Best Executive Compensation Practices

By James S. Patterson, C. Daniel Sherman and Tom Telford

By carefully managing executive compensation, a credit union's board of directors can minimize the risk that executives, members, the public, or regulators will complain about or challenge how they compensate top management.

We have discovered what does and doesn't work after years of working on executive benefits for tax-exempt organizations. Here are some ideas your organization should consider adopting.

Develop a Compensation Philosophy

A compensation philosophy is a formal document that codifies the credit union's guiding compensation principles and objectives and establishes performance targets. It should be signed by the board chair and added to board minutes. The philosophy should:

1. Identify a peer group of employers
2. Target positioning within the peer group
3. Specify the balance between guaranteed and incentive compensation
4. Define the mix of cash compensation and benefits

Once approved, the board should regularly review their compensation philosophy document to ensure that compensation practices continue to conform to its guidelines. The board should not set the compensation philosophy aside and ignore it.

Some Benefits of Having a Documented Compensation Philosophy

Having a documented compensation philosophy helps to establish consistency in compensation levels that can be especially helpful as positions open up and new executives are hired to fill those slots. It also creates a measure of fairness that reduces the risk of a disgruntled executive suing the organization for employment discrimination. The philosophy is helpful when board members change as it gives them a strong basis on which to continue the status quo or to make necessary changes in compensation.

Seek Comparability Data

Knowing the compensation levels and practices of a peer group is critical for setting executive compensation to achieve the objectives stated in the philosophy. The board should not rely on just one source of data. Instead, it should review two or three reputable sources and compare the data it receives. A board's analysis of compensation levels may involve averaging, or sometimes eliminating an outlier if results seem skewed. It is important to compare similarly sized credit unions, and comparable positions within those credit unions. If the board uses a consultant to find the comparability data, it should verify that the consultant is providing reliable data. The board should not rely solely on comparability data provided by the executive team.

Require Regulatory and Tax Compliance

Boards should ask legal staff or consultants to confirm that the plans and their funding vehicles comply with all applicable regulations. An audit is the wrong time to find out that regulatory review or approval was required before the plan was implemented and the funding assets acquired, or that benefits were taxable earlier than expected or subject to penalties. The 46 states that have state credit union charters each have their own set of credit union laws and regulations that must be followed and federally insured state-chartered credit unions must understand and comply with all federal regulations and standards as well. On the other hand, federal credit unions do not need to comply with the state credit union laws in the states where they are headquartered; they are covered only by federal law and regulations.

Review Compensation Annually

Although a compensation package may be fair and consistent with the standards set forth in the compensation philosophy document, some executives will still perceive they are underpaid or have inferior benefits. Annual reviews can help avoid the surprise and disappointment of an executive resigning to accept a better offer, or discovering that after many years a plan

Compensation issues are complicated. As credit unions increase in size and complexity, the board should consider establishing a compensation committee or executive committee to oversee compensation issues for the board.

is woefully over or under-funded. Executives should be given an opportunity to ask questions or raise concerns. With all of its various compensation components—salary, incentive compensation, benefits, and perquisites—an annual review is a good opportunity to look at the big picture and see how all of the components interrelate.

Consider the Multiplier Effect

An executive's benefits are often tied to base salary. A defined benefit SERP, for example, may specify that the executive receive payments of 1.5 times base salary on a certain date. If base salary increases, this will directly increase the SERP payments. SERP benefits may also be based on total compensation (i.e., base salary plus incentive compensation), which significantly increases the complexity of managing the changes in the projected SERP benefit. Incentive compensation plans can be designed with large variances in possible awards, creating an even greater impact on the executive's SERP benefit. A board needs to be aware of these multiplier effects as it analyzes appropriate levels of base salary and incentive compensation for its SERP participants.

Establish a Subcommittee for Executive Compensation

Compensation issues are complicated. As credit unions increase in size and complexity, the board should consider establishing a compensation committee or executive committee to oversee compensation issues for the board. The board should choose committee members based on their experience with and interest in compensation issues. A committee can dig more deeply into and address more knowledgeably compensation details that are too tedious to be addressed in a typical full board meeting. The committee members should receive materials well in advance of the meeting so they have adequate time for analysis and are prepared for discussion.

