CREDIT UNION

BENEFITS PREFUNDING

d. hilton associates inc.

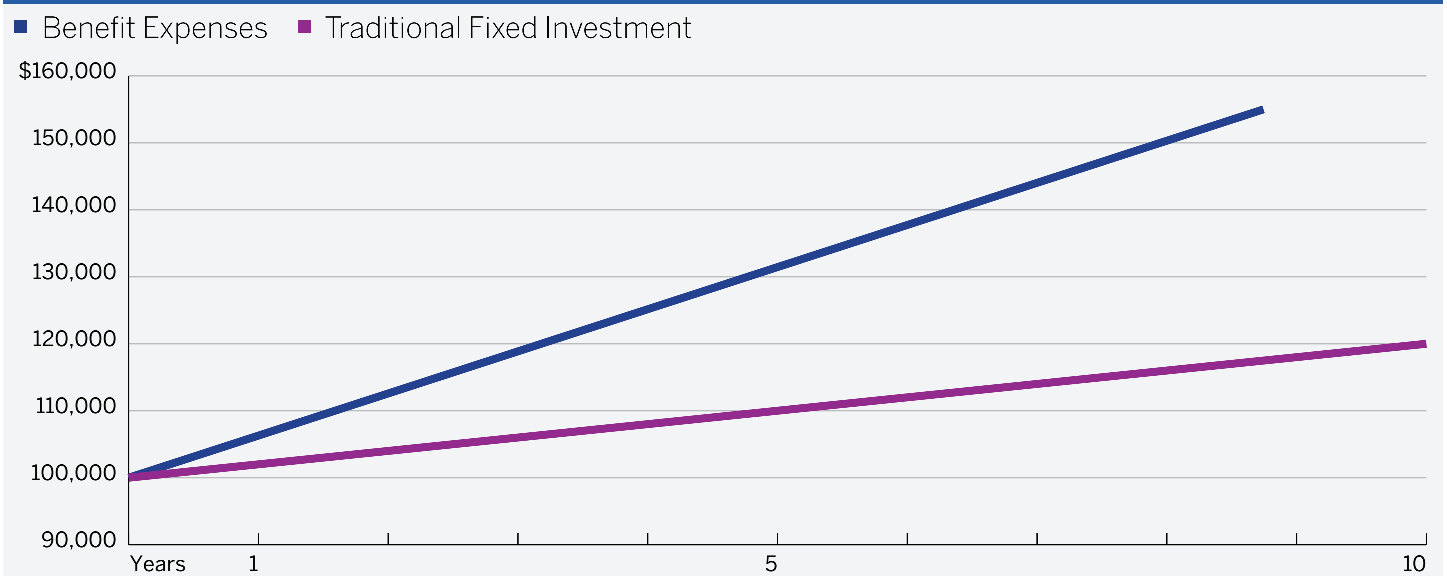
EXECUTIVE RECRUITING | COMPENSATION | RETENTION & RETIREMENT | STRATEGIC SERVICES

Time tells us that credit unions, like all of us, can expect expenses to rise. Many of those expenses rise without regard for the economy or the rate of inflation. The cost of employee benefits is a prominent example of a rising expense that leaves credit unions struggling to keep pace. And while many employers are cutting benefits, this is neither the only option, nor the best one.

WHAT IS BENEFITS PREFUNDING?

Benefits prefunding allows credit unions to direct a portion of their excess liquidity into investments to cover certain benefit expenses. Benefits prefunding is most commonly utilized for group health and life insurance premiums, disability insurance, and employer costs associated with employee retirement benefits (e.g., 401(k) plan). With a formal benefits prefunding program, credit unions can direct funds into investments like mutual funds, annuities, equities, and bonds, which have historically provided a return on investment that is more likely to match increases in employee benefit expenses.

Traditional Fixed Investment Growth vs. Expense Growth Over 10 Years
Example of 1% Investment Yield vs 5% Growth in Benefit Expenses



WHY IS BENEFITS PREFUNDING AN OPTION FOR CREDIT UNIONS?

