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A Utilitarian Solution to Disappearing Margins

A Potential Remedy to Burdensome Regulations and Low Interest Rates

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Many of today's community banks find themselves in a tough spot. The exponential rise in the cost of compliance and the low interest rate environment is adversely impacting banks' bottom-lines. The new regulations are affecting everything from mortgage lending to the viability of owning some of a bank's already limited range of permissible investments. One asset, however, that appears to have come through this regulatory cyclone unscathed, is Bank-Owned Life Insurance (BOLI).

Community banks have, in general, withstood the economic turmoil and are preparing themselves to thrive when the economy inevitably recovers. Bankers are waiting for their opportunities while still making careful, profitable loans. However, there are outside influences, beyond their control, eating into their profits: increasing regulatory burdens and the manipulated interest rate environment. BOLI counters both issues with clear, venerable, regulatory guidelines for banks to follow and the enjoyment of tax favored returns that typically exceed after-tax returns of more traditional bank investments by 150 to 300 basis points.

Not Every Banking Activity Needs a New Regulation

Despite recent overtures from federal agencies promising to ease the burden on smaller institutions, bankers remain unconvinced.

> …For the most part, the new regulations are directed at the largest institutions, whose failure would pose the greatest risk to the financial system, or at the lending practices that led to the crisis. Even so, the changes are so sweeping that many industry analysts have questioned whether the overall weight of regulation poses a threat to the future of the community bank model.—*Federal Reserve Board Governor Elizabeth A. Duke at the 2012 Bank Presidents Seminar, California Bankers Association*[1]

The massive new regulations are broad and complex which will cause compliance costs to significantly increase. A properly administered BOLI program shouldn't add to this cost, however, as the regulators have provided clear and decisive guidelines to follow via the Interagency Statement on the Purchase and Risk Management of Life Insurance (OCC 2004-56)[2].

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1 *See, e.g., Board of the Federal Reserve System Speech ("Opportunities to Reduce Regulatory Burden and Improve Credit Availability") (Jan. 13, 2012) (http://www.federalreserve.gov/newsevents/speech/duke20120113a.htm)*

2 *See, e.g., Bank-Owned Life Insurance, Interagency Statement on the Purchase and Risk Management of Life Insurance ("Interagency BOLI Guidance") (Dec. 7, 2004).*

The Agencies also solidified their opinion of BOLI in the recent Volcker Rule Proposal[3]. In it, Separate Account BOLI was exempted from the rule and referenced the adequacy of existing, long-standing guidelines. While this is still in proposal form, and there is no guarantee it will make it to the final rule, it re-emphasizes the permissibility, and the utility, of BOLI ownership.

The Low Rate Environment—A Depressant, Not a Stimulant

Economic indicators appear to be pointing toward a recovery. Or do they? What we do know is that the Federal Reserve initially announced they would hold rates down through 2013; strike that, now it's through 2014! The Fed issued a press release stating, "*…The Committee) anticipates that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.*"[4] Well, at least that removes some uncertainty for bankers. Now they're certain they won't make money until 2015. Camden Fine, President/CEO of the Independent Community Bankers of America (ICBA), made this point recently on his blog:

> "…But with the Fed setting rates at nearly zero percent and slack credit demand, how are community banks supposed to make a viable spread on their funds? Most community banks are swimming in liquidity. Meanwhile, they're holding short-term investments (encouraged by their field examiners, by the way) under the assumption that rates would begin to rise within the next year or so. Now they are faced with at least two more years of zero interest in a struggling economy."[5]

With the Federal Reserve's promise to keep interest rates low through 2014, coupled with low loan demand and regulatory pressure to keep investment funds in short-term low-to-no yielding securities, banks are challenged to find ways to grow revenue or to make a viable spread. BOLI confronts these challenges by providing higher before- and after-tax returns than most traditional bank investments while reducing risk exposure to sudden rate changes. BOLI carriers mitigate some of the portfolio rate risk by facilitating smooth earnings to the bank due to: assets (and yields) in the portfolio being carried at book value; average duration of portfolio assets being typically shorter than bankers realize; and any gains/losses from purchases/sales being amortized over a long period.

As community banks struggle to generate earnings via their core business, lending, they are being further threatened by considerable new regulations and an extended low interest rate environment. While not a cure all, BOLI, with its regulatory certainty and tax favored status, can provide a useful and timely solution for community banks.

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3 *See, e.g., Sec__.14, Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds (FRS Docket No. R-1432 & RIN 7100 AD 82; OCC Docket ID OCC-2011-14; FDIC RIN 3064-AD 85; SEC File Number S7-41-11).*

4 *See, e.g., Board of the Federal Reserve System Press Release (Jan. 25, 2012) (http://www.federalreserve.gov/newsevents/press/monetary/20120125a.htm)*

5 *See, e.g., Independent Community Bankers of America (ICBA) ("Finer Points") (Aug. 15, 2011) (http://camfine.wordpress.com/2011/08/15/backdoor-bailout-for-wall-street-back-of-the-hand-for-main-street/)*

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