

# In Touch

Community Bankers Association of Kansas

December 2011

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## BOLI RISK MANAGEMENT

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• Anniversaries •

Congratulations to the banks celebrating December anniversaries as chartered institutions!

**127 years**

First National Bank & Trust  
— Phillipsburg

**122 years**

Kansas State Bank — Overbrook

**102 years**

Farmers State Bank— Phillipsburg

**117 years**

Baileyville State Bank — Seneca

**125 years**

First Commerce Bank —  
Conway Springs

**98 years**

Johnson State Bank — Johnson

**98 years**

Montezuma State Bank — Montezuma



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**CBA's 34<sup>th</sup> Annual Convention & Tradeshow  
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**Monday, February 6, 2012**

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Legislative Update ..... 4:30pm

Legislative Reception ..... 5:00pm

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# Member Profile

By Alex Peak, Assistant Editor, BankNews Media

## • Roger Caudle •



We currently live in Atchison, Kan., having moved from our Bendena farm 10 years ago. We also serve on the board of Union State Bank of Everest, attending its board and loan meetings for the branches in Atchison, Horton, Gower and McClouth. • My wife, Donna, and I enjoy going to our nine grandchildren's sporting events, as well as cheering for KU and K-State from our living room. • I am a little short on hobbies, but I like to travel, read biographies, and return to the farm and community where I lived for more than 60 years.

**Roger Caudle** is chairman of Bendena State Bank in Bendena, Kan.

### Q What is your background in banking and with Bendena State Bank?

I was elected to the Bendena State Bank board in 1966. This was the community where I grew up. I joined the board because my wife's family owned stock in the bank, not because of my financial wisdom. I continued to serve and learn on the board for the next 45 years and enjoyed being part of a rural bank that grew from \$1 million in assets to more than \$40 million in assets.

### Q Bendena State Bank is more than 100 years old. What are some of the more significant events in its history?

In more than 100 years of community business, the bank has witnessed many changes. It has seen modernization of farm equipment advance from horses to GPS guidance systems. Rural telephones, electricity, water and all-weather roads have made rural living much nicer.

### Q How is the bank a reflection of it's community?

Our banking philosophy has been to re-invest as much of the local community resources back into that community as possible. We have always felt as if the success of the bank depends on the success of the people in the community.

### Q What is the most popular product or service the bank offers?

Our most valuable asset is the personal attention and concern the employees express for their customers.

**Q** What do you think is the biggest obstacle faced by community banks in small towns right now? What have you done to help the bank overcome any of these challenges?

I believe maintaining the population, small businesses and schools is our most pressing problem. Our bank sometimes takes greater risk for the hometown entity than is normally prudent but the favorable results are important.

► *“Our banking philosophy has been to re-invest as much of the local community resources back into that community as possible.” ◀*

**Q** How would you describe your leadership style?

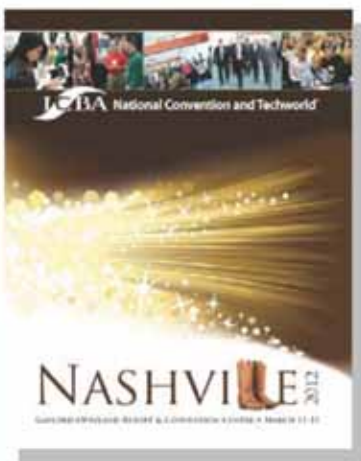
As a director and board chairman, I like to have decision-makers managing and operating the bank. We feel that micro-managing by the board can only slow the growth of good people.

