Create A Robust, Compliant Funding Program for Employee and Executive Benefits: Using the Online NCUA Examiner's Guide

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CUNA Mutual Group is the nation's largest provider of credit union executive benefits plans, with more than 3,700 plans at 1,200+ credit unions. The Executive Benefits team is fully credentialed to provide a wide array of plans and funding options, as well as comprehensive administrative support to help maintain oversight and compliance with National Credit Union Administration (NCUA) and state regulations.

CONTENTS

Introduction

Your Guide to a Trove of Great Information on Strong, Compliant Employee/Executive Funding Programs

Making investments to fund credit union employee and executive benefits programs is complicated. A key reason is that many credit unions have little or no experience with the types of investments the NCUA rules allow to fund these benefits.

It's not unusual for NCUA examinations to stop cold when examiners have questions about employee benefits funding programs. Sometimes, credit unions struggle to find supporting documentation. Or their board members and executives are unable to answer basic questions about the investment strategies and products they've deployed for employee/executive benefits.

This eBook can help you avoid these difficult, time-consuming examination glitches by showing you how to use a powerful tool the NCUA has installed: the online NCUA Examiner's Guide.

The NCUA published the online guide in late 2016, but if you weren't aware of it or you haven't done more than glance at it, you're probably in very good company. On the pages ahead, we'll help you navigate the guide and interpret the key sections relating to employee/executive funding programs.

In addition to helping you find relevant information in the guide, we're adding some depth and analysis based on CUNA Mutual Group's decades of experience assisting credit unions with these benefit programs. We work directly with the NCUA frequently on clarifying existing and proposed regulations in this arena.

We want to help credit unions use the NCUA Examiner's Guide not simply to cruise through examinations. We want to help you use it as a guide to a strong, compliant program built to adapt to changes in the coming years—across multiple turnovers in your board and C-suite—so you can attract and retain the best talent in the financial services marketplace.

How This eBook Refers to Federal vs. State Credit Unions

The material in the online NCUA Examiner's Guide generally refers to federal credit unions. It does have some content specifically pertaining to federally insured state-chartered credit unions, but otherwise, it cautions state-chartered credit unions to refer to their state's regulations. Some states have parity rules that allow them to refer to the federal regulations in either the absence of, or where there is disparity with, state regulations.

For the purposes of this eBook, consider any references to "credit union(s)" or "CU(s)" to mean federally chartered credit unions and/or credit unions chartered by states that use the parity rules.

CHAPTER 1: BASIC BACKGROUND

Key section of the guide: Employee Benefits and Investments for Employee Benefits

The language that grants credit unions the ability to use otherwise impermissible investments is cited in the online NCUA Examiner's Guide page, "Employee Benefits and Investments for Employee Benefits." This page notes that Section 701.19 of the NCUA rules "... allows federal credit unions to fund employee benefit obligations with investments that are not subject to the investment limitations of the Federal Credit Union Act and Part 703 or, as applicable, Part 704 of NCUA rules and regulations."

(Part 703 refers to federal CUs and Part 704 refers to corporate CUs. Many state-chartered federally insured CUs have the same or very similar rules, some of which are detailed in the guide.)

With the limitations of these rules removed, credit unions have the authority to invest in commercial bonds, securities, life insurance products and other instruments ordinarily not permitted under Part 703. Credit unions can use income from these sources to fund what Section 701.19 defines as "defined benefit" and "employee benefit" plans.

The guide lists these examples of benefits that fall under the broad category of employee benefits:

- Medical, disability, and unemployment insurance
- Vacation benefits
- 401(k) plans
- 457(b) plans
- 457(f) plans
- Split-dollar life insurance (both endorsement and loan regime)

Other sections of the guide touch on many of these benefits specifically, and we'll look into those details later.

Expanded—but not unlimited—options

Immediately after granting more investment latitude, the guide warns against "unsafe and unsound" practices, such as establishing unreasonable benefit plans and failing to perform due diligence:

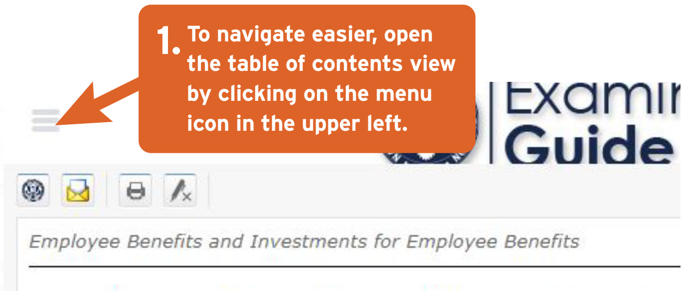
The investment authority established in §701.19 of NCUA rules and regulations can lead to investment holdings which are riskier and more complex than otherwise permissible for a federal credit union. The NCUA has noted an increase in the risk and complexity of employee benefit packages and in the number of federal credit unions purchasing otherwise-impermissible investments to fund employee benefit plans.

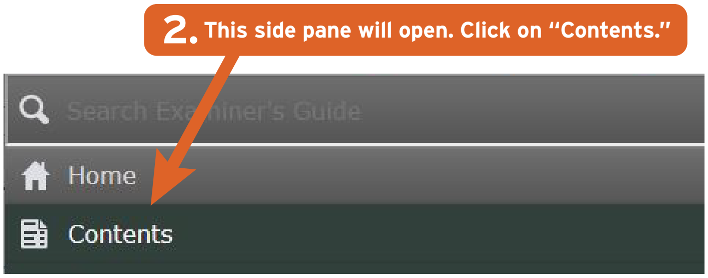
As you'll see, a great deal of the employee benefits material covered in the guide is devoted to spelling out for examiners what due diligence and risk management

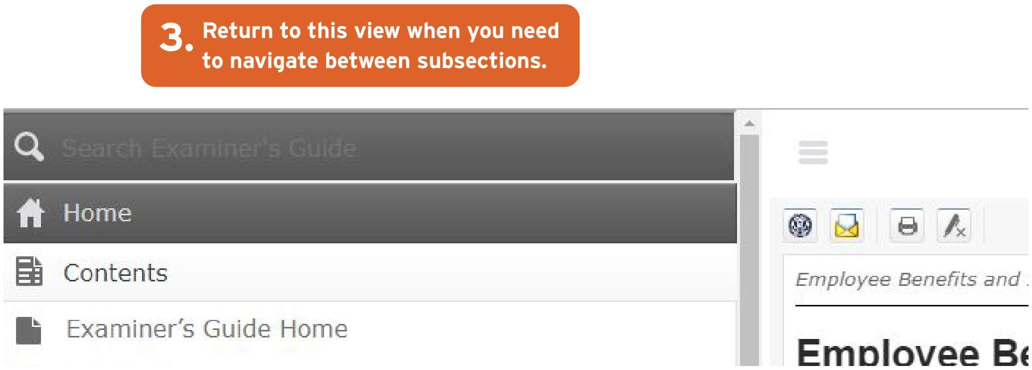
NAVIGATING THE GUIDE

The online NCUA Examiner's Guide can be challenging to navigate. These tips will help you find what you need:

