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The VAULT

A Banker's View

"Chase Credit, Not Yield"

by Mark Cvrkel, Senior Bank Consultant

Bank risk exposure can be defined generally under four separate categories: credit risk, interest rate risk, operation risk, and market risk exposure. In looking at the performance of the banking industry, one of these four exposures has always reared its ugly head no matter the extent of regulatory oversight. Interest rate risk (IRR) was the key issue driving the following four situations:

1. The savings and loan crisis of the 1980s and 1990s when 1,043 of the 3,234 savings and loan organizations failed (based on FDIC data)
2. Loans to Latin America in the 1980s…Remember the good bank, bad bank strategy?
3. A credit risk issue, the Asian financial crisis of 1997
4. The most recent impact of the Great Recession from the sub-prime real estate driven downturn from 2007 to 2008. If anyone needs a refresher, maybe a trip to the movies to see Hollywood's "The Big Short" is warranted.

With the history of failures in the banking industry and the inability to detect and manage risk effectively, one does wonder what risk exposure will directly impact the industry next. Or, have stress testing models and increased regulatory oversight eliminated such exposures? I believe the answer may lie in the above caption.

The financial services industry continues to be under earnings pressure driven by the low rate environment. Even with the most recent Fed tightening on December 16, the yield curve actually flattened as measured by looking at the 2-year, 10-year Treasury spread. The 2/10 spread is currently at only 100 basis points (bps) as of 4:00pm EST on Friday, February 19, compared to the average spread of 208 bps in 2014 and 204 bps in 2013 (Federal Reserve System H.15).

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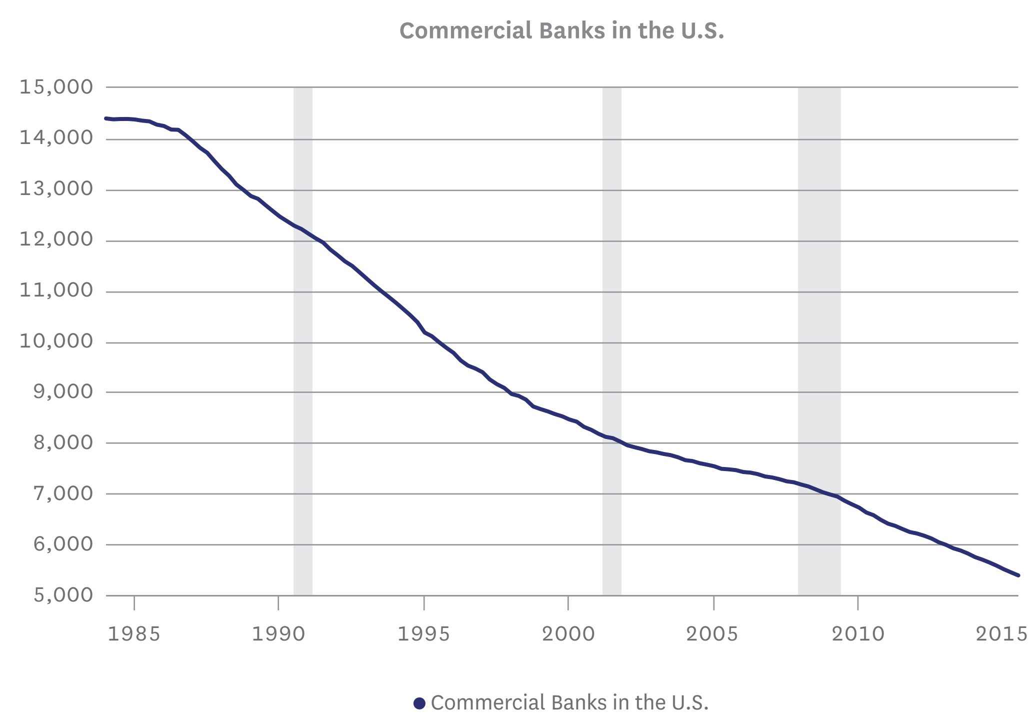
continued on page 2…

