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Q3 | 2016

The VAULT

A Banker's View

"The Times They Are A-Changin" (For Regulated Financial Institutions)

by Mark J. Cvrkel, Senior Bank Advisor

I recently attended a select risk management conference, and I thought the title of a 1964 Bob Dylan song from the album of the same name may be very appropriate for the title of this article.

I have been a member of this group for more than 20 years, and I find it quite interesting how the focus of the discussions has changed in that time. This organization has always been on the cutting edge of best practices relative to industry risk management measurement strategies on credit, interest rate risk, liquidity, market risk, and capital, along with profitability measurement. These meetings over the years have been instrumental in forming my opinions, providing me with a great deal of education for my professional development, and establishing some lifelong friendships.

The group's most recent discussion focused entirely on the current regulatory process, including the ongoing effects of the Dodd-Frank Act, which was signed into law on July 21, 2010. Requirements of the Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Act Stress Test (DFAST) process are creating an extensive amount of regulatory burden. I was totally unaware of the sheer volume of information required by and sent to the regulators. I had the very unique opportunity to testify in front of the U.S. congressional subcommittee prior to adoption of the Dodd-Frank Act relative to Title VII, which pertains to derivatives. It is clear that I did not do that good a job!

I will be the first to conclude that an effective risk management process is essential for any organization and is crucial in managing interest rate, market, credit, and operational risk exposures at financial institutions of all sizes. However, I also learned early in my career that if you eliminate risk, you also eliminate a substantial amount of opportunity for profit. The secret is to manage risk, not eliminate it, and use your risk management process for a competitive advantage. I believe the last point is extremely critical. Taking into consideration the tremendous regulatory cost for banks with assets above the three key regulatory triggers (greater than $10 billion, greater than $50 billion, and greater than $250 billion), the industry must now pivot and concentrate on how to effectively use this labor-intensive analytical exercise to drive returns.

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DFAST and CCAR are changing how larger institutions do business, which in turn offers a tremendous opportunity for smaller regional institutions and community banks to fill the void.

In a public comment, Federal Reserve Governor Daniel Tarullo recently said the Central Bank would probably decide to require eight of the largest U.S. banks to hold more capital to pass future stress tests. All indications are that the largest banks will not be broken up, but decisions will need to be made on the best return of their required capital. This proposed capital buffer is slated to be introduced later this year and take effect before 2018.

The quantity of information submitted during the CCAR and DFAST process is huge: Submissions routinely exceed 20,000 and 30,000 pages. I didn't recognize the amount and intensity of the submission requirements nor the extent of resources needed to meet the internal line of defense for the model validation process. Larger institutions are also required to do extensive reporting relative to liquidity. The requirement under the liquidity coverage ratio (LCR) limits banks that are over $50 billion in total consolidated assets and those, to a greater extent, over $250 billion.

Stress test results were reported in June, and the Federal Reserve approved the capital plans of 30 out of 33 financial institutions participating in CCAR. The capital plans of two of the remaining three (U.S. units of Deutsche Bank AG and Spain's Banco Santander) were rejected based on certain qualitative concerns, and the third (Morgan Stanley) received conditional consent contingent on resubmission. The banking industry continues to build capital while also gaining experience in taking the annual test.

This offers an opening for smaller regional and community banks to take advantage of market opportunities when they present themselves. Case in point is understanding the business line impact these added regulatory requirements have on larger banks. However, through my work with many smaller institutions, I have discovered that this is not yet on their radar. While resources to identify and focus on the possibilities these circumstances spawn may be limited, perhaps some attention should be given to maximizing and, hopefully, capitalizing on these opportunistic times.

Just remember this banking advice from our friend, Bob Dylan:

"Then you better start swimmin' or you will sink like a stone... for the times they are a-changin.'"