- Depending on your browser, the site may not appear with the guide's table of contents menu in a vertical bar on the left of your screen. You want that navigation bar—it's much easier to find things with it. So, if you don't see that left-hand navigation bar, click on the menu icon (the three stacked horizontal bars—also called a "hamburger") on the top left of the page, then click "Contents."
- Beneath each chapter heading, we include the title and link to the NCUA Examiner's Guide section most closely associated with that chapter's material.
- The guide material we'll be covering in this series is mostly in the section, "Employee Benefits and Investments for Employee Benefits," and its subsections.







entail for these investments.

CHAPTER 2: EXECUTIVE DEFERRED COMPENSATION PLANS

Key section: Senior Executive Benefits

The guide's material on deferred compensation plans for executives focuses on 457(b), 457(f), and split-dollar insurance plans. Credit unions use these plans primarily for two reasons:

- To compete with banks and other commercial financial institutions for top executive talent. These recruitment and retention tools can be offered in lieu of stock options and other perks available to for-profit employers.
- To close the retirement income gap faced by many highly compensated credit union employees.

The guide doesn't go into great detail about deferred compensation plans. We'll expand on that material, starting by explaining some terminology that can be confusing.

Qualified vs. non-qualified

A qualified retirement plan is subject to guidelines set forth in Title 1 of the Employee Retirement Income Security Act of 1974 (ERISA). Generally, all of the plan sponsor's employees who meet basic requirements—such as being 21 years old and working at least 1,000 hours during a plan year—can choose to participate in a qualified plan. Qualified plans include 401(k) and 403(b).

Most executive deferred compensation plans are "non-qualified," meaning they don't fall under the same ERISA Title 1 guidelines. A key difference in non-qualified plans is that they can be offered only to a "select group of management or highly compensated" employees, as defined in ERISA.

Non-qualified plans encompass some plans designed to pay out during an executive's tenure with a credit union, and others that generate supplemental retirement income.

A note about the terms "eligible" vs. "ineligible"

In this section of the guide, these terms do not refer to who is eligible or not eligible for an executive deferred compensation plan. In this context, the NCUA is referring to Section 457 of the Internal Revenue Code (IRC), which lays out how tax deferrals and tax payment is to be handled in 457(b) and 457(f) plans.

The tax rules are complex, but basically, a plan is "eligible" to be a 457(b) plan because it adheres to certain tax rules, and if not, it is "ineligible" to be a 457(b) plan, and for credit unions, that refers to 457(f) plans.

Section 457(b) plans

For governmental workers, a 457(b) is basically their version of a 401(k) retirement plan. For non-governmental tax-exempt organizations such as credit unions, however, these plans are limited to a select group of management or highly compensated employees, who can receive a 457(b) plan in addition to a 401(k) plan.

A 457(b) has similarities with a 401(k) plan, including:

- The employee and employer can contribute to the plan.
- The employee can direct the investment of funds.
- Contributions are not subject to income tax, as long as they do not exceed the threshold set by the IRS. The total combined contribution allowed for a 457(b) in 2019 is $19,000. (Currently, that ceiling is indexed to inflation and rises in $500 increments.)
- Employees within three years of normal retirement age can make "catch-up" contributions above the annual limit (see details here).

Unlike a 401(k) plan, however, the assets of a 457(b) remain on the credit union's balance sheet. And because those assets technically belong to the credit union, they are vulnerable to creditors if a credit union fails before the money has been distributed to the employee.

In short, a 457(b) can be a good, albeit limited supplement to the retirement plans of eligible executives.

Section 457(f) plans

These plans can also provide additional retirement benefits, but unlike 457(b) plans, 457(f) plans can be tailored to pay out before retirement age. Credit unions often structure them to pay out at multiple intervals, to create shorter-term incentives for executives to stay on board.

(For background on proposed rules awaiting final implementation that will affect 457(f) plans, see the CUES/CUNA Mutual Group webinar, "Proposed Regulations 409(A) and 457: Updates and Opportunities.")

The credit union allocates money for a 457(f) plan—executives can't contribute to it from their income. Also, the credit union, not the executive, generally directs investment of the allocated funds.

A 457(f) plan's assets aren't taxed as income until they are paid to the employee, as a long as the plan is structured with a "substantial risk of forfeiture."

In other words, the 457(f) plan agreement must contain one or more requirements the executive must satisfy to become vested in the plan.

Often, the main requirement is length of employment. For example, the executive must stay with the credit union for three years in good standing to receive a lump-sum payment. Or the executive will receive three lump-sum payments for remaining employed with the credit union for five, 10 and 15 years, respectively.

If the executive doesn't meet the plan's requirement, the funds are forfeited.

For 457(f) plans with multiple vesting dates, the payment amount for the year in which each vesting date falls is added as taxable income to the executive's W-2.

A 457(f) plan has some advantages over 457(b) or 401(k) plans:

- There is no limit on contribution amounts, so these plans can generate considerably more compensation.
- There is no penalty for receiving payouts prior to retirement age (treated as ordinary income for income tax purposes).
- They can be set up as a defined benefit or a defined contribution plan—whichever suits the credit union and the executive's needs best. A defined benefit plan generally yields a specific monthly or annual payment amount regardless of how the underlying investment performs. In a defined contribution 457(f) plan, the credit union contributes a specific amount, and the benefit varies according to the investment performance.

The guide points out that 457(f) plans "do not necessarily need to be funded by specific investments." Overall, 457(f) plans are more flexible tools than strictly retirement plans for credit unions to use in creating meaningful incentives for executives.

Split-dollar life insurance

Most of the guide's content on split-dollar life insurance focuses on "loan regime" split-dollar programs. It provides only a cursory description of other types of split-dollar plans—"economic benefit" and "non-equity regime"—because the vast majority of split-dollar plans for credit unions are loan regime.

