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SERP or SEIP...or Both?

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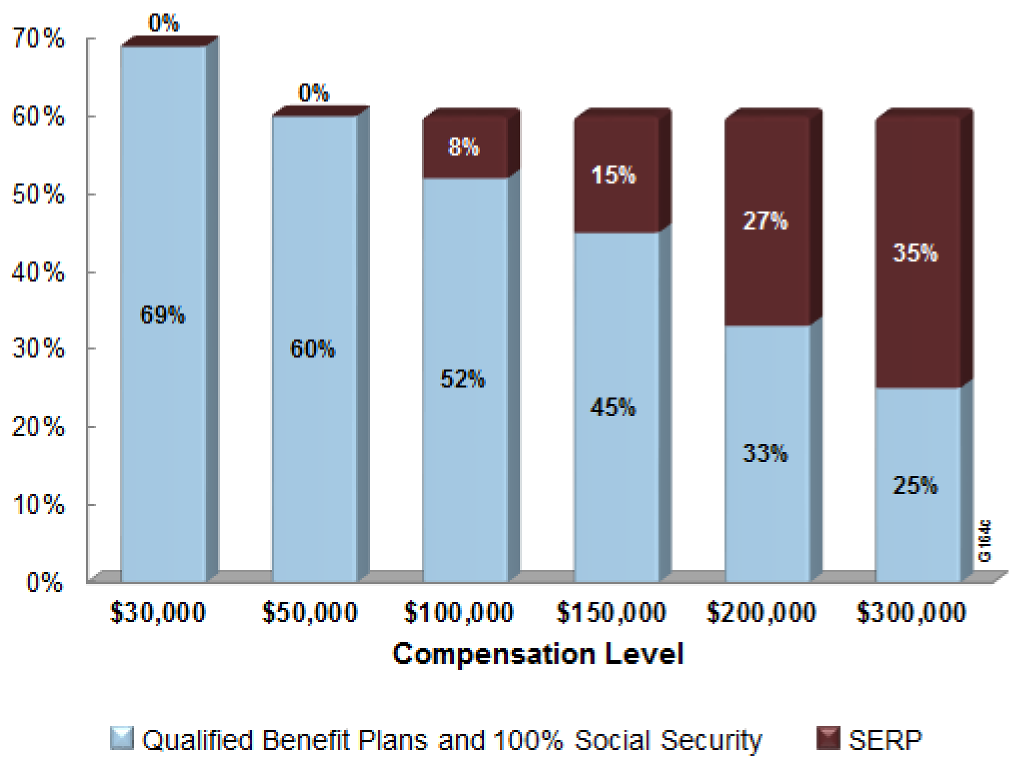
Bank senior management has been retiring at an accelerated pace succeeded in many cases by much younger executives. These young bank leaders may be in a different stage of life and need to be rewarded differently than their predecessors. Traditionally, banks employ executive benefit plans, or nonqualified plans, for their key employees with the intention to retain the executives through retirement. These plans have been around for decades and became more popular after 1993 when Congress reduced the compensation limit on qualified plans[1]. This significantly reduced qualified plan benefits and created a retirement shortfall for executives causing an increase in "supplemental" retirement plans (see Chart 1).

Chart 1—Example—Sample Retirement Income Replacement Ratios



Today this retirement shortfall still exists and the supplemental plan can play a significant role in an executive's retirement package. The traditional Supplemental Executive Retirement Plan (SERP) is a defined benefit plan, meaning the benefit to be paid at retirement is specified, or defined, in the plan document. The benefit amount is typically a set dollar

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amount or a percentage of final salary, payable for a certain number of years or for life. Banks must perform actuarial calculations (or hire an actuarial firm) to account for these plans to determine the benefit expense to the bank. These calculations are based on current discount rate assumptions and the benefit expense from year to year can fluctuate depending on changes to discount rates, especially in today's rate environment. Because of this, some banks look to defined contribution plans as an alternative approach to supplement the executive's retirement income.

A defined contribution plan can achieve a similar goal of targeting income replacement as the defined benefit plan. However, the defined contribution plan is different from defined benefit plan in that it specifies an amount of employer contribution into the plan, versus paying the specific future benefit. Contributions can be set dollar amounts, percent of salary, or based on achieving certain measurable goals on specified dates. Accounting for these plans is less complex as it typically does not require an actuary (unless one if needed to calculate lifetime payouts at retirement).

