WHITE PAPER

When To Take Strategic Risk In Your Credit Union—Your ACTion Point

ACT ADVISORS
• WEALTH MANAGEMENT •

Executive Summary

The time to take bold risks is an intersection of strategic direction for the credit union and strategic risk timing from your personal financial plan.

As a credit union CEO, you may have ambitious plans for the direction of your organization. Perhaps you would like to grow aggressively by acquiring another credit union or bank, acquire or develop fintech, expand your indirect program, access the subordinated debt market, or pursue cannabis industry lending. No matter the project, such bold initiatives always come with risk. Whether the risk is financial to your credit union or political with your board and membership, it ultimately results in a risk to your future employment as CEO.

When is the appropriate time to undertake your boldest or visionary projects? This paper will show that the answer involves a combination of strategic direction for the credit union and strategic risk-taking from your personal financial plan.

Once you have established a personal, long-term strategic financial plan, you can test the effect that early termination of employment would have on the success of your plan yearly. This process will allow the identification of your personal ACTion Point which we define as the point in time at which your financial plan would be successful if you were terminated from your position.

The ACTion Point would be the most appropriate time to undertake your most transformational endeavors for your credit union because you can do so with the additional knowledge that you have some level of economic safety net protecting you from the downside of going big.

In the following case study, we will examine the ACTion Point in the context of a personal financial plan and with the use of a common yet powerful credit union executive benefit, the collateral assignment split-dollar plan (CASD).

Financial Planning for Credit Union Executives

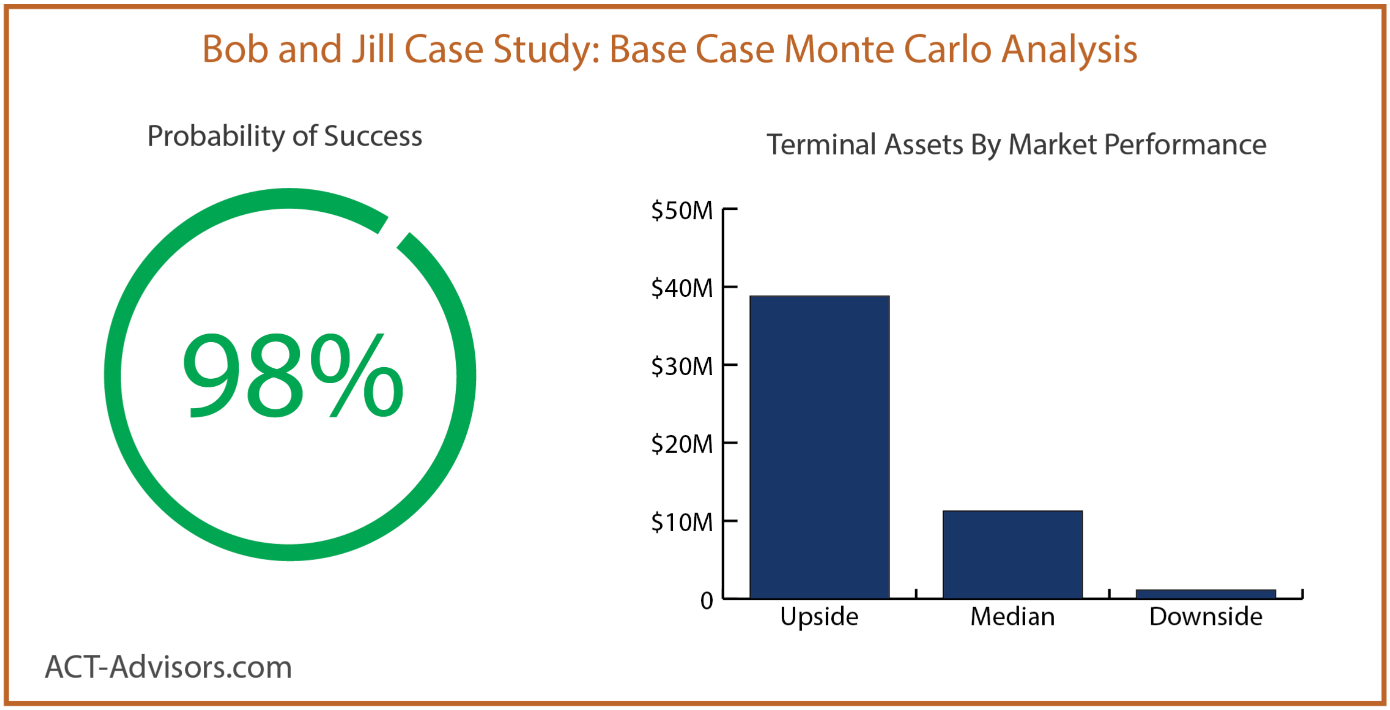
At ACT Advisors, we routinely develop personal strategic financial plans for credit union executives in which we seek to maximize retirement income by optimizing their various sources of retirement savings and income. We do so by utilizing a cash flow based financial planning tool that uses a statistical simulation called Monte Carlo. This analysis determines the probability of a plan's success by using 1,000 randomly generated market returns. To illustrate this process, let's examine a case study of a typical credit union CEO.

