

What's New, Next, and the Same in Executive Benefits

March 2018

Guy Collins, Regional Vice President

Mike Mason, Regional Manager



A DIVISION OF
Gallagher Benefit Services, Inc.

Highlights

- What's new
- What's next
- What's the same



Executive Benefit Plans

- Protect key leadership
- Nonqualified deferred compensation
- Split dollar plan
- Bonus plan



New:
Examiner Guidance
for 701.19

Section 701.19

Allows otherwise impermissible investments if the investment is “directly related” to the credit union’s obligations or potential obligations under an employee benefit plan

The logo for BFB Gallagher, consisting of the letters 'BFB' in white on a dark blue rectangular background.

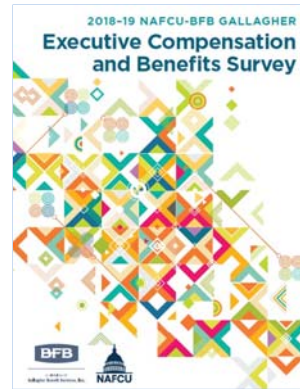
Direct Relationship Test

1. Determine benefit costs
2. Predictable return
3. Return < Projected costs
4. Split dollar predictability from interest rate
5. Exception: assets fully matching corresponding liability
6. Primarily equity/commodity investments generally not suitable

The logo for BFB Gallagher, consisting of the letters 'BFB' in white on a dark blue rectangular background.

Reasonable Retirement Benefits

- Compensation surveys
- Size
- Financial condition
- Duties



COMPENSATION		EXISTING BENEFIT PLANS			
Current Salary (\$)	Final Salary (\$)	Employer Social Security (\$)	Employer 401(k) (\$)	Total Existing Benefits (\$)	Total %
(1)	(2)	(3)	(4)	(5)	(6)
300,000	593,979	24,924	67,897	92,821	15.63%
RETIREMENT GOAL		SHORTFALL			
Goal Total %	Total Annual Benefit (\$)	Shortfall %	Split Dollar Annual Shortfall Amount (\$)	457(f) Alternative Lump Sum Distribution (\$)	
(7)	(8)	(9)	(10)	(11)	
50.00%	296,990	34.37%	\$204,169	\$2,612,790	
60.00%	356,388	44.37%	\$263,567	\$3,372,918	
70.00%	415,786	54.37%	\$322,965	\$4,133,046	

Risk Assessment

- Credit worthiness
- Interest rate
- Liquidity
- Transactional
- Compliance
- Strategic
- Reputation



BFB

Accounting

- GAAP
- Loan regime split dollar reporting



BFB

Educational Materials

- Senior executive benefit plans
- Common insurance products used
 - Institutional vs. Retail
 - General vs. Separate account
 - Whole life vs. Universal life

BFB

Due Diligence

- Pre-purchase
- Post-purchase

BFB

Exam Procedures

- Focuses on safety and soundness and compliance
- Employee benefits
- Investments that fund employee benefits
- Expanded scope



New:
Excise Tax

Excise Tax

- Section 4960 of Tax Cuts and Jobs Act
- Excise tax (current corporate tax rate) on tax-exempt employers
- Compensation in excess of \$1 million
- Parachute payments

BFB

Compensation > \$1 million

- Applies to top five highest compensated
- Compensation for income tax withholding purposes

BFB

Parachute Payments

- Contingent on separation from service
- Highly compensated employee
- Total severance equals or exceed three times the five-year average



BFB

Solutions

Compensation > \$1 million

- Restructure existing plan
- Change to Split Dollar Plan

Parachute payments

- Evaluate severance agreements

BFB

New: DOL Disability Claims

Effective April 1, 2018

- All ERISA plans – SERPs, other 457(b) and (f) plans, LTD plans, Split Dollar Plans
- Failure to establish or follow compliant procedures:
 - Allows claimant to go directly to litigation
 - Employer loses presumption of correct determination

New Requirements

- Response periods are shortened
- Impartial and independent
- Describe the basis for not following expert or professional evaluations
- Must be written in a culturally and linguistically appropriate manner



