

# The Acid Test of Governance: Executive Pay and Benefits

## Firefighters National Credit Union Summit 2010

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# Board Due Diligence

*“Executive compensation is the acid test of corporate governance.”*

*Warren Buffet*

# Board Due Diligence: Decision Framework

Human Capital Strategy

Compensation philosophy

- Framework
- Decision criteria

Compensation strategy addressing current and future needs and aligning with corporate strategy

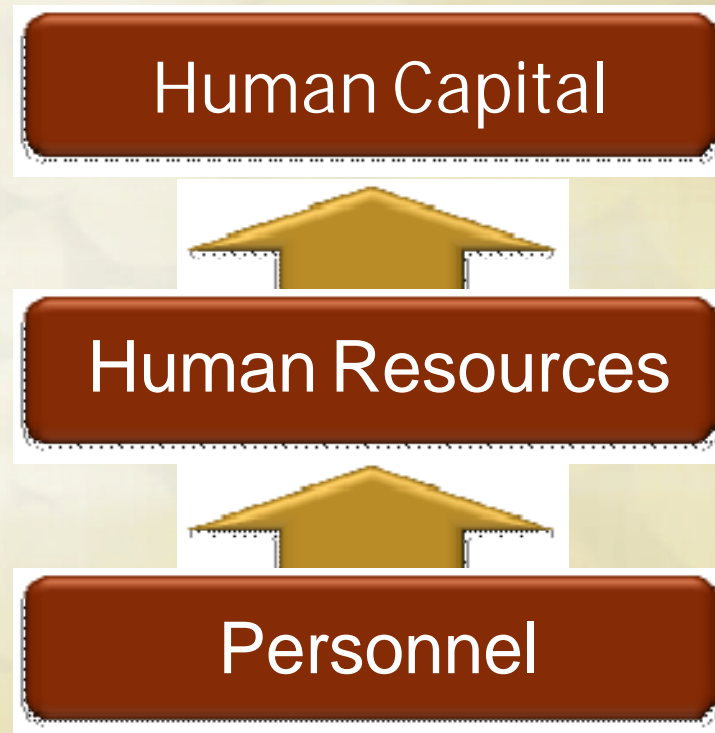
- Focus for actions and decisions

# Governance Hot Topic: Executive Compensation

- Executive compensation consistently ranks at the top of corporate governance hot topics
- Compensation has become a far more complicated issue
- Building a fair and attractive compensation package is critical for attracting and retaining employees
- CUES survey: 8 in 10 CEOs have been working for credit unions for 15+ years and NAFCU survey: almost 50% are age 55+
- NCUA 2008 task force final report: increased transparency of executive compensation would improve “accountability and be more consistent with the prevailing public policy.”



# Strategic View



# Board Due Diligence: Strategic Questions

1. Is our strategy working?
2. Are we building the capacity we need to drive strategic growth?
3. Do our incentive plans actually incent the performance and/or behaviors we need?
4. Do we have an adequate succession plan and are we managing our talent risk?
5. Are we meeting regulatory requirements?
6. Are our practices “fair and reasonable”?

# Board Due Diligence: Compensation Policy

## Board Oversight for Compensation policy

- Procedures to set compensation for the organization's chief executive, officers and "key employees"
- Review and approval by board of directors or compensation committee excluding those with conflicts of interest
- Application of data for comparable compensation for similarly qualified persons in functionally comparable positions at similarly situated organizations
- Documentation and recordkeeping of the deliberations and decisions regarding the compensation
- Assurance that activities and operations of branches or affiliates are consistent

# Measuring Return

## Traditional HR Metrics

- Turnover Rate
- Average time to fill positions
- Compensation Costs/employee
- Benefits as % of Compensation

## Human Capital Metrics

- Operating Income/employee
- Comp and Market Ratios
- Human Capital Efficiency Ratio
- Human Capital ROI
- Total Realized Value



# Measuring Return

Human Capital Efficiency Ratio

$$\frac{\text{Operating Income per employee}}{\text{Salaries and Benefits per employee}}$$

