Changing Trends in Credit Union Executive Compensation

presented by
Scott Albraccio

Agenda Topics

• Key Statistics around Changing Trends
• What’s Changing in Executive Benefits
• How to use Non-Qualified Deferred Compensation (NQDC) as a Reward and Retention Tool
Increased Regulatory Oversight

- July 21, 2010 -

**Dodd Frank Wall Street Reform and Consumer Protection Act**

Boards must report incentive based executive compensation information

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Increased Regulatory Oversight

- June 29, 2011 -

**NCUA ruling on Golden Parachutes**

- prevents financially troubled credit unions from certain “Golden Parachutes”
Increased Regulatory Oversight

- November 8, 2011 - Announced Proposal -

IRS proposed ruling on 457 plans for Federal Credit Unions

- FCU eligible to establish executive deferred compensation plans under Section 457

- Ruling is pending

Today’s Leadership

Low 5% management turnover for credit unions*

*CUNA 2011-2012 Credit Union Turnover and Staffing Survey
Emerging Leadership Trend

Caution for 2011-2016....

• 21% credit union CEOs plan to retire within 5 years*

• 2011 -1st baby boomers hit retirement age – more workers near retirement than are entering the workforce.

• 52% of U.S. employers are challenged to fill critical positions, (up 14% in 2010), according to ManpowerGroup’s sixth annual Talent Shortage Survey.*

• Only 63% of credit unions have a succession plan.*

The Compensation GAP

• A mere 30-40% of Executive Salary is replaced for Retirement with traditional Qualified Plans and Social Security.

• Credit Union CEO cash compensation is 71% of Bank CEO cash compensation.*

• Less CEO’s receive bonus and incentive awards in 2010 (60%) than in 2008 (73%).*
How Today’s Credit Unions Fill the Gap

**Split-dollar Life Insurance**

- Offering is on the rise, with more CUs offering than they did over last 2 years, (currently at 16%)*.

- Among the executive benefits in place in 2010, split-dollar had the highest median face value at approximately:
  - $1 million for CEOs*
  - $3 million to $5 million for senior executives**
The Age of Current CEOs

Plan to retire within 5 years (21% across all ages)

Succession Plans – 2 Types
Credit Unions and Formal Succession Plans
(Consistent with previously-reported trends!)

Have a Formal Succession Plan In Place
Don't Have One but Plan to Develop (in 2011)
Don't Have One and Don't Plan To

63%
14%
23%

Source: 2011-2012 CUNA Complete CU Staff Salary Survey

Thoughts from NCUA

“Management is the most forward-looking indicator of condition and key determinant of whether a credit union is able to correctly diagnose and respond to financial stress.” *

Thoughts from CUNA

“Although few CEOs are planning to leave their credit unions between now and 2013, it’s crucial for credit unions to determine how they’ll handle their CEOs’ departures.

Formal succession plans specify how a credit union will replace its CEO, preventing the credit union from operating without this key leadership position.”

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Motivation for a Well Designed Retirement/Retention Package

- Continuity of strategic decision making
- Financial needs of senior executives so they can focus on the credit union’s long term strategic goals and financial success
- Providing additional compensation and benefits - addressing the “Shortfall” gap
- Availability of the tax code for the advantage the credit union and executives
- Recruit, reward, retain and retire key employees
Credit Union CEO Appointments

2011 CEO Appointments

2012 YTD CEO Appointments

Through 1/30/2012


Industry CEO Appointments

• Booz & Company’s twelfth annual study on CEO succession*:
  
  – Companies released 35% of CEOs hired from outside, compared to 19% release of those promoted from within.
  
  – CEOs who come up from within, stay on their jobs for a year longer than outsiders, an average of five years, as opposed to four.
  
  – Four out of five new CEOs rise through the company ranks, says the study.

* New CEO Study Underlines Merits of Promoting from Within, Forbes, by Susan Adams, 5/25/12
Industry CEO Appointments

• Matthew Bidwell, assistant professor at Wharton, conducted a study that found external hires:
  – Get paid more, but for their first two years on the job, they receive significantly lower marks in performance reviews.
  – Are much more likely to get laid off than are those promoted from within.
  – Are 61% more likely to be fired from their new jobs than those promoted from within.

