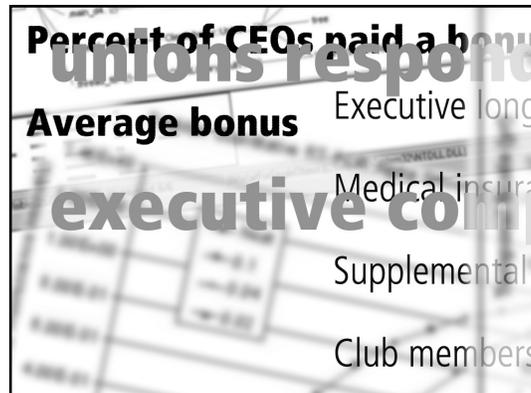


Quantifying the Value of LEADERSHIP

*Complex Executive Compensation Decisions
Face the Boards of the
Nation's Largest Credit Unions*

Written by Karen Bankston with Charles E. Carlson, CCP



Information in this manual is accurate as of the time of publication and consistent with standards of good practice in the general credit union and publishing community. However, as research and practices advance, standards may change. We recommend that readers evaluate the applicability of any recommendations to their particular situation and in light of changing standards.

The views presented in this manual are those of the authors. They do not necessarily represent the views of CUES or CUNA.



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EXECUTIVE SUMMARY

THIS WHITE PAPER EXPLORES the diverse factors that set the nation's largest credit unions apart from other financial cooperatives in terms of the challenges their boards of directors face in hiring and retaining a CEO and establishing a competitive, performance-based executive compensation program.

INTRODUCTION

THE QUALITY of a credit union depends to a great extent on its executive leadership. Thus, designing and maintaining an effective executive compensation program is a top priority for the boards of credit unions of all sizes. Hiring the right CEO is the most important decision most boards ever make; devising a salary, bonus and benefits plan that ties compensation to organizational performance and binds the executive to the credit union runs a very close second.

The total pay and benefits package must recognize the CEO's talents, skills and range of experience, and reflect the compensation practices of the credit union and wider financial services industry. It must be based on the organization's size, complexity and growth. It should reward the achievement of mutually agreed-upon performance measures that benefit the credit union

over the long term. And it should be tailored to meet the individual needs and preferences of the executive if it is to be an effective retention tool.

These are the goals of every board. The level of difficulty in achieving those objectives is directly related to the size and complexity of the credit union. The larger the organization, the greater the challenge facing the board to create a comprehensive executive compensation program. Recognizing that challenge, two leading organizations in the credit union movement recently introduced an innovative compensation resource for the nation's largest credit unions, those with \$500 million or more in assets. Sponsored by the Credit Union Executives Society (CUES®) and the Credit Union National Association (CUNA), the *Compensation Value Index (CVIndex™)* is designed to deliver to those credit union boards the comprehensive data they need to recruit

INTRODUCTION

and retain talented, committed CEOs. Its usefulness extends beyond the standard, one-dimensional compensation survey to encompass comparisons to peer credit unions and banks and to identify best practices and emerging issues in all components of executive compensation.

“There is a real emphasis today on managing executive compensation so it is competitive, aligned with performance and reasonable in light of what comparable executives earn, inside and outside of the credit union movement,” says Charles E. Carlson, president/CEO of Survey Research Associates (www.sra.com), Madison, Wis. Survey Research Associates has designed and is administering the survey component of *CVIndex*.

This white paper examines the preliminary data collected for *CVIndex* in comparison to credit union industry averages calculated in the 2005 *CUES Executive Compensation Survey*. This data serves as the starting point of a discussion of the special challenges the directors of large credit unions face in designing and maintaining an executive compensation program for their CEOs. Among those challenges:

- The approximately 250 credit unions eligible for *CVIndex* (more than \$500 million in assets) make up less than 3 percent of the nation’s financial cooperatives. As a result, they have a much smaller pool of executive candidates than other credit unions and fewer models of executive compensation practices in their asset range. They are also more likely than mid-sized and small credit unions to experience the need to extend their executive search to banks and other financial institutions to find highly qualified candidates, which expands

the information they must collect to include banking compensation practices.