Bob and Jill Case Study:
Base Case Assumptions

Bob is a 50-year old credit union CEO. His financial details are as follows.

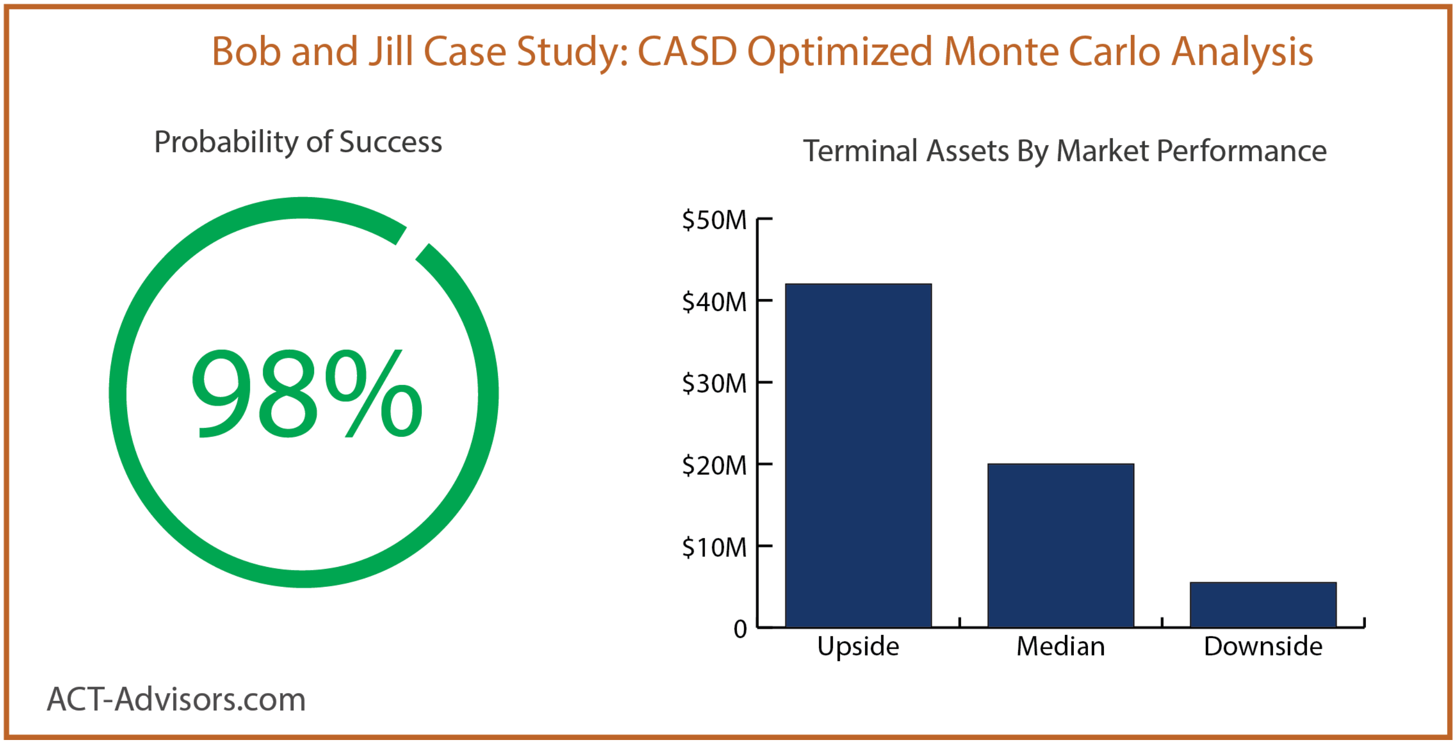
- Total annual compensation package of $325,000.
- 401(k) balance of $700,000—he makes the maximum annual contribution with catch-up, $26,000 for 2021, and the credit union makes a 5% matching contribution.
- 457(b) balance of $100,000—Bob makes the maximum annual contribution, $19,500 for 2021.
- Bob has a taxable portfolio with $125,000 in which he is saving $18,000 annually.
- His spouse, Jill, has $100,000 in a rollover IRA from a previous job.
- Bob and Jill have a total of $125,000 in cash savings.
- Bob and Jill will draw social security benefits of $39,876 and $19,938 respectively at their full retirement ages of 67.
- Bob plans to retire at age 62.
- Bob plans to receive his 457(b) payout in a lump sum the year after retirement (age 63). Any resulting excess cash flow for this year is assumed to be invested in his taxable portfolio.
- Additional assumptions are detailed in Appendix 1.

