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Under Pressure to "Move Money?"

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Why Banks Should Consider BOLI

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We are all being encouraged to "move money." The question is where? Moving money is a key to energizing this stagnant economy. The Fed agrees and is reducing the funds rate to near zero in an attempt to wrench open the liquidity spigot by emboldening banks, investors and borrowers to shift out of now poor performing "safe haven" investments. In theory, these low rates should result in banks moving their money into more loans and out of treasury and agency paper as the rates fall below their cost of funds. Investors should also move money out of low yield money market investments back into stocks and bonds, while borrowers should take advantage of historically low mortgage rates. However, not too long ago, the government was also encouraging community banks to invest in preferred shares of Freddie Mac and Fannie Mae, and we all know how that turned out. The Fed is doing all it can to get the money out of the proverbial mattress. However, this means taking a leap of faith by consumers and banks in an economic environment where being risk-averse seems to be the logical choice.

Consumers are being forced to simplify and deleverage their balance sheets. Savings is no longer a dirty word; our grandparents are looking down saying "it's about time!" The likely result will be a large increase of funds to banks as depositors move from low yielding money market investments into CDs. In the past a lack of liquidity in the banks has often been an issue, especially when it came to considering a BOLI investment. Tying up cash within a BOLI contract for an extended period of time has always been an issue even though the average internal portfolio maturity is 5–7 years. There is growing likelihood that 2009 may instead become a dilemma due to excess liquidity. With the slowing of loan demand and growing consumer saving sentiment and with $4 trillion in money market investments with yields now below 1%, how much of this market will move to banks and how much will you want?

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On top of this, almost $800 billion in bonds have been downgraded from AAA with less than $50 billion remaining at AAA.[1] The remainder is spread 50% A and above and 50% rated between BBB to CCC.[1] A review of top BOLI carriers shows that a high percentage of their portfolios are still invested in high quality investment grade bonds. Subprime exposure at these same carriers has been below .05% of assets with virtually no altered ratings from any of the major services despite significant changes in other industries. Insurance company BOLI portfolios, regardless of general account or separate account, are primarily comprised of MBS (Mortgage-Backed Securities) Pass-throughs with varying degrees of Treasuries, Agencies, CMBS (Commercial Mortgage-Backed Securities) and CMOs (Collateralized Mortgage Obligations). As the housing market credit losses peak in 2009 as many believe, this should allow for a strong second half recovery in high quality nonagency AAA MBS, AAA Agency and MBS. Given that this is what comprises most BOLI portfolios, now is the time to evaluate BOLI as an appropriate investment.

Although the BOLI market over the past several years has begun to move from general account to separate account, in many circumstances there may be reasons to consider staying with general account policies. Some of the advantages for choosing separate account products are the greater transparency that these products have, the potential for lower risk weighting for risk-based capital treatment and protection from carrier insolvency.[2] However one advantage that general account products have is the carrier's ability to blend in some equity exposure in its general account. Considering that we have just experienced back-to-back 40%+ bear markets, which have not occurred for 70 years, and that one third of S&P 500 stocks are trading below book value, it would seem that the ability to have some exposure to equities could be valuable. The good news is that banks have several options to suit their particular needs.

In comparing crediting rates of four top BOLI carriers—John Hancock, Mass Mutual, New York Life, and Met Life—between January 2005 and 2009, only one is crediting less today on its policies. In a review of carriers in the market the average crediting rate is still between 4.75%–5%. BOLI also presents an additional tax arbitrage opportunity due to its tax-favored status. Given the cost of funds at most banks, the profit margin has likely never been better. So, if you're contemplating "moving money," BOLI deserves consideration.

NOTE

This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice.

[1]Downgraded balances from 2007 to present. SOURCE: JPMorgan, HSH as referenced on page 10 in the "Sun Life Assurance Company of Canada (U.S.) MBS Sub-Account—GSAM Fixed Income Portfolio Review," dated January 22, 2009.

[2]OCC 2004-56 Interagency Statement on the Purchase and Risk Management of Life Insurance—page 19–20.

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