

# TAX REFORM ANALYSIS: ECONOMIC IMPACT ON BOLI



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## ABOUT THE AUTHOR

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## DO LOWER TAX RATES WARRANT BOLI SURRENDERS?

On January 4, WSFS Financial Corporation [announced a series of actions](#) resulting from the enactment of tax reform under the Tax Cuts and Jobs Act ("[H.R. 1](#)")<sup>1</sup>, including the planned surrender of BOLI policies.

While we have no direct knowledge of or involvement with WSFS's BOLI program, we believe this announcement is noteworthy to anyone involved in managing BOLI programs. We recommend that all BOLI owners evaluate the economic attributes of BOLI post-H.R. 1, since favorable tax treatment is an element of BOLI's attractiveness. Additionally, this announcement may generate similar inquiries across the banking industry.

## ANALYSIS OF WSFS BOLI SURRENDER ANNOUNCEMENT

As of 9/30/2017, WSFS owned approximately \$103 million of BOLI (\$63 million SA and \$40 million GA). The bank applied a 20% risk weight to its SA BOLI. WSFS's BOLI to Capital ratio was approximately 14.4%.

Based on the figures in the bank's press release, we posit the contracts were MEC contracts with approximately \$77 million of cost basis.<sup>2</sup> If

reasonably accurate, the policies would have tax deferred gains of ~\$26 million; or 33% of cost basis. It is interesting that the bank concluded that surrendering BOLI and redeploying the capital into alternatives outweighed the impact of incurring an \$8 million tax charge.

The bank noted that its BOLI policies were "no longer accretive to the Company's expected high-performance goals for ROA." We interpret this to mean that the BOLI policies' projected ROA was under the bank's targets. It is not entirely clear whether the bank's economic analysis included the opportunity costs associated with incurring taxes upon surrender.

WSFS also noted that BOLI presents ongoing administrative complexities and that the majority of its insured pool were no longer active employees. Policies on inactive employees are often more challenging to improve (i.e., via IRC Section 1035 exchange).

<sup>1</sup> Official title of the Act is *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*.

<sup>2</sup> This would result in surrender tax costs of approximately \$8 million and \$11.6 million at effective tax rates of 21% and 35%, respectively.

