Now More Than Ever: Why Today's Insurance-Dedicated Fund (IDF) Investment Options Make Sense for the Corporate-Owned Life Insurance (COLI) Market

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COLI Overview: Traditionally, corporations have utilized corporate-owned life insurance (COLI) as a financing or cost-recovery vehicle for pre- and post-retirement executive benefits, such as nonqualified retirement or life insurance plans. The corporation insures up to the top 35% of its employee payroll and its obligation to provide employee benefits is separate and distinct from the purchase of the life insurance. Investment returns accumulate on an income tax-deferred basis and are eventually received as a death benefit by a beneficiary (the corporation) on an income tax-free basis. As such, COLI provides for a higher return on capital via tax-free yield while providing a hedge against benefit liabilities.

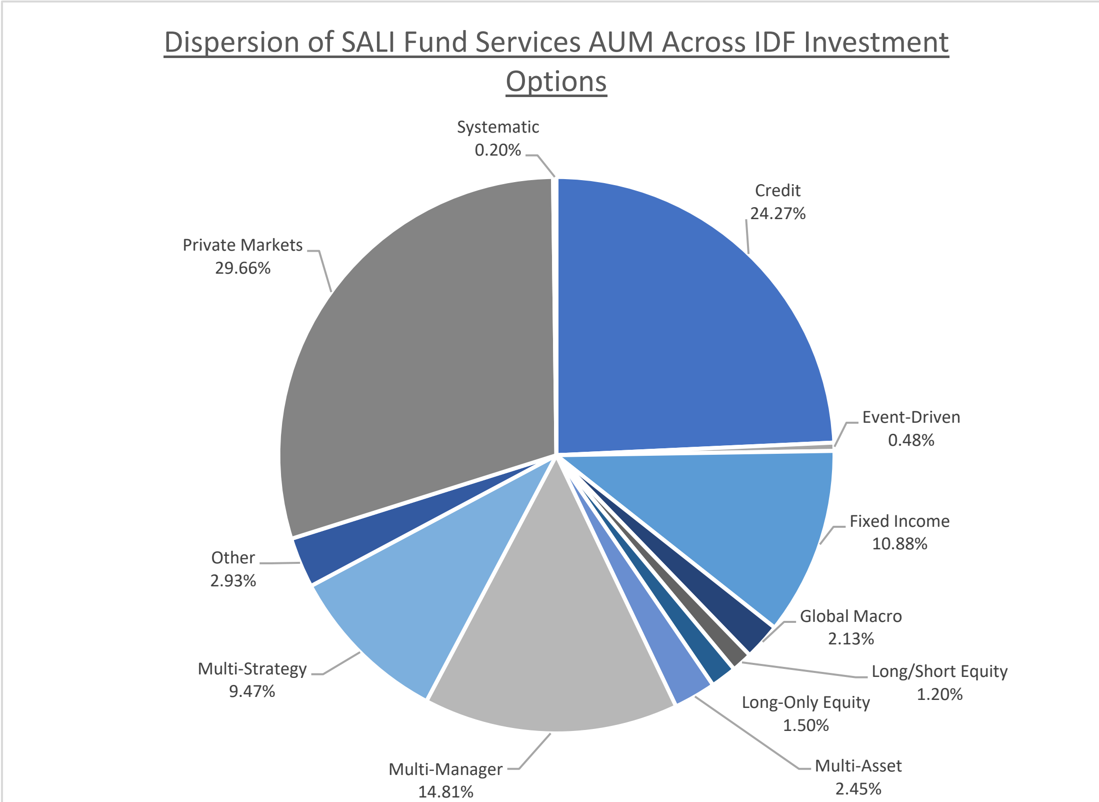
The Problem: Since 2008, the Federal Funds Rate has remained historically low. This perpetually low interest rate environment poses an issue for traditional COLI allocations designed to offset non-qualified deferred compensation plans through a mix of investments in equities and fixed income securities and/or fixed rate accounts. When faced with this new normal, employees are faced with unattractive, plain vanilla defined contribution plan investment options and corporations are forced to evaluate the efficacy of their current COLI allocations as a means of offsetting executive benefit liabilities.

For a variety of reasons described below, now may be the ideal time for enabling IDF alternatives as investment options for executives and/or considering COLI allocations/reallocations to alternative asset classes as a means of offsetting defined benefit plan liabilities.

The Opportunity

Abundant Insurance-Dedicated Fund (IDF) Investment Options: IDFs are commingled investment vehicles that accept allocations from the separate accounts of life insurance companies. Increased adoption rates among HNW and institutional investors, the punitive tax effects resulting from the 2013 expiration of the Bush tax cuts, and the loss of certain income tax deductions under the 2017 Tax Act have created the perfect storm for growth in the number of high-quality investment managers offering IDFs. To outline the maturity of the IDF market as it stands today, a few key statistics are included below:

- The number of IDFs in the market has grown from 92 in September 2011 to 190 as of December 2020;
- The participation from the institutional channel has grown to approximately $7 billion in subscriptions to IDFs administered by SALI Fund Services (SALI) since 2015 between bank-owned life insurance (BOLI) and insurance company-owned life insurance (ICOLI) buyers;
- Individual IDFs in the market have greater availability and are more accessible to a broader group of clients through multiple insurance company platforms, with 69 IDFs available through 3 or more insurance companies;
- With the assistance of a turnkey provider such as SALI Fund Services, new IDFs may be brought to market in much less time than was previously required;
- Liquid IDF investment options are available through daily- and monthly- valued vehicles;
- Structural options are available through SALI administration services for both IDFs or separately managed accounts;
- A wide variety of investment strategies and asset classes are available, including, but not limited to, opportunistic credit, long-short equity, quantitative trading, direct lending, private equity, real estate, cryptocurrencies, and hedge funds-of-funds.