Below, we'll flesh out the guide's explanation of loan regime split-dollar programs, and their potential advantages and risks. But for a more comprehensive overview of split-dollar plans, refer to the eBook, "Non-Qualified Executive Benefits: A Guide for Credit Union Leadership."

How a basic loan regime (a.k.a. collateral assignment) split-dollar life insurance program works

In a loan regime split-dollar arrangement, generally, a cash value life insurance policy is written on an executive, who owns the policy. The credit union issues a loan to the executive to pay premiums for the policy. In turn, the executive assigns at least a portion of the policy's cash value and/or death benefit to the credit union as collateral for the loan (which is why these arrangements are often called "collateral assignment split-dollar" or "CASD" life insurance).

The goal of loan regime split-dollar programs is for the life insurance policy to generate enough earnings, so that eventually the executive can withdraw a portion of the cash value to supplement retirement income.

Cash value earnings grow tax-deferred within these policies, and the executive's withdrawals also can be income tax-free.

Income taxes do come into play in some loan regime programs. For example, the credit union's loan to the executive can add to the executive's taxable income. Many credit unions offset this tax burden with an annual bonus to the executive.

Until the executive dies or the program is terminated for another reason, the loan remains as an asset on the credit union's books. The cash value and/or death benefit should be structured to repay the loan amount and the interest.

Loan regime interest rates

Credit unions set the interest rate for the premium payment loans, which the NCUA will expect to be a reasonable, market-based rate. The IRS publishes what it considers suitable rates for these loans each month, and a credit union can apply the rate suggested.

In operation, however, many plans don't charge the IRS suggested rate, and the guide doesn't appear to require it, stating: "Field staff should not take exception to [loan regime split-dollar] loan rates unless the rates pose a safety-and-soundness risk."

Contract sets requirements and "what-ifs"

As with a 457(f) plan, a split-dollar plan is governed by an agreement that spells out both parties' rights and responsibilities. For example, the credit union could require that the executive refrain from taking withdrawals from the policy until after retirement age.

The agreement should also spell out what happens under other typical "what-if" scenarios.

For example, if the executive leaves voluntarily or is fired for cause, is the full amount payable to the credit union immediately? What happens if the executive becomes disabled?

Split-Dollar Doesn't Trigger Excise Tax

A new consideration for examiners is whether credit unions are prepared to handle a potential 21% excise tax created by the Tax Reform and Jobs Act, which took effect for the 2018 tax year. The tax will be levied on credit unions for any annual executive compensation that exceeds $1 million to any of its covered employees. A "covered employee" is any of its current top-five paid executives and any employee still employed who was previously a covered employee.

A common trigger for this tax is likely to be when an executive's 457(f) plan vests. The vesting event triggers income tax for that year for the executive. And if it pushes that employee's W-2 compensation above $1 million, the credit union would be assessed the excise tax.

In contrast, an executive's proceeds from split-dollar life insurance policy withdrawals do not add to W-2 compensation.

Some credit unions are trying to plan for or mitigate the new tax by adjusting 457(f) vesting dates and amounts, and/or shifting some deferred compensation to split-dollar programs. These adjustments need to be handled carefully, with the appropriate legal counsel involved.

If your credit union has adjusted a deferred compensation package, or has a plan to do so, be sure to document that process to show examiners that you're prepared to minimize short-term or long-term excise taxes.

It's important to include an attorney with experience in split-dollar programs in executing these agreements. And it's a good idea keep documentation from the attorney's review so you can show examiners that you've taken this precaution.

Emphasize thorough design for split-dollar programs

The guide reinforces the necessity for a properly structured policy, a solid agreement and legal counsel for split-dollar insurance:

> *Unsuccessful programs can result from substandard returns on the permanent insurance policy and/or excessive borrowings by the covered executive (against the policy), undermining the policy's economic ability to safely fund the benefit. To guard against this risk, it is important for the credit union to select the appropriate policy, and to have a legal arrangement that protects the credit union's interests.*

If your credit union has one or more split-dollar plans in place, review them with the plan provider prior to an examination. Don't assume the examiner will have a complete grasp of how these plans work. You need to be able to explain:

- The type of split-dollar plan (loan regime or otherwise) you've chosen and why.
- How the plan is performing compared with projections.
- Whether you've made any adjustments in the split-dollar arrangement since the last exam, and why.

CHAPTER 3: RISKS

Key section: **Risks Associated with Employee Benefits Programs and the Investments That Fund Them**

The guide breaks down risks for employee/executive benefit funding investments according to the seven supervisory risk categories the NCUA has established for credit unions: credit, interest rate, liquidity, transactional/operational, compliance, strategic and reputation.

If you're a CU executive or board member, you've probably read about each of these risk categories extensively. However, it's worth seeing what the guide says about these risks specifically as they pertain to less familiar investments for credit unions, such as those funding employee benefits, 457(b) and 457(f) plans, split-dollar life insurance, etc.

Here are some notes on the seven risk categories, based on the examiner's guide and on CUNA Mutual Group's work on employee benefit pre-funding and non-qualified deferred compensation plans.

1. Credit risk: assess the issuer's strength

Two common investment types for executive deferred compensation plans and employee benefit pre-funding plans are life insurance policies and fixed income instruments within managed investment portfolios, such as corporate bonds.

These instruments contain two primary credit risks:

- The issuers of the bonds or policies will default.
- The prices of the investments will decline due to the issuer's declining credit quality.

So, do your due diligence on providers' long-term strength and stability. Start with assessments from established, independent rating agencies.

2. Interest rate risk: take the "open-book test"

Credit unions spend plenty of time scrutinizing interest rate risks on their loan portfolios and basic investments. But not all of them use the same level of IRR scrutiny on their employee/executive benefits investments.

In fact, the otherwise impermissible investments that can be used to fund certain employee/executive benefits may require more vigilance than more common credit union portfolios. And while much of the focus may be on the investments, don't lose sight of the plan details in conducting due diligence. The NCUA Examiner's Guide warns that liabilities associated with employee benefits can be difficult to model in net economic value (NEV) and net interest income (NII) simulations.

