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Third Quarter 2009

THE BOTTOM LINE
EXECUTIVE AND DIRECTOR BENEFITS AND BOLI

Capital Conundrum

How BOLI Impacts a Bank's Risk-Based Capital Ratio

In early September, the U.S. Treasury proposed adopting new capital and liquidity requirements for banks based on international standards in line with recent recommendations by the Basel Committee. Although specific levels and ratios have yet to be set, they are expected to be more stringent than current requirements, calling for higher capital levels, constraints on leverage and a minimum standard for funding liquidity.

Stronger capital requirements given today's economy is logical. However, raising capital is easier said than done. Raising additional capital is difficult and often not palatable to banks. Private markets are still reluctant to invest and the strings attached to TARP funds often are too restrictive and overreaching for many banks. Adding new capital may be avoidable for many community banks, but the stricter standards will necessitate a different approach as to how banks address their capital situation.

Adhering to new standards may facilitate new, more conservative, behaviors and strategies from banks in areas such as dividend payments, compensation and repurchase of shares. However, banks also have other options to strengthen their capital ratios. One option is Bank-Owned Life Insurance (BOLI).

When a bank purchases BOLI, they are essentially "exchanging" one asset for another. They may use cash to pay the premium, or they may sell another asset to generate the necessary funds. The impact on a bank's Risk-Based Capital (RBC) ratio is based on the risk-weighting of the assets they exchange. Some BOLI products with lower risk-weightings[1] can improve a bank's RBC Ratio. The better a bank's RBC ratio, the more capital it frees up for other purposes, such as loans.

The following summarizes the effect on a bank's RBC ratio when investing $10 million in BOLI in a product with a 20% risk-weighting versus keeping that amount in a 100% risk-weighted asset. In this example, by exchanging the 100% risk-weighted asset to the 20% risk-weighted BOLI product, the total risk-weighted assets in the bank reduce by $8 million (since the BOLI now has a

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[1] *Some separate account BOLI products have been designed to have RBC ratios as low as 20%.*

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risk-weighted value of $2 million) resulting in an RBC ratio improvement of 41 basis points.

Description	100% Risk-Weighted Asset	20% Risk-Weighted BOLI Product
Total Risk-Based Capital	19,869	19,869
Total Risk-Weighted Assets	199,333	191,333
Total Risk-Based Capital Ratio	9.97%	10.38%

Note: Above chart is used for sample purposes only and does not reflect an actual purchase.

The new, stringent standards reflect today's reality. Fortunately, most community banks are already following conservative business practices and shouldn't be overly burdened by the guidelines. However, there are ways, such as shifting assets to low risk-weighted BOLI, to improve a bank's RBC ratio (not to mention its bottom-line) and to free up capital for use in a more productive way.

Federal Reserve Set to Oversee Compensation at Financial Institutions

The Wall Street Journal and other media outlets have reported that the Federal Reserve is considering the adoption of a proposal that would put the compensation policies of thousands of banks under its review and subject to its veto power. The proposal's purpose is to rein in risk-taking at financial institutions.

The Fed wouldn't set the pay of individual employees under the proposal, but it could require changes to compensation policies to ensure they don't create incentives for harmful risk-taking. The Fed believes it has the ability to oversee compensation practices in this way under its powers as the "safety and soundness" regulator for the banks it monitors.

Fed officials now see compensation policy as possibly exposing individual banks—and even the broader financial system—to serious danger. The financial crisis of the past few years has given rise to examples of excessive risk-taking that was encouraged by compensation incentives. *The Wall Street Journal* cites as an example, loan officers who earned large bonuses for producing thousands of low-quality loans that later went bad.

The proposal has not been finalized and is likely still weeks away from a vote by the Fed's board. No congressional approval is required though some Congressman have taken issue with the Fed's authority to police compensation practices in this way.

House Financial Services Committee Chairman Barney Frank (D., Mass.) praised the Fed's move but said his Corporate and Financial Institution Compensation Fairness Act of 2009 (discussed above) is still needed to be signed into law because it would clear up ambiguity regarding whether the Fed had the authority to take such steps.

In one interesting reaction to the proposal, some bankers said the Fed's move is an indictment of a system that lets banks get too big. Chris Nunn, Chief Financial Officer of Security Bancorp of Tennessee Inc., a Halls, Tenn., banking company with nearly $700 million in assets is quoted as saying: "If institutions were not allowed to grow so large as to threaten the entire financial system, then federal intervention such as this would not be necessary."

Corporate and Financial Institution Compensation Fairness Act of 2009

In July 2009, Rep. Barney Frank, chairman of the House Financial Services Committee, introduced legislation that would require shareholder advisory votes and address other executive compensation concerns. The legislation passed the House on July 31, 2009, and has been referred to the Senate Committee on Banking.

