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Employee Benefits Pre-Funding Concept Analysis

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Concept: Credit unions today can choose to pre-fund all or part of their future employee benefit obligations by reallocating a portion of the credit union's investment portfolio into an investment(s) that would normally be impermissible and use the earnings from this investment to offset their future employee benefit cost obligations. These types of investments are deemed appropriate because they are tied to future employee benefit costs. This concept does not impact where the employee benefits are purchased or the cost of the underlying benefits.

Background: Credit unions have been pre-funding certain employee benefits for many years. Examples include supplemental executive retirement programs (executive benefit plans), pre-funding of defined benefit pension plans, and post-retirement health care programs. In these programs, credit unions have used a variety of investment vehicles to serve as the funding source, most of which would not be available for credit union investments except for the fact they are tied to future employee benefit obligations.

In 2006, the NCUA was asked if other ERISA employee benefits could be pre-funded under NCUA Rule 701.19(c). NCUA answered in the affirmative that any ERISA based future employee benefit obligation could be pre-funded using what would normally be impermissible investments as long as the credit union exercised prudence regarding the safety and soundness of the investment along with the amount invested. The NCUA did not issue an Opinion Letter ruling on this concept, but indicated that previous NCUA Opinion Letters dealing with the use of impermissible investments tied to employee benefits including Opinion Letter 06-0817, gave guidance this issue.

Program Goals: There are a number of goals often associated with utilizing a pre-funding program:

1. Normally at the top of a credit union's list of goals is the desire for investment yields higher than the credit union is experiencing in its standard investment portfolio.
2. Credit unions desire to better manage the growing employee benefit expenses, which are often driven by health care cost increases. While pre-funding doesn't impact the cost of the employee benefits, higher yields from pre-funding investments can help soften the financial impact of these cost increases.
3. Closely tied to the second goal above, is the desire to either add additional employee benefits or lessen/hold steady the financial impact of benefit cost increases on employees of the credit union.
4. Pre-funding helps fulfill a credit union goal to diversify their overall investment portfolio.
5. Depending on the type of investment, credit unions may seek investment portfolio appreciation in addition to the increased yields mentioned in number one above.
6. Credit union goals include limiting their risk exposure in these arrangements.
7. Credit unions want a pre-funding program with open access to their invested funds and have those funds held by an independent custodian.

Regulatory Issues: As noted above, NCUA has indicated pre-funding of employee benefits is governed by NCUA Rule 701.19(c) which permits the use of what would normally be impermissible investments to fund future employee benefit obligations. Since the time of NCUA's comment on pre-funding, pre-funding programs have now been in place in credit unions for over three years and Federal examiners have reviewed these programs in the course of their annual examinations. These examinations have reconfirmed the status of these programs as regulated under NCUA Rule 701.19(c).

Satisfying the Federal examiners doesn't simply include labeling an investment program as pre-funding; there are certain other supporting pieces of information that need to be in place:

1. There needs to be a formal analysis of what the future employee benefit costs for the credit union are projected to be so the current pre-funding investment amount can be determined to be reasonable.
2. There needs to be due diligence on the provider of the pre-funding program, on the investment(s) used in the program, and on any custodian used to hold the investments.
3. The investment type should be prudent based on safety and soundness considerations.
4. The dollar amount of the pre-funding investment must reasonable based on the credit union's capitalization and possible impact of losses to the credit union's financials.
5. There should be information available about how the credit union can access the investment, who from the credit union has access to the investment, and if there are any impediments/surrender charges that might impact access to the pre-funding investments.

The availability of a pre-funding program for state chartered credit unions varies by state. Today, most states have agreed this investment practice fits within their regulations or the state has parity with Federal regulations. In some states, credit unions must seek prior approval before the introduction of a program. It is best to check with the state regulator to determine the exact status of pre-funding in the state and any special steps the credit union might need to complete to implement a program.

Examiner Attention: Pre-funding programs have gone through numerous examinations by both Federal and state examiners. The following bullet points are items of emphasis in the examination:

- ✓ Is there a recent analysis of the future benefit costs to justify the current pre-funding amount?
- ✓ Is the amount allocated to pre-funding reasonable and prudent based on the size of the credit union, its excess liquidity, and future needs for liquidity based on its business plans?
- ✓ Has the credit union completed and documented due diligence on the pre-funding vehicle, underlying investments, and on the provider of the pre-funding program?
- ✓ Has the board of directors amended the investment policy statement to reflect the investment(s) in the pre-funding program?

- ✓ Is the credit union recognizing and accounting correctly for assets in the pre-funding program and any gains or losses (realized or unrealized) from the program?
- ✓ Has the credit union documented how access is available to the pre-funding investments and who in the credit union has access to those accounts?

