An Analysis of

Credit Union Owned Life Insurance

Retaining top talent is among the many challenges facing credit unions today. Quality benefits have been shown to improve workplace satisfaction and contribute to long-term retention. However, rising benefit costs in a low margin environment have made it more difficult to offer these benefits that top credit union talent wants and needs.

Benefits prefunding is a viable and regulator approved option for ensuring credit unions have the resources to provide competitive benefits to employees for years to come, while addressing the continued rise in overall benefits costs.

Benefits prefunding can be accomplished using a variety of investment vehicles. One product that credit unions often consider is Credit Union Owned Life Insurance (CUOLI). CUOLI products are designed to be the credit union version of a Bank Owned Life Insurance (BOLI) product. However, there are several distinctions that can make CUOLI products less attractive than their BOLI counterparts.

What is a BOLI?

A BOLI is where one or more bank employees are insured by a life insurance policy. The policy has a death benefit attached to it and employees are typically provided a portion of the death benefit or some other financial incentive to encourage participation. The policy provides a yield that is usually based on the insurance company's general account performance and is adjusted annually. It is important to note that the insurance company's general account is in place to support the insurance company's obligations and therefore is required to invest in conservative and low risk instruments (e.g., bonds, real estate, etc.).

The largest advantage of a BOLI is the tax advantages it provides for the bank. All premiums paid into the fund, as well as all capital appreciation, are tax-free for the bank. Therefore, banks can use the BOLI to fund employee benefits on a tax-free basis. BOLI instruments are also liquid, meaning a bank can surrender a BOLI at any time without surrender penalties. Despite the liquidity, banks typically hold BOLI plans for a long period to avoid the taxes and tax penalties associated with surrendering a policy early. In cases where the bank is insuring a large group of employees (typically 10 or more), BOLI products can also be guaranteed issue underwritten, meaning no individual medical underwriting for employees.

How Is CUOLI Different?

Credit Union Owned Life Insurance (CUOLI) is similar in some regards to BOLI. However, there are several items that one should be aware of before investing in a CUOLI product. There are no tax advantages to the credit union for CUOLI plans since credit unions are not-for-profit. Because credit unions have no tax penalties, insurance companies typically attach a surrender penalty on CUOLI plans to discourage early surrender. This eliminates the liquidity appeal of the product. In cases where a surrender period is present, the credit union's auditor or regulator may require the credit union to value the policy at the surrender value. This would cause the credit union to realize a loss in the early years of the policy.

A second issue that CUOLI plans present is their source of yield. Because the CUOLI yield is in many cases based on performance of the insurance company's general account, it is allocated to conservative investments (e.g., bonds). In a rising rate environment, the general account performance might not perform at the level needed to offset the credit union's benefit expenses. For example, health care expense growth has exceeded 5% for 19 of the past 25 years. In comparison, the 10-Year Treasury on December 31, 2015 was a Nominal Yield of 2.27%. After accounting for inflation of 1.74%, the Real Yield on the 10-Year Treasury was just 0.61%. As the Federal Reserve begins raising interest rates, one can potentially expect a negative impact on bond products. This could potentially limit the future yield on the CUOLI product in an increasing rate environment.

In cases where the CUOLI is tied to the general account, the credit union should also be aware of credit-risk exposure. In the case of an insurance company failure, the credit union would be treated as a general creditor vying for a portion of the general account proceeds.

CUOLI products can also be high commission insurance products with front-end commission loads, meaning the insurance agent receives a large commission at the sale of the product and a small ongoing trail for each year the policy is in force. Insurance companies typically place long claw back provisions on those commissions should the credit union surrender the contract early. This creates a potential conflict of interest because there is a financial disincentive for the insurance representative to advise the client to sell the product, regardless of whether the product is in the client's best interest.

While CUOLI is often positioned as a retention strategy, in many cases the product is an ineffective tool for retention. To encourage participation, credit unions will sometimes share the death benefit with the insured employee. However, death benefit incentives are far less attractive to younger audiences with longer time horizons for retirement and/or death.

Alternative Options to Consider?

There are several investment alternatives to CUOLI for a credit union's consideration based on the objectives of executive retention and expense offset.

When the objective is to retain key talent, we find a strategy that is customized to each individual executive has a greater likelihood of success. For some employees, a CUOLI or other insurance product may indeed be a strong option. Alternatively, the credit union might consider a life insurance product or money managed portfolio where yield is tied more directly to market performance. The portfolio can then be allocated across multiple asset classes that reflect the executive's time horizon and the credit union's appetite for risk.

When considering credit union income as the objective, the credit union could consider a money managed portfolio. Unlike an insurance product, a money managed portfolio is completely liquid, allowing the credit union to adjust the investment strategy at any point without consequence. Furthermore, should an executive leave or the demand for loan dollars exceed deposits, the credit union can easily liquidate its position.

When considering a benefits prefunding strategy, one should look for a partner with experience in a range of investment strategies, including CUOLI, individual life insurance and money managed accounts. This knowledge and flexibility of investment options can be used to fulfill your credit union's retention and employee benefit objectives.

BOLI vs. CUOLI

	BOLI	CUOLI
ADVANTAGES	• Can efficiently generate gains to offset the costs of employee benefits programs • Well defined guidance by regulators • Diversifies investment portfolio • Returns can compete favorably with other traditional investments • Cash values grow tax-deferred, death benefits are tax-free • Potentially less interest rate volatility • Typically no surrender charges	• Can efficiently generate gains to offset the costs of employee benefits programs • Well defined guidance by regulators • Diversifies investment portfolio
DISADVANTAGES	• If surrendered before retirement age, any gains can become taxable as well as subject to an IRS penalty • Subject to the credit quality of the carrier • Competitiveness of crediting rate vs. market rate	• No tax advantages, potentially long claw back commissions • Subject to the credit quality of the carrier • Competitiveness of crediting rate vs. market rate • Surrender penalty is typically unfavorable if surrendered early • Little to no liquidity due to surrender penalty • Lower yield compared to market, making it harder to offset the rising costs of benefits • Regulators may require the credit union to value the policy at the surrender value causing an immediate loss

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