M Benefit Solutions
Bank Strategies®
An M Financial Group Company

The Bottom Line

Executive and Director Benefits and BOLI

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Highlights of this Issue

- Update on U.S. Life Insurance Financial Strength Rating Changes in 2013
- The Exemption from Source State Income Taxation of Certain Retirement Income

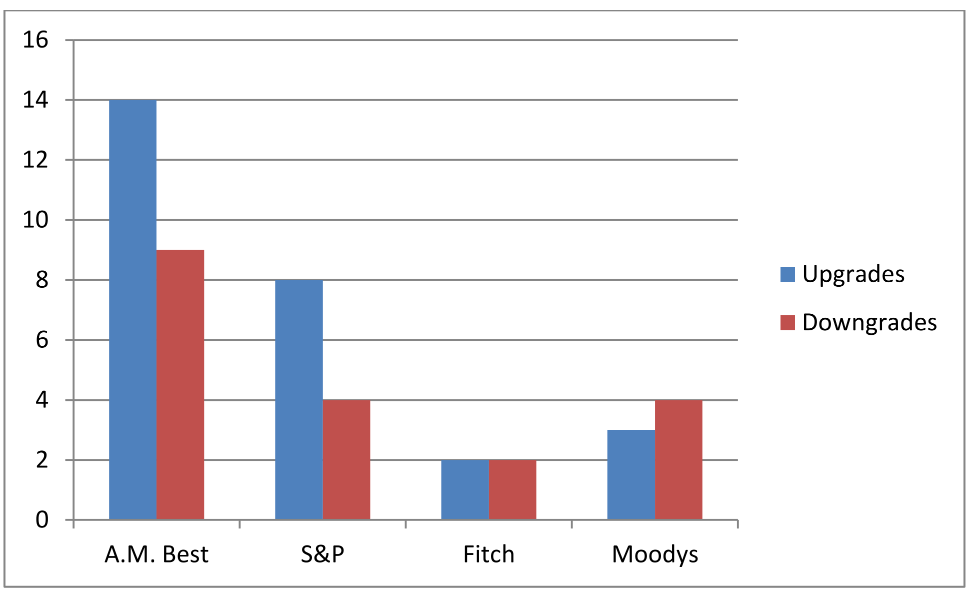
Update on U.S. Life Insurance Financial Strength Rating Changes in 2013

From the May 2014 M Financial Group Due Care Bulletin

The U.S. life insurance industry ended 2013 on an upward trajectory with regard to financial strength metrics and ratings. Relative to 2012, all four major rating agencies reported improvement in various aspects of their financial strength ratings. This could be seen in higher aggregate ratings and a higher number of upgrades than downgrades during 2013. In addition, according to A.M. Best, no U.S. life and health insurance companies were impaired[1] in 2013. Since A.M. Best started tracking life insurer impairments, this is the first year no companies required regulatory intervention.

During 2013, financial strength rating upgrades by the four major rating agencies outnumbered downgrades by a margin of 27 to 19. See Figure 1.

Figure 1. Summary of 2013 Financial Strength Rating Upgrades and Downgrades[2]

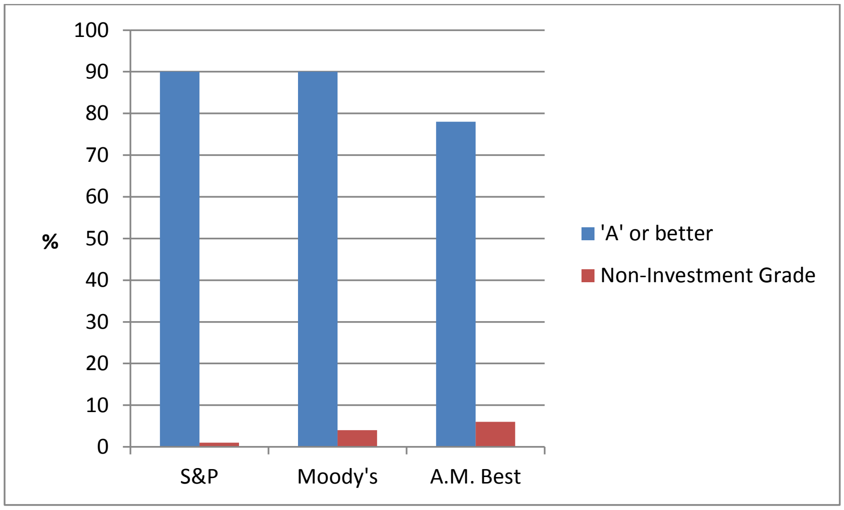


[1] *A.M. Best designates an insurer as a financially impaired company as of the first official regulatory action taken by a state insurance department. State actions include supervision, rehabilitation, liquidation, receivership, conservatorship, cease-and-desist orders, suspension, license revocation, and certain administrative orders.*