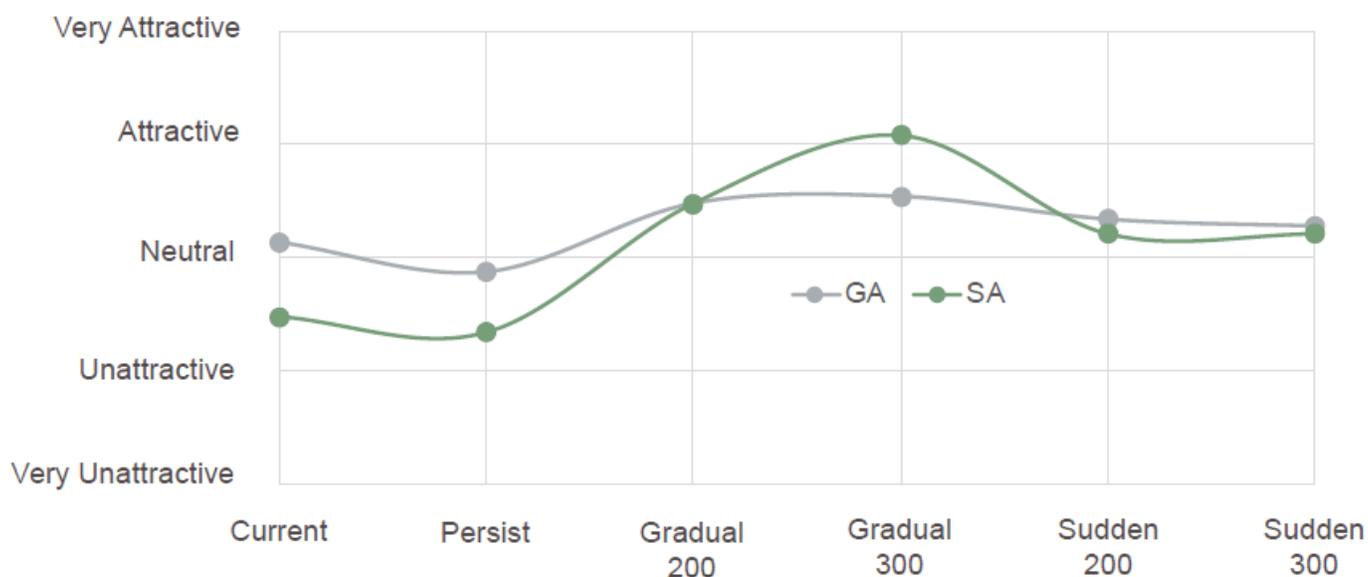


## SENTIMENTS FROM OUR SURVEY OF BOLI OWNERS

In the 4<sup>th</sup> quarter of 2017, we conducted a [survey](#) of those involved in managing BOLI programs. In addition to various other topics, we asked for views on the relative attractiveness of BOLI yields and the potential impact of corporate tax rate reductions.

Most respondents indicated that yields and ROA assessments were the primary performance measurement applied to BOLI programs. As a follow up, most respondents indicated that BOLI yields are compared to either prevailing corporate bond yields of similar credit quality (for GA BOLI) or fixed income indices like the Barclays Agg or MBS (for GA and SA BOLI). Most respondents indicated that other factors such as illiquidity, administrative complexity, etc., were considered only on a qualitative basis.

We asked participants to evaluate the attractiveness of BOLI yields on a current basis, as well as under a number of future scenarios, including persistent rates at current levels and various rising rate scenarios. The chart below shows the average responses.



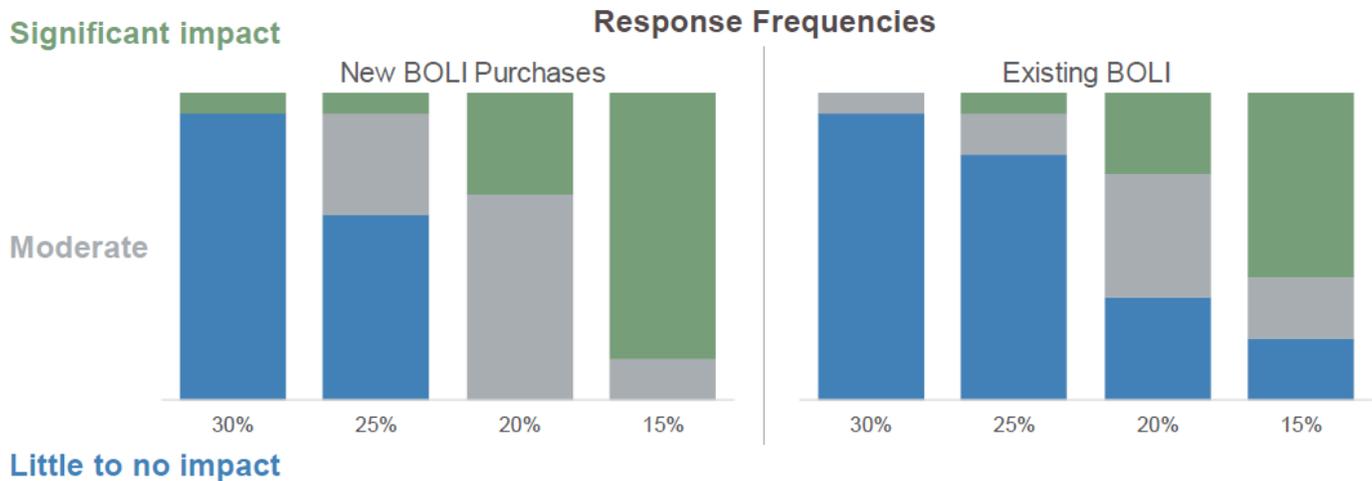
In short, SA yields were deemed relatively unattractive in the current environment, but neutral-to-attractive in higher interest rate environments. GA yields were judged relatively neutral in all scenarios.

