *The Banking Law Journal,* 122: 975

McDonald, Randall A., (1998) Consolidated Supervision of Banks, BankofEngland.co.uk

Nurnberg, Hugo, Douglas P. Lackey, (2010). The Ethics of Life Insurance Settlements: Investing in the Lives of Unrelated Individuals, *Journal of Business Ethics* 96:513–534.

Smith, Brian W., Kimberly M. Boylan, Gregory S. Feder, and Joseph E Yesutis, (2001). Bank-owned life insurance: Pre-purchase analysis and post-purchase compliance, *The Banking Law Journal,* 118: 208.

Smith, Brian W, Wendy L. Morris, (1997). Take another look at bank-owned life insurance, American Bankers Association. *ABA Banking Journal* 89: 22-24.

Wamberg, Warren T., (1995). *The Theory & Practice of Bank-Owned Life Insurance*, T. W. O. Pubication, NJ, United States.