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## Hybrid BOLI: Beware of Treatment Under Basel III

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## Hybrid BOLI: Beware of Treatment Under Basel III

Most banks find their guidance regarding BOLI purchases from the OCC Bulletin 2004-56 and other Interagency Statements. The OCC Bulletin 2004-56 includes rules related to the risk weighting of BOLI assets. With the adoption of Basel III and the passage of Dodd Frank, banks may no longer rely solely on the major rating agencies to determine the risk weighting of their BOLI assets.

In addition, new regulations have been issued regarding the risk weighting of BOLI assets held in General Account, Separate Account and Hybrid Account policies. Most concerning, is the ambiguity of how Hybrid BOLI will be treated from a risk weighting perspective under the *New Basel III Capital Rules*. The purpose of this document is to explain the differences in the products and expose the potential risks of owning a Hybrid product under the *New Basel III Capital Rules*.

Let's first examine the different types of products available to banks interested in purchasing BOLI. They include General Account, Separate Account and Hybrid Separate Account products.

### I. Types of BOLI

**General Account:** General Account BOLI assumes the general assets of the insurance company issuing the BOLI policy will support the policy's cash values. In addition the credit risk of the portfolio are guaranteed by the carrier and typically a minimum interest crediting rate is provided. General Account BOLI is and will continue to be recognized at a risk weighting at 100%.

General Account BOLI policies invest a significant portion in fixed income investments with a smaller percentage invested in equities. Separate account BOLI products also invest in fixed income investments -- basically bank eligible securities. Therefore, the potential difference in yield of underlying assets between General Account and Separate Account BOLI is usually minimal.

**“Banks may no longer rely solely on the major rating agencies to determine the risk weighting of their BOLI assets.”**

The advantage of a well-diversified traditional General Account product is that it incorporate a long-term investment strategy that is actively managed, well-diversified, and contains a long-term investment horizon. In addition, products issued by mutual life insurance companies can take a longer term view on the investment front, as they are not pressured by quarterly performance results.

**Separate Account:** In a Separate Account BOLI policy, the policy cash values are supported by assets segregated from the general assets of the insurance company issuing the policy. Multiple investment options may be available; however, products typically invest in bank eligible securities, such as bond funds and mortgage backed securities funds. Changes in the market value of the separate account portfolio fall through to the policy cash values on a pro rata basis.

Separate Account BOLI under the *New Basel III Capital Rules* is considered to be an equity exposure to the investment fund. There are three approaches for determining the risk weighting of separate account assets under the new rule. In the past, separate account products have enjoyed a minimum risk weighting of 20% following these three approaches. This may or may not be the case under the *New Basel III Capital Rules*.

**Hybrid Separate Account:** In a Hybrid Separate Account policy, like Separate Accounts, the policy cash values are backed by assets segregated from the general assets of the insurance company, but not subject to the claims from other creditors of the insured.

Under the Hybrid Separate Account structure, policy owners have the choice between investing in the Separate Account options offered within the product or in the General Account of the underlying issuing insurance carrier. There may be a minimum interest rate that is credited to guarantee against investment losses. Typically, there are restrictions on how assets can be moved from either the General Account to the Separate Account, or Separate Account to the General Account. The asset allocation management within a Hybrid policy can be restrictive.

**“Separate Account BOLI under the *New Basel III Capital Rules* is considered to be an equity exposure to the investment fund.”**

### **Effects of the New Basel III Capital Rules**

It is not clear under the *New Basel III Capital Rules* whether hybrid separate account will be treated as general account or separate account for determining risk weighting. The bank owning a Hybrid BOLI policy will make the determination on which risk weighting to select either a more conservative approach or more aggressive approach.