Human Capital ROI

$$\frac{\text{Net Income}}{\text{Total Salaries and Benefits}}$$

# Sample HC Metrics Study

Performance Factors/Ratios	2008	2007	2006	2005
Salaries and Benefits	9,760,692	10,412,043	9,996,635	8,807,696
Total Income	34,103,507	33,156,183	30,679,714	28,277,398
Operating Income	22,979,273	21,658,729	24,829,047	22,630,405
Net Income	2,387,570	1,383,443	3,975,202	5,464,358
FTEs	130	140	138	127
Total Assets	548,907,607	494,432,796	489,247,949	486,729,029
ROA	0.43%	0.28%	0.81%	1.12%
Comp Efficiency Ratio	2.35	2.08	2.48	2.57
ROI in Human Capital	24.46%	13.29%	39.77%	62.04%
Op Income/Employee	176,764	154,705	179,921	178,192
Total Comp/Employee	75,082	74,372	72,439	69,352

# HC Metrics Sample Comparisons

Performance Factors/Ratios	A	B	C	D	F	G	H
Total Comp + Benefits	1,294,646	2,376,313	7,225,734	7,496,176	8,463,279	15,457,471	67,267,988
Total Income	4,460,414	11,163,025	26,441,233	25,450,850	34,455,252	59,009,656	743,966,498
Op Income	3,351,443	6,278,350	17,465,532	14,778,889	19,468,196	30,886,461	230,429,701
Net Income	204,078	1,564,485	3,811,520	2,038,842	284,178	3,460,420	46,487,095
Member /Emp	1 to 334	1 to 363	1 to 317	1 to 370	1 to 323	1 to 348	1 to 803
Total Assets	53,017,246	170,136,648	372,850,787	417,515,943	494,164,466	1,031,166,248	12,942,944,625
ROAA	0.39%	0.95%	1.05%	0.51%	0.06%	0.36%	0.38%
Comp Eff Ratio	2.59	2.64	2.42	1.97	2.30	2.00	3.43
ROI H Capital	15.76%	65.84%	52.75%	7.20%	3.36%	22.39%	69.11%
Op Income/ Employee	167,572	209,278	108,482	167,942	105,233	160,033	222,208
Comp /Employee	64,732	79,210	44,880	85,184	45,747	80,091	64,868





# Goals of the Presentation

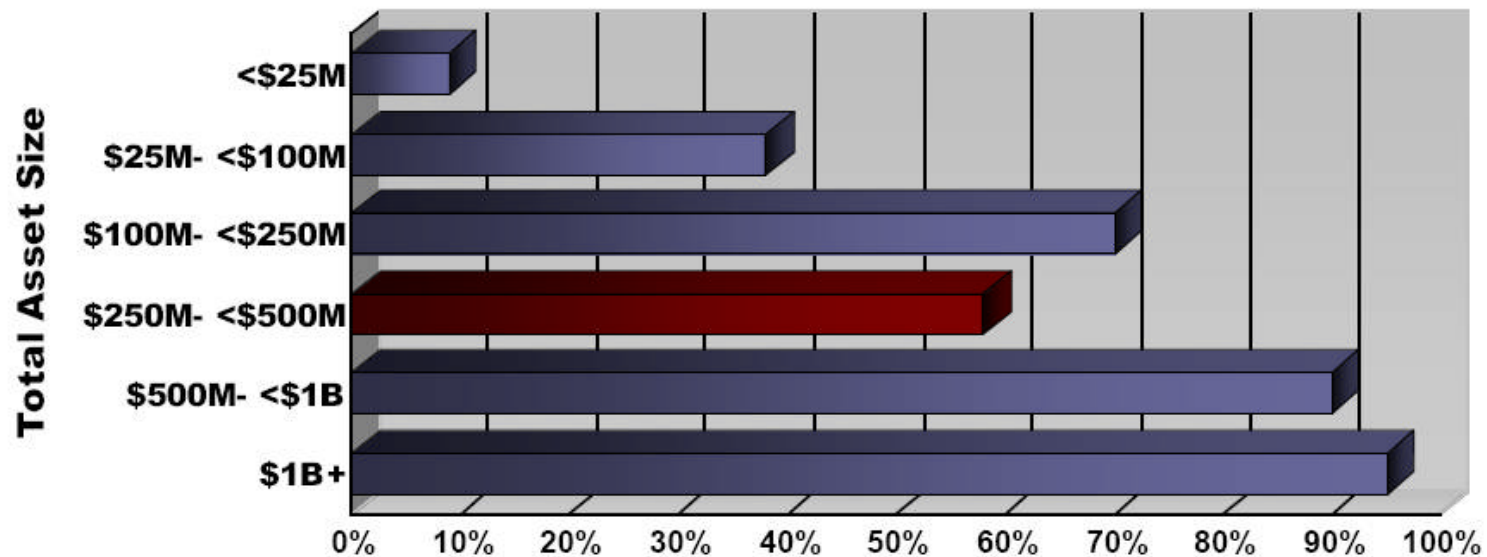
- Where Credit Unions are in the area of Executive Benefits Today
- Types and Uses of Executive Benefit Plans
- Determining what is Fair and Reasonable in Executive Benefits
- Sample Plans
- Roadmap to Safety and Soundness

