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CORPORATE-OWNED LIFE INSURANCE (COLI)

A Strategy for Risk Management, Deferred Compensation and Retirement Planning

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Chief Executive Officers have a lot on their minds. They are tasked to be visionaries, conceive of the big picture, chart pathways to success, plan long-term strategy, all while anticipating potential risks looming on the horizon. Perhaps this explains the aphorism "it's lonely at the top." It may also account for why they value relating to peers and comparing experiences.

Recently, while headed to the same investment conference in New York, two CEOs were sharing a row in First Class. Settling in for a long flight, Jim asked Susan, "What's keeping you up at night these days?"

Susan was quick to respond, "Risk management. Above all, we need to retain our founders." She relayed her predicament, having recently been hired as CEO of a newly formed public company, just taken public by a private equity firm. The company originally had three founders, and all three were critical since there had not been enough time to put together a long-term succession plan. If any of the three were to leave the company, the cost of attrition would be extremely high, and the loss of talent could have severe adverse consequences for the business plan.

"Been there, done that," replied Jim. "The so called 'War for Talent' is a tough one, and we took it head-on a couple years ago. Good thing we did, too."

Jim gave a quick history of his experience with locking in key talent. "We worked with our executive compensation and benefits consultants to weigh the merits of all sorts of total reward strategies that most appealed to our key people. We were afraid that our most entrepreneurial executives could leave our company and compete with us head-on. In addition to their own financial security to ensure their families could retire in comfort, we learned that they wanted to be sure that our company would remain the very best place they could apply their talents for the rest of their careers."

Jim then explained the solution he and his company put in place. For the key people, they installed a Nonqualified Target Benefit Plan, which created an account balance that by the time of their retirement would be sufficient to replace 60% of the projected final cash compensation for their lifetime.

"The cost of the benefit was a small percentage of their annual incomes, but was well worth the price, considering the cost of replacing those executives if they left for greener pastures."

Even better, Jim explained that the benefit could be tailored for other key people, adopting the same platform to allow unlimited pre-tax savings in case they wanted to defer their own income for retirement.

Susan was a little concerned about this. "Isn't a non-qualified plan unfunded and subject to creditors?"

"That's right. It's a benefit that would not have been attractive unless we were on solid financial ground. And because it is technically

unfunded, we elected to maintain a separate asset in a Rabbi Trust for them, equal to the account balance. Granted, Rabbi Trusts are taxable, so we had to be mindful of that additional cost. Ultimately, we decided to fund the benefit with *Corporate-Owned Life Insurance (COLI)*. There are expenses with COLI, too, but much less than the tax drag on mutual funds over time."

"Life insurance, huh?" Susan wondered. "I don't know. Some of our people have worked themselves hard. What about medical exams and health histories?"

"That's not an issue with COLI. Because it covers a defined class of our people, it's issued on a guaranteed basis without anyone having to go through medical underwriting."

"They'll like that. But what if one of them dies unexpectedly?" Susan asked. "Then what happens to the COLI assets?"

"Great question. We chose COLI for tax-efficient asset growth. But if an executive dies, two things happen. We owe his or her beneficiaries a lump sum payment of all the future benefits. That wasn't required, but we thought that type of design would keep the executives here, and focused on their work. More importantly, for the company, there would be the added benefit to cover the expense of replacing the talent. As you know, that can easily cost you a multiple of their annual compensation."

"Makes sense," said Susan, "Now THAT'S the sort of risk management solution that I could use. And quickly."

WHO THIS CHAPTER WILL HELP

In this chapter, we will explore how Nonqualified Deferred Compensation fits into the total reward strategy of successful corporations, and what role *Corporate-Owned Life Insurance* plays in support of retirement planning.

In addition, we will look at other institutional uses of life insurance. COLI, in its various forms, has unique characteristics as a financial instrument. Properly structured, institutionally priced life insurance allows corporate owners and some financial institutions to operate more efficiently and effectively while providing greater value to their owners, customers and shareholders.

