STATE OF MICHIGAN
DEPARTMENT OF INSURANCE AND FINANCIAL SERVICES
Office of Credit Unions

Bulletin 2013-18-CU

In the matter of

Deferred Compensation Arrangements
and Related Assets
_______________________________________/

Issued and entered
this 14th day of October 2013
By R. Kevin Clinton,
Director

This bulletin supersedes Bulletin No. 2008-09-CU, dated August 4, 2008.

The purpose of this bulletin is to clarify permissible employee deferred compensation arrangements and related investment limitations and to ensure safe and sound programs under Section 401(2)(ss) of the Michigan Credit Union Act (MCUA), 2003 PA 215, as amended, MCL 490.401(2)(ss). MCUA Section 401(2)(ss) permits domestic credit unions:

> To purchase insurance policies and other investment products to fund deferred compensation arrangements for its employees. If the deferred compensation arrangement does not present a risk to the safety and soundness of the domestic credit union, the purchase of those investment products is not subject to the limitations of this act.

This bulletin also addresses additional considerations for deferred compensation utilizing loans to executives, granted under the authority of Section 401(2)(i) of the MCUA, and commonly known as Collateral Assignment Split Dollar (CASD) arrangements.

Background

A deferred compensation program is interpreted by the Director to include any arrangement in which an employee receives future economic benefits, which may include health care, life insurance, disability income replacement plans and retirement plans. These arrangements may be qualified or nonqualified retirement plans under the Internal Revenue Code, including those fully or partially funded by the credit union.

Under the authority of MCUA Section 401(2)(ss), a Michigan credit union may purchase and hold certain types of otherwise impermissible investments to provide deferred compensation arrangements for their employees. However, Michigan state chartered credit unions may not purchase these investments:

- For speculation;
- As a means of providing estate-planning benefits for insiders, unless the benefit is part of a reasonable compensation package; or
- To generate funds for normal operating expenses, other than employee deferred compensation and benefits.

Under the authority of MCUA Section 401(2)(i), a Michigan credit union may grant loans to members. This may include loans granted to executives to fund deferred compensation/CASD arrangements, if the arrangement does not present a risk to the safety and soundness of the institution.

Requirements

The Department of Insurance and Financial Services (DIFS) recognizes credit unions may offer competitive benefits to retain competent, professional personnel. However, prior to offering these types of arrangements to its employees, the Board of Directors must perform and document appropriate due diligence to preserve safety and soundness, including these minimum requirements:

1. Basic Safety and Soundness Considerations: No deferred compensation plan, or part thereof, may present a safety and soundness risk to future earnings or net worth adequacy. Prior to implementation, and ongoing, the board must thoroughly document due diligence and consideration of all related risks, which include, at a minimum:

    a. *Interest Rate Risk:* the risk that funds devoted to the program will contribute less than a market rate of return to the credit union's gross income, over the term of the program, including the potential impact to earnings and net worth adequacy. At least annually, the total cost associated with the deferred compensation program (present value, including opportunity costs) shall be calculated, and the determination reviewed/approved by the board. Reasonable estimates of the term of the asset and of anticipated market rates shall be used; this may require the use of actuarial estimates and/or Asset Liability Management (ALM) models. The cost of deferred compensation arrangements shall be determined individually and in aggregate.

    b. *Liquidity Risk:* the effect of reduced liquidity in the short and long term. Careful consideration must be devoted to plans resulting in a high level of non-liquid, long-term assets. For deferred compensation programs, in which a credit union has committed to devote assets to the program incrementally, all unfunded commitments must be considered when assessing the safety and soundness of the program.

    c. *Transaction Risk:* purchase, implementation, and ongoing accounting/monitoring should include sound internal controls and require documented board approval. Administration and oversight should be performed by individuals duly authorized by the board; such should include sound dual controls and/or independent oversight. Related assets and liabilities must be reconciled at least quarterly.

