NON-QUALIFIED EXECUTIVE BENEFITS: A GUIDE FOR CREDIT UNION LEADERSHIP

Written by

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

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Table of Contents

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CUNA Mutual Group is the nation's largest provider of credit union executive benefits plans, with more than 3,700 plans at 1,200+ credit unions. The Executive Benefits team is fully credentialed to provide a wide array of plans and funding options, as well as comprehensive administrative support to help maintain oversight and compliance with National Credit Union Administration (NCUA) and state regulations.

Executive Summary

Competition for executive leadership has become increasingly intense in the financial services sector. Deferred compensation plans offer an effective means for credit unions to recruit, retain and reward talented executives and to support succession planning. This ebook provides an overview of the rationale for developing these plans and describes the most common forms of deferred compensation, including 457(b), 457(f) and split-dollar life insurance programs. Case studies illustrate elements of a nine-step process to develop and maintain a deferred compensation plan, and data from the 2017 CUES Executive Compensation Survey indicates current trends in the use of these plans across the industry.

Introduction

Deferred compensation programs are one of the few powerful incentives credit unions can prudently offer to keep the industry's best executive talent from jumping to competitors. It's natural that, in the coming years, deep-pocketed financial institutions will target more executives from credit unions. Success will do that.

Credit unions have made significant gains over the last decade: Membership in federally insured credit unions increased 26 percent to 109.3 million from June 2007 to June 2017, while total assets grew a whopping 82 percent to $1.35 trillion, according to a recent National Credit Union Administration report.

A 2017 Federal Reserve Bank of Philadelphia report notes that credit unions have grown faster than both large and small banks since 1984, based on total asset growth index. However, credit unions on average are still smaller than community banks ($198.5 million compared to $443.6 million, as of 2015) and still have a lot of market potential to grow, with their 7.1 percent share of all assets and loans held by U.S. depository institutions.

The Wisconsin marketplace is a good example of credit union emergence. Five of the top 10 financial institutions based in Wisconsin are credit unions, business reporter Judy Newman writes in The Wisconsin State Journal. From 2011 to 2016, assets of Wisconsin credit unions grew 43 percent, compared to 12 percent gains for banks based in the state. Since 2012, two banks in Wisconsin and one in Minnesota have been purchased by credit unions, Newman reports.

The Great Recession pushed many Americans toward a more responsible, consumer-friendly alternative to the giant financial firms that triggered so much misery. As this discussion so far suggests, credit unions have taken advantage of that opportunity to shine.

Many credit union leaders have earned their keep by growing their organizations, navigating through economic uncertainties and a prolonged squeeze on net interest margins. They've kept pace with technological advances in online and mobile services. And they're steering their institutions toward new products, such as commercial lending, without easing off the gas on consumer lending and other primary lines of business, such as credit and checking.

For example, the Credit Union Trends Report from CUNA Mutual Group on April 2017 data shows a 26.5 percent seasonally adjusted annual growth rate for auto loans. Overall, credit unions' combined loan balances increased 14 percent and savings balances grew 8.5 percent annually, and 433,000 new memberships were added in April, the report notes.

Credit union boards have recognized the need to reward this success. Over the past decade, the CUES Executive Compensation Survey (cues.org/ecs) has charted a steady rise in salaries and annual bonuses for CEOs and other executives. Executive compensation experts conclude from this data that credit union executives are nearly even with their community banking peers—at least in short-term compensation.

Longer-term compensation is another matter. For-profit banks can structure stock option plans to reward executives for success over time. Credit unions can't.

But credit unions do have deferred compensation tools that are helping to attract, retain and reward strong executives, while supporting a stable transition from one leader to the next. This ebook explores what options are available and how credit unions can customize them.

Part 1.
Overview: Components of a Non-Qualified Executive Benefits Program
Vocabulary of Deferred Compensation

In **deferred** or **long-term compensation** arrangements, executives earn income, in excess of their regular salary, that is paid at a future date. These arrangements may provide income paid in retirement and/or in increments prior to retirement. Deferred compensation is one component of an executive benefits package, which may also include an annual bonus, additional insurance benefits beyond those offered to all employees, and other monetary and nonmonetary perquisites (e.g., club membership, car, spousal travel on business trips).

The deferred compensation plans addressed in this ebook typically fall into the "non-qualified" category, a term relating to the Internal Revenue Service qualifications for tax deferral. These deferral rules are extensive, but here's a high-level comparison:

1. **Qualified plans** refer to retirement benefit programs in which all employees may elect to participate, including the CEO and other highly compensated employees; 401(k) programs are a common example. These plans have tax-deferred status and are governed by the IRS and the Employee Retirement Income Security Act of 1974, which detail contribution limits, benefit availability and nondiscrimination requirements.
2. **Non-qualified plans** are created for the CEO and, in a growing number of credit unions, other executives. Non-qualified plans encompass both retirement programs and other compensation arrangements designed to be paid out during executives' tenure with the credit union.

Here are a few key terms related to deferred compensation and non-qualified plans:

457(b) plan: a non-qualified defined contribution plan available to governmental and tax-exempt employers, including federal and state credit unions. Credit unions may develop this plan to allow for highly compensated employee and employer contributions beyond the 401(k) plan limit, adding up to $18,500 annually (the 2018 limit) in retirement funding.

457(f) plan: a non-qualified deferred compensation arrangement with no specific dollar limits, available to governmental and tax-exempt employers, including federal and state credit unions. Money set aside to fund this plan must be subject to a "substantial risk of forfeiture," a requirement that will be discussed later in this ebook

Defined benefit plan: a deferred compensation plan design that specifies the benefit amount. Common methods of expressing the benefit include a specific dollar amount, a percentage of final earnings and a schedule of amounts based on length of service. The employer contributes the amount necessary to provide the benefit.

Defined contribution plan: a deferred compensation program 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 contributions in an investment vehicle. Unlike a defined benefit plan, there is no guarantee of a specific benefit amount.

Salary replacement target: the percentage of an executive's annual working income that will be replaced by annual income from a combination of retirement programs, such as Social Security, 401(k) and 457 plans, and other qualified plans.

Split-dollar life insurance plan: an agreement built around an insurance policy wherein the benefits of the policy are “split” or shared between the employer and employee.

- A form of this arrangement is “loan regime split-dollar” (also commonly referred to as “collateral assignment split-dollar”) that works like this: The credit union issues a loan to the executive to cover the insurance premiums, and the death benefit is split between the credit union and the employee to ensure repayment of the loan. Under this arrangement, the executive can take distributions from the policy’s cash value for supplemental retirement income, and the remaining death proceeds (after repayment to the credit union) go to the executive’s beneficiaries.
- Another form of split-dollar plans is “endorsement split-dollar,” in which the credit union owns a life insurance policy covering the life of an executive. Typically the policy is owned as an investment in the cash value, and a portion of the death benefit is “endorsed” to the executive for the benefit of his/her beneficiaries.

Supplemental executive retirement plan: a commonly used term that refers to deferred compensation agreements between the credit union and key executives. In these agreements, the credit union agrees to provide supplemental retirement income to executives and their families if certain agreed-upon eligibility and vesting conditions are met. Examples of SERPs include 457(b), 457(f) and collateral assignment split-dollar life insurance plans.

