

IOWA BANKS' EXPANDED INVESTMENT AUTHORITY: A SELECTIVE ANALYSIS OF THE 1987 CHANGES TO IOWA CODE SECTION 524.901

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I. INTRODUCTION

Today's financial environment is rapidly changing. In the past decade, banks have faced unprecedented innovations in financial products and services, the loss of what had previously been almost exclusive control of checking accounts, and advances in technology. At the same time, restrictions on banking activities have placed banks at a perceived competitive disadvantage against various nondepository institutions and have caused a decrease in bank profitability.

In an effort to increase bank profitability and create an environment in which banks can more effectively compete with nondepository institutions, the 1987 Iowa Legislature passed House File 658. This legislation amended several chapters of the Iowa Code and increased the financial powers of a number of different financial entities throughout the state.¹ This article will examine and comment on the changes in Chapter 524 of the Iowa Code which relate to the increased investment authority given to state banks.

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1. The 1987 Iowa Acts, chapter 171, modified chapter 7C of the Iowa Code pertaining to the Private Activity Bond Allocation Act; chapter 524 of the Iowa Code regarding Iowa banking law; chapter 533 of the Iowa Code dealing with credit unions; and chapter 534 of the Iowa Code regarding savings and loan associations.

II. IOWA CODE SECTION 524.901(1)(f)—HEDGING AUTHORITY

A new lettered paragraph (f) was added to Iowa Code section 524.901(1) in 1987.² This new provision gives state banks the authority to use "futures,³ forward,⁴ and standby contracts⁵ to purchase and sell any of the instruments [otherwise] eligible for state banks' [direct] purchase and sale."⁶ As a result, state banks may now hedge⁷ any of the financial instruments which they are otherwise allowed to invest in by law.

Due to the speculative nature of futures, forward, and standby contract investments, it can be assumed that this will be an area of heavy regulation and supervision by the State Division of Banking. This is alluded to in the first sentence of the paragraph, which requires prior approval of the State Superintendent of Banking before these contracts can be entered into.⁸ Further, the second sentence provides that the purchase and sale of such contracts must be done in accordance with "safe and sound" banking practices and must be "reasonably related to the state bank's business needs and capacity to fulfill its obligations under the contracts."⁹ This second sentence provides substantial regulatory control and prevents state banks from speculating in the futures market.

The use of financial futures, forward placement, and standby contracts,

2. IOWA CODE § 524.901(1)(f) (1987) provides as follows:

Futures, forward, and standby contracts to purchase and sell any of the instruments eligible for state banks' purchase and sale, subject to the prior approval of the superintendent and pursuant to applicable federal laws and regulations governing such contracts. Purchase and sale of such contracts shall be conducted in accordance with safe and sound banking practices and with levels of the activity being reasonably related to the state bank's business needs and capacity to fulfill its obligations under the contracts.

3. "Futures contracts" are contracts which give a present right to receive at a future date a specific quantity of a given commodity for a fixed price. See *Clayton Brokerage Co. v. Mouser*, 520 S.W.2d 802, 804 (Tex. Civ. App. 1975). Financial futures contracts are contracts regarding interest rates futures which under § 2 of the Commodity Exchange Act, 7 U.S.C. § 2, are commodities contracts traded on and guaranteed by an exchange. Comptroller of the Currency, *National Banks Are Advised on Participation in the Financial Futures and Forward Placement Markets*, [Transfer Binder 1982-83] FED. BANKING L. REP. (CCH) ¶ 99,539 at 86,763.

4. "Forward" or "forward placement contracts" are over-the-counter contracts for the delayed delivery of certain securities in which the buyer agrees to buy and the seller agrees to make a delivery of a specified security at a specified price for future delivery. *Id.*

5. "Standby contracts" are optional delivery forward placement contracts. "The buyer of a standby contract pays a fee for the right or option to sell an agreed upon amount of specified securities to the issuer of the Standby Contract at a specified price at a specified future date." *Id.*

6. IOWA CODE § 524.901(1)(f) (1987).

7. A "hedge" is a means by which individuals secure themselves against the fluctuations of a market by counter-contracts for the purchase or sale of an equal or offsetting quantity of a commodity. BLACK'S LAW DICTIONARY 650 (5th ed. 1979).