[2] *Data for A.M. Best as of October 22, 2013. Data for S&P as of November 30, 2013. Data for Moody's as of December 4, 2013. Data for Fitch as of December 18, 2013.*

At the end of 2013, of all rated U.S. life insurers, 90% (S&P and Moody's) and 78% (A.M. Best) had investment grade (i.e., 'A' or better) financial strength ratings. See Figure 2.

FIGURE 2. 2013 FINANCIAL STRENGTH RATINGS DISTRIBUTION[3]



[3]*Data for A.M. Best as of October 22, 2013. Data for S&P as of November 30, 2013. Data for Moody's as of December 4, 2013. Data for Fitch as of December 18, 2013*

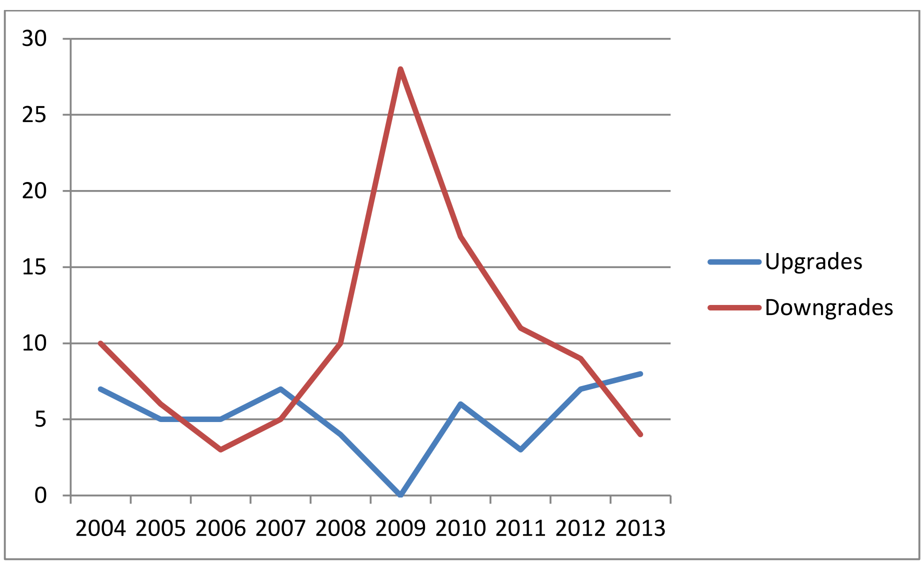
Below is a summary of recent commentary issued by each rating agency with respect to industry financial strength.

Standard & Poor's

S&P said in its most recent U.S. life insurance industry outlook that the credit quality of the industry remains stable, with headwinds subsiding and the economy continually improving. Companies with investment grade insurer financial strength ratings exhibit strong capital and liquidity, and stable investment portfolios. For the first time since 2007, S&P issued more upgrades (eight) on life insurers than downgrades (four). See Figure 3.

As of November 30, 2013, S&P had an 'A3' (Strong) rating or better on 90% of their 82 rated life insurance groups and more than 91% had a stable or positive outlook.

FIGURE 3. S&P U.S. LIFE INSURANCE UPGRADES AND DOWNGRADES



Moody's

Moody's recently upgraded its outlook for the U.S. life insurance industry to stable from negative, which was the outlook since September 2012. Moody's stated its view that the downside risks to the industry have diminished and should allow revenues and earnings to stabilize over the next 12-18 months.

Moody's provides financial strength ratings for 52 U.S. life insurance groups. As of December 4, 2013, Moody's rated 90% of these groups at 'A3' (Good) or better; 88% of ratings had a stable or positive outlook.

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A.M. Best

A.M. Best said the U.S. life and annuity sector has maintained strong risk-adjusted capital, steady operating earnings, and improved balance sheet fundamentals and continues to have a stable rating outlook for the industry.

At the end of 2013, A.M. Best had an 'A-' issuer credit rating (Excellent) or better on more than 78% of its rated companies. Ninety percent of the ratings have a stable outlook; the remaining 10% is split evenly between positive and negative outlook. A.M. Best also issued more rating upgrades (14) than downgrades (nine) during the year, which continued a trend observed over the past three years.