Prevalence of Deferred Compensation Components in Credit Unions

The *2017 CUES Executive Compensation Survey* measured deferred compensation plans available to CEOs and other executives. Asset size seems to be a major factor for survey participants. For example, the availability of 457(b) and 457(f) plans for CEOs increases steadily with asset size. Additionally, split-dollar life insurance plans for chief executives are most often used by credit unions in the $400 million to $999 million asset range.

CEO Eligibility for Retirement Benefits/Long-Term Compensation by Asset Range

	<$50M	$50-69M	$70-99M	$100-199M	$200-399M	$400-599M	$600-999M	$1B+
Split-dollar life insurance	10.0%	0.0%	23.1%	19.4%	31.0%	43.8%	43.8%	23.8%
401(k) plan	72.4%	90.9%	95.8%	96.7%	94.7%	96.6%	96.6%	98.6%
Defined benefit plan	6.9%	18.2%	25.0%	21.3%	19.3%	33/6%	31.0%	26.0%
Defined contribution plan	6.9%	0.0%	4.2%	11.5%	12.3%	16.1%	20.7%	11.0%
Money purchase plan	3.5%	0.0%	0.0%	4.9%	1.8%	3.2%	6.9%	2.7%
457(b) plan	17.2%	18.2%	12.5%	27.9%	35.1%	58.1%	51.7%	80.8%
457(f) plan	10.3%	9.1%	8.3%	29.5%	42.1%	29.0%	55.2%	53.4%
Other retirement plan	31.0%	0.0%	8.3%	9.8%	10.5%	6.5%	10.3%	10.3%

Deferred Compensation Plans Offered by Executive Position

	457(b) plan	457(f) plan	Split-dollar life insurance
CEO	44.1%	35.6%	25.7%
Executive Vice President	45.5%	28.6%	16.3%
Second Executive Officer	39.9%	19.3%	11.2%
Chief Operations Officer	37.5%	14.0%	9.8%
Chief Financial Officer	43.9%	19.9%	9.3%
Chief Lending Officer	35.8%	13.3%	4.8%
Branch/Member Service Exec	37.0%	13.5%	7.5%
Marketing Executive	39.1%	11.5%	4.4%
Human Resources Exec	47.2%	14.1%	7.4%
IS/E-commerce Exec	41.5%	14.3%	4.4%
Business Dev. Exec	22.7%	4.6%	0.0%
Business Lending Exec	33.3%	11.7%	7.9%
Senior CUSO Exec	58.8%	17.7%	0.0%
Legal Counsel Exec	47.8%	26.1%	6.7%
Chief Operating Officer	48.6%	28.6%	4.6%
Regional Branch Exec	15.6%	6.3%	0.0%
Top Mortgage Lending Exec	37.5%	10.7%	6.1%
Top Operations Officer	33.3%	19.1%	8.3%

Part 2.
Nine Steps to Creating a Deferred Compensation Program

1. Answer the question: Why are we doing this?

Why not just raise salaries and annual bonuses? Structuring and maintaining deferred compensation plans can be complex and time-consuming, but it pays off in ways a salary boost or annual bonus may not.

Short-term compensation is typically tied to short-term performance goals—how the credit union or the executive's department performs in relation to the board's annual goals. If the executive meets those goals over several years, the board sets its sights on keeping that high-performing leader with the organization for the long term. Notably, a competitor could easily match a salary boost or bonus or promotion. Without a long-term benefit plan in place, the credit union has few advantages in a bidding war.

On the other hand, a credit union can structure a deferred compensation plan that motivates its successful executive(s) to stay with the organization. Offering a $100,000 payout at the end of five years of service, for example, may be an effective enticement, especially as the end of that term draws nearer. An executive who has put in three and a half years of that term is much less likely to be tempted by the offer of a 10 percent raise elsewhere.

Recognizing the 'Driving Force' of Effective Leadership

Case Study: American Heritage Federal Credit Union, Philadelphia
($2 billion, 165,000 members, www.amhfcu.org)

When Bruce Foulke joined American Heritage Federal Credit Union in 1979, it was a $5 million financial institution serving 4,000 members. Under the CUES member's leadership as president/CEO, the credit union has grown to $2 billion. Over time, says Chair Cecilia Grady, "We began to hear warnings: 'You have to be careful about compensating him well, because as he makes a name for himself, other credit unions may try to steal him from you.' We began looking at other forms of compensation that would entice Bruce to stay with our credit union."

The board's executive committee took on the task of gathering information about options for structuring deferred compensation plans to supplement Foulke's salary and annual bonus. About 15 years ago, the board voted to offer him a 457(f) plan structured to enhance retention. In addition, a split-dollar life insurance program was put in place for him in 2016

American Heritage FCU now offers deferred compensation plans to its full senior management team. Ten vice presidents and executives qualify for a 457(b) retirement account after completing a year of service in their management positions, funded annually with the equivalent of two weeks salary. They have the option of allocating additional amounts from their paychecks, to those accounts up to the mandatory limit.

Foulke has also put in place 457(f) plans as a retention tool for the more experienced members of his senior staff. These forms of compensation are structured to take advantage of the greater number of investment options—and higher potential returns—offered by these plans, he notes.

Case Study: American Heritage Federal Credit Union, Philadelphia

The credit union's emergency succession plan calls for a committee of three executives (the COO, CFO and VP/human resources) to lead operations. Under the plan, the COO would serve as interim chief executive in the event that Foulke is unexpectedly unable to continue in his role. "But I'm living forever, so it doesn't matter," he says with a laugh.

Foulke, now 63, plans to retire at age 70. "I love my job. I'm having a great time. Our senior management is so great that I don't need to worry about day-to-day operations. I don't have to micromanage like I used to," he says. In addition to leading the credit union, Foulke also oversees its foundation, which has raised $1.5 million to support community organizations.

Foulke has ably led American Heritage FCU, from guiding financial performance to overseeing the exterior and interior design of its colonial-style headquarters, a Philadelphia landmark that members are proud to claim as their own, Grady says.

"The credit union benefits greatly by having a well-oiled machine. Bruce has been such a driving force, which encourages other people to go that extra mile," she says. "We're really proud of Bruce and what he's done, but he didn't do it alone. He's formed a really good management team and works with a board that has come together for the good of the credit union."

While the executive committee did the initial research, the CU's personnel committee leads the ongoing oversight of the compensation program, including reviewing the performance of the investments funding the plans on a quarterly basis and updating the board. In addition, the strategic plan assigns the HR department the responsibility to undertake an annual review of salaries and benefits for all staff, to ensure that the credit union stays competitive in the talent market.

Directors serving on the board come from a variety of backgrounds, including the blue-collar sector where executive compensation might seem excessive by comparison. But Foulke notes that the board has been committed to staying informed about current compensation practices and remains "very fair in terms of market rates for executives."

"We appreciated the advice we got when we were developing the compensation plans," Grady says. "It really works well when everyone has the same goals going forward."

