9/27

Mr. Martin

Governor Robertson returned this--said "I think we should see him (O'Leary) when he comes."

mnm

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Chairman Robertson

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date September 27, 1966

To Chairman Martin

Subject: Policy loans at life insurance companies

From Daniel H. Brill

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At your suggestion, I called Jim O'Leary of the Life Insurance Association yesterday afternoon to get whatever information he had about the impact of monetary restraint on life insurance companies. Jim's story was very interesting; it adds up to a situation of some gravity and concern. While at the moment it would not be appropriate to label the situation as panic or crisis, there are several companies in difficulty, and continued restraint, along with strong credit demands, will undoubtedly result in a spreading of difficulty throughout the industry.

In aggregate terms, Jim points out, policy loans have increased sharply relative to cash flows. Using the group of companies who report current and prospective cash flows to the Association (a sample that does not include the largest company but does cover about 66 per cent of the industry's assets), the figures show that in the fourth quarter of 1965 the net increase in policy loans was running at about 4½ per cent of the cash flow excluding receipts from sales of securities. By the second quarter of this year, the ratio had risen to 11 per cent and indications are that the ratio jumped sharply again in the third quarter. Final figures aren't in as yet.

There is a great variation in experience of individual companies. One medium-sized New England insurance company -- with assets of about $750 million -- has had an increase in policy loans amounting to over 100 per cent of its cash flow. There are about a dozen companies where the policy loan outflow amounts to from 20 to 70 per cent of cash flow. (We have been informed by the Chicago Fed of one large Midwestern insurance company whose policy loan outflow in August amounted to a third of its cash flow.) In addition to the policy loan drain, some companies have been hit by increases in the surrender of policies by withdrawal of policy proceeds left on deposit and by declines in the expected volume of mortgage prepayments resulting from housing turnover.

It is true that some insurance companies have been asking for trouble by aggressively selling, in recent years, a type of policy known as "minimum deposit insurance." These policies have high initial cash values. The policyholder is encouraged to borrow from banks in order to pay the premiums. Given the tax deduction permitted on the interest cost of the borrowing as against the interest accumulating on the surrender value of the policy, there is a tax incentive to this transaction which has been used as a lure in selling large unit policies to moderately wealthy individuals. As monetary policy has tightened this year, banks have not been

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willing to continue making these loans, forcing the policyholders back to the insurance companies in order to get the funds to pay the premiums. Also, in recent years, there has been an increase in "key-man policies," life insurance policies taken out by companies on key executives. As the cost of bank loans has risen, small and medium-sized companies have increasingly been borrowing from insurance companies on the cash values built up in these policies.

Life insurance companies have adjusted to the increased drains on their cash flows by selling securities, paring cash balances, using bank lines and trying to open new ones, cutting back on new loan commitments, and trying to take the latest options available for disbursements under earlier commitments. But given the increasing unavailability of bank lines and the pressure of customers for funds and the drop in security prices which has already created substantial capital losses, some companies are severely pinched and a few -- particularly newer ones -- are in a more serious bind.

Jim has already talked with Bill Treiber at the New York Fed about this problem and is aware of the Fed's interest in it and the fact that some plans have been adopted to take care of savings and loan associations and mutual savings banks suffering from exceptionally large withdrawals. He would like to discuss the situation with the Board, not with the intent of pleading for creation of any counterpart plan for life insurance companies, but to clarify the dimensions of the problem. By mid-October, he expects to have information on the third quarter cash flow experience of his sample of insurance companies and would like to bring this information down, along with any other specifics he can pick up in the interim. Would you be interested in having Jim in for lunch with some of the Board and the staff following this matter? The date of October 18 was mentioned as a possibility, but I am sure Jim would adjust his schedule to accommodate whatever date and time suited the Board.

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