- Broad-based 401(k) retirement savings programs, pension plans, and life and disability insurance offered to all credit union employees often have restrictions that make it impossible to offer proportional coverage of the CEO’s salary. The higher the executive’s salary, the greater the gap. Increasingly, boards of larger credit unions are investigating supplemental pension and insurance plans to close those gaps.
- Developing a compensation philosophy based on performance measures that benefit the credit union over the long term becomes more difficult as the credit union grows in size and complexity. In some cases, achieving those goals may take several years, raising the question of how the board can design a long-term incentive reward that does not open the CEO to tax liabilities negating the reward.
- Credit unions launching financial services, mortgage and technology CUSOs often hire executives to head those entities who may be accustomed to salaries and bonuses at the same level or higher than the compensation of their new boss. That presents a dilemma directors must address: Is it fair to expect the CEO to earn less than the people who report to him or her?
- Boards must deal with additional regulations in creating supplemental retirement programs and other benefits. Those rules are both complex and currently in flux, as the IRS reviews guidelines on tax-deferred retirement plans.

QUANTIFYING THE VALUE OF LEADERSHIP

The sum of these challenges points to the need for substantial, specific education on these complicated matters and an ongoing source of timely, unbiased information related to executive compensation for the full board. In developing a full-featured compensation program, the board will likely engage the services of investment and/or insurance firms as

well as its own lawyers, accountants, consultants and auditors to ensure that the program complies with federal and state regulations and serves the credit union's best interests. Information providers, like *CVIndex*, round out the resources the board needs to build a firm foundation for its executive compensation planning.

POINT OF COMPARISON

A COMPARISON OF the “average” U.S. credit union and responses from a wide range of financial cooperatives included in the 2005 *CUES Executive Compensation Survey* to preliminary data available through *CVIndex* offers a beginning point to identify the special compensation challenges that face the boards of larger credit unions.

For example, an overview of the “average” credit union vs. those with \$500 million or more in assets indicates that, in terms of assets, loan portfolio,

membership and employees, the credit unions in the *CVIndex* sample are at least three times the size of the industry average.

The complexity of the organization must be figured into compensation decisions as well. At least two-thirds of the nation's largest credit unions operate a financial services CUSO, and some of them operate two or more for-profit divisions. For example, ten CEOs responding to the *CVIndex* survey reported receiving compensation averaging \$419,000, reflecting their role as the CEO or paid executive of a CUSO.

	“Average” Credit Union (based on 2005 <i>CUES Executive Compensation Survey</i>)	Average Among Credit Unions with \$500 million + in assets (based on preliminary <i>CVIndex</i> data)
Asset size	\$337.4 million	\$1.2 billion
Loan portfolio	\$223 million	\$809 million
Number of members	38,365	118,752
Full-time equivalent employees	101	306

POINT OF COMPARISON

Those size and complexity differences are reflected in the averages of salary, bonus and other compensation. For example, across all credit unions responding to the executive compensation survey,

about three-fourths of the CEOs received a bonus averaging \$24,509. Among the largest credit unions, nine out of ten receive a bonus averaging \$63,356.

	"Average" Credit Union	Average Among Credit Unions in <i>CVIndex</i> Sample
Average base salary	\$151,409	\$274,505
Average base plus bonus	\$170,007	\$331,269
Average all comp	\$173,009	\$362,592
Percent of CEOs paid a bonus	75.9%	89.5%
Average bonus	\$24,509	\$63,356

The rate of salary and bonus increases among CEOs at the larger credit unions also significantly outpaces the industry average. According to the 2005 *CUES Executive Compensation Survey*, for example, total compensation for CEOs rose 8.1 percent—well above the norm for many other industries, but below the total compensation hike for credit unions in the largest asset range, which averaged 15.7 percent.

A side-by-side examination of the use

of executive benefits by the two industry groups—credit unions as a whole and those in the largest asset range—also indicates some noticeable differences. For example, the largest credit unions were more than twice as likely as the industry as a whole to extend executive long-term disability coverage, medical insurance premium reimbursement, supplemental life insurance, club memberships and paid spouse travel expenses to their CEOs (see the following chart).

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	Industry Average	Average CUs with \$500M+ Assets
Executive long-term disability coverage	15.8%	41%
Medical insurance premium reimbursement	12.4%	28%
Supplemental life insurance	25.9%	71%
Club memberships	10.2%	41%
Paid education benefits	26.9%	55%
Paid spouse travel expenses	19.2%	68%
Personal financial planning	3.1%	12%
Car or car allowance	59.1%	83%
Employment contract	17.8%	56%

Although the industry wide 2005 *CUES Executive Compensation Survey* did not ask about supplemental executive retirement plans (SERPs), the *CVIndex* sample of larger credit unions shows a growing interest in this executive benefit. Among those credit unions, 37 percent already have a SERP in place for their CEO and others have indicated that gathering information about SERPs is one of their primary reasons for participation in the program.