Beyond the complexity of calculating benefit expense for defined SERPs, some banks are looking for programs that are more relatable and meaningful to younger executives. I was recently at a bank discussing many of the SERP approaches that our clients use and the Vice President of Human Resources made an interesting observation that while a SERP works very well for retaining certain key executives it is not as effective for younger senior executives whose current focus is on raising families, purchasing new homes, and paying for college. In today's competitive marketplace it is this group of talented executives that is often hardest to retain.

The Supplemental Executive Incentive Plan (SEIP) is a solution for this need. The SEIP is a nonqualified plan that is based generally on an incentive based defined contribution formula with payouts that typically commence at specified dates prior to retirement age. Contributions are typically based on a financial metric such as ROA, or an individual performance metric or a combination. Payouts generally occur in a 3–5 year time period with a rolling vesting for each year's contribution. Cliff vesting is typical for the shorter three year plans. This means if the executive leaves prior to vesting no payout occurs. A SEIP can be designed in many ways, designed to achieve both the bank's strategic goals and the executive's wealth goals. Other forms of vesting can occur and vested account balances can be deferred until a later payout date. Balances can be tied to an index, specific equities, or insurance subject to the rules of 409A[2].

The following chart illustrates a SEIP plan based on achieving certain ROA and ROE levels.

Chart 2—Contribution to a SEIP (as a percentage of annual salary)

Return on Equity										
	10.00%	23%	23%	23%	23%	23%	25%	27%	29%	31%
	9.50%	21%	21%	21%	21%	21%	23%	25%	27%	29%
	9.00%	19%	19%	19%	19%	19%	21%	23%	25%	27%
	8.50%	17%	17%	17%	17%	17%	19%	21%	23%	25%
	8.00%	15%	15%	15%	15%	15%	17%	19%	21%	23%
	7.50%	7%	9%	11%	13%	15%	17%	19%	21%	23%
	7.00%	5%	7%	9%	11%	15%	17%	19%	21%	23%
	6.50%	3%	5%	7%	9%	15%	17%	19%	21%	23%
	6.00%	1%	3%	5%	7%	15%	17%	19%	21%	23%
		0.60%	0.65%	0.70%	0.75%	0.80%	0.85%	0.90%	0.95%	1.00%
		Return on Assets								

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In this example, the bank will contribute a certain percentage of an executive's salary to the SEIP, dependent on ROA and ROE results. This example targets a 15% contribution to the plan if an ROE of 8.00% and/or an ROA of 0.80% are achieved. The executive will either get a larger, or smaller, contribution based on various other combined ROE/ROA results. SEIPs allow banks the ability to provide executives with meaningful rewards that are linked to the success of the bank, while also using vesting schedules to aid in retention.

While traditional defined benefit retirement plans, such as a SERP, continue to be a valuable executive benefit plan, a new generation of bank executives may find more value in reward programs that relate to their current life needs, such as with a SEIP. Banks should investigate the benefits of both plans, and may conclude a combination of the two is the answer. Times may be changing, but the need for an effective rewards and retirement program for key talent hasn't.

To learn more, please contact John Gagnon at 781.942.5700; jgagnon@bolicoli.com.

[1] *Code Section 401(a)(17) (compensation limit reduced from $235,840 in 1993 to $150,000 in 1994 by the Revenue Reconciliation Act of 1993).*

[2] *Section 409A applies to compensation that workers earn in one year, but that is paid in a future year. This is referred to as nonqualified deferred compensation. This is different from deferred compensation in the form of elective deferrals to qualified plans (such as a 401(k) plan) or to a 403(b) or 457(b) plan. See IRC § 409A.*

About the Author

John has almost thirty years of experience in the executive benefits area and bank- and corporate-owned life insurance. From 1997 through 2004 he was the President and Chief Executive Officer of a nationally recognized executive benefit organization. Since that time he has been a consultant to banks as part of the M Benefit Solutions - Bank Strategies group of banking advisors, the endorsed provider of executive benefits and BOLI for the ICBA. His expertise in the review of the legal, actuarial and financing of executive benefits and life insurance programs as well as timeline control and presentation ability to board committees has been obtained through completion of hundreds of corporate engagements and board presentations. John is a registered representative with M Holdings Securities, Inc. He is a current member of AALU. John is a member of ABA, ICBA and various state banking associations as well as The Financial Managers Society.

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