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Benefit Brief

NQDC Plans 101

by Jonathan Barnes – Director, Executive Benefits

Per the IRS, "A nonqualified deferred compensation (NQDC) plan is an elective or non-elective agreement, between an employer and an employee to pay the employee or independent contractor compensation in the future. In comparison with qualified plans, NQDC plans do not provide employers and employees with the tax benefits associated with qualified plans because NQDC plans do not satisfy all of the requirements of IRC § 401(a). Under a nonqualified plan, employers generally only deduct expenses when income is recognized by the employee or service provider."

In this piece, I am focusing on the first of four categories that the IRS places the nonqualified deferred compensation plans, top hat plans.

- Top hat plans are NQDC plans maintained primarily for a select group of management or highly compensated employees. Most agree that the best level of compensation to be considered for a top hat plan are executives in the top 30% at the organization in terms of compensation. Some choose to be more conservative and select only the top 10% of wage earners in their pool of selected NQDC plan participants.

Top hat plans have the potential to:

- cover the gap between what an executive personally saves and what he/she invests in a 401(k) qualified pension plan and/or any other source of retirement income
- serve as an invaluable retention tool
- serve as a recruitment tool for those banks looking to enhance their talent pool and recruit new/top executives

No matter what is selected from the standpoint of who will and who will not participate, research shows that not enough executives in the financial sector are receiving NQDC plans. A survey recently released by PLANSPONSOR and Mullin TBG found that "current participation among eligible executives and key employees in these plans is a bleak 43%." Interestingly enough, nearly two-thirds of workers surveyed last year by Guardian's Workplace Benefits Study believe it is their employers' responsibility to provide financial protection via insurance and retirement benefits, whereas just 16% of employers agreed with that. This certainly highlights the contrast between the two.

NQDC plans can be tailored to fit the needs of the participant and match the long-term goals of the plan sponsor. Plan designs are very customizable, and plan sponsors (financial institutions/corporations) should ensure they work with a firm that understands their objectives and is well-versed in the regulations that govern NQDC plans (Internal Revenue Code Section 409A). Doing so will result in a fully compliant plan that is most suitable for the institution and the participants while making the implementation and ongoing management process simple.

> "Nonqualified deferred compensation represents a major source of personal savings for many employees. In light of the dramatically low rate of U.S. individual savings – the personal savings rate has dropped from 12.7% in the fall of 1981 to its current level below 6% – policymakers should consider ways to make it easier, not more difficult, for employees at all levels to save for retirement.
>
> **U.S. Department of Commerce, Bureau of Economic Analysis**

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The BOLI Blurb

Statistics

6,058 TOTAL U.S. BANKS*
(64 fewer banks than previous quarter)

61.3%
3,714 with BOLI

Total of $158.9 Billion
- $69.6 Billion General Account
- $72.3 Billion Separate Account
- $17.0 Billion Hybrid Account

Average Concentration of Tier 1 Capital for those banks holding insurance assets equals 12.5%

38.7%
2,344 without BOLI

*Source: FDIC Call Report Summary, 6/30/16

Addressing the Three Most Common Objections to Bank-Owned Life Insurance

by Mike Resch, Managing Director

The three most prevailing objections to bank-owned life insurance (BOLI) are as follows:

1. Liquidity, or the lack thereof
2. Discomfort with the structure – The bank/financial institution benefits from the death of its employees (reputation risk exposure)
3. Interest rate risk (IRR)

BOLI has been in existence since the original transaction in 1982. Since that time, many banks have pursued this alternative asset, gaining diversification of the balance sheet, increased tax advantaged income, access to non-bank-eligible asset classes, and additional non-interest income, among other benefits. Yet many institutions have an aversion to the product, citing one or all the above as reasons for not exploring it. Today, north of 60% of all U.S. banks have insurance assets of some form whereas just under 40% do not (FDIC Call Report Summary, 6/30/16). While these criticisms have a basis in logic, it may be appropriate to explore a different explanation or perspective addressing each.