As these comparisons show, larger credit unions take a different approach to executive compensation than their smaller peers, offering larger annual compensa-

tion increases, placing more emphasis on bonuses and developing more complex and varied benefits.

“As credit unions grow and become more complex, the need for more sophisticated and customized compensation packages increases as well,” notes Gene Zumwalt, assistant vice president of Executive Benefits for CUNA Mutual Group. “The boards of these credit unions need more precise information. They need to practice more due diligence and to pay more attention to corporate governance. That’s generally true across the credit union movement, but certainly it’s more acute for bigger credit unions.”

SMALLER GROUP OF PEERS

THE CREDIT UNION industry has long been known for its spirit of cooperation and for the willingness of executives and directors to share information and strategies in a way that strengthens the entire movement. This

legacy of sharing has been especially helpful when experienced executives at larger credit unions lend assistance to and share advice with the managers of smaller financial cooperatives. But where do the executives and directors of those larger

credit unions turn when they need advice—especially on issues where the body of knowledge within our industry is just beginning to form. Developing a SERP and creating long-term incentives are two examples of areas where credit union boards must look outside the industry for assistance.

Another, perhaps even more pressing, issue facing the relatively few credit unions in this asset range is the smaller pool of executive candidates with experience leading large, complex, often geographically far-flung organizations. Credit unions have a reputation for building their talent from within: According to the data collected to date through the *CVIndex* survey, 86 percent of CEOs have more than 15 years experience in the credit union industry. However, as credit unions grow in size and expand in complexity to offer such services as financial planning, insurance, and business lending, it only makes sense that they would look to the banking industry and other financial service sectors for candidates with experience in those areas.

When one of the nation's biggest credit unions mounts an executive search, the board must look beyond just asset size to consider the talents and skills a new CEO must have to lead a much more intricate organization, says Yvonne Evers, President/CEO of HRValue Group, LLC, Middleton, Wis. A leading credit union today may encompass a diverse branch network and sophisticated technology delivery channels. It may already operate one or more CUSOs and be looking to launch new lines of service and business partnerships.

“The pool of candidates with experience in managing credit unions with these complex organizations is obviously smaller, so boards may decide they need

to consider candidates from other financial institutions,” Evers says. “Then they have the dual challenge of assessing which candidates can best adapt to the credit union philosophy and how to bridge the compensation gap. For the most part, there’s a big differential between what bank and credit union CEOs make.”

That differential may stem, in part, from divergent philosophies—with bankers compensated for delivering the best possible return to stockholders and credit union CEOs rewarded for fostering an organizational culture that emphasizes member service. And it reflects the banking world’s ability to award stock options. “The banking industry obviously puts a different premium on compensating its executives,” Evers adds. “Is it right—this difference between compensation of banking and credit union executives? It may not be ‘right,’ but it’s the way it’s been for a really long time—and it’s something directors may need to acknowledge and address.”

Whatever the causes, credit union boards must learn about the levels of compensation to which banking executives are accustomed if they hope to recruit accomplished, talented candidates to lead their organizations.

CVIndex offers subscribers bank data comparisons within reports, teleconferences and Webinars, from four survey sources (the Independent Community Bankers of America, the American Bankers Association, the BAI Executive Compensation survey, and America’s Community Bankers survey). A general comparison of these surveys to credit unions in the current *CVIndex* sample shows that significant differences persist between the total compensation paid to bank and credit union executives, Carlson notes.

QUANTIFYING THE VALUE OF LEADERSHIP

In recent years, credit unions have been closing the gap in base pay, but the differences between bonuses, especially in

the form of long-term incentives, continues to separate the two industries, he explains.

Comparing Bank and Credit Union CEO's Compensation

Asset Range	BASE SALARY ONLY		BASE PLUS BONUS	
	Credit Union	Bank	Credit Union	Bank
\$500–\$999 million	\$240,063	\$243,916	\$276,577	\$318,977
\$1 billion and up	\$320,952	\$352,631	\$385,703	\$562,199

FILLING THE GAP

MOST BROAD-BASED benefits plans designed for all credit union employees don't extend far enough to provide adequate coverage for the CEOs of the nation's largest credit unions. Limits on many 401(k) and pension plans prevent higher-paid employees from being able to establish tax-deferred retirement savings that would represent an adequate replacement percentage of their salaries. Along the same lines, life and disability insurance coverage based on pay often include caps on salary, requiring additional plans to fill the gaps. These plans also often have restrictions that prohibit employers from compensating one group of employees differently than all other staff members.