Credit Union Candidates for Pre-Funding: While a pre-funding investment program brings the opportunity for possible increased yields, this type of program is not for every credit union. One of the first questions that should be considered, is whether the credit union has sufficient excess liquidity available to be able to commit some of it to a pre-funding program. If the answer is yes, then the follow-up question is whether this commitment is long-term versus short-term. This is an important consideration, since many pre-funding investment programs require a longer investment horizon to ensure the investments perform as anticipated. A short investment horizon may subject the investment to short-term market swings without the possibility of smoothing out these market corrections over a longer period of time.

Depending on the type of investment, the credit should assess the impact of possible unrealized or realized losses on their balance sheet or income statement. If the credit union has impairments or other issues with their financial ratios, a pre-funding program using investments that might expose them to market losses may not be appropriate.

These issues should be thoroughly discussed with the board of directors to ensure everyone understands the operation of the program, the amount of funds to be committed, the concept of this as a longer-term investment, and depending on the type of investment, the possibility of losses in the portfolio.

Program Development: The development and implementation of a pre-funding program at a credit union requires a number of important steps and actions:

1. As discussed above in the Candidates section, analysis must be done by the credit union to evaluate the appropriateness of a pre-funding program in light of the credit union's financials, excess liquidity, future needs for the liquidity, and the ability for the credit union to take on risk, if any, related to the investment(s). Seeking board approval using this information is an important step to ensure board acceptance of a program.
2. The credit union should develop a strategy that addresses its desires in a pre-funding program dealing with level of risk, desire for yield, level of investment, and access to liquidity.
3. The credit union should complete and document a thorough due diligence review on any provider(s) being considered for investment purposes including the following and incorporating the strategies in number two above:
   a) Review of the firm's background, business practices, financials, and experience in dealing with pre-funding programs.
   b) Review the investment itself to understand its track record, investment fees if any, surrender charges if applicable, and availability of access to the invested funds.
   c) Review the custodian, if there is one, to understand the relationship to the pre-

funding provider and proposed investments and the custodian's financials and business practices.

4. The credit union should have an analysis done on what the expected future employee benefit costs are going to be over some stated number of years. This analysis will provide a benchmark to ensure that any investment does not exceed the present value of the future employee benefit cost obligations.
5. The credit union should decide if the investment into a pre-funding program is going to be in a lump sum, in increments paid in over time, or a combination of both.
6. The credit union board of directors should amend the Investment Policy Statement by adding an addendum detailing the investments used to fund the program.
7. The credit union should ensure they have direct access to their invested funds and identify who on the board or as senior executives has access to the investments.

What to Look for in a Partner: An ideal partner thoroughly understands both the underlying investment and the potential positive and negative impact the investment can have on the credit union's financials. In a nutshell, the partner manages the investment to maximize yields while minimizing the risk the credit union is exposed to in the investment. A good partner offers an investment option that utilizes quality companies or funds with low expense ratios. A partner should provide custodian services (if necessary) from a well know and financially strong organization. A good partner should have a robust reporting system so that the credit union has 24/7 access to updated information about the pre-funding program that can be used for accounting, examiner access, and other management reporting. The provider should have a full suite of due diligence materials on all aspects of their program. Finally, if the provider has been doing this for an extended period of time, they should be able to share their results and put a credit union in touch with a wide variety of their clients for results from a credit union's point of view.

Investment Options: There are a wide variety of investment options that can be used to pre-fund employee benefits and these can be categorized into some common groups with similar traits and issues. Each of these groups will be discussed along with a list of pros and cons surrounding those investment options.

Managed Accounts: A managed account can be a very effective investment vehicle for a pre-funding program. The managed account can be designed specifically to address the special needs of a pre-funding arrangement. The managed account should have a dedicated advisor that can be focused on each credit union's individual needs and portfolio situation. This is important to efficiently handle market volatility and manage any impact to the credit union's financials.

Pros:

1. A diversified portfolio offers opportunities for significant dividend yields and market growth.
2. Within a managed account it is easy to invest additional amounts or to take money out of the fund.

3. A dedicated manager focused on the account based on credit union needs, can be very effective at managing the account for yield while minimizing any market volatility.
4. Use of institutional funds keeps the fees associated with this option low.
5. Generally, these programs offer credit unions immediate access to their funds.
6. Because the managed account typically is funded with "available for sale" funds, the account advisor can keep gains/losses as unrealized until the best time to realize gains or to realize losses when they can be offset with gains.

Cons:

1. A portfolio of bond and equity funds does carry the possibility of losses in a market downturn. This can often be mitigated because the funds are available for sale, but the possibility of realized losses cannot be ignored.
2. Caution should be used in selecting a managed account that is not actively managed only for the purpose of credit union pre-funding. If the investment is not focused in this manner, management decisions regarding the overall managed account might be okay, but the results on the credit union's financials could be devastating.
3. Make sure the custodian of the invested funds doesn't have separate rules regarding access to the credit union's funds.
4. Make sure there are no add-on fees and the asset advisory fee is reasonable in an institutional environment.