# What Others Are Doing

## How Many Have Nonqualified Benefit Plans?

The likelihood that a credit union provides a nonqualified benefit plan tends to increase with asset size. For credit unions with \$250 million to less than \$500 million in assets, about six of every ten (58%) provide these plans to one or more executives.

### Provide Executive Nonqualified Benefit Plans (Including Severance)



Source: 2010 NAFCU Survey

# What Others Are Doing

## **Total Assets of \$250 Million to \$500 Million**

### **Nonqualified Benefit Plans for Top Executive**

For credit unions in the asset group, it is estimated that nearly four in ten provide 457(b) plans, one in three provide 457(f) plans and one in three provide severance plans to their top executives.

#### **Type of Nonqualified Benefit Plan(s) for Top Executive**

SERP 457(b)	38%
SERP 457(f)	34%
Severance Plan	36%
Split Dollar Plan	17%
NQ or Severance Plan Not Available	46%

*Source: 2010 NAFCU Survey*

# What Others Are Doing

## CEO and Executive Benefits Data Asset Category: \$200 Million - \$399.9 Million

CEO	
1.	76.0% Bonus Eligible (Average 14.0% of base salary) Amount \$32,568
2.	62.0% Supplemental Life Insurance
3.	17.0% Split-Dollar Insurance
4.	37.0% Executive Long-Term Disability
5.	35.0% Medical Insurance Premium Reimbursement
6.	97.0% 401(k) Plan (Average plan match 4.0%)
7.	28.0% Defined Benefit Plan
8.	17.0% Defined Contribution Plan
9.	48.0% 457(b) Plan
10.	35.0% 457(f) Plan
11.	54.0% Paid Spouse Travel
12.	26.0% Club Memberships
13.	59.0% Paid Education Benefits
14.	78.0% Car or Car Allowance (Car allowance - \$5,674/year)
15.	48.0% Employment Contract
16.	14.0% Change in Control Provision

Other Executives	
1.	71.0% Bonus Eligible (Average 10.0% of base salary) Amount \$9,459
2.	40.0% Supplemental Life Insurance
3.	2.0% Split-Dollar Insurance
4.	19.0% Executive Long-Term Disability
5.	19.0% Medical Insurance Premium Reimbursement
6.	97.0% 401(k) Plan (Average plan match 5.0%)
7.	26.0% Defined Benefit Plan
8.	14.0% Defined Contribution Plan
9.	28.0% 457(b) Plan
10.	7.0% 457(f) Plan
11.	14.0% Paid Spouse Travel
12.	8.0% Club Memberships
13.	56.0% Paid Education Benefits
14.	7.0% Car or Car Allowance (Car allowance - \$2,350/year)
15.	2.0% Employment Contract
16.	1.0% Change in Control Provision

Source: 2010 Credit Union Executive Society Compensation Survey



# What Others Are Doing

## Corporate Benefit Plans by Asset Size

	All Banks & Thrifts	<\$250M	\$250M to \$500M	\$500M to \$1B	\$1B to \$5B	> \$5B
Sample Size	909	174	188	219	218	110
401 (k) Plan	89.9	71.8	91.0	94.5	97.7	91.8
Cash Incentive Plan	75.8	39.1	67.6	85.4	91.3	98.2
Change in Control Agreement	76.9	72.4	74.5	77.2	78.9	83.6
Deferred Compensation Plan	55.3	28.2	49.5	55.3	66.1	87.3
Director Stock Plan	69.0	62.6	60.6	70.8	71.1	85.5
Employment Agreements	70.5	75.3	70.2	70.8	72.0	60.0
ESOP *	47.9	38.5	45.7	44.3	56.0	57.3
Qualified Pension Plan	29.3	13.2	26.6	26.9	31.7	59.1
Qualified Profit Sharing	43.9	35.1	53.7	43.4	44.0	41.8
Restricted Stock Plan	40.8	24.7	27.7	37.0	49.1	80.0
Stock Option Plan	87.6	80.5	80.3	88.6	94.0	96.4
SERP **	49.5	22.4	46.3	57.5	55.5	70.0

