Executive Compensation Design Considerations

Many considerations factor into a credit union's decision in how to design its executive compensation plan. Plan components and design decisions are likely to vary depending upon the credit union, its size, level of sophistication, relationship with its sponsor, background of the sponsor, and backgrounds and experience levels of the members serving on the board of directors.

While considerations vary, the following basic questions should be considered in designing an effective package:

1. With whom does the credit union compete for business? For executive talent?

2. How does our executive compensation package compare to those offered by competitors (as defined in the previous question)?

3. Where, geographically, do we compete for executive-level positions? For example, if we had to hire a CEO today, would we most likely find a truly qualified professional locally, regionally or nationally?

4. What levels of compensation are expected by the key people?

5. Where on the salary continuum does the credit union want to pay? Which percentile does the credit union target? Does the chosen percentile place the credit union in the desired competitive position?

6. Do you wish to develop a linkage between incumbent performance and compensation, and how will this be reflected? Through base pay, bonus/incentive compensation or both?

7. What are the most appropriate measures of performance to link to base pay?

8. What are the most appropriate measures of performance to link to bonus/incentive compensation?

9. What is appropriate length of time to measure performance for incentive plan purposes?

10. What are the appropriate short-term incentives vs. long-term incentives for your institution?

11. What type of mix between salary and bonus or incentives will best support credit union objectives and be most consistent with executive job profiles?

12. What laws govern different compensation components, and what are the related compliance risks and burdens for the credit union and its executives?

13. What types of compensation impose the least tax liability for the executives and the credit union?

The Evolving CEO Compensation Equation

Today's complex competitive and regulatory environment requires a great deal from a CEO. A successful credit union CEO must have the ability to develop and communicate a strategic vision for the organization, a critical skill in a risk-filled and constantly changing business environment. A high-caliber CEO has the ability to translate this strategic vision into action at every level of the organization.

As a result, credit union boards have an interest in developing pay strategies to attract and retain the best leadership talent. This means paying for performance, providing total compensation packages that incorporate meaningful incentives/benefits to CEOs and establishing programs to keep the entire program on track on a year-to-year basis.

Changing times are also affecting the attitudes of both CEOs and boards. CEOs are more sophisticated, objective, results-oriented and innovative in their approach to their roles. Top-notch CEOs want to drive their organization's performance. Progressive boards understand their role in this equation. They must define, along with the CEO, the strategic vision and goals for the credit union, which should tie directly to performance goals and expectations of the CEO.

It has become increasingly evident that the development of financial service CUSOs has an effect on compensation patterns for the credit union CEO. The necessity of recruiting key CUSO executives from concerns outside of the credit union can cause significant pay compression issues when well-qualified candidates for CUSO leadership positions may already have compensation packages that equal or exceed that of the sponsoring organization's CEO. This circumstance calls for careful board action such as the upward adjustment of the CEO's compensation arrangement coincident with, or closely following, the recruitment of the outside candidate.

A developing compensation issue for credit unions is long-term incentives. Long-term incentives are programs with a measurement period greater than one year with payout potentials that typically match or exceed short-term incentive opportunities for plan participants. Such plans are a common and expected feature in the financial services industry.

While stock ownership is not an option for credit union executives, other long-term incentive vehicles are available and should be considered as part of the development of a total compensation strategy.

A competitive and performance-based package is essential to attract, motivate and retain the CEO. Retention of a top-notch CEO ensures that the credit union maximizes return on its compensation investment.

Executive Compensation Components Defined

It is important to establish a fundamental understanding of executive compensation components in order to use them correctly. While almost every credit union uses salary and bonus/incentive compensation, not all credit unions have integrated other components. The following definitions are provided as an explanation:

Cash compensation includes salary and cash payouts from annual bonus or incentive plans. Salary is the fixed element of executive cash compensation. Although salary is usually the largest compensation component, its percentage of total executive compensation has declined in recent years as credit unions have increased the variable portion (*i.e.*, the bonus or incentive). A bonus is a discretionary payout not based on predetermined objectives. An incentive, on the other hand, is at-risk compensation that is linked to the achievement of key goals developed and agreed upon at the beginning of the performance period, which is typically one year in duration.