Whether you are involved with corporations, banks, trusts or insurance companies, by the end of this chapter, you may think differently—and more creatively—when it comes to some of the most pressing issues pertaining to their people and financial strategies.

HOW COLI BENEFITS THE ORGANIZATION

With Corporate-Owned Life Insurance, the employer is the applicant, owner, beneficiary of the policy and pays all the premiums.

As Jim and Susan discussed on the plane, COLI is a risk management tool used by organizations for a variety of purposes. But it is not a solution all by itself. Rather, it is a *funding mechanism* to support specific planning strategies.

> *"Think of COLI less like insurance, and more as a funding mechanism to support specific planning strategies."*

The obvious purpose would be to compensate an employer for the loss of earnings or competitiveness should a key employee become disabled or die. It could also finance the cost of replacing such a key figure. However, it could also offset the expense of a stock redemption agreement and can be used as a financing vehicle for other employee welfare benefit plans, such as generous health plans.

COST-EFFECTIVE DEFERRED COMPENSATION

Nonqualified Deferred Compensation under IRS Code Section 409A (NQDC) solves the problem of saving for retirement on a cost-effective basis. NQDC plans are private arrangements between a plan sponsor and selected Highly Compensated Employees (HCE) that allows pre-tax savings in excess of the amounts allowed by the IRS Code in qualified plans, like the 401(k). Other than that, most plans look a lot like the 401(k). There is generally a list of investment alternatives, and typically, participants can change asset allocations at will.

These plans may allow for voluntary deferrals only, or may include employer contributions like a match, or a benefit like Jim described above. In any case, they are 'Unfunded" (under the ERISA definition of "funded"), meaning the HCE has no right to the plan balance except as an unsecured creditor of the corporation, until a scheduled distribution occurs.

GETTING COMFORTABLE WITH UNFUNDED LIABILITIES

This "unfunded promise to pay" is how these plans work on a pre-tax basis, but the notion of an unfunded liability on the sponsor's balance sheet can be disconcerting for the HCEs, and unwieldy for CFOs who don't like to see an ever-increasing income liability on the balance sheet. To solve this, CFOs can elect to maintain a specific asset to offset the amount the company owes in future income, and can take it one step further by establishing a grantor trust, known as a Rabbi Trust. Rabbi Trusts segregate the asset from the general assets of the company, so that they can only be used to satisfy the obligations under the plan. We call this "informal funding." This will meet the ERISA requirement of being unfunded.

> *"COLI solves the tax challenge created when a taxable grantor trust is used to satisfy unfunded liabilities."*

The challenge with Rabbi Trusts, however, is that they are taxable entities. So, while the account balance liabilities are growing tax-deferred to the participant, the asset is unable to keep up because of the taxes on short and long-term distributions. As participants continually reallocate their account balance, taxable events are occurring without changing the total plan liability.

COLI OFFSETS TAXABLE GROWTH

Corporate-Owned Life Insurance offers the solution. The IRS has determined that the "inside build-up," or growth of the cash value, will not be taxed if it exists inside of a qualified life insurance product. The cash value represents a portion of the total death benefit, which a beneficiary receives income tax-free. Further, IRS Code Section 101(j) reaffirms that COLI death benefits are received income tax-free as long as its conditions are met, namely that the COLI covers no more than 35% of its employees, and the covered employees have signed a consent to be insured.

NOT YOUR TYPICAL LIFE INSURANCE

COLI is not structured like the retail life insurance we buy for its death benefit. Rather, COLI is typically designed with a minimum death benefit (just enough to qualify as life insurance) which is "wrapped" around a group of sub-accounts or the insurance company's general account. A sub-account is an insurance qualified mutual fund that is managed separately from the insurance company coffers.[1] So while these funds are buying and selling securities, and while fund balances are constantly reallocated, these funds remain permanently tax-deferred as long as the policy remains in force.

