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Third Quarter 2011

THE BOTTOM LINE
EXECUTIVE AND DIRECTOR BENEFITS AND BOLI

S&P Downgrade of U.S. Credit Rating: Initial Perspectives

(As Featured in the August 2011 M Financial Group Due Care Bulletin)

On August 5, 2011, Standard & Poor's Rating Services (S&P) downgraded the long-term credit rating of the United States of America to 'AA+' from 'AAA' and maintained its negative rating outlook. The action came after S&P placed the rating on CreditWatch Negative on July 15, 2011.

According to S&P, the downgrade reflects their opinion that the fiscal plan approved by Congress and signed into law by President Obama falls short of what, in S&P's view, would be necessary to stabilize the government's medium-term debt situation. Additionally, S&P stated that the effectiveness and stability of American policymaking and political institutions have weakened at a time when persistent fiscal and economic challenges have continued to grow.

The Immediate Impact

In addition to the sharp financial market declines around the world, the S&P downgrade of the U.S. sovereign credit rating had an immediate impact on several life insurance companies. Because S&P constrains its financial strength ratings on insurers to the sovereign local-currency credit rating, S&P downgraded the financial strength ratings of the five U.S. insurance groups that held 'AAA' ratings. The affected insurance groups—which now have 'AA+' ratings with an unchanged negative Outlook—are Knights of Columbus, New York Life, Northwestern Mutual, Teachers Insurance & Annuity Assoc. of America (TIAA), and United Services Automobile Assoc. (USAA). Additionally, S&P affirmed the 'AA+' ratings on five other insurance groups—Assured Guaranty, Berkshire Hathaway,

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Guardian, Massachusetts Mutual, and Western & Southern—and revised the rating outlooks on these companies to negative from stable.

In explaining the downgrades, S&P stated that their view of each company's fundamental credit characteristics has not changed as a result of the U.S. sovereign credit downgrade. Instead, the actions reflect their view that the link between the ratings for these insurers and the sovereign rating for the U.S. could lead to a decline in the insurers' financial strength. The five downgraded insurance groups have significant holdings of U.S. Treasury and agency securities—between 60–200 percent of total adjusted capital for each of the five groups at year-end 2010. However, S&P stated that these companies maintain very strong capital and liquidity.

It is important to note that Moody's and Fitch have not taken action to downgrade the U.S. sovereign credit rating. While downgrades remain a possibility, Fitch noted in a statement that the United States' debt ceiling increase was approved, and "commensurate with its 'AAA' rating, the risk of sovereign default remains extremely low."

The NAIC View

In terms of the effect on the mechanisms in place designed to protect policyholders, the National Association of Insurance Commissioners (NAIC) stated the downgrade will have no direct impact on required regulatory capital for U.S. Treasury and agency securities. Even if regulators assigned a risk factor similar to corporate bonds when determining risk-based capital (RBC) ratio, it is estimated by one analyst that RBC ratios for their covered companies would only decline 7 percent from an average year-end 2010 level of 463 percent. In addition, it is not expected that life insurers will be forced to sell Treasury or agency securities. In a report issued early Monday, August 8, Colin Devine of Citi Investment Research & Analysis, stated: "Japanese life insurers adapted to that country losing its 'AAA' rating and continue to hold large levels of government bonds. We see no reason why U.S. insurers won't do so as well."

Interest Rates

In the Citi report, Colin stated that he expects life insurer shares will remain heavily influenced by the direction of long-term interest rates. If the downgrade creates upward interest rate pressure, "any increase in long-term yields would be positive with respect to both future investment income and liability valuations. It could also, in isolation, potentially be favorable for life insurers' share valuations. Conversely, any decline in equity markets would intensify existing earnings pressures on variable annuity lines and could potentially lead to either higher benefit costs and/or accelerated amortization of deferred acquisition costs (DAC)."

Still Financially Strong(est)

The U.S. Federal Reserve and several foreign central banks have announced that U.S. Treasury and agency debt will continue to be accepted as top-rated collateral. This is due to the fact U.S. Treasuries previously made up approximately 60 percent of the world's highest-rated debt. As a result there simply is not enough 'AAA'-rated debt available in the marketplace, meaning that the U.S. will continue to be the key issuer of the highest quality and most liquid securities available for the short- to medium-term. This will mitigate the impact on banks' ability—in the short term—to extend credit, as required reserves are not impacted by the downgrade.

However, foreign holders of our government debt (especially China, if recent statements are any indication) may seek to diversify into other investments systematically over time. Over the long term it may drive up the cost of capital, which would increase U.S. deficits and slow economic growth. While the impact on short-term rates may be negligible, it is believed that the downgrade may cause long-term interest rates to increase.