What's Next:
Better Due Diligence
Better Servicing

Better Due Diligence

- Vendor capabilities
- Board education
- Documentation



Better Servicing

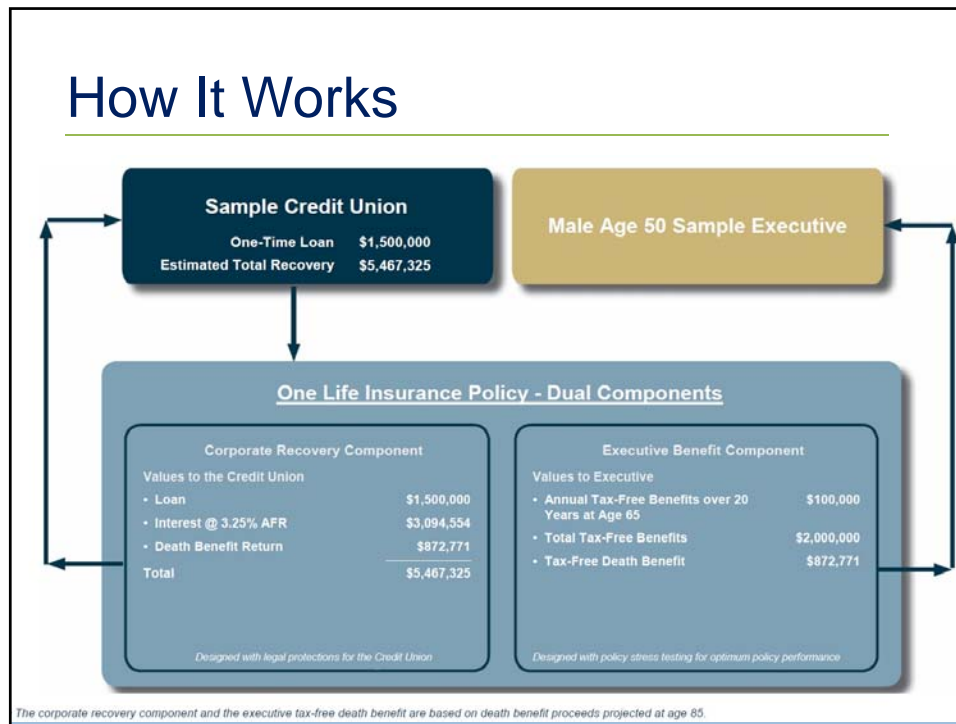
- Account access and reporting
- Performance monitoring
- Regulatory compliance



What's the Same: Split Dollar

Split Dollar Plans

- Tax-free retirement income
- Policy owned by executive with collateral assignment to credit union
- Loan to executive to pay for premiums
- Impact: loan with interest income



Advantages to Credit Union

- Off balance sheet transaction
- Safety and soundness
- Not responsible for paying benefit

BFB

Disadvantages to Credit Union

- Non-demand, non-recourse loan
- Long-term program



BFB

Advantages to Participant

- No taxation
- Control policy/income



BFB

Thank you!



Guy Collins
Regional Vice President
Guy_Collins@ajg.com
Ph: 214-202-3799



Mike Mason
Regional Manager
Mike_Mason@ajg.com
Ph: 877-332-2265

Coming Soon!
Split Dollar Plans: Key Decisions



BFB Gallagher is the NAFCU Services Preferred Partner for Executive Benefits and Compensation Consulting. More educational resources are available at www.nafcu.org/BFB.

Disclosures

Securities offered through Kestra Investment Services, LLC (Kestra IS), member FINRA/SIPC. Investment advisory services offered through Kestra Advisory Services, LLC (Kestra AS), an affiliate of Kestra IS. Kestra IS and Kestra AS are not affiliated with BFB Gallagher (BFB), Arthur J. Gallagher & Co. or Gallagher Benefit Services, Inc.

Please note that all investments are subject to market and other risk factors, which could result in loss of principal. Fixed income securities carry interest rate risk. As interest rates rise, bond prices usually fall, and vice versa.

Mutual funds and ETFs are sold by prospectus only. Before investing, investors should carefully consider the investment objectives, risks, charges and expenses of a mutual fund or ETF. The fund prospectus provides this and other important information. Please contact your representative or the Company to obtain a prospectus. Please read the prospectus carefully before investing or sending money.