> *"COLI is typically designed with a minimum death benefit—just enough to qualify as life insurance."*

The COLI death benefits, while structured to be the minimum relative to the premium, are not insignificant. Even though COLI expenses are low compared to taxable mutual funds (assuming the owner is a tax payer), they are not zero. In fact, in a typical private placement COLI structure, the expenses may be in the range of 100 basis points, depending on premium amounts, and the census of the insureds. But the cost of insurance on the pure term amount provides the death benefit which recovers the cost of the plan over time. The cost recovery aspect is appealing to stakeholders concerned about the expense of an Executive Benefit Plan. *Figure 1* provides a comparison of the typical difference between taxable mutual funds and assets invested under COLI.

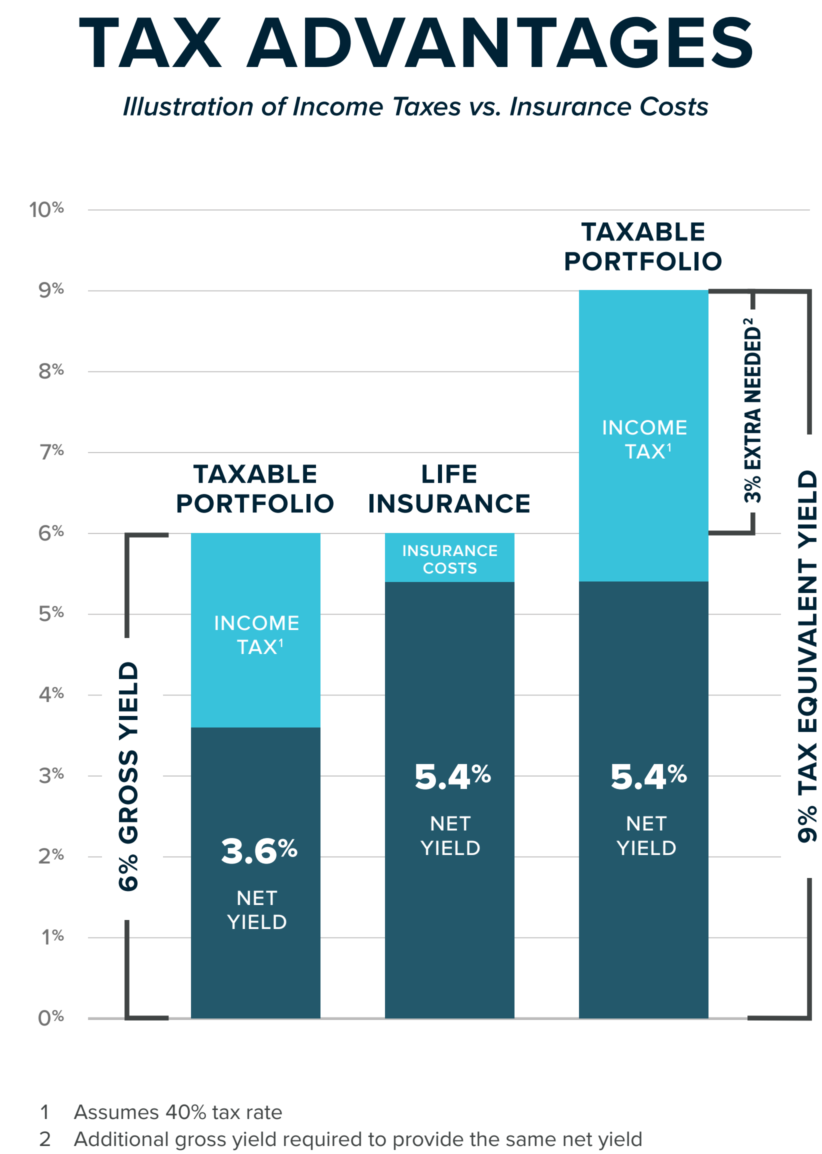

FIGURE 1

Put another way, COLI is what allows the plan sponsor to credit the participant account balances with the total pre-tax return on the selected funds, and to pay for the plan administration and related expenses over time. It is an excellent funding platform that secures financial efficiency over multiple generations of executives.

