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EXECUTIVE COMPENSATION SURVEY

SUMMARY REPORT

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California CREDIT UNION LEAGUE

SNAKE OIL OR LIQUID GOLD?
A BOARD'S GUIDE TO DUE DILIGENCE FOR LOAN REGIME SPLIT DOLLAR

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Loan regime split dollar – snake oil or liquid gold? If it works, loan regime split dollar is a powerful tool for compensating key executives and growing credit union assets. If it doesn't work, the costs are high.

When conducting due diligence for loan regime split dollar[1] (LRSD), in addition to evaluating standard interest rate, liquidity and concentration risks, boards should consider the following global questions:

- What do the regulators think of LRSD?
- What are the income tax consequences of LRSD for the executive?
- What are the financial implications of LRSD for the executive and for the credit union?

After reviewing the general structure of LRSD, we break these global due diligence questions into several sub-questions. We answer the easy ones. The hard questions depend on the specific design and product selection. For these questions we suggest how the board can find the answer.

General LRSD Structure

Designers invariably add bells and whistles, but the key elements of LRSD are:

- The executive acquires a cash value life insurance policy on the executive's life.
- The credit union pays premiums on the policy.
- The executive borrows against the policy's cash value to supplement retirement income.
- At a specified time or event, the policy cash value and/or death proceeds repay the credit union's premiums.

LRSD claims several advantages over traditional nonqualified deferred compensation:

- LRSD does not require "substantial risks of forfeiture" (e.g., cliff vesting) to defer taxes, but accommodates them if desired;
- The executive pays no taxes on loans from the policy;
- The executive's interests are not subject to the claims of the credit union's creditors;
- The credit union avoids the annual deferred compensation P&L expense;
- In some designs, the credit union recognizes interest income each year;
- Rather than a growing deferred compensation liability, the credit union's balance sheet reflects the right to recover premium payments as an asset; and
- The credit union recovers its advance and, in some designs, interest.

Not a bad list, if it works. Posing the following questions will allow the board to determine if LRSD works for the credit union.

Regulator Perceptions

What does the NCUA think about LRSD?

In 2007, the most recent published statement on LRSD, the NCUA stated:

> Split dollar life insurance is a valuable tool for funding employee benefit plans used to attract and retain senior managers and employees; the Office of General Counsel has stated FCUs may purchase split dollar life insurance for this purpose.[2]

In numerous discussions about LRSD over the past couple of years with the NCUA and NCUA regulators, we have heard nothing inconsistent with this published statement.

For state-chartered credit unions, what do state regulators think about LRSD?

This varies from state to state, so the board should ask its state regulator. Some state regulators have required specific structures, but no state has prohibited all forms of LRSD.

For example, California regulators have issued a letter confirming that LRSD does not create an "insider loan" and is otherwise permissible. Nevada regulators also generally support LRSD, subject to the credit union having sufficient financial strength.

Tax Considerations

What are the federal income tax consequences of LRSD?

LRSD tax rules are clear. On the positive side:

- The employer premium payments are not taxable to the executive.
- Interest on the loan can be handled in one of three ways:
- The executive pays the interest to the credit union each year at the applicable federal rate (AFR, discussed below);
    - The executive reports the interest in income each year; or
    - Interest accrues (compounded) and is paid to the credit union from the policy's death proceeds.
- The executive's loans from the policy are not taxable.
- The death proceeds are not taxable whether used to repay the executive's loans from the policy, to repay the credit union's premium payments (and interest, if applicable), to provide a benefit to the executive's survivors, or to provide key-person insurance for the credit union.

On the negative side:

- If the executive is not personally liable for repaying the credit union's premium payments, and if a reasonable person would not conclude the credit union is likely to be repaid its premiums, the participant will be taxed in the first year on potentially significant interest elements of the arrangement.
- If the policy lapses, the employee is taxed on the loans the participant has taken from the policy and on the portion of the credit union's aggregate premium payments it does not recover from the policy.