For example, a group disability

insurance program may have monthly benefit caps, so that the CEO could not receive the same percentage of income as other employees. A disability policy might replace 60 percent of an employee's income, with a cap of \$5,000 per month. That means that any CEO with an annual base salary of more than \$100,000 would receive less than 60 percent replacement income under the disability program—and since most executives in the *CVIndex* sample earn more than twice that amount, these caps leave them seriously underinsured.

Thus, larger credit unions are more likely to go beyond paying their executives more money in salary and bonuses, but also to add components to the compensation package.

MATCHING PAY WITH COMPLEX RESPONSIBILITIES

INITIAL DATA FROM *CVIndex* suggests that the boards of larger credit unions put different weights on criteria for awarding bonus and incentive pay than the industry on average. Consistently over the past several years, earnings and a board evaluation have been cited as the most common factors directors consider in awarding bonuses, according to the 2005 *CUES Executive Compensation Survey*. However, among the credit unions in the *CVIndex* asset range, almost two-thirds of respondents consider loan growth in setting bonus and incentive pay, and a majority also factor in membership growth, earnings and net income, and return on assets, return on equity and/or return on investments. The survey doesn't examine why loan growth is such a popular performance indicator among larger credit unions, but Carlson suggests one reason may be that more credit unions in this range are launching or expanding business lending programs.

What is certain is that the larger and more complex the organization, the more careful the board needs to be in developing a compensation philosophy that recognizes the role of the CEO's leadership in various aspects of the business. Directors must be certain that the performance-based incentives they build into the compensation package drive the credit union in the right direction for the long haul.

Determining a compensation philosophy may require a great deal of discussion, Evers warns. The more complex the organization, the more challenging it can be to win agreement among directors and the CEO about which factors to measure

and what role those factors play in the credit union's success—or, in other words, what weight to give each factor in the bonus/incentive award.

"In the past, credit unions typically turned to financial ratios and indicators in establishing base and bonus pay for CEOs, but there's so much more to it today," Evers says. "But agreeing to what those other factors should be and finding ways to measure them can be extremely difficult."

Contributing to this quandary are the individuality of executive compensation plans and the need to develop incentive rewards for the attainment of long-term goals.

The many components that can be built into an executive compensation program allow boards to design a one-of-a-kind plan tailored to the needs of an individual executive with unique skills and talents leading an organization that is unlike any other. Therein lies both the ultimate advantage and the time-consuming challenge of getting it just right. The CEO of a credit union that has just obtained a community charter and plans to launch a business services program needs a different set of benefits-including memberships in various community and business organizations-than an executive at the helm of a credit union whose chief sponsor has just announced major downsizing.

What both of those CEOs have in common is that success for their credit unions will likely be the result of implementing new strategies that will take longer than a year, sometimes even several years, to see the true results.

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Expanding the field of membership, launching a new CUSO, adding a new product line, or developing a whole new business strategy are all examples of performance measures that may require long-term incentives to adequately reward the executive team.

“We haven’t seen much, even among the largest credit unions, in terms of programs designed to measure performance based on meeting some long-term incentive goal,” Zumwalt says. “The performance horizon may tend to lengthen as credit unions look at more complex systems and strategies, and it may take longer to see results from those new directions. The incentive tied to the expected result from implementing those strategies would play out over a longer

period of time.”

As difficult as that challenge may seem, especially given regulations that restrict the forms of long-term compensation credit unions can grant their CEOs without opening them to serious tax liabilities, those longer term performance measures likely have a bigger impact on the credit union’s growth, stability and ability to compete in the marketplace than do short-term goals.

“In the for-profit world where the compensation package typically includes stock, you read a lot about how managers and executives are driven by that quarterly earnings report,” Zumwalt says. “They aren’t looking long term enough for the benefit of the organization.”

MAINTAINING A COMPENSATION HIERARCHY

CREDIT UNIONS ARE looking outside their own industry not only for CEOs, but for CUSO executives as well. The credit union CEO looking for the best candidate to head a financial services, mortgage or technology CUSO will likely be considering veteran managers from those industries. The most talented candidates from those business sectors may be accustomed to earning as much or more than their prospective boss. Does that mean credit union CEOs should earn more than the CUSO executives who report to them? Not necessarily, but it is an issue that boards must consider as they establish the CEO’s

executive compensation package.

“In certain organizational cultures, I could see where someone heading a financial services CUSO or mortgage department might end up earning more than the CEO because of the incentives in place, and that may be fine, because it would mean that division was doing great,” Zumwalt says. However, the ultimate responsibility for maintaining superior performance in all aspects of credit union operations lies with the CEO, which is why most organizations would strive to create and maintain an executive hierarchy both in terms of those responsibilities and in compensation.