8. IOWA CODE § 524.901(1)(f) (1987).

9. *Id.*

when done in accordance with safe and sound banking practices and levels of activity reasonably related to the bank's business needs, can become an effective tool in the management of a bank's investment portfolio. However, banks must be extremely cautious when dealing with these types of investment contracts. Banks should evaluate the interest rate risk exposure resulting from their overall investment activities to ensure that positions taken in futures, forward and standby contract markets will reduce their risk exposure.¹⁰ Short positions¹¹ in futures and forward contracts should reasonably relate to existing or anticipated cash positions and should be used to enhance the liquidity of the bank's investment portfolio.¹² Rather than use short positions against portfolio holdings for the purpose of income generation, banks should use contract gains to offset losses resulting from the sale of portfolio securities as asset yields are upgraded.¹³

In the area of asset-liability management,¹⁴ futures and forward contracts may be used as a general hedge against the interest rate exposure associated with undesired mismatches in interest-sensitive assets and liabilities. Long positions¹⁵ can be used as a hedge against funding interest-sensitive assets with fixed rate sources of funds. Short positions in contracts can be used as a hedge against funding fixed rate assets with interest-sensitive liabilities.¹⁶

Federal regulators have suggested certain measures for banks to implement in this area. For instance, the board of directors should endorse specific written policies and procedures authorizing the use of financial futures, forward and standby contracts.¹⁷ Policy objectives should be specific enough to indicate permissible contract strategies and their relationship to other

10. Comptroller of the Currency, *National Banks Are Advised on Participation in the Financial Futures and Forward Placement Markets*, [Transfer Binder 1982-83] FED. BANKING L. REP. (CCH) ¶ 99,539 at 86,764.

11. A "short position" is created when an investor borrows a security in order to sell it, believing that the price of the security will decline and that he will be able to replace the borrowed security at a cost lower than the income generated by the sale. The investor is in a "short position" until the investor purchases securities to repay the lender. BLACK'S LAW DICTIONARY 1236 (5th ed. 1979).

12. Comptroller of the Currency, *National Banks Are Advised on Participation in the Financial Futures and Forward Placement Markets*, [Transfer Binder 1982-83] FED. BANKING L. REP. (CCH) ¶ 99,539 at 86,764.

13. *Id.*

14. "Asset-liability management" involves the matching of fixed rate and interest-sensitive assets and liabilities in order to maintain liquidity and profitability. *Id.*

15. An investor is said to be in a "long position" when he has or controls an abundant supply of a particular security, or a supply exceeding the amount which he has contracted to deliver. BLACK'S LAW DICTIONARY 850 (5th ed. 1979).

16. Comptroller of the Currency, *National Banks Are Advised on Participation in the Financial Futures and Forward Placement Markets*, [Transfer Binder 1982-83] FED. BANKING L. REP. (CCH) ¶ 99,539 at 86,764.

17. *Id.*

banking activities.¹⁸ Bank personnel should be able to describe and document in detail how the positions they have taken in the futures, forward and standby contracts contribute to attaining the bank's stated objectives.¹⁹ Finally, to ensure adherence to bank policy and prevent unauthorized trading and other abuses, banks should establish appropriate internal controls including periodic reports to management, segregation of duties, and internal audit programs.²⁰

The dangers involved in assuming speculative positions in futures and option contracts could pose a great financial risk for a depository institution if used improperly. Leaving cash positions unhedged, however, also involves risk. Therefore, banks should limit the positions they take in futures and options to hedges. Establishing a hedge position in some cases can be a complicated matter requiring great care and expertise. But, if institutions limit their involvement to positions which are truly risk-reducing, these new contracts would appear to pose no threat to the financial health of Iowa's state banks.

III. IOWA CODE SECTIONS 524.901(1)(g), .901(3)(i), AND .901(3)(j)—MUTUAL FUND INVESTMENT AUTHORITY

Iowa Code section 524.901(1) was further amended in 1987 by adding new lettered paragraph (g).²¹ Paragraph (g) provides that bonds and securities which are authorized for investment by banks shall now include investments in investment companies or investment trusts and repurchase agreements which are fully collateralized by authorized United States Government obligations.²² This allows state banks to invest in mutual funds²³ which consist of previously authorized investments such as U.S. Government Treasury and agency securities.

The rationale behind the adoption of section 524.901(1)(g) was in the

18. *Id.*

19. *Id.*

20. *Id.*

21. IOWA CODE § 524.901(1)(g) (1987) provides that

Bonds and securities which are authorized investments under IOWA CODE § 524.901(1) ["a," "b," "c," or "d"] include investments in an investment company or investment trust registered under the Investment Company Act of 1940, 15 U.S.C. § 80a, the portfolio of which is limited to the United States government obligations described in paragraph "a," "b," "c," or "d" and to repurchase agreements fully collateralized by the United States government obligations described in paragraph "a," "b," "c," or "d," if the investment company or investment trust takes delivery of the collateral either directly or through an authorized custodian.

