MATTERS OF INTEREST

EXECUTIVE AND DIRECTOR BENEFITS AND COLI

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FEATURED ARTICLES

ECONOMIC CONDITIONS DRIVING BANKS TO BOLI

For decades Bank-Owned Life Insurance (BOLI) has been a trusted asset for banks, primarily used to help offset the costs of executive benefit programs. However, over the past several years, banks' use of BOLI has evolved as more banks are purchasing BOLI to help offset existing employee benefit expenses, from healthcare to 401(k) plans. This highlights BOLI as a valuable and versatile treasury asset and, given current economic conditions, BOLI purchases may expand considerably in the next few years.

A Look at Current Economic Conditions

Although banks, especially community banks, performed admirably during a very challenging 2020, they experienced deterioration in several key areas that are contributing to the surging interest in BOLI in 2021:

- Declining net interest margins
- Lower asset yields
- Excess liquidity
- Lower loan demand
- Potentially higher tax rates

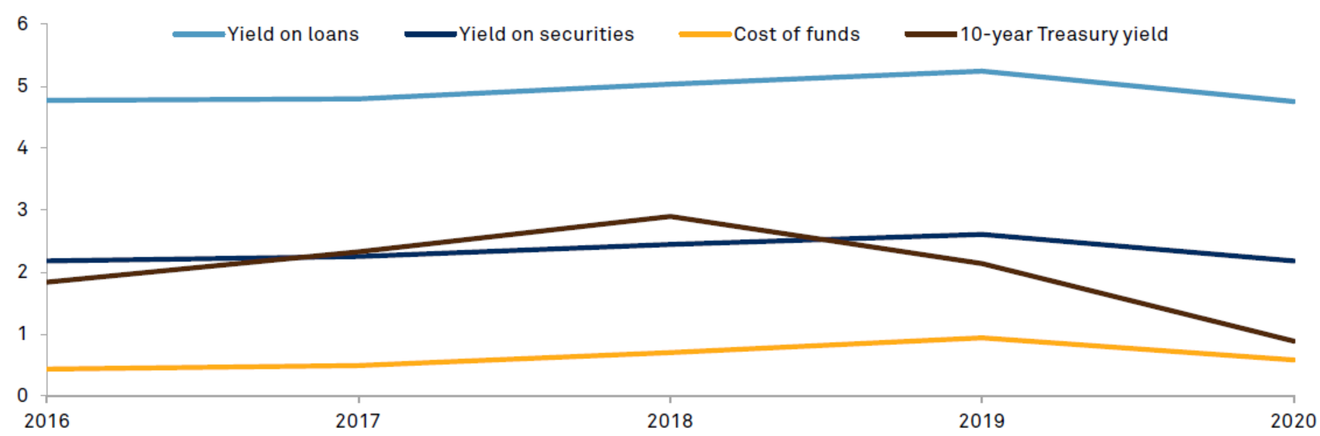
US BANKS—MARKET CONDITIONS YOY—2019 to 2020

	AVERAGE	MEDIAN
Net Interest Margin	-9.0%	-8.1%
Cash + Interest Bearing Deposits	196%	59%
Liquidity Ratio (%)	86.1%	23.6%
Yield on Loans	-6.29%	-5.05%
Yield on Securities	-13.98%	-12.62%
ROA	-4.34%	-10.13%
Provisions for Credit Losses	343%	14%
Total Reserves	40%	14%

Benefit Solutions™

While some metrics are turning in banks' favor in 2021, many of the pain points from 2020 continue as net interest margins and yields on both loans and securities fell further in the first quarter of 2021.

LOW RATES WEIGH ON YIELDS IN 2020 (%)



Data compiled April 9, 2021.
Source: S&P Global Market Intelligence

According to S&P Market Intelligence's 2021 U.S. Community Bank Market Report, historically low net interest margins weighed on community bank profitability in 2020, and earnings are projected to fall as much as 41% in 2021. And, if corporate taxes do rise, projected earnings will not recover to 2020 levels until 2024.