**the Community Bankers Association? What is your favorite event to attend?**

We have been CBA members since it was organized and have really enjoyed getting acquainted with bankers from similar communities across Kansas. The annual conventions have always been informative and a pleasant experience. •

**Q** How long have you been involved with

## ICBA National Convention and Techworld Preliminary



For more information contact

ICBA at 800-422-7285 or

convention@icba.org

### SATURDAY, MARCH 10

- Habitat for Humanity Build\*\*
- Registration Desk

### SUNDAY, MARCH 11

- Registration Desk
- ICBA Board of Directors Meeting \*
- First-Time Attendee Orientation\*
- Bank Director Seminar\*\*
- Techworld
- Welcome Mixer in Exhibit Hall
- Theme Party

### MONDAY, MARCH 12

- Registration Desk
- Techworld
- Concurrent Workshops
- Tours\*\*
- Lunch with Exhibitors
- State/Regional Partners and Exhibitor Receptions\*

### TUESDAY, MARCH 13

- First General Session
- Registration Desk
- Concurrent Workshops
- Tours\*\*
- ICBPAC Silent Auction\*\*

### WEDNESDAY, MARCH 14

- Final General Session
- Registration Desk
- Tours\*\*
- Annual Banquet and Show

### THURSDAY, MARCH 15 Depart

\*by invitation

\*\*additional registration required and in some cases may also require additional fees



# BOLI RISK MANAGEMENT

BY RICHARD K. BRATTEN

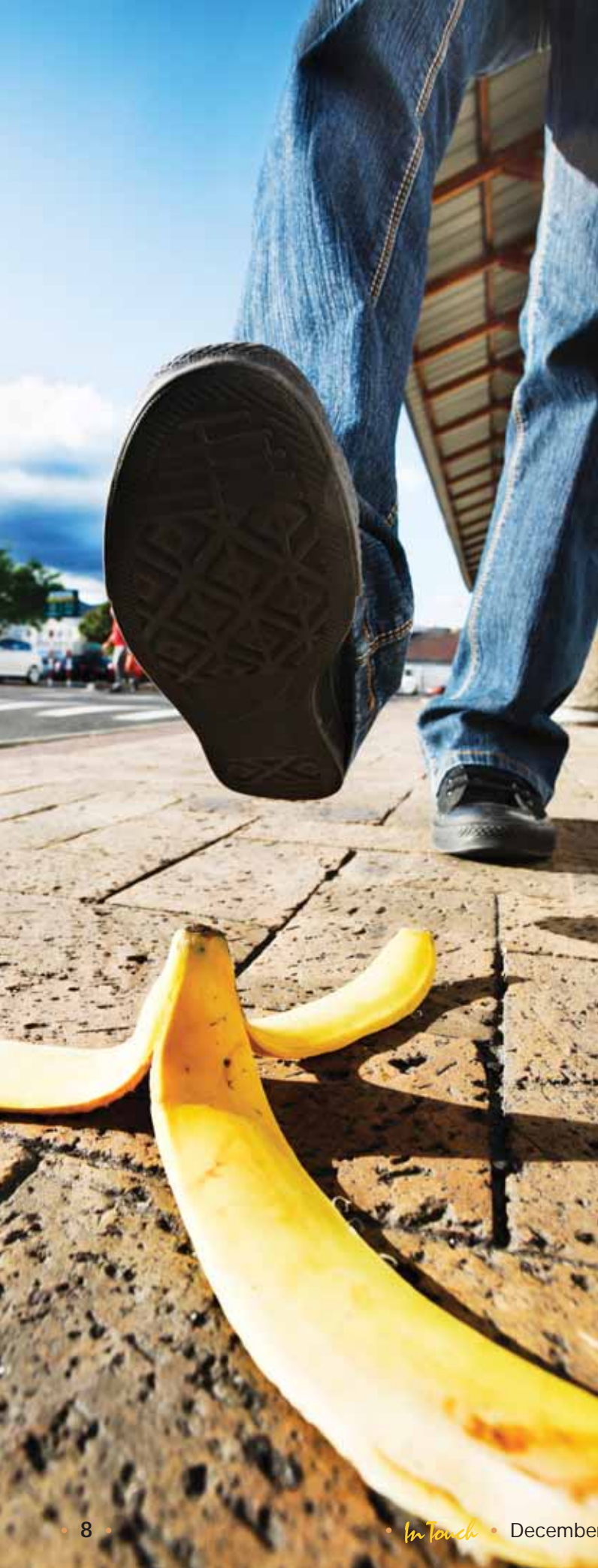
**T**oday's environment is far from ordinary. Many Kansas banks have seen their deposits increase, watched yields on securities portfolios decrease and experienced a drop in high-quality loan demand.

