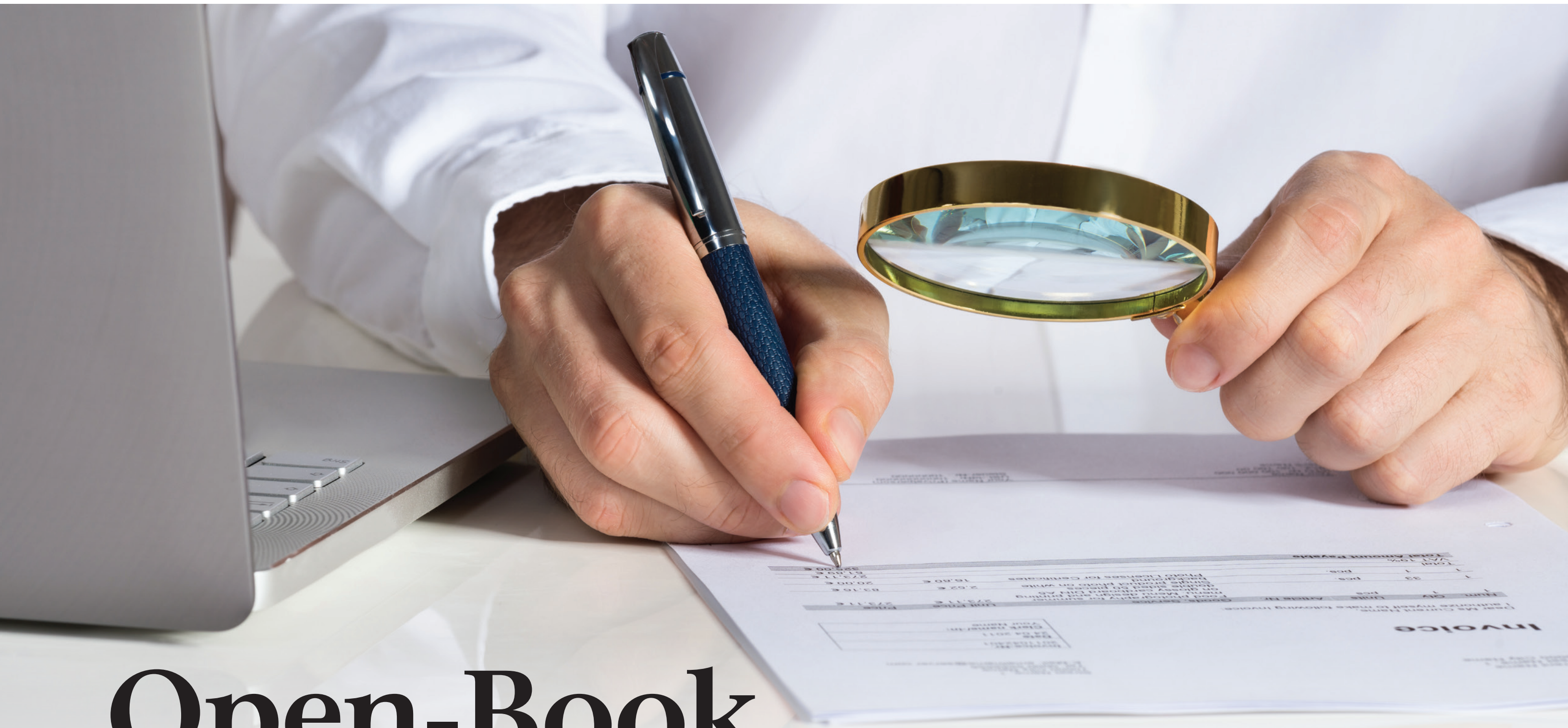

Open-Book *Executive Benefits Exam*

FOUR WAYS TO USE NCUA'S GUIDE TO STRENGTHEN YOUR CU'S APPROACH

BY JOHN PESH

If you've been through a number of National Credit Union Administration examinations, it's quite possible you've been on the wrong end of one that stopped cold when the examiner asked about investments tied to funding employee and executive benefit expenses.

Sometimes, credit unions struggle to find supporting documentation for their plans. Or perhaps board members and executives can't answer basic questions about the investment strategies and products they're using to prefund employee health plan and 401(k) expenses, fund a CEO's 457(f) plan, or myriad other benefits.

Whether you have a program or are looking to add one, you can avoid difficult, time-consuming examination glitches by using the online NCUA Examiner's Guide (*tinyurl.com/NCUAExaminersGuide*).

It's an excellent resource, especially in explaining the unique rules that pertain to investments for employee benefits.

Check out the section titled "Employee Benefits and Investments for Employee Benefits" (*tinyurl.com/NCUAEmployeeBenefits*). On this section's home page, NCUA establishes that, to fund certain employee or executive benefits, it "… 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 (*tinyurl.com/Part703*) or, as applicable, Part 704 (*tinyurl.com/yafjpdfw*) of NCUA rules and regulations." (Many state-chartered, federally insured CUs have the same or very similar rules, some of which are detailed in this guide.)

With this wider scope of investments, of course, comes a wider array of risks. The online guide provides a thorough road map for navigating these risks. To help you use the guide, here are four key topics that deserve your attention.