Get Help Setting an Overall Compensation Strategy

The decision about whether to extend an executive a deferred compensation plan is rarely just about that one person—it's part of an overall, long-term compensation strategy. Boards must carefully consider how far they can stretch their investment in the executive talent pool. A key question is: If the credit union commits to tying up significant capital over the long term for a retiring CEO, is there enough capacity to fund similar incentives for the incoming chief executive?

Credit unions commonly consult with and rely on the expertise of compensation professionals in structuring and funding deferred compensation programs. Compensation consultants can provide an objective review of a credit union's current executive compensation programs. They also can help boards do some up-front research so directors can ask the right questions of, and compare options among, several vendors.

Boards may question the costs of these consultations—which could range from a couple of thousand dollars to $100,000 or more depending on the scope of the project, but they can provide a significant value—whether that's validating and ensuring that compensation and benefits are aligned with the credit union's compensation philosophy or connecting strategic planning to leadership development, hiring and succession planning. Boards should conduct due diligence on the consultant as well. Some solely work as independent consultants, while others offer provider services as well.

There can be a perceived conflict of interest if the consultant also is a plan provider. This can be true if the consultant doesn't conduct a thorough assessment or doesn't hold the provider services at arm's length from the consultation. One the other hand, a firm that offers both sometimes may be best suited to design the plan because of the intimate knowledge of why a plan was designed the way it was, and the underlying objectives/constraints of the situation.

The board should consider including in the budget every few years funds to hire a compensation consultant to review the credit union's practices and plans.

If you do hire a compensation consultant, ask for an assessment not only of where the credit union stands among peers, but also within the overall competitive market for executive talent. The report should include whether current compensation plans are performing as expected.

Balance Costs and Opportunities

In addition to funding the plan, the board should factor in additional costs, such as attorney fees to negotiate and set up the document; CPA fees if an accounting firm is involved in developing the program; and the costs of ongoing administration by the board, senior management and/or human resources, plus any administrative fees charged by providers.

Among the costs that may be overlooked are opportunity costs. What is the credit union forgoing in offering this executive compensation program? What might the credit union have done with that capital, if the organization had opted for a shorter-term form of deferred compensation? The board must weigh those opportunity costs against what retention of that executive means for the organization's long-term success and against what other options might be available to support retention.

2. Confirm who's in charge of what.

As with general compensation, the board typically negotiates deferred compensation plans with the CEO directly, and the CEO negotiates them with other executives, with the board's oversight and approval. Some boards rely on a committee of two or three directors to negotiate these plans and present them to the full board for approval; others assign the negotiations to the executive or finance committee. Document these responsibilities and reporting relationships before beginning negotiations.

3. Set realistic target dates for implementing a plan.

At the outset, the board should allow adequate time to get educated about the purpose and design of deferred compensation plans. Gaining agreement across the board that these plans are needed and appropriate can sometimes be the most time-consuming part of the process.

Count on several months of work with consultants to determine whether these plans are right for the credit union and to what degree they should be deployed in the short and long term.

It may then take several more months to complete the steps that follow. Be realistic and don't push the process set out in this section too quickly—especially at first. After the process is established, a vendor is in place and the board gains knowledge, deferred compensation plans can come together faster.

Start Now

Sometimes, unfortunately, a board won't realize that an executive benefits package is inadequate until a high-performing executive has taken a job with another organization—and then it's too late.

A CEO shouldn't need to request compensation in line with what the talent marketplace is paying today; that puts the executive in an uncomfortable situation. Likewise, CEOs should stay informed about how the compensation paid to other key executives compares to the going rate in the financial services field. Both the board and the CEO need to be proactive about executive salaries and deferred compensation.

4. Choose a plan provider.

Consult with several providers about the options for structuring and funding deferred compensation programs. Before making a choice, do due diligence on the providers' experience, track record of credit union service and financial stability.

Credit unions have the advantage of a cooperative culture, so leverage that: Talk with other credit unions about their executive compensation programs and the vendors they've used for deferred compensation plans. Be sure to ask whether providers respond promptly to requests after plans are put in place and whether they provide support for audits and regulatory examinations.

Providers prove their quality not only in the work they do to get a plan in place, but also in how well they provide ongoing expertise in monitoring performance and maintaining compliance. If the provider that puts the plan in place does not offer continuing support, the board should hire an administrator to provide that necessary guidance. Some consulting firms (such as AJ Gallagher) offer administration services; administration-only firms (such as Pangburn) also exist.

5. Do a thorough assessment of the executives' needs and goals.

An assessment should consider the executive's expected years in service to the credit union and in retirement.

When more modestly paid employees retire, they can often replace 60 percent to 80 percent of their monthly paycheck with proceeds from a 401(k) and/or pension, Social Security retirement benefits, and savings. For a highly paid credit union executive, on the other hand, tax regulations limit the employer's contributions to pension and defined contribution retirement plans. These executives also face Social Security maximums, among other limitations. As a result, the standard retirement benefits allowed to most of a credit union's employees may replace only 30 percent or 40 percent of an executive's working salary.

Before designing a deferred compensation package to close this gap, it's important for the provider to assess each executive's personal financial situation and goals. The executives and their boards must agree on a target income replacement percentage and then work with the provider on solutions.

Another consideration in designing a plan that meets an executive's needs is to make it personal and meaningful during his/her career. The effectiveness of a deferred compensation program is directly connected to the perception of how the benefit is tailored for the executive. A thoughtful and thorough analysis of possible plan design should consider an executive's circumstances and life stage and not focus solely on retirement, as the accompanying case study demonstrates.

Tailoring Deferred Compensation to the Needs of Each Executive

Case Study: NorthCountry Federal Credit Union, Burlington, Vt.

($580 million, 44,000 members, www.northcountry.org)

The flexibility to design a deferred compensation program that reflects the preferences and life stage of an executive is evident in the plan in place for CUES member Bob Morgan, CSE, CCE, CEO of NorthCountry Federal Credit Union.

Morgan was hired in March 2000 as a branch manager. When he was promoted to CEO in March 2012, "the board made a promise to put in place an impactful retention deferred compensation program," he says.

Over the next 16 months, the board developed a compensation philosophy statement and then looked to develop a 457(f) plan that could be structured as an effective retention tool. To do this, the board formed a management development and compensation committee, which vetted proposals from three different vendors.

The resulting program is "a little bit different" than a standard deferred compensation plan that pays out at retirement, Morgan notes. When he became CEO, he was 41 and had three children, ages 10, 5 and 2.

"In our discussions, it became apparent that my financial priorities weren't solely based on retirement," he recalls. "Back in 2012 and 2013, you might have heard me say, 'I'm sure I'll appreciate retirement benefits in 25 years. But right now I'm really concerned about my kids' college education."

In response to those priorities, the provider selected by the board, CUNA Mutual Group, recommended a deferred compensation program that included both a split-dollar life insurance plan to fund additional retirement income and a 457(f) plan with payouts scheduled to coincide with the years Morgan's children would be college-bound.

Case Study: NorthCountry Federal Credit Union, Philadelphia

The board compensation committee "really dug into the weeds of the design of these plans, so that they thoroughly understood all the mechanics and options before making a recommendation," he notes. "The plan was very well designed. Putting in some payouts for the life stage that was most on my mind was definitely impactful."