Long-term incentives tie at-risk compensation to longer-term financial performance of the organization. Among publicly traded employers, the most common long-term incentives are stock options. Stock option programs allow participants to purchase stock shares at a future date at a set price today. The plans operate under the assumption the participant will be motivated to consistently perform at a level that increases the value of the employer's stock over time. As such, the executive can exercise his/her option to purchase the shares at the agreed upon (discounted) price at a future date and profit from it.

Phantom stock plans or stock appreciation rights (SAR) are private sector concepts often used in closely held organization to keep ownership undiluted and still provide a long-term incentive structure. Such plans tie contingent financial awards to organizational performance measures that tend to appreciate over time. Incentive payments from such programs are often spread over several years to encourage executive retention because the person must be employed there to receive them. The concept is adaptable to credit unions but must be tied directly to performance so as not to be viewed as deferred compensation, which is subject to stricter guidelines by the IRS.

Deferred compensation generally refers to any compensation that an employee takes as income in the future, rather than in the current year. This generally is done to create a retirement plan supplement. The objective is to defer income to a later date when income is subject to a lower tax bracket.

Key person life insurance is life insurance held by the organization to provide cash to cover the cost of recruitment and replacement of a key executive who dies. Some organizations use whole life insurance policies with the cash value converting to executive ownership over time and with the policy assumable by the executive upon retirement.

A **qualified retirement plan** is a retirement arrangement that receives favorable federal income tax treatment as a consequence of satisfying certain tax code requirements. Qualified plans offer credit unions and employees many advantages but significantly restrict credit unions from using the plans to direct benefits to executives in a special manner. To avoid some of the limits and restrictions of the tax code, some credit unions sponsor non-qualified deferred compensation programs, which include, for example, supplemental executive retirement plans (SERP).

Health insurance is usually provided under the regular health care plan extended to other credit union employees. Annual physical examinations are one of the most common supplemental health benefits credit unions provide to executives.

Life insurance is commonly provided to employees at all levels. However, the maximum benefit in the plan can sometimes fall short of creating a full benefit to the CEO relatively equal to what other employees are receiving. Some credit unions provide executives with additional insurance beyond the standard life insurance package offered to other employees to make up for this shortfall. Typical group-term life insurance may not be the most tax-efficient way of providing life insurance to executives who require larger amounts of life insurance coverage. Some alternatives to group-term coverage for executives include whole life, split-dollar life and non-qualified death-benefit-only plans.

Disability programs are designed to protect an employee from loss of income in the event of a short-or long-term disability. Most credit unions provide disability programs but need to be aware of caps and maximums that restrict executive coverage. Many credit union programs today have monthly caps that are too low to protect executives at the same relative levels as other staff members. This can be remedied by providing supplemental disability coverage.

Perquisites refer to incidental fringe benefits (e.g., use of a company car or auto allowance, spousal travel and club dues). Perks are usually taxable unless they can be excluded from an employee’s income pursuant to a specific tax code section. Types of fringe benefits that may be provided tax-free include those that qualify under the tax code as no-additional-cost services. These may include qualified employee discounts, working condition fringes or “de minimis” fringe benefits (benefits of small value).

Parachute payments (a specific type of severance payment) are paid when an executive is involuntarily terminated through a no-fault situation or after a change in control of the credit union (*e.g.*, a significant change in the board of directors or a merger). The golden parachute has been used as a defensive measure against corporate takeover attempts. Acquiring corporations do not want to incur the expense of paying out the golden parachutes. Severance pay is frequently negotiated into employment agreements of new executives as a protective measure of working with a new credit union and board of directors. This type of arrangement includes a predefined continuing salary payment or a lump-sum payment plus the benefits a credit union will provide to the eligible executive should his or her employment be terminated in the future.