\* ESOP/ESPP = Employee Stock Ownership Plan / Employee Stock Purchase Plan

\*\* Supplemental Executive Retirement Plan

Source : SNL Financial Executive Compensation Review (2007)

# Types of Executive Benefit Plans

## Tax Deferral (Deferred Compensation)

1. 457(b)
2. 457(f)
3. 451

## Taxed Immediately (Section 162)

1. Restricted Bonus
2. Secular Trust

## Tax Avoidance (Welfare Benefit Plans)

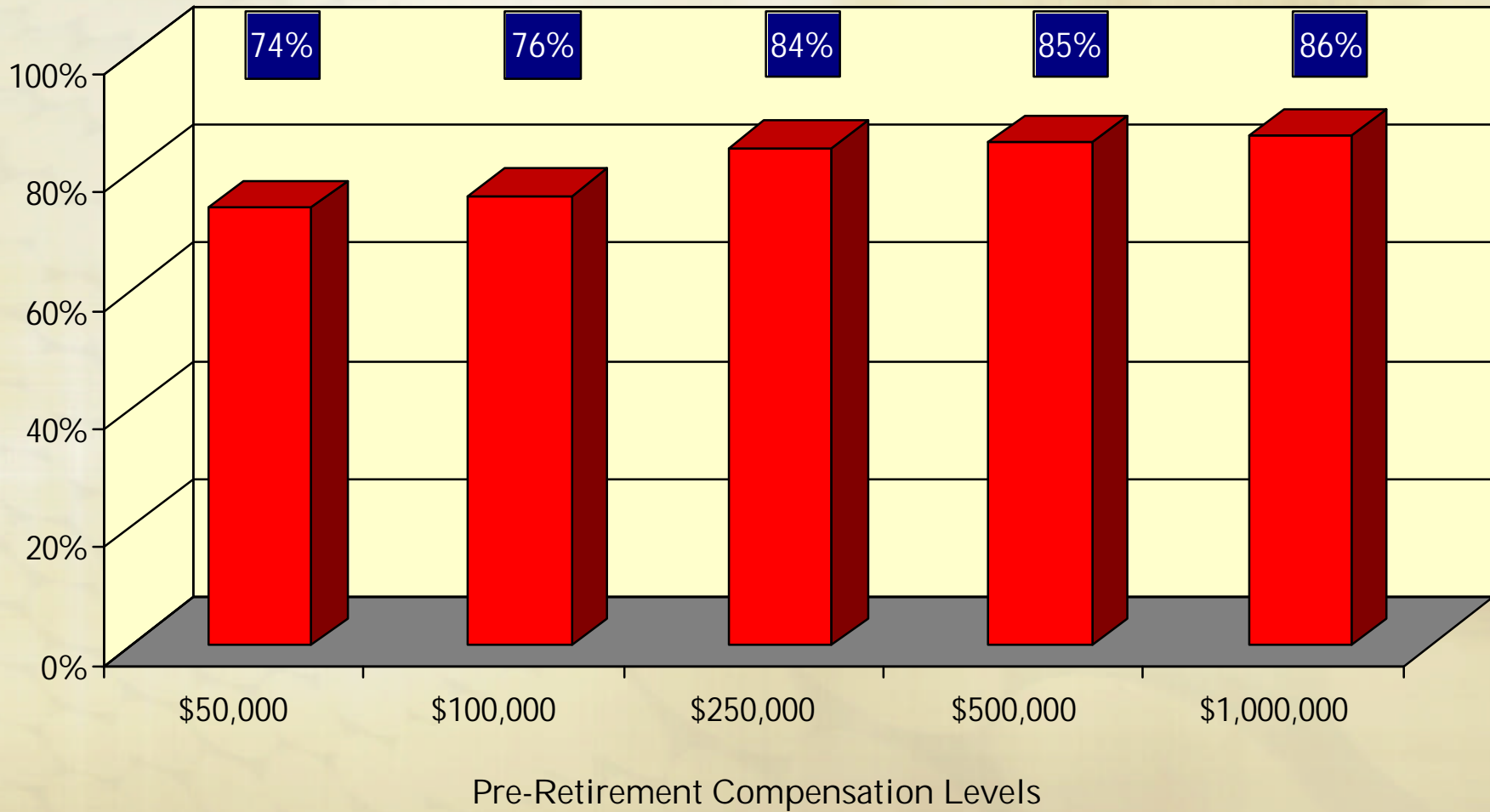
1. Post Retirement Medical
2. Split Dollar

