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Keep Turning the Hourglass

Directors' due diligence for supplemental executive retirement plans can't stop, especially as new rules and clarifications point to tighter regulatory oversight.

By John Pesh

If you serve on a credit union board that has implemented a "golden handcuffs" program or another type of supplemental executive retirement plan, you know it can be a complex process.

Certainly, it's worth the effort to attract and retain top C-suite talent with these incentives. But recent comments published by regulators clearly reaffirm that a CU board's oversight of SERPs shouldn't stop once the programs are in place.

Without regular review of SERPs, a CU risks losses to its bottom line, and SERP recipients may get less deferred income than they'd planned if underlying investments don't meet the initial projections. Another concern is that SERPs will create unexpected tax bills and penalties for recipients.

Through due diligence, CU boards can prevent these difficulties.

Two of the most common non-qualified deferred compensation components within SERPs are 457(f) plans and split-dollar life insurance.

A 457(f) is a deferred compensation plan that allows the employer to contribute to accounts for key executives on a pre-tax basis until vesting or retirement. This is a commonly used retention tool for credit unions.

A typical split-dollar arrangement is when a credit union and its executive split the death benefit and the cash value of a permanent (or "whole") life insurance policy. The credit union pays the full cost of the premium in the form of a loan to the executive, and the executive owns the policy. This is commonly used to provide supplemental retirement benefits to key employees in a cost-effective manner. These two instruments can be used together or separately, and both can have important advantages for CUs and SERP recipients.

As SERPs have become more common in our industry, regulators are proposing and clarifying certain rules about 457(f) plans and split-dollar insurance. Examiners

are gaining more experience with SERPs, too, and they'll likely be focusing more on potential risks regarding these deferred compensation arrangements.

Proposed Rules Affect 457(f) Plans

The Internal Revenue Service is expected to issue final rules for Internal Revenue Code Section 457, based on rules it proposed on June 22, 2016 (*tinyurl.com/irscode457*). If the final rules are issued in 2017, they could go into effect as early as Jan. 1, 2018.

The proposed rules cover a lot of ground, and it's worth reviewing them in detail. (Watch the playback of the webinar I gave last August, "Proposed 457(f) Regulations Offer Clarity and New Opportunities" at *cues.org/webinarplaybacks*.) Here are a couple key areas addressed by the proposed changes that CU boards should pay attention to:

- ***Non-compete agreements could be used in connection with deferred compensation.*** Unlike a 401(k) plan, contributions to a 457(f) are made solely by the CU, as the employer. Employees don't pay taxes on these contributions until vesting, as long as they and the CU adhere to certain rules.

A key rule is that the employee must face a "substantial risk of forfeiture" of the account's funds if specified conditions are not met.

A common condition to meet is length of employment. Say a CU offers to contribute to a 457(f) plan to provide incentive for its CFO to stay for at least 10 years. In the agreement that implements the 457(f), the CU spells out that the CFO will not receive the plan's payouts if he or she leaves the CU in less than 10 years.

This condition creates a substantial risk of forfeiture for the CFO.

Section 457 refers to this type of condition as "the future performance of substantial services." The proposed regulations add language that allows for deferred compensation to relate to the participant's performance of services for the employer's organizational goals.

Under this expanded definition, a non-compete agreement can also create a substantial risk of forfeiture. The proposed regulations include three conditions that must be satisfied for the non-compete agreement to constitute a substantial risk of forfeiture:

1. To be paid a deferred amount, the employee must refrain from performing future services according to an enforceable written agreement.
2. The employer must make reasonable ongoing efforts to verify compliance with non-compete agreements (including the non-compete agreement that applies to the employee).
3. At the time the enforceable written agreement becomes binding, the facts and circumstances demonstrate that both 1) the employer has a substantial and bona fide interest in preventing the employee from performing the prohibited services and 2) the employee has a bona fide interest in, and the ability to, engage in the prohibited competition.

- ***Clarifications about when an employee owes taxes on an employer's contribution to a 457(f) plan.*** The proposed rules clarify that deferred compensation agreements that fall under Section 457 also fall under Section 409A rules. These rules, for which the IRS also proposed changes and clarifications, are more detailed regarding when amounts paid into these plans by employers are considered taxable income for the employee.

Section 409A also details penalties that may be assessed *in addition to federal income taxes*, should contributions be made that do not comply with the section's rules. The last thing a CU board wants is for a top executive to discover at tax time that a 457(f) contribution has added a sizeable, unexpected burden of income taxes and penalties.