In addition to a deferred compensation program designed to enhance retention of its chief executive, NorthCountry FCU has also put in place smaller 457(f) plans, scheduled to vest after three years, for its two EVPs. Morgan has since established an additional deferred compensation plan for the EVP whose employment will continue beyond three years (the other is retiring). Along with incentives for remaining with the credit union until retirement, the plan also includes provisions for interim payouts that the EVP should find personally relevant as a retention incentive.

"If you look at simple psychology, the value of anything you're offered is a combination of the dollar amount and the immediacy of the reward," Morgan notes. "There's a tendency to discard rewards that are too distant. The value of having a compensation plan (with disbursements) staggered at interims definitely makes it more meaningful."

NorthCountry FCU has a formal succession plan in place to deal with both emergency and longer-term leadership transitions but, unlike many other credit unions, its deferred compensation plans are not directly tied to lining up successors, given that Morgan's expected retirement date is 19 years or more distant.

The performance of the investments funding the 457(f) plans for the executive team are reviewed quarterly to ensure that they are on target, and the split-dollar life insurance plan intended to supplement Morgan's retirement income is reviewed annually. These reports are given in briefings prepared for the executive team and board by CUNA Mutual Group.

6. Determine the plans and the funding mechanisms.

The three primary SERPs for credit union executives are the 457(b) plan, the 457(f) plan and collateral assignment split-dollar life insurance. We'll cover each of these separately.

In general, it's important to understand that funding for define contribution SERPs relies on the performance of some underlying asset. In the early 2000s, some plans were designed with the expectation of generating 7 to 9 percent annual investment returns. When the market collapsed a few years later, some of those plans declined in value by 40 percent or more. While that's the risk of being in the market, such a precipitous drop could diminish the value of a SERP as a retention tool, making it more likely the executive would be able to negotiate better compensation elsewhere.

Plans need to be designed with current market projections and both the credit union's and executive's risk appetites in mind. Some executives may prefer a conservative program and accept slower growth to avoid the possibility of significant losses.

457(b) plans

The 457(b) plan is a defined contribution plan with contribution limits. It basically augments a 401(k) plan to generate more retirement income. However, not all employees can participate in a credit union's 457(b) plan. It is reserved for the highly compensated or select "top hat" individuals in management.

Like a 401(k) plan, contributions are made pre-income tax, and earnings grow tax deferred until they're withdrawn. Unlike a 401(k) plan, however, the employer owns the assets until the executive withdraws them.

The participant and/or the employer can contribute to a 457(b) plan, up to the annual 401(k) limit. The plan is not eligible for age 50 catch-up contributions but does have a catch-up rule that may allow participants to defer additional amounts in the final three years before retirement.

These plans are common first steps in supplementing an executive benefits package. They're simpler to set up and administer than 457(f) plans. For example, 457(b) plans aren't subject to a "substantial risk of forfeiture," which we'll explain in the next section.

457(f) Plans

In contrast to a 457(b) plan, a 457(f) plan can be designed as a defined contribution or a defined benefit plan. The 457(f) plan also has no inherent contribution limits, so it offers the most flexibility to design a program tailored to the needs of an individual executive. However, only the credit union can contribute to the plan; executives are not able to make contributions into a 457(f) plan. Notably, the IRS has issued proposed final regulations for 457(f) plans that would allow executives to defer income into a 457(f), subject to certain rules and restrictions. As of the publication of this ebook, these proposed regulations have not been finalized.

The 457(f) plan as an "exclusive IOU." To execute a 457(f) plan, the credit union and executive enter into a written agreement, stipulating specific compensation that's typically tied to employment over a period of time. For example, the offer to the executive might be summarized as: If you stick around for the next five years, the credit union will pay you $100,000.

In effect, the credit union issues an exclusive IOU that shows up as a liability on its books, recorded over time, as an annual expense of $20,000 for five years. When the vesting date arrives, the payout is made and the IOU is complete.

These plans must be structured to comply with Internal Revenue Code section 457(f) as well as other related and applicable rules. Notably, some of the code in this area is not fully clear. For example, Internal Revenue Code section 4958 prohibits “excessive compensation,” but doesn’t clearly specify what level of compensation might trigger the IRS’s attention and possibly result in a penalty. Such penalties are uncommon.

It’s basically a judgment call by the IRS as to whether a payout is appropriate, based on peer group compensation. This is another reason for credit unions to work with consultants and vendors to offer compensation packages that reflect the credit union’s market position.

457(f): Substantial risk of forfeiture. Money allocated for a 457(f) plan must be subject to a substantial risk of forfeiture. In other words, the money won’t be taxed as income for the executive as long as the executive is prevented from receiving the money until that person meets certain requirements spelled out in the plan (typically, remaining with the credit union for a specified period).

Funds for a 457(f) plan are recorded as a compensation expense every year, but not paid out until the end of the term, and the executive does not pay taxes on the full amount until it is paid out. If the participant doesn’t meet the terms of the agreement, the executive forfeits the benefits of the plan. Additionally, if the credit union goes bankrupt in the interim, those funds are now subject to general creditors of the credit union, and the executive may or may not receive the benefits.

From that standpoint, these plans cannot be “formally funded.” In comparison, in a 401(k) plan, the money is held for participating employees within a separate trust. Money for a 457(f) plan is not. Credit unions allocate the money in good faith, and it’s highly probable the funds will be available to honor the contractual payment. But the credit union still has access to that money over the term of that agreement.

457(f) money can be invested more broadly. NCUA allows credit unions to invest 457(f) funds in instruments that are generally impermissible under Part 703 of its regulations. Credit unions are usually restricted to insured deposits, government securities and some foreign government instruments. They can also invest in some mutual funds and in mortgage-backed securities. But for 457(f) plans, credit unions can invest in some S&P 500 index stocks, corporate bonds and other instruments that have the potential for higher returns. Depending on the credit union’s and the executive’s risk appetite, the credit union has an array of funding options for structuring these plans.

Powering the Cycle of Executive Talent Development

Case Study: Education First Federal Credit Union, Beaumont, Texas

($370 million, 34,000 members, www.educationfirstfcu.org)

The recent history of executive benefits developed by the board of Education First Federal Credit Union illustrates the cyclical nature of these plans in recruitment and retention.

The board had put into place 457(f) plans for the CEO and EVP in 2005. When the CEO retired three years later, the EVP was promoted to chief executive and Keith Brenek was hired as the new EVP. At that time, “I’m 49 years old, I’m vested where I’m at, and things are looking good,” Brenek recalls. “To ask someone at that age to go back to scratch on vesting is very difficult to do.” He came over with the knowledge that a 457(f) plan would be put into place for his role as EVP.

When Brenek took over as CEO on July 1, 2015, the cycle began again, as the board developed a new 457(f) plan for him with a 10-year maturity. Looking down the road, Brenek says he will develop a deferred compensation plan for his recently hired second-in-command.

“I hired an EVP who I thought would be capable of learning enough to sit in my chair within five years,” he says. “In my day, it was cradle-to-grave when it came to employment,” but with increased mobility and the competitive market for financial services executives, a deferred compensation plan designed for retention will be in order.