Download the workbook from the guide's IRR Exam Procedures page. It's basically an open-book test for your next NCUA examination, broken into these parts:

- **Market risk:** Covers the primary quantitative assessment of a credit union's level of market risk exposure. This uses the NEV Supervisory Test, which, again, may not reliably model employee benefit liabilities.
- **Earnings at risk (EAR):** Generates multiple income simulations for a variety of scenarios to assess the EAR exposure to changing interest rates. This complements the NEV. It provides more insight into the actual structure and timing of cash flows for assets and liabilities (including employee/executive benefits expenses), so it helps examiners understand when IRR impacts the credit union's earnings stream.
- **Stress testing:** Includes both scenario and sensitivity analysis. In general, scenario analysis uses the model to show the financial effects from a macro event, such as an economic boom or bust. A sensitivity analysis, on the other hand, shows the impact of changes to one or a select number of risk factors on the credit union's financial position. For example, risks related to investments for employee benefits can be plugged into sensitivity analyses.
- **Measurement systems:** Should "capture all material sources of IRR and generate meaningful reports for senior management and the board of directors." Risks should be measured over a relevant range of interest rate changes, including meaningful stress situations.
- **Risk management:** Breaks down the responsibilities of the board, relevant committees (focusing especially on the asset/liability committee), and credit union management for documenting and conducting risk management policies.
- **Overall IRR rating:** Explains how examiners score the IRR results.

3. Liquidity risk: life insurance risk varies

Life insurance is used to fund a variety of executive benefits, and it can represent varying degrees of liquidity risk, depending on how it is used.

In a CASD, for example, the credit union spends liquid funds to pay premiums (and sometimes annual tax liabilities) for an executive. In addition, because the executive owns the CASD policy, the CU often won't have access to the policy's assets until the executive dies.

On the other hand, the assets of a life policy used to fund a 457(f) plan are still available to the credit union. The same can be said of managed investment portfolio assets and many other investment instruments. Although investments may be set aside to support a 457(f) plan, the credit union retains access to those funds.

To manage the liquidity risk of life insurance, thoroughly review the policy's terms and conditions, such as how surrender charges are calculated. When assessing liquidity in a CASD plan, also consider the CU's rights under the terms of the plan agreement.

4. Transactional/operational risk: get accounting and legal help

The NCUA warns credit unions about using proper accounting standards and practices:

> *The NCUA has encountered instances in which a credit union had material income restatements due to improper accounting. Credit unions should be aware that some assets used to fund employee benefits will have an immediate negative impact to earnings when purchased, and should consider the impact of this on financial statements.*

Many supplemental executive benefits are complex arrangements, and it's best to involve legal representation for both the credit union and the executive.

All parties should agree on what happens if something goes wrong between signing the contract and the final payoff. For example, what if a 457(f) plan is put in place for an executive whose job is later eliminated by a merger?

To forecast and track the accounting impact of the deferred obligations your credit union undertakes, you may need help from outside actuarial or accounting firms.

5. Compliance risk: credit union marketplace experience required

Are 457(b) and 457(f) plans—non-qualified deferred compensation plans often used to supplement executive benefits—subject to the Employee Retirement Income Security Act of 1974? If you said no, you'd have plenty of company in the credit union world. And you'd be wrong.

Much like transactional/operational risk, compliance risk can be managed by working with legal, accounting and product experts. You need people with specific experience in the credit union marketplace—people who know, for one thing, that while 457(b) and 457(f) plans are not subject to ERISA Parts 2, 3 and 4, they may be subject to Parts 5, 6 and 7.

6. Strategic risk: commit to the best talent without over-committing resources

The NCUA naturally cautions against the strategic risk of excessive financial commitments for employee benefits—especially for deferred compensation plans that will affect future balance sheets. Prudent investments must be made to offset this risk.

But credit unions today must also weigh the risk of losing the best available talent to competitors. Credit unions that offer competitive compensation packages, funded by otherwise impermissible investments, will have an advantage in recruiting and retaining the most effective leaders.

7. Reputation risk: be ready to explain and defend compensation

"While reputation risk arises from virtually all credit union products and services, it is particularly prevalent in employee benefits and investments for employee benefits," the guide states. "...For example, a credit union with high executive benefits and poor financial performance (such as low or negative earnings, or depressed or declining net worth) has an elevated reputation risk."

Any negative attention your credit union draws can be made worse if your members and community perceive that your executives are over-compensated—whether or not that's a valid criticism. Prepare to counter this perception in two ways:

1. Thoroughly document how executive compensation, including supplemental deferred benefits, was justified and calculated. Include the competitive bidding process for any products involved and the ongoing fiduciary oversight process.

2. Create a plan for when and how to communicate any relevant documentation to members and the media, should executive compensation become a public issue.

While credit unions assess risk and manage investments every day, the type of investments involved in funding employee/executive benefits might not be on your radar screen. The guide provides an excellent, brief overview to get you started.

It will also help you document how you've addressed these risks. That's good for examinations and audits, and it's also good for successors in the C-suite and the boardroom.

CHAPTER 4: LIMITATIONS AND EXCEPTIONS

Key sections: Investments that Fund Employee Benefits for FCUs

Investments that Fund Employee Benefits for FISCUs

The guide lists seven steps its "field staff" should take in assessing a credit union's otherwise impermissible investments. Among the steps are some quantifiable guidelines on the percentage of a CU's net worth these investments should represent, including:

• **25 percent of net worth threshold**
When a federally insured credit union's exposure to otherwise impermissible investments exceeds 25 percent of its net worth and the risk is not borne by one or more beneficiaries, field staff must expand the examination scope of review.

The description of "expanded scope of review" includes:

Credit unions with an aggregate exposure to otherwise-impermissible investments greater than 25 percent of net worth need to demonstrate a higher level of understanding and due diligence, which includes more sophisticated processes, controls, and governance.

The entire page on expanded examination scope is worth a look, as it summarizes many key points from the guide about due diligence and board oversight.

• **Exposure to single non-governmental obligors**
Individual exposures to non-governmental obligors in excess of 15 percent of net worth are considered unsafe and unsound. They may result in required corrective action and/or a downgrade in the CU's CAMEL or risk ratings unless there are sufficient mitigating factors.

• **Non-investment grade investments**
A concentration greater than 25 percent of net worth is generally considered unsafe and unsound and may result in required corrective action and/or a downgrade in the credit union's CAMEL or risk ratings unless there are sufficient mitigating factors.

Non-investment grade exposures include non-investment grade bonds, equities, commodities, real estate, hedge funds or other similar investments.

Even concentrations of less than 25 percent of these investments can be deemed unsafe and unsound for CUs that have inadequate net worth, elevated credit risk or other balance sheet issues.

Why Life Insurance Products Can Exceed Limits

Restrictions such as the 15 percent of net worth for a single obligor most often come into play with insurance products, including life insurance and annuities.

Even though the investments that underlie a life insurance policy may be diversified, the credit union's risk still lies with the viability of a single obligor: the life insurance company.