# A Question of Fairness

According to financial planners, employees will need about 70-80 percent of pre-retirement income to enjoy a comfortable retirement. Typically, retirement income sources include Social Security and qualified retirement plans. For employees with higher salaries, a gap is created due to IRS limitations on qualified plans and annual exempt amounts with Social Security.

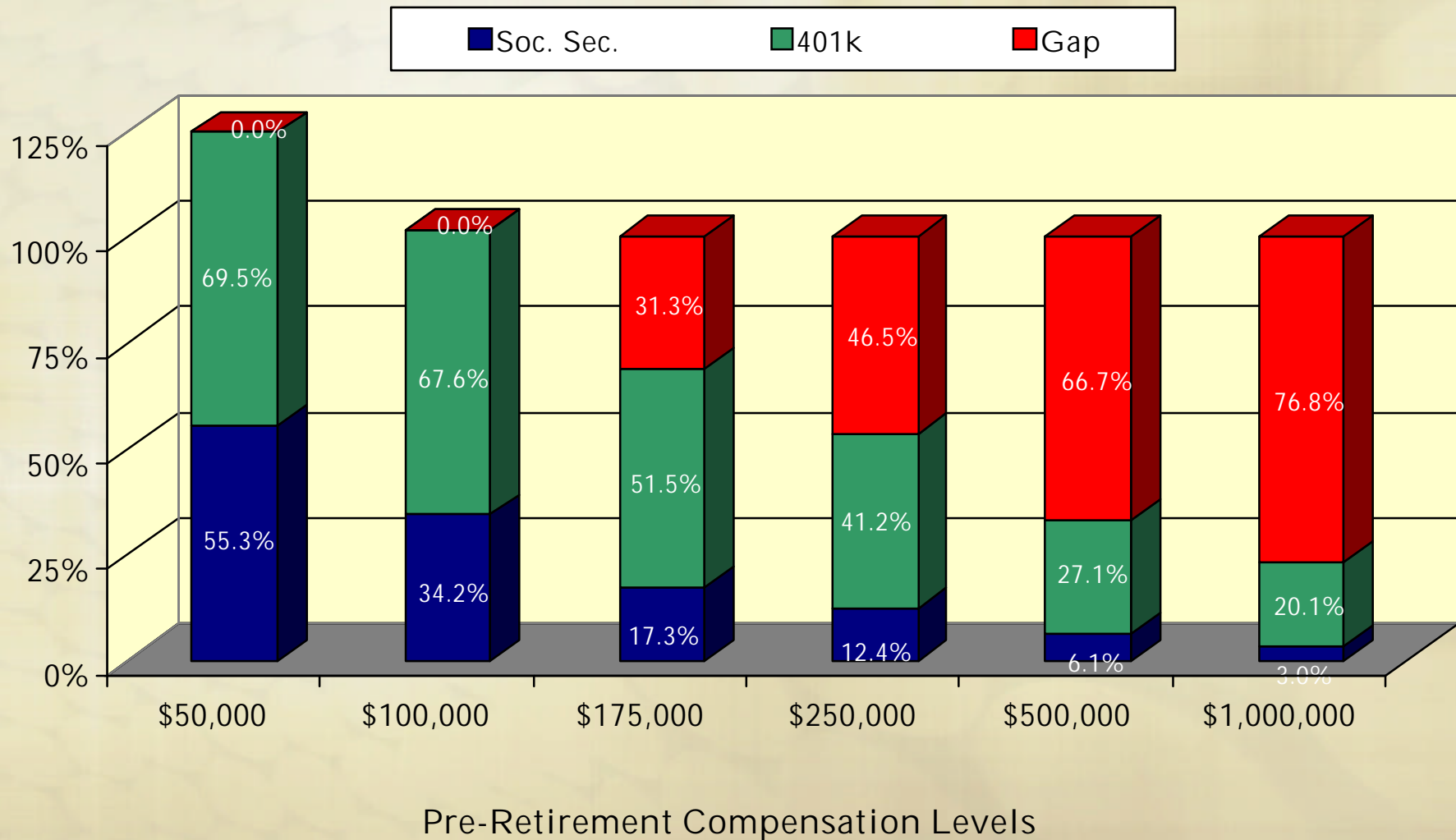
The graphs on the next slides show the income replacement at retirement provided by Social Security and qualified plans for different income levels.

