John E. Pesh
Director, Executive Benefits Advanced Sales Support
Phone: 608-665-8223
Fax: 608-236-7356
E-mail: John.Pesh@cunamutual.com

CUNA MUTUAL GROUP

May 27, 2014

Via E-mail (regcomments@ncua.gov)

Gerard Poliquin,
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Comments on Proposed Rule: Prompt Corrective Action – Risk-Based Capital

Dear Mr. Poliquin:

On behalf of the companies of the CUNA Mutual Group, I am pleased to provide comments on NCUA's proposed rule on Risk Based Capital. CUNA Mutual Group is the nation's leading provider of financial products and services to credit unions and credit union members.

Specifically in relation to the proposed rule, CUNA Mutual makes available various executive and employee benefit programs to help credit unions attract and retain high quality employees. Under NCUA Rule 701.19(c) and related state laws, federal and most state chartered credit unions may use otherwise impermissible investments to support competitive executive benefit plans and to keep pace with the rising cost of employee benefit plans generally. We are concerned that the proposed rule will adversely affect the ability of credit unions to do both thereby creating significant strategic risk for credit unions.

These comments will focus on the aspects of the proposed rule that we believe will negatively impact credit unions' ability to maintain competitive executive and employee benefit programs, leaving other significant aspects of the rule for others' comment.

<u>CONCERN</u>

The proposed Risk Based Capital rule does not take into account some critical factors as it relates to impermissible investments that are purchased for the purpose of funding for employee and executive benefit plans:

- The proposed rule does not take into account the purpose of the assets and their applicability to benefits funding, potentially creating risks from both a fiduciary front as well as the retention of front-line employees and executives.

- The rule aggregates mutual funds and related investments without considering the relative risks of the underlying holdings, management, investment strategies and objectives.

As a result of the currently proposed Risk Based Capital rule, credit unions will be less likely to fund and offer executive benefit plans. This will make them less attractive to quality executive talent, and lead to a long term erosion of overall credit union competitiveness compared to banks and other financial services related industries in the battle for talented front-line and executive employees.

In addition, credit unions will be less likely to fund appropriately for employee benefits in general. With employee benefits costs rising faster than the rate of inflation and the prevailing interest rates that credit unions can invest at, more money will have to be used to provide benefits leading to less money being used to fund other credit union initiatives, ultimately creating a rag on the progress credit unions are able to make in supporting their members.

The following sections describe the risks relating to various types of benefit plans and the different types of investments used to fund the credit union obligations, if any, under those plans. A recommended risk-weighting is included with each of the investment types.

<u>BENEFIT PLAN RISKS AND RECOMMENDED RISK WEIGHTING</u>

Investments that are held to fund a specific employee's defined contribution plan

- Employee bears all the investment performance risk, including loss of principle.
- Though held on the credit union's balance sheet, these investments should not be subject to the RBC requirements because they present no risk to the credit union and they should be excluded from both the numerator and the denominator of the RBC calculation.
- Applying the RBC requirements to these investments will create strategic risk for credit unions as they will be unable to effectively offer competitive benefit plans to attract and retain high quality employees and executive talent.

Investments that are held to fund a specific employee's defined benefit plan

- CU bears the investment risk, including loss of principle.
- These investments should be subject to the RBC requirements but at a percentage commensurate with the risk each presents. See investment product discussion below.

Investments that are held to fund employee benefit plans provided to the general employee population

- CU bears the investment risk, including loss of principle.
- These investments should be subject to the RBC requirements but at a percentage commensurate with the risk each presents. See investment product discussion below.

Plan contextual risk weight recommendation: Investments funding defined contribution non-qualified deferred compensation plans should not be subject to the RBC requirements and should be excluded from both the numerator and the denominator of the RBC calculation.

INVESTMENT PRODUCT DISCUSSION AND RECOMMENDED RISK WEIGHTINGS

For impermissible investments that are not directly correlated to an executive benefit, credit unions are using:

- Life Insurance
- Annuities
- Mutual Funds, ETFs, and Institutionally Managed Investment Accounts

Discussion for each will include the proposed risk weight, factors to consider including analysis of various risks, common accounting practices from other industries, and a recommended risk weight.

Life Insurance

Life insurance can potentially have multiple risk weightings under the proposal. Normal accounting practice is to carry any life insurance and annuity product as an “Other Asset” which has a risk weight of 100%. However, the Form 5300 instructions specify that any “Other Asset” held for the purpose of funding for a deferred compensation plan is to be recorded as an “Other Investment Asset” which has various risk weightings based on Weighted Average Life (WAL). It is unclear what the WAL should be for a life insurance product.