Fitch Ratings

Fitch continues to maintain a stable outlook for the U.S. life insurance industry, which it says reflects the industry's very strong balance sheet fundamentals, solid liquidity profile, and improved operating performance. Fitch also said it believes the industry is well positioned to withstand macroeconomic challenges over the coming year.

Nearly all of Fitch's 2013 rating actions through the third quarter were affirmations, with just two upgrades and two downgrades. As of December 18, 2013, 83% of their ratings had a stable or positive outlook.

Looking ahead to the remainder of 2014 and beyond, there are several areas of focus for rating agencies.

Interest Rates

The risk posed by low interest rates is declining as conditions improve and rates are expected to continue to rise gradually. A gradual increase in interest rates will relieve pressure on life insurers' profits. However, rates remain very low from a historical perspective and continue to put downward pressure on spreads and operating fundamentals. While the risk is viewed as manageable, concern remains about strategies some life insurers may use to generate incremental yield.

Macroeconomic Stability and Improvement

The economy has showed signs of improvement, albeit slow by historical standards. The economy is still viewed as being in a recovery mode, but economists see that recovery as vulnerable to a number of risks, including, but not limited to, disruption caused by the end of monetary stimulus (i.e., quantitative easing); legislative gridlock related to budget battles in the U.S. Congress; and a flare-up of the euro region debt crisis.

Equity Markets

Rising equity markets will continue to improve the performance of variable annuity portfolios and other assets under management-fee driven businesses. While equity market performance has been very good overall since 2009, rating agencies remain concerned about potential volatility in equity prices and the resulting impact on insurers' financial performance.

U.S. Life Insurance Industry Asset Portfolio Credit Quality

The concerns about the previous three items weigh heavily on the industry's asset portfolio credit quality. Credit-related impairments since the financial crisis have continually been below expectations and historical averages. Rating agencies expect credit-related investment losses to remain below pricing assumptions and historical averages even if the economic recovery stalls. But they will be watchful to see if insurers increase the risk profile in their investment portfolios should interest rates remain near historical lows.

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Summary

Since the financial crisis of 2008-2009, investors and policyholders have experienced a heightened sense of anxiety about the financial strength of life insurance companies. However, the failure rate of life insurance companies remains low in the wake of the financial crisis, with no impairments occurring in 2013. While financial strength ratings for life insurers understandably were lowered during the financial crisis, the industry generally remained resilient and has emerged with ratings that are on par with levels seen pre-financial crisis. While risks remain, life insurers are successfully managing their assets and liabilities to address these risks as exhibited by the current stable outlook provided by the rating agencies.

The Exemption from Source State Income Taxation of Certain Retirement Income

Under federal law, certain retirement income payments, including certain payments from nonqualified deferred compensation plans, may avoid income taxation by the state in which the income was earned. This article serves as a reminder of that fact as well as a review of an interpretation of the federal law by the New York State Department of Taxation, which found that substitute payments under nonqualified deferred compensation plans caused by the bankruptcy of the payer should not affect the characterization of the payments for purposes of this federal tax law.

The Federal Exemption

The federal "source tax" law provides that an individual's "retirement income" may only be taxed by the state in which the individual is a resident or domiciliary.*

**Section 114(a) of Title 4 of the US Code, as added by Public Law 104-95, January 10, 1996, and applicable to amounts received after December 31, 1995: "[no] State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State)."*

Retirement Income

"Retirement income" is defined as any income from, among other things:

- A <u>tax-qualified plan</u> (such as a 401(k) plan) or certain other kinds of tax-favored retirement plans, including 403(b) and 457(b) plans and individual retirement accounts, or
- A <u>nonqualified deferred compensation plan</u> described in § 3121(v)(2)(C) of the Internal Revenue Code of 1986 if it:
  - Provides solely for benefits after termination of employment in excess of limitations imposed by one or more of sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k), or 415 of the Internal Revenue Code, or
  - Provides income that is part of a series of substantially equal periodic payments (not less frequently than annually) made for:
    - The life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient), or
    - A period of not less than 10 years

So, for example, if an individual earns nonqualified deferred compensation while working in Oregon, Oregon may not tax that deferred compensation if the individual no longer is a resident of Oregon when the payment is received and the payment is made either in the form of a life annuity or in installments that last for a period of not less than 10 years.