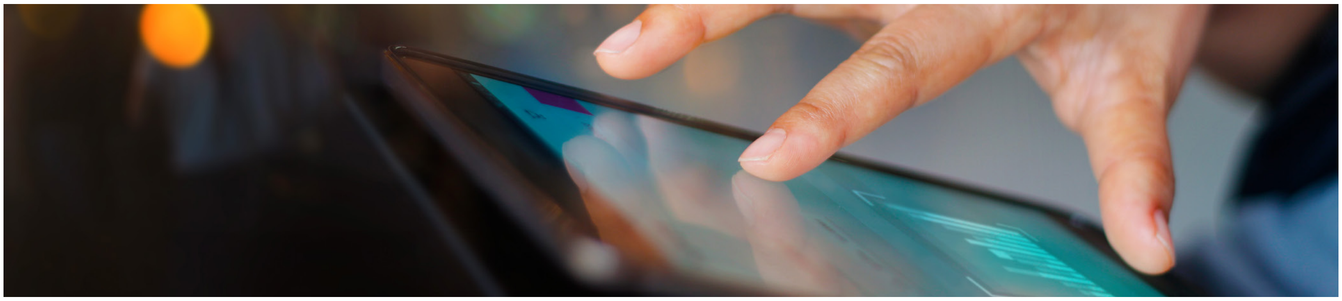
Community Bank Aggregate Profitability Metrics (%)

	2020A	2021P	2022P	2023P	2024P	2025P
Efficiency Ratio	61.70	64.36	64.99	63.34	61.88	61.28
Net Interest Margin	3.36	3.31	3.25	3.35	3.44	3.47
ROAA	1.13	0.89	0.99	1.03	1.29	1.30
ROAE	10.08	8.15	9.10	9.36	11.59	11.42

Adjusted for Potential Tax Increases
Assumes 28% Tax Rate Beginning in 2022

	2020A	2021P	2022P	2023P	2024P	2025P
ROAA	1.13	0.89	0.90	0.93	1.17	1.18
ROAE	10.08	8.15	8.31	8.58	10.65	10.55

Data compiled April 15, 2021.
A=Actual; P=Projected;
ROAA=Return on Average Assets;
ROAE=Return on Average Equity
Source: S&P Global Market Intelligence; Proprietary Estimates



The persistent low interest rate environment, along with an influx of cash from extremely high deposit growth has further pressured margins while loan demand has stagnated. And, according to another recent article by S&P Market Intelligence:

Banks do not appear to have deployed much of the excess liquidity since the end of first quarter of 2021 either. While banks reported in the Federal Reserve's latest Senior Loan Officer Opinion Survey published in April that demand in several loan categories such as auto, credit card and construction and land development loans had increased in the first quarter, that does not appear to have manifested into much growth yet.

"Piles of Cash Push US Bank Margins Even Lower" by Nathan Stovall and Rucha Khole, Market Intelligence, May 19, 2021.

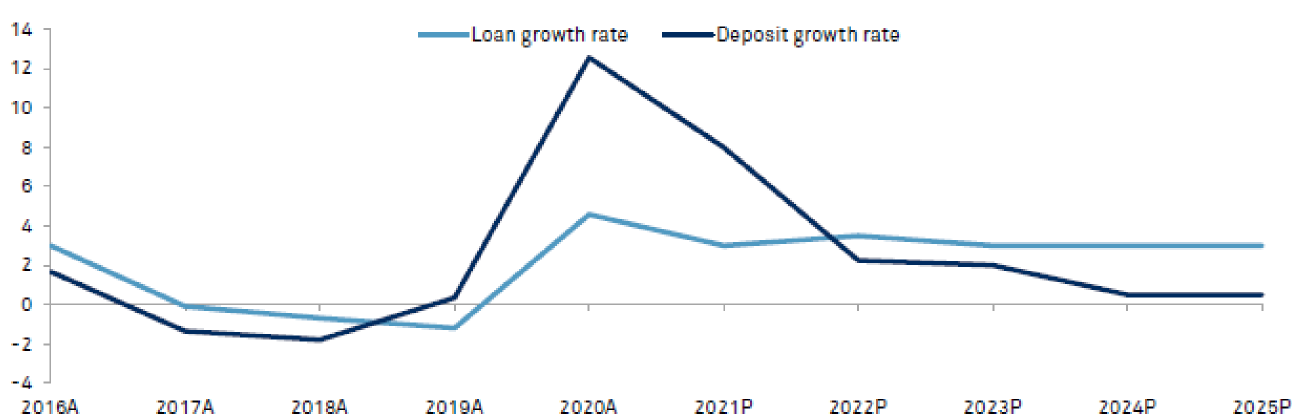
BOLI—Mitigation of Pain Points

Banks have limited options available to help them with these issues and this is where BOLI comes in. BOLI can help banks partially mitigate all of these pain points. Banks are sitting on record-level liquidity that is earning next to nothing; the loan landscape looks dim, not only from weak borrower demand but also from a risk perspective; and loan and securities yields keep falling.