Separately, we asked survey participants how BOLI would be impacted if corporate tax rates were reduced to various levels. The thresholds and choices provided were as follows:

Level of Impact	New BOLI Purchases	Existing BOLI
Little to no impact	No change in new purchase interest/activity	Virtually all policies retained
Moderate impact	Only extremely efficient contracts will be purchased	Less efficient contracts surrendered
Significant impact	Virtually no new contracts will be purchased	Policies deemed unattractive; surrenders likely depending on inside buildup



The charts below summarize the response frequencies at each tax rate.



At the 20% tax rate level, there was a wide range of views on the likely impact to existing programs – ranging from virtually all policies being retained to a view that most policies would be deemed unattractive. At a 25% tax rate level, the majority of respondents expected relatively little impact on existing holdings.

## OUR ECONOMIC ANALYSES AND FINDINGS

### *Modeling Approach*

When President Trump was elected in November 2016, joining a Republican-controlled Congress, the probability of material changes in tax law increased. We dedicated considerable resources to evaluating the potential impact of tax rate changes on existing BOLI programs and developed an analytical model that can incorporate various assumptions about tax rates, capital costs and returns on alternative assets.

We approached the analysis from two distinct perspectives:

1. Under a given scenario, what choice (retention of BOLI or surrender of BOLI) maximizes value to the institution on a standalone basis; and
2. Under a given scenario and assumptions that correspond with an alternative investment, what choice (retention of BOLI or surrender of BOLI and immediate reinvestment) maximizes value to the institution.

We note that the standalone analysis is most appropriate if the institution is not capital constrained. In other words, under a standalone analysis, as long as the ROA of the BOLI program exceeds an institution’s weighted average cost of capital (WACC), then retention of the asset maximizes value.

However, if an institution is capital constrained, we observe that BOLI surrenders may be advisable if alternatives are more compelling and if the capital constraints would otherwise preclude the institution from pursuing the alternative investment without surrendering the BOLI.

In our modeling, both perspectives are tested on an NPV basis, with all cash flows discounted by the applicable WACC as determined by input assumptions.



## Key Assumptions

Our model allows for variable inputs for an institution's funding costs and equity costs. Recognizing that each institution's funding costs and cost of equity are unique and proprietary, the assumptions we used in determining the WACC for the findings described below are worth noting.

- Funding Cost assumptions:
  - We assumed that initial funding costs approximate the current 5-year swaps rate plus 50 bps.
  - Subsequent years used a constant spread between the investment yield and the funding cost. For example, if the scenario reflected rising interest rates, the modeled funding cost would increase in parallel to the interest rate assumption.
- Capital assumptions:
  - BOLI asset RW equals the actual RW of the program under Basel III
  - Tier 1 Capital assumed to be 12.5% of total RWA
  - Cost of equity capital of 10%
  - Subsequent years used a constant equity risk premium. For example, if the scenario reflected an assumption of rising interest rates, the cost of equity capital rose in parallel.
- Alternative investment assumptions:
  - RW of 100%
  - Investment yield 100 bps higher than gross BOLI yield
  - Gains taxable at the effective tax rate

In scenarios where we assume changes in future interest rates, our model incorporates parallel changes in the funding and equity cost assumptions.

## Key Output Metrics

In our summary below, we focus on the following key output metrics:

- BOLI Return Spread over BOLI WACC: This translates the BOLI program's overall ROA on an NPV basis into an annualized spread over the BOLI WACC. This value excludes tax consequences of surrendering the contracts. If this output metric is positive, it implies that the BOLI program will outperform the applicable cost of capital.
- Opportunity Cost BOLI Return Spread over BOLI WACC: This translates the BOLI program's overall ROA on an NPV basis into an annualized spread over the BOLI WACC after accounting for the tax cost associated with surrendering the contracts.
- Value Gained (Lost) from Surrendering BOLI and Reinvesting in Alternative Asset: This compares the NPV of 1) surrendering the BOLI and reinvesting in the alternative asset to 2) retaining the BOLI and reinvesting only the death benefit proceeds in the alternative asset.