The following illustrates the Monte Carlo analysis (stress test) for an after-tax retirement income goal of $100,000.
This is not likely to be enough retirement income for Bob.



Bob and Jill have a 98% probability of success for this retirement income goal and with median levels of market performance, they will have approximately $12.3 million in assets at the end of their lives. Although they have a solid financial plan that would be the envy of many, this scenario could require a significant change in lifestyle. An after-tax retirement income of $100,000, indexed for inflation, represents only about 40% of Bob's final average credit union after-tax salary. Let's assume that the board at Bob's credit union offers him a Collateral Assignment Split Dollar (CASD) arrangement to reward him for his service and to retain him as their CEO until age 62. They engage an executive benefits specialist to design a plan that, along with his personal savings and social security, will provide at least 60% income replacement. The new plan projects an annual retirement income stream of $100,000 for 25 years with an access date of Bob's age 62. Additionally, the death benefit after receiving the income stream is illustrated to be approximately $2.6 million. In this scenario, Bob plans to receive his entire 457(b) payout in the year after retirement (age 63) and begin withdrawals from his CASD the following year (age 64).

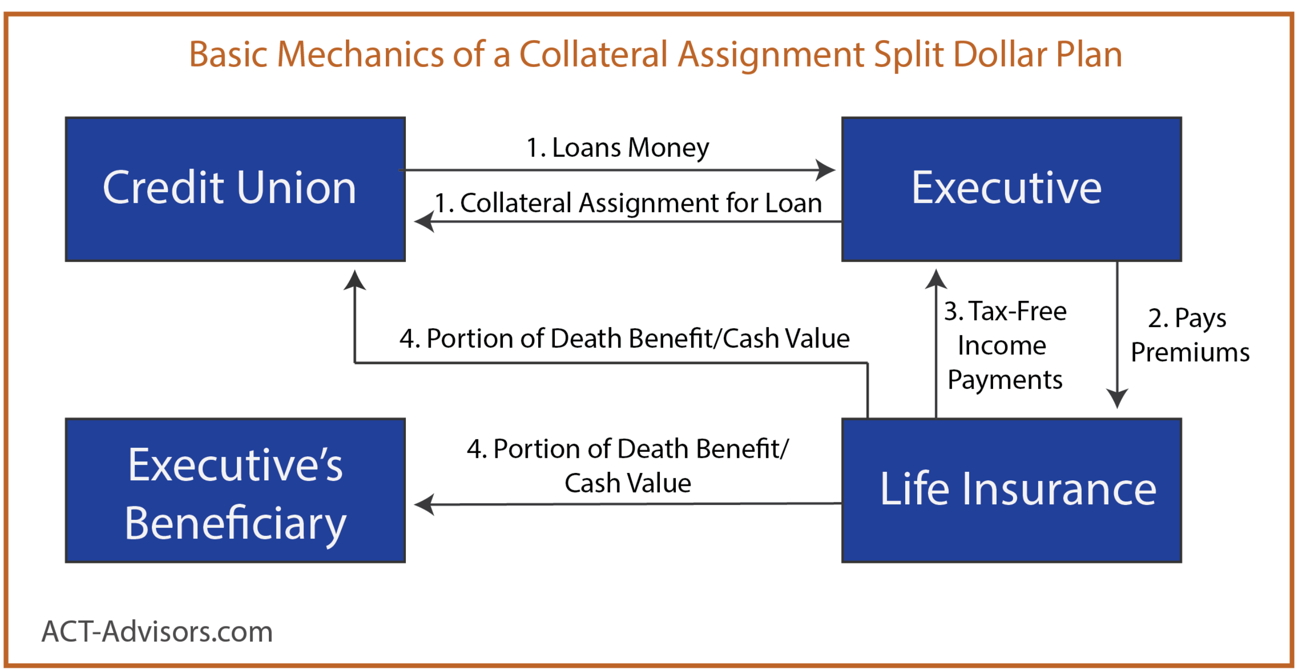
Using an after-tax retirement income goal of $150,000, the following are the results of the Monte Carlo analysis with the addition of the new CASD.