LIQUIDITY

Liquidity represents the most frequent and overt challenge. BOLI is inherently illiquid. It is intended as a buy-and-hold asset alternative to be maintained until the death of the insured so as to optimize all its positive attributes. As such, it lacks a built-in liquidity component to employ. There is no secondary market like that associated with municipal bonds. In addition, BOLI cannot be pledged for borrowing, whereas some fixed-income instruments can be. As a result, many banks and bankers are reluctant to seek this investment, favoring the flexibility of other, more liquid options (a legitimate and understandable conclusion).

Despite the fact that BOLI is fundamentally illiquid, it is arguably one of the more liquid assets on the balance sheet in terms of the ability of the bank to get its money. The timing is dependent on the type of BOLI owned. *Separate Account* is usually part of a private placement memorandum that includes a stable value wrap provider and mechanism. These agreements are complicated and difficult to exit, often having many restrictions. *General Account* and *Hybrid Account*, on the other hand, are simple insurance contracts. Accordingly, surrenders of these structures are much easier to execute should

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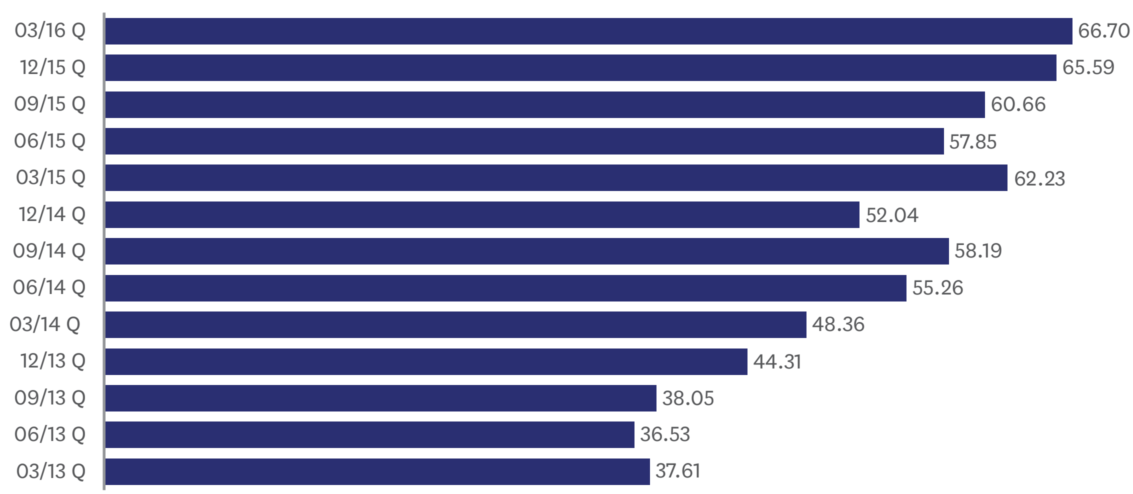
a need arise. Most insurance carriers can contractually hold the cash value for 180 days following surrender. However, it is customary to receive the money within five to 10 business days. Payout of a death claim typically falls within this same timeline after it has been fully processed.

The surrender characteristic might be an overlooked aspect of the product relative to liquidity risk exposure. This is likely due to the tax implications on the growth in cash value that has already been booked and recognized by the bank. If a scenario does arise in which a BOLI surrender is determined to be prudent, it is possible that the financial institution is not in a strong taxable position and, therefore, has a reduced tax consequence depending on its circumstance. Nevertheless, BOLI has a permanent feature, like a one-way call option, that tends to be missed or discounted. If the bank prefers to receive the cash value, it can surrender at any time. Given the persistent low-rate environment, the net proceeds after tax would likely yield a return comparable to other bank-permissible investments. Accelerating a tax situation is neither desirable nor feasible for most banks, but the choice is available if necessary. Having the capability to get "your money" back is a valuable quality. Wouldn't it be nice to have a call option on every loan?!

