



STATE OF INDIANA

DEPARTMENT OF FINANCIAL INSTITUTIONS

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DEPOSITORY DIVISION ADVISORY LETTER 2018-01 UPDATED MARCH 6, 2019

TO: Indiana state-chartered credit unions

FROM: Thomas C. Fite, Director
Christopher C. Dietz, Deputy Director, Depository Institutions

RE: Loan Regime Split-Dollar Life Insurance Programs and the Impact of Indiana Code 28-7-1-17.2 (Federal Reserve Board Regulation O)

As a result of several inquiries, the Indiana Department of Financial Institutions (“the Department”) is providing the following advisory to Indiana state-chartered credit unions regarding the applicability of Indiana Code § 28-7-1-17.2 to Loan Regime Split-Dollar compensation programs. This advisory intends to provide clarity regarding the regulatory expectations and standards of the Department concerning such activity.

Background

Financial institutions use split-dollar life insurance arrangements to provide retirement benefits and death benefits to certain employees as part of their compensation packages. Under split-dollar arrangements, the employer and the employee share the rights to the policy's cash surrender value and death benefits. Generally, under the Loan Regime Split-Dollar program, the employee purchases a life insurance policy and the employer agrees to lend the employee all of, or a portion of, the money to pay the premiums. In most cases, the employer prepays premiums to the insurance carrier using a Premium Deposit Account held at the insurance company. The insurance company debits the account every year to cover the required premium. The lump sum payment is treated as a single loan from the employer to the employee. In a Loan Regime structure, the employee signs an agreement and collaterally assigns the policy to the employer to secure the premium payment. The employee can then use the value of the policy to supplement retirement costs while the policy is active and potentially provide a return to beneficiaries at the policy owner's death. At a designated time or even over a period of time, the employee repays the loan via an agreement with the employer. The repayment can be set-up as a term loan or a demand loan, with most plans using the term loan structure to specify a maturity date for the premium repayment. Often times the plan structure will include a roll-out option, where the

employee can buyout the assignment of the policy by the credit union, repaying the credit union before the original term matures.

Application of IC § 28-7-1-17.2

In Indiana, state-chartered credit unions can use the Loan Regime Split-Dollar option if the structure of the plan does not financially obligate the employee to the credit union in excess of the thresholds established in IC § 28-7-1-17.2. Credit unions can do this in various ways, such as establishing an agreement that only obligates the employee to repay the portion of the collateral shortfall below the Regulation O threshold or using a non-recourse loan structure to fund the premium payment. In the case in which a non-recourse loan structure is used to fund the premium payments on the policy, the structure of the agreement must ensure that the employee does not have any potential financial liability, combined with other transactions, to the credit union, at any time, which would exceed the \$100,000 threshold specified in IC § 28-7-1-17.2, including during a defined vesting period. Given the collateral assignment structure in a non-recourse relationship, the cash surrender value of the policy plus the balance of the premium deposit account, or the death benefit derived from the policy, is the sole repayment source. The repayment from the policy is dependent on the insurer, not the employee; therefore, this structure is not considered an obligation of the employee.

Safety and Soundness Considerations

If a non-recourse loan structure is used, loss exposure to the net worth position of the credit union should be considered when structuring these compensation benefits. If an employee were to: voluntarily leave employment or be terminated *prior to* the cash surrender value, the premium deposit account value, and the tax fund account equaling, (or is in excess of) the premium outlay, the credit union would bare the sole financial risk of the collateral shortfall. In order to limit loss exposure to the net worth position of the credit union, the following standards have been established by the Department:

- The potential loss exposure in the event of surrender should be carefully assessed by the credit union's board of directors. The Department's position is that loss exposure, in aggregate for all split-dollar holdings, above **3%** of net worth does not comport with principles of safety and soundness. Examiners will assess safety and soundness concerns during routine examinations when analyzing net worth of each specific credit union, including a possible determination that the **3%** threshold may in some cases be too high based on the financial condition of the credit union. Credit Unions should consult with the external accountant to determine the proper balance sheet recognition of the asset based on the plan structure. EITF No. 06-10 Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements addresses the balance sheet recognition of non-recourse loan arrangements.
- The credit union's board of directors should ensure the plan document and agreement place parameters around employee withdrawals from the repayment source of the arrangement in order to ensure sufficient value remains in the policy to repay the premium outlay. The agreement should specify that employees are not allowed to withdraw funds in an amount that will leave insufficient policy value at the maturity term of the arrangement, and the original agreement should outline a specific dollar withdrawal limit, as determined by an actuarial review of the arrangement.
- The credit union's board of directors should ensure that the cash surrender value of such policies, combined with any Credit Union Owned Life Insurance ("CUOLI"), should not

exceed the total concentration guidelines on life insurance. The aggregate cash surrender value of all life insurance policies should not to exceed twenty-five percent (25%) of net worth, and the aggregate cash surrender value of life insurance from any one carrier should not to exceed fifteen percent (15%) of net worth.

