BEST'S REVIEW

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# Facts of Life

Bankers find even their bank-owned life insurance investments are affected by the economic downturn.

by Michael D. White

> ▶ **The Issue:** BOLI assets have become an increasingly sizable amount of bank and bank holding company capital.
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> ▶ **The Situation:** A handful of banks have taken large losses in their separate account policies, despite stable value agreements.
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> ▶ **The Outlook:** Most institutions hold their BOLI assets within regulators' guidelines for capital, but the situation still bears watching.

It's been a tough year for depository institutions. They've spent it writing down troubled residential real estate (and other) loans, boosting loan-loss provisions, weathering rising credit costs and enduring further depreciation in home prices. Banks have cut dividends, watched their shares sink in value and experienced a decline in net income that reached a 16-year low.

According to the Federal Deposit Insurance Corp., second-quarter 2008 net income was "the second-lowest quarterly total since 1991 and is $31.8 billion (86.5%) less than the industry earned in the second quarter of 2007." More than $50 billion was set aside in quarterly loan-loss provisions, greater than four times the amount set aside in the linked quarter. The FDIC also reported "almost 18% of all insured institutions were unprofitable in the second quarter, compared to only 9.8% in the second quarter of 2007."

Banks have rushed to bolster their capital through the sale of "noncore" businesses, repackaged mortgages and private equity. Some bank chairmen, chief executive officers and chief financial officers have been given unexpectedly early retirements. The federal government has rushed to aid the private financial services system with bailout measures that may reach $1 trillion.

What's more, several banks have even had trouble with their life insurance policies—specifically bank-owned life insurance, commonly termed BOLI.

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Banks and bank holding companies may purchase life insurance policies on directors, officers and employees. The companies are the owners and beneficiaries of these policies. Particular BOLI policies—called separate account policies—often have stable value agreements or stable value protection contracts from banks or insurance carriers. These arrangements provide limited protection of policy cash surrender values from declines in the values of the policies' underlying investments.

Generally, BOLI is a sensible investment that has served the banking industry and its stakeholders well. It's an economical way to finance or reimburse a company for its contributions to employee benefit programs and to offset the liabilities of certain employee retirement benefits. It's generally a good, stable source of revenue for a bank. However, significant amounts of capital are being committed to the purchase of BOLI and the build-up of life insurance policy cash surrender value.

Since BOLI is not without risk and could pose a variety of threats to the safety and soundness of a financial institution, the associated liquidity, reputation, and compliance risks should be measured.

## Trouble with BOLI

The first public sign of BOLI trouble occurred in January. Israel Discount Bank of New York sued its insurer, MetLife Inc., and investment manager BlackRock Inc. for breach of contract and fiduciary duty after losing $2 million in its BOLI policy due to subprime loan exposure. According to the bank, MetLife refused to move its investment, initially $10 million, because of "liquidity" issues that might affect other investors in the fund managed by BlackRock.

A policy owned by Cincinnati-based Fifth Third Bancorp "declined significantly due to disruptions in the credit markets, widening of credit spreads between U.S. treasuries/swaps versus municipal bonds and bank trust preferred securities, and illiquidity in the asset-backed securities market," according to Fifth Third regulatory filings with the Securities and Exchange Commission. "These factors caused the decline in the cash surrender value to exceed the protection provided by the stable value agreement." (Fifth Third had $116 billion in assets as of Sept. 30.)

Consequently, in the fourth quarter 2007, Fifth Third lost $177 million on a policy whose earlier cash surrender value was $505 million. The policy lost another $152 million in the first quarter of 2008. In April, Fifth Third filed suit in U.S. District Court against Transamerica Life Insurance Co. and Clark Consulting, both affiliates of Aegon USA, to recover damages on an initial investment of $612 million that constituted one-third of Fifth Third's BOLI assets.

Fifth Third alleges that the insurer and BOLI brokerage company engaged in breach of contract, breach of fiduciary duty, fraud, professional negligence, negligent misrepresentation and insurance bad faith, resulting in the policy's investment losses. The investments were made in the Falcon Strategies hedge fund, a Citigroup operation that reputedly lost more than 75% of its value.