The accounting rules that apply to these plans can be difficult to understand, and their design may need to be revisited periodically, Brenek suggests. Boards considering these forms of executive compensation should consult with experienced plan providers about the accounting impact of these investments and their alignment with plan objectives. For example, a concept that is sometimes misunderstood is that the executive doesn’t receive a direct payout of credit union funds through a 457(f) plan funded with an annuity, just the earnings on the investment.

In addition to regular reviews to ensure that the underlying investments are performing as expected, the board and executives covered by these plans may also need to revisit their structure. An executive’s expectations about retiring can shift over the 10- to 15-year term of a deferred compensation plan, and/or the risk profile of the plan may need to be adjusted, Brenek says.

Another consideration is the increasing responsibilities of leading a growing organization, he adds. When Brenek joined Education First CU nine years ago, it was a $200 million credit union.
Now at $370 million, it is a larger and more complex financial institution, with a commensurately greater range of duties for its chief executive. The executive team of an organization that has almost doubled in size may also expand, resulting in a need for additional deferred compensation plans to recruit and retain those individuals.

At the same time, there is always a balancing act, he adds. “You can’t outprice your credit union’s ability to fund these plans.”

Split-Dollar Life Insurance Plans

"Split-dollar" refers to the concept of sharing the costs and benefits of a life insurance policy among multiple parties, including the premium payments, cash values and/or death benefits. The two primary types of split-dollar plans used by credit unions are endorsement split-dollar and collateral assignment split-dollar, also commonly referred to as loan-regime split-dollar.

Endorsement split-dollar life insurance plans. Under the endorsement split-dollar design, the credit union owns a life insurance policy and the executive may name a beneficiary to receive a portion of the death benefit.

The credit union pays the premiums and owns the policy's cash value. And the credit union owns the death benefits, with the exception of the amount designated for the executive's beneficiary. As with any life insurance policy, the death benefits go to the beneficiaries income-tax free.

Under this arrangement, the executive recognizes income annually for the value of the death benefit to go to the executive's beneficiaries, resulting in an income tax bill for that income associated with the plan. Those costs tend to be relatively small, typically cheaper than buying a term insurance policy. The split-dollar agreement can also include an additional annual payment to the executive to compensate for the income tax increase.

Collateral assignment split-dollar life insurance plans. In the case of the collateral assignment split-dollar design, the executive owns the policy instead of the credit union. The credit union makes an advance (or loan) to the executive to pay the policy premiums. The executive, in turn, assigns the policy back to the credit union as collateral for the loan. The plan is typically arranged so the death benefits repay the loan to the credit union. Under this method, the executive doesn't have to pay taxes on the value of the premiums.

The cash value of the life insurance policy grows tax deferred. The goal is for the cash value to increase so the executive can eventually tap that money for retirement income.

These plans can include vesting requirements for retention or performance goals based on the strategic needs of the credit union.

It's important for all parties to understand that it takes time to build the cash value in these plans. Because the asset is owned by the executive, these plans are generally better suited for executives who may be seven to 15 years from the end of their careers. For executives in their 30s and 40s, in comparison, this plan may be less effective for retention.

As part of their discussions on executive benefits, directors must decide how to right-size these policies so that they can enhance the executive's retirement income without constraining the credit union's capital. The board should recognize that this is ordinarily a very long-term commitment that needs to be structured so that even when the executive is tapping the policy's cash value in retirement, the policy will still be able to support loan repayment after the death of the executive. Ongoing oversight is paramount, and occasional adjustments may be needed to achieve those aims.

A collateral assignment split-dollar arrangement is just one type of insurance-based plan that can be used to supplement an executive's retirement savings. The credit union could also choose to pay premiums on a life insurance policy on which the executive recognizes taxation on the value of the premiums but owns the policy outright. This design is called a bonus plan, often referred to as a Section 162 plan. In the Internal Revenue Code, Section 162, subparagraph M, refers to an employer's ordinary and necessary expenses to operate the business, and compensation bonuses are categorized as an ordinary expense.

Choosing the split-dollar policy form. A split-dollar arrangement can be built around various policy types, including variable, universal, index and whole life. The following brief descriptions are meant to provide a high-level overview of the nature of the different policy types to aid in assessing them. They should not be relied on as a definitive guide to the appropriateness of any given policy for a particular situation.

Whole life. Whole life insurance is generally fairly consistent in building cash value. In a “participating” whole life policy, the insurance company grants dividends annually, depending on the insurance company’s performance, and applies them to the policy’s death benefit and cash value.

“Nonparticipating” policies don’t pay dividends, so earnings should vary little from the insurer’s initial projection. But because nonparticipating plans don’t receive dividends, they typically don’t create enough leverage to cover the benefits and cost of the loan.

A participating plan’s dividends generally make it a relatively “safe” choice for an executive compensation program. Although these dividends aren’t guaranteed, a participating whole life policy can include certain guarantees that protect against loss in value, which helps to protect the credit union’s collateral.

Universal and variable life insurance. Universal life policies are fixed-interest policies; on a periodic basis, the insurance company states the interest rate that applies to the policy. UL policies were popular for funding split-dollar plans many years ago when interest rates were higher. Today, the average rate is much lower and generally not enough to fund a typical split-dollar arrangement.

Variable life insurance policies allow the owner to invest in various subaccounts inside the policy, essentially like a mutual fund. The subaccounts allow policy owners to diversify, such as when a mutual fund investment is split between funds in large cap stocks, small cap stocks and fixed-income options.

A variable life policy’s interest risks aren’t optimal for a split-dollar arrangement, as they are subject to the performance of underlying investment accounts. Because of the variable nature of the investments, these policies may be subject to Regulation U. This regulation from the Federal Reserve Board requires that, when a credit union makes a loan for the purpose of buying or carrying margin stock and the loan is secured by the stock, the maximum amount of the loan may not exceed 50 percent of the value of the collateral. This helps ensure the loan repayment can be made in the end.

Indexed universal life insurance. The index product is designed to provide a market-based return. The policy will track to the performance of an index. The insurance company can name an index or give the policy holder options from which to choose.

A common index today is the S&P 500. Typically, the return will have built-in floors and ceilings that limit losses and gains, thus providing inherent volatility reduction against the selected index(es), while providing market-based returns not subject to Regulation U.

Keep in mind that insurance companies charge for issuing and servicing policies, so even a floor of 0 percent can result in negative returns, which can be a serious issue if the investment returns were expected to pay the premiums at some point in the life of the policy..

Index funds can be designed for lower premium payments, whereas a whole life policy offers certain guarantees that make it more expensive. Credit unions can use either to generate an amount to add to an executive's targeted supplemental retirement income.

Three types of split-dollar plan loans: term, hybrid and demand. In a split-dollar insurance arrangement, a "term loan" defines the number of years the loan will be in place. In the case of a loan to pay the premium on a split-dollar policy, the term is typically for the life of the executive holding the policy.

Remember that the IRS considers the premium payments made by the credit union as a loan to the executives, and therefore the executive owes income taxes on the premium amounts, plus a reasonable market-based interest rate. The IRS publishes what it considers suitable rates for these loans each month.