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New York State Department of Taxation Advisory Opinion

In the case considered by the New York State Department of Taxation and Finance in advisory opinion TSB-A-13(5)I (April 8, 2013), an individual who no longer was a resident of New York had begun to receive monthly SERP payments in 2002 for his life and Deferred Compensation Plan payments in 2003 for a period to last 12 years. He received these payments based on his employment with the Dime Savings Bank of New York. Dime Savings Bank was acquired by Washington Mutual Bank in January 2002. The individual retired at the time of the acquisition.

In 2008, Washington Mutual filed a voluntary petition in Bankruptcy Court in Delaware, was seized by the FDIC and its assets were sold to JPMorgan Chase. Pursuant to a Global Settlement Agreement, JPMorgan Chase undertook certain obligations with respect to the SERP and the Deferred Compensation Plan. The Global Settlement Agreement specified that JPMorgan Chase was not required to assume any "nonqualified deferred compensation plan" but was required to "satisfy the obligations to pay or provide any and all benefits with respect to the arrangements" in those plans. JPMorgan Chase was expressly authorized "to the extent of applicable laws, change the manner and form of those payments."

In May, 2012, JPMorgan Chase disbursed to the taxpayer a lump sum distribution that represented the present value of the SERP annuity, the balance in the Deferred Compensation Plan, and interest during the period of bankruptcy when payments were suspended. JPMorgan Chase withheld from the distribution an amount equal to New York State and local estimated income tax. The taxpayer resided in both New Jersey and Virginia and had at the time of the opinion taken up residence in Pennsylvania. He had never been a resident of New York.

The Department of Taxation concluded that, for New York State and local personal income tax purposes, the lump sum payment received by the taxpayer in settlement of his SERP and Deferred Compensation Plan with Washington Mutual Bank will be treated as nontaxable retirement income of a person who is not a resident or domiciliary under section 114(b)(1)(ii) of the US Code. It based its determination on a Supreme Court case that held that in order to determine the nature and extent to which settlement amounts received by compromise or judgment are to be included in gross income, it is necessary to look to the nature of the item for which the settlement is a substitute. That is, the settlement amount received should be treated the same as the underlying item that was the basis for the settlement. The unforeseeable act of Washington Mutual filing for bankruptcy should not change the tax treatment of the taxpayer's payments under the SERP or Deferred Compensation Plan.

Upcoming Events

2014 ABA Annual Convention

October 19–21; Hyatt Regency Dallas
Dallas, TX

M Benefit Solutions - Bank Strategies is proud to exhibit. Join us at Booth 208 for your bank's customized BOLI Empowerment Page and enter to win a GoPro Hero3 camera.

Advisor Firms

M Benefit Solutions - Bank Strategies is structured to provide our clients with consistent nationwide coverage. We have identified several Advisors with extensive experience in bank executive and director benefits and BOLI to provide consulting services to clients nationwide.*

Distributed throughout the country, these Advisors work with M Benefit Solutions and bank clients to design programs which meet each bank's specific needs and to ensure high quality administrative and compliance services.

ECI/Bank Benefits

Thomas V. Lynch
tlynch@ecicompanies.com
Minneapolis, MN
Phone: 952.885.2727; Fax: 952.885.0995

Evergreen Consulting, Inc.

James Cheney
jcheney@evergreenci.com

Robert Kozloski
rkozloski@evergreenci.com
Chattanooga, TN
Phone: 423.756.3828; Fax: 423.265.0735

Financial Designs Ltd.

Gerald Middel
jmiddel@fdltd.com
Denver, CO
Phone: 303.948.4068; Fax: 303.832.7100

GW Financial, LLC

John Gagnon
jgagnon@bolicoli.com
Reading, MA
Phone: 781.942.5700; Fax: 781.942.5710

M Benefit Solutions - Bank Strategies

Mark Boomgaarden
mark.boomgaarden@mben.com
St. Peter, MN
Phone: 952.334.3239

Douglas Harper
douglas.harper@mben.com
Carefree, AZ
Phone: 480.223.8141

Thomas J. Jordan
tom.jordan@mben.com
Austin, TX
Phone: 512.656.9950

Dan Wagner
dan.wagner@mben.com
Chesterfield, MO
Phone: 636.530.1635

**These Advisors are associated with our Broker/Dealer, M Holdings Securities, Inc.*

About M Benefit Solutions - Bank Strategies

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