In addition to Fifth Third, Charlotte, N.C.-based Wachovia Corp. (assets of $809 billion) had invested more than $1 billion in Falcon, or approximately 6.6% of Wachovia's BOLI assets in 2007. After reviewing stable value agreements on three BOLI contracts, Wachovia reported on May 6 that it would record $315 million in first-quarter BOLI investment losses. Then on May 12, Wachovia said that 75% of its BOLI portfolio of nearly $15 billion in cash surrender value was in separate-account life insurance. Of that, approximately 95% had some form of stable value agreements protection, "with 74% of such protected portfolio being fully protected and 26% having partial protection."

Only three weeks later, as the BOLI losses caused the near doubling in first-quarter losses, G. Kennedy Thomson stepped down as chairman and CEO of Wachovia.

Reportedly, an unidentified regional bank also invested considerable BOLI assets in Falcon. Other banks, from $136-billion-asset BB&T Corp. of Winston-Salem, N.C., to $460-million-asset Evans Bancorp Inc. of Hamburg, N.Y., experienced declines in BOLI income and assets due to the policies' worsening performance in equity investments.

### Top 10 Bank Holding Cos. in BOLI Assets

($ Thousands)

| Rank | Bank Holding Company | Assets | Cash Surrender Values of BOLI in Force 2008 | 2007 | % Change |
|---|---|---|---|---|---|
| 1 | Bank Of America | $1,173,478 | $20,886 | $16,760 | 24.6 |
| 2 | Wachovia | 808,575 | 14,851 | 13,677 | 8.6 |
| 3 | JPMorgan Chase | 1,642,862 | 13,684 | 13,074 | 4.7 |
| 4 | Citigroup | 2,199,848 | 7,626 | 3,325 | 129.3 |
| 5 | Wells Fargo | 595,221 | 5,553 | 4,523 | 22.8 |
| 6 | U.S. Bancorp | 241,781 | 5,169 | 4,954 | 4.3 |
| 7 | Bank of NY/Mellon | 197,839 | 3,621 | *3,423 | 5.8 |
| 8 | Keycorp | 101,596 | 2,894 | 2,805 | 3.2 |
| 9 | BB&T Corp. | 136,417 | 2,653 | 2,408 | 10.2 |
| 10 | PNC Financial | 140,026 | 2,453 | 2,169 | 13 |

*Represents sum of Bank of NY and Mellon Financial prior to merger July 1, 2007

Source: Michael White-MullinTBG

### Mean BOLI Assets by BHC Asset Class

($ Thousands)

| BHCs by Asset Size | 2007 | 2006 | % Change |
|---|---|---|---|
| Exceeding $1 Billion | $306,196 | $265,963 | 15.1 |
| Less than $1 Billion | 8,906 | 8,403 | 6 |
| More than $10 Billion | 1,773,380 | 1,406,236 | 26.1 |
| $1 Billion to $10 Billion | 31,390 | 31,201 | 0.6 |
| $500 Million to $1 Billion | 9,397 | 8,994 | 4.5 |
| $300 Million to $500 Million | 6,085 | 5,717 | 6.4 |
| Mean of All Classes | 156,760 | 133,951 | 17 |

Source: Michael White-MullinTBG

## More Trouble?

Any concentration of obligations within an institution's asset structure, especially BOLI, could pose a risk of institutional illiquidity. Sufficient capital should be available in case poorly diversified risk harms the institution's financial position.

"It is generally not prudent for an institution to hold BOLI with an aggregate CSV that exceeds 25% of the institution's capital as measured in accordance with the relevant agency's concentration guidelines," said the federal Interagency Statement on the Purchase and Risk Management of Life Insurance in 2004.

According to the concentration guidelines of the Federal Reserve and Office of the Comptroller of the Currency, total capital for bank holding companies and national banks is the sum of Tier 1 capital and the allowance for loan and lease losses. Each national bank or bank holding company must maintain an allowance or reserve that is adequate to absorb estimated credit losses associated with its loan and lease portfolio.

The FDIC says total capital for state-chartered banks is Tier 1 capital.

Although there is no way to know how much BOLI is separate-account business, BOLI holdings and their ratios to capital can be measured. The *Michael White-MullinTBG BOLI Holdings Report* calculates the BOLI holdings of 7,700 banks and 950 large top-tier bank holding companies and analyzes their BOLI-capital ratios.

In 2007, large bank holding companies and freestanding banks (i.e., those without bank holding companies) together held $120.4 billion in BOLI assets, up 15.9% or $16.5 billion from $103.9 billion in 2006. Nationally, 752 (80%) of large bank holding companies held $117.9 billion in BOLI assets at the end of 2007, up 16.3% from $101.4 billion in 2006. Their mean BOLI assets increased 17% to $156.76 million in 2007. Among the largest banks, those with more than $10 billion in assets, the mean increased 26.1% to $1.77 billion.

