

## Funding Executive Benefits: Recent Regulatory Environment Developments

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*In an increasingly competitive environment for executive talent, credit unions must find ways to offer reasonable and meaningful executive attraction, retention and reward tools. There simply will not be enough talented people to go around. The marketplace for top value creators is not limited to the credit union movement. Credit unions will have to look to the banking industry, other financial services segments and perhaps beyond, for talent and they must also expect that banks and other institutions will take steps that they believe will best retain their people. As tax-exempt organizations that are, for the most part, owned by their members, credit unions start out with two distinct disadvantages in their pursuit of top people. They cannot offer equity based compensation in the form of company stock plans, and the benefits they can offer are subject to more restrictive rules than their competitors. However, recent changes in the credit union regulatory environment have made the job somewhat easier.*

### Background

It is estimated that close to fifty percent of all credit union CEO will retire in the next ten years. This is an emerging problem for the credit union movement, especially when state regulatory agencies and the NCUA are advising credit union directors that they need to consider retirement and succession the primary responsibility of the board. Several state credit union supervisors have issued bulletins on the subject. Concerned about the lack of focus on this issue, the Washington State DCU observed,

*“A large portion of our credit unions have management approaching retirement age in the near future.”*

The DCU bulletin went on to state that boards of directors, with the assistance of credit union management,

*...“need to be prepared to deal effectively with areas of recruitment, succession planning and compensation.” “DCU expects that succession planning will be part of the credit union’s strategic and disaster recovery plans.” “The primary responsibility of boards of directors is to hire and retain professional management....A prudent disaster recovery plan will have, at a minimum, persons identified and trained to act as interim management to ensure the immediate continuity of the credit union.”*

The bulletin goes on to say that the board of directors has the responsibility,

*“to have candid discussions with their key management and determine retirement plans.”*

Thus, credit union directors must not only consider retirement and succession a key responsibility; they must become educated as to the compensation and benefit environment in which they are competing for valuable people. This means that they need to know about the retirement plans of existing executives as well as what types of compensation and benefit programs can be effective in attracting talented people to their institutions. This is not an easy task in a rapidly changing environment. With regard to compensation and benefits, credit union boards are no different than boards of companies in the rest of corporate America. According to a Mercer Executive Compensation Consulting Manager,

*“Companies are striving to create executive compensation and benefit programs that are fair but responsible and above reproach.”*

With increased corporate and institutional scrutiny, credit union board members must determine what their institutions must do to attract and retain talent, establish reasonable and meaningful benefits that encourage top executives to stay, structure incentives based on long term performance, and assure that executives are able to accumulate sufficient retirement income dollars. They must also exercise responsibility and prudence as they informally fund these long-term programs with appropriate asset/liability matching techniques that are effective for the credit union.

#### **Credit Unions May Find It Easier to Address Executive Benefit Funding Issues**

The NCUA issued a proposed rule in December 2001 to clarify the scope of Section 701.19 which states that a federal credit union may provide reasonable retirement benefits for employees and officers. The NCUA opined that 701.19 is not limited to retirement benefits for employees and officers, but is more broadly applicable to other employee benefit plans, 66FR 65662 (December 20, 2001). In the language describing the rationale for changing the rule, the NCUA demonstrated a clear understanding of the increasingly competitive market for talented people as it went on to say,

*“As competition to attract and retain highly qualified employees has increased and the employee benefits marketplace has become more sophisticated, FCUs are increasingly providing more diverse and less traditional forms of employee benefits including, for example, deferred compensation plans...” “As a result, FCUs need flexibility to use safe, reasonable and efficient methods to fund their employee benefit obligations.”*

It had been a long standing position of the NCUA to allow the use of otherwise impermissible investment media to fund retirement and other employee benefits. But, the NCUA had always insisted that there must be a direct connection between the investment and the employee benefit obligation it serves to fund. Additionally, the NCUA suggested that once the obligation ceases to exist, the FCU must divest itself of the impermissible investment.

While many commentators suggested that such a divestiture might increase the cost of the benefit plan if it truncates the return on the investment before the investment has time to perform, the NCUA was focused on credit unions holding impermissible investments only until an obligation no longer existed. Further, the NCUA was concerned about a mismatch in funding defined benefit retirement plans with variable performance investment media. With this concern in mind, the NCUA issued a second proposal in September 2002 to address these issues and others that had been raised outside of the rulemaking process, 67FR 60184 (September 25, 2002). The second proposal distinguished defined contribution plans from various kinds of defined benefit plans. In the second proposal, the NCUA was particularly concerned about credit unions investing to fund defined benefit plans with variable investments, as they believed that these types of plans place investment risk on credit unions and make it more difficult for credit unions to demonstrate a direct relationship between an investment and the benefit promised.