In summary, the IDF market has evolved to a point where there are new investment options to help meet nearly any objective. To add to this, if the current IDF investment roster does not suit a client's specific needs, new IDFs can be up and running with a new investment manager within 4 to 8 weeks. Those who have not reviewed the landscape in the last couple of years should reconsider the options available to them and can do so by accessing IDF performance information and marketing materials via the SALI IDF Portal at www.saliportal.com.

Investment Landscape

- **Market Volatility**: 2020 saw a tremendous amount of market volatility. Using SPY as a proxy, 2020 statistics point to a trailing 3-year standard deviation of 18.58% as of 1/31/2021 with a max drawdown of -19.43% as of September 2020. As we reach the tail-end of the longest bull market in history, alpha, diversification, and downside protection may be more realistically achieved through alternative investment strategies compared to traditional investments. Per the above, there are now a multitude of investment strategies to choose from in an IDF format for COLI investors looking to diversify their holdings from traditional investments into alternative asset classes.

- **Perpetually Low Interest Rate Environment**: As mentioned previously, investors and insurance companies have been faced with a perpetually low interest rate environment with no end in sight. As such, COLI allocations to traditional investments in fixed income and bond funds are suffering. Furthermore, allocations to indexed universal life insurance products through insurance company general accounts have seen their guaranteed cap rates falling to as low as 3%. This capital could be allocated more efficiently/aggressively in search of yield amongst the wide array of alternative investment strategies available through IDFs today.

Political Outlook

- **US Debt to GDP Ratio**: The US debt-to-GDP ratio has reached historic levels above 100%. Regardless of your political outlook, these astronomical debt levels suggest a future in which there are higher tax rates at the federal, state, and local levels for individuals and for corporations. As such, the benefits of tax deferral associated with a COLI purchase may only be amplified in the coming years.

- **7702 Provision:** A recent provision of the HEROES Act Bill includes an interest rate provision to IRC Section 7702 of the Code which defines life insurance contracts. We believe this amendment will have a net positive impact on the private placement life insurance market requiring less death benefit per dollar of premium on behalf of these contracts. This may lead to lower cost of insurance and/or higher amounts of premium being deployed on a case-by-case basis. When coupled with Democratic control of the House and Senate, we see a tremendous amount of tailwind that maximizes the structural alpha that can be achieved through life insurance purchases and IDF investments going forward.

Technology

- **Solving the Administrative Burden:** One of the key hurdles to making alternative asset classes/IDF investment options available to non-qualified defined contribution plan participants is the administrative burden associated with investing in and redeeming from illiquid investment options that are not daily valued. 2020 brought a variety of challenges to the forefront of the insurance industry but with those challenges came some silver linings. Specifically, we've seen increased adoption of and investments in technology to solve administrative issues at the client, insurance company, insurance broker, and IDF administration level. This movement has created active dialogue around finding ways and reasons to embrace technology to enable more connectivity amongst the active players in this market. Namely, using technology to enable real-time data transfer and connectivity of legacy systems amongst counterparties. We are optimistic that as these conversations continue to evolve, the primary participants in this space will pave a path for "plug and play" optionality of investment options for each distribution channel, regardless of liquidity or other channel-specific constraints.

Other

- **Talent Retention**: The impacts of COVID-19 have taken a toll on small and large businesses alike. Companies face challenges with respect to talent retention in the face of salary cuts, diminishing compensation packages, etc. Corporations can look to innovate to offset the headwinds of the current environment and can do so by offering attractive deferred compensation plan investment options to their key executives. By offering key executives additional retirement benefits as part of their overall compensation package, a corporation is potentially able to retain top talent without the initial upfront "cost" given the offsetting COLI purchase will be retained as an asset on the balance sheet of the corporation.

Conclusion: Despite the long-term nature of COLI, there is no reason for organizations to become complacent with what is often a sizeable, overlooked block of assets. In fact, one of the key value propositions associated with a private placement life insurance investment account is that assets within the account may be reallocated without triggering negative tax consequences. The investment landscape and the key market data that supports it are not static, so why cling to an outdated COLI allocation plan that may have been designed for markets of years or decades past? COLI allocators can look to a rapidly maturing IDF marketplace to innovate, modernize, and diversify their portfolio and ultimately better offset their pre- and post-retirement employee benefits.

Next Steps: For additional information, please contact Cameron Vail, Chief Operating Officer at SALI Fund Services at cvail@sali.com or (512) 735-7254. Cameron joined the firm in 2013 and oversees business development, innovation, and scalability functions at SALI. To survey a list of available IDF investment options, consider visiting the SALI IDF Portal, which provides a dashboard for IDF market information along with relevant publications and source documents, at www.saliportal.com.