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The Consensus View

The consensus view on the downgrade is that it was a foregone conclusion and many have already adjusted for it. The downgrade is not the result of any change in the perceived risks and challenges facing our country's financial strength. Instead it is viewed as a "no-confidence" statement in the ability of the Congress and the Administration to achieve a consolidated fiscal plan to address the country's long-term debt and deficit situation. The U.S.'s fiscal condition has not changed, but S&P's faith in the U.S. government's ability to address the situation has deteriorated to the point that it has negatively impacted the nation's credit worthiness.

M Financial Group will continue to monitor and evaluate developments relating to M Carriers and the industry as a whole.

The American Jobs Act—Tax Provisions

In September 2011, President Obama proposed legislation called The American Jobs Act (the "Jobs Act") with the stated aim of putting more people back to work, cutting taxes on middle class workers, and increasing taxes on the wealthy. Some of the tax provisions contained in the Jobs Act are described here:

Temporary Payroll Tax Cut for Employers, Employees, and the Self-Employed

The Jobs Act would extend and expand the existing temporary reduction in payroll taxes. For calendar year 2012, it would: (a) further reduce the Old Age, Survivors and Disability Insurance (social security) portion of the payroll tax that was paid by employees during 2011 from 4.2 percent (reflecting the existing 2 percent temporary reduction from the permanent rate) to 3.1 percent; and (b) add a new reduction in the portion of this tax that is paid by employers from 6.2 percent to 3.1 percent. The employer reduction would apply to up to $5 million of wages that are paid by the employer.

Temporary Tax Credit for Increased Payroll

For the last quarter of 2011 and for calendar year 2012, the Jobs Act would provide a payroll tax credit that fully offsets the employer social security tax that otherwise would apply to increases in wages from the corresponding period of the prior year. For example, if an employer paid wages subject to social security tax of $5 million in 2011 and $6 million in 2012, the credit to which the employer would be entitled would eliminate the employer's portion of social security taxes on the $1 million of increased wages. The credit would be available on up to $50 million of an employer's increased wages.

28 Percent Limitation on Certain Deductions and Exclusions

The Jobs Act would limit the value of all itemized deductions and certain other tax expenditures by limiting the tax value of otherwise allowable deductions and exclusions to 28 percent. No taxpayer with adjusted gross income under $250,000 for married couples filing jointly (or $200,000 for single taxpayers) would be subject to the limitation. The limitation would affect itemized deductions and certain other tax expenditures that would otherwise reduce taxable income in the 36 or 39.6 percent tax brackets. A similar limitation also would apply under the alternative minimum tax. This section would be effective for taxable years beginning on or after January 1, 2013.

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Partnership Interests Transferred in Connection With Performance of Services

Current law allows service partners, such as hedge fund managers, among others, to receive capital gains treatment on labor income without limit. The Jobs Act would tax as ordinary income, and make subject to self-employment tax, a service partner's share of the income of an investment partnership attributable to a carried interest (such as a hedge fund performance fee) because such income is derived from the performance of services. To the extent that a service partner contributes "invested capital" and the partnership reasonably allocates its income and loss between such invested capital and the remaining interest, income attributable to the invested capital would not be recharacterized as ordinary income. This proposal would be effective for taxable years beginning after December 31, 2012.

The Jobs Act also has provisions for eliminating tax preferences for oil and gas companies and eliminating special depreciation rules for corporate purchases of aircrafts.

The President's Deficit Reduction Plan: "Living Within Our Means and Investing in the Future"

Shortly after the President proposed the Jobs Act earlier this month (see description above), the President sent to the Congress his plan to pay for the Jobs Act and to realize more than $3 trillion in net deficit reduction over the next 10 years.

The deficit reduction plan, in addition to cuts and reforms to mandatory programs such as Medicare and Medicaid, calls for the Congress to undertake comprehensive tax reform that lowers tax rates, closes loopholes, and observes the Buffett Rule—that people making more than $1 million a year should not pay a smaller share of their income in taxes than middle-class families pay.

In addition to the tax provisions of the Jobs Act and observation of the Buffet rule, the deficit reduction plan also calls for, among other things, the following:

- Allow the 2001 and 2003 high-income tax cuts to expire.
- Return the estate tax to 2009 exemption and tax rate levels.
- Expand pro rata interest expense disallowance for new COLI policies issued after December 31, 2012.
- Modify rules relating to the sales of life insurance contracts, including modification of "transfer-for-value" rules to prevent purchasers of in-force policies from avoiding tax on death benefits.