Life Insurance: Life insurance can be used to fund a pre-funding arrangement. This option brings minimum guarantees to the credit union without the concerns about possible investment losses in the market. Today, the interest or dividends from the life insurance policies often exceed what credit unions can achieve in yield from the returns on their normal investments.

Pros:

1. There may be guaranteed dividends or interest rates along with a solid track record of reliable returns without the risk of a market loss, makes this investment look attractive.
2. These dividends or interest amounts can be booked to the credit union's income statement on a monthly basis.
3. A minimum of expenses are tied to the life insurance funding arrangement.

Cons:

1. Paying for life insurance that is not needed.
2. While the dividends and interest often have guarantees, if the interest rate environment changes dramatically, these returns from the life policies may not be able to keep pace. Thus if the interest rates rise dramatically, the life insurance returns may lag behind and may even lag what the credit union could earn in their own investments.
3. Life insurance is a relatively ill-liquid. It may not be possible to simply invest additional money or to take money out of the policy. Additions or

withdrawals may require either adding another life insurance policy or cancelling a policy already in place.

4. Life insurance is a bit cumbersome in setting up, including whom to insure, beneficiary designations, and other administrative details.

Retail Investments: Retail investments incorporate a wide variety of investment products that are available for sale in the retail market. These investments include variable annuities, mutual funds, fixed annuities, and other direct investments. While these might serve to pre-fund employee benefits, there are a number of issues with these investments.

Pros:

1. Potential to provide higher returns than the credit union can get in its normal investment portfolio.
2. These investments help to diversify the credit unions investment portfolio.

Cons:

1. Retail investments carry high expense charges.
2. Retail investments often have significant surrender charges.
3. Accounting can be unfavorable to the credit union, if the investment requires the credit union to mark to market the investment values each month. Downturns in the market can have a significant negative impact on the credit union's financials.
4. Typically, retail investments aren't geared to the unique environment of pre-funding.
5. Retail investments are often offered through less sophisticated distribution channels.

Accounting: Depending on the investment vehicle employed to fund the pre-funding account, the accounting steps will vary. Some investments are deemed "available for sale" and this category allows gains/losses to either be booked as unrealized on the balance sheet or realized on the income statement. It will be the actions of the fund manager that will affect the realized or unrealized nature of these assets. In addition, these investments will generate yields that will be booked to the income statement on a monthly basis. Other investments are not in the category of available for sale, and the gains and losses in these investments must be booked monthly to the income statement as the gains and losses in these investments are "marked to market". Other investments with guarantees or fixed investment returns are simply booked as earnings on a regular monthly basis. It is important to be sure to understand the accounting of any pre-funding investment option and its impact on the credit union's books.

Important Emphasis in Accounting:

- Does the credit union have electronic access to or receive regularly, performance information to allow the credit union to properly account for the pre-funding asset and any gains and losses?
- Does the credit union maintain historical data showing monthly account information, changes to the account, and gains and losses?
- Certain investments such as variable annuities, mutual funds, and bonds are investments that must be marked-to-market each month reflecting gains and

losses based on the valuation of the underlying investment values at the end of each month.

- Investments such as a managed account are deemed available for sale and changes in the underlying managed account values may or may not need to be recorded as gains or losses on the income statement. If the managed account manager takes gains or losses by selling positions then these changes would be recorded on the income statement. If however, the manager maintains the underlying account, then gains or losses in the value of the underlying investment would be recorded on the balance sheet as unrealized gains or losses. These unrealized gains and losses do not impact critical ratios such as the PCA ratio.
- If life insurance is used to fund the pre-funding account, then accounting will require recognizing interest income monthly or dividends either spread out monthly over the year or as a lump sum when received.

Conclusion: Pre-funding of employee benefits is still a relatively new investment strategy. As discussed before, it is not for every credit union. But, for those who have sufficient liquidity and a solid capitalization ratio, it can be an effective means to increase the yields on a segment of the credit union's excess liquidity. While today not many credit unions are using this investment strategy, it is anticipated that in the future this will become a standard investment tool for credit unions to use to increase their yields on some of their investment portfolio to help offset the expenses associated with their employee benefits. These programs can be very helpful in increasing yields and can be done in a very safe manner so that the credit union can enjoy increased yields without being exposed to undue risk.

About the Author: Joe Tripalin is the Director of Marketing for OM Financial Group. Joe has 33 years of experience working with credit unions providing a variety of retirement, executive benefit, and investment programs.

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