The Northwestern Mutual Life Insurance Company

Bank Owned Life Insurance (BOLI)

Northwestern Mutual's General Account Product versus Separate Account Products

Northwestern Mutual®

Bank Owned Life Insurance (BOLI) can have a significant impact on a bank's financial position. Banks today have an array of life insurance products from which to choose.

Typically, banks purchasing life insurance as either informal financing for a nonqualified executive benefit plan or as an asset to offset general employee benefit liabilities will purchase permanent life insurance with a single premium. Within permanent life insurance, there are two types of product structure ("traditional whole life" and "universal life") and two choices for the investment of assets backing the cash value of the policies ("general account" and "separate account"). The Northwestern Mutual Life Insurance Company (Northwestern Mutual) offers a traditional whole life, general account BOLI product.

Recently, some publications, BOLI vendors, and insurance carriers have promoted separate account universal life products to the exclusion of all other product options. While separate account BOLI may be more appropriate for a certain segment of the banking industry, there are other situations where general account BOLI may be more suitable to the objectives and philosophy of the bank.

The purpose of this paper is to help bank decision-makers understand the differences between products. Armed with this knowledge, bankers can then ask the right questions in order to make an informed decision on what type of BOLI is best for their bank.

Policy Charges

All insurance carriers must cover the same basic set of costs: premium tax, distribution, underwriting and policy issue, administration, increase in reserves, death claims, etc. In addition, stock carriers (the vast majority of life insurance carriers today) must cover the cost of dividends paid to stockholders, a cost that mutual companies do not have. Carriers have considerable latitude in how they define and recover their costs. For example, one carrier may recover a certain cost by a direct charge against the policy's cash value while another carrier may recover the same cost through the spread between what is earned on investments and what is credited in interest.

Universal life policies were originally designed to allow changes in premium and death benefit after issue. This required that each charge and credit be explicitly defined. Even though BOLI policies are typically single premium, and therefore do not make use of this flexibility, the explicit charges are still shown. In contrast, a traditional whole life policy is built around a guaranteed death benefit and a schedule of increasing guaranteed cash values. These calculations, using state-mandated methodology and assumptions, do not lend themselves to showing separately – all costs are factored into the actuarial calculation.

Observation

Much is made of the "transparency" of universal life charges and credits. However, attempting to compare individual charges on a piece-meal basis is of little value, as it is rarely an "apples-to-apples" comparison. In addition, the transparency comes at a large cost – guarantees that are significantly weaker (see Guarantees section).

As with any product, the buyer of life insurance should focus on the value they are receiving, not on what the seller is charging. For example, a carrier that does a careful job of underwriting may have slightly higher acquisition expenses, but perhaps can charge significantly less for mortality costs due to superior experience. The carrier that does the best job on the fundamentals of investment return, expense control, and careful underwriting will be in the stronger position to provide the best long-term, overall value and the resulting rate of return. Northwestern Mutual has a long history of industry-leading operating fundamentals – low operating expenses, high persistency, and excellent mortality experience. These factors are not the only ones that directly affect the costs that Northwestern Mutual must recover from the policy – the fact that our policyowners stay with us for the long term allows for an investment strategy with a significant portion of assets in equities.

Product Illustrations

Illustrations demonstrate how a product will perform under a given set of assumptions. Illustrations are not estimates or projections of future results. Most states have adopted the National Association of Insurance Commissioners Life Insurance Illustration Model Regulation or a variation of it. These regulations, which apply only to general account products, prohibit the projection of improvement in any factor. In other words, the assumptions underlying each element of the general account illustrations must be no better than actual current experience. Some carriers allow the ability for illustrations to assume less than the current interest crediting rate.

Separate account illustrations are not bound by the same regulations. Carriers may base mortality assumptions on expectations that current improving trends will continue in the future. With respect to investment return, a gross rate up to 12% may be shown. A 0% rate of return with guaranteed charges is also required. The investment return that may be shown is not constrained by past performance of any particular separate account. It is also worthwhile to evaluate the illustration's investment expense assumptions to make sure that they are in line with the overall allocation which would be utilized after the policy is issued.