Why Promoting from Within Usually Beats Hiring from Outside, Forbes, by Susan Adams, 4/05/12

CEO Appointment Conclusion

“It’s not the will to win that matters, everyone has that. It’s the will to prepare to win that matters.”
- Paul "Bear" Bryant

Bench Strength Matters!
So Who’s Using What?

- Approximately 80% of credit unions have a 401(k) plan*
- Just over 30% offer a defined benefit or cash balance plan*

*CUNA 2011-2012 CEO Total Compensation Survey, and Senior Executive Total Compensation Survey

Traditional Sources of Retirement Funding
Today’s Drivers of Executive Compensation

- Maintain compensation package that is equal to or better than competition
- Keep executives at the CU by providing additional income and tax-effective compensation in the absence of a pension plan
- Relieve executives of retirement financial concerns, so they can focus on business problems
- Provide programs based on individual needs and concerns of the executive
- Recognition of current benefit shortfalls

Example – Shortfall Analysis

<table>
<thead>
<tr>
<th>Executive</th>
<th>John Smith</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gender</td>
<td>M</td>
</tr>
<tr>
<td>Date of birth</td>
<td>age 55</td>
</tr>
<tr>
<td>Plan start date</td>
<td>1/1/2009</td>
</tr>
<tr>
<td>Current Annual Pay</td>
<td>$125,000.00</td>
</tr>
<tr>
<td>Annual Increase</td>
<td>4%</td>
</tr>
</tbody>
</table>

401(k) Plan

| Current Balance | $200,000.00 |
| Salary Deferral Rate | 5% |
| Catch Up Amount (Annual) | $0 |
| % Salary Deferral Rate Matched | 0% |
| Max % Salary Deferral Rate Matched | 5% |

Other Defined Contribution Plans

| Current Balance | 0.00 |
| Contribution Rate | 0% |

Defined Benefit Plan

| Projected Benefit Rate | 0% |
| Projected Monthly Benefit Amount | 0 |
| Projected Lump Sum at Retirement | 0 |
| Payable at Age | 0 |
| Cost of Living | 0.00% |

Social Security

| Projected Monthly Benefit | $3,316.00 |
| Payable at Age | 66 |
| Cost of Living Increase | 0.00% |
**Example - Shortfall Analysis**  
*(John Smith)*

**After Income Tax**

- **70% of Salary @ age 65**  
  $89,812
- **Current Benefits projected**  
  $60,465
- **Benefit “Shortfall” gap**  
  $29,347

*(For 20 years)*

<table>
<thead>
<tr>
<th>Yearly Gap</th>
<th>Amount Needed at Retirement</th>
<th>Amount Needed to Invest Today</th>
<th>Yearly Gap</th>
<th>Amount Needed at Retirement</th>
<th>Amount Needed to Invest Today</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>$29,347</td>
<td>$692,432</td>
<td>5%</td>
<td>$16,517</td>
<td>$389,706</td>
</tr>
<tr>
<td>6%</td>
<td>$24,139</td>
<td>$535,096</td>
<td>6%</td>
<td>$11,308</td>
<td>$250,677</td>
</tr>
<tr>
<td>7%</td>
<td>$18,195</td>
<td>$379,739</td>
<td>7%</td>
<td>$5,364</td>
<td>$11,958</td>
</tr>
</tbody>
</table>

**Counter “Reverse Discrimination”**

**Qualified Plan Shortfall Corridor**  
Sample Credit Union

- **Defined Benefit, 30%**  
  61.17%
- **401k Match, 9.89%**  
- **Social Security, 21.48%**  
- **Defined Benefit, 29.94%**  
  38.21%
- **401k Match, 9.54%**  
- **Social Security, 7.73%**
Counter “Reverse Discrimination”

Qualified Plan Shortfall Solution
Sample Credit Union

What are...

• Supplemental Executive Retirement Plans (SERPS)?