22. *Id.*

23. A "mutual fund" is a "fund offered by an investment company that raises money by selling its own stock to the public and invests the proceeds in other securities, with the value of its stock fluctuating with its experience with the securities in its portfolio." BLACK'S LAW DICTIONARY 920 (5th ed. 1979).

nature of a technical correction. This is because section 524.901(1)(g) expresses what was previously thought to be an implied power which was potentially outside the scope of Iowa Code section 17A. To alleviate this problem, the legislature specifically allowed state banks to invest in mutual funds via section 524.901(1)(g).

Iowa Code section 524.901(3) was also amended in 1987 by the addition of two additional paragraphs, (i)²⁴ and (j).²⁵ These two paragraphs allow banks to invest in the shares of investment companies up to a maximum of "twenty percent of the capital and surplus of the state bank in any one company" if the state bank could otherwise invest directly without limitation in the security.²⁶ These paragraphs also allow for the purchase of shares of investment companies which are subject to limitations where the investment in such shares does not exceed the limitations set forth for investment in the underlying instrument.²⁷

These laws generally allow banks to invest in mutual funds on a relatively unregulated basis. However, the Office of the Comptroller of the Currency (OCC) has cautioned that "[g]overnment securities mutual funds are not risk free investments."²⁸ The Comptroller has warned that "[l]arge concentrations of such investments may expose banks to excessive market risks."²⁹ The OCC's experience has been that banks which have invested heavily in single government securities mutual funds which hold long maturity securities or in several funds with the same kind of investment strategy have been hurt by a rise in interest rates.³⁰ This occurred because the increase in interest rates caused a substantial drop in the share value of the funds and a commensurate rate decline in the bank's primary capital.³¹

This type of difficulty can be avoided if state banks exercise the same level of care in diversifying their mutual fund investments as they traditionally exercise in diversifying the maturity structure of their holdings of U.S.

24. IOWA CODE § 524.901(3)(i) (1987) allows a state bank to invest in "[s]hares of investment companies, up to a maximum of twenty percent of capital and surplus of the state bank in any one company, if the portfolio of such an investment company consists wholly of investments which the state bank could invest in directly without limitation pursuant to this section."

25. IOWA CODE § 524.901(3)(j) (1987) allows state banks to invest in "[s]hares of investment companies whose portfolios contain investments which are subject to limitations pursuant to this section, provided that a state bank's investment in such shares does not exceed in limitations set forth in this section for the underlying instrument."

26. IOWA CODE § 524.901(3)(i) (1987).

27. IOWA CODE § 524.901(3)(j) (1987).

28. Comptroller of the Currency, *National Banks Alerted to Potential Risks in Government Securities Mutual Funds*, Advisory Letter 87-3, [Transfer Binder 1987-88] FED. BANKING L. REP. (CCH) ¶ 87-183 at 93,309.

29. *Id.*

30. *Id.*

31. *Id.*

Government securities.³² Concentrations of bank assets in long term fixed rate assets, in any form, leave banks vulnerable to interest rate movements. Thus, when selecting mutual fund investments, an investor should exercise care to invest in mutual funds or families of mutual funds in a manner which permits diversification of all types of risk, including the price effect of interest rate movements.³³

Allowing banks to purchase shares in certain mutual funds provides an alternative to the direct purchase of securities, which can be costly.³⁴ Further, for many Iowa state banks, investing in mutual fund shares may provide more liquidity, risk diversification, flexibility, and convenience, while at the same time providing investment results comparable to those gained from purchasing securities directly.³⁵

To conform with safe and sound banking practices, the bank investment policy should specifically provide for such investments and board approval should be obtained before the initial purchase of the funds.³⁶ Banks should also conduct reviews of their holdings at least monthly to ensure that their portfolio is well balanced and diversified.³⁷

When purchasing a mutual fund, it is important to determine that the shareholders of the fund are shielded from personal liability for acts or obligations of the fund. Thus, one should determine whether a fund is organized as a Massachusetts Business Trust rather than as a corporation.