Reasonable Compensation

August 2015

Written by Kirk D. Sherman, partner at law firm of Sherman & Patterson, Ltd

Reasonable¹ compensation is a critical component of a credit union's success. Over time, paying executives too little risks starving the credit union of critical managerial talent. Paying too much wastes assets and risks embarrassing the board and sowing discord among employees and with members. This article reviews the reasonableness standard and how board members, who constantly walk this tightrope, can reach the right balance of paying enough but not too much.

For federal credit unions, the Federal Credit Union Act empowers the board to hire and compensate officers and employees.² NCUA regulations then empower credit unions to provide employee benefits, but the "kind and amount of these benefits must be reasonable given the federal credit union's size, financial condition, and the duties of the employees."³

The NCUA Examiner's Guide then picks up the baton. In the chapter on "Management," the Guide tees up the issue:

While examiners generally should not require changes to compensation arrangements in healthy credit unions, they should note, when appropriate, unsafe and unsound compensation practices.⁴

The Guide then provides a dirty-dozen list of practices that "may constitute unsafe and unsound practices." Chief among them:

Compensation arrangements that significantly exceed compensation paid to persons with similar responsibilities and duties in other insured credit unions of similar size, in similar locations, and under similar circumstances, including financial health and profitability.⁵

Therefore, reasonable compensation is a safety and soundness issue that is resolved by paying for executive services only what similar credit unions are paying similar executives. The challenge lies in identifying similar credit unions and similar executives, and determining how much the credit unions pay those executives.

Fortunately, credit unions can learn from the experiences of other organizations in different industries that face even greater scrutiny on this issue. The NCUA test of similarity is the same that the IRS applies to non-credit union charitable organizations that are tax-exempt under Section 501(c)(3) of the tax code, such as hospitals. These organizations, however, are subject to additional restrictions.

A 501(c)(3) organization executive who receives unreasonable compensation personally incurs significant "intermediate sanction penalties."⁶ Additional penalties are also imposed on decision makers at the organization that approved the compensation.⁷

Given these penalties, 501(c)(3) organizations have become very good at ensuring they pay only reasonable compensation. Their best practices, together with lessons learned from specific credit union failings,⁸ are a road map for credit unions to follow to achieve that same assurance:

- *Board-driven process*—The board should direct the process by overseeing those who are collecting the comparability data and retaining any consultants involved. Findings should be reported directly to the board without filtering by the executives whose compensation is being determined.
- *Independent body*—The compensation decisions should be made only by those who have no family, employment, business or other relationship with the executives that could taint their decisions. Deliberations should be in executive session, excusing those whose compensation is being determined.⁹
- *Data sources*—Published surveys can be the single most helpful source of compensation data. To supplement or assist in fine-tuning the data, additional sources for comparable employer compensation data include IRS Form 990s (filed by state-chartered credit unions), private inquiries to other credit unions, and written job offers from other credit unions.¹⁰
- *Recordkeeping*—The board should keep careful, contemporary records of the comparability studies and surveys used, the analysis for selecting the proper peer group, the process for determining total compensation (see below), and who participated in the deliberations.
- *Similar credit unions*—While perfect matches may be difficult to find, most surveys aid in coming close by reporting data based on asset size. In selecting size, the board should use the credit union's actual current size, not the size the credit union wants to become. For example, some boards say, "We're \$750M now but we want to grow to \$1B, so we will use the data from \$1B credit unions." The problem with this approach is every \$750M credit union wants to grow to \$1B, so the growth objective is already built into the compensation \$750M credit unions are paying.
- *Total compensation*—The comparison should be based on total compensation, consisting of salary, bonus and benefits. A comparison based only on total cash compensation (salary and bonus) can result in a total compensation package that is significantly lower or higher than the peer group depending on the strength of the benefits package.¹¹ Surveys become more helpful as they address the prevalence and amount of key benefits such as nonqualified retirement plans and paid time off.
- *Nontaxable benefits*—The benefit comparison should include all elements of compensation whether or not the element is taxable. For example, loan regime split dollar may result in no taxable income for the participant, but it provides an economic benefit that should be valued and included in the comparison.
- *Prior under-compensation*—The IRS allows a 501(c)(3) organization to pay higher than the peer group currently if the organization previously under-compensated the executive.¹² A credit union seeking the same treatment should follow the requirements articulated by the IRS and courts addressing the issue—quantify the amount by which the executive was undercompensated in the past, determine when and how the employer will make up the shortfall, and include the information in formal board or compensation committee minutes.

