WHITE PAPER

The 125% Credit Union Executive

Same Executive, Same Benefits Package, 25% More Resources Through Planning

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• WEALTH MANAGEMENT •

Executive Summary

The typical credit union executive benefits package presents many complexities that require personal, strategic financial planning.

The COVID-19 pandemic and the resulting phenomenon of the Great Resignation has disrupted labor markets across many sectors of the economy and credit unions are no exception. While much of the impact has been felt more in entry-level positions, there is a growing trend of retirements for CEOs. Credit unions seeking to replace executive leadership are faced with the high cost of benefits packages in the war to attract and retain top talent. However, most organizations are overlooking an important and inexpensive element to their offerings that can provide enormous benefit to their executives: financial planning.

In addition to the traditional 401(k) plan, most credit union executive benefits packages include some combination of collateral assignment split-dollar, 457(b), and 457(f) plans. However, without personal financial planning that optimizes income timing, risk allocation, and tax planning opportunities, the executive does not realize the full impact of their benefits suite. Financial planning is one of the least expensive benefits that a credit union can provide its executives while greatly improving their financial outcomes—by as much as 25%. The peace of mind that comes from engaging in this process also results in less financial stress and an executive that is more focused on leading their credit union.

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Executive Financial Planning is an Essential Component of a Robust Benefits Package

As in any industry, credit unions are engaged in an ongoing struggle to attract, retain, and compensate key executive talent. The Great Resignation of 2021 has made this a more difficult task. The pandemic has prompted many Americans to reevaluate their priorities, lifestyles, and work arrangements. Millions have quit their jobs in search of better pay, more flexibility, and a better work-life balance leaving massive labor shortages across most industries. Although credit unions have experienced this phenomenon more with entry-level positions, an increasing number of CEO retirements have credit unions searching for new leadership as well. Many CEOs delayed retirement during the pandemic to avoid leadership transition during such turbulent times. As operations have slowly returned to normal, CEO retirements increased sharply in late 2021 and the trend is expected to continue over the next few years.

As credit unions are presented with the task of recruiting and hiring their next generation of leadership, they must continue to adapt their benefits packages to meet this challenge. Executive benefits are expensive, and there are a limited number of traditional tools available. However, there is an essential element missing from most benefits packages that can provide massive value with little cost: financial education and planning.

Over the last 20 years, the consolidation of credit unions has driven executive salaries higher. Contribution limits to ERISA plans like 401(k)s make it difficult for highly compensated individuals to save enough for retirement to provide adequate income replacement. Over the years, the industry has evolved and now has many benefit tools at its disposal, such as 457(b) and 457(f) plans and collateral assignment split-dollar plans (CASD). These benefits, in tandem with a traditional 401(k), can make a substantial impact on an executive's retirement picture. However, many credit union leaders do not fully understand their benefits and how they work together.

Most employer-provided retirement education is geared toward the needs of the rank-and-file employee who can save enough for retirement through traditional means. It doesn't fully recognize the complexities surrounding taxes, timing, and risk that these benefits introduce into a personal financial plan. In the following case study, we will examine these issues and how, through proper financial planning, an executive can maximize the value of their benefits package with minimal cost.

The Power of Executive Financial Planning

Pam is a 50-year old credit union executive. She was recently promoted to CEO and with the promotion was granted a CASD to supplement her 401(k) and 457(b) plans. Figure 1 outlines Pam and her spouse Jim's financial details.

When planning for her retirement, Pam has several decisions to make. For each of her employer plans, she must choose when to begin income distributions and how much to take. She also must determine how to allocate risk across her portfolio before and after retirement. The choices she makes when structuring her benefits will greatly impact her financial outcomes in retirement.

FIGURE 1

Pam and Jim Case Study: Financial Details

- Total annual compensation package of $325,000.
- 401(k) balance of $700,000—Pam makes the maximum annual contribution with catch-up, $27,000 for 2022, and the credit union makes a 5% matching contribution.
- 457(b) balance of $100,000—Pam makes the maximum annual contribution—$20,500 for 2022.
- Pam's CASD will provide $100,000 annual tax-free income in retirement for 25 years.
- Taxable investment portfolio of $150,000 invested in a growth model, moving to a balanced model at retirement.
- Cash savings of $75,000.
- Her spouse Jim has a $150,000 rollover IRA.
- Pam and Jim plan to begin social security benefits of $39,876 and $19,938 respectively at their full retirement ages of 67.
- Pam plans to retire at age 62.