BOLI provides immediate accretive tax-deferred earnings (tax-free, if held until death), a meaningful positive spread versus bank permissible investments, and is better positioned if interest rates continue to rise. All reasons why many banks are considering a BOLI purchase now.

For more information and to learn if a particular bank is well positioned for BOLI, please contact Russell McMillan at russell.mcmillan@mben.com; 503.414.7307.

LOAN GROWTH RATE WILL REMAIN HARD TO COME BY IN THE NEAR TERM (%)



Data compiled April 15, 2021.
A=Actual; P=Projected;
Source: S&P Global Market Intelligence

PRESIDENT BIDEN'S TAX PROPOSALS AND NONQUALIFIED PLANS

President Biden has included many of his campaign tax proposals in two signature legislative proposals that form part of his Build Back Better plan: the American Families Plan and the American Jobs Plan.

American Families Plan

The American Families Plan (AFP), unveiled in late April, contains proposals on education, direct support to children and families, and the extension of tax cuts for families with children. The AFP proposes to offset the cost of these proposals with tax increases focused on high income taxpayers and the wealthy.

The tax increase proposals include:

- **Increase in the Highest Individual Income Tax Rate.** One headlined proposal is to increase the top federal individual tax rate to 39.6%, the same rate in effect prior to the 2017 Tax Cuts and Jobs Act and which is currently scheduled to come back into effect for tax years beginning after December 31, 2025. The rate would apply to taxable income over $509,300 for married individuals and $452,700 for unmarried individuals beginning in taxable year 2022.
- **Increase in Capital Gains Tax Rate.** Households with adjusted gross income in excess of $1 million would pay the same 39.6% rate on all income, including capital gains and dividends. This would be effective when first announced, somewhere around April 28, 2021.
- **Elimination of Stepped-Up Basis on Death.** Gains in excess of $1 million passed onto heirs will no longer get a stepped-up basis. The property would be taxed upon its gift by the property owner or upon the owner's death. In addition, gain on unrealized appreciation also would be recognized by a trust, partnership, or other non-corporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years, with such testing period beginning on January 1, 1940. Payment of tax on the appreciation of certain family-owned and -operated businesses would not be due until the interest in the business is sold or the business ceases to be family-owned and operated.
- **Elimination of Carried Interest Rule.** Elimination of the special rule relating to income associated with "carried interest". This would result in hedge fund partners paying ordinary income rates on their income.
- **Elimination of "Like-Kind" Real Estate Exchanges.** Elimination of the real estate tax break for gains greater than $500,000 that allows real estate investors to defer taxation when they exchange property.
- **Reform of 3.8% Medicare Tax.** The current 3.8% Medicare tax on high income earners will be applied consistently to those making over $400,000.

Potential Effect on Nonqualified Plans

These tax changes could significantly increase income taxes on high income employees. This would make deferred compensation plans, whether voluntary deferral plans or employer-contributed supplemental retirement plans more significant and tax-effective benefits for these employees.

The Made in America Tax Plan

The Made in America Tax Plan is part of President Biden's American Jobs Plan. The Tax Plan is designed to incentivize job creation in the United States, stop profit shifting to tax havens, and ensure large corporations pay their fair share of taxes. Some of its provisions include:

- An increase in the corporate income tax rate from 21% to 28%. The increase would bring the top corporate tax rates part of the way back to the top rate of 35%, the rate in effect prior to the 2017 Tax Cuts and Jobs Act.
- An increase in the minimum tax on U.S. corporations to 21 percent, calculated on a country-by-country basis so it will tax profits in tax havens.
- A 15 percent minimum tax on the income corporations use to report their profits to investors ("book income"), which will apply only to the largest corporations.
- Elimination of all tax preferences for fossil fuels.
- Denial of deductions to foreign corporations on payments that could allow them to strip profits out of the United States if they are based in a country that does not adopt a strong minimum tax.
- Other provisions designed to discourage companies moving to tax havens and offshoring jobs, as well as to ramp up tax law enforcement against corporations.

