EXECUTIVE BENEFITS NETWORK

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insights

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 *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 *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.

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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.

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 *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 is not going to be the case under the *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 *Basel III Capital Rules* is considered to be an equity exposure to the investment fund."

EFFECTS OF THE *BASEL III CAPITAL RULES*

It is not crystal clear under the *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. Most banks have elected to carry their Hybrid BOLI at a 100% risk-weighted level.

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.

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.

"The bank owning a Hybrid BOLI policy will make the determination on which risk weighting to select..."

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 *Basel III Capital Rules*.

CONCLUSION

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 *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.

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ABOUT EXECUTIVE BENEFITS NETWORK (EBN):

As the leading industry advisor, EBN specializes in the customized design, administration, and informal financing of Nonqualified Executive Compensation and Benefit Plans (Deferred Compensation Plans), as well as the procurement of Bank Owned Life Insurance (BOLI) programs to attract, retain, and reward key executive talent. We emphasize the importance of education and build long-lasting relationships with clients in all 50 states, and we have access to the highest rated insurance companies in the nation. Lastly, we believe that no two companies are alike in their needs; therefore, customization of executive benefit and compensation plans is paramount to a successful program.

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