Observation

Northwestern Mutual has never projected improvement in any factor on an illustration, even for policies not subject to the NAIC illustration regulation. A bank considering separate account BOLI should ask if illustrations assume improvement in any factor. For both separate account and general account BOLI, a bank might want to request illustrations under more than one interest rate assumption to better understand potential variations in return. In addition, a bank should consider asking for actual values on existing BOLI policies. This provides an example of how a carrier has actually treated existing policyholders and should be a consideration for a bank looking to buy BOLI.

Guarantees

A traditional whole life BOLI contract provides a set of guaranteed cash values. These guarantees are based on an assumed interest rate and mortality table. The interest rate and mortality table used to determine the guaranteed cash values are prescribed by state laws and do not change after contract issue.

A general account universal life BOLI contract guarantees a minimum credited interest rate and maximum mortality charges, but does not guarantee a set of cash values. Although state laws generally do not require a minimum guaranteed credited interest rate, most carriers guarantee at least 3%. It is important to note that the minimum credited interest rate is not a minimum cash-on-cash rate of return. The guaranteed values will be based on the minimum credited interest rate less maximum guaranteed mortality and expense charges.

Separate account BOLI contracts do not guarantee a minimum credited interest rate, except to the extent that an associated stable value rider contains one (discussed later). They do guarantee maximum mortality and expense charges. The maximum mortality charges are the same as those allowed for general account universal life BOLI.

Observation

In general, traditional whole life BOLI contracts provide greater guaranteed values than universal life BOLI. The guaranteed values of a traditional whole life BOLI policy are based on a prescribed formula and assumptions. The guaranteed values increase each year and will ultimately be equal to the death benefit if the insured survives to the end of the mortality table. Universal life BOLI only provides guaranteed maximum charges and, if general account BOLI, a minimum credited interest rate. Universal life BOLI does not have a set of guaranteed cash values. Often the cash value that is based on guaranteed charges and credits will be zero before the end of the mortality table, typically by the life expectancy of the general population. In order to understand the worst case performance of these products, the bank should perform a side-by-side comparison of the guarantees of all products under consideration. In addition, the financial stability of the company is paramount in its ability to honor any guaranteed values in these “worst case” scenarios.

Investment Of Assets

BOLI assets can be placed either in the carrier's general account, or in one or more divisions of the carrier's separate account. With general account BOLI, the carrier determines how its assets are invested. The policy's internal rate of return is largely a function of the rate of return of the general account. In this instance, the carrier bears the investment risk. With separate account BOLI, the bank determines the allocation of assets among the policy's investment divisions. Because the policy's internal rate of return is a function of the divisions' rates of return, the separate account investment performance results (good and bad) are passed through to the bank. Stated another way, over the long term the bank bears all the investment risk.

The general account investment portfolio of all insurers is heavily weighted toward fixed-income investments, such as bonds and mortgages. Fund options of separate account BOLI typically consist only of bank-eligible investments. Banks generally may not invest in a fund of equity securities, thus the full array of investment options normally available to owners of separate account life insurance is not available to banks.

Northwestern Mutual's general account is worth noting because the investment strategy with respect to the percentage of investments in equities is significantly different from that of most carriers. As a mutual life insurance company, Northwestern Mutual can maintain