The NCUA sought to distinguish between defined benefit plans subject to the funding requirements and supposed safeguards of the Employee Retirement Income Security Act (ERISA), and those that are not subject to the funding requirements of ERISA. For defined benefit plans not covered by ERISA, the NCUA proposed that investments used to fund obligations created under these plans must have a fixed rate of return, mature on or before the date of the employee benefit obligation, and must have a rating in the top four categories of a nationally recognized rating agency. By inserting these specifications into the proposal, the NCUA believed the requirement that a fixed return instrument be used to fund a determinable (defined) benefit would be adequately addressed.

This “directly related requirement” does not, as some credit union boards fear, preclude the use of defined benefit plans for delivering benefits to employees and officers of credit unions. Rather, it sets guidelines for the operation and funding of such plans. In many cases, defined benefit plans funded with long term fixed return investments generate better accounting treatment for the credit union and much more flexibility in operation than is generally suggested. In the final issuance of Section 701.19 in April 2003, the board of the NCUA decided not to distinguish between defined benefit and defined contribution plans or place additional requirements on defined benefit plans not covered by ERISA.

This means that all employee benefit plans are subject to the general requirements that an investment used to fund an employee or officer benefit must be directly related to the credit union’s obligation. The investment may only be held as long as the credit union is obligated, and the amount must be reasonable given the size and condition of the credit union. However, the NCUA did continue to provide in 701.19 that a credit union may hold a funding investment that might otherwise be impermissible as long as an obligation or potential obligation exists to pay benefits.

Section 701.19, as amended in 2001, allowed credit unions to fund existing or potential employee and officer benefit obligations (not restricted to retirement benefits), and allowed them to hold otherwise impermissible investments so long as those existing or potential obligations exist. This left credit unions to determine what was an existing obligation and what was a potential obligation. In May 2003, Executive Compensation Solutions submitted a whitepaper to the NCUA detailing the treatment of benefits and funding for credit unions and contrasting that treatment with the way the Office of the Comptroller of the Currency treats funding and benefits for banks.

### **Pooled Benefits and Pooled Funding**

In July 2003, the NCUA received a request for an opinion on what constituted a benefit obligation, whether existing or potential. Additionally, the request asked for an opinion as to whether benefit obligations could be pooled and, if so, whether funding could be pooled as well. In other words, could contracts (life insurance policies, for example) on some executives help to fund benefit obligations on other executives, and could the definition of a potential obligation include the future obligations developed under an ongoing benefit plan. Examples of such plans are a health and welfare program or a deferred compensation program that might have executives entering the plan in the future based on set eligibility criteria. The request also asked if recovery of funding costs and benefit costs were part of the calculated benefit obligations.

A response to these issues was published in Opinion Letter 03-0512 in February 2004. In that letter the NCUA said,

*“An FCU may purchase life insurance products, use the pooled approach, and hold the insurance products to maturity if it complies with Section 701.19 of NCUA’s rules regarding benefits for employees of FCUs. Specifically, among other things, the FCU must demonstrate a direct relationship between the pooled investments held to maturity and the employee benefit obligations to be funded.” “The FCU may structure its investment to recover the cost of the benefit and funding but not opportunity cost.”*

The NCUA opined that “an opportunity cost” was a measure of the credit union’s opportunity to invest for its own account, which is inconsistent with the provisions of Section 701.19. Over the course of the next several months, the NCUA engaged in colloquies with several parties, regarding a differentiation between opportunity cost and cost of funds. Several commentators submitted letters suggesting that credit unions were operating under a distinct and singular disadvantage when compared to banks and other industries in the country, on the basis that a credit union would always have a higher cost for funding employee and officer benefits, if a credit union had to forego any earnings on monies used for benefit funding rather than deployed elsewhere within the investment portfolio.

