CU MANAGEMENT

Two Different Benefits Pre-Funding Programs That Work Well Together

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Learn why a good option—especially in this pandemic-stricken economy—may be to use both general and pension benefits pre-funding.

The term "pre-funding" is not interchangeable between defined benefit pension plan pre-funding and overall employee benefits pre-funding. They're different tools, and credit unions with defined benefit pension plans can gain advantages from using both forms of pre-funding simultaneously.

Read on to learn how credit unions use both types of pre-funding. But first, here are some very basic definitions:

Employee benefits pre-funding. To help meet overall employee benefits expenses—including health insurance, retirement plans, supplemental executive compensation, etc.—you can use certain investments that credit unions otherwise aren't permitted to use.

For example, the National Credit Union Association and many state regulations allow credit unions to pre-fund employee benefits with corporate bonds, securities, life insurance products and other instruments that fall outside of those allowed by the Code of Federal Regulations, Part 703 (or in some circumstances, Part 704).

Defined benefit pension plan pre-funding. A pension plan fund grows from two main sources: the credit union's contributions and the investment earnings on plan assets.

Employers that have available liquidity and are looking to control expenses may consider making a contribution to the pension plan, even when the plan is well funded.

Similar to employee benefits prefunding, this allows the pension plan sponsor to make investments that certain credit unions otherwise aren't permitted to use. This is often referred to as pre-funding because it is dedicated to covering future retirement benefits that plan participants haven't earned yet.

Use Pre-Funding to Manage Your Income Statement and Excess Liquidity

Having both defined benefit pension pre-funding and overall employee benefits pre-funding programs can make perfect sense because they can both improve your income statement. Defined benefit pension pre-funding can reduce the pension cost shown on your income statement, while employee benefits pre-funding can increase the investment income.

In this pandemic-stricken economy, such traditional investments as CDs and Treasury bonds will probably yield very low interest rates for the foreseeable future. Credit unions need better places to park excess liquidity until loan demand returns. Here's how each type of pre-funding can help you manage this excess liquidity:

Defined benefit pension plan pre-funding: Defined benefit pension plan accounting is based on plan expectations. If the expected return on assets assumption is 7%, the income statement reflects a reduction of 7% times the value of plan assets in the first year. So, by pre-funding, the income statement improves by 7% of the amount funded.

For example, if you pre-funded your defined benefit pension plan by investing $1 million with a return assumption of 7%, your income statement would be improved by $70,000, regardless of the actual return.

To the extent future experience is different than the assumed rate, the gains or losses created will be slowly amortized into the future pension cost. So, you will always see an immediate improvement to the income statement from pre-funding, even if the short-term returns are low. And, the long-term compounding of returns on your $1 million could reduce the pension expense by more than $70,000 in the future.

A caveat for using defined benefit pension plan pre-funding is that pension assets can't be used later for any other purpose. Once money is in the pension trust, it can only be used to pay plan benefits. Upon plan termination, any excess assets typically revert to the credit union without penalty. (A taxable entity would have an excise tax on surplus assets at plan termination.)

In general, it's critical to work with experienced partners who understand defined benefit pension plan pre-funding regulations.

Employee benefits pre-funding: If your lending income is lagging, a general employee benefits pre-funding program can help you counter that by turning excess liquidity into a new income stream.

Unlike defined benefits pension pre-funding assets, most investment gains and losses for overall employee benefits pre-funding flow directly into your income statement as earnings (although this isn't the case for certain types of securities). Also unlike defined benefit pension assets, these are liquid assets and can be used for other purposes, such as meeting loan demand.

Credit unions that have this type of pre-funding program generally don't offset more than a fraction of their employee benefits expenses. If that's the case at your credit union, consider increasing your pre-funding program contributions. The NCUA Examiner's Guide recommends allowing up to 25% of your net worth to be invested in non-703 instruments.

Pre-Funding: An Investment in Your Employees' Well-Being

The ultimate goal of both of these pre-funding programs is protecting your employees.

Employee benefits pre-funding helps you maintain or enhance benefits in general, so you can recruit and retain the best talent. Defined benefits pension plan pre-funding can help you avoid the tough decision to reduce or eliminate pension benefits, as many employers have had to do.

One decision that shouldn't be difficult is choosing one of these pre-funding programs over the other: Use them both.

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