Contrast that with a mutual fund. Each investment within the fund can be a separate obligor that represents a separate risk. The investments, ideally, are chosen to balance the risk across these obligors. This is why a credit union can invest up to 25 percent of its net worth in a mutual fund without violating the 15 percent limit for any one obligor.

Again, the investments made by life insurers may balance risk every bit as effectively as a mutual fund, but as the sole issuers of the insurance contracts, examiners must treat their products as single entities.

(See Chapter 6 for more about the guide's content regarding insurance products as investments for employee and executive benefits.)

Mitigating factors

Some of these investment limit guidelines are a fairly new addition to the NCUA Examiner's Guide, so a credit union's CAMEL rating may not take an immediate downgrade for exceeding them. You would probably have a window for correcting the situation.

For example, regarding the limit of 15 percent of total assets for a single non-government obligor, the guide says, "...for credit unions that entered into employee benefit agreements before the issuance of this guidance and where the exposure to net worth is expected to drop below 15 percent within the next 36 months examiners will generally not take exception."

The guide includes a few other examples of mitigating factors for exceeding the concentration guidelines:

- If the risk is carried by the beneficiary of the employee benefit, and not the credit union, such as a 457(b) plan.
- If part or all of the exposure is FDIC insured.
- When an executive assumes the risk for the amount above 15 percent for a single non-governmental obligor.

CHAPTER 5: DIRECT RELATIONSHIP BETWEEN BENEFITS AND INVESTMENTS

Key section: Direct Relationship Requirement

The NCUA hasn't given credit unions permission to earn unlimited returns from investments that are outside the limitations of Parts 703 and 704. You must show that these investments are "directly related to a defined benefit plan or employee benefit plan, when a credit union has an actual or potential obligation under the plan."

The "Direct Relationship Requirement" section summarizes how credit unions can demonstrate this direct relationship. In general, the NCUA is looking for investments that will generate returns consistent with—but not more than—the projected expense.

Employee health benefits, for example, have a somewhat consistent cost year over year, so NCUA will be looking for an investment, or pool of investments, with a relatively predictable return.

One good option for the expense might be institutional life insurance (often called business-owned life insurance and corporate-owned life insurance—BOLI and COLI—read more in Chapter 6). With the right type of policy, you get a consistent rate of interest as stated by the insurance carrier, and it typically has very low volatility.

You can demonstrate to examiners how the investment ties to the expense, both through financial modeling and by examining the terms of the contract.

Equity and commodity investments can rarely be used

The guide states that equity and commodity investments generally aren't suitable for funding employee benefits because their expected returns aren't predictable.

"Historical return information for non-contractual-return asset classes (such as equities, stock futures, commodities, etc.) is not a reliable indicator of future (expected) returns," the guide says. "It is not acceptable for a credit union to assert that a contractual-return relationship exists for such asset classes just because documented historical returns are equal to the projected employee benefit liability against which they're paired."

However, the guide doesn't assert that such investments are prohibited. It offers an example of when NCUA could permit an equity investment:

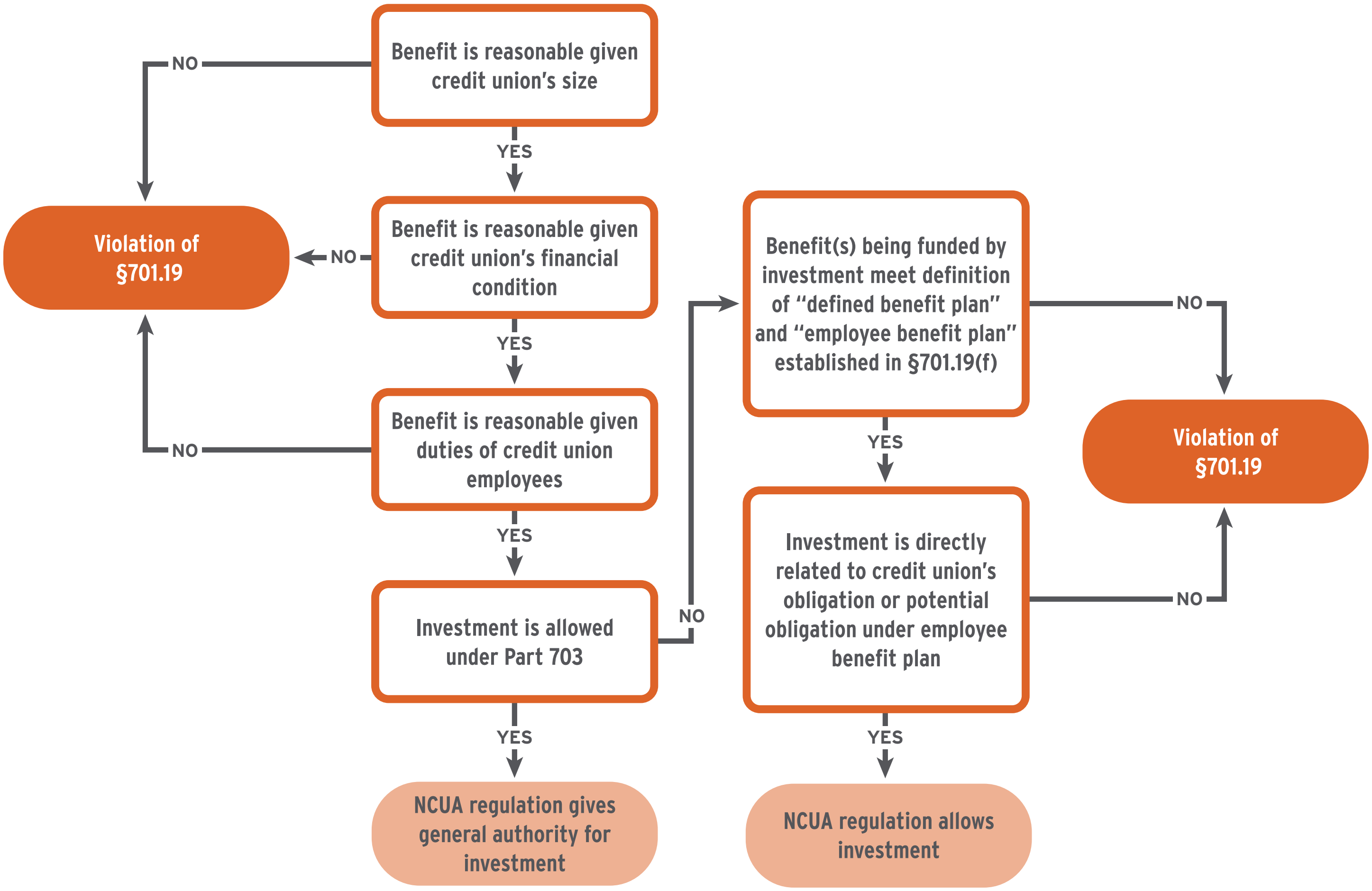
> *...a credit union may want to offer equity options for a senior executive's 457(b) plan. In such circumstances, it would be prudent for a credit union to manage the exposure of having an equity-based liability by holding an identical offsetting equity asset on its balance sheet. The matched asset and liability would mitigate undue basis risk (the credit union would avoid a net long or short exposure) and meet the direct relationship requirement.*

Another potential use of equities would be for a defined contribution benefit, such as a 457(f), for which the risk is born by the recipient, not the CU.