# A Question of Fairness *(Continued)*





# A Question of Fairness *(Continued)*



# Example of "GAP"

PARTICIPANT DATA						PROJECTED ANNUAL DISTRIBUTIONS FROM EXISTING BENEFIT PLANS				
Proposed Participant	Age as of 4/1/2010	Years of Service	Salary (\$) as of 4/1/2010	Proposed Retirement Age	Projected Final Salary (\$)	Retirement Length (Yrs)	Social Security (\$)	Current Plans (\$)	Total Existing	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
PRESIDENT/CEO	44	21	275,000	62	661,820	20	19,584	112,213	131,797	19.91%
COO	42	25	153,831	62	388,723	20	20,160	112,503	132,663	34.13%
CAO	44	39	132,132	62	317,991	20	19,584	105,823	125,407	39.44%
CLO	40	41	134,513	62	374,748	23	21,390	122,467	143,857	38.39%
SVP MORTGAGE LENDING	59	4	170,362	62	187,824	23	12,114	4,614	16,728	8.91%
CCO	43	21	130,000	62	312,861	20	19,578	69,353	88,931	28.43%
CONTROLLER	43	37	104,000	62	262,803	20	19,506	90,089	109,595	41.70%
TELLER	25	40	29,544	62	171,113	23	19,266	79,662	98,928	57.81%
BRANCH MANAGER	57	37	74,066	62	90,028	23	10,548	28,094	38,642	42.92%
HR MANAGER	31	36	68,000	62	293,892	23	24,552	117,960	142,512	48.49%
IT SUPPORT SPECIALIST	35	30	39,097	62	139,016	20	15,498	47,658	63,156	45.43%
<i>Average benefit for lower tiered employees as a % of final salary:</i>										48.66%

**Notes/Assumptions:**  
 - The report indicates the participant's projected final average compensation rate, growing from the current compensation rate at a 5.00 percent annual increase (inflating on January 1 of each year).

# Safety and Soundness

Roadmap to Construct a Plan, Identifying and Avoiding Risks

Third Party  
Relationship  
Vendor  
Selection

Legal and  
Product  
Risk Analysis

Ongoing  
Board Due  
Diligence &  
Administration

# Vendor Selection Guidelines

## Three Key Considerations:

1. Evaluate the vendor's experience and expertise
  - History
  - Endorsements
  - Business Model
2. Weigh the vendor's reputation in the industry
  - Clients
  - Financial Health
3. Examine key operational issues
  - Online Administration
  - Compliance Reporting
  - SAS70
  - Field Personnel



# Assessing Risk

The vendor should conduct a Pre-Purchase Analysis of all products used to ensure the credit union understands the risks, rewards and unique characteristics.

Risk Management Analysis of Permissible Product – understand and address potential informal funding risks, which include:

- Market/Transactional Risk – Type of Product
- Interest Rate Risk – Market Volatility
- Credit Risk – Carrier Rating
- Liquidity Risk – Ability to Liquidate Assets Quickly with Minimal Loss in Value
- Strategic Risk – Function of the Compatibility of the Credit Union's Strategic Goals
- Compliance Risk – Initial and Annual Compliance Update
- Reputation Risk – Full Understanding by Board of Plan

# Assessing Risk *(Continued)*

The credit union should understand the contractual risks of a benefit plan.

Risk Management Analysis of Legal Obligation which includes:

- Type of Promise
  - Nonqualified
  - Welfare Benefit
- Events that Trigger Payments (Cash Flows)
  - Payment Date/Retirement
  - Death
  - Disability
  - Change of Control
  - Termination – Voluntary/Involuntary

# Ongoing Due Diligence

- Implementation
- Ongoing Administration System
- Financial Reporting/Compliance
- Annual Review
  - Plan
  - Product



# Board Due Diligence

# Questions?