Traditional Financial Education

First, we will examine Pam's retirement picture assuming that she structures her income timing and risk allocation according to traditional financial education.

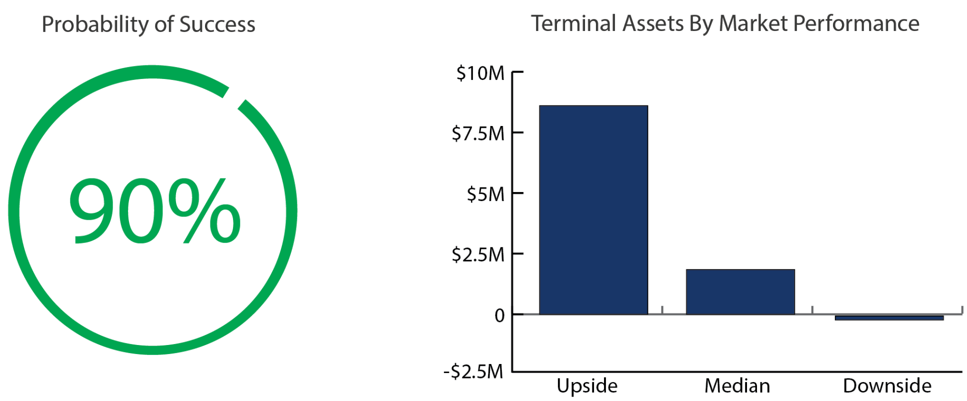
Pam decides to take distributions from her 457(b) plan over a ten-year period immediately following retirement. Since these distributions are entirely taxable, she feels that this is necessary to distribute the tax liability over several years. This results in an annual withdrawal of $115,000 from her 457(b). Additionally, she decides to receive income from her CASD immediately after retirement.

Pam has always been taught that as you approach retirement, you should decrease the risk in your portfolio. So, at retirement, she reallocates her 401(k) and 457(b) accounts and Jim's IRA from a growth strategy with an 80/20 mix of stocks to bonds to a more conservative 50/50 balanced mix.

Pam realizes that after she retires, she and Jim will need to purchase private health insurance, so she budgets $26,400 annually[1] in today's dollars for the years between retirement and the beginning of Medicare at age 65. Finally, she estimates that she will need $160,000 in after-tax dollars for living expenses in retirement through age 90, decreasing to $125,000 thereafter. An inflation rate of 3.25% is assumed for all expenses.

The success of financial plans is commonly evaluated with a Monte Carlo simulation. This is a statistical tool that analyzes the probability of a plan's success by using 1,000 randomly generated scenarios of market return. Using the assumptions described above, the following is a representation of the Monte Carlo analysis which, in addition to the probability of success, predicts the remaining value of Pam's portfolio at death.

Traditional Financial Education Scenario Monte Carlo Analysis



	Percentile	Portfolio Assets
Upside	97.5%	$8,853,418
Median	50.0%	$2,350,399
Downside	2.5%	($176,999)

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1 The average cost of a silver plan on the Affordable Care Act (ACA) exchange for a couple.

Executive Optimized Financial Planning

Although this is a strong retirement plan, it can be improved substantially by strategic risk allocation, timing of income, and tax planning. Let's examine an optimized version of Pam's plan.

In the first version of her plan, Pam decreases the risk level in her 401(k) at retirement. This is consistent with traditional retirement education that assumes withdrawals will begin soon after retirement. In Pam's situation, we project that she will not need to withdraw from the 401(k) until she begins taking her required minimum distributions (RMDs) at age 72. With a time horizon of greater than ten years, she can maintain the more aggressive 80/20 growth allocation in this account for longer—until age 71.

Next, a major consideration in the timing of distributions from a 457(b) deferred compensation plan is that, although it consists of Pam's contributions only, they are considered assets of the credit union and can be at risk of forfeiture. For this reason, many individuals prefer to take these distributions soon after retirement. We project Pam's 457(b) plan to be worth approximately $835,000 at retirement and assume that she will take a full lump-sum distribution the year after retirement (age 63). After taxes and living expenses for the year, she invests the excess cash flow into her taxable investment account. By distributing the 457(b) in one year, she can delay the start of her CASD income by a year.

Pam will be able to cover her living expenses for the next several years with her tax-free CASD income and her personal savings resulting in little or no taxable income for those years. This tax situation creates additional financial planning opportunities that would not have otherwise been available without tax-free CASD income and strategic timing of the 457(b) distribution. The following income tax table illustrates the dramatic reduction in the effective tax rate that Pam would experience in early retirement.