While about half of all banks in the country already own Bank-Owned Life Insurance (BOLI), many that do not own BOLI are taking another look. High credit quality and security, favorable tax treatment, the ability to give a benefit to bank officers to help attract and retain top talent, and favorable yield profiles have prompted many bankers to dust off what they used to know about BOLI and find out how today's BOLI products can be a benefit to executives and shareholders alike.

Though everyone would agree that risk management is critical to the safe and sound operation of banks at any time, today's environment places a true premium on risk management. This article describes some of the risks associated with BOLI and how to proactively manage those risks.

## Liquidity Risk

Liquidity risk is the risk to earnings and capital arising from an institution's inability to meet its obligations when



they come due without incurring unacceptable losses. Cash values of life insurance policies are assets carried on the bank's balance sheet in the "other asset" category. As assets, they affect liquidity. The insurance policy contract allows the bank the right to demand payment of its cash values at any time. By law, the insurance company has up to six months to pay; as a practical matter, however, it generally pays out the proceeds of policy surrender within 14 days, unless it is financially insolvent.

Although BOLI can be liquidated at any time, doing so would have adverse tax consequences, particularly when using Modified Endowment Contract (MEC) policies. For this reason, banks will limit their purchases from individual carriers and in the aggregate based on the long-term nature of BOLI. The tax-deferred build-up of BOLI becomes taxable if the policies are surrendered, in whole or in part, prior to the death of the insured. In managing its liquidity risk, a bank should analyze the effects of surrendering the policies at various points in time.

### Transactional/Operational Risk

As it applies to BOLI, transactional/operational risk is the risk to earnings and capital arising from problems caused by the institution's failure to fully understand or to properly implement a transaction. To help mitigate this risk, management must have a thorough understanding of how the insurance product works and the variables that dictate the product's performance.

### Reputation Risk

Reputation risk is the risk to earnings and capital arising from negative publicity regarding an institution's business practices. This risk exists with BOLI because of perception issues associated with owning or benefiting from life insurance on employees. Banks manage reputation risk by limiting the insured group to only key officers and/or directors, as well as obtaining written, positive consent from all participants. Most banks also share a portion of the net death benefit with plan participants. The Pension Protection Act of 2006 codifies what have been the best practices concerning the use of employer-owned life insurance.

### Credit Risk

Credit risk is the potential impact on earnings and capital arising from an obligor's failure to meet the terms of any contract with the institution or otherwise perform as agreed. Because BOLI must be held until the death of the

insured in order to receive the most favorable tax treatment, it should be viewed as a long-term asset. As such, addressing credit risk is particularly critical.

Diversification, in general, is the concept of spreading a given element of risk over more than one source of that risk. One way to help lower one's exposure to credit risk is to spread the risk over multiple parties so there is not a high concentration of risk with any one creditor. Banks are very familiar with diversifying credit risk and have executed this strategy effectively in their BOLI portfolios by purchasing BOLI products from various insurance companies, subject to legal lending limits, as well as any additional internal lending limits. Exposure to insurance-company credit risk should be closely monitored and reported regularly to senior management and the board of directors.

Credit risk manifests itself in several ways for BOLI. It is also affected by the type of product that has been purchased (i.e., whether one has a general account, hybrid/general account or true separate account products). Each product has varying degrees of credit risk amounts and mechanisms. Broad categories of credit risk for a BOLI product include general creditor risk with respect to the payment of the policies' cash value upon demand, the claims-paying ability of the insurance company with respect to the total death benefit, and the responsibility and/or ability to pay the difference between the book value of the policies and the market value of the underlying assets for a product that involves a separate account. Although insurers also utilize reinsurance to help manage their risk, the additional complication of reinsurance is not within the scope of this article.

### Interest Rate Risk

Interest rate risk is the risk to earnings and capital arising from movements in interest rates. Interest rate risk for BOLI is primarily a function of the maturities of the assets in the carrier's investment portfolio. In addition, the crediting rate methodology used for a given product will affect future earnings.

