Pre-Funding Employee Benefits

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Pre-Funding Defined

Pre-funding of employee benefits is an investment strategy that allows utilization of investment options that wouldn’t normally be permissible but because the investment is tied to the future cost of employee benefits they can be used.
Goal of Pre-Funding

The goal of pre-funding of employee benefits is quite straightforward...to gain access to investments that aren’t normally available which may provide a higher rate of return than those investments credit unions traditionally utilize.
Interaction with Human Resources

You may ask why should the human resources executive be interested in this concept? The answer is the HR exec is tasked with providing benefits and as they become more expensive, if there is an option that “mitigates” the out-of-pocket costs to the CU, then the CU should look at the option. You can bring this idea to the executive team.
Scaling the Benefit Cost Mountain
Lowering the Impact of Benefit Costs

• First, the benefit costs don’t change after the implementation of a pre-funding investment program.

• What changes is the earning potential for the credit union. Today, the Yield on Average Investments for most CU’s is about 1.25%. If for example, the pre-funding can yield 3.75%, these extra earnings on part of the excess liquidity helps the CU’s bottom line and may take pressure off of the ever rising benefit cost paradigm.

• The investment strategy tied to benefits helps the CU better afford benefit expenses.
Pre-Funding by the Rules

What is the regulatory basis for this program?

• For Federal CU’s, NCUA Rule 701.19(c) allows CU’s to use impermissible investments for funding as long as they are tied to current or future employee benefits

• Most states either have parity with the NCUA rules or have similar rules within their regulatory framework
CU’s that Benefit from Pre-Funding

- CU’s with significant excess liquidity
- CU’s that don’t see significant future changes in their loan to share ratios
- CU’s that have low investment yields
- CU’s that struggle with their benefit costs
- CU’s that want to maintain their benefit packages
How Does Pre-Funding Work

• CU determines their future employee benefit cost obligations
• CU looks at their liquidity situation and investment options
• CU picks an alternative investment option to utilize and ties that option to their future employee benefit costs
• Extra earnings help the bottom line
Types of Investment Available

- Managed accounts
- Life insurance based options
- Annuities
- Retail investments
How Much to Invest

- Maximum based on the present value of the future employee benefit costs
- Need to be prudent based on the amount of excess liquidity and future needs of the credit union
- Need to avoid an over-concentration in this investment
- Every CU will have a different solution based on their unique circumstances
Impact of Investments

Let's take an example of a credit union that is 70% loaned out and has $60 million in excess liquidity. If the credit union is earning 1.25% on the excess liquidity investments and could take $5.0 million and put it into a pre-funding investment that yields 3.75%, the additional earnings would be $125,000.
Earnings

The additional earnings of $125,000 in the previous slide go on the credit union’s income statement and boost the credit union’s bottom line and ROA. While the CU’s cost of benefits haven’t changed, the improved bottom line might make supporting the employee benefits easier.
Conclusion

Pre-funding of employee benefits is not an appropriate strategy for every credit union, but for many credit unions it can provide a vital boost to investment yields and take some of the pressure off of the expenses related to employee benefits.
Additional Information

If you would like to receive additional information about this important topic please contact Joe Tripalin at joe.tripalin@omfingroup.com for a copy of an article written by him for the CUNA CFO Council on this topic that provides detailed information on pre-funding.
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