EXECUTIVE Compensation

Dealing with the Deferred Compensation Dilemma

WRITTEN BY
Karen Bankston and Scott M. Dettmann

PROJECT CONSULTANT
David A. Dettmann, Attorney,
Lane & Waterman, LLP, Davenport, Iowa

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Credit Union Executives Society (CUES)
5510 Research Park Drive
Madison, WI 53711
Toll-free: 866.508.0744
E-mail: surveysupport@cues.org
cues.org

Credit Union National Association (CUNA)
5710 Mineral Point Road
Madison, WI 53705
Toll-free: 800.356.9655
E-mail: mktresearch@cuna.coop
cuna.org

Kristina Grebener, CUNA senior research analyst
Holly Poast, CUES vp/products and services
Trish Barrette, survey support
Design by Lorraine Ortner-Blake, freelance graphic artist

ABOUT THE AUTHORS

KAREN BANKSTON has been writing for and about credit unions since 1995. She is a regular contributor to *Credit Union Management* and has written several publications for CUES, including *CareerQuest: Mapping Your Professional Success* and the *Director ToolKit*. Most recently, she coauthored with Diane Franklin *Win/Win: Optimizing the CEO/Board Relationship*, published by CUES in 2006. She has also written and edited several training manuals for CUNA on member service, technology and marketing. Her freelance writing and editing business, Precision Prose, is based in Stoughton, Wis.

SCOTT M.DETTMANN is Vice President and Principal with the Carlson Dettmann Consulting division of e**netrix**, of Middleton,Wis. e**netrix** conducts various compensation survey programs for CUES and CUNA. He holds a Master's degree in business administration from Drake University and a Bachelor's degree in business administration from the University of Wisconsin. He began his consulting career in 1985, following 10 years work experience in several Human Resource and line management positions. In his present position, Scott provides compensation counsel, with special emphasis on executive compensation matters, to a broad range of employers throughout the continental United States. He also serves as part-time adjunct faculty member at the Graduate School of Banking at the University of Wisconsin–Madison.

DAVID A. DETTMANN is a practicing attorney with the law firm of Lane & Waterman LLP, Davenport, Iowa. He holds a CPA Certificate and earned an MBA from Drake University. He started practicing law in 1974—the year the Employee Retirement Income Security Act was enacted and spends a substantial portion of his practice in the areas of qualified and nonqualified deferred compensation planning. He is recognized by Best Lawyers in America (www.bestlawyers.com) and Best of the U.S. (www.bestofus.com) for his expertise in these practice areas.

EXECUTIVE SUMMARY

THIS WHITE PAPER EXAMINES the quandary facing the boards of the nation's mid-sized and larger credit unions in developing a deferred compensation program for their CEO and other highly compensated executives. We examine why long-term compensation and retirement plans are gaining increased attention and the options credit unions have at their disposal to fund an executive retirement program that is proportionate to that of other employees and competitive in the field. In addition, we discuss the challenges of determining the current "market rate" for funding deferred compensation programs and provide a snapshot of the status of federal regulations in this area. The text offers a step-by-step overview for developing the multiple components of a deferred compensation plan, as well as a case study of the process featuring USA Federal Credit Union.

INTRODUCTION

CREDIT UNION DIRECTORS have confronted their share of strategic challenges in recent years: whether and how to expand products and services to serve all the financial services requirements of all members; how to grow the organization without sacrificing member service; whether and how to pursue CUSO creation and membership, merger opportunities and other strategic partnerships; how to comply with myriad new regulations; and how to get the most out of investments in brick and mortar and technology delivery channels.

Once the board sets the strategic direction in those areas, the "getting there" rests firmly with the chief executive officer and his or her executive team. To say the CEO's job has become more complex over the past two decades is an understatement of massive proportions. For most mid-sized and larger credit unions, membership and asset size, the number and types of employees, and the number and complexity of managing facilities and automated delivery channels have all increased significantly. The fact that the industry is contracting in terms of numbers of credit unions but expanding in overall membership and assets is evident in the individual growth of financial cooperatives with $500 million or more in assets.

Even if, from the outside, these institutions look more like banks than ever—with the same range of products and services, comparable pricing and delivery channels that rival their for-profit competitors—they continue to adhere to the cooperative spirit of the credit union movement. That's no surprise when you consider their leaders have grown with the industry. Most credit unions are headed by executives with experience and commitment to the movement that can be measured in decades.

In addition to their commitment to credit union ideals and to leading their organizations to competitive footing with banks and others in the financial services marketplace, many of these CEOs have something else in common. They are baby boomers who are beginning to think seriously about retirement at a time when their leadership contributions are the most valuable and critical. It is only natural that they consider whether they are adequately prepared financially for retirement that is approaching sooner than not.

Simply stated, here are the issues to be resolved:

1. Many CEOs of highly successful credit unions are at the pinnacle of their careers—they are offering tremendous leadership value to their organizations at a critical time in the life of the organization; i.e., the CEO is likely to be a valuable item in the marketplace, and the credit union can ill afford to lose the CEO to a competing organization.
2. The CEO has to prepare for retirement, which means replacing a stream of income for what is becoming a longer period of time given the increase in life expectancy.
3. Typically, the retirement plan for the CEO is under-funded in terms of replacement income.

And so, the board must convene over yet another challenge. If directors are pleased with their CEO's performance, a central goal has to be rewarding the chief executive for his or her accomplishments to date, incenting continued performance at high levels, and making it worth the executive's while to continue his or her career with the credit union. A substantial portion of that recognition should be in the form of deferred compensation, and, in this regard, the term "golden handcuffs" takes on significance to a board hoping to hold onto a high-performing CEO until retirement. The CEO's and the credit union's interests should converge in a well-designed deferred compensation plan.

