

MCUL AC&E 2014
2014 Annual Convention and Exposition
Split Dollar Collateral – Part 1

Michigan Credit Union League & Affiliates
Annual Convention and Exposition
Helping Credit Unions Serve, Grow and Remain Strong #mculace

Split Dollar Collateral (Part One)

Presented by:
Robin D Hoag, Chuck Holzman, and John Kolhoff


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 www.mcul.org June 6, 2014 | 1:45 – 2:45 p.m.  www.uniteforgood.org

DIFS Bulletin 2013-18-CU

Permissible Employee Deferred Compensation Arrangements and Related Investment Limitations



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Discussion Components
Deferred Compensation & CASD

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- Board responsibilities & evaluation documentation
- Benefit design
- Economic level of benefit created
- Affordability: net income & capital level – RBNW
- Legal documentation
- Liquidity risks
- Accounting and internal controls
- Due diligence: vendor and products



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Basic Safety & Soundness
Considerations

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- Deferred compensation plan(s) may not present a safety and soundness risk to **future earnings** or **net worth** adequacy
- **Prior** to implementation and ongoing, board must thoroughly document due diligence (written file documentation)
- Consider all related risks



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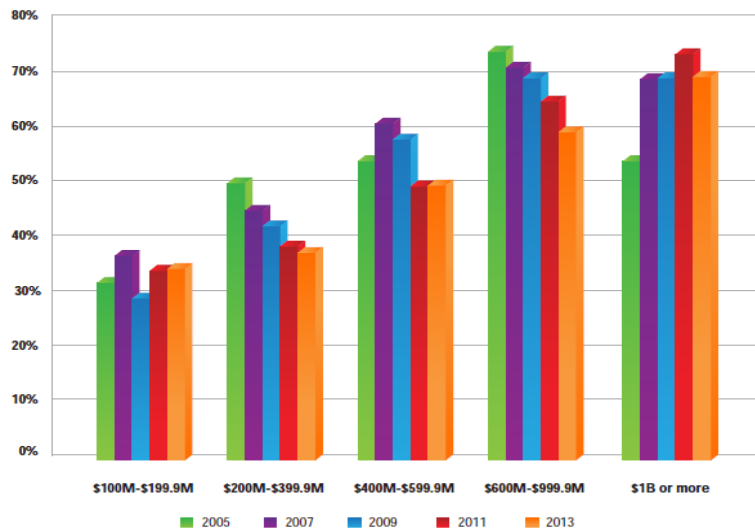
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SERPs by Credit Union Assets