For instance, if a credit union had issued a nine-year term loan for a split-dollar life insurance policy in August 2017, the IRS's long-term (nine years or longer) interest rate of 2.58 percent would apply throughout its term.

The term for a "hybrid loan" is until the death of the executive. As the credit union can't know what the actual term length will be, it uses the long-term federal loan rate. However, the tax implications of a hybrid loan are a little different than for a term loan.

With a term loan, the interest generally accrues. With a hybrid loan, it's possible to pay interest only on recognized taxation on any related interest on an annual basis. Interest doesn't necessarily need to be accrued, but it can be.

A third option is a "demand loan," which can be called (or demanded) at any time. The demand loan is commonly used when the credit union wants to forgo interest on the loan, but the executive still needs to recognize the value of that forgone interest using what's called the "blended short-term annual rate," which is generally a much lower rate than the long-term rate. The result is a reduction in the potential tax burden.

Many of the collateral assignment split-dollar life insurance arrangements traditionally used by credit unions involve demand loans. Credit union interest in term loans has increased recently, however, largely because of the current low-rate environment.

Keep in mind that insurance companies assess charges inside of the policies which can include costs of insurance, state mandated charges, and other expenses related to issuance and service. These charges are typically assessed after the application of any performance returns, so even a floor of 0 percent can result in negative returns, which can be a serious issue if the investment returns were expected to pay the premiums at some point in the life of the policy.

Setting the interest rate. The final regulations on collateral assignment split-dollar plans issued by the IRS in 2003 specify the interest rate in a table of applicable rates, issued monthly, as noted previously. The table includes short-, medium- and long-term rates.

The credit union may propose holding the loan until the executive's death, in which case the long-term rate would apply. It's a loan for tax purposes, so this favorable rate is appropriate. The agreement might specify that interest will be accrued over the life of the loan; thus, the credit union earns interest income, which makes the loan a working asset.

The credit union may always charge more than the federal interest rates, but charging less can have onerous tax implications for the executive, depending on the type of loan. Assessing the tax consequences of deferred compensation plan design is beyond the scope of this ebook, but directors and executives should discuss this topic with plan providers.

7. Address the “what-ifs.”

The credit union and the executive should rely on their own attorneys to negotiate and draft any terms, contracts or agreements involved in establishing a non-qualified executive benefits plan.

Non-qualified programs involve a lot of what-ifs. For example, what if the executive leaves voluntarily or involuntarily before the end of the arrangement’s term? What if the credit union merges and the executive’s position is eliminated? One aspect of the attorney’s role is to anticipate these scenarios and address them in writing.

Let’s look at a few examples:

- An executive with a collateral assignment split-dollar plan suffers a disabling illness and will not be returning to work. While negotiating the agreement, representatives for the executive and the credit union agree that if this happens, the vesting would be accelerated and the policy kept in force. This way, the executive can use any cash value as income sooner, and the agreed-upon death benefit remains intact for the executive’s beneficiaries.

- A CEO who has a substantial long-term deferred compensation plan is considering whether the credit union should merge with another. The CEO stands to lose a significant portion of the supplemental benefits should a merger be approved. Wouldn’t it be difficult to make an objective decision in that situation? The board should be careful about putting a chief executive in the situation of needing to decide between the best interests of the credit union and the fate of hard-earned executive benefits. By guaranteeing those benefits whatever the outcome of the merger discussions, the board gives the CEO the freedom to assess the merits of the merger and advise the board more dispassionately.

- If an executive is dismissed for cause or leaves the credit union voluntarily, the agreement for a collateral assignment split-dollar life insurance arrangement may require accelerated repayment of the loan. The executive may even have to give up the policy. If the policy’s cash value is insufficient to repay the loan, the executive may have to repay any shortfall from personal funds. The repayment amounts can be substantial and may be considered as part of the retention incentive by the credit union. An executive who goes into this kind of plan must understand the potential consequences, especially in the short term until the cash value of the policy grows enough to repay the loan amount.

8. Prepare to defend the plan with examiners.

When a credit union considers a deferred compensation plan, the board must commit to maintaining a long-term arrangement that conforms to IRS, NCUA and any applicable state regulations. If an auditor asks, “Can you justify what you’re paying this individual—not just in salary but in other forms of compensation?” the board needs to be able to respond.

When examiners review compensation practices, they don’t ask executives what they think about their long-term benefit packages. The examiners are going to grill the board and the committee in charge of SERPs on their due diligence and level of oversight. Examiners will want to know, “Does this program pose any threat to the credit union’s safety and soundness?”

That’s why directors should be working with providers that demonstrate a thorough understanding of the available plans and have a history of success supporting these types of plans.

9. Establish policies and procedures for ongoing oversight.

The board's work does not conclude with the implementation of a deferred compensation plan. The committee assigned to oversee them should review all plans annually. Adjustments may be needed along the way, especially if underlying investments are underperforming. The board should expect regular reviews with providers so that updates, modifications and/or additions to deferred compensation plans can be made, if necessary.

For example, when an executive wants to take money out of a split-dollar policy, the board and executive need to assess the long-term impact of the distribution requested.

To reduce the chance of competitors luring executives away, regular reviews should also ensure that deferred compensation plans are in line with the market. For defined benefit plans, the credit union is on the hook to deliver the promised amount and compensate for any shortfalls in the funding mechanism. In the case of a defined contribution plan, the credit union runs the risk of losing leverage with a high-performing executive if the plan falls short of expectations.

Think back to 2008 when the market tanked. A lot of executives saw the projected returns for their deferred compensation plans plummet, and a lot of credit unions responded by working with plan providers to return these plans to a successful trajectory. Their vigilance, foresight and commitment helped keep their most valuable executives in the fold.

What happened to credit unions that didn't step up? That may be impossible to measure, but ask yourself how you'd feel under those circumstances. Would you feel that your loyalty to your credit union employer had been returned in kind? Would you be more or less motivated to consider job openings elsewhere or listen to recruitment pitches?

A plan that is implemented in good faith must be maintained in good faith.

Revisiting Compensation Plans When the Economy Sours

Case Study: Railway Credit Union, Bismarck, N.D.

($105 million, 7,250 members, www.railwaycu.com)

You could say credit unions are in Railway Credit Union President Paul Brucker's blood. His father, Jacob Brucker, was the first treasurer of the financial cooperative now known as Railway Credit Union, and Paul began working there during the summers of his high school years, filling in as its three employees took their vacations.

Brucker joined the staff full-time in 1987 and was named president a decade later of the then-$12 million credit union. By 2005 when Railway CU had more than doubled in asset size to $33 million, the board began to consider a leadership retention strategy and put into place an executive benefits package that included a life insurance policy with Brucker's family members as beneficiaries and a 457(f) plan scheduled to vest in 15 years, when he would be 55.

Given that the organization's roots are in serving railroad workers, the board has favored employee benefits that reflect compensation practices in the industry it serves, including executive compensation, though the credit union now serves multiple select employee groups. "What the board wanted to create for me was something equivalent to a railroad officer's retirement benefits," Brucker notes.

