Income Sources That Build Goodwill

Two CUs model successful charitable donation accounts and benefits pre-funding strategies.

By Mark Wilson

Two sources of income that many credit union leaders are not yet fully aware of could help them offset potential losses in non-interest income—while at the same time improving relationships with employees, members and their communities as a whole.

Unfortunately, non-interest income isn't likely to become less important for CUs anytime soon, especially with the possibility of slower lending growth after the Federal Reserve Board's return to rate increases.

When it comes to non-interest income, many CU leaders think first of the industry's largest non-interest income source: card interchange fees. According to a July 2016 survey by Callahan & Associates (*www.creditunions.com*), card-related interchange and fee income comprised 42.3 percent of annual non-interest income for the 170 CUs surveyed.

But relying too heavily on interchange could hurt CUs, as the future for this income is uncertain—well, even more uncertain than usual. It's possible that future regulatory changes will ease debit interchange fee caps that affect the largest CUs. But at the same time, more giant retailers are launching their own payment systems to combat interchange fees, which could affect all credit unions that issue cards.

Loan payment protection products are another well-known non-interest income option for CUs. This article will focus on two types of investment programs that can also accomplish this and are relatively new to credit unions: charitable donation accounts and employee benefits pre-funding programs.

CDA Enables Record Library Donation

If your credit union is currently subtracting charitable donations from your operating income, consider CDAs. They generate investment gains to support your gifts to charity via investments that were impermissible for this purpose just a few years ago. In addition, you can channel up to 49 percent of CDA earnings toward your bottom line. (Also read the sidebar on p. 14.)

$4.4 billion Redstone Federal Credit Union (*www.redfcu.org*), Huntsville, Ala., implemented a CDA at the outset of 2016 that generated the seed money for its largest single donation ever: $2.5 million to the Huntsville Library Foundation. Not coincidentally, this is the largest single donation the foundation has ever received.

Redstone FCU President/CEO Joe Newberry, a CUES member, announced the donation at an Aug. 22 ceremony. He remembers how good it felt. "It was the most amazing feeling to do this in this community where I grew up, knowing that we're going to help people that we will probably never know, and it will affect their children's lives and their grandchildren's lives, forever," Newberry says. "It was just a feeling that we were really fulfilling this thing we talk about every day: people helping people."

The initial donation came from earnings on Redstone FCU's CDA, which was launched with the CU's $20 million investment. Although the CDA investment policy is conservative and relatively risk-averse, Newberry says, a very favorable market carried earnings over $1 million in less than five months.

The CU used the earnings to donate $1 million to the library foundation, and committed $1.5 million more over the next five years.

The credit union's name will be prominently displayed permanently as a principal donor in the new branches.

"This donation is a big motivator for our employees, our members and future members," Newberry says. "There's no doubt in my mind that new members signed up—and they've said this to me—because of our dedication to helping the communities we're in."

Newberry points out that Redstone FCU has always been a generous donor to local non-profits, and many of the CU's employees are devoted volunteers for civic causes. The CDA has boosted Redstone FCU's civic commitment.

"This CDA has opened up opportunities we never would have had in a million years if we'd had to take the money out of capital," Newberry says. "When you know you've got the extra capacity, through what the NCUA allows credit unions to do now and what CUNA Mutual helped us set up, you can do wonderful things—bigger than you ever imagined."

Benefits Pre-Funding Program Helps Offset Cost Increases

Leveraging another way to take advantage of NCUA rules that open up access to previously disallowed investments, Redstone FCU set up an employee benefits pre-funding program at the beginning of 2016.

Newberry says that as part of its due diligence on CDAs and employee benefits pre-funding, the credit union checked with other credit unions who are using these tools, including $7.3 billion Randolph-Brooks Federal Credit Union (*www.rbfcu.org*), Live Oak, Texas. (Also read the sidebar on p. 14.)

Randolph-Brooks FCU has had an employee benefits pre-funding program

since 2013. CFO Robert Zearfoss says the program is helping maintain the level of benefits the CU's leadership needs to attract, reward and retain good employees.

"The [cost of the] benefit side of compensation has been rising tremendously, both on the healthcare side of things and because we've been increasing our contributions to the 401(k) over time. The pre-funding program allows us to garner additional revenue to help us pay for those benefits," says Zearfoss, a CUES member.

Zearfoss says the broadened investing options—which the NCUA allowed for benefits pre-funding programs in 2003—have given the credit union more flexibility.

"This allows us to diversify our investment portfolio a little bit more, with some securities or other investments that are not as rate-sensitive, or that correlate with interest rate changes," he says. "This program allows you to invest in stocks as an investment vehicle, and historically over time, stocks have done better than all other investment types. So it gives us more flexibility."

Two Key Implementation Steps

If your credit union is considering a CDA and/or a benefits pre-funding program, plan to take two important steps:

Create a written investment plan. Work with your plan providers, investment managers and board of directors to formalize an investment plan. It should include your risk tolerances, review and approval procedures, and the instruments your investment managers can use. This will not only guide your investment and risk management tactics, but will be important documentation for examiners.

Get regular investment performance updates. Quarterly reviews with your investment managers and plan providers are a good idea. An advantage of CDAs and pre-funding programs is the flexibility to invest in instruments credit unions don't typically use—but that's all the more reason to actively oversee their performance and adjust your portfolio as necessary.

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Charitable Donation Account and Benefits Pre-Funding Basics

In December 2013, the National Credit Union Administration amended regulations §703 and §721 to allow federal CUs to contribute to charitable donation accounts using previously impermissible investments. Since then, many states have allowed their state-chartered credit unions to do the same.

This means your CU can invest CDA funds in certain corporate bonds, securities, and business-owned life insurance that couldn't be used for that purpose before.

NCUA's CDA rule change gives CUs the flexibility to increase investment earnings while helping to limit risk to their overall financials. The rules also ensure that the majority of earnings are donated to charity. Key requirements for CDAs include: the aggregate annual investment in a CU's CDAs is limited to 5 percent of its net worth; assets in a CDA must be held in a separate custodial account or special-purpose trust; a CU must distribute a minimum of 51 percent of the CDA total returns to charities at least every five years; donations must be to tax-exempt 501(c)(3) charities; and accounting for CDAs must follow GAAP principles.

NCUA also requires that CU boards document their policies relating to CDAs to clearly show how they will adhere to regulations, and to establish their investment strategies and risk tolerances.

A CDA portfolio can be built relatively safely and still potentially yield significantly higher earnings than the CDs and government-backed securities CUs typically invest in. Even a conservative CDA portfolio can make a big difference in a CU's ability to support its chosen charities.

For example, say you invest $1 million for a year in a CDA that earns a 5 percent return (interest + dividends + capital gains) and $1 million in certificate of deposit that earns 1 percent. With your CDA earnings, you can choose to contribute a minimum of $25,500 to charity from the CDA—and retain $24,500 as income—but your contribution from the CD return is a maximum of $10,000. In this scenario, you would also have the option to contribute the entire $50,000 in CDA earnings to charity.

Unlike a CD, however, with a CDA there is risk that your investments will underperform. It's critical to have someone with experience administering CDAs, and experience managing the investments credit unions are allowed to make.

If this sounds familiar, it's because NCUA made a similar change to §701.19 in 2003, allowing similar investments for pre-funding employee benefits obligations.

Common expenses to pre-fund through these programs include premiums for group health, group life, short/long-term disability insurance, 401(k) matching funds and retiree health coverage.

A benefits pre-funding plan does not replace a CU's normal method of paying for employee benefits from its operating capital. These programs simply add another source of potential long-term income to help pay for certain benefit expenses.