FMS Update

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Compensation Considerations

Executive strategies require careful planning

AFTER a prolonged period of post-recession austerity, the money for executive compensation and incentives is once again flowing within many community institutions. But where it's heading is still a subject of debate.

"During the Great Recession, base salaries were pretty much frozen and incentives were eliminated, because even healthy institutions went into bunker mode just to make sure they could survive," says R. Scott Richardson, President and CEO of IZALE Financial Group in Elgin, Ill. "Since the recession ended, things are starting to be adjusted, and institutions are again trying to find the right balance between base salary, annual incentives and longer-term incentives for a total package that works not only for the institution but for the executive as well."

Finding that balance, however, is easier said than done, with a number of important issues coming into play.

Setting the Scene

Scott believes one of the first things that every institution needs to do is formulate a compensation philosophy that lays out how things will be set up and where the institution wants to be in the marketplace relative to peers.

This can be something as simple as targeting the 50th percentile in terms of base pay – that is, average salary for average performance – and having incentive compensation that will reflect performance above that 50th percentile. For example, if the institution's performance puts it at the 80th percentile relative to peers, it will have an incentive that pays an extra 30% to bring the total compensation that year up to the 80th percentile.

"The best practice always starts with having a philosophy and sticking to it," Scott explains. "Having a philosophy means that everybody knows how they're going to be paid and how things are going to be benchmarked. This is especially important as boards change over, so everything is documented and everybody understands why they're doing what they're doing and what the reasoning was behind setting it up that way in the first place."

Long-Term Thinking

The goal of finding workable executive compensation is not only to attract great talent to an institution, but to hold onto those key individuals as their careers progress and their performance excels, which means an institution's compensation philosophy needs to go beyond just base salary and annual incentives. Therefore, the philosophy should have a long-term perspective, addressing what can often be a fairly significant disparity for executives when it comes to retirement benefits.

Scott says that the income that gets replaced at retirement from 401k matches and contributions – those things that are paid for by the employer, not the employee – for a rank-and-file employee who stays at an institution for 20 or 30 years or more is often a much higher percentage than what can be found in the executive suite.

"It's pretty common when we run a disparity analysis to see where a rank-and-file employee might have 45% or 55% of his final salary replaced, whereas the CEO, participating in the same kinds of programs, might only have 35% of her income replaced," Scott explains. "Most of the time when we talk to boards about it they'll say they didn't intend to create a disparity, and they want to work to cover the gap so there's parity across the organization. But there's definitely an art and a science to getting there."

In terms of how institutions are trying to manage that art and science, Scott says that while long-term incentives are certainly back in vogue these days, they're not necessarily taking the same forms as they have in the past. For example, many equity-based

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incentive plans are either being phased out or significantly retooled, as even high-performing institutions have seen their stocks being held down by the general beating the industry as a whole has taken. As a result, the trend has moved toward long-term incentive compensation that is not stock-based, not only in the form of traditional SERPs, but also set-aside cash plans that pay out a cumulative amount at retirement based on incentives hit throughout the executive's career.

"Now when that executive gets to retirement, you look at the cumulative, long-term set-asides and pay that out as a retirement benefit," Scott says. "In truth, it may turn out to be the same $50,000 a year for 15 years that he or she may have gotten from a SERP, but at least from the board's perspective, they're very clearly able to tie it back to specific performance measures year after year after year."

Institutions also need to have a good handle on what they're trying to accomplish with the long-term incentive and compensation strategies they ultimately select, adds John Gagnon, a compensation advisor at BoliColi.com in Reading, Mass.

"Many institutions confuse the goals behind SERPs and deferred compensation and believe they both accomplish the same thing," Gagnon says. "Our experience is that SERPs are generally better at retaining key executives, especially those beyond age 50 who are often very concerned about retirement savings. Long-term incentive programs, on the other hand, are very effective from a performance standpoint and will be attractive to your best performers, even if they generally won't help from a retention standpoint."

Not every strategy may work for every institution, but there should be an effort to find some type of long-term incentive plan that fits. Scott says that it all comes back to deciding upfront and making it clear what the institution stands for and believes in when it comes to executive compensation.

"The best practice always starts with having a philosophy and sticking to it," he says. "The philosophy shouldn't change significantly from year to year, and might only really change over the course of four to five years as the institution evolves." ■

Compensation To-Do List

NO TWO institutions are exactly alike, which is why there's no one-size-fits-all equation for getting the right executive compensation and incentive plan in place. Even so, Scott Richardson says there are a handful of things that every institution should be focusing on more intently.

Start with a philosophy
"If you don't have one, get one. If you have one, make sure it still sticks."

Get your base salary right
"If you're relying upon maybe only one or two surveys in order to help you set your base salary, you're probably off the mark – and maybe considerably. Every single survey that's out there has a flaw or a limitation – it's just the nature of surveys – so you really need to take an average of three to six surveys. But smaller community institutions may need to work with a consultant to get their hands on that much information."

Have a long-term perspective
"Take a pulse of where your executive group is relative to your overall employees in terms of what kind of retirement income they can expect from working for your institution, and address any shortfalls."

Go beyond cash
"If your only element of compensation is this year's cash (current-year salary and bonus), you're always at risk for the bigger checkbook, because if your bank or credit union has sustainable performance, big banks know they can come in and buy some of the executive talent responsible for that performance rather than buying the whole institution. It's really just shortsighted thinking."

Incent the right things
"Never have incentives that can be manipulated or even have the appearance that they could be manipulated. For example, if you have a bonus or incentive based solely on ROE, there are things that someone could do to manage a balance sheet that will artificially inflate ROE in any given period. So if you don't have at least three or maybe four performance measures that you're looking at – maybe efficiency or charge-offs in connection with ROE – you're probably shortchanging the process. It's the old adage 'you get what you pay for' – if you incent the right behaviors, you're going to get them." ■