NCUA regulation 701.19(c) specifies that:

"A federal credit union investing to fund an employee benefit plan obligation is not subject to the investment limitations...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."

When asked to clarify whether prefunding employee benefits is allowed, the NCUA affirmed that federal credit unions could participate in such prefunding for specified future employee benefits obligations. Federal examiners review prefunding programs annually and, as a result, have reaffirmed prefunding compliance with NCUA regulations.

State chartered credit unions have not been left out. In most cases, state-chartered credit unions are afforded the same opportunity through parity or approval from state regulators.

WHY ARE CREDIT UNIONS PREFUNDING EMPLOYEE BENEFITS?

Three in four employees say their benefit package influences their job engagement.

Employee Retention and Health

Credit unions that provide attractive benefits packages are more likely to retain their most talented employees. In addition, with access to a more robust health plan, rather than a pared-down plan, employees are more likely to take advantage of health services that can keep them healthy and productive.

Portfolio Diversification

Utilizing a benefits prefunding plan helps the credit union diversify its investment portfolio while achieving its cost objectives.

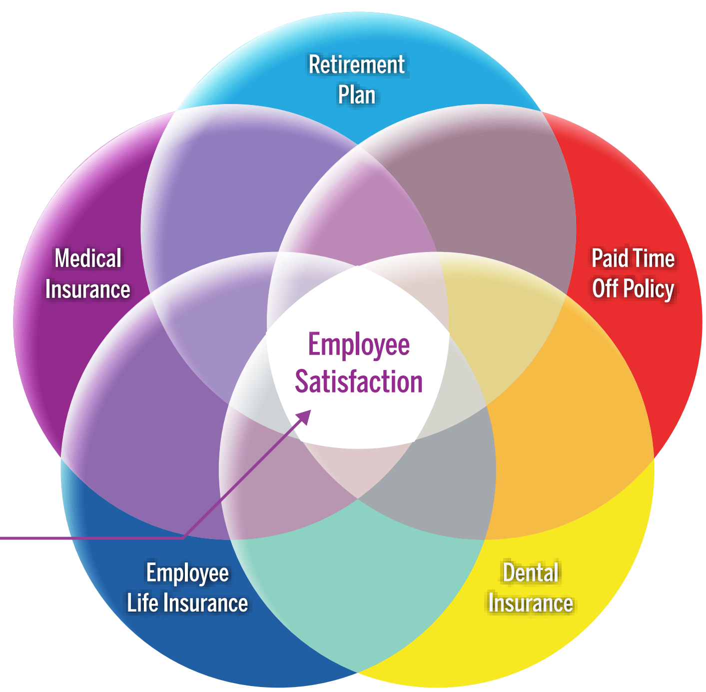
Employee Satisfaction

Benefits have always played a role in employee satisfaction and recent research shows that three in four employees feel their overall benefit package influences their job engagement. A recent study found that 43% of employees say benefits are an important reason for why they came to their current employer and 50% say benefits are an important reason why they remain at their employer. Employee satisfaction and engagement have significant influences on efficiency and productivity in the workforce. Benefits prefunding can provide credit unions with the security of knowing they can continue to give employees desired benefits in future years.

Cost Management

Credit unions of all sizes continue to feel the pressure of decreasing margins coupled with historically low returns on assets. Credit unions, however, continue to see steady increases in operating expenses. While many efforts have been made to cut expenses, the reality is that compensation and benefits comprise roughly half of total operating expenses. Credit unions find themselves in a difficult position where trimming compensation and reducing benefits be at a detriment to employee recruitment and retention. Health care benefit costs alone per employee are expected to continue increasing by more than 5% per year.

The Key to Achieving **Employee Satisfaction**



WHICH TYPES OF EMPLOYEE BENEFIT PLANS ARE ELIGIBLE FOR PREFUNDING?

Credit unions can establish benefits prefunding plans for a variety of potential employee benefits obligations:

- 401(k) match contributions
- Life insurance expenses
- Health insurance expenses
- Long-term and short-term disability expenses
- Defined benefit (pension) plan contributions
- Post-retiree health benefit plan funding
- Non-Qualified deferred compensation arrangements

WHAT TYPES OF PREFUNDING INVESTMENTS ARE AVAILABLE?