Observation

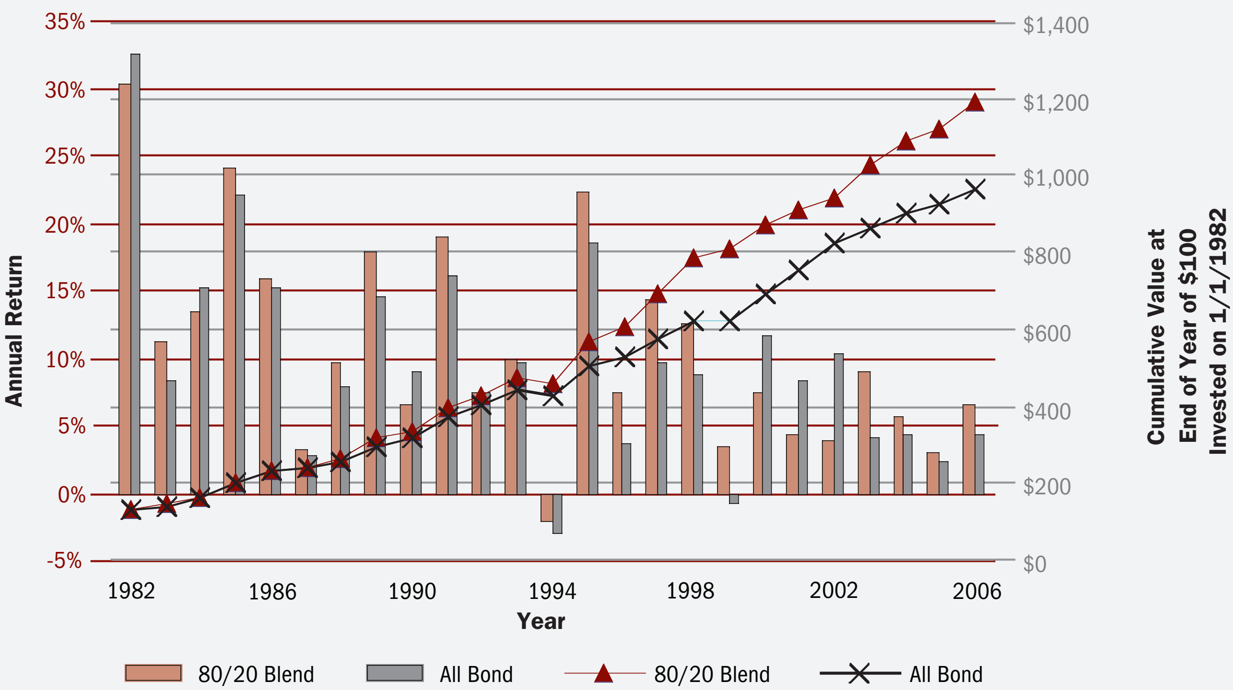
Northwestern Mutual's life insurance products in its general account portfolio can broaden the investment horizon for a bank, thus allowing a bank to potentially enhance its yields by including assets beyond separate account BOLI's typical strategy of holding only bank-eligible securities. Our dividend interest rate is a portfolio rate based on the total yield of all applicable investments. This includes older investments made at rates that were higher or lower than the rates at which the newer investments were made. Thus, the performance of its portfolio will differ from prevailing new money rates. The portfolio method of crediting interest protects policyowners by smoothing the effects of large swings in current interest rates.

To better understand the significance of Northwestern Mutual's investment strategy, the graph compares 25 years of Lehman aggregate bond returns to the returns based on a blend of 80% of these bonds and 20% of S&P 500 equities. If $100 had been invested on 1/1/1982 in these bonds, it would have grown to $962 on 12/31/2006. If $100 had been invested in the 80/20 blend of bonds and equities, it would have grown to $1,193 on 12/31/2006. Over that 25-year period, the all-bond investment produced an annual return of 9.48% while the blended investment produced an annual return of 10.43%, or approximately 95 basis points more than the all-bond investment. These historical results do not guarantee future results, nor do they illustrate the returns on any Northwestern Mutual life insurance policy. They simply demonstrate how a strategy similar to that of Northwestern Mutual's general account portfolio can produce long-term returns that are superior to those of a portfolio more heavily weighted in bonds.

a long-term focus on the investments in its general account. The objective is to generate competitive total returns, including both current income and capital appreciation while preserving the highest possible financial strength ratings. Northwestern Mutual's general account investment portfolio has a balance of about 80% fixed-income investments and about 20% equity instruments, which include public and private stock, limited partnerships, real estate, and commercial mortgages. It has both a level of surplus that is adequate to cushion against the volatility of equities, and a longer-term liability structure than other insurers – in part because of its excellent persistency (the degree to which policyowners keep what they purchased), and in part because of its outstanding mortality experience. The goal of Northwestern Mutual's general account portfolio is to produce a return of 60 to 75 basis points greater than the return on a 100% fixed-income portfolio.

Why don't other carriers pursue a similar investment strategy? The simple answer is – they can't. A combination of higher operating expenses, poorer persistency and mortality experience may force other carriers to maintain more liquidity. Stock companies often have less tolerance for fluctuations in return or downturns in asset values, due to Wall Street analysts' expectations and the corresponding negative impact on a company's stock price.

Historical Comparison of Blend of 80% Lehman Aggregate Bond Return / 20% S&P 500 Return versus 100% Lehman Aggregate Bond Return



Source: Calculated by Northwestern Mutual using information and data presented in Ibbotson Investment Analysis Software,

Stable Value Rider

The investment performance of a separate account BOLI policy will likely be more volatile than that of a general account BOLI policy. However, the volatility of the divisions of the separate account can be controlled through a stable value rider which smoothes the pattern of year-to-year earnings. Note that these riders are provided by an outside third party and carry a cost to the bank that is netted from the investment yield. Some providers do not offer a stable value rider to BOLI purchases under a certain size.