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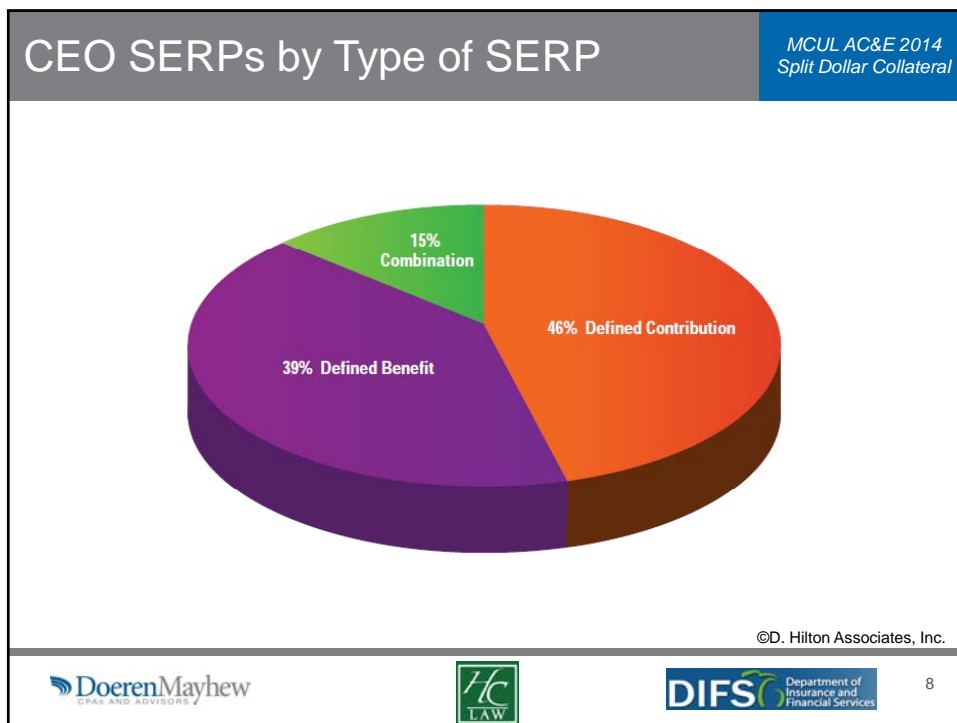
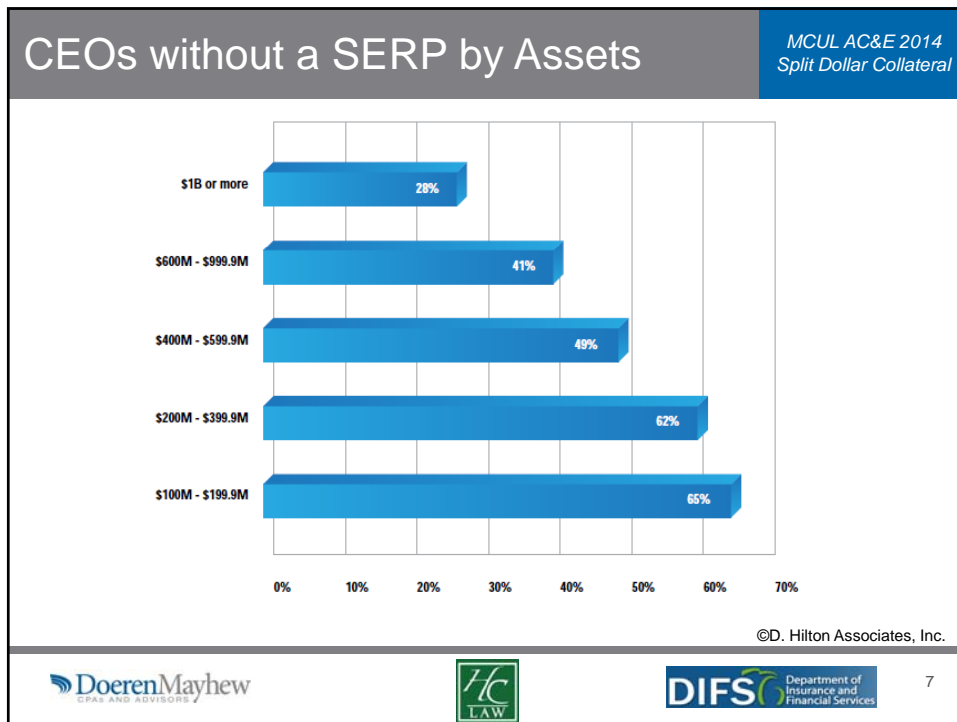
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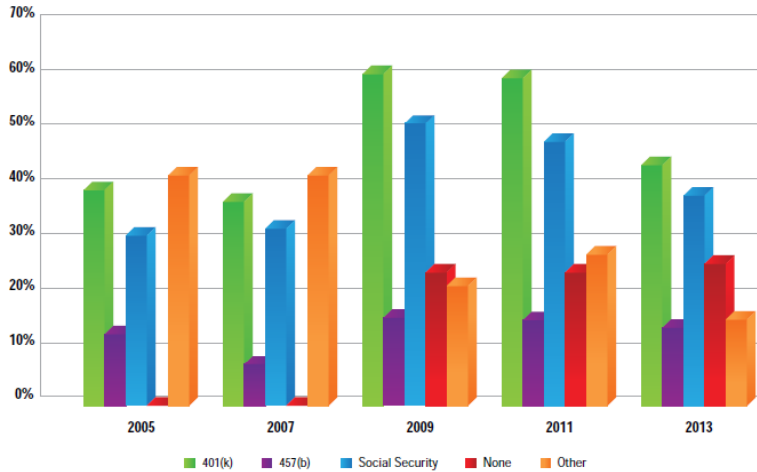
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Employer Contributions Included as SERP Offsets

