BOLI-Related Earnings Announcements

Last week, Fifth Third Bancorp (FITB) said it expects fourth quarter 2007 earnings to decline due to higher provision expenses for credit losses and a non-cash charge to reduce the current cash surrender value of one of its Separate Account (SA) BOLI policies. While it is difficult to comment on this specific event without a direct understanding of the facts and circumstances surrounding the transaction (FITB is not a client), MB Schoen & Associates, Inc. would like to provide some background information and observations regarding circumstances that we believe may contribute to this type of financial adjustment. The following discussion will cover recent changes in the structure and terms of SA BOLI stable value protection (SVP) agreements, developments relating to available SVP investment portfolios, and potential accounting ramifications that may result from extreme, exigent market conditions.

Background

The introduction of SVPs to the SA BOLI product in the mid-1990s brought with it a change in buyer appetite: from predominately short duration government–only investments to bank-eligible fixed income portfolios using Lehman Aggregate and/or Lehman MBS benchmarks. Traditional BOLI products from all the major SA BOLI insurance carriers typically offered several bank-eligible investment divisions with the choice of one or more institutions to provide the SVP contract. As the SA BOLI market has matured in recent years, banks have begun to explore ways in which to diversify their fixed income-only investment portfolios and/or seek higher returns in their SA BOLI portfolios. In response, some newer SA BOLI investment divisions are now linking returns to the performance of underlying equities, hedge funds or fixed income investments employing high degrees of leverage; or, in the case of bank holding companies (BHCs), actually making direct investments in such assets. As these newer investment options become more prevalent in today's SA BOLI products, the SVP contracts continue to evolve in order to accommodate these more complex, non-traditional asset classes.

The Basic Stable Value Contract

SVP, a staple among 401(k) plans, was adapted to SA BOLI in the mid-1990s to address and alleviate the earnings volatility attributable to FASB TB 85-4 mark-to-market accounting and introduce book value-like accounting results. SVPs serve to smooth the income volatility of SA BOLI cash values by amortizing gains and losses of the underlying investment division via a pre-defined formula and a specified duration. In the event of policy surrender, the SVP provider contractually bridges any gap between the market value (MV) of the underlying assets in the investment division and the reported book value (BV) of the BOLI cash surrender value. The SVP amortization formula helps limit the differential between BV and MV from widening beyond acceptable risk thresholds. Eligible SVP investment divisions were traditionally core fixed income with average durations ranging between two and five years (most portfolios were comprised of either MBS or Lehman Aggregate securities with detailed investment management guidelines strictly limiting the scope of investment activities of each respective division). The typical SVP contract provided that assets remain in the stated investment division as long as the ratio of BV to MV remained within a predefined ratio (e.g., < 120%). In the event the BV to MV ratio was breached, the SVP contract required immediate liquidation and reinvestment of the investment division into an "immunization portfolio" or Money Market division. Importantly, this contract provision allowed the SVP provider to provide contractual assurance that the applicable crediting rate for any given period would never fall below 0%. In other words, BV could never drop or produce negative earnings. This contract provision exists in almost all "basic" SVP contracts and serves to limit total exposure of the SVP provider to extreme volatility in the fixed income markets. This provision has generally been viewed as acceptable by BOLI owners given the remote probability of an immunization scenario occurring within traditional fixed income portfolios. Historical analysis suggests that there were only a few entry points during the past twenty five years when such thresholds may have been breached.

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More Recent Stable Value Contracts

As new, less traditional investment divisions were being introduced to the BOLI marketplace, SVP providers sought ways to make contractual changes to accommodate them while still maintaining acceptable risk exposures. In many cases, these new asset classes presented dramatically different risk profiles than the traditional fixed income divisions. The volatility associated with these new asset classes is typically less predictable than with traditional fixed income portfolios. These investments also tend to be less transparent and more difficult to value and/or liquidate. Accordingly, the overall risk is more difficult to assess, especially when the SVP provider attempts to continue offering a similar amortization formula to that of traditional portfolios. In an effort to create a workable solution to their potentially increased exposure to risk, SVP providers established tighter maximum BV to MV ratio thresholds (e.g., 110%-115%) and introduced a new provision which may be triggered when the ratio is breached. Under this new provision, when the BV to MV ratio threshold is breached, the SVP provider adjusts BV downward until the ratio of BV to MV is restored to a predefined level. Unlike earlier SVPs, a downward adjustment in BV would now result in a charge to earnings during the reporting period when the adjustment is applied. This provision is in some ways analogous to the financial adjustment a bank books for impaired securities (albeit, limited to the amount exceeding the threshold defined within the SVP contract). In some instances the policyholder may have the contractual right to either allow the portfolio to be repositioned to a Money Market division or to incur the BV to MV adjustment with its corresponding P&L adjustment. However, a move to a Money Market division is commonly viewed by the SVP writer as an inadequate means of mitigating its risk to certain asset classes (e.g., those with severe liquidity restrictions and/or those with underlying values that are not immediately determinable). It is also important to note that in the absence of this new BV/MV write down provision, the BOLI policyholder would be forced to immediately liquidate the investment division holdings no matter how unfavorable the timing and/or market conditions. As a result, the ability to remain invested is generally viewed as more desirable than a forced liquidation and concomitant reinvestment to a Money Market division. Interestingly, this BV adjustment provision is now also being adopted within the traditional fixed income SVP segment.

Recent Non-Cash Charge Reflecting Drop in BOLI CSV

SVP providers generally place an upper limit on the percentage of the overall CSV that may be allocated to these new asset classes under a single SVP agreement (e.g., generally 20%-45%). However, we are aware of exceptions where markedly higher percentages have been allowed by SVP providers. We are also aware that certain bank-eligible BOLI portfolios consisting of leveraged fixed income and fixed-income-only fund-of-fund hedge funds have incurred significant drops in MV this year, especially during the unprecedented market turmoil since late July. Given the new contractual SVP provisions referenced above and the sizable recent allocations to alternative asset classes, it appears probable that the BV to MV ratio for at least a few of these allocations have been breached, thus triggering downward adjustments in BV.

We believe it is worth noting that, while the cited dollar amount of FITB's write down seems quite large, it represents only a tiny fraction of the collective assets wrapped by SVP contracts (estimated to exceed $50 billion). In light of the unprecedented market conditions since July, we would not be surprised if announcements similar to FITB's follow in the coming months. We are monitoring related developments, including reactions from regulators and auditors, and will provide updates when available.

If you would like to discuss this topic further, please contact either John Pfleger (jpfleger@coliaudit.com) or Matt Schoen (mbschoen@coliaudit.com).

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