INTERPRETING COMPLEX REGULATIONS

ORGANIZATIONAL COMPLEXITY isn't the only issue with which directors must contend in developing a compensation package. The regulations also get increasingly more complex for executive benefits and supplemental plans than for the broad-based benefits programs available to all employees.

Consider, for example, the quandary a board would face if it decided to develop a 457(f) retirement plan as an incentive reward for a CEO leading the credit union through a three-year effort to expand its field of members and introduce business services. Because of restrictions on nonqualifying retirement plans for the executives of not-for-profit organizations, the CEO would be liable for taxes on the incentive plan as soon as he or she had earned it.

"In the for-profit sector, executives can attain a goal and earn the incentive, but not be required to pay the taxes on the bonus until later, when it's paid to them," Zumwalt notes. In other words, a bank can more easily structure a meaningful, long-term incentive program than a credit union. Under the rules governing these plans for nonprofit organizations, the executive is liable for taxes on a bonus plan as soon as he or she has the rights to it.

The IRS is currently reviewing the

457(f) rules as they apply to federal credit unions and is expected to issue a ruling in 2006. In the mean time, credit unions must tread even more carefully as they create supplemental retirement plans for their executives and keep in mind that they may need to make some adjustments down the road to comply with new tax regulations, Zumwalt advises.

For the most part, credit unions have been developing 457 plans not as an incentive reward but as a supplemental retirement plan to cover the shortfall caused by limits on the pension and 401(k) programs.

"One clear issue that credit unions have been dealing with as CEO salaries have spiked up rather rapidly in the last five or ten years is coming to grips with the fact that their pension and 401(k) programs won't keep up." Zumwalt says. "Not every credit union has a 457 plan in place at this point, but the percentages that do are rising rapidly."

Federal regulations also govern how credit unions may collect information about executive compensation from peer organizations. The Sherman Antitrust Act prohibits salary and bonus surveys in which specific data can be tied to one organization, which would restrict the ability of a business to conduct its own informal salary survey, Carlson notes.

THE BOTTOM LINE: BOARD'S NEED FOR RELIABLE, CURRENT INFORMATION

THE FOREMOST ASSET the boards of the nation's largest credit unions need to take on these challenges is reliable, unbiased, up-to-date information on compensation practices and regulations in the credit union industry and wider financial services sector.

"The need for informed, independent board awareness and action in determining executive compensation has never been greater," Carlson contends. "*CVIndex* was designed to create a more knowing community of persons with similar interests. We want to delve into the more complicated nuances of CEO compensation because we perceive that the various elements are changing rapidly."

Over the past several years, the *CUES Executive Compensation Survey* has indicated that CEO base and bonus compensation has been increasing more rapidly than pay in general in the larger economy. At the same time, credit unions have been exploring other executive benefits and compensation components. "The intent of *CVIndex* is to increase our knowledge about these matters and give participants a meaningful way to extract and report the data by selected peer group," Carlson explains.

Unlike conventional compensation surveys, *CVIndex* goes beyond the amounts credit union executives are paid in base salary and bonuses to collect and share data on wider compensation practices, such as supplemental retirement plans and other executive benefits. *CVIndex* subscribers can access the online

survey 24/7 to create user-managed custom reports based on the peer group they select. These reports can compare compensation practices of credit unions grouped by asset, membership, or loan portfolio size, state, field of membership, size of metropolitan area, or number of full-time employees.

CVIndex subscribers also have access to upcoming teleconferences, Webinars and executive workshops on topics of interest to subscribers, such as employment contracts and supplemental benefits plans. Access to human resources consultants and mini-research reports rounds out the resources that aim to identify best practices in a changing executive compensation environment.

Given the corporate scandals and boardroom stand-offs in recent years over executive compensation, credit union boards face increasing regulatory reform and an emphasis on making open and well-documented compensation determinations. Boards and compensation committees will increasingly be held to higher standards of performance. Disclosure, documentation and alignment of compensation outcomes with good measures of organizational effectiveness are a clear trend. Basing compensation decisions on solid data, such as the information available through *CVIndex*, provides a solid foundation for this critical board responsibility.

"What sets the largest credit unions apart is the need to compensate CEOs at levels that are commensurate with their significant responsibilities," Carlson says.

THE BOTTOM LINE:
BOARD'S NEED FOR RELIABLE, CURRENT INFORMATION

“The CEO’s leadership really does impact organizational success, I believe, and these are major positions that are comparable to executives in private sector firms that receive significant compensation packages.” □