If your CU has deferred compensation agreements in place, the CU board should initiate a review of those agreements with legal and accounting professionals.

Regulator Spells Out Split-Dollar Plan Risks

In January 2017, Michigan's Office of Credit Unions Director John Kolhoff issued a letter to CUs (2017-CU-01, *tinyurl.com/michstatecus*) about collateral assignment split-dollar life insurance used in deferred compensation plans.

Even if your CU isn't in Michigan, the concerns expressed in the letter are probably a good gauge for what examiners will be looking for in these split-dollar life insurance agreements.

The letter warns CU boards and management teams about a lack of "sufficient initial and ongoing due diligence." The letter's more specific warnings (adapted slightly from the original text) include:

- ***Administrator(s) are not independent and/or knowledgeable about the product held.*** Control of the ongoing administration/monitoring must include individuals who demonstrate a thorough understanding of the product, its risks and reporting requirements. Adequate understanding of, and management of, the higher interest rate risk, liquidity risk, transaction risk, credit risk, reputation risk, and strategic risk must be clearly demonstrated. These individuals must be formally authorized by the board and report directly to the board.

Plan administrators must also be free from being unduly influenced by the executive. The individuals charged with ongoing administration and monitoring of the plan are usually credit union board members or executives—such as a CFO or HR director—other than the person named in the plan. They can also be employees of a vendor that administers the plan, so long as the employees aren't incentivized by selling or retaining the products.

- ***Collateral assignments not fully documented or sufficient to protect the credit union.*** Assignments must be fully executed with acknowledgement by the collateral issuer, acknowledging the credit union's superior interest in the collateral. Documentation should ensure the owner/borrower cannot borrow against the policy without authorized permission by the assignee (credit union). The board must ensure the insurance issuer is made aware of who is (and is not) authorized to act on behalf of the credit union in this matter.
- ***Lack of sufficient or independent legal review on behalf of the credit union.*** Legal counsel acting solely in the interest of the credit union should be engaged by (and for) the credit union to ascertain the extent of the credit union's potential liability and risk/exposure from the collateral assignment split-dollar arrangement.
- ***Arrangement (collateral adequacy) not properly accounted for or monitored sufficiently.*** The credit union administrator(s) must have the ability to periodically verify the collateral value remains sufficient to adequately secure the outstanding loan for premiums.

This typically requires enforced loan covenants requiring the borrower to provide this information on a regular

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basis, or another means of direct access to the insurance information. There must be assurances loans against the collateral cannot be granted unless compliant with the agreement and the collateral's cash surrender value remains sufficient to support the asset recorded on the balance sheet.

Further, the condition of the insurance issuer must be periodically monitored by qualified persons to identify "red flags" which could trigger further investigation and action by management, to properly manage the related credit risk.

Three Steps Toward Due Diligence

Board members can be forgiven if all this regulatory language of doom makes them think deferred compensation plans are too complex to be practical. But that isn't true: These plans have worked, and are working, perfectly well for many credit unions and plan recipients. And with due diligence, our industry can safely continue to use these programs to compete for the best available leaders.

After all, most CUs can't prudently offer higher salaries than most banks for the same senior level positions. CUs also can't offer stock options or some of the other perks available to for-profit financial institutions.

Follow these three steps to get a handle on the due diligence for SERPs:

1. Establish a SERP committee and commit to training. Even if your board already has designated a go-to person for SERP issues, be sure at least one other person has some in-depth knowledge. In addition to hands-on experience working with deferred compensation plans, the committee should take advantage of industry educational offerings to stay up to date on new developments.

2. Review all of your current SERPs. After the complex process of setting up a deferred compensation agreement is complete, it's tempting to just step away from it until the need arises for another agreement. But each of these plans should be reviewed annually by the board, its legal counsel and accountant, and the plan provider. For example, the board should confirm:

- that underlying investments are performing reasonably close to expectations. If not, adjustments may need to be made;
- that the participant's employment status is the same, and no other needs or issues have arisen with that employee's performance or plans for the future; and
- that the plan provider continues to be financially stable and responsive to your needs.

3. Work with the provider(s) of your SERPs to prepare for your next audit or regulatory examination. Examiners may be more rigorous going forward in reviewing documentation for your deferred compensation plans. Be ready to demonstrate how each plan was set up, how the underlying investments are performing and how often their performance is reviewed.

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