Banks should address the portfolio characteristics of the chosen carriers in conjunction with its financial analysis of each company and evaluation of the different products available. Carrier cash value projections as well as crediting rate histories also should be reviewed. The insurers' cash-value projections, at multiple interest-rate scenarios, should be evaluated. In addition, the crediting-rate methodology of

Continued on page 13

PHOTO GALLERY

# CBA Membership Appreciation Tailgate

More than 300 Kansas bankers, their friends and families attended the CBA Membership Appreciation Tailgate on Oct. 8 at K-State.

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# BOLI RISK MANAGEMENT

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each product should also be reviewed, as well as the investment earnings pattern of each insurance company.

## Compliance/Legal Risk

Compliance/legal risk is the risk to earnings and capital arising from violations of, or nonconformance with, laws, rulings, regulations, prescribed practices or ethical standards. Failure to comply with applicable rules could result in fines or penalties imposed by regulatory authorities or loss of tax benefits.

Examples of areas (but not a complete list) to be evaluated include the following: state insurable interest laws; the Employee Retirement Income Security Act of 1974 (ERISA); Federal Reserve Regulation O and W (12 CFR 215 and 223 respectively); the Interagency Guidelines for Establishing Safety and Soundness; the requirements set for under the legal authority section of the statement; and federal regulations applicable to BOLI. Other risk areas involve undue “control” of separate account assets and potential Federal Reserve Regulation W violations. These items only apply for a Private Placement Separate Account product purchase.

Banks should address compliance/legal risk by analyzing each of the applicable regulations relevant to their transaction. In addition, the bank should seek the advice of counsel on these and other legal, accounting and regulatory areas.

## Price Risk

Price risk is the risk to earnings and capital arising from changes in the value of portfolios of financial instruments. Owners of general account products are permitted to use an approach that is essentially based on cost plus accrued earnings. By limiting its purchase to general account and hybrid/general account products, which function in the same manner as general account products, banks can largely eliminate price risk due to this accounting treatment.

## Tax and Legislative Risk

Tax and legislative risks stem from the long-standing favorable tax treatment that life insurance receives. This favorable treatment is part of consistent policy efforts to encourage the private sector to save and invest in financial security programs for individuals. Individual financial security helps to decrease the need for and burden upon

public welfare programs. This favorable tax treatment of life insurance is beneficial to banks in their efforts to help offset and recover the costs of employee benefits.

This favorable public-policy approach to insurance notwithstanding, the possibility exists that legislators could — at some point in the future — change this long-standing policy and alter the tax treatment of insurance through legislation. A tax code change that would either tax the inside buildup of life insurance cash values or make future BOLI cash flows subject to income tax would have a negative impact upon the economics of BOLI holdings.

Historically, however, most tax law changes have been applied prospectively, grandfathering previously existing financial arrangements. No known legislation is pending, nor is there any information of any current intent to propose legislation that would negatively impact the tax treatment of insurance.

## Conclusion

High credit quality and security, favorable tax treatment, the ability to give a benefit to bank officers to help attract and retain top talent, and favorable yield profiles have prompted many bankers to review what they know and find out what’s new in the BOLI market. BOLI products are designed to benefit executives and shareholders alike. As with everything else a bank does, risk management plays a critical role in the success of any strategy. Being educated on how to manage the various risks of BOLI can help bank leaders to capitalize on the benefits of this common banking practice. •

• ABOUT THE AUTHOR • • • • •  
Richard K. Bratten has worked in the executive benefits and bank-owned life insurance markets for over a decade. As an actuary and a CFA charterholder, Bratten is uniquely positioned to educate institutions on the many decisions inherent in the bank-owned life insurance market. Bratten is a partner of Bank Financial Services Group, which works exclusively with community banks and bankers on creating and managing supplemental benefit plans and bank-specific financing of supplemental benefit plan costs as well as overall employee benefit expenses. Bratten can be reached at 303-482-18449, or by email at [rbratten@bfsgroup.com](mailto:rbratten@bfsgroup.com). To learn more, visit [www.bfsgroup.com](http://www.bfsgroup.com) to view a brief video about the BFS Group.