An important point the guide makes about demonstrating a direct relationship between an investment and a benefit: You must have the benefit plan you intend to fund in place before making the investment. "This means the benefit plan has been formally adopted and the CU has calculated the projected expense using reasonable and supportable methods and assumptions," the guide says.

The decision tree

The Direct Relationship Requirement section includes a useful decision tree to illustrate the regulatory requirements associated with investments federal credit unions use to fund employee benefits.



Source: Online NCUA Examiner's Guide section, "Direct Relationship Requirement."

CHAPTER 6: INSURANCE PRODUCTS

Key section: Insurance Products Typically Used as Investments to Fund Employee Benefit Plans

"The complexity of insurance products requires an enhanced amount of due diligence and familiarity that may require certain credit unions to obtain third-party assistance," the NCUA Examiner's Guide notes.

The guide's material on insurance products is fairly basic, so it makes sense to augment your due diligence with some outside expertise.

Annuities

The guide describes annuities this way:

> *Annuities are issued by insurance companies, mainly to provide the potential for lifetime income; however, they also have cash value and death benefit components. Annuities do not require medical underwriting, as the death benefit is generally a return of premium or cash value, whichever is greater. However, considering the mortality risk, annuities typically have higher mortality and expense cost structures and more punitive surrender charge schedules.*

Credit unions don't appear to be using annuities as investment vehicles often, but they can be useful. For example, some include competitive fixed crediting rates. Certain varieties can protect against downside risk because the provider guarantees a floor for returns.

A fixed annuity—or an indexed annuity that has a guaranteed floor and cap—might be a reasonable option for fulfilling the requirement for a direct relationship between projected returns and expenses (as discussed in Chapter 5).

Life insurance

The life insurance material in the guide includes a good summary of the difference between two types of permanent life insurance called "institutional insurance" and "retail insurance." This is a helpful distinction for CU executives and boards who are considering these products to fund supplemental executive compensation plans.

Here's an example to illustrate the key difference between institutional and retail life insurance: If you pay, say, a $5,000 premium for a retail life insurance policy, its surrender value at first may be something like $1,500. The cash values typically build slowly. But if you pay the same premium for an institutional policy, the initial cash value will usually be about $5,000. It looks more like a true investment. (These numbers are for illustrative purposes only. They do not represent any specific investment and may not actually be achievable.)

Business-owned life insurance (BOLI)

Although the guide doesn't include BOLI specifically in its life insurance section, it's a common term used to describe institutional life insurance for offsetting employee/executive benefits expenses.

Here's a common method of using BOLI at a credit union:

- The credit union gets permission from a key executive to purchase a BOLI policy on that person, with the credit union as the policy's owner and beneficiary.
- The policy is a type of permanent life insurance called "cash value" insurance. In these policies, part of the payment covers the cost of insurance, and part goes into a type of savings account that generates interest.
- The CU may choose a policy that is paid with a single premium (most common), one that is paid in annual payments over a set period (10 years, for example), or one that requires payments for as long as the insured executive lives. It depends on how quickly the credit union wants cash value to accumulate and the specific needs or use of the policy.
- As earnings grow on the cash value component of the policy, the credit union recognizes income to offset employee benefits expenses.
- When the insured executive dies, the CU receives the death benefit tax-free. Or the credit union and the executive can set up an agreement whereby the executive's family receives some or all of the death benefit.

BOLI agreements and insurance products vary, but the above arrangement can generate a steady, tax-efficient income stream for credit unions that may exceed what they can expect from other investment types.

Split-dollar life insurance

In a split-dollar life insurance agreement, a credit union and an executive enter into a contract to "split" or share a cash value policy's earnings and/or death benefit. It's a complex arrangement, most often used for supplemental executive retirement plans (SERPs). (Split-dollar plans were covered in more depth in Chapter 2.)

CHAPTER 7: PRE-PURCHASE ANALYSIS

Key section: **Pre-Purchase Analysis of Investments for Employee Benefits**

This section amounts to a step-by-step guide to performing due diligence. It specifies that boards should have a written policy covering the credit union's process for pre-purchase research and decision-making for purchasing investments for employee benefits.

It's important to conduct a thorough pre-purchase analysis because some plans and investments may be difficult to get out of after they've been implemented. And regularly updating pre-purchase analyses demonstrates ongoing due diligence and oversight.

The guide presents 10 steps that could form the backbone of such a written policy. Here's a summary of the 10 steps with some additional commentary for some of the steps:

Step 1: Identify the need for the investment.

According to the guide: "A credit union should determine if it actually warrants making an investment by first identifying the actual or potential benefit it seeks to fund (for example, health insurance, deferred compensation agreement, post-retirement benefit, or others)."

The guide also clarifies that these investments are to offset future expenses, not past expenses.

Step 2: Ensure what the amount and direct relationship of investments are.

This step emphasizes that a credit union's investment strategy should be to generate returns that meet—but do not exceed—projected benefit costs. If returns exceed actual benefit costs, the NCUA may require the credit union to reduce its otherwise impermissible investments.

Examiners may differ on what constitutes excessive earnings that would require corrective action. It depends on each credit union's circumstances. And sometimes it depends on how well credit unions explain and defend the relationship between the benefits and investments.

(See Chapter 5 for more about direct relationship requirements.)

Step 3: Determine the economic benefits and appropriate investment types.

This advocates for using multiple scenarios when determining potential returns. For example: "Before purchasing insurance products for employee benefits, a credit union should analyze expected returns using multiple scenarios. A CU should consider using a range of interest-crediting rates and mortality-cost assumptions for insurance products."

Step 4: Assess the qualifications of insurance vendor(s), if applicable.

