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## *Should credit unions re-evaluate their Pre-Fund plan options?*

The past year has challenged many credit unions with ongoing margin pressure and lost interest income, pushing executive teams and boards to seek out additional income sources. To provide relief to the hurdles credit unions face compared to their bank counterparts, the NCUA enacted section 701.19, "Benefits for Employees of Federal Credit Unions", which allows federally chartered institutions to circumvent Section 703 of the NCUA rules and regulations. As employee benefits costs have outpaced the reasonable expected return profile of a federally chartered core bond portfolio (governed by 703), the need for expanded investment authority was apparent.

### *A Brief History of Pre-Fund Plans*

Institutions have long used various insurance products as pre-funding investments, either in Bank-Owned (BOLI) or Credit Union-Owned (CUOLI) Life Insurance form. However, over the last three years, one of the more popular choices has become a pre-funded securities portfolio. With nearly a 50% increase between June 2017 and June 2020, according S&P Global Market Intelligence, it's easy to see why this has become a more widespread investment vehicle. Affording institutions the opportunity to purchase corporate bonds and equities, securities portfolios provide flexibility in their mandate, both from an interest rate and credit risk standpoint, with little barriers to exit, and relatively low management fees (assuming the portfolio is not managed internally). One of the pitfalls, however, is the mark-to-market accounting treatment these portfolios receive, giving rise to potential income statement volatility. To alleviate accounting concerns, and smooth P&L recognition, institutions are exploring a middle ground, known as a Stable Value Wrap, or Annuity. We discuss the finer points below:

- ***What is a Stable Value Wrap?*** An annuity, managed in a separate account, whose sole beneficiary is the institution, or company. The "wrap" is provided by an insurance carrier, which smooths the accounting impact of more volatile investment exposures, such as equities. Rather than being classified as a trading portfolio, the annuity is considered an insurance contract and the value change is managed over an amortization period given the expected return profile at inception. ***The important takeaway is that the "wrap", or protection, is only meant to be an accounting solution, it does not provide any economic benefit***

**Example:** 4% expected return, with a 5-year "smoothing" or amortization period

  - ABC institution credits 4% expected return, straight line, with no volatility
  - ABC institution earns 5%. The additional 1% increase is then recognized over the amortization period
    - Book 4.20% for year 2 (1% increase over the "smoothing" period), and reassess annually

- ***Beyond friendly accounting, what other benefits does my institution receive?*** In the "traditional" mold, BOLI and CUOLI have served as the standard bearer. The beneficiary's assets are setup in a general account, meaning they are invested in and owned by the insurance provider, often leading to a more rigid mandate. The other side of the coin is a securities portfolio, which is typically seen as a low-cost, hands-on alternative, offering a better liquidity profile and lower barriers to exit. Ultimately, a Stable Value Wrap may give your institution the best of both worlds. Managed in a separate account, the assets are set up in a bankruptcy remote trust eliminating carrier risk, or risk that the carrier should default. Additionally, you have the freedom to change the portfolio strategy without penalty and designate an asset manager separately from the insurance provider. This allows the beneficiary to more closely align institutional goals and risk tolerance with portfolio guidelines, and partner with an asset manager your institution trusts.

***A Reason to Re-Evaluate Your Pre-Fund Plan or Consider Implementing a New One***

After a volatile 2020, where rates remain historically low, and the search for higher returns continues, we believe, a Stable Value Wrap is a worthwhile consideration for any institution looking to reduce income statement volatility and maximize earnings. Many benefits provided by a securities portfolio are still available to the beneficiary, without the headache of mark-to-market accounting treatment. Uncertainty has loomed large throughout the year, but a Stable Value Wrap offers more certainty to the way institutions manage and offset an ever-growing expenditure.

**Want to learn more?** Contact us at info@almfirst.com to discuss your institution's specific needs in more detail.