### **Cost of Money and Cost Recovery**

In November 2004, the NCUA resolved the cost recovery issue in Opinion Letter 04-0453. In that letter directed to Executive Compensation Solutions, the NCUA said,

*“Yes, an FCU may recover its cost of funds within limits”....“Accordingly, we clarify that an FCU is permitted to recover its cost of funds under Section 701.19 but reiterate that an FCU is prohibited from recovering opportunity costs on the money it invests to fund an employee benefit.” “While the NCUA does not require an FCU to follow any particular methodology for calculating cost of funds, the NCUA recommends an FCU adopt an appropriate, conservative approach to doing so. An FCU must maintain adequate documentation to support its calculations and demonstrate its approach is appropriate. An FCU may wish to consult with its NCUA regional office early in the process in this regard if it has any concerns.”*

### **IRS Believes Federal Credit Unions Are Federal Instrumentalities**

On April 9, 2004, the IRS issued a Private Letter Ruling (PLR) that indicates that federally chartered credit unions may not be considered “eligible employers” under Section 457 of the Internal Revenue Code. The IRS, in its responding letter to the inquiry of an FCU, considers FCUs to be “federal instrumentalities,” and, therefore, FCUs cannot offer Section 457 plans. If that continues to be the IRS position (which many experts doubt), federally chartered credit unions will have to look to other provisions of the Internal Revenue Code for governance on deferred compensation.

This could be good news since Section 457 is the most restrictive interpretation of deferred compensation arrangements in not-for-profit entities. If federal credit unions are not subject to the 457 rules, they *may* be able to operate like “for-profit” entities who are guided by much more flexible rules. Thus, it seems that an existing plan that was established by an FCU, and that already is consistent with the more restrictive provisions of 457, should be a good foundation for what may turn out to be a more flexible plan design later. Some amendments or changes may be necessary to allow for the more liberal rules of vesting and distribution if the IRS identifies another Section of the Code as authority.

There is much confusion around this issue because the PLR letter is a departure from previous positions taken by the Service. As the dust settles, there appears to be no reason for federal credit unions to put consideration of long-term retirement benefits in limbo. Designing plans consistent with 457(f) (“ineligible plans” by definition) will be a conservative action path. Certainly, no changes should be made to existing plans until clarifications are sufficient to guide a credit union to a different course.

There is an old saying, “Be careful what you wish for because your wish may come true.” In discussions with the credit union that submitted the request to the IRS for a ruling that Section 457 does not apply to executive benefits, the submitter revealed that

it was seeking more favorable treatment as to the vesting and distributive provisions of its executive supplemental retirement plan. However, the IRS failed to state what provisions of the Revenue Code do apply instead of Section 457. So, the only certainty that can be identified to date is that the submitting credit union undermined its own 457(b) plan. That happened because a PLR applies only to the party that submitted the request for a ruling.

The IRS position in this particular PLR does not apply to any other credit union, but it may well be a signal of an IRS general opinion that federal credit unions are federal instrumentalities. The IRS refers to court decisions that also imply that federal credit unions are federal instrumentalities. This is somewhat misleading because the courts have only considered the issue of federal instrumentality in terms of immunity from taxation. However, the courts have consistently refrained from making a categorical determination that federally chartered credit unions are federal instrumentalities.

The First Circuit Court of Appeals, in *TI Federal Credit Union vs. Debonis* (95-1702) looked to the legislative history and the types of functions provided by federal credit unions to underpin the income tax immunity of FCUs. The court cites such activities as, “promoting thrift among members,” “providing credit at reasonable rates,” “issuing loans and dividends to members,” “investing in obligations of the United States,” and “serving as depositories for public monies” as governmental functions. It can legitimately be asked if the IRS and, perhaps, the courts, are swayed to their positions because federal credit unions are federally chartered. Certainly, all of the functions that the courts cite as suggesting that federal credit unions are federal instrumentalities are performed by state credit unions as well. Herein resides a problem for the credit union movement to resolve if the IRS issues guidance on this issue. Is differentiating between state and federal credit unions, and how they structure benefits to retain and reward executives, in the best interest of the credit union movement and the public at large?

The confusion around these issues is exacerbated because the IRS does not distinguish between 457(b) plans and so-called 457(f) plans. There may be a rationale for this lack of differentiation. The purpose of subsection (b) under Section 457 is to define an “eligible” employer. The purpose of subsection (f) under 457 is to define when an employer is an “ineligible” employer. Thus, 457(f) plans are really “ineligible plans” that do not meet the IRS requirements under 457(b). The IRS views 457(f) plans as arrangements of deferred compensation that are not “eligible” for the more favorable vesting, distribution and tax treatment afforded to the participants of 457(b) plans. Thus, when the IRS is talking about 457 plans, it is not a stretch to think they are referring to those plans that meet the requirements of 457(b), and that they are not considering plans that fall into the 457(f) category because those are simply other arrangements of deferred compensation that are outside the parameters established for favorable treatment under Section 457.

While the private letter ruling might let one conclude that executives of a federally chartered credit union are not subject to the onerous limitations of Section 457, there is no indication (that is, the letter is silent) as to which rules do apply. The IRS has announced that they will provide guidance within six to nine months regarding applicable law.