"A Massachusetts Business Trust is a business vehicle that, rather than being organized and formed by articles of organization under applicable state corporation statutes, is formed by voluntary action of trustees."³⁸ A declaration of trust sets forth the rights and obligations of the trustees and shareholders.³⁹ A number of cases in Massachusetts have held that shareholders may be personally liable for obligations of the trust where they have the power to control the actions of the trustees or the affairs of the trust. However, if the actions of the trustees along with the affairs of the trust are not subject to control by the shareholders, then the shareholders have no personal liability.⁴⁰ Thus, it is important to determine whether a Massachusetts Business Trust exposes shareholders to personal liability for the obligations of the trust. If there is any possibility of personal liability to the

32. *Id.*

33. *Id.*

34. Comptroller of the Currency, *National Bank Purchase of Shares and Money Market Mutual Funds*, OCC Guidelines, Banking Bulletin 83-50, FED. BANKING L. REP. (CCH) ¶ 49,102 at 28,105.

35. *Id.*

36. *Id.*

37. *Id.*

38. *Bank Investment and Mutual Funds Organized as Business Trusts*, FED. BANKING L. REP. (CCH) ¶ 83,106 at 76,113.

39. *Id.*

40. *Id.* at 76,114.

shareholder, the mutual fund should not be purchased.

Although virtually all Massachusetts Business Trusts include express provisions in the declaration of trust (a) disclaiming the personal liability of the shareholders, and (b) obligating the trust to indemnify any shareholder against liability, one should exercise extreme caution before investing in such a mutual fund.

IV. IOWA CODE SECTION 524.901(6)—CASH VALUE LIFE INSURANCE INVESTMENT AUTHORITY

Subsection 6 was added to Iowa Code § 524.901 in the 1987 legislative session to allow a state bank to invest in cash value life insurance contracts not to exceed twenty percent of capital and surplus of the bank.⁴¹

The impetus behind the adoption of section 524.901(6) came in early 1987 when the Iowa Bankers Association, through its subsidiary, Iowa Bankers Insurance and Services, Inc., lobbied the State Division of Banking to allow banks to purchase life insurance products as a vehicle for funding key employee insurance and salary continuation plans. Their argument was that state banks implicitly had the power to set the compensation of officers under sections 524.703 and 524.801 of the Iowa Code.

Although persuasive, this position was not accepted by the Superintendent of Banking for the reason that cash value life insurance contracts were not specifically enumerated as legal "investments" for Iowa banks. In other words, the use of depositors' funds in an "investment" in a life insurance contract, which in turn would fund a salary continuation plan, key employee insurance, or a fringe benefit, did not appear to have been contemplated by the legislature under the investment powers set forth in section 524.901 of the Iowa Code. A change in the law was needed and that course of action was proposed and supported by the Superintendent.

In the spring of 1987, the Iowa Legislature passed Iowa Code section 524.901(6), which gave state banks the specific power to invest in "cash value life insurance." Since that time the State Division of Banking has established a number of guidelines for bankers to follow as they consider the use of cash value life insurance as an investment and to fund key employee, salary continuation, and fringe benefit plans.

The primary restriction on the use of life insurance contracts as an investment is a statutory investment limit: a state bank may not invest in excess of twenty percent of its capital and surplus in any one company.⁴² In

41. Iowa Code § 524.901(6) (1987) provides that

A state bank may, in the exercise of the powers granted in this chapter, purchase cash value life insurance contracts which may include provisions for the lump sum payment of premiums and which may include insurance against the loss of the lump sum payment. The cash value life insurance contracts purchased from any one company shall not exceed twenty percent of capital and surplus of the state bank.

42. *Id.*

practical terms, this means that there is no limit as to the number of contracts in which a state bank may invest. However, a state bank may not invest more than its lending limit in any one insurance company.

A further requirement is that, in order to receive approval from the State Division of Banking, each insurance company must be "A" rated or better to be a qualified company for investment purposes.⁴³ However, the consequences of a company being downgraded to less than an "A" rating have not been addressed. If such a downgrading were to occur, the regulators would probably classify the asset as "special mention" or "substandard."

A restriction to be expected from the State Division of Banking is that certain limitations shall be placed on the amounts of funding available for a salary continuation plan which shall not exceed more than fifty percent of an executive's final salary (defined as the average of the executive's last three to five years' salary). It can be expected that key employee insurance will be limited to three times the executive's salary. Therefore, when the bank's board of directors seeks to answer the questions "How much is enough?" and "How much is too much?" it should be remembered that common sense will be the lens through which each program will be brought into focus and scrutinized.