d. *Compliance Risk:* the need to ensure compliance with all pertinent state and federal regulations, including the potential tax and reporting implications. The pertinent regulations and appropriate accounting and reporting are highly dependent upon the structure of the arrangement and underlying investment(s); necessary and independent legal, CPA, or other professional advice should be sought and documented as appropriate.

e. *Credit Risk:* the credit risk present in the underlying investment must be evaluated to ensure risk exposure does not result in an unsafe and unsound condition or exceed the board's risk tolerance levels. Periodic ongoing evaluations are required through the duration of the program to ensure ongoing risks are timely identified, quantified, and mitigated.

f. *Strategic risk:* long-term planning, ALM analyses, and budgeting should include consideration of the long-term effects of employee deferred compensation programs. The board must document the 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.

g. *Other Due Diligence:* the board must carefully document the rationale for the chosen investment type/structure including:

   i. Comparisons with alternative investment types, structures, and issuers, with documented rationale for the chosen course of action.
   ii. Documenting a clear understanding of the investment characteristics, including the investment's rate of return, effect of costs, investment assumptions and guarantees.

2. <u>Purpose and Investment Relationship</u>: The benefit plan(s) may only be offered to credit union employees. For the purposes of this bulletin, the Director interprets that "to fund" a deferred compensation arrangement, there must be a clear relationship between the investment funding and the obligation related to the deferred compensation arrangement.

   a. Anticipated investment revenue should not exceed the deferred compensation expense. The relationship between investment performance and the related obligation should be re-evaluated periodically and any material disparity which may emerge should be remedied as soon as possible/practical.

   b. The benefit provided to the employee must reflect reasonable compensation. The board must thoroughly review and approve the arrangement as part of an overall employee compensation program.

c. The board must provide reasonable and sufficient documentation of due diligence ensuring the credit union's plan-related assets will not present an unsafe/unsound concentration of risk. For a well-capitalized and well-managed institution, related investments that, <u>in aggregate</u>, exceed 15% of net worth are a material concentration of credit union assets. Other factors including the risk profile of the institution and nature of the investments must be considered and could significantly reduce the level of investment considered safe and sound. For the purposes of this bulletin, total cash outlay and unfunded commitments shall be used to determine materiality.

d. 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.

e. For life insurance products, the DIFS' Office of Credit Unions is adopting the December 07, 2004 Interagency Statement on the Purchase and Risk Management of Life Insurance (issued jointly by the OCC, FRB, FDIC and OTS) which outlines important due diligence and risk management considerations and practices.

f. Each deferred compensation program, either through policy or written agreement, must detail:

   i. A clear description of the plan, including eligibility criteria and vesting periods;
   ii. The disposition of the obligation/agreement under varying circumstances, including the effects of early, timely, voluntary, or involuntary termination of employment;
   iii. The responsibility and obligations related to potential tax consequences;
   iv. Specific identification of person(s) or position(s) authorized by the board to act on behalf of the credit union relating to the deferred compensation program. Such persons should have custody/control of the related documentation; and
   v. All other obligations/responsibilities of the employee and the credit union related to the arrangement.

3. <u>Accounting and Reporting</u>: The appropriate accounting and reporting treatment will depend entirely upon the type and structure of the investments and the specific provisions of each deferred compensation agreement between a credit union and an employee. Based upon those factors, the board must evaluate the possible financial effects and risks under all reasonable investment performance and employment scenarios (e.g. voluntary or involuntary termination, upon or prior to retirement, disability of employee, etc.):

a. The credit union must follow generally accepted accounting principles in accounting for the arrangement and adhere to call report instructions for required quarterly reporting;

b. The credit union must comply with all IRS provisions and maintain documented evidence of this compliance;

c. Required evidence of proper valuation may include biennial actuarial estimates and annual CPA review/validation of accounting/expense recognition/tax reporting, including consideration of any changes in circumstances;