Golden handcuffs are designed to retain executives and are usually provided through deferred compensation. For example, the executive may receive a bonus only after he or she completes a certain period of service and has demonstrated a defined level of performance. In this way, the program is designed to "handcuff" him or her to the credit union.

Questions from the Boardroom

The following are a few of the most frequently asked questions by board members regarding CEO and executive compensation.

1. What is most important in determining competitive compensation for CEOs and executives?

To remain competitive, it is critical to make appropriate market comparisons. For example, if yours is a traditional credit union providing loans, deposit accounts, savings, etc., then compare the executive pay package to the median at credit unions that most closely match your profile. On the other hand, if you are aggressively moving to a full range of financial services similar to community or regional banking institutions, then you may want to lead the market and pay above the median, either targeting the 75th percentile or higher with respect to base salary, total compensation or both measures.

Appropriate competitive market data must be selected and appropriately matched to the credit union's position.

Executive compensation practices are changing for those credit unions that are becoming full-service institutions. Credit unions with aggressive growth goals may also want to look outside the credit union market and develop a broader range of comparisons, including banking and other financial service institutions.

It is critical not to view the CEO's salary as a cost. Instead, view it as an investment with an expected return. This is accomplished by developing a strategically aligned total compensation philosophy that involves base compensation, incentives, benefits and perquisites.

2. How do we obtain critical compensation information, including comparisons, outside the credit union market?
Increasingly, we are asked to offer comparisons between the level of executive compensation in credit unions and the banking community. Several reliable surveys are published on an annual basis that deal with compensation paid to banking executives/employees. Because salaries vary considerably by asset size and geographical location, accurate comparisons can be difficult. When making these comparisons, it is important to note whether the data source is reliable, the sample size is sufficient and an appropriate job match can be made to a banking position.

3. Are surveys trustworthy?
It depends. Well-designed surveys collect data from a large number of institutions, use well-tested data review techniques and are most often conducted by experienced outside firms. Successful firms that conduct salary surveys are experienced in compensation and salary analysis, and objective and competent in statistical analysis.

Sample size is extremely critical when judging the quality of the data. The larger the sample size, the more reliable the data is expected to be. Larger sample sizes reduce the impact that extremely high or low salaries have on the summary statistics.

Poorly designed surveys do not control for sample size and do not provide adequate cautions against using data from small samples. Always consider your survey source when deciding what weight to give it in your analysis.

e**netrix** conducts dozens of compensation surveys covering positions from many sectors of the economy. It is our experience that participants intend to provide accurate information. Of course, inadvertent errors can and do occur, and we have procedures in place to catch and correct as many as we reasonably can in the preparation of the online reports.

4. Our board has a difficult time evaluating the salary trends for our CEO. What can we do?
This is perhaps one of the most challenging issues facing boards when establishing and evaluating compensation levels for a CEO. Unfortunately, it calls upon everyone involved to move into uncomfortable territory. We strongly urge any board that is struggling with this issue to obtain adequate expert advice. Keep in mind that you are not alone on this issue. Most boards struggle with this responsibility.

Further, remember that the credit union, as a business, is part of the financial services industry—**not the industry of its members**. As board members democratically elected to represent members, it is your responsibility to attract and retain the highest quality talent to carry out your mission for the credit union. This means that close attention must be paid to competitive rates and paying reasonably within these parameters. Failure to do so will subject your organization to the significant consequences of under- or over-paying.

Generally speaking, engaging in "bargain shopping" when it comes to employees, particularly executives, seldom lends itself to a positive, long-term result for the employer. A top-notch CEO will be able to save money and generate revenue for the credit union many times greater than the compensation he or she is paid. Again, we encourage you to think about CEO compensation as an investment with an expected return.

5. It's hard to be sure we are using the data correctly and really understand what it means. What can we do?
Consider hiring an expert in the field. Not every board has a member who is knowledgeable about compensation surveys and experienced in interpreting data.

