Trends in Bank-Owned Life Insurance (BOLI)

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Banks have been purchasing Bank-Owned Life Insurance policies with some regularity since the 1980s. In recent years, more community banks across the country are doing so, according to data from the Federal Reserve.

By 2013 year-end, 3,467 community banks reported about $29 billion in BOLI assets, marking an increase in not just asset growth from the previous year, but in the number of community banks that purchased policies.

A bank can purchase a BOLI policy for any employee, but typically it is done to insure the life of the principal, an officer or other highly compensated employee. The policies are, of course, bank-owned, meaning the bank receives the death benefit or accrued investment earnings on the policy, just as the bank bears the risk for investment losses.

The primary benefit of purchasing BOLI is the income earned on them is tax-free for the bank, and the benefit payment in the event of the named insured's death is also tax-free for the bank, according to a recent primer from the Federal Reserve.

In most cases, banks do not receive cash flow from BOLI policies until the death of the insured. The Federal Reserve notes that there are typically two ways to extract liquidity from a BOLI policy before the death of the insured: one, to surrender the policy; and two, to borrow against the policy. Be mindful of fees and tax ramifications, warns the Federal Reserve.

Community banks have adopted BOLI policies at different rates and concentrate different levels of bank assets relative to their sizes. At the end of 2013, Fed data shows 698 banks with less than $100 million held $819 million of bank assets in BOLI policies, representing an average percentage of Tier 1 Capital plus the allowance for loan and lease losses (ALLL) of 17.28 percent.

Comparatively, 1,913 community banks with $100 million to $500 million in assets held about $7.8 billion in BOLI policies, and on average had 15.6 percent of bank assets in the policies.

The decision to purchase a BOLI should not be executed without the guidance of a financial-institution insurance specialist. Banks must weigh many considerations—the extent of which cannot be fully addressed in this article. But for example, banks can purchase general account policies, separate account policies or hybrid account policies. Each has benefits and attending risk-management ramifications for bankers.

There is also the fundamental question of how much of a bank's assets should be used to purchase a BOLI policy. The Federal Reserve says that at the end of 2013, 363 institutions spanning community bank size reported a cash surrender value of their policies that was greater than 25 percent of the sum of Tier 1 and ALLL assets -- the measure bank regulators use to gauge concentration of policy assets.

And 18 banks with less than $50 million in assets reported a concentration of greater than 50 percent of assets.

"While it may be understandable that smaller community banks have a greater BOLI concentration because of their relatively smaller balance sheets, they must be aware of and actively manage and mitigate additional risks," according to a primer on BOLIs from the Federal Reserve.

Credit, market, liquidity, operational, legal and reputational risk all have implications on the how BOLI policies are bought and managed by banks.

The good news is that Federal Reserve has been addressing banks' needs relative to managing BOLI policies for well over a decade with comprehensive guidance on managing risk and accounting considerations.

Clearly, BOLIs have a growing place on community bank balance sheets. Determining whether your bank can benefit from the strategy is a decision best arrived at with the benefit of a financial institution insurance specialist helping to balance all of the necessary considerations that go into policy underwriting.