The power to invest in cash value life insurance, used prudently and with foresight for the well-being of the bank, has the potential to be an effective stabilizer for the bank upon the death of the insured executive. The insurance should protect the bank by furnishing immediate cash with which to search for and compensate a new key officer. Life insurance also protects the bank by funding a salary continuation plan upon an executive's retirement and at the executive's death for his survivors so that the bank does not have to fund the salary continuation plan out of earnings.

An investment in cash value life insurance can furnish liquidity within the bank at the time of the insured executive-shareholder's death for general bank capital or to pass cash dividends to a holding company. Once at the holding company level, the cash can then be used to pay bank stock debt or to redeem the deceased shareholder's stock from his estate. This protects the estate of the bank shareholder and stabilizes continuity of ownership within the community.

Life insurance contracts which have been used to date have been specially negotiated and designed policies which emphasize internal tax-free cash value build-up in order to enhance investment qualities and flexibility. Although it is probable that there are a number of insurance companies capable of offering this type of contract, the only source known to the writers at this time is Iowa Bankers Insurance and Services, Inc., which is a subsidiary of the Iowa Bankers Association.

43. The rating as determined by A.M. Best's Life/Health Division publications.

To implement an investment in life insurance, goals must be established. These goals may include the funding of a salary continuation plan or key employee insurance; providing a fringe benefit for a key officer or officers; or simply providing a tax-free investment. Once the bank's goals have been established, the bank will be able to calculate the amounts needed to accomplish these goals within the guidelines of reasonableness, legal lending limits, and common sense.

Once the bank's goals have been established, an insurance agent will be able to lead the investor through the application procedure. Of course, there must be an insured who is physically able to qualify. When the policy is ready to issue and the insurance company has made an "offer" of the contract to the bank, the bank will be asked to wire-transfer the single premium amount to the insurance company. At the time of the receipt of the premium, the company will send the bank a letter of receipt acknowledging the premium payment and the policy will be in force.

There are two methods of bookkeeping for these policies. The first is to establish and debit "CVL Insurance" and to credit "Cash." Upon receipt of the annual or quarterly report of policy values, the entries to adjust to actual values are to debit "CVL Insurance" and credit an expense account which might be titled "Insurance Expense" or a similar account. The latter may create a negative expense balance which would be closed out to undivided profits at year-end. This method, however, does not allow an accrual of income equal to the increase in cash value of the policy.

The second method of bookkeeping allows for the accrual of income between reporting periods in order to reflect the actual performance of the asset as an investment. The entries would be to create and debit "XYZ Insurance Co. Policy No. 123456" and to credit "Cash." The bank must also set up accrual and income accounts hypothetically entitled "Interest Earned Not Collected" and "Interest Earned—Other Securities." The accruals, based upon a calculated assumption, are then recorded so that the earnings of the bank reflect this income as would be the case in recording accrued interest of a bond or other investment. Of course, these accounts must be adjusted to actual values upon receipt of the report of policy values.

In the usual deferred compensation or salary continuation plan situation, generally accepted accounting principles require that the liability must be recorded on the books as a credit to an account which might be entitled "Accrued Salary Continuation Plan Payable" and a debit to "Salary Expense" to fund it. However, due to the special nature of the ownership of the policies designed for this investment purpose, it need not be so treated in this case.

Mechanically, within the bank, it is suggested that a six-sided folder be used to accommodate the actual policy and all correspondence, receipts for funding, rating service listings showing the most current rating of the company, reports of policy values, and a comment sheet. This should be kept in the bank's ordinary fireproof facilities along with the regular credit files.

It has also been suggested that it would be possible to use this type of investment to keep a troubled loan from causing ultimate economic loss to the bank. An investment contract of insurance could be taken out on the life of a troubled borrower (assuming he or she was insurable). The face amount of the insurance would be equal to the principal and accrued interest on the troubled note. Upon the death of the borrower, the proceeds of the policy would be paid to the bank to retire the principal debt plus some of the interest. The investment qualities of the policy would also give the bank a tax-free return during the life of the contract. Thus, the borrower would have the debt paid without cost and the bank would avoid a charged-off loan.

Cash value life insurance can be a viable investment. It offers strength to the bank and can enhance the possibility of continuity of ownership. However, with life insurance as with all other permissible state bank investments, approval by the board of directors, attention to detail, and the prudent use of other safe and sound banking practices are the key to a successful investment.