The 457(f) plan was designed with a goal that the investments funding it would generate enough income to produce the full anticipated benefit at vesting and earn the credit union a bit of additional income to cover the cost of funds (the board had also put in place a key person life insurance policy to cover recruitment and transition costs in a worst-case scenario). In effect, the plan was to operate as a gain-sharing program between Brucker and the credit union, with a target for benefits identified but no guarantees

"We agreed that we could not put the credit union in harm's way" with a defined benefit program that might prove onerous for the small financial institution to fund, he explains.

Then the Great Recession struck. Income production on the investments slowed, then stopped, and ultimately Railway CU began recording losses on those funds. Eventually, though, the economy leveled off and began to improve, as did performance of the investments funding the deferred compensation plan.

However, a gap in expected benefits from those low-performing years remains. The board decided to explore options for making up at least some of the shortfall and settled on putting in place a supplemental 457(b) plan, fully funded with monthly payments into the account by the credit union beginning in December 2012.

The board looked at other alternatives, including adding to or changing the structure of the investments funding the 457(f) plan, but decided that a 457(b) would have fewer up-front costs, such as attorney and investment fees and surrender costs, making it the most cost-effective option to put into place.

The original deferred compensation plan was structured primarily for retention, specifying that Brucker would not receive benefits if he were dismissed for cause or left voluntarily before the plan vested. The downside for the credit union is that its contributions to the 457(b) plan are not subject to such restrictions.

Case Study: Railway Credit Union, Bismarck, N.D.

As time has moved on and performance of the investments underlying the plans has improved, with the combination of the 457(f) and 457(b) plans, “we’re starting to close the gap on the original target,” he notes.

Now 52, Brucker has dedicated his career to leading Railway CU. The current cost of health care coverage casts a pall over the likelihood of retiring in three years, when the 457(f) plan is scheduled to mature. There are tax implications for him to consider carefully, as the payout will be fully taxable, under current laws, when the plan vests.

In addition to Brucker’s executive benefits, the board also agreed to fund a small 457(b) plan for the former president of a small credit union that merged with Railway CU, to supplement his other retirement benefits.

The board conducts an annual review of the credit union’s deferred compensation program, with an emphasis on the performance and allocations of the investments funding the plans. In 2017, NCUA assigned a compensation specialist to review the design of the 457(f) plan, which passed without comment, he adds.

For credit unions considering introducing a deferred compensation program for their executives, Brucker recommends starting by identifying the purpose of offering this benefit. For example, is the credit union’s aim primarily long-time retention or is it a supplement of retirement funding?.”

Having clear-cut objectives can help sort through the proposals the board may receive, he notes. “These providers are really good at selling their plans, so it’s helpful to develop a clear understanding of what each plan does, what risks are associated with its design, how it is expected to generate a return, and what might happen if the economy goes sideways. It’s not good to get into something that the executive and board don’t understand.”

Another consideration in selecting a plan is the provider’s track record and longevity in this business, he suggests.

“Find a business partner you can trust and work with over the long run,” Brucker says. “Look for professionals who are information specialists providing the data the board needs to decide what is in the best interests of the credit union

Specific oversight considerations for split-dollar program maintenance. Split-dollar insurance plans are unique and require additional oversight of the policy's performance, and of the relation between policy forms and the repayment obligation. Review these plans regularly to ensure ongoing support from vendors and providers to monitor performance and regulatory compliance.

Over the potentially long life of a split-dollar plan, the credit union may have to implement any of a number of exit strategies commonly spelled out in the agreement. For example, an executive's average life span is about 80 years. So if a split-dollar plan is offered to a 50-year-old CEO, the loan will sit on the books for 30 years on average—and a lot can happen during that time.

Part 3.
Industry Trends to Consider When Setting Executive Compensation Strategy

As the financial services industry evolves, the talents executives need to steer their organizations toward success change. Two examples for credit unions are the rising emphasis on member business lending and on data analytics.

With NCUA's recent revisions to its commercial lending rules, many credit unions are expanding their business services—and looking for talented, experienced executives to lead those efforts. Meanwhile, across industries, the growth of sophisticated data analytics as a driver of strategy and daily operations is garnering exciting results. Credit unions looking to build their business intelligence capabilities must compete with other financial institutions—and with other types of companies—to recruit data management leaders.

In business lending and data management, the demand for executive talent may significantly outweigh availability. Credit unions need to up their compensation game to compete for these valuable capabilities.

Aside from these emerging areas of management expertise, credit unions may have executives leading areas of traditional credit union strength—consumer and mortgage lending, finance, member engagement, marketing and PR, and human resources, to name a few—whose contributions may be crucial to the organization's future success.

Much of the focus for deferred compensation advice in the credit union world relates to CEOs and their immediate successors. But credit unions should consider the costs of losing what some of their other valuable executives bring to the table.

Deferred Compensation as a Recruiting Tool

A credit union looking to recruit a high-performing executive away from another organization may need to consider buying out, say, an existing 457(f) deferred compensation plan. This recruitment strategy requires the board to thoroughly understand the capital constraints in structuring an offer.

For this type of 457(f) plan buyout, remember that the closer executives get to the payout date, the more expensive it is for them to leave. If an executive is in the first year of a $100,000 deferred compensation plan that vests in a lump sum 10 years down the road, that's a relatively easy buyout. A competing employer could simply offer $10,000 more a year in salary. But if the executive is only one or two years from vesting, it presents a much more significant hurdle. The executive is much more likely to decide, "I'm not leaving until I get that extra $100,000." To lure the executive away, a competitor would likely need to offer both a raise and that $100,000 in lump sum compensation.

Now, flip that scenario around. If it's your credit union this executive works for, how difficult and expensive has your deferred compensation plan made it for competitors to poach that person?

Part 4.
Using Deferred Compensation to Support Succession Planning

When a CEO retires, staff uncertainty and new learning curves can affect financial performance and member service. Worse yet, a sudden, unexpected departure of the chief executive can reverse the forward progress of a thriving organization. Carefully designed succession plans guard against these setbacks.

NCUA emphasizes the importance of having a CEO succession plan in its Letter to Credit Unions #161 (1994): “The ongoing success of credit unions will be greatly impacted by the ability to fill management positions in the event of resignation or retirement. The existence of a detailed succession plan that provides well-trained management personnel to step in at a moment’s notice is essential to the long-term stability of a credit union. A succession plan should address the Chief Executive Officer (or equivalent) and other senior management positions (manager, assistant manager, etc.).”

This specific message has been reinforced consistently in the examiners guide and in credit union education as recently as 2016 when NCUA produced a series of videos focused on educating credit unions on the importance and steps of the succession planning process. Though there are no formal requirements at the federal level for a succession plan, examiners may comment on the existence and adequacy of these plans during their reviews. In addition, adequacy of management and board oversight of executive compensation put in place to support leadership retention and succession are key elements of CAMEL ratings.

According to the 2017 CUES Executive Compensation Survey, more than three-fourths (76.5 percent) of responding credit unions have succession plans in place for their CEOs. The larger the organization, the more likely succession planning is a priority: 81.3 percent of credit unions with $1 billion or more in assets have formal succession plans, compared to 73.7 percent of credit unions with less than $50 million in assets.

Credit union boards use two primary vehicles to retain high-performing executives for a specific tenure: employment agreements and deferred compensation.