The bill would require annual "say on pay" votes at all U.S. companies; mandate separate investor votes on "golden parachute" payments; impose stricter independence standards on compensation committees; and authorize pay panels to retain their own independent consultants. The bill also directs the Securities and Exchange Commission to prepare a study on pay consultant independence within two years.

The advisory vote provisions are similar to those in legislation that the House of Representatives approved in 2007. Currently, only companies that have received (and not paid back) federal assistance from the Troubled Asset Relief Program (TARP) are required to hold annual votes on pay.

With the SEC's support for "say on pay" for TARP companies, the Treasury declaration for an advisory vote, and Congressman Frank's draft legislation, there appears to be considerable momentum for such legislation.

The bill directs the SEC, the Federal Reserve, and other financial regulators to jointly prepare regulations that direct financial institutions to disclose information on their incentive-based pay arrangements so regulators can determine if their compensation structures are structured to account for the time horizon of risks, are aligned with sound risk-management, and meet other criteria set by regulators designed to reduce unreasonable incentives to employees for taking undue risks that could threaten the safety and soundness of covered financial institutions or could have serious adverse effects on economic conditions or financial stability. The bill also calls for rules within nine months of enactment that prohibit compensation structures that financial regulators conclude would encourage inappropriate risks by financial institutions or officers or employees that could have serious adverse effects on economic conditions or financial stability; or could threaten the safety and soundness of the institution.

These regulations would not be limited to TARP recipients and would apply to all banks, bank holding companies, broker-dealers, credit unions, investment advisers, and other financial institutions designated by regulators. The requirements, however, would not extend to institutions with assets of less than $1 billion.

Rabbi Trust Disclosure

On May 29, 2009, the Division of Corporation Finance posted new Compliance and Disclosure Interpretations ("C&DIs") regarding executive compensation disclosure required in proxy statements and Annual Reports on Form 10-K pursuant to Item 402 and 601 of Regulation S-K.

The new interpretation under Section 246.15 clarifies that when a company files its non-qualified deferred compensation plan as an exhibit and it subsequently establishes a rabbi trust to informally fund the plan, then the subsequent establishment of the rabbi trust would trigger filing under Item 601(b)(10)(iii) of Regulation S-K only if it materially modifies participants' rights under the previously filed deferred compensation plan.

Senate Bill 1491: Ending Excessive Corporate Deductions for Stock Options Act

Senate Bill 1491, Ending Excessive Corporate Deductions for Stock Options Act, sponsored by Senators Levin (D., Mich.) and McCain (R., Ariz.), would radically alter the tax treatment of employee stock options.

Under current tax law, employees generally recognize income on stock options at the time they exercise the stock option. The income is equal to the difference in the fair market value of the stock at the time of exercise and the exercise price. All income is ordinary income. The corporation is entitled to a compensation deduction equal to the amount of income the employee recognizes.

The Bill would first amend the Internal Revenue Code to limit the employer tax deduction for stock options granted to its employees to the value of such options as recorded on the employer's books at the time such options are granted. Under FAS 123R, employee options are generally included as an expense at their fair market value when they are granted—not when they are exercised. If the options are not vested when granted, the option value is still measured at the grant date but the expense may be charged over the vesting period. Thus, whether it is vested or not vested, under FASB accounting rules, the option expense is measured on the grant date. Option expense measured in this way has historically been lower than the amount of the ultimate tax deduction.

Offsetting, to some extent, the lower amount of the deduction, the Bill would accelerate the deduction to the grant date (instead of the exercise date) or to some period following the grant date determined by the vesting schedule of the options.

In addition, the Bill would modify the rules limiting compensation deductions for employees to $1 million (Section 162(m) of the Code) to provide that stock options no longer qualify as performance-based compensation. Under section 162(m), performance-based compensation is not subject to the $1 million limitation. The result for those executives covered by Section 162(m) would be that the deduction for stock options would be twice capped—first by the accounting treatment and then by the $1 million limitation.

Teleconference Recap—How Safe is Your BOLI?

M Benefit Solutions - Bank Strategies, ICBA's Preferred Service Provider for Executive/ Director Benefits and BOLI, presented Marc Cadin, Senior Vice President of Legislative Affairs for the Association for Advanced Life Underwriting (AALU), in a teleconference on September 29. Mr. Cadin discussed current critical legislative issues facing the life insurance industry and Bank-Owned Life Insurance. He also provided insight on how the economic downturn has affected the financial strength of the life insurance industry.

If you missed this event and would like to receive the recorded audio file of the teleconference, please contact Russell McMillan at russell.mcmillan@mben.com or 503.414.7307.

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