Frequently Asked Questions about Purchases by Not-for-Profits of Company-Owned Life Insurance ("COLI")

Q: ***Why do not-for-profits institute COLI programs?***

A: Primarily to finance employee benefit plan expenses and increase net income. For example, not-for-profits have substantial costs for medical, group life, and other basic insurance as well as qualified and nonqualified benefit plan expenses that can be financed with Company–Owned Life Insurance ("COLI"). The reasons not-for-profits use COLI include:

- □ COLI matches the long-term nature of benefit plan expenses.
- □ COLI assets can be matched with benefit liabilities to offset the impact on earnings created by the benefit expenses.
- □ Use of COLI to fund benefits can be a self-completing program
- □ COLI can be structured so that the not-for profit funds its benefits obligations and recovers its premium cost as well.
- □ COLI death benefits or cash value assets are available to pay pre-retirement survivor benefits.
- □ COLI provides important indemnification for the loss of one or more key executives (key person life insurance).

Do many employers have COLI plans?

A: Many not-for-profits, including some of the country's largest, are using COLI to fund benefit obligations. For-profit companies also use COLI in this way. Based on industry surveys from 2009 done by Clark Consulting, 71% of the Fortune 1000 companies finance SERP obligations with COLI programs; and of the 50 top banks and thrift institutions in the United States, 43 have implemented COLI programs.

Q: ***How does COLI work?***

A: The not-for-profit purchases insurance on lives of a group of employees. The insureds usually include a group of highly compensated or key management employees, for example, assistant directors and above.

The not-for-profit pays the premium(s) and owns the cash value of the policies. The not-for-profit is also the beneficiary of the insurance. The insured employees do not receive any of the insurance benefits directly, nor do they pay any of the premiums. The coverage does not replace nor interfere with any other insurance provided by the not-for-profit (e.g., group-term life insurance).

The COLI policies produce financial statement income for the not-for-profit if the cash value increases exceed the premiums paid. The income earned may be higher or lower than the return available on other alternative investments.

Q: ***Do the policies actually fund the benefits like a pension plan funds retirement benefits?***

A: No. The policies are part of the general assets of the not-for-profit. Properly stated, the insurance informally finances the cost of the benefits. The policies are often placed in a grantor trust (generally a "rabbi" trust), which is an asset of the not-for-profit, or they may be held by the not-for profit directly and not otherwise segregated.

Q: ***What are the different types of COLI policies?***

A: Two basic types are characterized as:

1. **General Account COLI –** These credit a fixed interest rate annually to each policy. The interest rate is based on the expected return of the investment assets purchased by the insurance company less a margin for expenses. These assets are held in the general account of the insurance carrier. Either a "new money" approach or a "portfolio" approach (both described later) is used to determine credited interest rates. General Account COLI policies may provide minimum annual interest guarantees in addition to full book value (cash value) guarantees and asset default protection.

2. **Separate Account COLI –** The interest rate

credited to a Separate Account COLI policy is a variable yield that is based on the return on the underlying policy assets less a margin for expenses. These assets are selected by the not-for-profit and are held in separate accounts of the insurance company. The separate account assets are sheltered from the general creditors of the insurance company in the unlikely event of the insurance company's insolvency. Unlike a General Account contract, the cash values of a Separate Account contract will fluctuate with the market value of the underlying assets and are fully subject to the risk of asset default. The fluctuations of asset values have a direct impact on the purchaser's balance sheet and income statement, since the cash value represents the book value of the life insurance contract. Some carriers employ a hedge strategy to smooth the annual returns.

Q: ***Is one type of COLI policy better than another?***

A: The answer depends on a not-for-profit's desire to participate in selecting the investment mix of the funds underlying the COLI policy values. If the not-for-profit does not want the burden of selecting the investment mix and accepting the risks associated with the investment results, General Account COLI is preferable. There are no investment decisions for the not-for-profit to make, and it will have the underlying protection of a minimum interest guarantee. On the other hand, if the not-for-profit is comfortable that it can select an investment mix likely to outperform the investment results of the insurance carrier's general account and is willing to accept full risk for investment results, the Separate Account COLI policy may be preferable. Some not-for-profits split their coverage so that a portion of the not-for-profit's contributions is allocated to each type of policy.