This white paper delves into many of the aspects of long-term compensation, including:

- Many directors today are well versed in establishing competitive salary and bonus packages for CEOs, but long-term deferred compensation plans are new territory. Boards have to figure out how these additional benefits fit into the credit union's overall compensation philosophy.
- Many CEOs are in the position of playing "catch-up" to bring their deferred compensation plans in line with their expectations for a retirement income. The result is likely to be "sticker shock" for many directors in the early phases of discussion and exploration.
- Federal and state regulations affect group benefit plans, such as life insurance and retirement benefits, so that highly compensated employees typically are unable to participate proportionately in standard plans to the same extent as other employees.
- Competitive market data is not always readily available. Informal surveys may yield disparate results, and it can be difficult to determine how much other organizations are investing in these plans to decide ultimately how fair and competitive the program is.
- The need to comply with the federal tax code contributes additional

complexity to developing long-term and deferred compensation programs for CEOs and other top executives.

- Board members face a steep learning curve in educating themselves about the many options, components and requirements of a deferred compensation program.
- The board likely calls on consultants and attorneys to assist them with the process. Necessary expertise may be drawn from executive compensation specialists, companies supplying market data, pension actuaries to help determine fair plan value, attorneys to ensure that the plan passes regulatory muster, and funding agents to recommend and develop an investment vehicle for the program.

WHY DEVELOP A DEFERRED COMPENSATION PLAN?

Executive compensation in the for-profit sector has been getting a lot of bad press. Most reasonable people believe that executive compensation relative to corporate performance has been taken to absurd, ill-conceived and frequently uncontrolled proportions in a number of high-profile instances in recent years. This is a sensitive issue among credit unions.

Although there is bound to be a bad exception that someone can point to, in the credit union movement, executive compensation standards and the performance of executives on behalf of their organizations should be viewed in an entirely different manner. The CEOs and executive teams of the nation's mid-sized and larger credit unions have guided the transformation of their organizations in recent years into full-service and full-sized financial institutions. The decisions made by CEOs have a great impact on the short- and long-term results of their credit unions, and their performance requirements are more demanding than ever before.

As employer and employee, the credit union board and its CEO have common and distinct interests. Their common interests are focused on the credit union's optimal performance. Beyond that, the board has a fiduciary duty to represent members' interests. Those interests include retaining high-performing leadership.

The CEO also has legitimate competitive compensation concerns that include building a retirement asset base that will continue a similar lifestyle in retirement. Where those interests converge is in motivating and rewarding the chief executive for leading the credit union in the right direction and in incenting the CEO to stay on with the credit union instead of moving to a different organization.

If directors like what they see in terms of executive performance, hiring and retaining a top-quality CEO is among the board's highest priorities. If a central concern for a high-performing, middle-aged executive is putting together an adequate retirement program, the board that fails to respond to this concern may find itself looking for a new CEO—and still facing the need to develop a long-term compensation plan, as these components of the overall executive compensation package become more and more commonplace.

According to the 2006 *CUES Executive Compensation Survey*, credit union earnings, board evaluations of organization and executive performance, and loan growth are cited as the top factors for awarding bonus and incentive pay. In 2006, the salary and bonus increases awarded to credit union CEOs continued to be substantial, continuing a multi-year trend.

SALARY AND BONUS INCREASES

Asset Range	$400–599.9 million	$600–999.9 million	$1 billion +
Average base salary	$238,422	$256,657	$345,688
Average bonus	$39,368	$50,578	$79,823
% change base salary	10.77%	8.24%	9.59%
% change base + bonus	12.89%	10.70%	8.91%
% change total compensation	14.01%	10.54%	8.80%

This information is derived from the 2006 *Executive Compensation Survey*.

In light of this information, the question is: Are retirement plan set-asides for credit union CEOs (and other executives) keeping pace?

COMPONENTS OF A DEFERRED COMPENSATION PROGRAM

Basic terminology

Credit union boards will find themselves developing a whole new vocabulary as they take on the task for developing a deferred compensation plan. Generally, a board creates a total retirement program for the CEO and other executives with components from two broad categories of retirement benefits:

1. qualified plans that cover all employees or in which all employees may elect to participate, including the CEO and other highly compensated employees, and
2. nonqualified plans created for the CEO and, in some credit unions, a select group of highly compensated employees, also known as **top hat benefits**.

Essentially all employees may participate in **qualified plans** or retirement benefit programs that have tax-preferred status and are governed by ERISA (the Employee Retirement Income Security Act of 1974). ERISA rules define benefit availability and nondiscrimination requirements. Qualified retirement programs include:

Defined benefit plan—a retirement program specifying the benefit at retirement; generally, the benefit is based on a percentage of final earnings and/or length of service. The organization contributes the amount necessary to provide the benefit. Due primarily to the cost of funding and operating these retirement programs—which include PBGC premiums (Pension Benefit Guaranty Corporation) and actuarial fees—defined benefit plans are increasingly rare.

Defined contribution plan—retirement programs specifying the amount of contribution to the plan, based on salary, credit union performance, years of service, etc. The value at retirement depends on the appreciation of the investment vehicle over time. In other words, there is no guarantee of a specific benefit amount at retirement. Common forms of defined contribution plans include:

- **Money purchase plan**—a defined contribution plan that permits the highest tax-deductible contribution rate, up to 25 percent of salary with a $44,000 per year limit when combined with a profit sharing plan or 401(k) plan;
- **Profit sharing plan**—a defined contribution plan to which the employer contributes a portion of its profits each year to be allocated to plan participants; and
- **401(k) plan**—a defined contribution plan into which employees and/or employers can make pretax contributions through salary reduction agreements. Participation in these plans is voluntary, and credit unions may match up to a certain percent of the employees' contributions in addition to or as a replacement for other retirement benefits.