There is an important distinction between separate account BOLI policies with stable value riders and general account BOLI policies. General account BOLI policies provide either a set of guaranteed cash values in the case of traditional whole life BOLI or a guaranteed minimum credited interest rate and maximum mortality charges in the case of general account universal life BOLI. However, a stable value rider on separate account BOLI policies generally only provides a guarantee that the credited interest rate will be at least 0% before expenses. For an additional cost to the bank, the stable value rider will mitigate the volatility associated with separate account BOLI by protecting against changes in the market value of assets from changes in interest rates, but the rider does not protect against any asset defaults. Due to the carrier's diversified portfolio, a general account BOLI contract can mitigate the market value risk of specific investments or asset classes.

Observation

Care must be taken when purchasing a separate account BOLI contract with a stable value rider. The rider provides a guarantee to make up the difference between market value and book value, but only up to a specified amount (typically 10% to 20%). Greater volatility could render the rider ineffective.

OCC Bulletin 2004-56 and FASB's Emerging Issues Task Force Issue 06-5 provide guidance as to the value of policy assets that a bank can reflect on its financial statements. Banks should be aware that the rider may introduce restrictions on when the policy can be surrendered or exchanged, and how the bank receives its cash value. For example, some riders require that the bank surrender all the carrier's policies in order to receive the total book value and may spread the bank's receipt of the book value over a period of time (e.g., 5 years). Prior to the purchase of these products, a bank may wish to consider asking its auditor to review the rider's impact on the bank's financial statement. In fact, some stable value rider providers require banks to confirm in writing that the bank's auditor has reviewed the stable value rider provisions and approved the proposed accounting treatment.

Another factor to be aware of is that a stable value rider typically involves a third party. Under OCC Bulletin 2004-56, a bank's ongoing monitoring and analysis of its BOLI should include the evaluation of the credit risk related to the third-party stable value rider provider, thus adding another element of complexity.

Risk-Based Capital

Under current rules, separate account BOLI generally has a lower risk-based capital requirement than general account BOLI. Separate account BOLI risk-based capital allows a "look-through" to the actual investments held in the separate account fund option which are typically bank-eligible investments (this leads to a risk weighting factor as low as 20%). The risk weighting factor for general account BOLI is 100%.

Recently an agreement in principle has been reached between the various bank regulatory bodies regarding the implementation of the Basel II Accord in the United States for a core group of banks consisting of large United States banks that compete internationally. When adopted, the core group of banks will look to the credit risk of the insurance carriers in computing the risk-based capital requirement rather than BOLI's actual underlying investments. BOLI from insurers with more favorable credit ratings will carry a lower risk weighting factor than those from insurers with less favorable credit ratings. This approach will serve to neutralize the risk-based capital distinctions between separate account and general account BOLI for the core group of banks.

Observation

In evaluating which BOLI product to purchase, a bank considers many factors in addition to the death benefit provided. The importance of the lower risk-based capital requirement will vary by bank. For example, a well-capitalized bank may focus less on the difference in risk-based capital requirements between a separate account and general account product, and more on factors such as the long-term yield potential and guarantees.

Insurer Insolvency

It is often cited that one of the advantages is that separate account BOLI assets are not subject to the claims of general creditors whereas general account BOLI assets are. However, any activity (for example, poor management) that could adversely impact an insurer's general account also could affect a carrier's separate account. Moreover, if an insurer becomes insolvent, the claims of policyowners rank above those of general creditors, regardless of whether the BOLI contract is supported by a carrier's general account or separate account. The degree of "separateness" of the separate account assets depends upon state law, the language of the contract, and the management of the insurer, but under any circumstances, BOLI assets are not trust assets. General account or separate account, they are company assets, and in the event of a company's insolvency they are subject to the receivership process. How a separate account contract policyowner might fare if carrier insolvency occurred would be the result of a number of factors, some of which cannot be foreseen.