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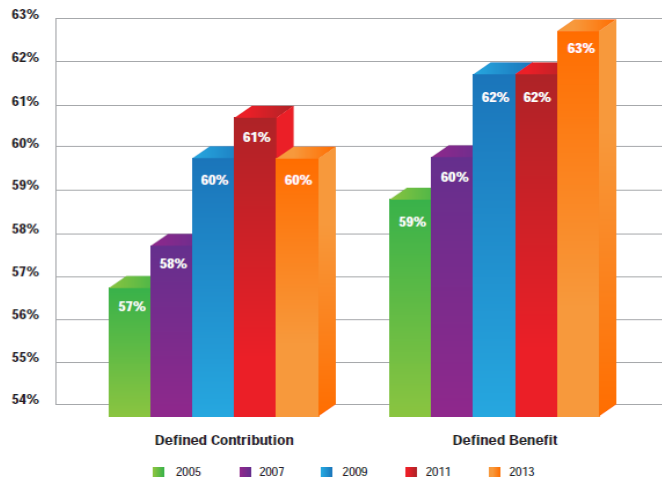


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Targeted Percentage of Income to Replace at Retirement

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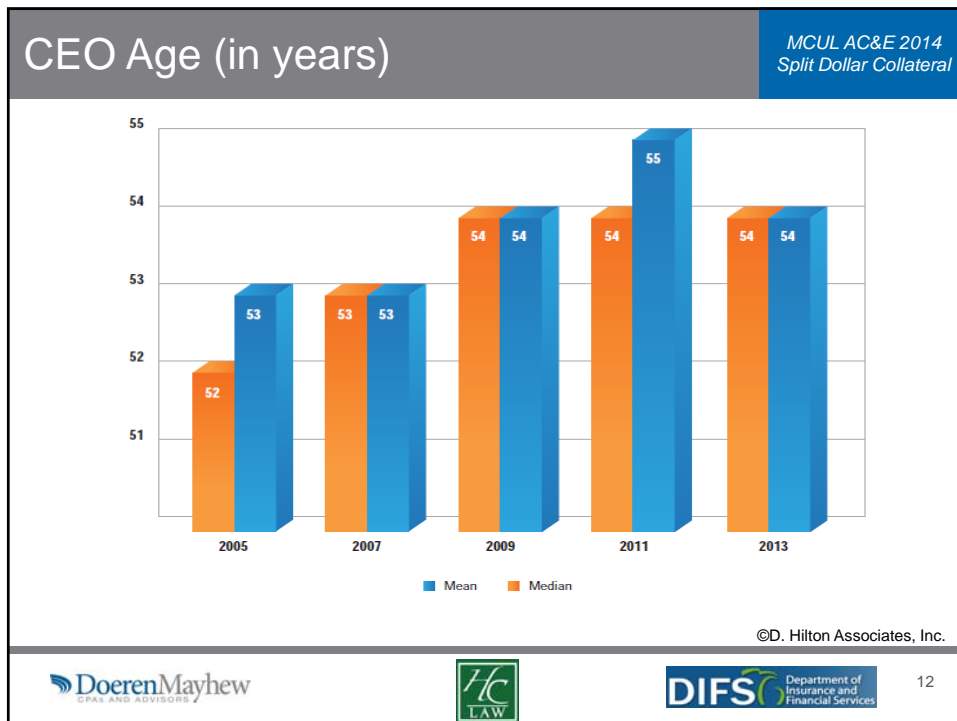
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Target Final Compensation			MCUL AC&E 2014 Split Dollar Collateral
Assets	25 th Percentile	Median	75 th Percentile
\$100m - \$199.9m	60.0%	65.0%	70.0%
\$200m - \$399.9m	57.5%	60.0%	70.0%
\$400m - \$599.9m	50.0%	65.0%	70.0%
\$600m - \$999.9m	55.0%	65.0%	70.0%
\$1b or more	60.0%	65.0%	70.0%