The IRS and the NCUA put no limitations or restrictions on the type of investments that may be used to fund employee benefits. The best approach, however, is to determine the parameters of the benefit and then to analyze appropriate investment options, all of which should be screened for suitability and financial soundness.

Investment options available include, but are not limited to, the following:

- Actively managed diversified accounts
- Equities and bonds
- Mutual funds
- Variable and fixed annuities
- Exchange traded funds (ETFs)
- Split-dollar life insurance
- Corporate-owned life insurance
- “Key Person” life insurance

Risk tolerance, the length of time until distribution of benefits, security of principal, and the impact of investment and benefit expense to the credit union’s financial statements should be taken into consideration prior to making any investment decision. The investment decisions (the mix of insurance, annuities, and actively managed accounts) should be tailored to the credit union’s risk tolerance, the length of time until distribution of benefits, asset allocation mix, and the employees’ health and insurability.

WHAT ARE THINGS TO CONSIDER?

Benefits prefunding is a strategy that should be considered with a great deal of care. Credit unions contemplating benefits prefunding should make their decision based on the following:

- Adequate liquidity of the credit union
- Long-term and short-term plans for employee benefits
- Ability to accept potential losses in the portfolio, especially in the short term
- Safety and soundness of the investment
- Best-case scenarios balanced by worst-case investment scenarios
- Ability to manage the plan continually
- Choice of third party partner to manage the portfolio
- Implications for how benefits prefunding will affect the credit union's financial statement
- Strategies for communicating the decision to prefund benefits to members

WHAT REQUIREMENTS SHOULD I KNOW ABOUT?

Examiners who evaluate credit union benefits prefunding programs will be reviewing the following:

- Analysis of future benefits costs and projections as proof of the reasonableness of the investment amount
- Reasonableness of the investment for the size and financial status of the credit union
- Completion of due diligence of investment choices by the credit union or its third party partner
- Appropriate approval from the Board of Directors and a statement from the Board indicating a revision to the credit union's investment policies
- Proper accounting of assets, gains, or losses associated with the program
- Documentation regarding access to the assets of the investment portfolio

WHAT IS THE PROCESS?

Phase 1: Select a trusted, experienced partner

Prefunding employee benefits can be more complex than traditional prefunding for defined benefit or SERP plans and other specified liabilities. It is best to undertake benefits prefunding with the assistance of a trusted, expert advisor with experience in credit union benefits prefunding. A firm of this type can remove a great deal of uncertainty from the process and provide expertise most credit unions do not have internally.

Phase 2: Evaluate current benefit expenses

The credit union should begin with an assessment of its current benefit expenses. This analysis should include, but is not necessarily limited to, the following:

- 401(k) match contributions
- Life insurance expenses
- Health insurance expenses
- Long-term and short-term disability expenses
- Defined benefit (pension) plan contributions
- Post-retiree health benefit plan funding
- Non-Qualified deferred compensation arrangements

The assessment should yield a complete, accurate and well-documented snapshot of what employee benefits cost the credit union today. The analysis should also take into consideration the credit union's financials, liquidity, and risk profile.

Phase 3: Evaluate future benefit expenses

With an accurate assessment of costs today, the credit union should then forecast benefit expenses moving forward to estimate a reasonable contribution. Expense forecasting is typically done over a five and/or ten year horizon. All documentation should be recorded to ensure that the credit union can replicate the methodology for regulators.

Phase 4: Develop a detailed report of the findings and strategy

With completed assessment of current expenses and an evaluation of future expenses, the credit union can develop a report that describes the steps it has undertaken as well as the findings of the process. At this point, the credit union is ready to prepare an investment strategy that fits with its objectives and covers its expenses.