A question to consider when weighing this criticism might be "Is liquidity really an issue or concern for the bank?" On the surface, it may seem so with no appetite to give up control of cash. However, upon a deeper look, there is usually adequate liquidity via other means such as balance sheet pledging, market-generated funds, access to capital markets, Federal Home Loan Bank (FHLB) capacity, or the Federal Reserve. The 25% of Tier 1 Capital guideline provides a natural limit to how much can be invested in this tax-favored instrument. Allocating capital for BOLI in many instances should not have a meaningful impact on liquidity. Various funding options, including cash, deposits, wholesale funding, repositioning a portion of the investment portfolio, or any combination of these, are available to manage or mitigate any perceived liquidity risk exposure.

The following graph identifies the on-hand liquidity of 403 financial institutions (commercial banks, savings banks, and savings and loan associations) with total assets ranging from $350 million to $7.5 billion that do not currently have BOLI on the balance sheet as of 3/31/16. Liquidity is ample with the trend showing an increase. Fifty-one percent of these banks have a return on average assets (ROAA) of less than 1.0%. An initial or incremental BOLI investment would enhance financial performance with limited risk.

Financial Institutions with Assets Between $350M to $7.5B as of 3/31/2016 without BOLI
On-hand Liquidity Liabilities (%)



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DISCOMFORT WITH THE STRUCTURE

BOLI/COLI have been around for some time now as noted earlier, and the industry has evolved significantly since the product first came to market. Many firms were purely transaction-driven, offering second-tier carriers with a key focus on maximizing personal sales incentives. Consequently, several banks and companies ended up with poorly structured plans they didn't fully understand. This has contributed to some of the adverse sentiment towards BOLI/COLI over the years. In addition, there is/was a lot of negative association with BOLI/COLI as "Dead Peasants" or "Janitors" insurance with companies taking insurance out on employees without their knowledge and benefiting from their deaths – an unethical act contributing to the reputation risk attachment to the product. Regretfully, the negative perception and discomfort with the structure persists to this day, warranting a proper description of the product.

BOLI is an institutional product that is designed to provide maximum cash value with minimum excess death benefit. In order to qualify as life insurance while maintaining its tax-advantaged status, there must be a specific amount at risk to the insurance carrier. In combination with the increased tax-free earnings of the investment that occur immediately and throughout the life of the policy, the proceeds received by the institution from the insurance policies contribute to the total return of the asset supporting the long-term profitability of the financial institution. These proceeds provide an indirect cost-recovery mechanism to offset current and future employee benefit costs that continue to increase. This benefits **every employee** of the bank and not just the institution itself. In addition, signed consents are required by each employee asked to participate in order to comply with the BOLI/COLI Best Practices provision of the Pension Protection Act of 2006. These provisions define eligibility, notice, and consent requirements for the insureds along with year-end reporting obligations. After being informed and educated about the investment and its objectives, the employee can choose to decline if uncomfortable. It is also relevant to mention that participating in a BOLI program does not prohibit any employee from procuring life insurance deemed important to meet his/her own personal financial planning needs. Finally, the institution may decide to share a portion of the death benefit with the employee, which can be offered pre and/or postretirement. It is up to the discretion of the institution to determine the benefit amount payable to the beneficiary of the employee. One way to overcome the perception that the bank is benefiting from an employee's death is to offer the full net amount at risk (NAR) to the employee's beneficiary/estate. The NAR is essentially the difference between the cash surrender value and the death benefit. This would afford a generous employee benefit particularly for those institutions that place a high value on their employees and the relationship they have with them.

INTEREST RATE RISK

Interest rate risk is mentioned as a grievance against BOLI. It is often viewed as a fixed rate asset, and some institutions model it this way as part of their asset liability management process.

However, BOLI offers a variable rate yield with carriers providing a minimum guaranteed interest rate. The rate of return historically follows the trend in 10-year Treasury yields. Insurance companies review their current interest crediting rate at least on an annual basis; in many cases, as often as monthly. Changes are based on a number of factors including investment performance and the cost of insurance.