# A REGULATORY FIELD DAY FOR LOAN SHARKS

*BY PETER G. WEINSTOCK*

**B**en Bernanke and Sheila Bair have expressed concerns with the cost of regulation. Perhaps the pendulum is about to swing toward moderation in banking regulation. Regulators can start with the fair lending laws.

Regulators evaluate consumer loans for “disparate pricing.” Community banks offer these loans as a service under CRA. Perhaps the bank breaks even, but there is no profit after the net cost of small-dollar loans. Now bankers’ good-faith lending practices may be a “pattern or practice” of discriminatory loan pricing.

The consequences of such a determination are extraordinary. Specifically, regulators consider a referral to the Department of Justice as mandatory whenever “the agency has reason to believe that one or more creditors has engaged in a pattern or practice” in violation of the Equal Credit Opportunity Act (ECOA). Even if not required, referral is

always discretionary for possible ECOA violations. Such a referral results in “less than satisfactory” CRA and compliance ratings. Additionally, the DOJ seeks restitution and also damages based, in part, on the creditor’s net worth. Of course, the legal and consulting fees associated with responding to subpoenas and document production, even if a bank capitulates (because the money involved does not justify the cost) is high.

The FDIC and the Federal Reserve, in particular, have been focusing on these issues. We have heard that the comptroller is now making fair lending a point of emphasis for compliance examinations. We currently

have nine clients fighting actual or potential referrals to the DOJ. The regulators review HMDA data for disparities in loan pricing and approval/denial rates. They review the bank's procedures for both secured and unsecured consumer loans. They also seek to compare average interest rates charged between different classes, such as gender and ethnicity. Statistically significant disparities lead to DOJ referrals.

Interagency procedures are not uniform regarding the standard for "statistical significance." The standard is unclear to non-mathematicians. Bank regulators have handed these issues over to statisticians to perform regression analyses. If a statistically significant disparity is alleged, then bankers are notified of potential violations of law and possible DOJ referral. Unfortunately, the courts have recognized that evidence of disparate impact can support a claim for lending discrimination under the ECOA, even absent intent. Thus, the regulators' position is that they do not need to have overt, or even comparative, evidence of disparate treatment.

If matters advance that far, there is a battle of the experts. The bank's statistician then develops its regression analysis. Recently, the Federal Reserve indicated it does not even need to show specific customers who have suffered discrimination. The regression model becomes the sole test of discrimination; other issues, such as file reviews to show a comparison in rates and terms charged to different borrowers, are effectively moot. Bankers should consider developing internal mechanisms to provide loan-pricing uniformity, including:

- Creating a loan pricing matrix without discretion;
- Providing that deviations from the matrix are explained through legitimate (permissible) factors;
- Developing internal evaluation procedures, including, unfortunately, periodic internal regression analysis; and
- Providing that bank pricing policies are transparent and uniform.

Examiners, though, are currently looking at data previously developed, which predates when corrective actions can take hold. Bankers experiencing such an examination must be proactive from the moment the institution is flagged as a HMDA outlier. Senior people need to be involved. Oftentimes, community banking core-processing systems are not designed to provide fair lending review data (they were designed for loan-operation purposes). It is important to understand why the regulators are asking particular questions. Giving off-the-cuff

answers to questions that then become memorialized is a good way to get in to trouble. It is permissible to have counsel at the interview stage of the process. Oftentimes, this is where a serious and robust response can avoid the process running awry.

Any letter requesting detailed information regarding such matters is significant. A targeted information request indicates a regulatory belief that some evidence of discriminatory pricing or underwriting exists. This is the critical moment in the regulatory inquiry. The bank needs to vigorously respond to minimize the likelihood that the inquiry progresses. At each step along the process of an inquiry turning into a potential enforcement action, the costs of defense increase and the likelihood of success diminishes. It is my experience that too many bankers trust that the regulators will "get it right." Regulators increasingly are making DOJ referrals. Recently, one of the bank regulators acknowledged that DOJ's model was flawed once the data was presented correctly.