With the addition of this tax-free income source, our analysis indicates that Bob and Jill will now enjoy an annual after-tax retirement income of $150,000 with the same 98% probability of success. While the CASD improves Bob and Jill's retirement income picture, it also allows for a much greater level of generational wealth to pass on to their heirs. The death benefit of $2.6 million combined with a slower consumption of their personal savings results in terminal investment assets of approximately $20 million under median levels of market performance. The addition of the CASD creates a 50% increase in retirement income and a 54% increase in projected terminal investment assets. While the addition of the CASD immensely improves Bob and Jill's financial picture, the credit union also benefits by retaining Bob as their CEO until age 62. They also have an executive that feels more financially secure and focused on the credit union rather than his own financial future. Now that we have illustrated the impact that it can have on an executive's financial plan, let's get into more detail on this important credit union executive benefit, the CASD.

A Powerful Tool—The Collateral Assignment Split-Dollar Plan

What exactly is a split-dollar arrangement? In short, it is an agreement between an executive and a credit union that applies to any form of cash value life insurance. This agreement dictates how the two parties will "split" the "dollar" provided by the policy. Although split-dollar arrangements can be structured in many ways, the most common type among credit unions is the loan regime or collateral assignment split-dollar (CASD). In this type of arrangement, the credit union loans the executive premiums for a large cash value life insurance policy. The executive agrees to assign a portion of the life insurance death benefit to the credit union to repay the loan plus interest at the executive's death. The remaining death benefit can be divided by the executive's beneficiaries and the credit union. Most importantly, the life insurance policy is designed to generate enough cash value to provide supplemental, tax-free income to the executive in retirement through policy loans. The following flowchart illustrates the basic mechanics of a CASD.



CASDs provide many important benefits to the credit union as well as the executive. Most importantly for the credit union, it provides a cost-effective means of recruiting and retaining key employees. For a highly compensated executive, the annual contribution limits on qualified plans can make it difficult to save enough for retirement to provide adequate income replacement. CASDs can help to close this gap by providing a tax-free, pension-like income stream in retirement through policy loans for a defined number of years, typically 20-25 years. Having a significant tax-free income source often keeps the executive in unusually low income brackets in early retirement. This can open the doors to many financial planning opportunities that would not otherwise be available such as Roth conversions and premium assistance tax credits for health insurance under the Affordable Healthcare Act (ACA). Finally, the executive may receive a substantial amount of life insurance coverage for their beneficiaries, often with a multi-million-dollar death benefit.

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A key feature of CASDs is the vesting schedule which determines at what point or at what rate the executive gains ownership in retirement income and death benefits of the arrangement. CASDs typically use the same types of vesting schedules common among qualified retirement plans such as graded and cliff schedules. The length of these schedules can vary greatly and are usually driven by the succession plan of the credit union. The plan agreement defines the types of terminations that will result in partial vesting or complete forfeiture of benefits. Termination of employment with cause usually results in forfeiture of benefits and is defined as being due to factors such as conviction of a crime, violation of credit union policy, gross negligence in the performance of duty, or breach of fiduciary duty. Conversely, termination of employment due to disability or change in control of the credit union are usually events that trigger full vesting of benefits. If the agreement allows partial vesting, it typically applies to termination without cause or mutual agreement. The following testing of Bob’s plan will focus on this concept of partial vesting.

Identifying Your ACTion Point

In Bob's example, we have assumed that he will remain employed by the credit union until the access date of age 62. However, we all know that in the real world, events do not always happen as we plan. Over 12 years, credit union board members change which can cause a shift in dynamics between the board and CEO. Sometimes this results in conflicts or differences in philosophy that cause a board to terminate a CEO before the CASDs access date which means that the success of Bob's financial plan can be at risk during the vesting period. Thus, it is important to take a deeper dive into the yearly outcomes of Bob's financial plan if his employment were terminated before the access date. To examine this period in further detail, we will assume that the vesting period of Bob's CASD is 12 years (current age 50 until access date of age 62). We will also assume that Bob's CASD agreement allows for partial vesting for terminations without cause or mutual agreement and that any future termination of his employment is for one of these two reasons. Finally, we will assume that Bob's plan vests in equal increments annually during the 12 years (1/12 per year).