- The credit union's board of directors should be aware of the impact to liquidity when implementing this compensation strategy. In the Loan Regime structure the credit union is not the owner of the policy, therefore they cannot easily control liquidation of the policy. A credit union should consider addressing this issue in any agreement with the employee.
- In addition to regulatory treatment, the credit union's board of directors should also consider tax treatment under Treasury and IRS regulations when implementing a split-dollar program.

If there are additional questions regarding this advisory opinion please contact Christopher Dietz at 317-617-8440 or cdietz@dfi.in.gov.

EITF ABSTRACTS

Issue No. 06-10

Title: Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements

Dates Discussed: November 16, 2006; March 15, 2007

References: FASB Statement No. 5, *Accounting for Contingencies*
FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*
FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*
FASB Statement No. 154, *Accounting Changes and Error Corrections*
FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*
FASB Concepts Statement No. 6, *Elements of Financial Statements*
APB Opinion No. 12, *Omnibus Opinion—1967*
APB Opinion No. 21, *Interest on Receivables and Payables*
AICPA Issues Paper, *Accounting for Key-Person Life Insurance*, dated October 31, 1984
International Accounting Standard 19, *Employee Benefits*
EITF Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements"
EITF Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4"

ISSUE

1. Companies purchase life insurance for various reasons that may include protecting against the loss of "key" employees, funding deferred compensation and postretirement benefit obligations, and providing an investment return. The two most common types of arrangements are endorsement split-dollar life insurance arrangements and collateral assignment split-dollar life insurance arrangements. Generally, the difference between these arrangements is dependent upon the ownership and control of the life insurance policy. In an endorsement split-dollar life insurance arrangement, the company owns and

controls the insurance policy, whereas in a collateral assignment split-dollar life insurance arrangement, the employee (or the employee's estate or a trust controlled by the employee, hereinafter referred to as the "employee") owns and controls the insurance policy.

2. The Task Force reached a consensus on Issue 06-4 that for an endorsement split-dollar life insurance arrangement, an employer should recognize a liability for future benefits in accordance with Statement 106 (if, in substance, a postretirement benefit plan exists) or Opinion 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee.

3. The issues are:

Issue 1— Whether an entity should recognize a liability for the postretirement benefit associated with a collateral assignment split-dollar life insurance arrangement in accordance with either Statement 106 (if, in substance, a postretirement benefit plan exists) or Opinion 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee

Issue 2—How an employer should recognize and measure the asset in a collateral assignment split-dollar life insurance arrangement.

EITF DISCUSSION

4. The Task Force reached a consensus on Issue 1 that an employer should recognize a liability for the postretirement benefit related to a collateral assignment split-dollar life insurance arrangement in accordance with either Statement 106 (if, in substance, a postretirement benefit plan exists) or Opinion 12 (if the arrangement is, in substance, an individual deferred compensation contract) if the employer has agreed to maintain a life insurance policy during the employee's retirement or provide the employee with a death

benefit based on the substantive agreement with the employee. For example, if the employer has effectively agreed to maintain¹ a life insurance policy during the employee's retirement, the estimated cost of maintaining the insurance policy during the postretirement period should be accrued in accordance with either Statement 106 or Opinion 12. Similarly, if the employer has effectively agreed to provide the employee with a death benefit, the employer should accrue a liability for the actuarial present value of the future death benefit as of the employee's expected retirement date, in accordance with either Statement 106 or Opinion 12.