• Non-Qualified Executive Benefit Plans?
“A plan for a ‘Select Group of Management’ not subject to participant-protection guidelines and discrimination testing of the Employment and Retirement Income Security Act”
(ERISA – 1974)
Traditional SERP Plan Design Factors to Consider

- Flexibility
- Income Tax-Free Death Benefits
- Cost Recovery
- ERISA or “Top Hat” Limitations
- Ease of Administration
- Financial Statement Impact
- Deferral of Income Taxation
- Supplemental Retirement Income
- “Golden Handcuffs” (Retention Tool)
- Defined Benefit or Defined Contribution

Executive Benefit Plan Designs for Credit Unions

Customized Supplemental Executive Retirement Plans:

- §457(b) Retirement Plan
- §457(f) Supplemental Retirement Plan
- §7872 Split Dollar Life Insurance Plans
- Executive Bonus Plan
- Executive Long-Term Care Insurance
- Executive Supplemental Disability
Plan Funding Alternatives

- Managed Investment Accounts
- Mutual Funds
- Annuities
  - Variable
  - Fixed
- Split-Dollar Life Insurance
  - Corp./Bank Owned Life Insurance (BOLI / COLI)
  - Collateral Assignment
- General Assets

457(b) Deferred Compensation Plan

- An inexpensive, easy to administer, supplement to the 401(k) for your top-hat employees
- Annual indexed contributions currently limited to $17,000
- Assets are credit union assets - subject to claims of general creditors of the credit union
- Deferrals are 100% vested by executive
457(b) Deferred Compensation Plan

- Federal and state income taxes are deferred until the monies are distributed
- Money is generally distributed after separation from service, except for hardship distributions
- Rollovers to IRAs are not permitted
- Age 50 and over catch-up not available for 457(b) plans in credit unions
- 990 form – amount deferred is reported each year

457(b) Pros and Cons

<table>
<thead>
<tr>
<th>Executive</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Deferred compensation until after retirement or after deferred periods</td>
<td>• Plan limits</td>
</tr>
<tr>
<td></td>
<td>• Can defer compensation into potentially lower tax years</td>
<td>• Subject to general creditors until distributed</td>
</tr>
<tr>
<td></td>
<td>• Vests right away</td>
<td></td>
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<tr>
<td></td>
<td>• Select payout method; substantially equal amounts</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Ability to invest as desired</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Catch up provisions</td>
<td></td>
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</tbody>
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<table>
<thead>
<tr>
<th>Credit Union</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Easy to set up and administer</td>
<td>• Plan limits</td>
</tr>
<tr>
<td></td>
<td>• Allows for a deferred compensation bonus tool</td>
<td>• Not necessarily a retention tool</td>
</tr>
<tr>
<td></td>
<td>• Assets still owned by the credit union</td>
<td>• After service separation, asset still on books and accounting need</td>
</tr>
<tr>
<td></td>
<td>• Succession Planning</td>
<td></td>
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<tr>
<td></td>
<td>• Recruiting</td>
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<tr>
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<td>• Flexible</td>
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457(f) Deferred Compensation Plan

- Eligible employees are the select group or highly compensated
- Assets are credit union assets and subject to general creditors until distributed
- No plan limits on contributions

457(f) Deferred Compensation Plan

- The entire benefit is taxed in the year the “risk of forfeiture” lapses regardless of when it is distributed
- Defined Benefit Formula
- Defined Contribution Plan (earnings only)
- 990 form – accrual amount reported each year, then the entire benefit is reported when vested
### 457(f) Pros and Cons

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<thead>
<tr>
<th>Executive</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>• No plan limits</td>
<td>• No plan limits</td>
<td>• Subject to taxation at vesting</td>
</tr>
<tr>
<td>• Payment at defined age, defined years of service, death, disability or involuntary termination by employer without cause</td>
<td>• Payment at defined age, defined years of service, death, disability or involuntary termination by employer without cause</td>
<td>• Subject to general creditors until distributed</td>
</tr>
<tr>
<td>• Flexible</td>
<td>• Flexible</td>
<td>• Fixed Date</td>
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</tbody>
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<table>
<thead>
<tr>
<th>Credit Union</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>• No plan limits</td>
<td>• No plan limits</td>
<td>• Volatility</td>
</tr>
<tr>
<td>• Payment at defined age, defined years of service, death, disability or involuntary termination by employer without cause</td>
<td>• Payment at defined age, defined years of service, death, disability or involuntary termination by employer without cause</td>
<td>• Opportunity cost</td>
</tr>
<tr>
<td>• Flexible</td>
<td>• Flexible</td>
<td></td>
</tr>
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</table>

