Pre-Funding Employee Benefits to Help the Bottom Line

Presented by:
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Our Objectives Today

• Review the basics of Benefits Pre-Funding
• Understand the current footprint of the concept
• Explore regulatory outlook and ramifications
• Compare investment strategies for program
Declining investment yields and net interest margins make it increasingly difficult for credit unions to support the rising cost of employee benefits.
Why Benefits Pre-Funding?

In the past 5 years, employer-sponsored health insurance costs have risen by as much as 22%. ²
Why Benefits Pre-Funding?

Credit union yield on investments is low and has fallen 36% in the last 5 years.¹
Why Benefits Pre-Funding?

DECLINING MARGINS

2010 3.26% TO 2014 2.85%

The net interest margin for credit unions has also declined 13% in the last 5 years.¹
Definition: Benefits Pre-Funding

“A federal credit union investing to fund an employee benefit plan obligation is not subject to the investment limitations of the Act and part 703 or, as applicable, part 704, of this chapter and may purchase an investment that would otherwise be impermissible if the investment is directly related to the federal credit union’s obligation or potential obligation under the employee benefit plan and the federal credit union holds the investment only for as long as it has an actual or potential obligation under the employee benefit plan.”

(Federal Register; Volume 68, No. 83 April 30, 2003)
[Italics/bold Added for emphasis]
Benefits Pre-Funding

- Regulatory provisions allow pre-funding of employee benefit costs
- Helps potentially enhance credit union financial performance
- **Investment & Insurance Options**
  - Bank Owned Life Insurance (BOLI)
  - Annuities
  - Separately Managed Accounts
Pre-Funding: Major Considerations

- Ensuring program will not imperil the credit union
- Integration into risk management of credit union
- Ongoing monitoring and testing
- Compliance with NCUA 701.19
- Accounting treatment
- State regulations as applicable

Approaches to TBPF:
- Bank Owned Life Insurance
- Managed Money
- Annuities

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How Does it Work?

Estimate employee benefit obligation

Credit union purchases investment

Earnings from program impact investment income potentially offsetting benefit costs

Results in improved CU financial performance
Credit Unions Today (12/31/2014)

• Assets of CUs > $100mm in assets: $1.0 Trillion

• Section 703-exempt investments: $13.3 Billion

• % of Capital Represented: 12.3% of available capital

Source: NCUA 12/31/2014 Call Report Data
Regulatory Considerations

- 5300 CU Call Reporting (updated March 2014)
- Insurance Laws
- State/Federal Regulations
- GAAP
Due Diligence

NCUA Risk Categories:
• Credit Risk
• Interest Rate Risk
• Liquidity Risk
• Transactional Risk
• Compliance Risk
• Strategic Risk
• Reputational Risk
Safety & Soundness

- OCC Guidelines
- NCUA Discussions & Activity
- State Discussions & Activity
Investment/Product Options

- Variable Annuities
- Bank Owned Life Insurance
- Managed Money
- Combination
Types of Variable Annuities

Includes a array of investment choices:

• Mortality, expense and surrender charges
• May include a principal protection rider
• Only type available for TBPF Programs
Bank Owned Life Insurance (BOLI)

- Genesis in the banking industry
  - (GAAP Earnings/Tax Liability Arbitrage)
- Credit union is the owner and beneficiary of policy
- Can be Separate Account or General Account in nature
  - General Account option offers a generally stable return
BOLI Best Practices

- Top 35% of highest paid employees
- Executive must provide permission/written consent
- Credit union files IRS Form 8925 each year to disclose employer-owned insurance
- Subject to capacity constraints
- Minimum Guaranteed Rate
- Credit union concentration limits may be involved
BOLI Underwriting Options

• **Guaranteed Issue** – typically requires 10 or more executives.
  – Simple questionnaire
  – No underwriting

• **Full Underwriting** – Health questionnaire, paramedical exam, financial questions.
  – Attending physician’s statements are often needed
Managed Money

• Portfolio of investments professionally managed
• Can include mutual funds, stocks, bonds & other investments
• Variable Investment
• Potential to customize portfolio
• Balance Sheet/Accounting Classification Vital
Combination

• “Best of all worlds”
• Use attributes of each asset class that benefit CU most
• Requires partner with enhanced sophistication and deep understanding of CU environment
Takeaways

• Persistent low rate environment = CUs exploring all options

• TBPF may be a viable option to help enhance earnings

• More dynamic calculus than initial review suggests
Q&A

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