Life insurance comes in different forms:

- Whole Life Insurance – a permanent life insurance product that also has cash values. Cash values accumulate at a guaranteed rate of interest which the insurance company cannot change. Insurance carriers also have the ability to declare dividends annually in addition to the guaranteed performance of the policy. Policy charges (e.g. – cost of insurance) are already factored into the guaranteed performance of the policy cash values so as long as premiums are paid, the policy has guaranteed cash values and death benefits.
- Term life insurance – a temporary insurance product purchased for a specified “Term” of years (e.g. – 10, 15, 20). Term insurance has no cash value and does not affect the balance sheet so is not germane to this discussion.
- Universal Life Insurance – a permanent life insurance product that also has cash values. Cash values accumulate at a declared rate of interest which the insurance company can re-declare periodically. Policy charges (e.g. – cost of insurance) are taken out of the cash values as well. The products typically have a contractual minimum guaranteed rate of interest and maximum policy charges.

- Indexed Universal Life Insurance – a permanent life insurance product that also has cash values. An indexed life insurance product credits based on the performance of a selected index (e.g. – S&P 500), but within a "collar". A typical collar might be 0%-10% (varies by company and product, but used here for illustrative purposes). If the index performs within that collar, the product credits the actual return. If the index performs above that collar, the product will credit only 10%. And if the index performs below that collar, the product will credit 0%. Policy charges (e.g. – cost of insurance) are taken out of the cash values regardless of index performance. The products typically have a contractual minimum guaranteed collar and maximum policy charges.
- Variable Universal Life Insurance – a permanent life insurance product that also has cash values. Variable life insurance performance is driven by the variable subaccounts. A subaccount is a mutual fund that is only available through an insurance product. Subaccounts have various investment objectives and holdings, from relatively safe (e.g. – government bond fund) to relatively risky (e.g. – emerging markets fund). Policy charges (e.g. – cost of insurance) are taken out of the cash values regardless of subaccount performance. The products do not have a contractual guarantee on the performance of any subaccounts, but do have a contractual guarantee on maximum policy charges.

1) Interest Risk: Life insurance gains/losses are driven by the performance of underlying accounts and are recognized on the income statement in each reporting period. Universal life and whole life insurance performance is based on dividends and credited interest rates which are stated by the insurance carrier and reset periodically. Because the interest rate is declared by the insurance carrier, there is no limited interest rate risk, but because insurance companies may reset crediting and dividend rates periodically, reset interest and dividend rates will factor in economic conditions at that time.

   Indexed life insurance products have some interest rate risk, but that risk is substantially mitigated by the collar that the carrier provides in the product.

   Variable subaccounts typically don't have interest rate risk with individual investments held in those subaccounts, but do carry broader interest rate risks that may be applicable to a specific industry, the economy in general, and, in the case of fixed income investments an inverse relationship between the value of underlying holdings and interest rates in general.

   Different from variable annuities, life insurance products do not offer a Return of Principle feature, but may offer a guarantee of death benefit which can provide the owner an assurance that, upon the death of the insured, even if the subaccounts have lost money, the beneficiary (or beneficiaries, if more than one) will receive the death proceeds.

2) Liquidity Risk: Assets are very liquid at surrender value – proceeds upon surrender typically can be available within a few days. Retail life insurance products typically include surrender charges, decreasing the amount received relative to the account value. Institutional life insurance products typically do not have surrender charges. All permanent life insurance products are also liquid in that cash values can be withdrawn or borrowed against at any time so the policies do not have to be surrendered to be liquid.

3) Credit Risk: Life insurance companies are highly regulated. For universal life, indexed universal life insurance and whole life insurance, assets at risk in the case of insurance company failure. For variable life insurance, the subaccounts are separate and insulated against the insurance company. However, any guarantee of death benefit is backed by the carrier and not protected against insurance company failure. Given the highly regulated nature of life insurance companies, and the requirement that they hold substantial reserves relative to the policyholders' cash values, the risk of insurance company failure is very small.

   Each state also has an insurance guaranty fund to ensure the continuation and payout of death benefits in the case of insurance company failure. The amount of the guaranty fund coverage is state-specific.

Life insurance risk weight recommendation: Record on balance sheet as "Other Asset". *For whole life insurance, risk weight at 20%. For universal life and indexed universal life, risk weight at 100%. For variable universal life, look through to underlying subaccounts and weight according to risk profile of those specific subaccounts, between 20% - 150%. (See mutual fund discussion below for further detail.)*

<u>Annuities</u>

Annuities can potentially have multiple risk weightings under the proposal. Normal accounting practice is to carry any life insurance and annuity product as an "Other Asset" which has a risk weight of 100%. However, the Form 5300 instructions specify that any "Other Asset" held for the purpose of funding for a deferred compensation plan is to be recorded as an "Other Investment Asset" which has various risk weightings based on Weighted Average Life (WAL). It is unclear what the WAL should be for an annuity. Annuities are purchased with a specified duration (common durations include 3, 5, 7 and 10 years).