NOTE: The combined annual limit for defined contribution plans is $44,000, plus an additional $5,000 deferral available to those over age 50.

Defined benefit and most defined contribution plans are **noncontributory retirement plans**, meaning the programs are funded exclusively by employers, 401(k) plans are the most common forms of employee contributory retirement plans.

CEOs and other executives may participate in these programs; however, their contributions and contributions on their behalf are limited by law. Consequently, highly compensated individuals are not permitted to save the same percentage of income in qualified retirement funds as other non-highly compensated employees.

In any discussion about retirement plans, it is critical to understand the difference between a "qualified" plan and a "nonqualified" plan. A plan is qualified if it meets the requirements of ERISA, and this is important because qualifying leads to important positive tax advantages. A nonqualified plan does not have those tax advantages; however, it is likely to provide substantially greater flexibility. As a result, **nonqualified plans,** not being subject to the limitations of ERISA, can be designed for specific, highly compensated employees.

One example of a nonqualified plan is a **457(b) plan**, which is available only to government employees and some nongovernmental organizations, including some federal credit unions and state credit unions, at least at present (see discussion under the section "Within the Letter of the Law"). Credit unions may set aside an additional $15,000 (the 2006 limit) or up to 33 percent of includable income, whichever is less, for their CEO under a 457(b) Plan. (NOTE: The $5,000 catch-up contribution for executives over age 50 also applies to these plans)

Another nonqualified plan is the **457(f) plan**, which is a deferred compensation arrangement with no specific dollar limit(s) associated with the plan. A 457(f) plan is available only to state and local government employees and nongovernmental organizations exempt from tax under Internal Revenue Code Section 501. In some ways, a 457(f) plan resembles nonqualified plans available to for-profit employers, in that deferrals must be subject to a "substantial risk of forfeiture." Unlike participants in a 457(b) plan, participants in 457(f) plans are taxed on elective deferrals and any employer contributions to the plan when those amounts cease to be subject to a sustantial risk of forfeiture.

Until recently, it was understood that the Internal Revenue Service allowed all credit unions to develop a 457(f) plan for their CEOs, but a recent ruling limits that practice to state-chartered credit unions. (Again, see the section on regulatory changes later in this text.)

A **supplementary executive retirement plan (SERP)** is a nonqualified plan that need not be funded and can be lost if the employer declares bankruptcy. SERPs offer employers the ability to grant more liberalized benefits to ensure that retirement amounts beyond those authorized under ERISA can be provided to one or more highly paid employees. (A 457(f) plan is a SERP.) SERPs may be structured in several ways. In one common form, the credit union sets aside an agreed-upon amount of investment capital, which earns interest over a specified number of years, and that interest is applied toward the executive's retirement fund.

Another alternative is establishing a **salary replacement target**, and structuring the plan to amass enough money to fund those payouts in retirement.

The salary replacement target is typically stated as a percentage of salary and bonus or incentive pay in the executive's final years with the credit union, perhaps as an average of the final three years of compensation or the top three of the five final years, for example. The executive's age and years of service may also be part of the formula.

Current practices in the credit union industry

Participants in the 2006 *CUES Executive Compensation Survey* and 2006 *Compensation Value Index* (*CVIndex*™) reported these retirement plans for their CEOs:

RETIREMENT PLANS FOR CEOS

Asset range	All CUs responding	$400-599.9 million	$600-999.9 million	$1 + billion	*CVIndex* Group*
401(k) match %	4.2%	4.3%	4.0%	4.7%	4.0%
Defined benefit plan	28.0%	38.1%	29.3%	51.0%	45%
Defined contribution plan	15.0%	15.9%	26.8%	23.5%	24%
Money purchase plan	9.9%	7.9%	7.3%	2.0%	8%
457(b) plan	36.1%	58.7%	58.5%	49.0%	61%
457(f) plan	27.4%	42.9%	46.3%	37.3%	52%
Other retirement plan	9.7%	7.9%	4.9%	17.7%	3%

**CVIndex* tracks compensation information exclusively for CEOs of credit unions with asset sizes of $500 million and greater.

Plan incidence aside, *the critical question to ask* is, what is the cumulative value of income these plans will replace for a career executive at the point of retirement? *CVIndex* provides valuable information in this regard. The total salary replacement target for all retirement plans as reported by *CVIndex* participants is by overall average and percentile of responses is as follows:

TOTAL SALARY REPLACEMENT TARGET

	Average	10th %	25th %	50th %	75th %	90th %
Replacement Target	56.98%	22.00%	50.00%	60.00%	70.00%	73.00%

For **other** executives, credit unions reported these levels of participation in retirement plans:

PARTICIPATION LEVELS IN RETIREMENT PLANS BY OTHER EXECUTIVES

Asset range	All CUs responding	$400-599.9 million	$600-999.9 million	$1 + billion
401(k) match %	4.1%	4.2%	3.5%	4.8%
Defined benefit plan	28.7%	35.9%	21.8%	49.4%
Defined contribution plan	15.2%	13.5%	25.9%	12.2%
Money purchase plan	8.0%	11.3%	6.4%	0.0%
457(b) plan	27.0%	33.7%	52.6%	36.9%
457(f) plan	8.6%	16.4%	15.4%	11.6%
Other retirement plan	4.4%	3.2%	2.6%	6.7%

As you can see in the tables above, one commonality is that participation in the nonqualified 457(b) and 457(f) plans and "other retirement plans" increases as asset size grows. Since we know total direct compensation also increases by asset size and we know the set-aside limits of qualified plans, we should expect this result. The most highly compensated employees would have to use additional retirement options to have similar income replacement proportions at retirement.