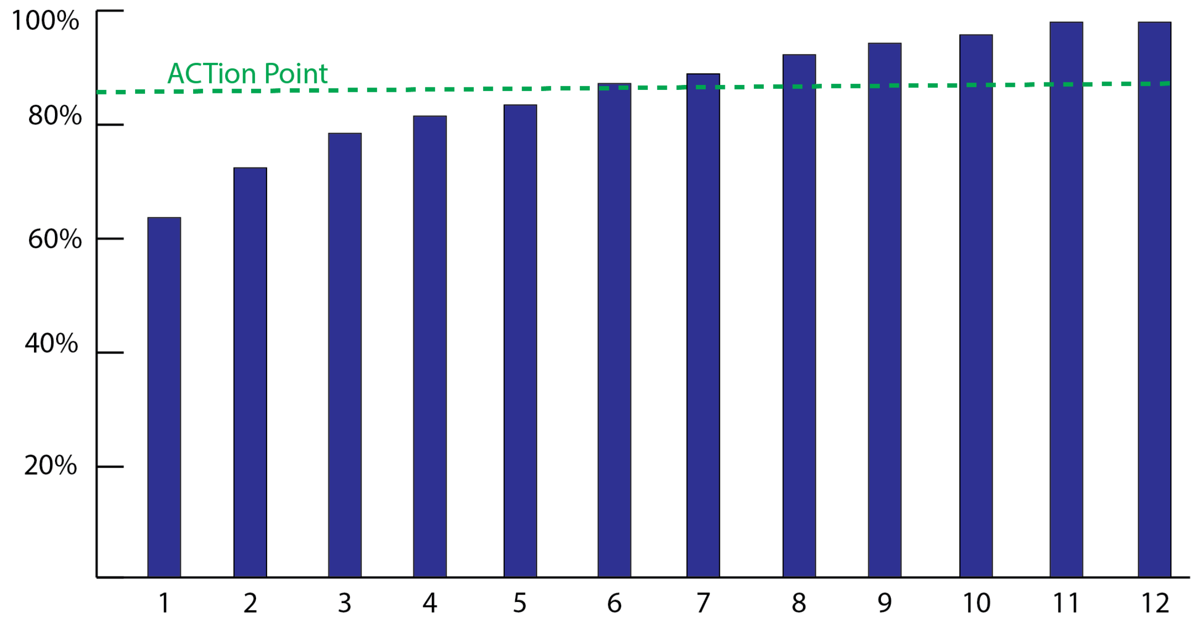
In the following analysis, we have tested Bob's financial plan year by year to determine the impact that an early termination will have on the success of his plan. A simulation was performed after each year in the 12-year vesting schedule assuming termination occurs after each year. The after-tax retirement income goal of $150,000 that resulted from the addition of the CASD is used and the following assumptions were applied.

Bob and Jill Case Study: ACTion Point Analysis Assumptions

- The 457(b) plan is paid out to Bob entirely in the year of termination. The net distribution is reinvested in his taxable portfolio.
- Bob continues working with another employer until age 62 where he continues to make a maximum annual 401(k) contribution and receive a 5% match. No future 457(b) participation is assumed.
- The death benefit of $2.6 million is also prorated according to the vesting percentage. See Appendix 1.

The yearly probabilities of success and terminal assets for termination of employment after each year in the vesting schedule are illustrated in the following chart:

Bob and Jill Case Study: Probability of Plan Success During Vesting Schedule



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So, when does Bob's financial plan become successful? Bob and his financial advisor determine that they would feel comfortable with an 85% probability of success which is achieved after year five. Although this point in time can be subjective depending on the executive and his risk tolerance, we will refer to this point at which the plan becomes successful as the ACTion point.

The Intersection of Strategic Planning and Your ACTion Point

Let's now take this concept of ACTion point a step further and examine how it can affect an executive's leadership and strategic vision for their credit union. On the surface, these two ideas seem unrelated. What effect could a CEO's personal finances have on his decision-making at the credit union? Strategic planning is guided by the mission and vision of the credit union and then looks forward to determine where the organization is going. If major strategic initiatives are identified, the research, consulting work, systems acquisition, and potential staffing needed are complex and slow-moving systems to build. Change is difficult, shifting culture is difficult, and the larger the scale and more significant the change the more time that may be needed.