d. For investments classified as Held to Maturity, any deficiency between the investment's book value (including accrued interest, if applicable) and the present liquidation value shall be included in the Appropriation for Non-Conforming Investments. If Available for Sale, the difference is reflected in the Unrealized Loss Account;

e. Endorsement Split Dollar Plans: Where the credit union and employee possess rights to different parts of the investment principal, income stream or cash flow, additional considerations apply. Institutions considering entering into a split-dollar life insurance arrangement should consult qualified tax, insurance, and legal advisors (independent of the insurance issuer); and

f. Collateral Assignment Split Dollar Plans (CASD): Generally, an institution may not rely on its security interest in a life insurance policy to extend credit on terms that excuse the borrower from making interest and principal payments during the life of the borrower. However, extensions of credit secured by life insurance, may be made to an executive in connection with a CASD arrangement, but must be made on terms that are consistent with safe and sound practices. Additional due diligence and controls are warranted to manage the unique risks they present:

    i. Such loans may only be made to an employee of the credit union. CASD loans issued subsequent to employment, other than to complete a pre-existing arrangement are inappropriate;

    ii. Since the investment is <u>not</u> directly purchased and owned by the credit union, the authority to purchase otherwise impermissible investments under MCUA Section 401(2)(ss) does not apply. However, when loans are executed to fund deferred compensation arrangements (including premiums for life insurance products); the aggregate loan limit established by MCUA Section 423(12) does apply;

    iii. Unfunded commitments must be included when determining compliance with the aggregate loan limit prescribed by MCUA Section 423(12) and reported accordingly on the call report. CASD loans shall also be included in 'Loans to Officials', pursuant to call report instructions;

iv. If the arrangement requires the employee to repay the employer irrespective of the collateral assigned, the employee loan is collectible and the employer intends to seek recovery beyond the cash surrender value of the collateral, the loans may be recorded at face-value with corresponding accrued interest (if applicable). The board is responsible for maintaining current documentation to support the underwriting decision including, at a minimum, the aforementioned factors;

v. When determining collectability, consideration of 'capacity and intent' to repay must include: the borrower's responsibilities/obligations under varying employment scenarios, the borrower's verified repayment capacity from earnings and/or unencumbered assets pledged, and the presence/absence of a structured repayment plan. Absent adequate support of the borrower's capacity and intent to repay, the asset should be recorded at no more than the collateral liquidation value and accrued interest only recognized if/when received or substantiated by the increased value of the underlying collateral. CASD arrangements that lack adequate support of borrower intent/capacity to repay, or rely on the collateral as the primary source of repayment, will be classified and treated accordingly during the normal examination process. Adjustments to regulatory capital and net worth may occur for any deficiency between the credit union's recorded asset(s) and the underlying collateral value;

vi. The board is responsible for ensuring and documenting due diligence outlined throughout this bulletin with regard to understanding the nature of and risks associated with the individual CASD arrangement and that appropriate reserves are maintained on CASD credit arrangements.

vii. If a CASD loan arrangement is not designed to be paid upon employment separation or according to a reasonable and timely liquidation plan upon separation, the board shall maintain documentation demonstrating due diligence has been exercised in the evaluation and control of risks associated with maintaining the CASD arrangement beyond employment separation. Due diligence shall include consideration of any legal, accounting, and regulatory capital requirements, as well as the impact on future executive recruiting. Loan covenants should exist, requiring the borrower to provide periodic updated financial capacity and collateral information necessary for ongoing evaluation of the asset (and any other considerations, etc); and

viii. CASD related collateral assignments must be clearly documented, validated by the investment issuer, and have controls in place to ensure independent monitoring and risk management of the underlying collateral by the credit union throughout the duration of the loan. CASD loans, where the borrower/employee is not the insured, are considered an unsafe and unsound activity.

Examiners will review and evaluate employee benefit arrangements and related investments for reasonableness and overall impact on the credit union's safety and soundness during the examination process.

Any questions regarding this bulletin should be directed to:

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