Some considerations and risks to consider:

1) Interest Risk: Annuities gains/losses are driven by the performance of underlying accounts and are recognized on the income statement in each reporting period. Fixed annuity performance is based on a credited interest rate which is stated by the insurance carrier and typically fixed for the term of the annuity. Because the

interest rate is declared by the insurance carrier, there is no specific interest rate risk.

An indexed annuity credits based on the performance of a selected index (e.g. – S&P 500), but within a “collar”. A typical collar might be 0%-5% (varies by company and product, but used here for illustrative purposes). If the index performs within that collar, the annuity credits the actual return. If the index performs above that collar, the annuity will credit only 5%. And if the index performs below that collar, the annuity will credit 0%. Indexed annuities have some interest rate risk, but that risk is substantially mitigated by the collar that the carrier provides in the product.

Variable annuity performance is driven by the variable subaccounts. A subaccount is a mutual fund that is only available through an insurance product. Subaccounts have various investment objectives and holdings, from relatively safe (e.g. – government bond fund) to relatively risky (e.g. – emerging markets fund). Variable subaccounts typically don’t have interest rate risk with individual investments held in those subaccounts, but do carry broader interest rate risks that may be applicable to a specific industry, the economy in general, and, in the case of fixed income investments an inverse relationship between the value of underlying holdings and interest rates in general.

Many variable annuities offer a Return of Principle feature which can provide the owner an assurance that, at the end of the annuity term, even if the subaccounts have lost money, the owner will receive all of its principle investment back.

2) Liquidity Risk: Assets are very liquid at surrender value – proceeds upon surrender typically can be available within a few days. However the surrender value may include surrender charges, decreasing the amount received relative to the account value.

3) Credit Risk: For fixed and indexed annuities, assets at risk in the case of insurance company failure. For variable annuities, the subaccounts are separate and insulated against the insurance company. However, the Return of Principle feature is backed by the carrier and not protected against insurance company failure.

Annuity risk weight recommendation: Record on balance sheet as “Other Asset”. For fixed and indexed annuities, risk weight at 100%. For variable annuities, look through to underlying subaccounts and weight according to risk profile of those specific subaccounts, between 20% - 150%. (see mutual fund discussion below for further detail)

<u>Mutual Funds, ETFs, and Institutional Managed Money</u>

Mutual funds and ETFs currently carry a risk weight of 150% under the proposal. While all open ended mutual funds and ETFs are liquid within 3 days of surrender, consideration should also include what the funds are invested in. In particular mutual funds can range from highly risky investments such as emerging markets to highly safe investments such as government bonds. In addition to the diverse mutual fund strategies and objectives, mutual funds are, by nature, diversified. When a credit union purchases a bond, it is exposed to the credit risk of that individual issuer. However, when a credit union purchases a bond fund, it is limiting the exposure and impact of default by any given issuer.

In an institutional managed money portfolio, the credit union will work with the money manager to develop a specific investment policy which can include asset classes, types, durations, and benchmarks. Because of the customized nature of such a portfolio, it can allow for more targeted investments while being more broadly diversified than purchasing only a mutual fund. Summary of the risks and considerations follow:

1) Interest Risk: Gains/losses are driven by the aggregate performance of underlying investments. Funds strategies range from safe to risky, market sensitive to market neutral. Managed money portfolios can be more broadly diversified compared to mutual funds. Assets sit in the balance sheet - accounting treatment will determine the effect of gains/losses to financial statements.
2) Liquidity Risk: Assets are liquid at account value (NAV), and surrender proceeds must be received within 3 days.
3) Credit Risk: Securities positions within funds are insulated against the fund company or money manager. Funds are relatively insulated against losses of an individual holding, but not insulated from broader market fluctuations.

Risk weight recommendation: Weight mutual according the risk profile of the fund's underlying investment strategy, managed money according to their actual holdings:

- *State and federal governmental funds: 20%*
- *Municipal bond fund strategies: 50%*
- *Asset backed, mortgage backed, bank loan funds: 100%*
- *Other funds, including ETFs: 150%*
- *Bonds: according to WAL (remaining duration)*
- *Equity securities: 200%*

For all recommended risk weightings, consideration should be allowed for modification if sufficient justification is presented and approved by the NCUA.

Thank you for your consideration of these comments and recommendations. Should you have any questions regarding this submission, please do not hesitate to contact me.

Sincerely,

John E. Pesh
Director, Executive Benefits Advanced Sales Support