Phase 5: Ongoing management

As credit unions implement prefunding programs, they should continually manage their plans or retain a firm to manage the plans for them. These tasks include but are not limited to, the following:

- Annual review of the investment performance and assessment of risk in the portfolio
- Annual review of any material changes in the benefit expense assumptions
- Annual assessment for recommendations of alterations
- Updates regarding trends and regulatory changes
- Data compilation for plan administration

THE D. HILTON ASSOCIATES DIFFERENCE

We set the Industry Standard. Since 1985, D. Hilton Associates has been launching new initiatives and pioneering consulting and outsourcing processes for the credit union industry. We are the largest and most experienced company of our kind.

We are Independent. At D. Hilton Associates, we base our recommendations on your credit union's unique situation and needs. We are not affiliated or associated with any other credit union service provider. This ensures that our recommendations are entirely independent and reliable. We pay no fees to organizations and receive no fees from endorsements.

We Work Exclusively with Credit Unions. D. Hilton Associates specializes in the credit union industry, so we really know your business. We devote our full energy to providing you with specialized expertise in each practice area.

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We Value Our Client Relationships. Our goal is to create and foster a long-lasting partnership with you. D. Hilton Associates believes in accommodating your schedules and goals, rather than requiring you to accommodate our schedules and goals. We know you are in the business to serve, and we respect and support your need to provide exceptional service.

We are the Most Qualified Firm in the Business. No other individual or group offers the breadth and depth of both analytical and operational services available through D. Hilton Associates. Our unique blend of credit union experience and technical expertise offers you the option of sole source support through our variety of interrelated practices.

Debra J. Hilton, SPHR, SHRM-SCP

President, D. Hilton Financial Services & Executive Vice President, D. Hilton Associates, Inc.

Debbie Hilton specializes in the design, implementation and management of employee benefit plans, Supplemental Retention and Retirement Plans (SERPs) and benefit prefunding. A professional money manager since 1983, Hilton joined D. Hilton Associates in 1996 after successfully selling her money management practice. While working with credit unions in the recruitment and retention of senior executives, she recognized the important relationship between total compensation, SERP design, and investment performance as an integral retention tool.

As an Independent Registered Representative with LPL Financial, Hilton established D. Hilton Financial Services in 1999 for the express purpose of facilitating the implementation and ongoing oversight of executive retirement plans. She has been instrumental in the implementation of more than $1 billion in retention, retirement and compensation plans for credit union executives. The firm has consulted with more than 900 credit union clients nationwide in the development of SERP solutions.

She has been recognized with numerous professional accolades including Registered Rep Magazine's "Top 100 Independent Advisors in America" and "Top 50 Independent Broker/Dealer Women Advisors", as well as Top Financial Advisor for LPL Financial for the previous five years. She was also recognized as a Five Star Wealth Manager in The Wall Street Journal and Texas Monthly and as one of the nation's top 400 financial advisors by The Financial Times.

Hilton maintains the FINRA Series 7, Series 24, Series 63, Series 66, and Life and Health Insurance licenses, the Senior Professional in Human Resources (SPHR) designation of the HR Certification Institute, and the Senior Certified Professional (SCP) designation of the Society for Human Resource Management. She holds a bachelor's degree from The University of Houston.

DAVID M. HILTON, PH.D.

President, D. Hilton Associates, Inc.

David Hilton, founder and President of D. Hilton Associates, is renowned for his insight on industry trends and his company's ability to offer innovative solutions to help credit unions stay competitive in the market's constantly changing conditions. Hilton began his career in banking and then joined a large Long Island, New York credit union during a time when the industry was known for its "plain vanilla" approach to financial services. During his tenure at the organization, Hilton rose to the number two position and became known for process improvement and technology innovation.

Hilton established D. Hilton Associates in 1985 as an executive recruiting firm servicing the credit union industry. For almost 30 years, the firm has been involved in many of the high profile credit union executive job placements across the nation.

Today, the firm provides executive recruiting, executive and staff compensation, variable pay design, succession planning, and SERP development to credit unions throughout the United States. Clients range from $50 million in assets to more than $15 billion.

Hilton holds a bachelor's degree in Accounting from City University of New York, a master's degree in Business Administrationfrom New York Institute of Technology, and a doctorate in Organizational Management from Walden University, Minneapolis, Minnesota.