The increase of the tax rate to 28%, if enacted, would increase the tax efficacy of COLI funding of nonqualified plans and decrease the attractiveness of taxable investments for nonqualified plan funding.

Response to Passage of the Tax Proposals

In the event of passage of these tax provisions, M Benefit Solutions will be available to review current nonqualified plans as well as to design new plans to aid employers to provide tax-efficient funding vehicles for their nonqualified plans and help thigh income earners to save for retirement and other future financial needs in a tax-effective manner.

NONQUALIFIED DEFERRED COMPENSATION PLANS: DESIGNING FOR RETENTION

Nonqualified deferred compensation plans (NQDC plans) provide an important supplemental savings vehicle to an employer's qualified retirement plan(s) that can serve as a significant benefit to an employer's high-impact employees while also helping the employer retain those employees.

- Employees gain an opportunity to save for their retirement and other financial needs in a tax-efficient manner over and above what they can save in a 401(k) plan.
- The plan can be designed to foster retention of an employer's high-impact employees, an important consideration in light of the high turnover employers have experienced over the last year.

Voluntary Deferrals

Employee Benefit. Employee's voluntary deferrals of salary and incentive compensation into a nonqualified deferred compensation plan are not taxed as income when deferred and will only be taxed when distributed to the employee. The taxation of such deferrals is the same as 401(k) deferrals and distributions.

Designing for Retention. Voluntary deferrals will always be 100% vested and payable to employees upon termination of employment. Restricting payments upon termination prior to retirement to lump sums, will cause immediate taxation on all sums deferred, as well as earnings on those deferrals. This taxation will create friction for employees who are thinking about terminating prior to retirement age or any other appropriate installment eligibility age set by the employer.

Employer Contributions

Employee Benefit. Employer contributions of any kind, whether matching, performance based, or ad hoc, are a significant benefit to employees, akin to a long-term bonus.

Designing for Retention. When subject to a vesting schedule, employer contributions can foster retention of an employer's high impact employees.

Unlike qualified plans, there are no limits on the length or type of vesting schedule within an NQDC plan. As a consequence, vesting schedules can be tailored to the individual needs of clients. Employers may wish to have small portions of their contributions vest each year. In such cases, a vesting schedule of 10%/year over 10 years for each contribution made may be ideal. The employee will always forfeit a significant portion of the employer's contributions if leaving prior to retirement.

In some cases, a 10-year wait for full vesting might not be acceptable. Cliff vesting after 5 years for each contribution may be preferable and will still result in the employee forfeiting significant employer contributions in the event of early termination.

Selecting the optimal vesting schedule will depend on an employer's workforce and what timeframes the employees and employer think in. For some, a 10-year schedule may attenuate the value of the benefit too much to improve retention. For others, a 10-year schedule may be ideal.

It is also important to note that it is always possible to accelerate vesting for an individual (and no one else) should the employer wish to encourage that employee to leave.

In addition to the vesting schedule, providing that vested employer contributions are paid only as a lump sum payment prior to retirement age will increase the taxation and the consequent financial pain of early termination by an employee.

Micro-Design

Another aspect of design flexibility in NQDC plans to consider is the ability to provide for special employer contributions with their own vesting schedules in cases where a small group of eligible employees is selected to receive the contribution. This tailoring of contributions and vesting schedules is possible for a subset of key employees or even a mission-critical individual. There is no requirement that the same vesting schedule be used for any contribution. Thus, plans can be micro-designed should that be advantageous to an employer.

This can raise communication issues with employees who are not included in the micro-design and may increase administrative costs. However, employers may consider these costs negligible when compared to what is gained by including special provisions for select individuals.

M Benefit Solutions' Capabilities

Not all administrators can accommodate special contributions and/or special vesting schedules. M Benefit Solutions' administrative system and team handle these custom designs without breaking stride. We are happy to discuss your business's unique situation with you.

UPDATE ON CHANGES TO INTERNAL REVENUE CODE SECTION 7702

In January of this year, M Benefit Solutions sent to our clients an email outlining the changes made to Internal Revenue Code ("Code") Section 7702 and the effect the changes could have on new life insurance policies. Since then, life insurance carriers have begun to implement the changes. This is an update on progress since then.