A simple example will illustrate this point. The federal tax code limits an employee's 401(k) contributions to $15,000 in 2006, plus an additional $5,000 catch-up contribution for individuals age 50 and older. That limit would allow a midlevel credit union manager age 50 or older earning $80,000 a year to set aside up to 25 percent of his or her income toward retirement. However, the same tax code requirements would limit a CEO earning $250,000 a year to an 8 percent contribution. When you extrapolate this example for a number of years, it is easy to understand why many executives' retirement plans are under-funded proportionately compared to the managers at their own credit union.

In presenting this analysis, it is understood that a Board may react by saying, "Well the CEO's retirement is not our responsibility. The CEO makes more and can save for retirement out of direct pay." Again, this paper is about competitiveness; equity also is important, and all our experience indicates that it will be weighed into the compensation decision, too. Credit unions have a long history of being fair to all of their employees.

A step-by-step process

Developing these programs is a process of layering retirement and long-term compensation plans, each with its own level of complexity and risk, to achieve an agreed-upon payout at the end of the executive's successful employment. Some of these plans will be funded by the credit unions, others will be funded with the executive's contributions, and still others may be funded jointly. Here are a few steps boards take as they begin to develop a deferred compensation strategy for their CEO and other employees:

1. Get a feel for the market and other comparisons by examining the credit union's overall retirement program for all employees, gathering data on deferred compensation standards in the credit union and related industries, and seeking more specific market comparisons.
2. Identify whether the deferred compensation program will be available only to the CEO or to other executives as well.
3. Evaluate what type of assistance the board may need in developing a strategy, including, for example, an executive compensation specialist and/or pension actuarial firm, an attorney with experience in developing these plans and assuring the plans are drafted in accordance with state and federal laws, and a financial services organization that can help the credit union develop a funding strategy to support the desired level of benefit and manage the administrative tasks associated with supporting that funding strategy.
4. Determine the components and likely ranges that will pinpoint the anticipated payout and necessary investment in the deferred compensation program, including the anticipated rate of replacement income at

retirement age, anticipated retirement date, and years to fund the plan.

5. Sum the total of existing retirement plans funded to maximum levels, including 401(k) plans, defined benefit or contribution programs, money purchase plans, and 457(b) plans, to determine the remaining gap that must be funded with a SERP.

Credit union boards should prepare themselves for the possibility of "sticker shock" in learning about the costs of funding a deferred compensation program for their CEO and other executives. To keep those costs in perspective, we recommend the following exercises to establish a basic concept of fairness in assessing the CEO's and other executives' expectations for what they consider adequate retirement funding.

STEP 1: Determine competitive levels of income replacement percentage provided by peer credit unions and other financial service organizations for career executives. *CVIndex* is an excellent source of this information.

STEP 2: Compare, as a proportion of annual income, the total retirement benefits employees who are *not* classified as highly compensated can amass through the credit union's programs to the level of participation permissible for the CEO and other highly compensated executives. (In 2006, federal laws governing these employee benefits defined a highly compensated individual as earning $100,000 or more annually.) We suggest building several models that would encompass individuals from a variety of earning spectrums commonly employed at credit unions.

For example, you might wish to consider the case of individuals earning (in 2006 dollars) $35,000, $55,000 and $75,000. Use an operational assumption that these individuals will complete a long service career with the credit union comparable in length of service to the executive in question and utilize all of the retirement vehicles offered by the employer. Next, calculate what retirement asset base they could accumulate to the "normal" retirement date of age 65. The organization(s) that provide record-keeping/administrative services for the credit union's retirement plans should be able to provide this service. Many retirement planning financial models are available today from advisors or on the Internet.

Completion of this step allows you to determine the credit union's current commitment of financial support to retirement for its career employees who are defined in law as not highly compensated. This is one means of determining the employer's "philosophy of compensation" as it relates to the retirement portion of the benefit package. This exercise also will document the portion of asset accumulation created by employer contributions and the portion attributable to employee contributions.

STEP 3: Using available information provided by the credit union's retirement plan administrator for the executives in question, ascertain the current status of the funding of their retirement accounts and compare those amounts, considering the circumstances listed below, to the modeling suggested in Step 2.

Completion of this step will help determine the amount, if any, of a funding shortfall, based on the income target selected as appropriate. Determination of the "target" should consider several variables, including at least:

- competitive standards, mentioned previously
- the desires of the incumbent

- length of service for the individual in question (board members may feel differently about an executive who has spent a majority of his or her career with the employing credit union versus someone who has arrived only recently with the current employer, fairly late in his or her career, for example)
- a comparison with how the credit union provides for its non–highly compensated employees' retirement
- the ability of the institution to fund additional programs
- the strength of the board's desire to retain the services and motivate the individual in question
- other subjective elements

Often it is helpful to have an outsider, such as a experienced executive compensation consultant, facilitate this conversation to serve as an information source on competitive standards, provide an "arms length" liaison with the affected executive and provide balance to the conversation, as the dollar amounts involved often are quite large and the information is personal and thus quite sensitive.