JOHN W. ANDREWS, CCP, CSCP, SPHR

Executive Vice President,
D. Hilton Associates, Inc.

John Andrews joined D. Hilton Associates in 1986, a year after the company's inception. He is considered a thought leader in the credit union industry regarding executive compensation and pay-for-performance programs. His extensive knowledge in governance and his passion for working with nonprofit organizations makes him a fundamental part of the D. Hilton team.

Through his leadership, D. Hilton's Compensation Practice has become the industry leader in custom designed salary administration and performance evaluation systems. D. Hilton is renowned for accumulating the most current industry salary and incentive data available on the market. He is also responsible for the development of D. Hilton's Annual SERP Survey and Quarterly Compensation Impact Reports, considered best in the industry.

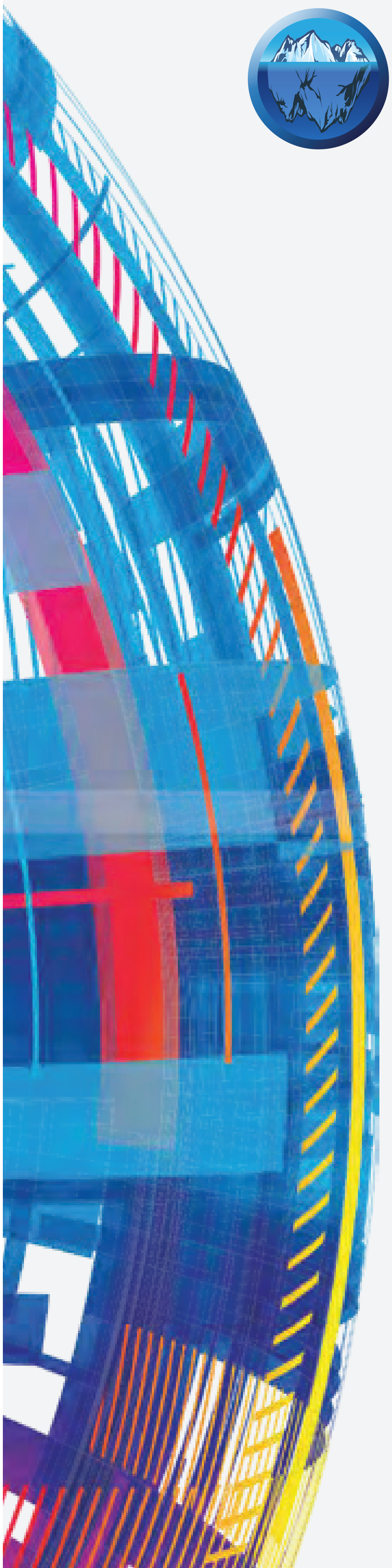
Andrews received a bachelor's degree in Communications from the University of Tulsa and went on to Emerson College to pursue his master's degree in Business and organizational Communication. Andrews holds the designation of Senior Professional in Human Resources (SPHR) rom the Society of Human Resource Professionals, as well as the Certified Compensation Professional (CCP) and Certified Sales Compensation Professional (CSCP) designations from the WorldatWork Association.

BRIAN J. KIDWELL

Executive Vice President,
D. Hilton Associates, Inc.

Brian Kidwell is an Executive Vice President and manages all client research and strategy initiatives for D. Hilton Associates. His specialties include executive succession planning, compensation and benefits analysis, executive recruiting analytics, qualitative and quantitative research, and organizational assessment. Kidwell is responsible for the development of an exclusive research tool used for executive behavior and lifetime value. Prior to joining D. Hilton, Kidwell worked as a consultant focusing on behavioral business strategy.

He holds a bachelor's degree in Management from Texas Tech University and a master's degree in Business Administration from Texas State University. Kidwell is also a published author in major research journals and trade publications.



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9450 Grogan's Mill Road
Suite 200
The Woodlands, Texas 77380

www.dhilton.com

For More Information

Debbie Hilton, SPHR
(800) 367-0433, ext. 121
debbie@dhilton.com

Brian Kidwell
(800) 367-0433, ext. 125
brian@dhilton.com