Under the final rules of Basel III, the bank must determine if the product qualifies as a separate account or a general account. To qualify for a separate account, the following conditions have to be met:

1. The account must be legally recognized under applicable law.
2. The assets in the account must be insulated from the general liabilities of the insurance company under applicable law and protected from the insurance company's general creditors in the event of the insurer's solvency.
3. The insurance company must invest the fund within the account as directed by the contract holder in the investment alternatives designated or in accordance with specific investment objectives or policies.
4. All investment performance, net of fees and assessments, must be passed through to the contract holder, provided that contracts may specify conditions under which there may be a minimum guarantee but not a ceiling.

It will be difficult going forward for Hybrid Separate Account policies to meet the definition of separate account requirement outlined in point number four. With this in mind, it may be difficult for banks after January 1, 2015, to take advantage of the lower risk weighting available with such a product due to the classification rules.

**“It is not clear under the *New Capital Rule* whether Hybrid Separate Account will be treated as General Account or Separate Account for determining risk weighting.”**

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## How to Determine the Appropriate Risk Weighting

To ultimately make the decision on what the appropriate risk weighting is for a Hybrid Separate Account BOLI product, there are three methodologies that financial institutions will select from to determine how to classify their BOLI products from a risk weighting standpoint.

1. Full Look-Through Approach: The aggregate risk-weighted asset amounts for all investments held by the fund are multiplied by the banking organizations' proportional interest in the fund.
2. Simple Modified Look-Through Approach: A banking organization multiplies its exposure to the fund by the highest risk weight of any of the assets in the fund.
3. Alternative Modified Look-Through Approach: Calculate risk-weighted asset amount based on pro-rata basis based on permitted maximum allocation by sector. Risk-weighting over 100% is possible.

## Risks to Banks Regarding Hybrid Separate Accounts

In the past, many vendors promoted Hybrid Separate Account products, primarily due to the lower risk weighting reflected by many of these programs, while technically enjoying the General Account benefits (i.e., a minimum interest crediting rate). This aggressive approach to determining risk weighting is now called into jeopardy under the *New Basel III Capital Rules*.

It is Executive Benefits Network's opinion that relying on justification for a lower risk weighting for a Hybrid Separate Account product based on the fact that there is a Separate Account option within the investment portfolio is not grounds under the *New Basel III Capital Rules* for continuing this lower risk weighting. The result is that many banks who have structured their overall risk weighting calculations assuming a 20% risk weighting for their BOLI asset may find an unwelcome adjustment going forward.

In today's lower interest rate environments, General Account products have typically outperformed Separate Account products and also carry a guaranteed minimum crediting rate. It may be prudent for banks to rely on General Account products, as the more predictable, reliable BOLI investment option versus the more aggressive Hybrid and Separate Account products being presented by other vendors.

**“General Account products have typically outperformed Separate Account programs and also carry a guaranteed minimum crediting rate.”**

**“Relying on justification for a lower risk weighting for a Hybrid Separate Account product... is not grounds under the *New Basel III Capital Rules* for continuing this lower risk weighting.”**

Look for more information on this topic as it develops by visiting [www.ebn-design.com](http://www.ebn-design.com) and please [contact us](#) with further questions or comments.

Executive Benefits Network welcomes questions and comments. Please contact Nikki Kook at (414) 755-8276 or [nkook@ebn-design.com](mailto:nkook@ebn-design.com).

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## About Executive Benefits Network

Executive Benefits Network (EBN) specializes in the design, administration and informal financing of customized **deferred compensation** plans and the procurement of **Bank Owned Life Insurance (BOLI)** programs. BOLI can help offset the costs of **nonqualified plans** for key employees and/or the costs of existing employee benefits. In addition, BOLI is immediately **accrue to earnings** and improves non-interest income and shareholder value.

EBN emphasizes the importance of **education** and builds long-lasting relationships with clients. As the **leading industry advisor**, EBN develops **customized** plans to attract, retain and reward **key executive talent**. EBN can service in all 50 states and has access to the highest rated insurance companies in the nation. Please contact EBN today for more information on how to improve your financial portfolio.

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