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Second Quarter 2010

THE BOTTOM LINE
EXECUTIVE AND DIRECTOR BENEFITS AND BOLI

Moody's Concludes That U.S. Life Insurance Industry Remains Well Capitalized

According to a Special Comment issued by Moody's Investors Service, the U.S. life insurance industry remains well capitalized after completing a review of 2009 year-end statutory financial statements filed by insurers. This conclusion takes into account "cosmetic" changes that boosted 2009 year-end risk-based capital (RBC) but did little to alter the true capital levels of companies.

Among the conclusions reached by Moody's are:

- Most companies reported stronger capital positions relative to 2008. The median RBC ratio improved to 429% at the end of 2009 (up from 394% at year-end 2008). The improvement was attributable to capital contributions, improved statutory earnings, and industry regulatory and accounting changes.
- Capital remains vulnerable to investment losses, particularly in commercial and residential real estate-related assets.
- Moody's expects continued high levels of volatility in regulatory capital due to legacy blocks of variable annuities with "meaningful" guaranteed benefits and equity market sensitivity.
- The recent turmoil in capital markets has caused life insurers to remain cautious about spending excess capital, although Moody's expects some companies to resume returning excess capital to shareholders later in 2010.

Overall, companies rated by Moody's reported a 13% increase in capital in 2009 after reporting a 13% decline in capital in 2008.

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

Featured Articles

- Moody's Concludes That U.S. Life Insurance Industry Remains Well Capitalized
- Notes on the 409A Corrections Programs
- FASB Exposure Draft—Proposed Accounting Standards Update
- M Benefit Solutions Releases a White Paper on BOLI Product Options

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Notes on the 409A Corrections Programs

Speaking in early June at the Practising Law Institute webcast, *Hot Issues in Executive Compensation 2010*, IRS Special Counsel Stephen B. Tackney reviewed the §409A document corrections program under Notice 2010-6 and comments received since the notice was issued.

The IRS will be bringing out a revenue procedure to consolidate guidance in Notice 2010-6 and Notice 2008-113, on operational corrections. There will be some changes to the document corrections guidance based on comments received, including possibly removing disclosure requirements when there is no income inclusion under the transition relief period of Notice 2010-6.

Other Issues

Other issues to be considered include:

- ***Audits.*** Under Notice 2010-6, employers are not eligible to participate in the document corrections program if they are under audit to the extent nonqualified deferred compensation has been identified as an issue. Individuals also are not eligible if they are under audit.

  Employers have asked how will they know an employee is under audit. The IRS did not intend for the employer to have to specifically ask the employee or to invade the employee's privacy. The employer should notify employees that they are not eligible if they are under audit. If an employee is under audit, he or she will have to address the issue with IRS officials.

- ***Stock Rights.*** Employers would like the ability to correct stock rights intended to be compliant with §409A—currently not eligible for correction under Notice 2010-6—for example, to fix an exercise date or an exercise year. This is something that may arise in the international context and is something the IRS is considering.

- ***Short-Term Deferrals.*** You can't correct to get out of 409A. For example, if a payment was meant to be a short-term deferral, but you didn't do it right, you are under 409A. You can't correct and make the payment a short-term deferral.

- ***12-Month Lookback.*** When a document failure is fixed under Notice 2010-6, there is no income inclusion at the time of correction, but if the operation of the plan is affected by the correction, then a participant can get caught in the 12-month lookback. In such a case, the participant must pay the 20% tax on 50 percent of the deferred amount. This is meant to encourage early correction and to discourage people from waiting to correct.

Come See Us!

Tom Lynch of ECI Companies, Inc./Bank Benefits will be attending the Annual Convention of the Community Bankers of Iowa (CBI) at Lake Okoboji, July 14–16.

As an Associate Member and a Sponsor, ECI enjoys CBI's exclusive endorsement for Wealth Preservation and Benefit Planning, as well as for Bank-Owned Life Insurance (BOLI). Approximately 2/3 of all member banks will be in attendance.

FASB Exposure Draft—Proposed Accounting Standards Update

Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

On May 26th the Financial Accounting Standards Board (FASB) released an exposure draft of a proposed accounting standards update on accounting for financial instruments. The proposal aims to create reporting standards that are more transparent and consistent by requiring the use of mark-to-market accounting with regards to most Financial Instruments, including loans and deposits. All entities that have financial instruments would be affected, but the effect on banks would be extensive.