Observation

BOLI is expected to remain in force for a long period of time – perhaps 40 years or longer. Rather than focusing on separate account versus general account with respect to potential insurer insolvency, it is more important for the bank to purchase BOLI from an established carrier with strong financial ratings and a long-term track record that demonstrates its financial stability through different economic climates. While third-party ratings do not reflect the strength of the carrier's separate account, they do reflect the overall financial strength of the carrier. For example, A.M. Best states that "A Best's Financial Strength Rating (FSR) is an opinion of an insurer's ability to meet its obligations to policyholders." (See http://www.ambest.com/ratings/guide.asp.) Carriers have lower ratings, in part because they have a less successful business model that may show up in the charges and credits of the insurance product. Northwestern Mutual has consistently earned the best possible insurance financial strength ratings from all four major rating agencies: Standard & Poor's: AAA (11/2007), A.M. Best: A++ (7/2007), Fitch: AAA (7/2006), Moody's: Aaa (3/2006).

Experience Rating

Some carriers experience rate their separate account BOLI products. This means that all the insureds of a particular bank are placed in a separate pool and separate mortality charges are established. As new insureds are added and death claims occur, the mortality charges are adjusted. As the pool of insureds matures and deaths occur, the mortality charges increase and impact the performance of the remaining policies. There is concern by some over whether this type of arrangement is truly life insurance because, in the long term, there is not a significant transfer of risk from the policyowner to the insurer.

Observation

Experience rating presents a risk to the bank. If the IRS took the view that experience rated contracts do not qualify for the advantages of life insurance under the Internal Revenue Code, this could mean that the bank would be taxed annually on the cash value accumulation as well as on the death benefit at the time of death.

Conclusion

OCC Bulletin 2004-56 and related Interagency guidance stress that a BOLI purchase should follow the same safe and sound banking practice as any other bank decision. When conducting its pre-purchase analysis for risk management and product features, it may serve the bank to conduct the analysis in much the same manner as it would a loan. The insurance contracts could be treated like a loan document. What are the terms of the loan? What are the assets backing the loan? What are the credit ratings of the collateral?

Before accepting assertions about separate account products compared to those of general account products, and Northwestern Mutual BOLI in particular, all relevant factors must be considered. The regulatory agencies have laid out specific criteria for the evaluation of BOLI, both in a bank's pre-purchase analysis and its ongoing risk management. A bank may wish to consider such issues as the benefits of a well-diversified underlying portfolio versus a separate account of bank-eligible assets, accounting issues with separate account products with a stable value rider that might create uncertainty regarding the realization of a policy's full cash value, and long-term product performance versus short-term return. Because any purchase of BOLI is a long-term commitment, it is important that the risks, rewards, and unique characteristics of BOLI are understood.

Northwestern Mutual has consistently maintained the best possible insurance financial ratings from all four major rating agencies and is considered AAA by Standard & Poor's (November, 2007). Its financial strength along with the diversification of the general account assets and the active management of the investment portfolio help to protect its policyowners against market volatility and unexpected events. The commitment of Northwestern Mutual to provide its policyowners with superior value, while maintaining exceptional financial strength, will stand the test of time – just as it has for the past 150 years.

This paper has briefly described the investment strategy for the managed assets (which do not include policy loans) in Northwestern Mutual's general account.

The investment performance of the managed assets is reflected in the company's dividend scale interest rate for unborrowed funds (which also reflects charges for taxes and a contribution to surplus). This rate is set annually by the company as part of the dividend scale and is used in determining dividends for cash value policies in the company's general account. All other things being equal, a higher (lower) dividend scale interest rate for unborrowed funds means a higher (lower) policy dividend.

The dividend scale interest rate for a particular policy is the interest rate used for crediting interest on policy values after deducting mortality and expense charges. It reflects investment performance of both managed assets and policy loans. Depending on the type of policy, either individual policy loan activity or average loan activity of all policies in the dividend class is reflected.

Because the mortality and expense charges vary each year, a policy's cash value growth will vary each year. As a result, one should not use the dividend scale interest rate as a measure of what the policy's internal rate of return on cash value is or may be.

Policy dividends and underlying interest rates are not guaranteed for the future. The dividend scale is reviewed annually and is subject to change by the company

For more information about Northwestern Mutual dividends and investments, the following information brochures are available.

· The Power of the Portfolio (29-4692)

· The Portfolio Approach (29-4306)

· Value Through Performance (29-4714)

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34-2004 (0208)

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