Some CEOs may be hesitant to take bold action even when it is bold action that the credit union needs most. Even the servant leader intuitively knows that significant change brings with it a heightened risk of failure and an increased load of stress. However, when a CEO understands their ACTion point they can consider their decreasing personal economic risk in the equation. They may be hesitant to follow the most forward and impactful ideas in their strategic vision if they have no clearly understood economic safety net.

By identifying your ACTion point, you can feel safe enough to be bold and create the most value for the credit union by leading daringly and fearlessly.

Back to our example, in Bob's case, the first four years of his tenure are not the ideal time to pursue higher-risk strategies in his strategic plan. As we've demonstrated, an unexpected termination in those years would not result in success for his financial plan, and he would be forced to consider a reduction in retirement income or delay his retirement date. If Bob's ACTion point is after year five, he can wait until after this point to execute the bolder items from his strategic plan. And, during those first four years, he can focus on positioning his credit union and board for the strategic changes to come. For instance, he might develop his team, research and identify key vendors, and ready his board by keeping them up to date on the latest research. At his ACTion point, he can confidently and swiftly begin implementation of the forward-thinking and difficult pieces of his strategic plan. It's a win-win for the credit union and for Bob, his strategic plan is well-executed, and his personal financial plan is poised for success.

Split-dollar arrangements are perhaps the most powerful executive benefits tool available to credit unions to reward and retain key executives. Their benefits can have a profound impact on the executive's financial picture. Although CASDs are becoming more commonplace in the industry, there are many other similar tools used to reward and retain executives such as 457(b) and 457(f) plans and contractual retention bonuses. Whatever the benefit mix, it is imperative that the executive have a well-established financial plan in place that defines their personal ACTion point. This will not only provide financial peace of mind but help inform the executive on the appropriate time to take career-related risks.

Appendix—Case Study Assumptions

- Life expectancy-age 95 for both clients.
- Income and expenses are indexed at 3.25% annually.
- Investment return assumptions:
  - Cash savings: 0.50%
  - All other investments:
  - In pre-retirement, growth portfolio consisting of 80% stocks/20% bonds averaging 7.81%.
  - In retirement, income with moderate growth portfolio consisting of 53% stocks/47% bonds averaging 5.97%.
- Yearly excess cash flows are assumed to be spent in pre-retirement and saved in retirement.
- The following prorated CASD income and death benefits were used in the yearly analysis of early termination:

Bob and Jill Case Study CASD Income and Death Benefit Assumptions

Year of Termination	CASD Retirement Income	CASD Death Benefit
1	$8,333	$216,667
2	16,667	433,333
3	25,000	650,000
4	33,333	866,667
5	41,667	1,083,333
6	50,000	1,300,000
7	58,333	1,516,667
8	66,667	1,733,333
9	75,000	1,950,000
10	83,333	2,166,667
11	91,667	2,383,333
12	100,000	2,600,000

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Doug English, founder of ACT Advisors, has served senior credit union executives' personal financial analysis and risk management needs for more than 20 years. He recently launched a podcast, C.U. on the Show, where he interviews industry insiders, seeking out insights credit union leaders can use to drive personal financial success.

Educational Resources

Webinar Replay: Don't Tell Anyone... But You're Planning Your Exit Strategy— actionable and strategic steps to take 10, 5, and even 1 year before retirement. https://act-advisors.com/webinar-dont-tell-anyone-but-youre-planning-your-exit-strategy/

Webinar Replay: How High-Income Earners Can Prepare for New Tax Laws— as a credit union executive, you may fall into the the salary range most heavily impacted by the Biden Administrations proposed tax laws. https://act-advisors.com/how-high-income-earners-can-prepare-for-new-tax-laws/

C.U. On the Show Podcast—Personal Financial Wisdom for Credit Union Executives. Timely information on maximizing benefits, reducing risk, and becoming more strategic about your own finances. https://podcasts.apple.com/us/podcast/c-u-on-the-show/id1566211665

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About ACT Advisors

When you advance to the executive suite, your finances reach another level, too. That's when strategic financial guidance can be a helpful solution. We design strategic financial plans that optimize the specialized retirement plans of the credit union executive suite. As experts in credit union retirement strategies, we can help.

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