Examiners are instructed to make sure credit unions know what they're buying and who they are buying it from. "Management should demonstrate a familiarity with the technical details of the credit union's insurance investment assets and be able to explain the reasons for, and the risks associated with, the product design features they have selected."

Because insurance products are often purchased through third-party vendors such as brokers, credit unions need to vet those vendors as well as the product carriers. This is especially important when the insurance program will require supervision by the vendors for many years—even decades.

Another key warning in this section: Quoting a vendor's marketing materials to examiners won't demonstrate due diligence.

"A credit union that is unable to demonstrate an adequate understanding of insurance or other investment products it has purchased and the associated risks may be subject to supervisory action, including divestiture."

Step 5: Review the characteristics of available insurance products.

Basic insurance products can be combined and modified into more complex products, the guide warns. It also offers an example of how COLI can be configured for CU accounting advantages (See Chapter 6.).

Step 6: Review the characteristics of available non-insurance investment products.

This brief item echoes the advice in Step 5 about the complex nature of different and potentially complex investment instruments.

If you're creating a pre-purchase analysis policy, this section could overview how your credit union should generally structure non-insurance investments based on the risk profile of the benefit you're funding.

For example, a diversified, low-risk portfolio suits general employee benefit plans such as health insurance—which is relatively stable from year to year. On the other hand, if you're funding an executive's defined-contribution (as opposed to defined benefit) 457(f) plan, only one employee carries the risk, so the portfolio could carry more potential volatility in equities/commodities.

Step 7: Select a counterparty.

The guide stresses that using brokers or consultants can help credit unions choose which carrier to buy from (the counterparty); however, it keeps the final selection solely the credit union's responsibility. Due diligence on counterparties should include conducting a credit analysis, the guide recommends.

This step singles out general account cash value life insurance products for scrutiny regarding interest-crediting rates, which are defined as:

> *...the gross yield on the insurance, the rate at which the cash value increases before considering any deductions for mortality cost, load charges, or*

other costs that are periodically charged against the policy's cash value.

In a general account policy, the yield comes from the performance of the insurer's investments, rather than from a separate portfolio (similar to a mutual fund), which is called a "separate account" product.

Step 8: Analyze the associated risks and the ability to monitor and respond to risks.

This step basically directs credit unions to include in their pre-purchase analysis the key risks listed above in Chapter 2: liquidity, transaction/operational, reputation, credit, interest rate and compliance/legal. The step also mentions proper accounting, which we'll cover in the next chapter.

Step 9: Evaluate alternatives.

Be able to show documentation that illustrates how you compared your options, and why you chose as you did. This should apply to any executive benefit program, including any underlying investments funding employee/executive benefits. And, again, the guide puts extra emphasis on insurance products:

A credit union should be able to justify the purchase of insurance products versus more traditional investment products if investment return is the primary feature of the insurance product. It should also be able to justify purchasing retail insurance products over institutional insurance products.

Step 10: Make and document the investment decision.

The nine previous steps constitute a comprehensive and supportable pre-purchase analysis. Include this in your documentation and update regularly as part of the ongoing oversight of the investments selected.

CHAPTER 8: ACCOUNTING

Key section: Accounting

The basic message of this section is to adhere to generally accepted accounting principles (GAAP) in dealing with employee benefit-related investments—and to seek the help of an independent accountant if necessary. Examiners are told to expect a credit union to have documented accounting policies regarding these investments.

In the subsection, Funding Employee Benefit Assets, the guide describes some very general accounting guidelines (and emphasizes that examiners will need more specific accounting guidance) of a few common asset types:

General benefit funding

Investments—even COLI products—that are intended to offset general employee benefit obligations such as health insurance and 401(k) matching contributions should not be tied to offset a specific benefit. It can be confusing that non-qualified deferred compensation liabilities for executives, including 457 plans, can be considered general benefits, and therefore the investments otherwise impermissible by Part 703 are not categorized as specific offsets to those benefits.

Economic benefit regime life insurance

In an economic benefit split-dollar arrangement, the credit union—not the executive—owns the insurance policy. Generally, the credit union endorses some or all of the death benefit to the executive for the benefit of that person's named beneficiaries.

As the policy owner, the credit union should include on its balance sheet the policy's liquidation value (a.k.a. surrender value), which is what the insurer would pay out if the policy were cashed out and canceled. As this value changes over the years, it should be changed on the income statement.

Also, review these plans periodically to ensure that the death of the executive does not cause undue financial harm to the credit union because too much of the death benefit proceeds are going to the executive's beneficiaries.

Loan regime split-dollar insurance arrangements

The executive owns the life insurance policy in a loan regime arrangement, and the credit union loans the executive the amount of the premium payments.

The loan regime agreement typically requires the executive to assign at least a portion of the cash value and/or death benefit to the credit union, to repay the loan. The credit union then books that loan as an asset on its balance sheet. The guide spells out one method for valuing this asset:

> *Similar to other life insurance assets, the loan value is typically recorded at liquidation value on a credit union's balance sheet, since the loan to the executive is typically nonrecourse. As a nonrecourse asset, only the collateral will back the loan. The difference between the original loan and liquidation value may need to be reported on the income statement as well as periodic value changes.*

Loan regime split-dollar plans also may be structured as recourse. Review these options with legal and accounting counsel to make sure such plans are appropriately accounted for.

The guide points out in the Pre-Purchase Analysis section (Step 8) that split-dollar life insurance, particularly, has the potential to require credit unions to issue restatements when errors are found.

FASB's change in categorization of equity investments

Although it isn't touched upon directly in this section of the guide, examiners may be checking for compliance with a Financial Accounting Standards Board (FASB) change that took effect for fiscal years beginning after December 15, 2018.

Credit unions are now required to categorize equity securities, whether 703-compliant or otherwise (e.g. stocks, government mutual funds) as "trading securities" on annual income statements (and also on interim income statements for fiscal years beginning after December 15, 2019).

Credit unions need to be aware of this change for all of their investment portfolios.

These investments could previously have been categorized as "available for sale." When investments in this category change in value from one year to the next, they didn't affect the credit union's income statement because they're considered an "unrealized gain/loss."

However, now that these investments are categorized as trading securities, they must be assigned a fair market value, and any changes in value must appear on the income statement as income or an expense.

CHAPTER 9: EXAM RESPONSIBILITIES AND EXPANDED SCOPE

Key section: Examination Procedures

(Note: Much of the material on the guide's sub-page "Investments that Fund Employee Benefits" was covered in Chapter 4: Limitations and Exceptions.)