Q: ***What are the differences between a "New Money" rate product and a "Portfolio" rate product?***

A: "New Money" and "Portfolio" describe the two philosophies or methods used by insurance companies in setting credited rates on their insurance policies. A New Money philosophy credits each policy with an interest rate based on assets available specifically at the time of purchase. These assets are tracked and determine the future interest of each specific case. A Portfolio approach is based on a pooling philosophy. The insurer pools all its assets and all its policies and determines a rate for all policyholders regardless of when the policies were purchased. While New Money policies usually are more responsive to changes in interest rates than Portfolio policies, interest rates trends and the underlying investments in these products will ultimately determine which type of product is better over a longer time horizon.

MAKING A COLI PLAN WORK

Q: ***Do the insurance policies have to be placed into a separate account or trust?***

A: No, the policies always remain part of the general assets of the not-for-profit. For administrative or other reasons, the not-for-profit may choose to implement a grantor trust to own and hold the policies.

Q: ***Does the not-for-profit keep the coverage when the insured employees terminate or retire?***

A: Yes. The coverage on each individual insured is carried as part of an aggregate COLI pool. To make sure death benefits are collected on retired employees

COLI pools administered by Schiff Executive Benefits

employee dies we access information via the Social Security System to file the death claim with the carrier.

Q: ***What has been employee reaction to the plans?***

A: While an employee cannot be forced to be covered within the COLI pool, the employee must sign a consent that notifies the participant that the insurance is being purchased on their life, that the owner and beneficiary will be the corporation, and that the policy will remain in force even after separation from the company. It has been our experience that about 90% of eligible employees "opt" to allow their employer to insure them.

Q: ***Do the employees receive any of the cash benefits from COLI?***

A: Generally, no. However, some not-for profits provide some additional death benefits to insured COLI participants by allocating a stated portion of the proceeds for the benefit of the participant's designated beneficiaries.

Q: ***How long does it take to implement a COLI arrangement?***

A: Normally 2 to 3 months from start to finish.

COLI FINANCIAL IMPACT

Q: ***Will COLI have an impact on a not-for-profit's financial performance?***

A: COLI may favorably impact a not-for profit's financial performance by creating higher net income to offset the benefit expense. The result is an increase in earnings.

Q: ***Are COLI premiums a charge to earnings?***

A: To the extent that COLI premiums result in cash surrender value, the not-for profit is treated as having purchased an asset. COLI premiums (except for the recognition of any early surrender charges) require a cash flow outlay, but over time may enhance earnings.

Q: ***Is COLI liquid?***

A: Yes*. COLI policies allow the not-for-profit to borrow against the cash value, and the policies can be surrendered at any time and the cash value will be paid to the not-for-profit. In very large COLI programs, some carriers may require a 4 to 5 year surrender period to allow them to gradually wind down their investment in the arrangement.

Q: ***What happens if the coverage is surrendered?***

A: The carrier pays the not-for-profit the cash surrender value of the policies.

Q: ***If the insurance had to be surrendered in the future, is COLI still a good deal?***

A: Yes. The investment yield is still attractive.

Q. ***What is the credit risk of a COLI program?***

A: Before any COLI purchase, the not-for profit should carefully review (with our help) the financial strength of each proposed carrier, as well as its track record in the market. Regardless of product type, the financial strength and reputation of a carrier is critical to the future viability and credibility of a COLI program. Separate account products minimize the credit risk in the event the carrier becomes insolvent as the assets are protected in a separate account. However, insolvency is an infrequent event.

COLI ACCOUNTING TREATMENT

Q: ***How is the income earned and recorded?***

A: The not-for-profit earns income in a COLI arrangement from two sources. The first is from the growth of the cash value of the policy. While the full cash value works for the not-for-profit, the not-for-profit records as an asset the cash surrender value (the full cash value less any applicable surrender charges in the event the contract is surrendered in the year being recorded). The cash value increases each year as the insurance carrier credits interest or as the separate account increases in value. The second source of income comes from the insurance proceeds paid to the not-for-profit as each insured employee dies. The accounting treatment for a typical COLI plan can be summarized as follows:

- COLI purchase is reflected as an OTHER ASSET.
- Earnings (increases to cash surrender value) will be recorded as a credit to an income account (OTHER INCOME).
- Receipt of the net-at-risk portion of death proceeds is also reflected as a credit to an income account (OTHER INCOME).

Q: ***How does the balance sheet change with the purchase of COLI?***

A: The not-for-profit will normally use funds generated through cash flow to purchase COLI. Since both are assets, there is no initial charge to the balance sheet (other than the possible recognition of an early year COLI surrender charge). However, since COLI may earn a rate of return that may be higher than other similar type investments, the income statement will show additional income, which translates into increased surplus.

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