A flatter yield curve will continue to put pressure on bank margins. This may (as it has in the past) force banks to assume additional risk to satisfy investor pressure and demands. Recognized risk exposure may come in the form of IRR, credit risk, operation risk, market risk, or a combination of these risks. Most, if not all, industry experts hold the view that the margin business in banking is evaporating with a definite need to generate more fee-based income. Stock buy-backs and cost-cutting measures have an impact and the release of provisioning can help, but there's a limit to each of these activities. Continued performance challenges will likely lead to additional consolidations, and another possible industry risk management hiccup could accelerate that trend (see consolidation movement affecting the number of commercial banks below). Recent regulatory comments have raised potential concerns with the expansion of multi-family lending, C&I lending, and CRE lending not to mention the worry surrounding the oil patch (and shale) lending. Perhaps the positive trend in credit risk is reversing?

Credit risk exposure continues to be the largest risk that banks underwrite. Improved underwriting criteria and increased regulatory oversight through stress testing may have decreased this exposure, but it is still by far the largest risk a financial institution faces. It can probably be argued that continued tightening of credit spreads, the growth in longer term fixed-rate lending, and the substantial increase in core deposits (possibly higher than modeled betas in a rising rate outlook) could lead to heightened risks with much tighter spreads for assuming those risks. Consequently, it is time for banks to review their risk-based pricing strategies to ensure they are receiving an adequate return for the possible credit risk exposure and IRR they may be taking on. A return on allocated capital approach may be needed now more than ever to meet a targeted return (hurdle rate). The current economic recovery cycle has been long, and who knows what the recent volatility in the equity markets is actually telling us. If history repeats itself, all indications are that the banking industry will miss the turning point.



Source: Federal Financial Institutions Examination Council (U.S.)

continued on page 3...

According to a recent publication of C&I pricing trends by Automated Financial Systems (Volume 5, Issue 1 January 2016), fixed-rate pricing spreads for loans between $1 million and $5 million is at 204 bps with a weighted average repricing term of 4.8 years. I believe a reasonable assumption for a probability of default (PD) on these credits, based on a mid-credit rating, is probably in the 2.3% range for middle market type credits (based on RMA Journal December 2015-January 2016). I do not have current data relative to the loss of given default (LGD), but I would assume it is somewhere in the neighborhood of 30% to 35% for such credits. LGD is defined as the actual incurred loss on credit after collateral liquidation. As we all are aware, LGD can change substantially with another market meltdown, which would directly affect the value of the perceived collateral.

The banking industry will likely continue to face challenges in growing its basic business while managing through all the headwinds that exist today that include compliance, cyber security, energy and commodity market uncertainty, and connecting with millennials, among many others. This should continue to fuel the M&A fire, but it may also incite pursuit of riskier credits that could ultimately lead to history repeating itself. The dilemma is clear, and while the solution is murky, concentrating on strong credit has been and always will be a sound banking practice to follow. The probability of default of an AA+ rated credit assuming a five-year term structure is approximately 0.35% based on my experience. This is substantially below the C&I PD highlighted above. Unless a full C&I relationship is developed by the bank offering numerous other products, I find it difficult to see how risk-adjusted return on capital can outperform a higher rated investment credit. A prudent level of investment may want to be focused on instruments that limit credit risk exposure given the current tight spreads. Remember, **"Chase Credit, Not Yield."**

The BOLI Blurb

Statistics

6,270 TOTAL U.S. BANKS*

59.9%
3,759 with BOLI

Total of $154.5 Billion

- $66.3 Billion General Account
- $71.7 Billion Separate Account
- $16.5 Billion Hybrid Account

Average concentration of Tier 1 Capital for those banks holding insurance assets equals 12.6%

40.1%
2,511 without BOLI

*Source: FDIC Call Report Summary, 9/30/15

continued on page 4...

General Account BOLI...Arguably the best credit bank capital can buy

by Mike Resch, Managing Director

As you hopefully just read, Mark Cvrkel penned a nice write-up about the importance of credit and management of credit risk titled, "Chase Credit, Not Yield." I thought it would be appropriate to piggyback on his article to focus on the credit associated with General Account Bank-Owned Life Insurance (BOLI), and more specifically, the credit affiliated with the highest rated mutual life insurance carriers.