Review of Changes

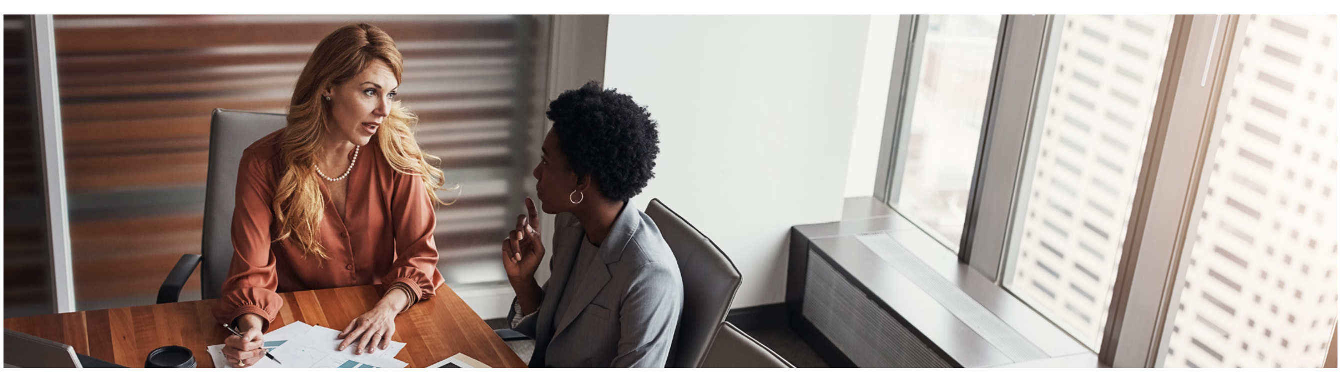
As part of the Consolidated Appropriations Act, 2021, Code Section 7702 was updated to reflect the current low interest rate environment and to ensure that rates used to determine what will qualify as life insurance under the Code reflects current economic conditions.

The Act provides that the previously mandated rates of 4% and 6% will now be used as maximum rates and requires that floating rates be used post-2021. For 2021, the Act prescribes rates of 2% and 4% to replace the previous rates. The amendment was effective for insurance contracts issued after December 31, 2020.

Impacts of Lower Interest Rates

The provision of lower interest rates has the following implications:

- For a given death benefit, the maximum premium that can be paid for a given death benefit will be greater.
  - This lowers the insurance charges for any given premium investment in a life insurance policy, and
  - Provides for increased cash value accumulation for the same premium amount.
- While the lower interest rate generally allows for more cost-efficient investing, it does lower death benefits, which in some cases can lower total expected return from the policies.



Status of New Insurance Products

Some carriers have updated some or all of their products for the new interest rates, while others are taking the update more slowly. Illustrations of updated products show the higher cash value accumulation per unit of premium that was expected, but the significant death benefit decreases has affected the internal rate of return of policies which are held until death, in some cases reducing that internal rate of return to less than that expected under the previous Section 7702 interest rate regime.

Taking Advantage of New Section 7702

Exchanges. In some cases, it may be advantageous to exchange old policies into new policies that provide greater investment efficiency. However, each case is different and needs to be analyzed separately for each client.

New Policies. For companies seeking to maximize cash value accumulation for each premium dollar invested, 2021 is a great year to put a life insurance investment to work. The interest rates in effect this year may rise in 2022 and in years following limiting the cash value accumulation advantage gained by the current low interest rate environment.

M BENEFIT SOLUTIONS BUSINESS INFRASTRUCTURE

SSAE 18 Audit Report

In order to maintain its first-rate service to our clients, M Benefit Solutions made a corporate commitment in 2003 to undergo external audits to ensure we examine our internal structure so that we may continually improve upon our existing practices. Since then we have had SAS 70 audits through 2010 and SSAE 16 and SSAE 18 audits through 2020 resulting in an annual SOC 1 Type 2 Report.

The SOC 1 Type 2 Report represents that a service organization has been through an in-depth audit of their control activities which generally include controls over information technology and processes which relate to the data belonging to their clients.

In 2020, M Benefit Solutions received a clean opinion without exception in our SSAE 18 SOC 1 Type 2 report, an indication of our ongoing success in maintaining control over our information technology and internal data processes.

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