Thoroughly read the survey(s) you are using. Many surveys include explanations of methodology, medians, terms, applications, etc.

Another resource can be your credit union's human resource manager as he or she should be well-versed in the use of compensation surveys.

In general, it is advisable to analyze more than one survey. Although surveys are not inexpensive, their cost is well worth the expenditure and the effort required to analyze the data in a competent manner, given the significance of the decisions you are considering.

Another good resource is the CEO. Bear in mind most CEOs are very aware of compensation patterns within the industry and are quite familiar with methodology, reporting and results.

If these resources still don't provide you with the reassurance you need, you may want to consider contacting a compensation consultant.

How to Use the Survey Data

The following method is intended to serve as a guide for evaluating and establishing CEO and executive salary levels, incentive opportunities, total cash compensation targets and supplemental benefit/perquisite packages. It can also be used in reviewing broader employee benefit plans.

Although survey information is an important tool, keep in mind that it is an approximation of your competitive market's pay levels, not an exact scientific figure. The ways to determine appropriate pay levels for employees vary because each credit union's needs and preferences are different and fluctuate over time. Even looking at pay data in the same survey from one year to the next does not provide an exact number because the credit unions that participate from year to year may change or situational factors occurring during the year may affect one organization more than another.

Compensation survey data provide a starting place, however, and offer a basic guide for paying employees. From this starting place, an individual organization will need to adjust survey values up or down. The next section is a guide for how to do this.

Process for Determining Pay Levels

1. **Identify total compensation principles and goals**
   This means determining what you want to accomplish through the credit union's compensation system (*e.g.*, retain high-performing executives, reward individuals who add significant value, and support and encourage executive team performance) and then setting objectives accordingly.

2. **Assess desired compensation mix among base salary, short-term incentives, long-term incentives, etc.**
   Consider the proportional relationship between base salary, short-term incentives, long-term incentives and, if desired, benefits/perquisites. The desired mix reflects how much risk you want to build into the compensation package and how performance oriented you want to be.

3. **Examine appropriate executive labor markets both geographically and among competitors**
   You might think of this as defining the target marketplace for talent. For example, do you look for executive staff (or typically lose them) in a national or regional marketplace? Do you and/or should you compete for executive talent among organizations of similar size that perform similarly on key performance indicators? Do any specific groups compete with you for executives? Do you compete only with other credit unions or with the broader financial services industry?

   It is becoming more and more common for credit unions to determine peer credit unions and to annually review the total compensation packages of the CEOs from these credit unions to ensure that they are appropriately paying their CEO.

4. **Determine competitive levels for each part of the compensation package**
   Within the bounds of your target marketplace, consider what competitive level (median, 75th percentile or perhaps somewhere in between) is relevant for each piece of the compensation picture. Depending on your credit union's human resources requirements, financial condition and operating performance, it is possible that you may decide to focus on one level for base salary (*e.g.*, median), another for short- and long-term incentives (*e.g.*, 75th percentile) and yet another for benefits (*e.g.*, average). For example, for your Chief Financial Officer's compensation, you might want to be at the competitive level of median salary among credit unions with $200-399.9 million in assets, but at the 75th percentile level in terms of bonus awards.

5. **Compare position descriptions to survey position descriptions**
   A rule of thumb is that if at least 80% and not more than 120% of a job's scope and activities, in terms of the number of responsibilities and level of authority, are the same as the survey position description, you have a good match.

6. **Adjust data depending on quality of match to survey position description**
   If the position is smaller in scope than the survey position, you may consider adjusting the survey data down, generally between 5% and 15%. If the position is larger than the survey position, you may consider adjusting the survey data upward, generally between 5% and 15%. If an adjustment of 20% or more seems suitable, the job is probably not a correct match for the survey position.