Main Objectives and Changes

The FASB exposure draft states:

> *The objective of the proposed guidance is to provide an improved and consistent financial reporting model for the recognition, measurement, and presentation of financial instruments in an entity's financial statements.*

The aim is to develop standards that improve financial reporting and provide financial statement users with a clearer depiction of an entity's financial instrument holdings, while simplifying the accounting for those instruments.

How does this affect community banks?

The draft intends to alter how banks account for all financial assets and liabilities, including loans and deposits. These will now be recorded at "fair value" on the balance sheet. Currently, banks measure their long-term loans at amortized cost. These illiquid assets are intended to be held to maturity and not for immediate resale. The shift to fair value accounting poses significant problems for banks. The appraisal cost and time spent to set a market price for assets where a historical market doesn't exist will be significant and the market price will most likely cause these assets to immediately lose value.

Many industry trade groups also fear this will create ancillary problems such as:

For Banks

- Incentives for banks to abandon long-term loans and shift to shorter-term maturities due to:
  - Increase maintenance cost and excessive burden of carrying long-term loans
  - Shorter-terms will be preferred to hedge against economic downturns
- Credit attenuation
  - Value of long-term loans immediately reduced
  - Long-term loans available only to select clients

For Borrowers

- Very difficult to obtain long-term loans with favorable interest rates
  - Many will only be able to obtain shorter-term loans with higher interest rates
  - Banks' extra cost associated with appraisals and regulatory burdens will trickle down to borrowers
  - Risk focused regulators will result in banks lowering loan amounts and requiring higher principal payments

For Investors

- Regarding long-term loans, the new accounting methods may create more misleading financial statements
  - The methodology determining market value of illiquid assets is subjective and without any real basis
  - Fairness of procedure
    - If no viable market for product, credit analysts may apply "fire sale" pricing, even if loan is performing as intended

The inclusion of almost all financial instruments without regard to the entity type could be an overreaction to the economic crisis. This also diverges from FASB's long-standing goal to work with the International Accounting Standards Board (IASB) to converge standards on accounting for financial instruments. This proposal is in conflict with IASB rules which take into account an entities business model when it comes to mark-to-market accounting.

FASB's intent is to provide investors and regulators with financial statements that are easier to understand and contains more relevant information about an entity's exposure to financial instruments. However, by applying this change in a blanket fashion to all entities that have financial instruments and not providing more practical, separate standards for different entity types, FASB may create unintended negative consequences for certain marketplaces, such as community banks, and for the economy in general.

How does this affect a bank's Bank-Owned Life Insurance (BOLI) portfolio?

The exposure draft currently excludes Bank-Owned Life Insurance (BOLI) because these contracts have an insurance element and there may be significant practical issues measuring these contracts at fair value. Banks generally purchase BOLI to help offset costs of executive benefit plans and other employee benefit plans, such as healthcare, due to its tax-preferred status.

If these standards are adopted, a bank's BOLI assets would increase in importance. It would be one of a few

assets held by the bank that wouldn't create extra accounting work or regulatory burden due to this change. And, as it does now, it would continue to provide the bank with a highly-rated asset that grows tax-deferred (tax-free if held until death) and a dependable net income stream.

Next Steps

FASB did not specify an effective date, however the effective date for non-publicly held banks with assets less than $1 billion will be delayed for four years.

This proposal is open for comments until September 30, 2010. FASB will then hold public roundtable meetings in October before making its final decision. For further information, and to view the draft in full, please visit FASB's website at http://www.fasb.org/home.

M Benefit Solutions Releases a White Paper on BOLI Product Options

M Benefit Solutions recently published a white paper on Bank-Owned Life Insurance (BOLI) Product Options, addressing the General Account, Separate Account, and Hybrid selections. Over the last 20 years the BOLI product landscape has evolved tremendously into an increasingly dynamic strategy for firms and banks, and has become more prevalent with community banks in the past ten years. More than 3,800 banks nationwide reported BOLI on their December 31, 2009 call reports, and now have the ability to purchase a life insurance product that better fits its specific needs.

Today, the BOLI industry offers choices that are likely to fit the investment appetite and strategic financial goals for many banks. The advantages and disadvantages of each type of product should be analyzed in detail so that each investment decision aligns with the financial goals of banks. To obtain a copy of the white paper, please visit our website www.mben.com/bank.

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About M Benefit Solutions - Bank Strategies

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