Committees Must Communicate Effectively With the Board

Although such committees can add significant value to the board, their role is to administer the board's policy, not to create the policy itself. Effective communication between the compensation committee and the board is critical. Benefit levels can get out of control and create division when compensation committees fail to communicate effectively with other board members. At the end of each year, the committee should give the board a full report that reminds the board of the compensation philosophy it approved; that clearly and accurately discloses compensation levels of its executive team and relates that compensation to peer data; and provide minutes that summarize the committee's discussions throughout the year.

Engage Consultants Who Report Directly to The Board

Consultants live and breathe compensation and benefits, whereas most board members have only a general understanding. A specialist's review can ensure the credit union's compensation dollars are being used efficiently and that plans are fulfilling board and executive expectations. Consultants retained by, and reporting directly to the board help ensure that the board is receiving accurate, unbiased and unfiltered information. Consultants help boards understand complicated concepts, such as the nuances of comparability data.

No Screening or Filtering by the CEO

Boards received clear direction through NCUA's Rule 701.4 in January of 2011 that the NCUA is concerned about senior executives, especially chief executive officers, having too much influence over the executive compensation set by the board. The NCUA clarified that the board must set executive compensation without any "screening" or "filtering" from the CEO. In most areas of credit union governance, boards appropriately follow the CEO's direction. With executive compensation, however, board members need to analyze consultants' recommendations, lead out and make decisions without any pressure from the CEO. In the past, many boards allowed the CEO to set compensation for the other executives, but more and more boards are realizing that they need to take a more active hand in setting compensation for the other senior executives as well.

Before approving a plan modification, the board should understand the reasons for the change, their costs and the impact of the changes to benefits.

Inspect Plan Modifications

Before approving a plan modification, the board should understand the reasons for the change, their costs and the impact of the changes to benefits. As it reviews suggested changes, the board should meet in an executive session to ensure that executives and any board members with a personal stake in the outcome do not participate in the final decision. The board should also document its intent as it approves changes to plans, so it is clear to future board members and executives why the board approved the change.

Ensure Plan Dcumentation is Compliant and Terms Understood

A plan sponsored by a credit union is subject to state and federal regulations, as well as a number of provisions under the Internal Revenue Code—Section 457(f) and Section 409A to name two. Since 409A's inception in late 2004, the Internal Revenue Service has issued over 1,000 pages of guidance under that section alone. Having plan documentation prepared by a benefits attorney minimizes chances for regulatory or tax violations or for disagreements with executives or beneficiaries. Periodic professional review ensures that law changes are incorporated into the documents in a timely manner.

In a recent review of a SERP designed with annual payments following termination, we discovered that the board and executive believed that the SERP benefit would be taxed as the credit union paid the benefit each year. We explained that taxation under Section 457(f) occurs when the substantial risk of forfeiture lapses (e.g., retirement date attained during employment), regardless of when the credit union pays the benefit. This resulted in a significantly lower projected net benefit than previously anticipated, and required some difficult discussions for all parties involved.

Associate With Professionals to Monitor Legal Developments

The legal environment is fluid. Regular consultation with compensation professionals helps keep boards informed and prepared for the changing landscape. For example, the Internal Revenue Service in 2007 indicated it would issue guidance under Section 457(f) of the Code, but despite some occasional rumblings, the IRS has yet to issue any guidance. If and when the IRS does issue guidance, boards will need to review their plans to ensure compliance with the new rules.

Summary

Compensation best practices bring comfort to boards and executives in knowing that their executive compensation is competitive, compliant and an appropriate use of credit union resources.

Jim Patterson is an attorney with Sherman & Patterson, Ltd., a law firm focusing on executive compensation in credit union and other tax-exempt entities. Jim has worked closely with state regulators in the 46 states that have state credit union charters, as well as with regulators at the National Credit Union Administration. www.SPLawFirm.net.

Dan Sherman is also an attorney with Sherman & Patterson, Ltd.

Tom Telford Chris is an Executive Vice President with Burns-Fazzi, Brock & Associates (BFB). Tom specializes in executive compensation consulting for the credit union and other not-for-profit industries. www.BFBbenefit.com.