The history of the life insurance business is long, and compelling stories that detail the origins, growth, and accomplishments of life insurance companies abound. Much of the emphasis is placed on the treatment and protection provided to the policyholder. Although some life insurance companies have experienced financial issues and credit rating downgrades, it is worth noting that traditionally in the life insurance business (personal and corporate markets), other life insurance companies sometimes step in when necessary through acquisition or other means to ensure no obligations are missed. Additionally, policyholders are in first position ahead of any general creditors. Life insurance is built on trust, and the risk to the entire industry could and likely would be substantial should a commitment to a policyholder not be met.

While this narrative should help ease any angst about the entire space, there ought to be no misgivings about the credit of the highest rated mutual life insurance companies as awarded by the four major rating agencies: A.M. Best Company, Fitch Ratings, Standard & Poor's, and Moody's Investors Service. Following are currently the highest ratings assigned to life insurers by these rating agencies:

- A.M. Best Company – A++
- Fitch Ratings – AAA
- Standard and Poor's – AA+
- Moody's Investors Service – Aaa

Many of these mutual insurance entities have been in existence since the mid-1800s, demonstrating financial strength and performance that often is unrivaled. The investment philosophy of these companies can be a distinct advantage to policyholders, particularly for those that maintain a long-term horizon instead of trying to eke out a few extra basis points for the next quarter.

> General Account BOLI as an earning asset and component of the overall blueprint can be an extremely important and meaningful piece – quite possibly exhibiting the best credit risk on the balance sheet.

Banks and other financial institutions that invest in General Account BOLI with highly rated mutual insurers can also be positive recipients of their success. Banks benefit from a mutual carrier's financial aptitude, investment diversity, and long-term focus, all of which contribute to lower volatility within a General Account BOLI portfolio. While it is a violation to represent any financial instrument as safe and secure, an investment with a highly rated mutual life insurer presents arguably the best credit bank capital can buy. Perhaps one question that should be asked is, "What is the probability of default from a highly rated mutual life insurance company?" When also factoring in the current fully tax equivalent BOLI yield, the risk-adjusted return is extremely attractive compared to other bank-eligible investments. Yes, it is imperative that banks maintain adequate liquidity and preserve capital to support loan growth, business strategies, and other investments. However, General Account BOLI as an earning asset and component of the overall blueprint can be an extremely important and meaningful piece – quite possibly exhibiting the best credit risk on the balance sheet.

continued on page 5...

Internal Revenue Code Section 101(j) – COLI Best Practices

by Jonathan Barnes, Director, Executive Benefits

The Pension Protection Act of 2006 created IRC Section 101(j), which affected the taxation of Corporate Owned Life Insurance (COLI). Under Section 101(j), life insurance proceeds received by an employer will only be tax free to the extent that the death benefit exceeds the premiums, unless one of the stated exemptions applies and certain notice and consent requirements are met. With regard to COLI used to informally fund a Non-Qualified Deferred Compensation (NQDC) arrangement or offset other ongoing operating expenses, the most important exemption is the "employee exemption." If the insured falls under the employee exemption and the notice and consent requirements are met, the full proceeds from the insurance policy will escape income tax upon the distribution of the death proceeds. The "employee exemption" will apply when the insured:

1. Was an officer, director, or "highly compensated employee" (a 5% shareholder or earning at least $118,500 in 2015-indexed for inflation) at any time during the 12-month period before the insured's death, or,
2. Was at the time of policy issue a director, "highly compensated employee," or "highly compensated individual" (one of the 5 highest paid officers, a 10% shareholder, or among the highest paid 35% of all employees).

The notice and consent rules require:

a. The employee to provide written consent to being insured;

b. The employee be made aware that coverage may continue after the insured terminates employment; and

c. The employee be informed that the employer is the beneficiary under the policy.

The employer is also required to file an annual report with the IRS (form 8925), which will disclose such items as: (i) the number of employees insured; (ii) the total amount of insurance (death proceed/ face amounts) in force at the end of said tax year – the 2015 tax year for purposes of this article.

The amounts entered into IRS form 8925 are *ONLY* relative for policies issued or materially modified after August 17, 2006. Per the IRS, a material modification will have occurred if any material increase in the death benefit or other material change causes the contract to be treated as a new contract and, thus, subject to section 101(j) – therefore, needs to be included on form 8925 that is filed with the employer's corporate tax return.

