2013 Summit Round Table

EXECUTIVE COMPENSATION SURVEY

SUMMARY REPORT

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California CREDIT UNION LEAGUE

NEVADA CREDIT UNION LEAGUE

EXPANSION OF INTERAGENCY STATEMENT AMONG STATE AND FEDERAL REGULATORS

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Background

On December 7, 2004, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the former Office of Thrift Supervision combined forces to issue much needed guidance on the use of bank-owned life insurance ("BOLI" or "Institutional Insurance"),[i] which had become widespread in the financial services community at that time. The new guidance, titled the Interagency Statement on the Purchase and Risk Management of Life Insurance ("Interagency Statement")[ii] created helpful standards for purchasing and managing such life insurance arrangements. This guidance quickly became the industry standard even for credit unions, even though the National Credit Union Administration ("NCUA") did not adopt it. Instead, in Opinion Letter 07-0332, the NCUA responded to a request to provide guidance similar to that contained in the Interagency Statement by stating "our practice is not to review and approve materials such as you provided" but recognized the "thrust of the guidelines in OCC 2004-56 may be useful to FCUs...."

Times Have Changed

With credit unions now facing the same challenges banks faced almost a decade ago, the NCUA plans to issue guidance that closely mirrors that contained in the Interagency Statement. The regulators seem to believe that guidance would provide the examiners and the industry with standards that would help to maintain a balance between funding benefit plans with Institutional Insurance and maintaining safety and soundness at the credit union. For instance, some credit unions across the country have purchased investments to fund benefit plans that are significantly greater than the generally applicable 25% of capital concentration limit provided in the Interagency Statement. Without specific guidance, however, it is difficult for credit unions and regulators to know the standards to apply.

Some state regulators are following the same trend. The Washington Division of Credit Unions recently issued an Interpretive Statement[iii] in which it specifically addressed the ability of Washington credit unions to invest in BOLI. In setting out standards for BOLI purchases, the Division required that its Interpretive Statement be followed, "including, without limitation, the Interagency Statement issued by the Federal Banking Authorities...."[iv]

On March 6, 2012, Indiana passed a new law making it easier for credit unions to invest in life insurance,[v] but which provides that those new rules are "[s]ubject to any limitations or restrictions that the department or a federal regulator may impose by regulation, rule, policy, or guidance...." The head credit union regulator in Indiana has stated that the Interagency Statement is an example of "policy or guidance" that must be followed.

Other states have either formally or informally started to follow the guidance contained in the Interagency Statement. Although the California Department of Financial Institutions and the Nevada Division of Financial Institutions have not specifically addressed the applicability of the Interagency Statement, its increasing use in other states makes it safe to assume that California and Nevada would likewise view it as helpful guidance. However, until the NCUA, California or Nevada issues guidance on these issues, it is advisable to review and follow the guidance contained in the Interagency Statement.

Summary of Interagency Statement

Following is a summary of the prudent risk management process set out in the Interagency Statement as it would apply to credit unions:[vi]

- Effective senior management and board oversight. The Board remains ultimately responsible for Institutional Insurance purchases, even though decision-making authority may be delegated to senior management.
- Comprehensive policies and procedures, including appropriate limits. The Credit Union should set those out in the Credit Union's Investment Policy, which may not authorize the purchase of otherwise impermissible investments.
- An ongoing system of risk assessment management, monitoring, and internal control processes.
- The management and Board of Directors must perform adequate pre-purchase analysis on the purchase of Institutional Insurance that occurs before the funding of the insurance. This analysis includes the following:
    - Identify the need for insurance and determine the economic benefits and appropriate insurance type
    - Quantify the amount of insurance appropriate for the Credit Union's objectives
    - Assess vendor qualifications
    - Review the characteristics of the available insurance products
    - Carrier selection
    - Analyze the associated risks and the ability to monitor and respond to those risks
    - Evaluate alternatives
    - Document decision
- Credit Unions should establish internal policies and procedures for its Institutional Insurance. It is generally not prudent to hold Institutional Insurance in an amount greater than 25% of capital. If Boards desire to exceed that amount, they need Board approval for aggregate cash surrender value in excess of 25% of capital, the Board should properly document the business purpose for exceeding the 25% level, and it should expect closer scrutiny from its examiners. The Credit Union should consider its legal lending limit and the capital concentration threshold in establishing this standard.

- Based on a 15% lending limit for banks, many Credit Unions have adopted a 15% of capital limit for Institutional Insurance placed with a single carrier.
- The Credit Union may only purchase life insurance in connection with:
    - Employee compensation and benefit plans
    - Key person insurance
    - Insurance on borrowers
    - Insurance taken as security for a loan
- The Credit Union cannot purchase Institutional Insurance as part of a "yield chasing" strategy or:
    - to generate funds for normal operating expenses other than employee compensation and benefits
    - to provide estate planning benefits for insiders unless the benefit is part of a reasonable compensation package
    - for speculation
- The management and Board of Directors should review annually the performance of any Institutional Insurance it owns and any associated risks. This analysis should include, among other things, the following:
    - Risk assessment
    - Identification of employees who are or will be insured
    - Assessment of death benefit amounts relative to employee salaries
    - Calculation of the percentage of insured persons still employed by the institution
    - Evaluation of the material changes to Institutional Insurance risk management policies
    - Analysis of mortality performance and impact on income
    - Evaluation of material findings from internal and external audits and independent risk management reviews
    - Annual compliance review on laws and regulations
    - State insurable interest laws and appropriate financial reporting in compliance with GAAP
- Analyze Seven[vii] Institutional Insurance Risks
    - Liquidity Risk – What is the risk to earnings if the investment has to be liquidated?
    - Transactional Risk – How does the purchase of the investment affect the bottom line of the Credit Union?

- Reputation Risk – Will any negative publicity result from profiting from the employee's death?
- Credit Worthiness Risk – What is the credit rating of the carrier(s) the board is considering? What is the risk to earnings and capital if the product fails to perform as expected?
- Interest Rate Risk – How do the changes in the market affect the Credit Union's earnings and capital?
- Compliance Risk – Is the purchase of the investment compliant with all laws, rules and regulations?
- Strategic Risk – Does the structure of the investment align with the Credit Union's philosophy?

Conclusion

Credit unions should review the best practices for the use of Institutional Insurance contained in the Interagency Statement. The NCUA will likely (and presumably soon) issue guidance along these lines. Some states are already officially following the Interagency Statement, and the numbers will likely continue to increase.

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[i] The terms "BOLI" and "Institutional Insurance" are used interchangeably in this article to mean the ownership of life insurance by a financial institution, such as a credit union.

[ii] OCC 2004-56.

[iii] Interpretive Statement I-13-04 REVISED, as revised on July 15, 2013. The Washington Department of Financial Institutions also recently issued ISGC-2013-002-DCU dated February 28, 2013, which addressed other issues (e.g., parity process) relating to establishing and administering benefit plans.

[iv] Id., at Section 3.3.

[v] Indiana Code § 28-7-1-9(c).

[vi] As credit unions have some different issues relating to Institutional Insurance than those faced by banks, credit union regulators will hopefully tailor the new guidance specifically to credit unions. For example, the liquidity provisions (and the resulting concentration standards) in the Interagency Statement focus on the fact that banks are for-profit entities that would suffer negative tax consequences upon early surrender of the Institutional Insurance. As tax-exempt entities, credit unions do not face the same issues.

[vii] Risks changed from the eight risks applicable to banks.