THE NONQUALIFIED DEFERRED COMPENSATION (NQDC) PLANNING PROCESS

You may be wondering what Susan would take away from her conversation with Jim. How will she manage the process of establishing the sort of solution that Jim described? To do so, it's important to understand the landscape of Nonqualified Deferred Compensation Planning. Let's look at four available alternatives.

1. BUNDLED SOLUTIONS FROM INSURANCE CARRIERS

Some insurance carriers offer bundled solutions for nonqualified deferred compensation. They provide the plan documents, administration, insurance solutions and ongoing record keeping.

The challenge for the plan sponsor here is obvious. Why *this* insurance carrier? Does bundling take away flexibility or objectivity? Is the insurance product the solution to our human capital challenges, or should we be more focused on design alternatives?

2. SIMPLE PLANS FROM RECORD KEEPERS

Often, we see NQDC plans provided by the 401(k) record-keepers, usually as a courtesy to the plan sponsor. In fact, that's how non-qualified plans began after Congress limited the income recognition for qualified plans.

Sometimes this might be an adequate, simple solution. But plan designs may be limited to simple 401(k) features, and cannot take full advantage of the flexibility of the 409A statute. In addition, the funding for the plans are often limited to the taxable funds available by the 401(k) providers. That means if the sponsor is interested in COLI funding for its inherent advantages, an additional COLI administrator is required, which may duplicate efforts in some respects.

3. THIRD PARTY ADMINISTRATOR PLANS

Another approach is to go directly to a TPA/Record keeper for non-qualified plans. Good, independent record keepers are vital to handling the ongoing administration, communication, web portal and technical resources.

However, they may not be as familiar with retirement design

strategy, compensation benchmarking, and integration of retirement with the company's comprehensive total reward strategy. Should there be a company contribution to the plan? If so, how much? What is competitive in the marketplace? These are typically not questions for a record keeper, but for an advisor who specializes in solving complex compensation issues.

4. A COMPREHENSIVE APPROACH

A fourth and more comprehensive approach to the planning process may combine aspects of the first three. Susan could engage an executive benefits consultant to be her advisor and advocate in the establishment and ongoing administration of the plan. Here's how such a process might unfold.

BRING IN EXPERTISE

An executive benefits consultant must first understand Susan's objectives. While that sounds simple, there are many aspects worth considering:

- Is the mission to retain three founders?
- What about the other key executives?
- Do they have a stock-based incentive plan?
- Would they like to integrate their stock grants with the deferred compensation plan in order to preserve tax deferral after vesting?
- What portion of the long-term incentive budget should be directed to retirement planning?
- Who should be allowed into the plan?

Once the design variables are established, the independent consultant will understand which record keeper might be best suited for the level of complexity in the plan. Is it a simple plan needing a low-cost solution? Is participant experience with the web interface important? If necessary or desired, the consultant can run an RFP to help Susan understand the differences in cost, technology and participant/sponsor experience.

EVALUATE THE FINANCES

After partnering with the selected record keeper, the consultant will help Susan's finance department evaluate plan financing alternatives, insurance carrier selection (assuming the solution is unbundled), executive fund menu, and prepare the plan for enrollment. And remember, COLI is never the basis of a plan. It is simply a tool to be managed to offset the future income liability created by the plan.

> *"Remember: COLI is not the basis of a deferred compensation plan. It is simply a tool to be managed to offset the future income liability created by the plan."*

Key to Success

ASSIST PLAN PARTICIPANTS

Enrollment, education and communication are extremely important aspects of a successful plan. While the record keeper is the "face" of the plan to the participants, the consultant works with the sponsor and the record keeper to ensure that the messaging is right, the technical explanations are accurate, and that questions are answered completely.

Participants often have other parties interested in their decisions to the plan. Consultants should be available to take questions from spouses, accountants, financial advisors, attorneys, etc.