### Anatomy of a Defined Contribution

- Earnings-based plan design has been used in widespread fashion
- This plan allows the executive benefit to come from earnings on an underlying investment
- Seemingly allows credit union to obtain a “free ride” on the markets
- Causes challenges when original investment is under-water
Split Dollar Life Insurance:

A recent alternative to provide predictability and tax advantages for the Credit Union and Executive

Split Dollar Life Insurance

- Alternative to 457 plan, if available
- Executive applies for a whole life policy
- CU pays the premium
- Premium is treated as a loan
- Policy secures the CU’s interest
### Split Dollar Life Insurance

- Executive can withdraw $ for retirement
- CU paid back upon executive’s death
- Excess death benefit goes to executive’s family
- Tax advantages for executives
- More predictable yields for credit union

### Endorsement Split Dollar – Pros & Cons

<table>
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<th>Pros</th>
<th>Cons</th>
</tr>
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<tr>
<td></td>
<td>• No program limits</td>
<td>• Executive is taxed on the economic benefit annually</td>
</tr>
<tr>
<td></td>
<td>• Can be structured to avoid Internal Revenue Code Section 457 and 409A</td>
<td>• Insurability</td>
</tr>
<tr>
<td></td>
<td>• Tax free death benefit</td>
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<table>
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<tr>
<th>Credit Union</th>
<th>Pros</th>
<th>Cons</th>
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</thead>
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<tr>
<td></td>
<td>• Low cost to credit union</td>
<td>• Medium Time Frame</td>
</tr>
<tr>
<td></td>
<td>• Credit Union is repaid from either the policy’s split death benefit or its cash surrender value.</td>
<td>• Insurability</td>
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<td></td>
<td>• Low impact to financials of the credit union</td>
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Collateral Assignment – Loan Regime Split Dollar – Pros & Cons

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<th>Cons</th>
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<tr>
<td><strong>Executive</strong></td>
<td>• No program limits</td>
</tr>
<tr>
<td></td>
<td>• Structured outside of Internal Revenue Code Section 457 &amp; 409A</td>
</tr>
<tr>
<td></td>
<td>• Tax free retirement cash flow</td>
</tr>
<tr>
<td></td>
<td>• Income tax free withdrawals</td>
</tr>
<tr>
<td></td>
<td>• Cash value grows tax deferred</td>
</tr>
<tr>
<td><strong>Credit Union</strong></td>
<td>• Executive is taxed on imputed interest annually</td>
</tr>
<tr>
<td></td>
<td>• Insurability</td>
</tr>
<tr>
<td></td>
<td>• Low cost to credit union</td>
</tr>
<tr>
<td></td>
<td>• Credit Union is repaid from, and is secured by, either the policy’s death benefit or its cash surrender value, or both</td>
</tr>
<tr>
<td></td>
<td>• Availability of “cost of funds” recovery</td>
</tr>
<tr>
<td></td>
<td>• Low impact to financials of the credit union</td>
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• Provide programs based on individual needs and concerns of the executive

• Recognition of Current Benefit Shortfalls
Motivation Recap

• Continuity of strategic decision making

• Address financial needs of senior executives so they can focus on the credit union’s long term strategic goals and financial success

• Provides additional compensation and benefits - addressing the “Shortfall” gap

• Lets credit union and executives utilize the tax code to their advantage

• **Recruit, Reward, Retain and Retire key employees**

Executive Benefits Focus & Resources

• CUNA Mutual Group currently offers comprehensive executive benefit programs to over 1,200 CU’s with 3,700 executive plans.

• Experience in every component of Executive Benefits
  – Plan design
  – Compliance
  – Administration
  – Investments
  – Participant education
  – Multi-touch service
Any Questions?

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