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Risk



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Types of Risk

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- Interest rate
- Liquidity
- Transaction
- Compliance
- Credit



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Interest Rate Risk

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- Funds devoted to deferred compensation programs contribute less than a market rate of return to the credit union's gross income
 - Opportunity costs and yield are lost to fund the benefit
 - Board needs to evaluate and document the potential impact to earnings and net worth adequacy
 - At least annually, evaluate the total cost associated with the deferred compensation program
 - Evaluate present value of funded and future funding including opportunity costs (investment yield not earned)



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Liquidity Risk

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- Effect of reduced liquidity in the short and long term.
- Consideration of plans resulting in a high level of non-liquid, long-term assets.
- For deferred compensation programs with incremental funding
 - Unfunded commitments must be considered when assessing the safety and soundness.



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Transaction Risk

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- Purchase, implementation, and ongoing accounting/monitoring
 - Include sound internal controls
 - Require documented board approval
 - Administration & oversight performed by board-authorized individuals
 - Sound dual controls and/or independent oversight
 - Related assets and liabilities must reconcile at least quarterly



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Compliance Risk

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- Compliance with all pertinent state and federal regulations
 - Concentration
 - MBL limitations
 - Employee benefit prefunding limits
 - Credit union tax and reporting implications
 - Accounting and reporting are highly dependent upon the structure of the arrangement and underlying investment(s); get CPA input
 - Independent legal and other professional advice should be sought and documented



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Credit Risk

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- Underlying credit risk **inherent** in the investment is evaluated to ensure exposure to loss (e.g., insurance company default) does not result in unsafe and unsound condition or exceed board's preset risk tolerance levels
- Periodic (annual at a minimum) evaluations are required through duration of the program.
 - Original risk assessed and changes in risk must be timely identified, quantified, and mitigated



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Strategic Risk

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- Long-term planning, ALM analyses, and budgeting should include consideration of the long-term effects of employee deferred compensation programs. Board must document effect of the proposed commitment on the credit union's ability to offer similar benefits to successor employees, pursuant to the overall employee compensation program and the board's long term strategic plan.

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Due Diligence



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Due Diligence

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- Must document the board's rationale for chosen investment type/structure
 - Comparisons with alternative investment types, structures, and issuers, with documented rationale for the chosen course of action
 - Documenting a clear understanding of the investment characteristics, including the investment's rate of return, effect of costs, investment assumptions and guarantees



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Purpose and Investment Relationship

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- Benefit plan(s) must be a clear relationship between investment funding and obligation related to the deferred compensation arrangement
 - Anticipated investment revenue should not exceed deferred compensation expense. Relationship between investment performance and related obligation should be **reevaluated periodically** and any material disparity which may emerge should be remedied as soon as possible/practical.



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Purpose and Investment Relationship

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- Benefit plan(s) must be a clear relationship between investment funding and obligation related to the deferred compensation arrangement
 - Benefit provided to employee must reflect **reasonable** compensation. Board must thoroughly review and approve the arrangement as part of an overall employee compensation program.



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- Board must provide **reasonable** and **sufficient** documentation of due diligence ensuring plan-related assets will not present an unsafe/unsound **concentration of risk**
- For a well-capitalized and well-managed institution, related investments that, in aggregate, exceed 15% of net worth are a material concentration of its assets



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Purpose and Investment Relationship

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- Other factors, including the institution's risk profile and nature of the investments, must be considered and could significantly reduce the level of investment considered safe and sound
- Total cash outlay and unfunded commitments shall be used to determine materiality



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Legal Requirements

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- The board **must** obtain legal counsel related to the deferred compensation policy and agreements, outlining the credit union's potential liability (legal and financial), and documenting compliance with the Internal Revenue Code and other applicable statutes