The amount of positive carry supplied by an investment in BOLI is significant. For instance, repositioning short-term investments that may be earning anywhere from 30 to 50 basis points (bps) to fund a BOLI purchase can result in a spread pick-up of as much as 450 bps on a fully tax-equivalent basis. The crediting rate is dependent upon the amount invested and with what carrier. Hypothetically, if that trade was to occur today and interest rates would increase 200 bps tomorrow, there would still be a substantial amount of positive carry with little to no impact on the banks' projected interest rate sensitivity position. While BOLI yields would likely lag in this scenario, it is important

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to note that BOLI rates will respond because they are not static. It also presents a hedge in both a downward rate environment and the continued low rate environment with no prepayment risk like that associated with loans and a mortgage-backed security (MBS) portfolio.

Many banks have been forgoing a meaningful amount of positive carry in this continuing low-rate environment. The majority of banks are positioned for higher rates. Financial engineering and intervention from central banks throughout the globe have been themes since the financial crisis. This is cause for much angst as many ponder whether markets will behave normally again. Assuming they will, an increasing rate climate should portend a stronger economy. As such, the positive impact to the balance sheet will offset, to a certain degree, any liability sensitivity.

Accordingly, how much IRR is associated with BOLI? Maybe much less than it appears, particularly considering how much money has been idle for years in anticipation of higher rates and the dearth of earning assets available. While the market is presumably closer to higher rates, it is quite possible they may languish at or near current levels for the foreseeable future. As a result, isn't a BOLI investment an ignored strategy, and not investing in BOLI, or at least not considering it, a greater risk from an interest rate and opportunity cost perspective? Diversifying the balance sheet with an asset that has no mark-to-market risk and minimal effort to manage provides some protection.

Timing may never be perfect, but opportunities could be present to harvest some gains through the sale of securities. The mark-to-market risk associated with those securities would be eliminated. The proceeds from the sale could supply some or all the funding for an investment in BOLI.

CONCLUSION

The objections to BOLI are understandable and present a fair argument. On the other hand, examining the product in greater depth could allay existing concerns, revealing a different outlook. Why dismiss an opportunity to take advantage of a tax-preferred earning asset with a strong credit (highly rated life insurance company) while adding steady income along the way? BOLI may not yet be on the radar or a priority, but perhaps it's time to take a closer look.

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In the Kitchen with The Galbreath Group

Homemade Gnocchi

by a True Calabrese Italian, Pasqualina Patitucci

I (Mike Resch) asked my mother-in-law if she could supply a recipe for this installment of The **VAULT**. Mom, as I affectionately call her, was born in Roggiano, a small town in the region of Calabria (southern Italy). This area is known for its beautiful rolling hills with endless rows of olive trees. I enjoy every meal my mother-in-law prepares, but gnocchi has to be one of my favorites.

Ingredients:

- 2 medium-sized, peeled potatoes
- 2 cups all-purpose flour
- 1 egg, slightly beaten
- A pinch of salt

Instructions:

1. *Place the potatoes* into a medium-sized saucepan, and cover them with water. Bring the water to a boil. Cook the potatoes approximately 15 minutes until they are tender. Be careful not to overcook them, because they should be a little firm.
2. *Drain the water,* and mash the potatoes with a potato masher.
3. *Transfer 1 cup of mashed potatoes* to a large enough bowl. Add the all-purpose flour, egg, and pinch of salt to the bowl. Mix and work the ingredients together until the mixture forms a ball.
4. *Separate the ball* into four equal portions. On a floured surface, roll each portion into long snakes. Cut each snake into half-inch pieces. If you wish, use the back of a fork and roll each piece of gnocchi off the tines making grooves.
5. *Bring a large pot* of salted water to a boil. Place the gnocchi into the boiling water, and cook them for approximately 3 to 5 minutes until they float to the top. Drain them in a strainer.

You can serve them with your favorite sauce (tomato, Bolognese, pesto, butter, etc.). I personally like going lighter on the sauce as it should not overwhelm the pasta.

Buon Appetito!!

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***