STEP 4: Determine how much of the funding shortfall, if any, the credit union feels obliged or motivated to make up, and under what conditions it will do so. As previously mentioned, the dollar amounts involved can be significant, and a strategy to move forward requires careful consideration. Often, this exercise will result in conversation about the establishment of an employment agreement/contract for the individual involved, in which the credit union will agree to fund any "catch-up" amounts and future retirement plan contributions based on the executive's continued employment and what the board would like to see accomplished through the course of his or her continued employment.

STEP 5: Consult with executive compensation specialists and/or pension actuaries on market practices for funding executive retirement plans and how to best achieve the desired level of deferred compensation. If they have not already done so, the board and CEO may decide at this point to develop an employment agreement that represents both parties' interests.

Example of deferred compensation planning in action

Let's consider a recent example that demonstrates each of the steps.

The long-serving CEO of a large, successful credit union, while well-compensated from a cash compensation perspective, was quite aware of the funding shortfall of his retirement savings program. Failure to correct this circumstance in short order would likely result in the credit union in question losing the services of this talented executive, as the individual had been courted on several occasions by other credit unions that were willing to offer an attractive supplementary retirement program as one incentive to motivate the executive to finish out his successful career with their organization.

With a 10-year horizon remaining before anticipated retirement, completion of steps 1 through 3 (of the aforementioned five step process) suggested a funding shortfall (in current dollars) ranging from $1.8 million to $2.2 million to provide a competitive retirement benefit from all sources. Close analysis suggested that much of the shortfall was **not** due to a lack of saving on the part of the executive, who had participated to the maximum extent possible in every available retirement savings option. Instead, this gap was largely due to the cumulative result of mandated cutbacks on employer-funded contributions to qualified plans over years of employment.

While the amount of the funding shortfall appeared staggering to directors involved in the planning process, both the board and executive were motivated to make fundamental changes so his career would be completed with the current employer and the funding shortfall would be corrected over time. As a part of this planning process, the board and its CEO, with the assistance of outside counsel, negotiated two successive five-year employment agreements.

In this particular case, the wants and needs of each party were considered, including retirement plan funding and other issues important to the parties, which were then reduced to writing and agreed upon. Among those important features were:

- articulation of specific goals to be successfully completed by the organization through the CEO's remaining employment period;
- articulation of the total compensation philosophy, and the metrics to support that philosophy, to be applied to the executive's compensation package moving forward;
- specific replacement income ratio targets to be funded by the credit union upon successful completion of each successive employment agreement; and
- necessary safeguards to make sure all of the commitments occurred in timely fashion.

The board concluded that the financial value of the continued positive growth of the credit union more than justified this investment in their CEO.

The establishment of an appropriate 457(f) program was a key ingredient to the success of this project. Options for funding 457(f) plans typically include mutual funds and life insurance policies. A recent NCUA opinion letter states federal credit unions have authority to compensate their employees, and under this authority, investments made to fund an employee benefit obligation are not subject to the investment limitations stated in the Federal Credit Union Act and NCUA regulations. The impact of the new Section 409A of the Internal Revenue Code on split-dollar life insurance policies as funding mechanisms is unclear, and the IRS may have more to say on that point in the future. For the purposes of this example, suffice it to say the board worked with executive compensation specialists to develop and fund a competitive retirement plan that would comply with 457(f) rules.

One reason developing a 457(f) arrangement is so complex is that it cannot, technically, "be funded." That is, employer assets cannot be completely segregated to take care of this obligation, although most organizations take steps to "informally fund" these obligations—to give the executive some reassurance the money will be there when the time comes to pay up. This stipulation is part of the "substantial risk of forfeiture" requirement that will be discussed later in this text.

To build on this example, let's move on to a case study from a credit union that developed a deferred compensation program for its CEO and other top executives.

CASE STUDY: USA FEDERAL CREDIT UNION

NEGOTIATING A DEFERRED compensation plan for the first time can be a lengthy and complicated process, as directors become familiar with a complex web of regulations and potential funding mechanisms for a planned payout well outside of many directors' personal and professional experiences.

An added challenge in the current environment is establishing some sort of market-competitive baseline for deferred compensation formulas and standards at a time when these plans have not been widely adopted and industry averages are not readily available, suggests Dr. Michael Willoughby, chairman of the USA Federal Credit Union board. Willoughby also chaired the board's compensation committee through the development of not one but two different formulas for a deferred compensation program for CEO Mary Cunningham.

Ultimately, though, the directors "sleep well at night," Willoughby says. They are secure in the knowledge they have created a long-term compensation plan that benefits the executive team and achieves the aim of ensuring the continued leadership of executives motivated to marshal high performance for the credit union.

Drafting and redrafting

About a year after Cunningham joined the San Diego credit union in late 2001, the board offered their new CEO a deferred compensation plan, which she accepted with no qualms. At that point, Cunningham now admits, she didn't know much about this form of compensation.

"I kept telling them, I want the Cliff Notes here. Explain to me in terms of monetary benefit at retirement. That, I can understand," Cunningham says.

She already participated to the maximum extent possible in USA FCU's 401(k) plan, and those retirement funds were figured into the deferred compensation program. The bottom-line payout of the deferred compensation program reflects the combined contributions by Cunningham and on her behalf in the USA retirement plan, its 401(k) program and the 457(f) program the board developed.

The 457(f) plan is funded, in part, by a whole-life insurance plan, with Cunningham's husband listed as beneficiary while she remains with the credit union. The insurance policy also serves as a funding mechanism for retirement benefits; excess premiums are currently invested in mutual funds. The board closely monitors the performance of those funds and has the option to change the funding mechanism down the road.

