MERCER
MAKE TOMORROW, TODAY

Corporate-owned life insurance (COLI): minimizing risks in the financing strategy

Companies often use corporate-owned life insurance (COLI) to finance non-qualified executive retirement benefits. Because of its tax advantages, COLI can be an effective financing asset. However, current economic conditions can potentially exacerbate some of the risks and challenges associated with COLI. In particular:

- When COLI is used to hedge plan liability growth, the company is often exposed to investment volatility.
- Many companies have more COLI than is needed, unnecessarily tying up corporate cash

Because COLI is complex and can be difficult to understand, companies often are unaware of these problems until the magnitude becomes severe. What can companies do to help anticipate and protect against these issues? Here are four recommended actions.

Eliminate unnecessary investment risk

With variable (or "separate account") COLI, growth in value is based on the performance of underlying investment funds. Companies typically purchase variable COLI to hedge the growth of variable plan liabilities. But because most companies hedge pre-tax liabilities, instead of after-tax liabilities, these companies are directly (and often unknowingly) exposed to investment volatility. (See Exhibit I.) Remedies for this situation may include eliminating some of the COLI or implementing a different investment strategy within the COLI.

Ensure the financing strategy supports the company's liquidity needs

To maximize tax advantages, companies often hold COLI until the insured's death, rather than accessing COLI to pay plan benefits. However, companies facing cash constraints may want to consider using the COLI values to pay benefits. In addition, if the company has paid significant benefits over time from corporate cash, COLI values may far exceed plan liabilities, resulting in excess funding.

Before accessing or liquidating COLI policies, companies need to understand the ramifications – what is the impact to long-term performance? Do trust provisions limit the company's ability to access the assets? And how should the COLI be accessed (withdrawals, surrenders, loans, etc.)?

Understand the impact of reduced COLI values

For many companies, plan liabilities and COLI value are now lower than expected due to reduced deferrals and/or investment losses. However, lower COLI values can cause the level of policy charges to increase, adversely affecting performance. (See Exhibit II.) In some cases, this can be mitigated by reducing policy death benefits, which will reduce insurance charges. However, several factors should be considered in the decision to reduce death benefits, such as tax ramifications, the insureds' ages, and the time horizon on which the company is focusing.

The company's current financial condition may affect the financing strategy in other ways. For example:

- If the qualified pension plan is underfunded, the company may be pro-hibited from contributing to the COLI policies financing the executive retirement plans due to Pension Protection Act of 2006 limitations for companies with "at-risk" pensions.
- If the company no longer expects to be a taxpayer for some period of time (due to net operating losses or alternative minimum tax treatment), the decision to continue with a tax-deferred strategy such as COLI should be revisited.

To help ensure the strategy remains appropriate, COLI should be reviewed periodically given changes in plan liabilities, company objectives, and the company's financial situation. At a time when companies are looking for cost savings and efficiencies wherever possible, an independent review of the COLI strategy may provide a significant opportunity to realize financial improvements. The cost of such a review is typically far outweighed by the savings realized.

To learn more

For more information, contact your local Mercer office or any of the following consultants in Mercer's executive benefits group:

Doug Frederick
+1 502 561 8962

Laura Balser
+1 404 442 3418

Janet Den Uyl
+1 212 345 4870

Lisa Dietrich
+1 502 561 4663

LaCinda Glover
+1 502 561 4629

Micah McNatt
+1 502 561-4762

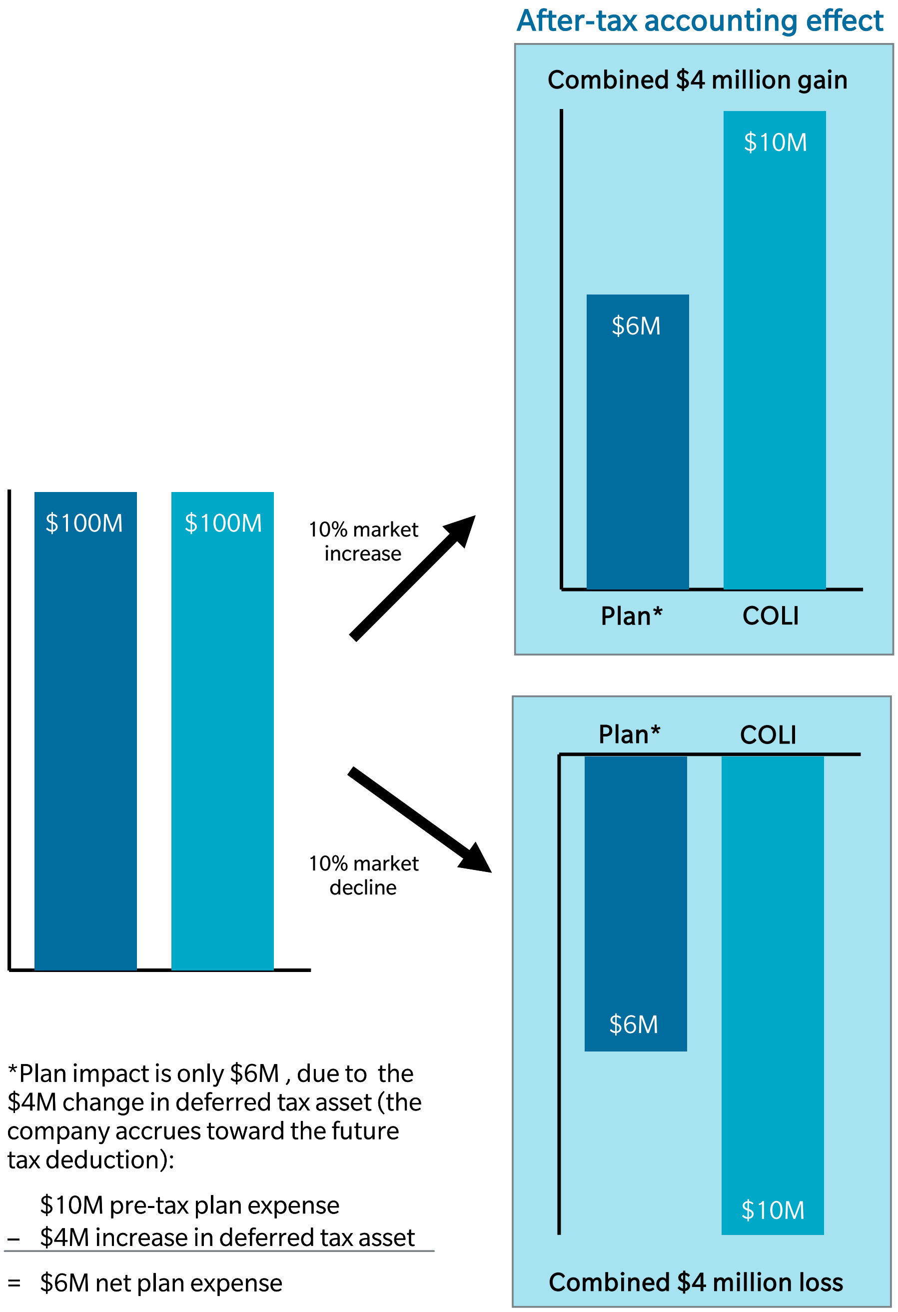
Kevin Mitchell
+ 1 312 917 0825

Heidi O'Brien
+1 213 346 2531

Aaron Pedowitz
+1 502 561 2677

MARSH & McLENNAN COMPANIES

Exhibit I: Financing with COLI equal to pre-tax liabilities can expose the company to market volatility



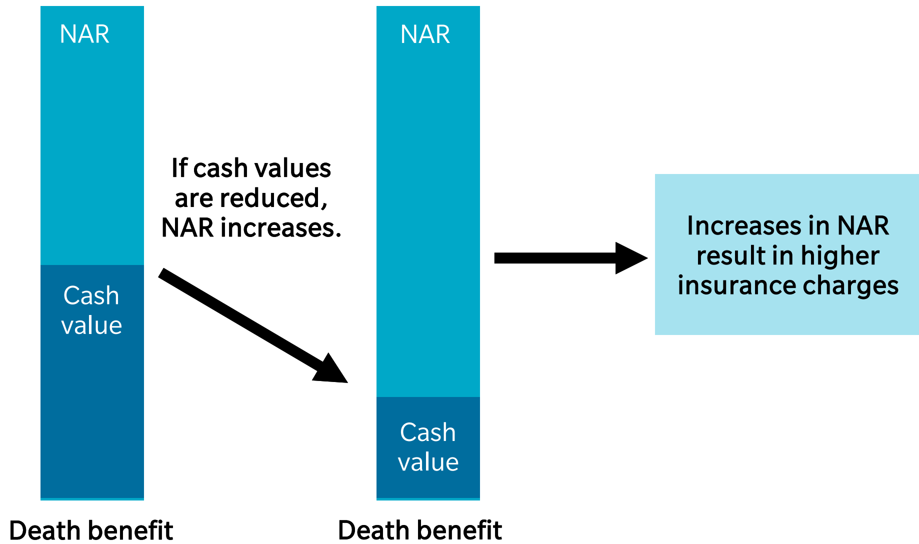
*Plan impact is only $6M , due to the $4M change in deferred tax asset (the company accrues toward the future tax deduction):

	$10M pre-tax plan expense
–	$4M increase in deferred tax asset
=	$6M net plan expense

Note: COLI results do not reflect the impact of insurance-based charges and loads. This exhibit is for illustrative purposes only and is not intended to predict market performance, but merely to demonstrate the effect of market volatility on plan liabilities and cash values.

Exhibit II: Reduced values increase risk in the COLI structure

- Insurance charges are based on the net amount at risk ("NAR"; death benefit less cash value).
- Reduced cash values (due to decreased premiums, market losses, etc.) increase the NAR.



Note: Cash value and death benefit are based on a hypothetical COLI policy.