5. The Task Force observed that all available evidence should be considered in determining the substance of the arrangement, such as explicit written terms of the arrangement, communications made by the employer to the employee, the employer's past practices in administering the same or similar arrangements, and whether the employer is the primary obligor for the postretirement benefit. For example, if the terms of the arrangement are such that the employer has no obligation, either stated or implied, to provide loans to an employee to cover insurance policy premiums in the postretirement period, that may be an indication that there is no postretirement obligation. However, if the employer through the collateral assignment arrangement with the employee has an obligation, either stated or implied, to provide loans to an employee to cover the experience gains and losses of the insurance company, that may indicate that an employer

¹ For purposes of this Issue, an employer has agreed to maintain a life insurance policy if the employer has a stated or implied commitment to provide loans to an employee to fund premium payments on the underlying insurance policy during the postretirement period. Absent evidence to the contrary, it shall be presumed that an employer will provide loans to an employee to fund premium payments on the underlying insurance policy in the postretirement period if the employer has provided loans in the past or if the employer is currently promising to provide loans in the future.

has a postretirement benefit obligation. In determining the appropriate measurement and attribution of the cost and obligation under any particular arrangement, employers should refer to the guidance in Statement 106 or Opinion 12, as applicable.

6. In periods following the inception of the collateral assignment split-dollar life insurance arrangement, the Task Force observed that employers should continue to evaluate (pursuant to the guidance in Statement 106) whether a change in facts and circumstances (for example, an amendment to the arrangement or change from the employer's past practice) has altered the substance of the collateral assignment split-dollar life insurance arrangement, which could result in a liability or an adjustment to a previously recognized liability, for a postretirement benefit.

7. On Issue 2, the Task Force reached a consensus that an employer should recognize and measure an asset based on the nature and substance of the collateral assignment split-dollar life insurance arrangement. The Task Force observed that in determining the nature and substance of the arrangement, the employer should assess what future cash flows the employer is entitled to, if any, as well as the employee's obligation and ability to repay the employer. For example, if the arrangement limited the amount the employer could recover to the amount of the cash surrender value of the insurance policy held by the employee (or retiree), and if the employer's loan to the employee (or retiree) is greater than the cash surrender value of the insurance policy, at the balance sheet date the employer's asset would be limited to the amount of the cash surrender value of the insurance policy. Conversely, if the arrangement required the employee to repay the employer irrespective of the collateral assigned and the employer (a) has determined that

the employee loan is collectible and (b) intends to seek recovery beyond the cash surrender value of the life insurance policy, the employer should recognize the value of the loan (including accrued interest, if applicable) considering the guidance in Opinion 21. An employer should evaluate all available information in determining the nature and substance of the collateral assignment split-dollar life insurance arrangement.

Transition

8. The consensus in this Issue is effective for fiscal years beginning after December 15, 2007, including interim periods within those fiscal years. Earlier application is permitted. Entities should recognize the effects of applying the consensus in this Issue through either (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods.

9. If an entity chooses to apply the consensus in this Issue as a change in accounting principle through a cumulative-effect adjustment to retained earnings, the entity should disclose the cumulative effect of the change on retained earnings or on other components of equity or net assets in the statement of financial position.

10. If an entity chooses to apply the consensus in this Issue as a change in accounting principle through retrospective application to all prior periods, the entity should include the recognition of:

- a. The cumulative effect of the change in accounting principle on periods prior to those presented reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented

- b. The cumulative effect of the change in accounting principle on retained earnings or on other components of equity or net assets in the statement of financial position as of the beginning of the first period presented
 - c. Adjustments to financial statements for each individual prior period presented to reflect the period-specific effects of applying the change in accounting principle.
11. If an entity chooses to apply the consensus in this Issue as a change in accounting principle through retrospective application to all prior periods, the entity should disclose the following:
- a. A description of the prior-period information that has been retrospectively adjusted
 - b. The effect of the change in accounting principle on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement caption, and any affected per-share amounts for any prior periods retrospectively adjusted
 - c. The cumulative effect of the change in accounting principle on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.

Board Ratification

12. At its March 28, 2007 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

STATUS

13. No further EITF discussion is planned.

Suggested Index Entries for Issue No. 06-10, “Accounting for Collateral Assignment
Split-Dollar Life Insurance Arrangements”

COMPENSATION TO EMPLOYEES: DEFERRED

Split-Dollar Life Insurance Arrangements

. . Collateral

Assignment 06-10

LIFE INSURANCE

Split-Dollar Life Insurance Arrangements

. . Collateral Assignment

06-10

POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

Split-Dollar Life Insurance Arrangements

. . Collateral

Assignment 06-10