Dodd-Frank authorizes the U.S. Treasury to provide incentives for banks to make small-dollar loans. The FDIC's recent pilot program on such loans demonstrates that when a pricing matrix is introduced, banks increase what they charge. Are customers truly benefiting from this new approach to fair lending enforcement?

It is also important to realize that these issues go well beyond HMDA data. It also includes unsecured vehicle loans. The referrals to the DOJ, however, are not just limited to disparate pricing. We are addressing allegations of "steering" and RESPA violations. We even have one claim of reverse discrimination against a minority bank. It is important to understand the new compliance environment and potential consequences of allegations of misconduct.

The effect of the current approach to examination will be that banks stop offering certain consumer loan products or increase what they charge. The entire banking system loses if the cost of compliance forces regulated lenders to send their customers to the payday lender down the street or, worse yet, to the back-alley loan shark. What makes this even scarier is that Dodd-Frank requires bankers to obtain HMDA-like data for their small business loans to "aid enforcement of fair lending laws." •

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## FINE POINTS

# THE VIEW FROM DOWN HERE

**T**he dizzying view looking out or down from a skyscraper on Wall Street; in Charlotte, N.C.; or San Francisco is much different from the view from a modest building on Main Street, USA. So let's talk about the view from down here on Main Street.

**BY CAMDEN  
R. FINE**

First, I figure that ICBA is pretty much considered a big pain in the neck by several other financial trade groups in Washington. I mean, the gall of thousands of community banks to band together and speak out forcefully for their rightful place in the financial services sector! Who do these banty roosters think they are?

Of course, it is perfectly acceptable for the 100 largest financial firms to create their own association — the Financial Services Roundtable — or for the mortgage bankers to form the Mortgage Bankers Association, or the consumer bankers to organize through the Consumer Bankers Association. And, of course, the 10 or so largest financial banks and investment firms in America have their own robust individual lobbying offices humming with staff in Washington to represent only themselves. But shame on the community banks for disrupting industry “unity” (whatever that is) by banding together through ICBA to speak out with their own voice on issues critical to their franchises.

ICBA does not question the right of any other segment in the financial industry to form an advocacy group, yet our existence is questioned all the time. For some reason, ICBA alone threatens “industry unity,” but no other financial trade group does. Why is that?

For example, as the Wall Street Journal mentioned in a recent article, Bank of America was an early endorser of the Consumer Financial Protection Bureau, but other trade groups did not brand Bank of America as “divisive” and hurting the industry. Yet when ICBA fought hard for community bank exemptions from CFPB oversight and for assessment premium parity, we were excoriated by other financial trades as damaging industry unity (and, unlike Bank of America, we never did endorse the CFPB).

As for ICBA-advocated regulatory carve-outs and exemptions for community banks, these are modest compared to more than three decades of the government's favored policies and treatment for the nation's very largest financial firms, starting with Continental Illinois in the mid-1980s.

Community banks only want to have the opportunity to compete equally on the financial playing field and mitigate the enormous advantages in funding, regulatory costs, examinations and capital access that the nation's largest banks have enjoyed courtesy of government policies for more than three decades, as numerous academic and Federal Reserve studies have shown and as the recent financial crisis bitterly proved.

Community bankers joined together because they just want recognition of the view they see outside their window on Main Street. They want recognition of the view from down here. •

• ABOUT THE AUTHOR •



Camden R. Fine is president and CEO of ICBA.



# WWW



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## CBA Educational Cruise

CBA's fifth Educational Cruise is scheduled for June 16 - 23, 2012. This 7- day air/land package includes the cabin (lodging, food and entertainment aboard the ship), airfare from Kansas City, transfer charges to and from the airport in Barcelona, Spain, port charges and taxes. CBA's Educational Cruise offers members the opportunity to mingle with banking professionals while attending short educational seminars. Imagine the combination of working and relaxing in the beautiful Western Mediterranean with family, friends and banking professionals.

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**14** Your Social Media Communication Policy: Strategies to Protect Your Bank  
TELE/WEB SEMINAR

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**31** SBA Eligibility Hot Topics  
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*Happy holidays and  
all the best for the new year!*

*May 2012 be full of love, health  
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*Sincerely,  
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