



ENDSIGHT

Volume 39
First Quarter
2010

ENDSIGHT is a quarterly publication of Executive Compensation Solutions, which is entirely responsible for its content. Please contact us at www.ecs-m.com, creditunion@ecs-m.com, or (626) 914-2333.

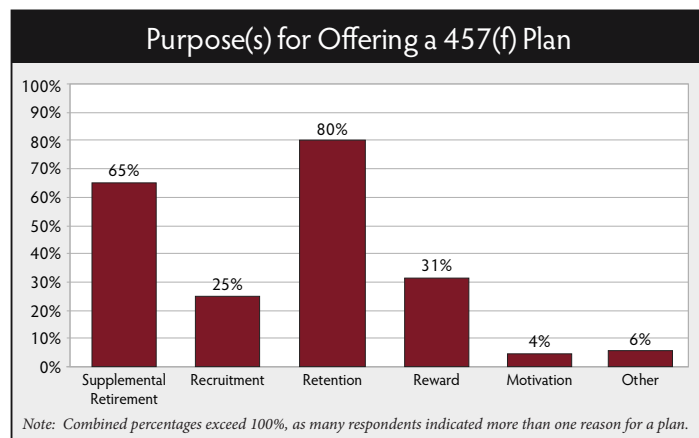
Performance Linked Benefits: A Shifting Perspective

Executive long-term compensation programs have become a popular tool for rewarding long-term service of credit union executives. However, care needs to be taken when determining which performance factors to use. Short-term performance goals can put too much emphasis on excessive risk. In some cases, short-term performance achievements that drove bonus compensation subsequently evaporated. Recent economic realities have resulted in a shift in perspective on these programs. Moreover, there has been increasing regulatory and legislative pressure on financial institutions to move away from executive bonus systems that recognize and reward short-term performance. Thus, it may be time to consider greater "at-risk" elements and longer-term performance factors in the design of executive compensation programs.

Credit union boards will increasingly focus on aligning the interests of executives and members in assuring long-term success. They will also have to stay abreast of reasonable and meaningful executive attraction, retention, and reward programs. This is especially important in troubled economic times, when credit unions are competing with other financial institutions for talent that can create value for the credit union and its members. The NCUA and state regulatory agencies consider retirement and succession as a primary board responsibility.

What Is A SERP?

The regulatory limits of qualified retirement plans regarding contributions, benefits, and compensation amounts used for benefit calculations usually result in a lower retirement benefit for executives as a percentage of income replacement. One way to make up for these limitations is a non-qualified supplemental executive retirement plan (SERP). The authority for SERPs in the credit union world is Internal Revenue Code (IRC) §457. Recently published, *The Survey 2009: Employee and Executive Compensation and Benefits for the Credit Union Movement* shows that credit union boards see recruitment and retention as important purposes for a SERP plan, as well as the more traditional reward and retirement SERP goals. *The Survey* also indicated that 57 percent of credit unions provide a benefit of at least 40% of final compensation.



(Source: *The Survey 2009: Employee and Executive Compensation and Benefits for the Credit Union Movement*)

Can A SERP Be Tied To Performance?

A SERP can be tied to both the long-term objectives of the credit union and the long-term performance of the executive. The SERP contribution or benefit can be conditioned on a variety of performance measures that are important to the credit union and consistent with its strategic objectives. Specific and strategic measures such as revenue, membership loyalty, growth factors, and individual accomplishment can be used to determine the delivery and magnitude of the

benefit. The most important aspect of performance linkage is making sure the goals are understandable in advance, and establishing the right level of accomplishment that will determine the reward contribution and delivery. If the executive is clear about the goals, and considers the performance measures and the delivery of the benefit to be reasonable, meaningful, understandable, and fair, he or she will be motivated to achieve them.

How Do Performance Linked SERPs Work?

Specific performance measures are used to determine the amount contributed to the plan or the benefit amount earned by the executive. Since a non-qualified plan is only informally funded (see discussion below, "How About Cost?"), there are no real contributions to the plan. Instead, a bookkeeping entry is made upon the achievement of a performance benchmark. If the SERP is designed with a defined benefit target at the outset (either as a percentage of final average compensation, or as a specific dollar amount), there is an accrual (present value of a piece of the benefit earned) as a future obligation to the executive.

Any vesting of a SERP benefit governed by 457(f) triggers immediate taxation on the entire benefit earned or on the existing account balance. For this reason, most credit union SERPs are paid at the distribution event in a lump sum. SERPs can be structured with multiple payout dates, as long as those dates are determined in advance. For example, partial payments of the benefit earned could be paid at age 55, age 60, and age 65. The tax on any payment is due when the payment date is reached, regardless of when the money is actually paid, so payments are made when the date is reached and vesting occurs. The upside is that the reward is delivered closer to the performance achievement.

How About Cost?

Cost is best defined as the impact to the income statement. The goal is to reward performance based benchmarks or growth and to pay for the reward with incremental dollars. Conversely, there is no benefit if the established goals of the credit union are not achieved. However, any deemed contribution or benefit accrual is a liability and there needs to be a charge to the earnings of the credit union in the year that this liability is incurred.

Since 2004, the NCUA has provided that informal funding that is used for the purpose of creating gains to offset "employee and officer benefit expenses, liabilities, or potential liabilities" may be redeployed in assets that a credit union would normally not be allowed to hold. Such "otherwise impermissible" assets can include mutual funds, bonds, life insurance, annuities, or equity securities. The gains on these assets cannot exceed the credit union's overall benefit costs and liabilities. If, over time, the credit union recovers its outlay for the benefit, the funding dollars and a cost of funds, the members are made whole.

What Can We Conclude?

Credit unions will increasingly find it advantageous to include a long-term "at-risk" component to their executive compensation packages, including the alignment of credit union goals and executive performance criteria to drive the supplemental retirement plan. The credit union must motivate the executive to achieve organizational and individual goals over the long-term, rather than providing short-term incentives that may increase risk in order to create short-term success. Performance linked SERPs can be flexible and fit into an executive compensation package that is focused on the strategic goals of a credit union. Long-term incentive plans should be meaningful and motivating to the executive, coordinated and integrated with the other components of the executive compensation package, and reflect the culture and philosophy of the credit union.

To promote a healthy environment, ECS will begin providing the **ENDSIGHT** Quarterly Newsletter electronically by e-mail. To continue receiving **ENDSIGHT**, please send your Name, Credit Union Name, and E-mail address to creditunion@ecs-m.com. Please reference **ENDSIGHT Newsletter** in the subject line of the e-mail. Thank you!