This tax treatment leads to additional tax-related questions:

How does the structure assure the credit union will recover its premium payments, facilitating the reasonable person conclusion?

The board should consider the reasonableness of the interest rate assumed in the illustration and any "cushion" built in to assure credit union recovery.

What steps are taken to protect against the policy lapsing during the participant's lifetime?

The board could ask the designer to show what happens if the actual interest earnings are significantly less than illustrated, to highlight any protections in the arrangement against the executive borrowing too much from the policy, and to specify if anti-lapse policy provisions or riders are available.

Financial Considerations

How confident can the credit union be that the policy will perform as illustrated?

Policy performance is critical to LRSD "working." Key performance drivers are the interest credited on the cash value and the charges (mortality and administrative) within the policy. The board should evaluate both elements to understand the risk of the policy under-performing.

LRSD is typically funded with variable universal life insurance or indexed universal life insurance. The cash value in a "variable" policy fluctuates with the performance of specific market investment funds within the policy, whereas the cash value in an "indexed" policy varies by the performance of a general index (e.g., S&P 500).

An indexed policy may also have the protection of a "collar" on the indexed rate. The bottom of the collar protects the cash value in down years. In exchange, the top of the collar limits index growth participation in exceptional years. For example, with a 0% - 12% collar, the policy would be credited with 0% in years the index returns 0% or less, 12% in years the index returns 12% or more, and the actual index performance in years it returns between 0% and 12%. In evaluating the costs and benefits of a collar, the credit union should consider how often the carrier can change the collar, and its history of doing so.

Finally, the policy should be “stress tested” to determine how it would perform in a prolonged period of negative market returns.

Mortality charges within the contract can also increase to a maximum schedule set forth in the policy (the “guaranteed” mortality rates). The maximum rates are typically much higher than the rates in effect when the policy is issued, and can be a significant drag on performance. To evaluate this risk, the board should inquire as to the carrier’s history of raising mortality charges.

If the policy does not perform as illustrated, will the credit union be required to pay additional funds into the policy to keep it from lapsing?

Some policies have provisions or riders that guarantee the policy will not lapse.

Since policy performance depends on how much is borrowed from the policy, how is the amount to be borrowed determined?

The executive’s ability to borrow from the policy must be monitored and limited so that it never puts the policy at risk of lapsing during the participant’s lifetime.

The board should explore the qualifications and experience of those who will have responsibility for monitoring the arrangement over its life. A key complaint of entities that adopted LRSD in the past is that no one was around to help the participant determine how much could be borrowed from the policy. The board should expect to pay an annual administrative fee to assure professional monitoring remains in place for the duration of the arrangement.

Which AFR will apply?

The AFR that applies is critical. Typically, one of two AFRs will apply:

- If the credit union can demand the loan’s repayment at any time, the AFR is the blended annual rate. This rate changes each year. The blended annual rate for 2013 is .22%.[3]
- If the loan cannot be demanded, it is a term loan. The length of the term determines the applicable rate, as follows:
    - Not over 3 years – Short-term AFR (.23% in July 2013).
    - Over 3 but not over 9 years – Mid-term AFR (1.22% in July 2013).
    - Over 9 years – Long-term AFR (2.80% in July 2013).

For demand loans, the current blended annual rate is extremely low but risks significant future increases. For term loans, the rates are somewhat higher but can be locked in for the life of the arrangement, bringing more certainty to the projections.

Conclusion

Armed with responses to these questions, the board will be better able to cut through the hype and howls and determine whether LRSD for its credit union is snake oil or liquid gold.

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[1] Around since the mid-20th century, split dollar refers to a wide variety of arrangements where an employer and employee split the dollars (cash value and/or death proceeds) from a life insurance policy. Loan regime split dollar (sometimes referred to as "collateral assignment split dollar", or CASD) takes its name from the applicable tax rules that treat the arrangement as a loan from the employer to the employee even though there may be no actual loan but rather a joint investment.

[2] Opinion Letter 06-0924, January 19, 2007.

[3] The blended annual rate is the average of the January and July short term rates each year.