Employment agreements

Executives who sign these contracts are no longer at-will employees who can leave without facing specified consequences or whose employment can be terminated by the organization without cause at any time. Almost half (46.2 percent) of credit unions participating in the CUES Executive Compensation Survey have signed employment agreements with their CEOs. The most common contract lengths are three years (39.5 percent), five or more years (34.1 percent) and one year (14.7 percent).

Contracts with credit union CEOs typically spell out these terms of employment:

Provision for severance pay	83.7%
Change-in-control provision	59.4%
Automatic renewal of the contract	56.5%
Details of the executive benefit plan	42.9%
Change-in-control specifies continuation of contract	41.6%
Non-compete covenant	36.4%
Non-solicit covenant	32.6%
Change-in-control specifies multiple of annual pay	27.3%

Employment agreements with other executive team members aren't common, though several survey participants shared information on agreements with second-in-command executives. Three-fourths of these contracts extend five or more years.

Boards pursuing a CEO employment agreement should consult an employment attorney about that process. CEOs may want their deferred compensation arrangement spelled out in the agreement. Executives will likely benefit from legal representation in this negotiation so that both sides in the process of drafting an agreement can consult their own attorneys.

How deferred compensation arrangements support succession plans

Deferred compensation plans can create the critical incentive for a designated CEO successor—and perhaps other key executives—to stay with the credit union through a CEO turnover. The incentives give the board the leverage it needs to develop and maintain a succession plan.

To illustrate a typical succession planning process, let's look at the fictional ABC Credit Union, where the CEO of 16 years, Mike Smith, plans to retire in three years at age 65. ABC CU's succession plan specifies that EVP, Kim Jones, would be interim CEO if Smith is unexpectedly unable to lead the credit union. Jones is being groomed as the credit union's next chief executive when Smith retires.

Jones is a talented and experienced executive, well known in the credit union field. She has been recruited for CEO openings at smaller financial cooperatives. To give Jones incentives to stay at ABC CU, Smith and the board agreed that a compensation plan be developed for her.

The components of this plan include: an annual salary at the 75th percentile of the median for EVPs in ABC's asset range and an annual bonus at the same rate of base salary as Smith's bonus (which is determined annually based on a board evaluation and key performance indicators, including earnings and loan growth).

These new features are added to an existing deferred compensation arrangement with Jones that has a payout scheduled in three years, when Smith retires.

The board has asked Smith to identify other current executives who would help Jones transition smoothly to CEO by staying on after Smith retires. Smith has tentatively identified the current CLO as Jones's successor as EVP. He plans to offer the CLO and CFO a deferred compensation plan with a term of four years, to keep them on board during the transition.

The power of multiple vesting events

As mentioned previously, a 457(f) plan may be designed to generate payouts at multiple intervals, tied to specific vesting events. This makes 457(f) plans a more meaningful retention incentive.

Let's move forward five years at ABC CU, where Kim Jones has now been CEO for two years and the board is negotiating a deferred compensation program designed to keep her on board for the next decade.

The committee responsible for executive compensation, after meeting with vendors and consulting with directors at other credit unions, has recommended offering a 457(f) plan with a 10-year term to pay out $500,000 in multiple payouts across the span of the agreement: $100,000 in three years, $200,000 in five years and the remaining $200,000 at the end of the plan.

In other words, the benefit vests 20 percent in year three, 40 percent in year five and 40 percent at the end of year 10; Jones recognizes taxation on each of those vesting events.

Once the board and Jones agree to the broad strokes of this compensation plan, the credit union's attorney develops a formal contract, which is then reviewed by Jones's attorney. The document addresses the many potential situations that may arise over the 10-year agreement.

What happens if Jones becomes disabled and unable to continue work in year four, after only 20 percent of the benefit has been paid out? Will she receive any further benefit from the program? What happens if ABC CU merges in year seven of the agreement, and Jones is not named as CEO of the continuing credit union? Would a finding of wrongdoing on Jones's part nullify the agreement? Would Jones's beneficiaries receive any benefits under the plan if she died before the end of the term? The terms of the agreement may also require the board to secure supplemental insurance to guard against funding shortfalls.

Jones has negotiated that her beneficiaries would receive the full benefit of the 457(f) plan should she die before the end of the term. If she dies in year four of the arrangement, for example, the credit union would have previously paid out $100,000 and accrued $100,000 toward the next payment, but it would owe the beneficiaries $400,000. To protect ABC CU against this unexpected expense, the board has agreed to purchase a key person life insurance policy to cover the deferred compensation arrangement and the recruitment costs to hire a replacement.

Care must be taken in developing the agreement to ensure that it complies with rules prohibiting the use of "golden parachutes," which specify certain significant benefits if employment is terminated. In general, the terms of a deferred compensation agreement must be written to avoid inadvertent interaction with other rules and regulations—another reason to work with an experienced, qualified provider in developing these plans.

Conclusion

The deferred compensation programs outlined here provide a variety of options, on their own or in combination, to aid in the recruitment, retention and reward of high-performing executives. The 457(f) plan is the most versatile vehicle to supplement salary and short-term bonuses to enhance retention throughout an executive's career. In terms of non-qualified executive benefits plans, a 457(b) plan, a 457(f) plan and a split-dollar life insurance policy structured to provide additional income in retirement all provide tools to entice an executive to remain with the credit union to the end of his/her career and to present a reward for valued service.

As the board decides to begin layering in different forms of long-term compensation, directors need to keep in mind and seek guidance on the application of myriad regulatory restrictions and guidelines to choose the best combination of benefits. Some forms of compensation may fit better in certain situations than others. For example, the credit union may provide a 457(b) plan so the executive can set aside a portion of his/her salary for retirement in addition to fully funding a 401(k) program.

A 457(f) plan is typically structured with the goal of retention: If the executive meets the terms of the program—that is, if he/she stays for the length(s) of time specified in the agreement—the benefit is awarded. If the executive doesn't meet the terms of the plan, there is no benefit.

A split-dollar life insurance arrangement is most often offered as a reward to the executive, conveying the message, "Your leadership has been valuable to the credit union. We want to compensate you with a long-term benefit since your service will have benefited the credit union over the long term."

It is possible to use life insurance plans for retention and 457(f) plans as rewards. In order to keep someone on board, organizations either use a carrot or stick approach—offering a reward or exacting a stiff price in terms of lost compensation for not living up to the terms of the agreement. Consider this simple example of a life insurance policy that might be used to fund a split-dollar plan: If the premium is $100,000, the actual cash value in the policy might be, in rough numbers, around $20,000. Immediately out of gate, there's an $80,000 shortfall. If the plan is designed properly, it would be up to the executive to come up with that $80,000 if he/she left the credit union. The policy would revert to the credit union, and the executive would need to cover the remaining cost of the premium. In that way, the executive has an incentive to stay and a penalty for leaving.

The responsibilities of executives in leading their credit unions through competitive, financial, regulatory and technological challenges have amped up over the past two decades and show no signs of slowing down. By structuring deferred compensation plans appropriately for recruitment, retention and reward, credit union boards recognize these mounting responsibilities and the need to keep talented leaders in place to execute on their organization's strategic vision.

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