Why do banks underutilize Deferred Compensation Plans for their key executive retention?

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I have worked with community banks for a number of years designing executive and director retirement programs as well as BOLI investment portfolios. While each program is unique and catered specifically to a bank's needs and strategic goals, one potentially beneficial approach often overlooked is the Deferred Compensation Plan.

A Deferred Compensation Plan is, in theory, similar to a 401(k) plan as it allows compensation to be saved both pretax and tax deferred until a later date. Section 409A of the Internal Revenue Code regulates the tax treatment for nonqualified deferred compensation programs. The two primary requirements under 409A are that an executive must elect to defer the income prior to earning it and defer it until a specific date or age. The executive also must decide the form of payment when it is ultimately paid. Form of payment refers to the beneficiary being paid via a lump sum or paid over a period of time. A major difference in comparison to a 401(k) plan is that any amount deferred is subject to creditors of the bank until they are paid out. This can often be a stumbling block with smaller privately held corporations. However, this is less of an issue with community banks as most have long histories and strong balance sheets and, given the current regulatory scrutiny, troubled banks most likely will merge with another bank as an exit strategy rather than fail.

Due to the ever increasing tax rate environment, deferral of income from a savings perspective becomes very meaningful, especially for individuals in higher tax brackets. Deferred Compensation programs are flexible and can be structured on a voluntary basis, where the employee voluntarily contributes a portion of their pay, employer paid or a combination of both.

To illustrate, three employees have marginal tax rates of:

- 22% (third lowest federal tax bracket, applicable to those with taxable income between approximately $38,700 and $82,499),
- 37% (the highest federal income tax bracket), and
- 45% (a tax bracket many highly compensated employees may fall into).

Each employee splits $20,000 evenly between two investment vehicles:

- An outside investment that is fully subject to ordinary income taxes, or
- Their employer's NDCP (or 401(k) plan)

For simplicity, we will assume the outside investment and the employer plan both earn pretax annual rates of return of 6% and the employees' marginal tax brackets remain the same in all years.

	Employee 1	Employee 2	Employee 3
Marginal Tax Rate	22.0%	37.0%	45.0%
Value of Investment (after-tax) After 20 Years			
Outside Investment	$19,470	$13,232	$10,529
NDCP (or 401(k))	$25,016	$20,205	$17,639
% Increase in Investment Value provided by NDCP	28.5%	52.7%	67.5%

While each employee substantially benefits from deferring the payment of taxes, the value of the tax deferral increases significantly for the two highest tax bracket employees. The opportunity cost to these highly compensated employees of not taking advantage of their tax deferral opportunities can be quite high.

A Deferred Compensation plan is a valuable savings vehicle for top earners and it is a proven reward and retention device for employers. Competition for top talent is increasing as the economy improves and keeping key employees is critical to a bank's long-term success. Key employees are a valuable entity to an organization but also a prized target for competitors. Voluntary contributions into a Deferred Compensation Plan offers a valuable tool for future savings and if a bank's peers don't offer a similar program, the plan participants are more unwilling to leave.

Another way to add a retentive quality to these plans is to utilize them as a vehicle with other reward programs. **Many organizations are placing greater emphasis on incentive compensation. Banks can pay a portion of an executive's reward into a Deferred Compensation Plan that is subject to vesting requirements always leaves something at risk for a top executive that might consider leaving.**

As an example, I recently worked with a bank that paid 50% of incentive compensation payments into their deferred compensation plan. The plan had a five year rolling vesting schedule, with each contribution having its own vesting terms, allowing executives to either take the payment once vested or defer until termination or retirement. The result was that each executive always had approximately $150,000 of unvested dollars in the deferred compensation plan. This is a significant amount of money to walk away from if another opportunity arises.

Executives in leadership positions where a high level of their compensation is incentive, or commission, based, this type of program performs well. It also allows the bank to provide a higher level of compensation knowing there is a retention aspect.

Deferred Compensation Plans is a widely used strategy in corporate America that is being overlooked in the bank market. It may not be the right fit for every bank, but because it provides a unique savings tool and retentive qualities for key employees, it's worth exploring.

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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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