7. **Age data to account for market adjustments (no manual calculations are needed when using the automated option within the online surveys)**
   The steps for aging data to a common point in time are as follows: *(1)* divide the number of months that have passed since the survey data's effective date by 12 and *(2)* multiply the result by the assumed market movement. For example, aging six-month-old data assuming a 5% annual salary growth would require increasing the published salary rates by 2.5%.

   Calculation example:

   6/12 = 0.5 or 50%

   50% x 5% (assumed annual salary growth) = .025

   Average Salary Rate x 1.025 = Aged Salary Rate

8. **Select target market criteria (asset size, membership, etc.)**
   You may select one or several criteria depending on which you consider the most important in determining pay levels.

9. **When choosing multiple criteria, assign weightings based on importance of each criterion**
   You may assign weights in any proportion as long as the total weights equal 100 percent. For example, if you believe your CEO compensation level depends equally on two factors, asset size and membership size, assign weights of 50 percent to each of those two factors; each of the remaining factors will have zero percent weight. (This can easily be done using the *Compensation Comparison Worksheet* located on the *Compensation Tools* tab within the online surveys.)

10. **Compare present pay levels and compensation mix (bonus vs. base salary) to survey data**
    Each compensation exhibit has a *Respondent Information* section that lists the demographic characteristics of the market sample and allows you to compare where your credit union falls.

This respondent information is a guide for deciding if you need to adjust the survey numbers for your credit union. For example, if you are looking at CEO compensation in the asset category of $100-199.9 million, you will find a median asset size of $137 million and a 75th percentile of $161 million. 75th percentile pay levels may be considered "market competitive," given the strong correlation between pay and asset size in this survey. If you fall on the high or low end of two adjacent asset categories, you may want to average pay amounts from these two adjoining category levels.

11. Determine what desired pay level should be used

The level you select should be consistent with your compensation philosophy and your target marketplace. If you want to pay at or near market pay levels, you may choose to pay at the median. If you'd like to pay above market levels, target the 75th percentile or perhaps in between the median and 75th percentile. A common strategy in performance-driven organizations is to target base salary at or slightly below the median, but choose the 75th percentile for targeting total compensation (base plus bonus). We have also provided 10th and 90th percentile data within the Executive Survey, although generally the former is too low to attract and retain employees, while the latter generally results in pay levels that are difficult to justify from a cost or strategic perspective.

12. Develop salary and total compensation ranges with your target pay level as the midpoint

It is common to set a range for executive-level employees of +/- 25% or 30% of your target market percentile of base salary or total compensation.

For example, assume you have chosen to target pay levels at the median. If this value is $165,000 (base + bonus) for a $150 million credit union, and you used a +/- 25% range, then your range would be:

$165,000/1.25 = $132,000
$132,000 X 1.5 = $198,000

Minimum	**Midpoint**	**Maximum**
$132,000	$165,000	$198,000

Compensation falling within this range is considered to be competitive. Note: when setting base salary relative to total compensation, remember to consider your compensation mix philosophy (see previous steps). Also, don't forget to age the market data to the present (or to whatever date for your salary review year) to ensure that the figures are current. To age (or trend) salary data, see Step 7 of this section.

13. Decide where each individual's pay belongs in the range

Once you have developed your base salary and/or total compensation ranges, your next step is to determine whether an individual executive's salary is appropriate within the competitive range. Many factors, such as performance, internal equity, experience and/or length of time in position, can influence where an incumbent's pay should fall within the competitive range. Consider the guidelines below:

Employee Characteristics	**Position in Range**
Entry level; little or no relevant job experience in similar position	At or around minimum
Performing most functions of position in a satisfactory manner; substandard overall performance (but performance is clearly improving); at least some experience	Between minimum and midpoint
Performing all functions of position; satisfactory performance levels; experienced	At or around midpoint
Performing all function of position; may have extra responsibilities; performance that often exceeds expectations; experienced	Between midpoint and maximum
Performing all functions of position, including extra responsibilities at an exemplary level; highly experienced	At or around maximum