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# BOLI Portfolio Optimization

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**Before jumping into the core of the discussion on optimization this article will address what some in the BOLI business are calling a new strategy to rescue underperforming policies, I reference this as the "SPIA Strategy". Then this article will look at BOLI portfolio optimization with a holistic approach which includes details on the SPIA Strategy.**

## The "SPIA Strategy":

**Is the "SPIA Strategy" new?** Not at all, it has been around for many years in a variety of forms, including in the retail insurance market where it's been used when an individual outlives their need for life insurance coverage and instead has a need for retirement income. They are able to exchange the life policy for an annuity, and take advantage of the periodic payments from the annuity.

**What is the SPIA Strategy?** SPIA stands for Single Premium Immediate Annuity. The strategy takes an underperforming BOLI policy and executes a 1035 exchange into a new SPIA. The SPIA only requires the single upfront premium, and pays annual cash flows over the term of the annuity. Depending on the SPIA selected the bank has the opportunity to improve return, move to a higher rated insurance carrier, and divest of an unwanted BOLI policy.

**Does the SPIA Strategy make sense for my bank?** That depends. It should not be considered a simple BOLI replacement tool, and is not a one size fits all strategy. Your specific circumstances, tax situation, performance of existing BOLI, age of BOLI participants, bank strategic goals, risk tolerance, and liquidity needs all play a role in determining if the SPIA Strategy is right for you.

## BOLI Portfolio Optimization Strategies:

**BOLI portfolio optimization.** A bank has several options to consider relative to optimizing their BOLI portfolio. The first and most common option is to continue to hold the BOLI and reap the benefits of tax-free income and death benefit proceeds. However in the event the

BOLI is not performing as expected, possibly the credit of the insurance carrier has fallen below investment grade, the cash value growth is subpar because of a reduction in crediting rate, or the bank needs to reduce their risk weight, then either a full surrender or a 1035 exchange many be necessary to remedy the problems.

**Surrender** involves terminating the BOLI policy, the insurance carrier pays the full cash value to the bank, and the bank pays tax on the inside buildup. This is typically not financially viable, given the inside buildup is taxable as ordinary income, and for MEC policies a 10% penalty tax will also apply.

**Surrender and redeploy into another asset at the bank**. This allows the bank to divest themselves of the in force BOLI, pay the tax cost, and invest the after-tax proceeds into another asset class, make loans, etc. This can make financial sense in the long run if the new investment returns enough to cover the tax expense of the surrender.

**Surrender and redeploy into new BOLI.** Often, it's not that the bank wants out of the BOLI asset class altogether, but a particular policy is underperforming or is no longer needed. This policy can be surrendered, the tax cost paid, and a new BOLI policy purchased. The new BOLI policy may have a feature that offsets the tax expense. The feature is a cash value enhancement that makes the transaction balance sheet and income statement neutral.

**1035 exchange** involves exchanging the BOLI policies of one insurance carrier for new policies at a new carrier. The new policies can be either another BOLI policy or an annuity. BOLI policies typically have 1035 exchange charges in the first 10-15 policy years, which will be an expense at the time of the exchange.

**1035 exchange into a new BOLI policy** is a common transaction that many banks have utilized. In order to comply with insurable interest regulations and maintain favorable tax treatment under IRC 101(j) only insured that are still employed by the bank are eligible. This limits the value of the strategy because with time the percentage original insured that are still employed by the bank declines. To complete the transaction the active insured will be required to go through a new enrollment process including a new notice and consent form. For those BOLI policies that are eligible, there is an opportunity to improve cash value return, lower risk weight, and improve carrier credit rating, all while maintaining the tax treatment of BOLI earnings. There are some insurance carriers that provide an enhancement to cover this

1035 exchange expense, making the transaction balance sheet and income statement neutral.

**1035 exchange into an annuity**, specifically into a single premium immediate annuity (SPIA). For many years this has been a strategy in the retail insurance market, but is now becoming more common with corporate owned insurance. The BOLI owner executes a 1035 exchange of some or all of their BOLI policies into a SPIA, with the same or a new insurance carrier. The term of the annuity is typically 15 years, over this time the SPIA makes annual payments and amortizes the balance to zero. This provides liquidity to the owner. The SPIA is a period certain, meaning that the death of an annuitant does not change the payments in anyway. Payments are guaranteed for the term of the annuity.

At the time of transaction, based on IRC 1035, there are no tax consequences to the owner. Under IRC 72(u) the tax treatment of an immediate annuity is based on the exclusion ratio, gains are spread ratably over the annuity term. A portion of each cash flow will be treated as ordinary income, and a portion will be treated as return of basis. The effect is to provide tax deferral during the term of the annuity. In addition, the MEC penalty tax is avoided since immediate annuities are not subject to the penalty tax. For these reasons the SPIA provides advantages over a surrender, but may not be as attractive as a 1035 exchange into a new BOLI policy.

Insurable interest is required under state law in order to issue a new BOLI policy. However, insurable interest is not required with the fixed term annuity used in this transaction. This means that both active and inactive insured are able to participate, which is a distinct advantage over the 1035 exchange to new BOLI strategy. The insured under the BOLI policy becomes the annuitant under the SPIA.

