EXECUTIVE BENEFITS LEARNING SERIES

The Dos and Don'ts of Vendor Selection

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Agenda

Executive Benefits: The Dos and Don'ts of Vendor Selection

- Overview of executive benefit plans
- Three stages of relationship with vendor
- What the NCUA expects

Executive Benefit Plans

- Nonqualified Plans (Top Hat Plans)
  - 457(b), 457(f), and 409A
- Welfare Benefit
  - Split Dollar
- Section 83 Bonus
  - Deferred Compensation and Welfare Benefit

Nonqualified Deferred Compensation Plan: 457(f), SERP, SIP

Features

- Benefit defined by and paid for by credit union
- No IRS limitations on expense/contributions
- Flexibility in benefit amount and payment schedule
- Typically benefits are “at risk” - they are generally forfeited following voluntary termination or for cause prior to vesting date

Nonqualified Deferred Compensation Plan: 457(f) Plan

PROS

- Predictable expense
- Plan ends at executive’s termination
- Option for cost-recovery investment

CONS

- Legal promise with associated ongoing expense and liability

Nonqualified Deferred Compensation Plan: 457(b) Plan

Features

- Annual contributions made by the executive and/or the credit union
- Combined annual contributions may not exceed IRS limit ($18,000 for 2015)

Nonqualified Deferred Compensation Plan: 457(b) Plan

PROS

- Predictable expense
- Plan ends at executive's termination

CONS

- IRS limits can make accruing a meaningful benefit difficult

Welfare Benefit Plan: Split Dollar

Features

- Credit union pays premiums on life insurance policy owned by the executive
- Premium payments are treated as loans from credit union to the executive
- Credit union is repaid the premiums plus interest from the policy death proceeds
- During retirement, executive has access to tax-free income from policy values

Welfare Benefit Plan: Split Dollar

PROS

- No promised benefit
- Built-in cost recovery
- Flexibility regarding vesting
- Benefit caps

CONS

- Long term commitment – 30 year Mortgage
- Interest rate is fixed

Section 83 Bonus: BFB Restrictive Bonus Plan

Features

- Credit unions pays premiums on life insurance policy owned by executive
- Premium payments are taxable income to the executive
- Credit union bonuses executive for taxes due
- During retirement, executive has access to tax-free income from policy values

Section 83 Bonus: BFB Restrictive Bonus Plan

PROS

- Predictable expense
- Plan ends at executive’s termination
- Option for cost-recovery investment

CONS

- Ongoing expense and bonus commitment until termination

Vendor Selection – Planning for the Three Stages of Relationship

1. Design
2. Installation
3. Post-implementation Service

Design — What to Expect

- Discussion of Credit Union's current compensation philosophy, strategic goals, vision, and culture
- Education on various plan methodologies and provisions that protect and incent both the Credit Union and the executive
- Vendor develops specific models to address goals
- Vendor analyzes census and current benefits to produce shortfall analysis
- Educational board presentation

Design — What to Evaluate

- Does the vendor have the consulting expertise to provide the Credit Union with all necessary considerations and evaluations to make a decision that will affect the performance of the institution?
  - Knowledge of different types of plans
  - Accounting and reporting background
  - Regulatory considerations

Design — What to Evaluate

- Can the vendor accurately model the financial impact of how the purchase of institutional products to informally fund benefit expenses will affect the Credit Union’s financial statements?
  - Systems and technical capabilities
  - Realistic projections depicting Credit Union impact
  - No surprises

Design — What to Evaluate

- Is the vendor able to spend the time and talent to provide a resource to the Credit Union?
  - Resources and staffing
  - Education, experience, certifications, licensing
  - Ongoing regulatory compliance

Installation — What to Expect

Following Board approval, completion and/or consultation of preparation and documentation for:

- Legal agreements
- Accounting / journal entries
- Administrative support
- Regulatory due diligence
- Participant communication
- Compliance manual
- Password-protected online account access
- Annual Board reviews and reports

Installation — What to Evaluate

- Does the vendor have qualified legal and accounting expertise to ensure that all regulatory, accounting, and IRS guidelines are fully met?
- Does the vendor have sufficient staff to support the installation during the complex implementation phase of the plan?