Executive Optimization Income Tax Projection

	Year	Age	Gross Total Income	Regular Federal Income Tax	Capital Gains Tax	State Income Tax	Total Income Tax	Effective Income Tax Rate
	2033	60/60	$472,735	$86,252	$0	$41,633	$127,885	27.05%
	2034	61/61	489,221	89,715	0	43,219	132,934	27.17
Retirement	2035	62/62	506,331	93,148	0	44,865	138,013	27.26
	2036	63/63	823,322	221,737	0	73,173	294,910	35.82
	2037	64/64	144,165	707	0	495	1,202	**0.83**
	2038	65/65	139,238	0	0	177	177	**0.13**
	2039	66/66	187,107	4,654	0	2,629	7,283	**3.89**
	2040	67/67	178,624	3,292	0	2,120	5,412	**3.03**
	2041	68/68	230,490	8,333	0	0	8,333	**3.62**
	2042	69/69	228,403	7,645	0	0	7,645	**3.35**
	2043	70/70	240,403	9,114	0	0	9,114	**3.79**
	2044	71/71	341,284	24,320	0	4,661	28,981	**8.49**
RMDs Begin	2045	72/72	433,384	46,200	0	9,279	55,479	12.80
	2046	73/73	449,022	48,924	0	9,877	58,801	13.10
	2047	74/74	466,433	52,058	0	10,562	62,620	13.43
	2048	75/75	483,765	55,133	0	11,236	66,369	13.72

Low effective income tax rates

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For those retiring before Medicare eligibility at age 65, a major concern is the high cost of private health insurance. In the first version of Pam’s plan, she budgeted $26,400 annually in today's dollars for health insurance as a couple. Since she took 457(b) distributions over a 10-year period at $115,000/year, they will have too much taxable income to receive assistance on their insurance premiums obtained through the Affordable Care ACT (ACA).

In the optimized version of Pam’s plan the 457(b) is distributed in a lump sum in one year, and there will be two years in which there will be close to no taxable income. In those years, Pam can qualify for the maximum premium assistance tax credit and pay almost nothing for health insurance. For an individual like Pam, who has been highly compensated for many years, the thought of qualifying for heavily subsidized health insurance may sound unrealistic but is made possible by tax-free CASD income and proper timing of 457(b) distributions.

After Pam reaches Medicare eligibility at age 65, she can recognize additional income without jeopardizing the tax credits she received for health insurance. Therefore, the years between 65 and 71, before RMDs begin at 72, are ideal years to take advantage of the continued low-income tax situation by converting 401(k) assets to Roth. Between ages 65 and 71, we assume that Pam makes a series of annual Roth conversions totaling $140,000 over six years. These conversions will allow her to recognize income from 401(k) withdrawals at lower tax rates and decrease the size of the account that will be subject to minimum distribution requirements. These conversions lower her first RMD at age 72 by approximately $8,000 and this difference will grow each year for the remainder of Pam's lifetime resulting in a total cumulative tax savings of approximately $127,000. Additionally, since our projections indicate that it is not likely that Pam will need to take distributions from the Roth, we have assumed that it remains invested in a growth model throughout retirement.

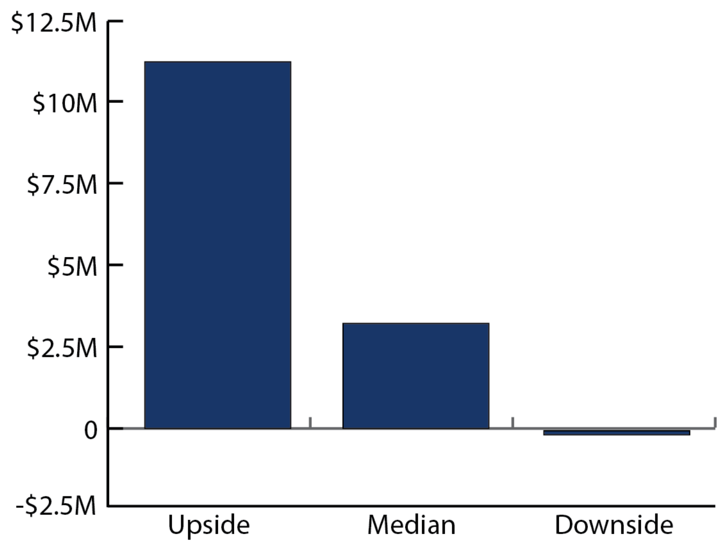
Traditional Financial Planning	Executive Optimized Financial Planning
• Distributes $115,000 annually from 457(b) over a 10-year period beginning in retirement year. • Begins CASD distributions in retirement year. • At retirement, reallocates 401(k) and 457(b) to a more conservative investment allocation. • $26,400 annual budget for health insurance premiums in today's dollars for the years between retirement and Medicare eligibility.	• Lump-sum distribution of 457(b) the year after retirement. Remainder after tax and living expenses invested in a taxable account. • CASD distributions are delayed to two years after retirement. • At age 71, reallocates 401(k) to a more conservative investment allocation (aligned with time horizon of account, not retirement date). • Saves $50,050 in today's dollars in health insurance premiums over a two year period by structuring income to qualify for tax credits before Medicare. • Roth conversions in low-tax years allow for income to be recognized at lower tax rates and decrease the account size subject to RMDs.