Overall, 3,682 banks held BOLI assets of $107.97 billion in 2007, of which 453 freestanding banks held $2.51 billion. Mean BOLI assets held by banks increased 12.6% to $29.32 million in 2007.

**Bank Holdings Companies' Mean BOLI Assets as a Percentage of the Sum of Tier 1 Capital + Allowance for Loan and Lease Losses**

| BHCs by Asset Size | 2007 | 2006 | % Change |
|---|---|---|---|
| Over $1 Billion | 13.89% | 13.20% | 5.20% |
| Under $1 Billion | 13.73% | 13.34% | 2.90% |
| Over $10 Billion | 16.55% | 15.32% | 8.00% |
| $1 Billion-$10 Billion | 13.39% | 12.77% | 4.90% |
| $500 Million-$1 Billion | 13.57% | 13.37% | 1.50% |
| $300 Million-$500 Million | 14.69% | 13.23% | 11% |
| All | 13.81% | 13.28% | 4.00% |

Source: Michael White-MullinTBG BOLI Holdings Report

## Signs to Watch

BOLI assets grew rapidly—nearly 16%—in 2007. (Of course, growth can be as much a result of new purchases as it is of significant earnings.) They grew even faster among the largest bank holding companies, rising 18.1% from $88.6 billion in 2006 to $104.6 billion. High industry growth in BOLI assets may signify more buying of BOLI or more rewarding—albeit riskier—investments.

Declining growth rates in BOLI earnings are a sign that the good times for some are ending. While total bank BOLI assets were up in 2007, the rate of earnings for 16 of the top 100 banks in BOLI earnings slowed (and 15 others were new BOLI owners).

> "Declining growth rates in bank-owned life insurance earnings are a sign that the good times for some are ending."

Watch the ratio of BOLI assets to capital. The higher the ratio, the closer an institution is to the 25% BOLI-capital guideline established by regulators. Most banks and bank holding companies with BOLI are well within their 25% capital concentration guidelines.

Some institutions have exceeded it. At the end of the second quarter 2008, 61 large bank holding companies exceeded the 25% capital-concentration guideline. Of those, 11 were bank holding companies with more than $10 billion in assets, representing 20% of the largest bank holding companies with BOLI. Another 21 bank holding companies with assets between $1 billion and $10 billion exceeded the 25% guideline. Among banks, 548 had BOLI holdings that exceeded 25% of Tier 1 capital and 335 exceeded the sum of Tier 1 capital and the loss allowance.

The number of national banks and bank holding companies exceeding the capital guideline has declined slightly. Because of the subprime crisis and deteriorating earnings, bankers rapidly added to their allowances for loan and lease losses. Along with Tier 1 capital, the allowances constitute, for many institutions, their denominators in calculating their BOLI-to-capital concentration.

From second-quarter 2007 to second-quarter 2008, the allowances grew $53 billion or nearly 70%, from $76.9 billion to $129.9 billion. Bank holding companies over $10 billion in assets raised their allowances for losses 56%, from $64.2 billion to $100.1 billion. Had all these companies not increased their AL&LL so substantially, their ratios of BOLI holdings to total capital would have been higher and a few would have exceeded the 25% guideline.

## Steps for Bankers

Because BOLI is part of banking capital, it must be guarded, particularly in turbulent times. Bankers with separate-account BOLI policies must review and understand the accounts' investment policies, investment instruments and stable value agreements.

They also must assess reductions in BOLI liquidity imposed by stable value agreements, since they often place restrictions on how much may be withdrawn from separate accounts. And they must limit the aggregate cash surrender value of policies from each insurer and all life insurance companies.

When exceeding the 25%-of-capital limit, bankers should obtain board-level approval and expect that they'll have to prove to regulators that the excess cash surrender value is necessary and does not constitute imprudent capital concentration.

Each BOLI holder should also obtain an independent "peer analysis of BOLI holdings … [to] compare its BOLI holdings relative to capital to the holdings of its peers to assess whether it is an outlier," as the Interagency Statement instructs. Institutions that are unable to demonstrate a thorough understanding of BOLI and its associated risks may be subject to supervisory action. BR