Form 8925 is filed by attaching it to the policyholder's income tax return for each tax year during which the policyholder has employer-owned life insurance contracts in force. Form 8925 is not required to be filed for any tax year ending before November 14, 2007. Thus, for calendar year taxpayers, form 8925 was not required to be filed until the 2007 tax year.

So, why did Congress include this life insurance provision in pension legislation? These new rules find their origin in tax shelter cases involving a strategy known as "broad-based leveraged COLI." In this strategy, employers purchase permanent life insurance policies on employees without their knowledge. Premiums were often leveraged, providing income tax deductions for interest expense while the insurance policy's cash surrender values would grow tax free. Eventually, employees would die and the employers would benefit from tax-free policy death benefits, while dependents received nothing. The self-serving and extreme nature of these tax shelters eventually caught national attention when the *The Wall Street Journal* renamed them "dead peasant insurance" and "janitor insurance." (WSJ obtained those names from internal planning memos used by employers to describe their creative tax planning strategies.) After several IRS court battles, IRC §101(j) was enacted. Now armed with the new reporting requirements embodied in IRC § 6039I, the IRS has the means to begin to quantify how many of these types of transactions and policies may be out there. They monitor these contracts now by requiring IRS form 8925 to be completed and filed each and every year – making said form only a disclosure document and not an IRS form for calculating any taxation.

Disclaimer: The above content is for educational purposes only, and it is not intended as tax advice. Please consult a tax advisor or professional to review your own circumstance.

continued on page 6...

In the Kitchen with The Galbreath Group

JB's "Traditional Monday Red Beans"

by a true Cajun from south Louisiana, Jonathan Barnes

Ingredients:

- 2 lbs of red kidney beans
- 2 onions
- 2 bell peppers
- 2 stalks of celery
- 4 tbs of minced garlic
- 4–5 large boxes of chicken broth
- 2 lbs of Cajun (not hot) pork sausage (cut how you would prefer...I like cubing into four pieces, but some like just round pieces without cubing)
- 2–3 sticks of butter; NOT MARGARINE (can substitute oil, but not nearly as good)
- *Better than Bouillon Ham Base* (one heaping table spoon added to hot water) – Beef or Chicken Base works okay but Ham Base will add the best and most distinctive flavor to your finished product

Instructions:
Mince the veggies or dice small. Sauté onions, bell peppers, and celery in butter for ~30–45min (until almost clear and really soft). Low to medium heat. While you are doing this, add the 2 lbs of beans to a colander and rinse with water to clean and start the softening process. Add sausage and brown for ~15min., but careful not to burn the veggies. Add garlic at this time as well. Once done, add 2 lbs of beans and 2–3 boxes of chicken broth, reserving the other 2–3 boxes to add once liquid is decreased in your pot later in the cooking down of the beans process.

Add one large tablespoon full of Ham Base to a bowl of scalding hot water and stir to mix evenly in the water. Add this to the pot with the chicken broth. Can also add bay leaves here if you can find them at the store in your part of the country. Bring to a boil then reduce heat to medium to low. Be sure to stir often so the beans don't stick to the bottom. Make sure you have plenty enough broth throughout so the beans have enough liquid to absorb. The beans are ready when they are soft enough to eat and it seems to be at the right consistency and not crunchy. If you want thicker beans, smash beans against the walls of the pot (they'll be easily smashed once ready). For thinner beans, add more chicken broth. I also like adding Louisiana Hot Sauce, Worcestershire Sauce, and Tony Chachere's seasoning for flavor.

Prepare your rice on the side during the final 30 minutes – 1 hour of the bean cooking process. I'd recommend four cups of rice, to be safe, in a rice cooker. You may want more, but this should be plenty.

Makes ~12 servings.

C'est si bon!

The Galbreath Group, headquartered in Abington, PA, advises financial institutions and corporations on Bank-Owned Life Insurance (BOLI) and BOLI portfolio management; design, implementation, and administration of BOLI and COLI plans; analysis of current BOLI and COLI plans; strategic planning and compliance analysis; and design, implementation, and administration of non-qualified deferred compensation plans. We would welcome any opportunity to be a resource for you and your institution.

For more information contact us at ***www.TheGalbreathGroup.com***