



National Credit Union Administration

November 24, 2004

Mr. Alec Berkman
Executive Compensation Solutions
510 S. Grand Avenue, Suite 302
Glendora, CA 91741

Re: Cost Recovery For Federal Credit Unions (FCUs) Funding Employee Benefit Obligations With Life Insurance.

Dear Mr. Berkman:

You have asked us to clarify what costs an FCU may recover when investing in a life insurance product to fund an employee benefit under §701.19 of NCUA's rules regarding benefits for employees of FCUs. 12 C.F.R. §701.19. Specifically, you have asked if an FCU may recover its cost of funds used to purchase the investment. Yes, an FCU may recover its cost of funds within limits.

Section 701.19 exempts an FCU from the investment restrictions of the Federal Credit Union Act and NCUA rules when it invests under its authority to provide and fund employee benefits. 12 U.S.C. 1757(7), (8), (15); 12 U.S.C. 1761b(12); 12 C.F.R. Part 703; 12 C.F.R. §701.19. Specifically, an FCU may purchase an otherwise impermissible investment to fund an employee benefit obligation as long as, among other regulatory limits, there is a direct relationship between the investment and the employee benefit obligation it serves to fund.

In legal opinion OGC 03-0512, dated February 27, 2004, we discussed an FCU's ability to recover some of its costs of investing in life insurance products to fund its employee benefit obligations under §701.19. Specifically, we stated:

NCUA has long taken the position that, if an FCU complies with §701.19 and is not investing for its own account, then the FCU may recover some of its costs of funding the employee benefit obligation. This is certainly the case when an FCU is purchasing life insurance products for that purpose. For example, an FCU that promises an employee a retirement benefit of \$500,000 may invest \$250,000 in a life insurance policy reasonably expected to yield \$750,000 at the time the retirement obligation comes due to pay the obligation and recover its \$250,000 investment. In that example, however, the FCU may not invest additional funds or otherwise structure the investment to return more than

\$750,000 for the purpose of recouping the opportunity costs associated with its \$250,000 investment. Those opportunity costs equate to a return on investment the FCU could have realized on its \$250,000 had it not invested it to fund its employee benefit obligation. That unrealized return would have been for the FCU's own investment account. The relief granted by §701.19 from statutory and regulatory investment restrictions does not extend to investments made for an FCU's own account.

You believe that, in addition to the costs discussed in that opinion, an FCU should be able to recover its cost of funds used to purchase the investment. You suggest an FCU's cost of funds could be that which it must pay to members or others to borrow money or the return it would forego if it takes money out of an existing earning position. You characterize each of those transactions as a real cost of investing to fund an employee benefit obligation and not an opportunity cost. You believe the ability to recover that cost is consistent with the purpose of §701.19 to put FCUs on a more level playing field with banks to attract and retain talented employees.

We agree that cost of funds is a real cost of investing that should be recoverable under §701.19, but we do not completely agree with your characterization of what should be considered cost of funds under the rule. We agree that the amount an FCU must pay its members or others to borrow money reflects its cost of funds although we acknowledge there are other acceptable ways of calculating this cost. We do not believe, however, that the return an FCU would forego if it takes money out of an existing earning position to fund an employee benefit obligation should be considered cost of funds for purposes of §701.19. Rather, we view that cost as an opportunity cost, which Barron's Dictionary of Finance and Investment Terms Fifth Edition 1998 defines as the highest price or rate of return an alternate course of action would provide. Our position is supported by the fact that, in almost all circumstances, an FCU will be able to obtain cheaper money to fund an employee benefit from member deposits than from liquidating an investment it may be holding. Accordingly, we clarify that an FCU is permitted to recover its cost of funds under §701.19 but reiterate that an FCU is prohibited from recovering opportunity costs on the money it invests to fund an employee benefit.

NCUA recognizes that an FCU may acquire funds at various rates from various sources to fund the same investment, which will require a somewhat more complicated cost of funds calculation and justification for recovery. While NCUA does not require an FCU to follow any particular methodology for calculating

Mr. Alec Berkman
November 24, 2004

Page 3

costs of funds, 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.

Finally, as noted in legal opinion OGC 03-0512, NCUA cautions FCUs that purchasing life insurance can be complicated and is not without risk. NCUA recommends FCUs fully understand the nature of insurance products and the risks associated with them before investing.

Sincerely,

A handwritten signature in blue ink that reads "Sheila A. Albin". The signature is fluid and cursive, with the first name being the most prominent.

Sheila A. Albin
Associate General Counsel

GC/FSK:bhs
04-0453