In November 2004, NAFCU submitted a letter to the IRS suggesting that Section 451 should apply to federal credit unions on the basis that, prior to the 1986 amendment to Section 457, there was no specific Code treatment for FCU deferred compensation plans and that such plans were established in accordance with the tax provisions of Section 451. The advantages to the potential applicability of 451 are that benefits are taxed only when received, flexible vesting is allowed and distributions do not have to be paid in lump sums. Under Section 457, except for eligible plans, benefits are taxed at separation from service. Whether the applicable section of the Code turns out to be 457 or 451, there appears to be no reason why a federal credit union cannot set up an arrangement of deferred compensation, exactly as they have been doing with ineligible plans that do not meet the requirements of 457(b), and amend them later when the IRS makes clear its intentions. By corollary, it is too early to modify existing plans to conform to Section 451 (the rule for “for profit” organizations). A decision to do so could end up creating a series of remedial actions.

### **Conclusion**

After many years of relative quiet around the issue of deferred compensation arrangements for executives of credit unions, there has been a flurry of activity on many fronts. The catalysts for this increase in interest may be summarized as follows:

1. There is intense pressure on institutions in both the credit union movement and the banking industry to attract and retain quality people in a shrinking market place of talented and experienced individuals. Deferred compensation arrangements in the form of Supplemental Executive Retirement Plans (SERPs) have been offered to bank executives for many years. Being competitive requires that such programs be used to attract and retain top talent.
2. Many credit unions across the country have changed their operation and style and, in many ways, are serving the often neglected banking needs of their communities. Changing fields of membership and competitive pressures have made it necessary for credit unions to rethink how they deliver products and services to their members.
3. The NCUA has focused on providing more flexibility in regulating credit unions and the state regulatory agencies have seen reasons to do so as well. The NCUA’s attention is on safety and soundness as its primary regulatory responsibility. The NCUA’s willingness to dialogue with credit union

management and compensation experts regarding executive benefit issues has been helpful in establishing more understanding about what executive benefits credit unions can provide and how they should arrange funding most efficiently.

Credit union boards, in their consideration of reasonable and meaningful executive benefits, should incorporate the following steps into their decision paths.

1. It is important to be educated. Board members must develop an understanding of the competitive environment, and how it impacts their people and the institution. Even though executive benefits are an emerging piece of the overall compensation package for credit union executives, there is sufficient data available (both in the credit union movement and in the banking industry) to make informed decisions.
2. It is also important to dispense with sacred cows. The tools that got the institution to where it is will not necessarily get the institution to where it needs to be. Board members should avoid making decisions about executive compensation and benefits solely based on how their own compensation and benefits were structured.
3. It is smart to interview those consultants who have expertise in the design, implementation and administration of credit union executive compensation and benefits. Boards should build relationships that allow for dialogue and exploration of ideas. Those relationships should also be based on values and commitment.
4. Boards should be positioned to understand the financial impact of executive compensation and benefits on the organization. They must look not only to the expense and liability, but also to the positives that should come from the implementation of retention and reward programs. This includes the impact such plans have on continuity and succession.
5. In the long term, boards should develop a monitoring process for the programs they implement to assure that they are continually effective and in compliance with regulations and institutional expectation.

It is probable that more and more credit unions will utilize deferred compensation arrangements to attract, motivate, retain and reward those people who create value for their institutions and for their members. There has been a rapid increase in the number of credit unions that have adopted non-qualified deferred compensation plans over the last five years and there seem to be few obstacles to the acceleration of that trend.

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1. Executive Compensation for Credit Union Leaders; The HR Value Group, Yvonne M. Evers, President/CEO Presentation 2003.
2. Washington State Department of Financial Institution, Division of Credit Unions Bulletin B-03-11.
3. Federal Register: April 30, 2003 (Volume 68, Number 83) [Rules and Regulations [Page 23025-23027].
4. 12 U.S.C. 1761b(12); 12 CFR 701.19 In our colloquies with the NCUA they have made it quite clear that their concern was not with the nature of defined benefit plans, but, rather, with the potential mismatch in funding. They described their focus as being on safety, soundness and flexibility enough so that a credit union can competitively fund employee and officer benefits.
5. Perspectives on Executive Benefit Funding Issues and Historical Guidance Within the Treasury Department (May 2003).
6. NCUA Opinion Letter 03-0512, February 27, 2004. The NCUA General Counsel considers this letter to be a clarification of 701.19.
7. NCUA Opinion Letter 04-0453, November 24, 2004.
8. Internal Revenue Service PLR Index # 457.08-01, April 9, 2004.