More than a year after she and the board worked out the details of this program, Cunningham began to develop a similar plan for the chief financial officer with the same consulting firm the board had dealt with on her program.

"I wanted golden handcuffs so that he would be locked in here as well. He and I make a great team," she notes. "Leadership at a large credit union these days is never about one person. It's about having the right team and the right mix of abilities and talents. I wanted to protect myself and the credit union by ensuring that I would have a strong leadership partner in the CFO. "

Cunningham learned a great deal more about 457(f) plans as she went through the process of developing a program for the CFO. The board had created a program with enough flexibility that the CEO could add other "top hat" executives to it. Elements of the plan can be customized to each executive enrolled in the plan, including percent of pay available at retirement, date of retirement, years of service, and by what formula the ending base pay is determined. The USA FCU board established those particulars for Cunningham, and she establishes the benefits for other executives to be included in the plan.

That flexibility is a key component of 457(f) plans. "We basically sat down with each executive employee (the plan now includes three executives in addition to Cunningham) and said, 'What is it you need?' Each person's financial circumstances are different. Each one has a different level of need in terms of their standard of living and being able to satisfy that," she explains. "They're a different age and have different expectations in terms of a retirement date."

Cunningham and the CFO began conducting informal market research, primarily with credit unions in USA FCU's asset range and higher, on a competitive rate at which to fund the CFO's deferred compensation plan. During that process, they discovered "the terms of my plan were not competitive for a CFO, let alone a CEO," she recalls. "The formula was so low it could never have functioned as golden handcuffs for the CFO, which was the purpose."

Not that there was a lot available data out there. Cunningham and the CFO informally surveyed about a dozen credit union executives in 2004 and picked up some general information from CUNA Mutual's Executive Benefits specialists. Because these plans are relatively new in the credit union industry, executives are uncertain about how much information they should be sharing without their board's consent.

After completing an initial round of research, Cunningham e-mailed the board chair with the results. "I noted that I couldn't even entice our CFO with my plan, so I would have to offer him a plan more generous than mine," she notes. The board decided to take another look and ended up negotiating a new plan for the CEO and CFO.

"I accepted (the first plan) gratefully and graciously and didn't think that much about it. It was only later that I learned through my CFO how uncompetitive it was in the marketplace, and that's when we dealt with it," Cunningham says. "It was an interesting challenge for all of us to work through."

Juggling the numbers

Deferred compensation programs can take a variety of forms and be based on different formulas. The USA FCU board worked with its executives to establish retirement funding equal to a replacement rate of their full salary in the year before they retire. The deferred compensation plan also spells out a date of retirement for each executive and takes into account their years of service with the credit union. Once those components were negotiated, the next step is to calculate the investment needed to fund the plans and explore all the options and choose a funding mechanism to make the program work.

Willoughby, a retired naval officer whose post-retirement professional pursuits include work as an investment counselor, had been learning about deferred compensation vehicles for a couple years before being appointed to chair the compensation committee. He was intrigued by the idea of 457(f) as a compensation component, a workforce management tool, and as an asset, a more flexible means of investing for the credit union (more about that later). Willoughby advises other boards considering developing a plan to identify a director willing to educate him or herself about these complex programs. “It takes a lot more than a couple hours with a PowerPoint presentation,” he cautions.

In addition to learning about the composition and regulation of these plans, Willoughby says he also began conducting regular “table surveys” whenever he attended a credit union conference or workshop, asking all the directors with whom he shared a table whether they had developed a 457(f) plan for the CEO and what the general terms of that arrangement were.

Ultimately, Willoughby notes, it took the committee and board more than two years of research and negotiation to get the plan in its current form in place. Willoughby estimates he alone spent 60 to 80 hours on research. “It’s practically a full-time job for someone on the board—and you still need to hire a third-party firm to structure and administer the fund and attorneys to review compliance aspects and ensure that regulatory filings are completed on time and in order,” he notes.

The final plan was reviewed by the board and its attorney, the CEO and her attorney, and later the CFO and his attorney. It was carefully drafted to comply with the regulations of NCUA, the Department of Labor (namely ERISA), the Department of Treasury, as well as state regulations.

Points of contention

Though the board has been consistently pleased with Cunningham’s performance and developed the long-term compensation program with the intent of retaining her relationship with the credit union over the long term, the process of developing the program was at times arduous. The point at which the compensation committee reopened the plan to negotiate terms the CEO and CFO considered market competitive was “a bit aggravating” for some board members, Willoughby says. The board considered its first offer to Cunningham to be generous, both in terms of their own experiences with retirement benefits and with Willoughby’s informal surveys of other credit union directors.

The age of retirement and replacement ratio can become points of contention, he notes. Most of the directors on the USA FCU board are retired naval officers, who believe their retirement plans offering 50 percent of their salaries after 20 years in military service were fair and adequate models (especially given their responsibilities in the armed forces of defending the country and putting their lives on the line) for the CEO’s plan. Instead, they were hearing 60 to 70 percent replacement ratio after 14 or 15 years with the credit union would be more competitive “because that’s what other plans in the country were providing,” Willoughby notes.

Willoughby’s informal surveys turned up that about 1 in 7 or 8 of the directors with whom he shared a conference table had created a 457(f) plan for their executive. And he heard from credit unions that were funding replacement ratios in the 40 to 45 percent range, compared to the CEO’s and CFO’s informal surveys, which were picking up an average of

62.5 percent, with some in the 80, even 90 percent range.

"Our board was comfortable with a plan in the range of the 40s, with a cap at 50 percent. We felt that the military offered a generous plan at 50 percent, which should be a good benchmark for other industries," Willoughby says.