Several insurance carriers offer SPIA products, both general and separate account. Depending on the size of the transaction product offerings maybe limited. With separate account products several investment options are available, and they are offered with and without stable value protection.

**Bank eligibility** is addressed in OCC Interpretive Letters #1021 and #878. #1021 categorizes fixed rate annuities as a debt obligation of the insurance company, and discusses a bank's ability to invest in them for their own account. This provides broad latitude in investing in an

annuity. However, if the SPIA is replacing a BOLI policy, the SPIA can be used for the same purpose as the BOLI, to fund employee benefit expense. Interpretive Letter #878 discusses using various insurance company products, including annuities, to hedge, on a dollar-for-dollar basis, a bank's obligation to make payments under nonqualified deferred compensation plans.

**Concentration of credit and legal lending limits** should be followed. The annuity is not life insurance, so in general is not aggregated with BOLI limits (25% of capital). However certain state regulators may require aggregation.

**Valuation of the SPIA** depends on the product type. With general account products the interest rate is guaranteed for the term, the term is guaranteed, and the only cash flows are the annual payment made each year until the end of the term. Thus, under ASC 820 Fair Value Measurement, the discounted cash flow approach is used to value the SPIA. Depending on how the discount rate changes over time there is a level of interest rate risk.

With separate account products, the investment performance will drive the SPIA payments, thus discounted cash flow approach is not available. The value of the SPIA will be the Market Value, or Account Value. This presents more interest rate risk than the general account SPIA, however a Stable Value Wrap can be utilized to minimize this risk.

The SPIA is **classified on the call report under "Other Assets".**

**Comparison of Strategies:**

| | Continue to Hold Existing BOLI | 1035 Exchange to new BOLI | 1035 Exchange to new SPIA | Surrender for Cash |
|---|---|---|---|---|
| **Eligibility of Insureds** | NA | Only active insureds | Active and inactive | Active and inactive |
| **Tax Impact** | Cash value grows tax free, and death benefits will be tax free. | No change to tax treatment, as long as only active insureds are exchange. Cash value will continue to grow tax free, and death benefits will be tax free. | None at time of exchange, a portion of each cash flow will be taxable based on the exclusion ratio, MEC penalty tax is avoided. | Inside buildup taxable as ordinary income, plus 10% MEC penalty tax may apply. |
| **Risk Weight** | Depends on product type. | Chance to improve, depends on product type. | Chance to improve, depends on product type. | Chance to improve |
| **Return on Cash Value** | Likely to decline over time as cost of insurance rates increase. | Chance to improve | Chance to improve | Take proceeds back into bank and invest. |
| **Death Benefits** | Yes | Yes | None | None |
| **Investment Options** | Depends on options in existing policy. | Many bank eligible options available in Separate Account plans. | Many bank eligible options available in Separate Account plans. | NA |
| **Liquidity** | Only if death claims occur. | Only if death claims occur. | Annual cash flow over 15 year term of SPIA. | Immediate |

**Hypothetical Example:**

Assumptions:

- Yield on existing BOLI: 1.00%
- All BOLI insureds are inactive, so 1035 exchange to a new BOLI policy is not an option
- BOLI inside buildup 25%
- Tax rate 25% (federal plus state)
- SPIA pretax IRR 3.00% (based on current general account SPIA rates)
- SPIA cash flows are reinvested at 3.00% taxable

Based on these assumptions, the bank can complete a 1035 exchange into a SPIA, and over the 15 year term achieve an average after tax return of 1.98% which represents a 0.98% improvement over the BOLI return of 1.00%, and 0.22% improvement over a full surrender and reinvestment into a 3.00% taxable asset. Future BOLI death claims are forfeited, which erodes the SPIA advantage. Clearly in this example the SPIA Strategy provides the bank a strong financial incentive to complete the transaction.

**Considerations**

**Before executing any 1035 exchange, to a new BOLI policy or to a SPIA,** a thorough comparison of the existing and the new product needs to be completed. Items to compare include:

- Minimum guaranteed interest crediting rate. Many older policies have guaranteed rates of 3-5%, whereas new policies are in the 0-3% range.
- Policies may contain 1035 exchange charges, crawl-out provisions, market value adjustments, or other restrictions.
- Fees under the new contract may be higher that under the existing policy.
- Is the new insurance carrier highly rated and financially strong?
- How does the risk weight of the new policy compare to the existing policy?
- If available, compare the investment options in both policies.

**BOLI 1035 exchange to SPIA is not the end all be all**, it's financially viable in some situations, but not all. It's not an alternative to BOLI, can't be used to provide split dollar benefits, and requires ongoing risk management just like BOLI.

**Contact us** if you have questions about any of these strategies; surrender, 1035 exchange to new BOLI, or 1035 exchange to an annuity.

**At Newcleus we are specialists in BOLI portfolio optimization** and have many unique, and also common, strategies that can help you to maximize your earnings, risk weight, exposure.