1. HOW EXAMINERS ASSESS INVESTMENTS

The guide lists six steps its "field staff" should take in assessing a CU'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:

- 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.
- Review the CU's exposure to single non-governmental obligors. Individual exposures 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.
- Review the credit union's concentration of any 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.

Such restrictions as the 15 percent of net worth for a single obligor most often come into play with insurance products such as 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 entity: the life insurance company.

Overall, the "Investments that Fund Employee Benefits" section of the guide is an excellent overview of the entire guide. It's almost like an open-book test for an exam.

Quick Click to This Section:
Federal credit unions: *tinyurl.com/NCUAFCUBenefits*
State-chartered CUs: *tinyurl.com/NCUAFISCUBenefits*

2. INSURANCE PRODUCT OVERVIEW

Insurance products are among the otherwise impermissible investments that can be used to fund benefits.

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

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

The key difference is that 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.*)

Quick Click to This Section:
tinyurl.com/NCUAInsuranceProducts

3. DEMONSTRATE DIRECT RELATIONSHIPS

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, NCUA is looking for investments that have return profiles 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 with a relatively predictable return.

This expense might be a good fit for institutional life insurance (often called BOLI; read more at *cumanagement.com/0217boli*). 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.

The guide states that equity and commodity investments generally aren't suitable for funding employee benefits because their expected returns aren't predictable. However, it doesn't state that such investments are prohibited, and details some circumstances in which equity investments would be permitted:

For example, 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.

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.

Quick Click to This Section:
tinyurl.com/NCUADirectRelationship

4. THE PRE-PURCHASE ANALYSIS

The "Pre-Purchase Analysis of Investments for Employee Benefits" section is a step-by-step due diligence guide. Again, almost like an open-book exam—except that these steps must be taken long before an actual NCUA examination.

The guide specifies that boards should have a written policy covering the investment pre-purchase research and decision-making process. It presents 10 steps as one example of an approach to a comprehensive pre-purchase process:

Step 1: Identify the need for the investment. The guide states: "A CU should determine if it actually warrants making an investment by first identifying the actual or potential benefit it seeks to fund (for example, 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. The language in this section includes, "When using investment strategies to recover employee benefit costs, the projected future returns from investments should not exceed the estimated benefit costs." If returns exceed benefit costs, NCUA may require CUs to reduce their otherwise impermissible investments.

Step 3: Determine the economic benefits and appropriate investment types. This advocates for using multiple scenarios when determining potential returns. For example: "Before purchas-

MORE ON EXEC BENEFITS

What Is 'Split-Dollar' Life Insurance? (*cumanagement.com/0518splitdollar*)

Split-Dollar Plans: Tools for Retention (*cumanagement.com/0717splitdollar)*

The CUES Podcast 61: Pre-Purchase Analysis of Investments for Funding Benefits Plans (*cumanagement.com/podcast61*)

ing 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." In addition, the guide states: "A credit union that uses a vendor should conduct due diligence to assess the vendor's ability to honor its long-term commitments, particularly when the vendor will service the credit union's insurance program over an extended period of time."

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 corporate-owned life insurance (COLI—also called business-owned life insurance or BOLI) can be configured for CU accounting advantages.

Step 6: Review the characteristics of available non-insurance investment products. Same basic advice as Step 5 about the complex nature of different and potentially complex investment instruments.

Step 7: Select a counterparty. The guide stresses that using brokers or consultants can help CUs choose which carrier to buy from (the counterparty); however, it keeps the final selection solely the CU's responsibility. "Before purchasing an investment, a CU should perform a credit analysis on the selected counterparty in a manner consistent with safe and sound investment practices."

Step 8: Analyze the associated risks and the ability to monitor and respond to risks. This includes a warning about using the right accounting methods for benefits-related investments. "There may be instances where CUs are unaware of the accounting for employee benefit investments and subsequent restatements will be necessary. Insurance products, in particular split-dollar insurance, have the potential for the most material restatements." See the "Accounting" section (*tinyurl.com/NCUAAccounting*)."

Step 9: Evaluate alternatives. Be able to show documentation that illustrates how you compared your options, and why you chose as you did.

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.

Quick Click to This Section:
tinyurl.com/NCUAPrePurchase

Documentation to Have *Ready for Examiners*

During an examination, NCUA field staff may request a list of any otherwise impermissible investments to fund employee/executive benefits. The online NCUA Examiner's Guide (*tinyurl.com/NCUAExaminersGuide*) lists other documentation the examiners may request to assess those investments, including:

- ☐ board minutes
- ☐ audit reports
- ☐ 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
- ☐ employee manuals
- ☐ financial statements for liabilities and other obligations, such as post-retirement benefits

SEE THROUGH EXAMINERS' EYES

If you already use otherwise impermissible investments to fund certain employee and/or executive benefits, studying the information that NCUA examiners use should help you prepare for examinations and audits.

If you *don't* currently use these types of investments, this guide can be a resource to help you start a solid investment program that can be used to offset some of the growing costs for employee benefits and supplemental executive benefit plans.

That fact that the guide was written primarily for NCUA examiners is an advantage. It helps you prepare by looking at your benefits funding program through the eyes of someone whose job it is to make sure you're doing the right thing.

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