Tempering that position is the fact that many people retire from the military at a young enough age to launch second careers to further augment their retirement savings. Cunningham notes that she intends to finish out her career at USA FCU.

Also, each employment sector in the U.S. economy develops its own internal standards in terms of compensation practices—without regard for how demanding, arduous and essential each job is in relation to another. Across industries, however, it is accepted that chief executives earn their pay by achieving the performance objectives set out for the organization by the board of directors and taking the responsibility to turn things around when objectives are not met.

Those types of discussions and ruminations went on among USA FCU directors for about a year, until Willoughby realized either the board would have to come up in its offer or the executive expectations would have to come down. He says bluntly that "some directors thought those demands amounted to robbery." Ultimately, though, Willoughby asked the board to think about "whether they're worth it"—and to consider the price the credit union would have to pay if members of its executive team left the organization.

He also talked the board through the responsibilities of executives in the credit union industry and the justifications for paying them compensation considered comparable within the industry.

With the negotiations behind them, the board is relieved and pleased to find their investment in the executive team is paying off. The credit union is doing well under the direction of "people whose achievements are proving a worthwhile investment for our credit union," Willoughby says. "Our investment in this plan takes off the table the possibility of these top executives leaving as a team."

The bottom line, he adds, is "every day these executives work for our credit union makes the investment worthwhile."

Additional considerations

In addition to the funding formula, the USA FCU deferred compensation plan deals with several other issues, including provisions that focus on the continued high performance of the credit union and its executive team throughout the years covered by the plan. Willoughby notes the formula itself provides a key incentive, since one of the components that determines the lump sum payout on retirement is the executives' ending salary. They can work to increase that figure annually by meeting or exceeding performance standards in return for annual raises and bonuses.

Another clause in the plan spells out the conditions under which an executive could be considered to be "occupying the position but not doing the job," or attempting to ride out the last couple years to retirement without continuing to work hard to earn the benefit, Willoughby says.

Because the USA FCU board doesn't have an employment agreement with its CEO, the deferred compensation plan also defines "separation for cause," the circumstance under which a CEO could be dismissed and lose any rights to the plan proceeds.

Finally, the board included a clause that if the CEO or her spouse contracted a terminal illness, the CEO would be allowed to retire before the date specified in the plan with a scaled-down lump sum payment. “I think we were pretty thoughtful in laying out these terms,” Willoughby says.

The plans also laid out staggered retirement terms so that the CFO stays five years beyond the CEO’s retirement to ensure continuity in credit union leadership. Willoughby calls it “choreographing retirement dates.”

Under a 457(f) plan, the board has the option of investing in more aggressive securities than are permitted for other credit union funds. That entails more risk and more attention, but the return is that the credit union, with careful management, should be able to produce the funds to fulfill the plan with less capital that would be required with more conservative investments, Willoughby explains. “So far our plans are over funded, which is a big gain for us.”

Cunningham emphasizes the importance of developing a proper funding mechanism that over time should produce gains that will help fund the retirement program. “Many boards I’ve spoken with don’t understand that aspect of the process, and they end up erring on the side of being unnecessarily frugal because they are trying to protect the credit union,” she says. “What really happens is that if they’re too frugal, they put the credit union at risk by not offering a competitive plan that will retain top-performing executives.”

Advice for peers

Credit union boards just beginning the process of developing a deferred compensation program should allot plenty of time and money, Willoughby recommends. He estimates boards should be prepared to spend $50,000 in consultant and legal fees to establish the plan and ensure it passes regulatory muster.

Initial development of a plan can take up to two years, he says, and it may take 60 to 90 days to add another executive to an established plan.

Willoughby suggests directors and their CEO should prepare for some serious discussions about the costs and benefits of these programs. For example, they may need to work through the question of who should pay the costs of restrictions on and unfavorable tax treatment of retirement savings of highly compensated individuals. He uses this example: A CEO earning $200,000 a year and intent on building a retirement savings fund might be offered a $160,000 annual salary with an additional $60,000 annual contribution to a deferred compensation plan. Some directors might consider that a win-win solution in comparison to the alternative of the credit union offering the CEO a “subsidized savings plan” on top of what the board considers an already generous salary and bonus award, he contends. Of course, the bottom line is that when retention is the critical impetus behind developing these programs, directors also need to be aware of the compensation standards developing in the industry.

In fact, the boards most likely to be developing 457(f) plans are those with CEOs in transition, Willoughby adds. If your credit union has hired a CEO recently or will soon be hunting for a new chief executive, “these plans have become part of the recruiting market,” he says.

In the best of all worlds, he says, boards ought to consider letting their outgoing CEO develop the 457(f) plan as a disinterested, but fair, arbiter for his or her successor. "It would be much more comfortable to be able to set up this policy without the beneficiary looking over your shoulder as you do it," he advises.

Willoughby continues to conduct his table surveys, "but these days, I'm more interested in how many people they have in their plan. I ask them, 'Is it just your CEO? How extensive can you see your plan becoming?' We currently have four executives in our plan, and we foresee a maximum of five."

WITHIN THE LETTER OF THE LAW

As we write this text, the federal regulations and interpretations of those rules by the Internal Revenue Service remain in flux. At this moment, it appears federal credit unions with 457(b) plans in place before August 2005 can continue to maintain those plans, but this option may be closed to other federal credit unions. The future of 457(f) plans is also in limbo, awaiting the issuance of final rules under a new section of the Internal Revenue Code, § 409A.