A credit union board that follows these best practices¹³ in setting executive compensation will have greater comfort that it is neither under- nor over-compensating executives, and will be able to demonstrate compliance to its examiners, members and

Endnotes

1. Common parlance refers to compensation being “*fair* and reasonable.” Nowhere in the tax code or NCUA rules or regulations is there specific reference to compensation being “*fair*.”
2. 12 U.S.C. § 1760(c)(12).
3. NCUA Regs. § 701.19(a) (emphasis added).
4. Examiner’s Guide at 7-20 to 7-22.
5. Examiner’s Guide at 7-22 to 7-23. Others on the list include compensation based on short-term operating results, contracts with automatic renewals, contracts with terms exceeding three years, excessive severance compensation, compensation programs “including deferred compensation, retirement and insurance” not commensurate with the duties of the employee contracts with undefined duties, credit union collateralizations or guarantees without an escape clause if the credit union becomes troubled, credit union reimbursement of employee legal fees, immediate vesting on change of control while in a troubled condition, severance payable following a voluntary termination, and golden parachute payments. *Id.*
6. 501(c)(3) organizations lose their exempt status if their earnings inure to the benefit of a private individual. However, the IRS is reluctant to revoke an organization’s exempt status for private inurement. Therefore, Congress enacted the intermediate sanction penalties in 26 U.S.C. § 4958. Intermediate sanction penalties imposed on the executive are a requirement to repay the unreasonable compensation and then pay a 20% penalty on that amount. 26 U.S.C. § 4958(a)(1). If the executive fails to repay the unreasonable compensation, the executive must pay an additional penalty of 200% of the unreasonable compensation. *Id.* § 4958(b).
7. The penalty is 10% of the unreasonable compensation (capped at \$20,000). All decision makers are jointly and severally liable for the payment of the penalty. *Id.* § 4958(a)(2).
8. E.g., WesCorp Federal Credit Union, where executives were sued for having misled the board on the impact of corporate actions on the amount of retirement benefit accumulations.
See, e.g., <http://www.ncua.gov/News/Press/NW20100831AttachmentWESCORPComplaint.pdf>.
9. In comments to the final rules under NCUA Regs. § 701.4, the NCUA stated:

An FCU’s board of directors cannot permit the chief executive officer (CEO) to screen all the board’s information sources. While the board of directors should not attempt to bypass the CEO in giving *direction* to management and employees, the board is free to ask any manager, employee or independent contractor to provide the board and its committees information directly and not through the filter of the CEO. The NCUA’s Office of General Counsel has previously opined that board members must be free to gather information from any source in the credit union to perform their board duties. OGC Op. No. 03-0763 (Sept. 29, 2003).

75 Fed. Reg. 81380 (December 28, 2010) (emphasis original).
10. 501(c)(3) organizations can also rely on compensation paid by similar taxable organizations. A similar taxable organization for a credit union could be a bank. However, the constant drum beat from banks that credit unions should not be tax-exempt would only be strengthened to the extent executive compensation at credit unions matches or exceeds that paid by banks.
11. Consider two credit unions, each paying their CEO a salary of \$400K with a bonus opportunity of another \$100K, for a total of \$500K of total cash compensation. However, one credit union provides a conservative benefits package, and the other a rich package:

	Annual Benefit Cost	
	Credit Union A	Credit Union B
Health insurance premiums	\$ 14,000	\$ 20,000
Life insurance coverage	1,000	4,000
Long-term disability coverage	-	6,000
457(b) plan	-	18,000
457(f) plan (SERP)	10,000	34,000
Paid-time off (\$2000/day)	30,000	60,000
Auto	-	8,000
Total Benefits	\$ 55,000	\$ 150,000
Cash Compensation	500,000	500,000
Total Compensation	\$ 555,000	\$ 650,000

12. See, e.g., *Reasonable Compensation - Job Aid for IRS Valuation Personnel*, October 29, 2014, <http://www.irs.gov/pub/irs-utl/Reasonable%20Compensation%20Job%20Aid%20for%20IRS%20Valuation%20Professionals.pdf>
 13. See also Best Executive Compensation Practices, 2014 Summit Round Table Executive Compensation Survey.
-