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7 Key Risks of Funding Benefits Programs

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NCUA Examiner's Guide covers often-misunderstood investments.

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(This is part two of a four-part series about funding a credit union employee/executive benefits program, based on guidance from the online ***NCUA Examiner's Guide****. Read part one* ***here****.)*

If you're a credit union executive or board member, you're probably familiar with the seven key risks identified by the NCUA: credit, interest rate, liquidity, transactional/operational, compliance, strategic and reputation. You may not be aware, however, that the NCUA has detailed in its **online Examiner's Guide** how each of these risks applies to a specific—and too often misunderstood—area of credit union investments: employee benefits funding.

Reading the guide's section, "**Risks Associated with Employee Benefits Programs and the Investments that Fund them**," will help you address the seven risks when investing to fund benefits such as health insurance, 401(k), 457(b), 457(f) and split-dollar life insurance plans. 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.

Here are some notes on the seven risks, 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. Credit risk manifests in two primary concerns: risk that the issuers of the bonds or policies will default, and risk that the prices of the investments decline due to worsening credit quality of the issuer. 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 plans in conducting due diligence. The Examiner's Guide warns, "Liabilities associated with employee benefits can be difficult to model in NEV and NII simulations."
Download the workbook from the Examiner's Guide's **IRR Exam Procedures page**. It's basically an open-book test for your next NCUA examination.

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 collateral assignment split-dollar plan, 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 credit union 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 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

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

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

Any negative attention your credit union draws can be made worse if your members and community perceive that your executives are over-compensated. 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 be on your radar screen no more than once per year or less. De-mystify the risks of this type of investing by studying them. The Examiner's Guide provides an excellent, brief overview to get you started.

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