## Summary of Findings

We applied our analytical model to various in-force policies that we administer and to numerous hypothetical scenarios. Not surprisingly, a reduction in the corporate tax rate has a negative impact on the attractiveness of BOLI. The magnitude of impact varied by contract. The BOLI Return Spread over BOLI WACC decreased by ~40-60 bps. Despite the materially lower return spreads, BOLI continued to outperform the applicable cost of capital (ranging from ~25-50 bps annualized spread above WACC).

In comparison to the BOLI Return Spread, the Opportunity Cost BOLI Return Spread directly depends on the amount of inside build-up in a given tranche of BOLI. Tranches with little inside build-up have Opportunity Cost BOLI Return Spreads that are very close to the BOLI Return Spread. Contracts with significant inside build-up and exposure to MEC



excise taxes have Opportunity Cost BOLI Return Spreads that are markedly higher than the asset return spreads. For example, the table below shows the Opportunity Cost BOLI Return Spreads for a hypothetical MEC contract at varying levels of inside build-up.

Inside Build-Up Percentage <sup>1</sup>	Opportunity Cost BOLI Return Spreads (Annualized)	
	35% Marginal Tax Rate	21% Marginal Tax Rate
0%	0.81%	0.41%
20%	1.26%	0.72%
40%	1.62%	0.95%
60%	1.91%	1.14%
80%	2.15%	1.29%
100%	2.35%	1.41%

<sup>1</sup> Inside Build-Up Percentage equals Inside Build-Up divided by Cost Basis. Inside Build-up equals the difference between the cash surrender value and the cost basis.

While the lower tax rate materially reduces the opportunity cost associated with surrendering BOLI, our analysis indicates that seasoned policies continue to bear significant opportunity costs even at the lower marginal tax rate. Therefore, on a standalone basis, we did not observe any instances where surrendering a BOLI contract was compelling economically.<sup>3</sup>

The final step of our analysis considers whether surrendering BOLI might be advisable to free up funds to invest in an alternative investment. Again, this scenario is conditioned on the premise that the institution is capital constrained. Absent a binding capital constraint, the institution would evaluate BOLI and the alternative investment each on a standalone basis. As noted in the assumptions section above, we assumed the alternative investment would earn 100 bps spread over the *gross* BOLI crediting rate.

For BOLI tranches with little inside build-up, we observed a crossover tax rate as high as 20%. This means that if an institution is capital constrained, believes it can earn a spread of 100 bps per year over the gross return of BOLI, and has relatively little tax cost associated with surrendering the BOLI, then pursuing the alternative investment may be advantageous.

For contracts with more significant inside build-up (e.g., 20% or more), the tax rate would need to be considerably lower (ranging from 10%-15%) for surrendering and reinvesting to outperform retention of the BOLI asset.

## CONCLUSION

To our knowledge, WSFS is the only financial institution thus far to announce its intention to surrender BOLI policies in the aftermath of H.R. 1. The press release issued by WSFS refers to both quantitative and qualitative factors that impacted its decision. It is possible that anomalies (e.g., excessively high policy costs) with WSFS's BOLI caused them to perform materially worse than the actual and hypothetical contracts we have analyzed with our model. Nevertheless, our analyses suggest that BOLI surrenders will continue to be infrequent post-tax reform because most contracts will continue outperforming the owners' costs of capital.

If you would like more information regarding our modeling approach and results, please [contact us](#).

<sup>3</sup> It is worth noting that our analysis was limited to Separate Account policies at current product pricing. The relatively higher capital costs of General Account policies would have a material impact on the outcome of the analysis. Also, policies with material exposure to higher cost of insurance (COI) charges in the future present economic risk that is not considered in our baseline analysis.