SEC Delays Planned Implementation for Dodd-Frank Executive Compensation Requirements

In late July 2011, the SEC revised its Dodd-Frank implementation timeline. The planned adoption of several executive compensation provisions was delayed from the end of 2011 to the first half of 2012. The provisions are:

- Disclosure rules regarding pay-for-performance and CEO pay disparity ratio (Dodd-Frank §953)
- Rules regarding compensation clawbacks for executive officers (Dodd-Frank §954)
- Disclosure rules regarding employee and director hedging (Dodd-Frank §955)
- Final rules (to be published jointly with other Federal regulators) regarding incentive compensation arrangements at financial institutions (Dodd-Frank §956)

Section 956 rules have been proposed. Rules under the other sections are slated to be proposed by the end of 2011. The revised timeline means that it is unlikely that any of the above provisions will be implemented in time for the 2012 proxy season. Additionally, the clawback rules under Section 954 are subject to implementation by the national securities exchanges, which could delay implementation beyond mid-2012.

The SEC's timeline indicates that it still expects to adopt final rules under Section 952 (exchange listing standards for compensation committee and advisor independence, as well as disclosure rules regarding compensation consultant conflicts of interest) by the end of 2011. The proposed rules under Section 952 contemplate that the national securities exchanges would have an additional one year following publication of the final SEC rules to implement the new listing standards; however, assuming the SEC meets its schedule, it is possible that the new disclosure requirement regarding consultant conflicts of interest will be effective for the 2012 proxy season.

"Say-on-Pay" Litigation

As of September 23, 2011, there have been nine separate lawsuits filed against corporate boards after shareholders rejected board-recommended executive compensation programs. Executive compensation programs, beginning in 2011, are subject to an advisory shareholder vote under Dodd Frank's "say-on-pay" voting requirements. In one of these lawsuits, filed on behalf of Cincinnati Bell by the NECA-IBEW Pension Fund, a court for the first time, in late September 2011, denied the board's motion to dismiss the suit. The corporate legal community has been expecting these lawsuits to be dismissed as frivolous. The failure to dismiss has made the corporate bar and boards sit up and take notice.

The court began its analysis noting that, normally, a board of directors is protected by the "business judgment rule" when making decisions about executive compensation, and courts "will not inquire into the

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wisdom of actions taken by a director in the absence of fraud, bad faith, or abuse of discretion." The court also noted that "[u]nder Ohio law, directors will face liability only if it is shown by clear and convincing evidence that their actions were undertaken with 'a deliberate intent to cause injury to the corporation' or 'reckless disregard for the best interests of the corporation.' Ohio Rev. Code Ann. §1701.59(D) (2011)."

The federal District Court in the Southern District of Ohio framed the issue in this way:

"This civil lawsuit presents the question, among others, whether a shareholder of a public company may sue its directors for breach of the duty of loyalty when the directors grant $4 million dollars in bonuses, on top of $4.5 million dollars in salary and other compensation, to the chief executive officer in the same year the company incurs a $61.3 million dollar decline in net income, a drop in earnings per share from $0.37 to $0.09, a reduction in share price from $3.45 to $2.80, and a negative 18.8% annual shareholder return."

The court went on to find, however, that the factual allegations made by the plaintiffs "raise a plausible claim that the multi-million dollar bonuses approved by the directors in a time of the company's declining financial performance violated Cincinnati Bell's pay-for-performance compensation policy and were not in the best interests of Cincinnati Bell's shareholders and therefore constituted an abuse of discretion and/or bad faith."

Where this case goes from here will be closely watched by all in the corporate community. This case will remain of high concern to compensation committees, their counsel and advisors, when considering their responsibilities during the next proxy season in setting appropriate executive compensation levels. In addition to this case, other factors that will need to be considered by compensation committees and their advisors when setting compensation levels include:

- Continuing public concern and even anger at large income disparities, especially at a time when unemployment remains high.
- A declining economy and stock market.
- Potentially stricter positions taken during next year's proxy season by ISS and institutional shareholders.

Advisor Firms

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

Distributed throughout the country, these Advisors work interactively 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
Twin Falls, ID
Phone: 480.223.8141

Thomas J. Jordan
tjordan@ecicompanies.com

Austin, TX
Phone: 512.656.9950

Dan Wagner
dwagner@mben.com

Chesterfield, MO
Phone: 636.530.1635

SilverStone Group

Thomas J. Von Riesen
tvonriesen@ssgi.com

Omaha, NE
Phone: 800.288.5501; Fax: 402.963.4084

Jamie Corbin
jcorbin@ssgi.com

Des Moines, IA
Phone: 515.285.5882

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M Benefit Solutions®
Bank Strategies

An M Financial Group Company

ICBA
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M Benefit Solutions - Bank Strategies
M Financial Plaza
1125 NW Couch Street, Suite 900
Portland, OR 97209
503.238.1813
fax: 503.238.1815
www.mben.com/bank