ONGOING OVERSIGHT

The final piece of the process is ongoing oversight. Susan's consultant keeps her team apprised of COLI performance, record keeper changes, best practices evolution and statutory issues as they occasionally surface. Independent consultants and record keepers represent Susan's team working in concert on behalf of the sponsor and participants. NQDC rules may be subject to change from time to time, and the penalties for noncompliance can be extremely disruptive.

This overview reveals that using COLI to fund NQDC plans does take some forethought, planning and effort. However, the financial efficiency, flexibility and appeal to participants make it worthy of consideration. This may explain its growing use not just by employers. Banks and insurance companies are recognizing the unique advantages that owning life insurance assets can offer, as we'll see next.

BANK-OWNED LIFE INSURANCE (BOLI)

Increasingly, banks are also now using life insurance as part of their mix of reserve assets because of its tax characteristics.

In a BOLI transaction, the bank insures the lives of a group of select management, pays the premium, owns the cash value and is the beneficiary of the death benefit of the policies, just as we described in COLI programs. However, having different investment criteria than the average corporation and being subject to more scrutiny, there are additional factors that make BOLI appealing. In fact, new BOLI transactions have tripled since 2009.[2] Here are some of the advantages driving this growth:

- BOLI is typically a high performing asset. While it matches the long-term nature of benefit plan liabilities, it typically provides a higher after-tax return than other bank eligible investments.
- The policies are institutionally-priced, single premium policies specifically designed for the BOLI market.
- Banks can enhance yield without increasing credit risk.
- BOLI can be a key driver of non-interest income.
- BOLI offers a viable alternative to loan growth.

Currently, BOLI is being used by over 3,000 banks nationwide to offset the rising costs of employee benefit programs and over $170 billion of BOLI cash values reside on bank balance sheets today.[3]

Historical Insight

REGULATION STABILITY

As with any unique asset, clear direction is needed from oversight bodies before investors grow comfortable with the long-term prospects of holding it. Fortunately, the tax and regulatory environment that supports BOLI has remained stable.

- *In 2004, Bank regulators laid out a blueprint for BOLI purchases and risk management.*[4]
- *Congress and the IRS created a safe harbor for COLI/BOLI and confirmed its use as a benefit funding tool.*[5]

INSURANCE COMPANY-OWNED LIFE INSURANCE (ICOLI)

Insurance carriers, like banks, are permitted to purchase life insurance designed for the institutional investor market.

As we write this, the total ICOLI held by life and property and casualty carriers is approximately $22 billion among 249 companies. Expected placements in 2017 exceed $1 billion.[6]

The primary benefits of ICOLI in support of Full Fair Value Accounting could be:

TAX-FAVORED INVESTMENT GROWTH

Invest the cash value in eligible assets that would otherwise generate taxable yields. By making the yields tax-deferred/tax-free, the policy loads are 100± basis points vs. tax loads of 250± basis points depending on yield.

FAVORABLE ACCOUNTING TREATMENT

ICOLI accounting enables the recognition of both realized and unrealized gains in income (“other income”) similar to trading securities (without taxation).

EXTENSIVE INVESTMENT MENU

Depending on the carrier, ICOLI investment menus make available between 100 and 300 institutionally priced investment options across traditional and alternative style categories.

FAVORABLE RISK-BASED CAPITAL TREATMENT

The NAIC Risk-Based Capital (RBC) charge for ICOLI is 5% for P&C insurance. ICOLI is held as an “other than invested asset” regardless of the underlying investment allocation. AM Best and Standard & Poor’s have provided guidance on ICOLI. The Best Capital Adequacy Ratio (BCAR) adopts a similar asset charge when the ICOLI assets do not exceed 5% of capital surplus.

UNDERWRITING CONSIDERATIONS

As Susan expressed in our opening story, one of the biggest concerns when purchasing life insurance is the health of the insured individual and the impact that can have on a policy being issued and the amount of premium to be paid. However, if the pool of key individuals is large enough, and the amount of coverage reasonable, this is not likely to be an obstacle.