The difference between 457(b) and 457(f) plans is that the former is an *eligible deferred compensation plan*. If it meets the specific requirements of the Internal Revenue Code 457, participants may defer taxes on their elective deferrals and any employer contributions. Once benefits become vested, FICA, FUTA and other taxes become payable. Thus, an issue in developing 457(b) plans is how to pay these taxes once the benefit becomes vested. Must the executive come up with his share out of pocket, or does the credit union structure its compensation plan to provide funds to cover the liability?

On the other hand, participants in an *ineligible plan*, including 457(f) plans, are taxed on the contributions they and their credit unions make to the plan as soon as those amounts cease to be "subject to a substantial risk of forfeiture."

What does a substantial risk of forfeiture mean? This is subject to much debate, but a private letter ruling issued by the IRS a few years back indicates "continuation of employment" serves this purpose. Hence, both parties may agree to an employment contract that secures the promise of future payment of funds in the amount to secure the desired retirement payout.

As with a 457(b) plan, credit union executives must pay taxes under a 457(f) plan as soon as they are, in effect, "vested," even if the funds are not immediately available to them. When that substantial risk of forfeiture lapses, the executive must pay payroll and income taxes immediately on the whole amount in the plan. Typically, the plan is designed so the risk of forfeiture lapses when the executive retires.

For example, a board could develop a 457(f) plan in which it would invest for a set period—say nine years—which coincides with the date the CEO turns 65. The plan would specify that the earnings on that investment would be turned over to the CEO as a retirement fund if the executive stays with the credit union until that date and achieves annual performance criteria established by the board. Under the risk of forfeiture, the CEO would not be entitled to any benefits if he or she left employment before the established date or failed to comply with the performance standards.

The requirement that the funds be at a substantial risk of forfeiture is not satisfied by the possibility that the funds might decline in value, as any investment might, or that they are subject to an employer's creditor's claims. Instead, the risk must involve conditions of the executive's future adequate performance and tenure.

Federal credit unions have had the option to develop 457 plans for their executives since the late 1980s when the tax law was changed to extend this deferred compensation option to tax-exempt organizations. However, in 2003 the IRS issued regulations interpreting the words in that earlier statute to exclude a "federal instrumentality"—which would cover federally chartered credit unions—from employing 457 plans.

The following year, the IRS issued a letter ruling that federal credit unions are not "eligible employers" under the 457 rules. That ruling caused such an uproar that the IRS promised a wider response, beyond the ruling sent to a single credit union, on whether federal credit unions would be allowed to create 457 plans and what would happen to existing programs.

A subsequent notice (IRS Notice 2005-58, announced in Internal Revenue Bulletin 2005-33) issued a decision by the U.S. Department of Treasury that effectively set an Aug. 15, 2005, deadline for credit unions to establish 457(b) deferred compensation plans. In part that notice clarified that:

> … a plan in effect on August 14, 2005, that is maintained by a federal credit union and is intended to be an eligible nonqualified compensation plan of a non-governmental tax-exempt entity under § 457(b) will not fail to be a § 457(b) plan solely because the employer establishing and maintaining it is a federal credit union … provided that the federal credit union has consistently claimed the status of non-governmental tax-exempt organization for all employee benefit purposes …

The notice goes on to pledge that if future guidance rules that federal credit unions may not develop 457(b) plans for their executives, then "a reasonable transition period … to revise its arrangements in order to avoid possible adverse tax consequences for participants" will be provided.

Guidance on the treatment of 457(f) plans developed by credit unions is also left to new rules being promulgated for Section 409A of the Internal Revenue Code. The adoption of the American Jobs Creation Act of 2004 added this new section to the IRC to enact new rules applying to 457(f) plans. Section 409A rules apply to "amounts deferred after 2004," while pre-section 409A regulations apply to pre-2005 deferred compensation, as long as the plan has not been "materially modified" after Oct. 3, 2004.

Section 409A rules, which were still in the proposed stage in the summer of 2006, are designed, in part, to head off some of the abusive practices that contributed to the downfall of Enron and played a role in other corporate scandals that made headlines earlier in this decade. For example, the new rules are expected to establish specific restrictions on an executive's ability to defer his or her benefits in a long-term compensation program indefinitely.

Credit union officials are also looking to 409A to clarify whether and how 457(f) plans may be employed by credit unions. Industry analysts do not expect final regulations under Section 409A until fall, and they're also unsure about whether the deadline for documentary compliance will be extended beyond the Dec. 31, 2006, deadline stated in the proposed rules.

CONCLUSION

Credit union boards face an ongoing challenge to develop and maintain an executive compensation philosophy that adequately rewards their CEO and other top managers for leading increasingly complex organizations and that ensures their retention. Deferred compensation, or additional retirement funding to offer a replacement income upon retirement on par with benefits afforded other employees, is becoming an increasingly desirable part of the overall compensation program, especially among top-performing executives for whom retirement age looms just a decade or so in the future.

Development of a deferred compensation program entails careful planning and multi –disciplinary consultation with professionals familiar with programs of this type. These would include:

- A competent executive compensation consultant who can guide the investigative process, provide the market standards for such programs, provide balance to the interaction with the board and the executive, and assure the resultant program is motivational to the recipient, and benefits both parties;
- experienced legal counsel to ensure a program structure that complies with complex and ever-changing state and federal regulations; and
- professional financial service provider(s) to develop the investment strategy necessary to informally fund the plan in a tax effective manner.

Furthermore, directors should consider these programs to be a work in progress, requiring regular monitoring and perhaps the inclusion of other executives to ensure continued high performance by the executive team and an orderly transition as these top employees near retirement age.

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