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Legal Agreements Required

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- All deferred compensation arrangements must be properly described within a **written agreement or plan document**.
- CASD plans must include, at a minimum:
 - Split Dollar Loan Agreement
 - Demand Note
 - Collateral Assignment of Life Insurance Policy Insurance Policy
 - An Insurance Policy
 - Department of Labor Notification



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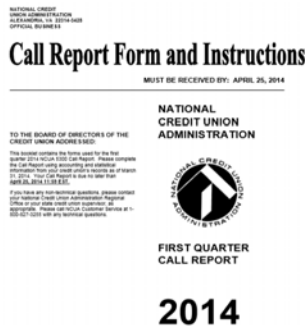


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Quarterly Reporting

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- Call Report instructions for required quarterly reporting.



INSTRUCTIONS FOR REPORTING REQUIREMENTS
The Call Report contains three sections: a core section (pages 1-10), PCA Net Worth Calculation Worksheet (Page 11), and supplementary schedules. All credit unions must complete the core section every reporting period. The PCA Net Worth Calculation Worksheet requires no input unless you completed a merger or acquisition that qualifies for Business Combination Accounting or intend to use an optional Total Assets Election and/or Alternative Risk-Based that would calculate to simplify your net worth ratios. In both cases, you must input your financial information into the system. The supplementary schedules A - E, pages 12 - 25, require your input only if applicable. The table below reflects the supplementary schedules and applicable reporting requirements for each schedule.

SCHEDULE	REPORTING REQUIREMENT
A - Specialized Lending	Complete this schedule if your credit union: <ul style="list-style-type: none"> • has indirect loans outstanding. • has real estate loans outstanding or real estate lending activity year to date. • has purchased loans from, or sold loans to, other financial institutions year to date. • has participation loans outstanding or participation • has business loans outstanding or business lending • has any Troubled Debt Restructured (TDR) loans outstanding or has approved TDR loans year-to-date. • has purchased or obtained credit impaired loans in a merger.
B - Investments, Supplemental Information	Complete this schedule if your credit union: <ul style="list-style-type: none"> • has investments classified as Trading, Available for Sale, or Held to Maturity. • has nonaffiliated investments that meet the requirements of Section 133 (a)(1). • has investments purchased under an investment plan • has investment repurchase agreements. • has investments not authorized by the FCU Act or • has investments in brokered certificates of deposit or brokered share certificates.
C - Credit Union Service Organization (CUSO) Information	Complete this schedule if your credit union has a wholly owned CUSO or has investments, loans, or an aggregate cash outlay in CUSOs.
D - Derivative Transactions Report	Complete this schedule if your credit union uses derivative contracts.
E - Bank Secrecy Act/Money Laundering Information	Complete this schedule if Money Services Businesses hold accounts at your credit union.

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Documentation and Diligence

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- Deferred compensation programs, either through policy or written agreement, must detail:
 - Clear plan description: eligibility criteria and vesting periods
 - Disposition provisions: obligation of parties within agreement under varying circumstances
 - Effects caused by early, normal retirement, disability, death, voluntary, or involuntary termination of employment

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Documentation and Diligence

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- Deferred compensation programs, either through policy or written agreement, must detail:
 - Responsibility and obligations of credit union and employee related to tax consequences from vesting, termination or normal retirement payments
 - Identification specifically of person(s) or position(s) authorized by the board to act on behalf of the credit union



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Designated Person

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- This person/board position (e.g., chairman, treasurer) should have custody/control of all plan-related documentation



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Designated Person

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- Plan-related documentation includes:
 - Legal agreements
 - Notes
 - Collateral agreements
 - Policies
 - Procedures
 - Due diligence
 - Financial analysis
 - Compensation evaluation of benefits being provided
 - Annual insurance (CSV) valuation statements
 - Initial insurance forecasts
 - Copy of policy
 - Assignment agreements
 - Annual financial statements for parties with recourse notes
 - Compliance checklists



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Questions?



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