The following represents the Monte Carlo analysis for the optimized version of Pam's plan:

Executive Optimized Planning Scenario Monte Carlo Analysis

Probability of Success

Terminal Assets By Market Performance



	Percentile	Portfolio Assets
Upside	97.5%	$11,336,125
Median	50.0%	$2,942,699
Downside	2.5%	($174,950)

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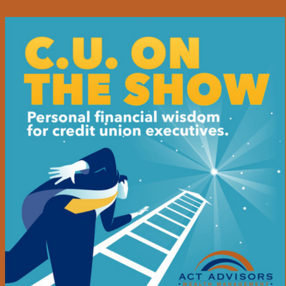
The probability of success for this scenario is only slightly higher than in the non-optimized version of the plan. However, under median levels of market return, in today's dollars, Pam's portfolio assets are projected to be approximately $2.9 million at her death—an improvement of 25% from the first version. This is a dramatic improvement made simply by engaging in an inexpensive process of strategic financial plan optimization.

Conclusion

As Pam's case study illustrates, the executive benefits provided by credit unions are instrumental in ensuring a comfortable retirement for its leaders. However, without proper financial planning, executives cannot realize the full impact of those benefits. While CASD, 457(b), and 457(f) plans may require hundreds of thousands of dollars to fund and maintain, subscription based financial planning for credit union executives is available for as little as $6,000 per year. Only about 25% of all credit unions provide financial planning for their executives, and it is most prevalent in larger credit unions. Given the complexities that credit union executive benefits present, it is essential that executives are provided with personal financial planning advice. In addition to maximizing the impact of credit union benefits, financial planning also has the equally important effect of providing education and peace of mind that will keep executives focused on leading their credit union rather than on their financial future.

The 125% CU Executive

- 25% increase in projected terminal investment assets under median levels of market returns.
- Pam feels financially secure and focused on the credit union rather than her own finances.
- Approximately $127,000 in cumulative tax savings from Roth conversion strategy.
- $50,050 total health insurance premium savings in today's dollars over a two-year period.
- The credit union retains Pam as CEO until age 62.
- The credit union is able to attract a talented successor CEO.



Listen to this C.U. on the Show podcast episode to learn more about financial planning for credit union executives.

Why Financial Planning is an Essential Executive Benefit for Credit Union Leaders https://act-advisors.com/why-financial-planning-is-an-essential-executive-benefit-for-credit-union-leaders/

Appendix—Case Study Assumptions

- Life expectancy—age 100 for both clients.
- Income and expenses are indexed at 3.25% annually.
- Investment return assumptions:
    - Cash savings: 0.50%
    - Investment models:
        - Growth: 80/20 mix of stocks to bonds with an average long-term annual return of 7.81%
        - Balanced: 53/47 mix of stocks to bonds with an average long-term annual return of 5.97%
- Yearly excess cash flows are assumed to be spent in pre-retirement and saved in retirement.
- Federal income tax calculations based on current tax law. State calculations are based on North Carolina tax law.

Sources

1. NAFCU-Gallager, 2020 Executive Compensation and Benefits Survey
2. McCarthy, Ken "Just tired: Why so many bank, credit union CEOs are calling it quits" American Banker December 7, 2021

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Educational Resources

White Paper: When to Take Strategic Risk in Your Credit Union—Your ACTion point. https://act-advisors.com/when-to-take-strategic-risk-in-your-credit-union-your-action-point/

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/

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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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