  - Qualified partners familiar with subject matter
  - Predictability – again – no surprises
  - All served in-house rather than independently outsourced

Post-implementation Service — What to Expect

- Annual Board reviews
- Annual compliance manual updates
- Annual visits with participants
- Daily online support
- Ongoing due diligence on funding investments
- Ongoing state and federal regulatory compliance

Post-implementation Service — What to Evaluate

- Does the vendor have the financial strength to provide the institution with administrative support services for the long-term?
- Does the vendor provide support services directly or farm it out to a third party?
  - Succession plan – longevity
  - Carrier/mutual fund/ annuity provider not the answer!
  - Size of credit union client base – one off vs. committed partner

Post-implementation Service — What to Evaluate

- Does the vendor have sufficiently trained support staff to provide the Credit Union with all regulatory and accounting support into the future?
  - Team approach
  - Resources
  - Continuity

NCUA Requirements

Credit Unions are required to conduct due diligence on potential vendors:

- NCUA Guidance Letters #07-01 (Oct 2001) and #08-CU-09 (Apr 2008)

Additionally, due diligence on the specific investments is required:

- Funding Risks
- Interagency Statement on the Purchase and Risk Management of Life Insurance — OCC 2004-56

Interagency Statement on the Purchase and Risk Management of Life Insurance — OCC 2004-56

- Quantify the amount of insurance appropriate for the institution's objective

  Estimate the size of the employee benefit obligation or the risk of loss to be covered and ensure that the amount of institutional insurance purchased is not excessive in relation to this estimate.

- Concentration of the investment

  It is generally not prudent for an institution to hold Institutional Insurance with an aggregate CSV that exceeds 25 percent of the institution's capital as measured in accordance with the relevant agency's concentration guidelines.

Funding Risks

Otherwise impermissible investments

- State and federal regulators allow credit unions to recover expenses associated with employee benefits and mitigate unexpected cash flows with the purchase of assets generally considered "impermissible"

- Employees benefit obligations include:
  - Defined benefit plan contributions
  - 401(k) match contributions
  - Employee life insurance expenses
  - Employee health insurance expenses
  - Deductible long- and short-term disability expenses
  - Nonqualified plan expenses

Funding Risks

Seven risks to analyze when purchasing investments

1. Transactional – How does the purchase of the investment affect the bottom line of the credit union?
2. Interest Rate – How does the changes in the market affect the credit union's earnings and capital?
3. Credit Worthiness – What is the credit rating of the carrier(s) the Board is considering?
4. Liquidity – What is the risk to earnings if the investment has to be liquidated?
5. Strategic – Does the structure of the investment align with the credit union's philosophy?
6. Compliance – Is the purchase of the investment compliant with all laws, rules and regulations?
7. Reputation – Does the Board fully understand the investment?

Questions?

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2015 NAFCU–BFB Executive Benefit and Compensation Survey
NAFCU Annual Conference, Montreal

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- Investment products may be subject to investment risk, including possible loss of value.
- Withdrawals made from investment products during the first 15 years could result in unfavorable LIFO taxation under IRC Section 7702(f)(7) “force-out” rules. Withdrawals in excess of cost basis may be taxable. Lapsing a policy with an outstanding loan results in the loan, and any accrued interest, being treated as a distribution, which may be taxable. Modified Endowment Contracts ("MECs") are taxed differently and are not suitable for this program if surrenders or loans are anticipated. Please check policy illustrations to see if the policies being considered are MECs. Certain changes to a non-MEC policy could result in the policy becoming a MEC. Professional tax advisors should be consulted. Any loans, withdrawals or partial surrenders will reduce cash values and death benefits.
- Mutual Funds & Variable Universal Life Insurance Policies: Before investing, investors should carefully consider the investment objectives, risks, charges and expenses of the variable product and its underlying investment options. The current contract prospectus and underlying fund prospectuses provide this and other important information. Please contact your representative or the Company to obtain the prospectuses. Please read the prospectus carefully before investing or sending money.
- Past performance cannot predict future results. The purpose of this discussion outline is to present the issues and plan mechanics associated with a taxable investment and corporate owned life insurance financing strategy. The insurance products shown in this report are representative of the market and are based on a hypothetical investment yield which is not guaranteed.

Split-Dollar Disclosures

- Split-Dollar Disclosure for plans created prior to September 17 2003:
  Split-Dollar Insurance is not an insurance policy; it is a method of paying for insurance coverage. A split-dollar plan is an arrangement between two parties that involves "splitting" the premium payments, cash values, ownership of the policy, and death benefits. Split dollar arrangements are subject to IRS Notice 2002-8 and Proposed Regulations that apply for purposes of federal income, employment and gift taxes.

  Split-Dollar Disclosure for plans created after September 17 2003:
  Split-Dollar Insurance is not an insurance policy; it is a method of paying for insurance coverage. A split-dollar plan is an arrangement between two parties that involves "splitting" the premium payments, cash values, ownership of the policy, and death benefits. These arrangements are subject to Split-Dollar Final Regulations that apply for purposes of federal income, employment and gift taxes. The final regulations provide that the tax treatment of split-dollar life insurance arrangements will be determined under one of two sets of rules, depending on who owns the policy.

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