February 27, 2004

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

Re: Funding Employee Benefit Obligations With Life Insurance.

Dear Mr. Berkman:

You have asked if a federal credit union (FCU) may invest in life insurance products to fund its employee benefit obligations. You also have asked if an FCU may use a pooled funding approach and hold these products to maturity as part of its investment strategy. An FCU may purchase life insurance products, use the pooled approach, and hold the insurance products to maturity if it complies with §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. Finally, you have asked if an FCU investing in life insurance products to fund its employee benefit obligations may structure its investments to recover the cost of the benefit, the cost of the funding itself, and its opportunity costs. The FCU may structure its investment to recover the cost of the benefit and funding but not opportunity costs.

Pooled Funding Approach and Holding to Maturity

You have described the pooled funding approach as an investment strategy where an FCU purchases life insurance on a number of employee benefit plan participants to fund some or all of its employee benefit obligations. You have explained that individual policies would not necessarily correspond to the benefits owed the employee whose life is insured. Rather, policies would be placed on participants in amounts disproportionate to their individual benefits. You also have explained that by doing this an FCU can design the most effective asset/liability match from year to year. Under this approach, an FCU might continue to hold policies issued on the lives of terminated or retired participants to fund, in part, current employee benefit obligations. You have further stated that this is a routine practice among banks and corporations. Finally, you have stated that an FCU might "re-earmark" a policy by substituting a new participant life for the insured participant who has left the FCU. You believe it is more efficient and cost-effective, however, to hold the policy to maturity on the original participant.

You define maturity of a life insurance policy as "the moment when the beneficiary is entitled to receive an amount equal to the face value of the policy." You have explained that maturity occasionally occurs when the policy endows, that is the policy's cash value equals its face value, but usually maturity occurs upon the insured's death. You have stated that holding a life insurance policy to maturity, instead of withdrawing from it earlier, usually yields a higher return. Accordingly, you believe that allowing an FCU to hold a policy to maturity will maximize the FCU's investment and place the FCU on a more level playing field with banks and corporations.

In theory, NCUA does not object to an FCU using the pooled funding approach or holding investments to maturity in connection with funding employee benefit obligations with life insurance products. In practice, however, an FCU may only purchase life insurance, an impermissible investment for an FCU's own account, and use these investment strategies if it does so in a manner consistent with the terms of §701.19. Section 701.19 states:

A federal credit union investing to fund an employee benefit plan obligation is not subject to the investment limitations of the Act and part 703 or, as applicable, part 704, of this chapter and may purchase an investment that would otherwise be impermissible if the investment is directly related to the federal credit union's obligation or potential obligation under the employee benefit plan and the federal credit union holds the investment only for as long as it has an actual or potential obligation under the employee benefit plan.

12 C.F.R. §701.19.

NCUA does not object to the above investment strategies, if an FCU can demonstrate that a pool of insurance product investments covering certain plan participants and held to maturity is directly related to the FCU's employee benefit obligations. NCUA cautions FCUs, however, that purchasing life insurance can be complicated and is not without risk. NCUA recommends that FCUs fully understand the nature of insurance products and the risks associated with them before investing and take into account applicable law regarding the purchase of insurance on certain individuals without their knowledge or permission.

In some instances, an FCU that holds an insurance policy to maturity would violate the requirement in §701.19 that it hold an investment only for as long as the investment funds an employee benefit obligation. For example, this would be the case when an FCU has purchased a life insurance policy on an individual exclusively to fund only that individual's benefits and the individual ceases to be entitled to the benefit. NCUA recognizes, however, the value of permitting FCUs to use the pooled approach and believes that the requirement to hold an investment only for as long as it serves to fund an obligation is satisfied in the pooled approach context so long as the FCU can continue to demonstrate a direct relationship between the investments held to maturity and the remaining employee benefit obligations they fund.

Cost Recovery

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.

Sincerely,

Sheila A. Albin
Associate General Counsel

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