The Examination Procedures section can help you focus on the underlying basics regarding how examiners will look at your benefits funding program. It may also help you decide who will be responsible for addressing examiners' needs and concerns.

Basic documentation

The sub-pages "Employee Benefits" and "Investments that Fund Employee Benefits" list some basic documentation examiners may request to show the benefits you provide and the investments used to fund them (this is a combined list from those two sub-pages, and we've added some context to some of the items):

- ✓ Board minutes
- ✓ Audit reports
- ✓ Management contracts
- ✓ 5300 Call Reports
- ✓ Investment schedules and reports, such as management contracts, executive compensation plan agreements, insurance policy contracts, etc.
- ✓ Employee benefits policies, such as your policy for investments that fund employee benefits, which should include controls and limitations regarding investments that are permissible only for offsetting employee/executive benefits costs
- ✓ Investment pre-purchase analyses and updates
- ✓ Employee manuals
- ✓ Financial statements for liabilities and other obligations, such as post-retirement benefits
- ✓ Benefit valuation reports from third-party vendors
- ✓ Actuarial reports for pension plans and other post-retirement benefits
- ✓ Benefits-related invoices and expense reports

The guide specifies that the list isn't comprehensive. But this should be a good start.

Reviewing new/changed benefits and projecting long-term viability

The guide instructs examiners to focus on any changes in employee benefit programs since the last exam. You may be asked for analysis and quantification relating to newly adopted or changed benefits. Also, be ready to provide evidence that a given benefit or change was properly approved.

That brief look backward, however, may not require nearly as much detail as projecting whether new benefits—and all other employee benefit programs—are likely to be sustainable for the long term.

"In conjunction with an overall review of the credit union's earnings, assess whether the credit union can afford the kind and amount of employee benefits offered given its size and financial condition," the guide states.

This section details steps examiners should take to assess a credit union's ability to afford its employee benefits, and confirm that these benefits are accurately recorded on financial statements.

The guide gives examiners the discretion to assess whether a credit union's benefits are "reasonable." As for executive compensation packages, these don't need to be reviewed individually unless compensation costs appear to be contributing to "significant earnings weaknesses."

However, even if your benefits costs are objectively in line currently, and your credit union's earnings are strong, it's smart to stress-test your benefits costs against various economic trends—especially if you're using otherwise-impermissible investments. Be ready to show that your benefits packages are built to withstand downturns, and that they are flexible enough to be adjusted if necessary.

Three lessons from the expanded scope sub-page

In Chapter 4, we mentioned some circumstances the guide lists that will prompt an "expanded scope" examination. The main trigger is exposure to otherwise-impermissible investments that exceed 25 percent of your credit union's net worth.

But even if that's not a concern for your credit union, this sub-page has some strong ideas that can shape your strategy for handling examinations of your employee benefits funding.

1. Be ready to answer basic questions about benefit program investments.

In an expanded scope examination, examiners should evaluate "...management's understanding of the employee benefit-related investments," according to the guide. Management should be able to demonstrate "a higher level of understanding and due diligence."

Board members and executives may be questioned about the types of products used in senior executive benefit plans such as a 457(f) non-qualified deferred compensation plan or a collateral assignment split-dollar life insurance program.

Another topic you should prepare to address is the exit strategies for investments. What happens, for example, if an executive leaves or is fired before becoming vested in a deferred compensation plan? For insurance products, the exit strategy should address adverse impact of early surrender.

If you're not able to answer basic questions about how these products work and why you chose them, that could be a red flag that would expand the examination's scope.

2. If you have documentation from product providers, be ready to show that you understand the products, and that the provider is trustworthy.

If board members and management need a refresher on the products you've used to build your employee benefits funding program and executive compensation packages, work with the product providers for a quick overview before your next examination.

However, you should also have your CPA and attorney review the products and agreements involved in these programs. Vendors—even long-term, trusted providers—are not neutral parties.

According to the guide, "When evaluating a credit union's due diligence process, field staff should place more weight on internal analysis conducted by a credit union versus analysis prepared by a third party." (See NCUA Letter to Credit Unions 07-CU-13, Evaluating Third Party Relationships.)

In short, you need to be able to provide evidence of your own due diligence. This should include your product research, and the ratings and track records of the providers themselves.

3. The board must be especially involved and aware of investments for executive benefit packages.

Most credit union board members are acutely aware of their oversight obligations regarding investments. But when the investments are attached to executive benefit packages, oversight is doubly important because of the potential for conflicts of interest and unrealistic projections.

On the Expanded Examination Scope page, the guide states:

> *A credit union's board needs to apply enhanced oversight if the investments for employee benefits are for senior executive benefits. For example, management should not focus primarily on the benefit of any related investments in optimistic scenarios while putting less focus on potentially negative scenarios. Furthermore, boards are often presented investment and plan structures that appear to be "zero cost" (that is, the credit union projects that it will recover the benefit funding costs when the plan terminates). When evaluating a plan presented as "zero cost," the board should ensure the proposal accounts for all costs, including any lost earnings potential.*

Assume that examiners will assess not only the nuts and bolts—products, contracts and earnings—of your employee benefits funding program, but also your policies and procedures for ensuring due diligence and ongoing oversight.

Conclusion: It's Not Just About Examinations

Learning how to use the online NCUA Examiner's Guide would be a smart investment of your time even if you never had another examination. The best goal of this guidance is to build strong, sustainable, and competitive compensation and benefit programs.

We recommend that credit union boards and executives use the guide proactively: Most of the requirements and guidelines should be followed *before* investments are made and vendor contracts are signed.

In other words, this material isn't something to pore through to "cram" for an exam.

Consider starting by browsing through the guide sections highlighted above and bringing key sections to the attention of the board members, executives and/or staffers who deal directly with each area.

Use the guide to put yourself in the shoes of an NCUA examiner who needs to document that your benefits funding programs are not only compliant, but necessary for your credit union to be known in your marketplace for properly rewarding high-performing, loyal employees and executives.

Information in this eBook is accurate as of the time of publication and consistent with standards of good practice in the general credit union and publishing communities. The source material is the online version of the NCUA Examiner's Guide as of April 12, 2019. This guide may be updated periodically. Also, the additional commentary is based on current standards of good practices within the credit union and publishing community, which can change over time. Readers should evaluate whether the recommendations in this eBook are applicable to their specific needs.

The views presented in this manual are those of the authors. They do not necessarily represent the views of CUNA Mutual Group or CUES.

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