GUARANTEED ISSUE

For those plans that will cover a broad section of key executives (25 or more as a rule of thumb), the COLI carriers will typically extend a guarantee issue offer of $2.5 million per life. The process is simple and codified in the IRS section 101(j).

The best practice under this scenario is to confidentially inform the selected group (for example, the top 35% of income earners) and ask that they give their consent to be insured by the employer. There are usually just a few questions:

- Are you a US Citizen?
- Do you use tobacco?
- Have you been hospitalized in the last 90 days?

As you can see, it’s simple and non-invasive. If a person chooses not to give their consent to be insured, we simply move on to the next individual.

MEDICAL UNDERWRITING

When a company has one or more owners, or key people, and need large life insurance policies of $10 million or more, carriers will want to obtain financial, medical, and lifestyle evidence of insurability.

FINANCIAL EVIDENCE

The insurance and re-insurance carriers want to understand the economic value of an insured's contribution to the employer. If the policy is to fund a buy-sell agreement, evidence of the business valuation and ownership stake will be required. For key person insurance, insureds need to provide justification for the face amount and can usually insure for 10 to 20x annual income. Ultimately, logic drives the financial evidence standard: if this person dies, what is the economic impact and to whom?

MEDICAL EVIDENCE

This area is logical also, inquiring as to height, weight, medications, blood pressure and tobacco use. Most often, a carrier-approved nursing facility can schedule a convenient appointment at the insured's desired location to complete a basic Paramedical exam—requiring about 30 to 45 minutes. The insured can expect:

- A medical questionnaire
- A blood draw
- A urine specimen
- A resting 12-lead EKG

In addition to this information, the carrier may want attending physician statements from all doctors seen in the last 5–10 years.

LIFESTYLE EVIDENCE

Skydivers need not apply! Actually, we joke about that, but a skydiver will be considered for insurance IF they will accept a waiver of coverage for death due to a skydiving accident. What carriers are really looking for are hazardous hobbies, frequent foreign travel to war zones and areas where, historically, insured individuals tend to disappear and no bodies show up! Yes, fraud

and attempted fraud is rampant in the life insurance industry and carriers must protect against this with background checks.

> *“Fraud is rampant in the life insurance industry and carriers must protect against this with background checks.”*

Even though the medical underwriting may appear challenging, please know that the insurance companies want to issue policies—that is their business. It is very important to have a skilled and experienced insurance broker build the case and interact with the carrier to get the best possible insurance offers. For more on just how important this kind of assistance can be, and the impact it can have on obtaining the best priced coverage, please see *Chapter 8: Competitive Underwriting*.

REGULATORY ACCEPTANCE AND PURCHASE LIMITATIONS

As previously mentioned, there are statutes and guidelines that cover the placement of the types of institutional insurance we have covered. These are subject to change, so it is advisable to consult with a professional who remains current on these matters.

As we write this chapter, there are some important guidelines to consider:

- An institution should estimate the size of the employee benefit obligations or the risk of loss to be covered and ensure that the amount of insurance purchased is not excessive in relation to the estimated present value of the expected after-tax employee benefit costs for the entire census.

- The maximum ICOLI regulators like to see is 25% of Total Adjusted Capital (TAC). However, for the more favorable RBC and BCAR asset charges, 5% of Total Adjusted Capital is the maximum. Over 5% will cause RBC and the rating agencies to “look through” the policy and assess charges based on the underlying mutual fund type invested in the ICOLI.

- IRS Section 101(j) requirements, which entails the following:
    - Limits insured group to the top 35% of the most highly paid employees.
    - Mandates notification in writing that the employer intends to insure the employee's life and for how much.
    - Requires notification that the employer will be the beneficiary of the insurance.
    - Mandates the employee to give written consent to be insured and that coverage may continue past employment.

