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DATE: January 27, 2017
LETTER NO: 2017-CU-01
TO: The Boards and Management of Michigan State-Chartered Credit Unions
SUBJECT: Collateral Assignment Split Dollar Plans for Executive Deferred Compensation Plans

The purpose of this letter is to discuss recurring issues noted during recent Office of Credit Union (OCU) examinations relative to Collateral Assignment Split Dollar executive deferred compensation plans. OCU requests this letter be provided to each credit union board member at their next attended board meeting.

Boards are reminded to carefully review Bulletin 2013-18-CU and the December 07, 2004 Interagency Statement on the Purchase and Risk Management of Life Insurance (issued jointly by the OCC, FRB, FDIC and OTS) which outlines important due diligence and risk management considerations and practices.

Collateral Assignment Split Dollar (CASD) plans are complex and carry substantial risk, particularly if not approved, implemented and/or administered in a sound manner. In the interest of assisting boards in ensuring the safe and sound implementation and maintenance of these complex plans, we are sharing relevant findings which have been noted relative to these programs. It is my hope that this information will help educate board members regarding the complexity of these products and the need for significant due diligence to appropriately understand the product's impact on a credit union's risk profile. Below is a listing of the typical findings OCU examinations have noted:

- *Lack of sufficient initial and ongoing due diligence.* Qualified, independent review and advice should be sought before purchasing/implementing any new or material product/investment. The board must ensure they have full knowledge/understanding of the arrangement being entered into. This should always include financial review of the impact on the institution, legal counsel review, an accounting review, and compliance analysis. These products are designed to be very long-term instruments. Organized and comprehensive procedures must be in place, and qualified authorized persons designated, to ensure competent administration, and risk control on an ongoing basis.
- *Unsafe/unsound aggregate of investments in, and loans collateralized, by otherwise impermissible investments.* Credit Unions usually assume more risk with CASD plans, collateralized by insurance products, than they would with the direct purchase/ownership of the same insurance product. As such, they are included in the 15% materiality threshold referred to in Bulletin 2013-18-CU.

- *Administrator(s) are not independent and/or knowledgeable about the product held.* Control of the ongoing administration/monitoring must include individuals who demonstrate a thorough understanding of the product, its risks and reporting requirements. Adequate understanding of, and management of, the higher interest rate risk, liquidity risk, transaction risk, credit risk, reputation risk, and strategic risk must be clearly demonstrated. These individuals must be formally authorized by and report directly to the board of directors, and be free of undue influence by the borrower/executive.
- *Collateral assignments not fully documented or sufficient to protect the credit union.* Assignments must be fully executed with acknowledgement by the collateral issuer, acknowledging the credit union's superior interest in the collateral. Documentation should ensure the owner/borrower cannot borrow against the policy without authorized permission by the assignee (credit union). The board must ensure the insurance issuer is made aware of who (and who not) is authorized to act on behalf of the credit union in this matter.
- *Lack of sufficient or independent legal review on behalf of the credit union.* Legal counsel acting solely in the interest of the credit union should be engaged by (and for) the credit union to ascertain the extent of the credit union's potential liability and risk/exposure from the CASD arrangement.
- *Arrangement (collateral adequacy) not properly accounted for or monitored sufficiently.* The credit union administrator(s) must have the ability to periodically verify the collateral value remains sufficient to adequately secure the outstanding loan. This typically requires enforced loan covenants requiring the borrower to provide such information on a regular basis, or another means of direct access to the insurance information. There must be assurances loans against the collateral cannot be granted unless compliant with arrangement/agreement, and the collateral's cash surrender value remains sufficient to support the asset recorded on the balance sheet. Further, the condition/capacity of the insurance issuer must be periodically monitored by qualified persons to identify 'red flags' which could trigger further investigation/review/action by management, to properly manage/mitigate the related credit risk.
- *Absence of a viable long-term plan regarding administration, and successive product offerings to similarly qualified individuals.* Board policy must sufficiently demonstrate the long term plan related to this portfolio, and control over the overall portfolio size/risk in the event of staff/management changes over the duration of this program.

Examiners will review and evaluate CASD arrangements and related investments for reasonableness and overall potential impact to the credit union's safety and soundness during the examination process. If your board is considering engaging in this activity, have consulted with all appropriate independent sources in their due diligence process, and are still uncertain if a regulatory concern may still be present, they are encouraged to contact their examiner or this office with their questions and concerns.

Sincerely,


John J. Kolhoff, Director
Office of Credit Unions