CONCLUSION

By now, you may be thinking a little differently about the strategic role that COLI may play in an organization. Ultimately, COLI is a risk management tool that can help:

- Retain top talent
- Make deferred compensation more affordable
- Reduce the impact in the sudden loss of institutional knowledge
- Fund key planning strategies
- Protect the interests of owners, shareholders and customers
- Serve as a tax-favored investment strategy

COLI is a specialized area of life insurance with specific requirements and limitations. However, for the Life Insurance 10X advisor who has the knowledge and patience to use it properly, COLI is well worth explaining and including in the financial toolbox of any company seeking to maximize their results and competitive standing.

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1 Investment of cash values held in general accounts are at the discretion of the insurance carrier, and subject to the claims of its creditors in the event of insolvency. Separate account investments are chosen by the policy owner, and held apart from the insurance company's regular assets, providing a layer of protection. For a discussion on the merits of each, see *Chapter 3: Types of Policies.*

2 "BOLI*tracker*™." *The Newport Group*. 2017.

3 "BOLI*tracker*™." *The Newport Group*. 2017.

4 Office of the Comptroller of Currency, Bulletin OCC 2004-56.

5 IRC §101(j).

6 "2016 Year End Statutory Filings." *SNL Financial*.

PROFESSIONAL DESIGNATION DEFINITIONS

- Certified Financial Planner (CFP®) – The CFP® certification marks identify professionals who have met the high standards of competency and ethics established and enforced by CFP Board. CFP Board's Standards of Professional Conduct require CFP® professionals to act in their clients' best interests. For more information, see https://www.cfp.net/about-cfp-board/cfp-certification-the-standard-of-excellence

- Certified Public Accountant (CPA) – As with many other professions, accountants have a number of professional credentials and certifications designed to ensure a high level of professionalism. The most widely sought credential is the CPA, or certified public accountant. It is both a designation and a certification process. For more information, see http://www.aicpa.org/BecomeACPA/Pages/default.aspx

- Chartered Financial Consultant (ChFC®) – A professional designation representing completion of a comprehensive course consisting of financial education, examinations and practical experience. Chartered Financial Consultant designations are granted by The American College upon completion of seven required courses and two elective courses. For more information, see https://www.theamericancollege.edu/designations-degrees/ChFC

- Chartered Life Underwriter (CLU®) – A chartered life underwriter (CLU) is a professional designation for individuals who wish to specialize in life insurance and estate planning. Individuals must complete five core courses and three elective courses, and successfully pass all eight two-hour, 100-question examinations in order to receive the designation. For more information, see https://www.theamericancollege.edu/designations-degrees/CLU

- Million Dollar Round Table (MDRT), Top of the Table (TOT) – for a list of membership requirements, see: https://www.mdrt.org/membership/requirements/

- Association for Advanced Life Underwriting (AALU) – for a list of membership requirements, see: https://www.aalu.org/membership/join-aalu/
- Life Underwriter Training Council Fellow (LUTCF) – NAIFA's Life Underwriter Training Council Fellow (LUTCF®) Designation Program is often considered the first designation any insurance professional should earn and has delivered value to more than 70,000 professionals since 1984. For more information, see http://www.naifa.org/professional-development/pdp/lutcf
- Registered Financial Consultant (RFC®) – A professional designation awarded by the IARFC to financial consultants who meet high standards of education, experience and integrity. For more information, see: http://www.iarfc.org/default.asp
- Licensed Insurance Consultant (LIC) – A counselor's license will allow a person to counsel in one or more of the following areas with the proper qualifications: life (LI) insurance, accident and health (AH) insurance and/or property and casualty (P&C) insurance. Persons admitted to the practice of law in Michigan may counsel insurance without obtaining a license, but cannot represent themselves as licensed counselors by the State of Michigan. For more information, see http://www.michigan.gov/difs/0,5269,7-303-22535_60490_23035---,00.html
- Trust and Estate Practitioner (TEP) – A designation that is recognized worldwide and is a way to formally identify qualified trust and estate practitioners and distinguish them from non-specialists who occasionally deal with trusts and estates. For more information, see https://www.step.org/sites/default/files/Basic_principles_of_marketing/Why_Become_a_TEP_2011.pdf

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