Executive Benefits: Plan Overview and Strategies

September 2016

Guy Collins, BFB Gallagher

A DIVISION OF Gallagher Benefit Services, Inc.

About BFB Gallagher

- Focused on nonqualified plans for highly compensated individuals in nonprofit organizations
- 385+ nonprofit clients
- Coast-to-coast offices
- Executive and Board education
- Plan audit, design, implementation, and ongoing service
- Regulatory compliance and due diligence requirements for nonprofits

The Market

Executive benefits are growing in usage

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Why Is This Happening?

70%+ aged 50+ + 3 out of 10 retiring soon = Recruiting frenzy

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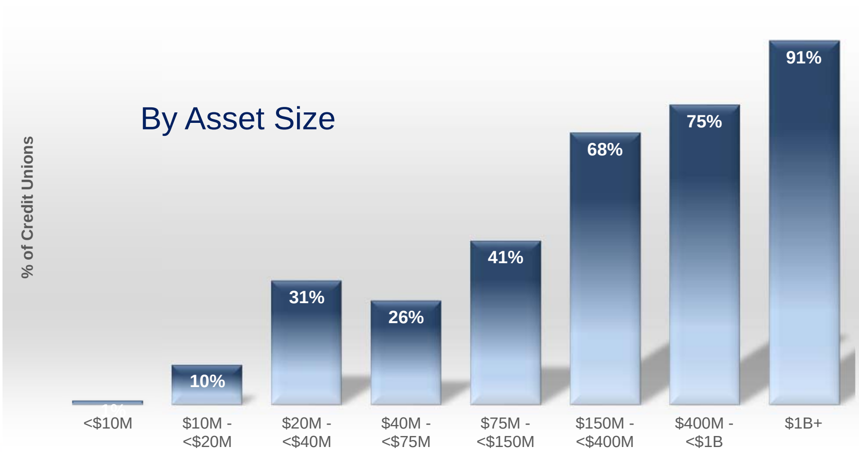
Credit Unions with Nonqualified Plans
(excluding severance)



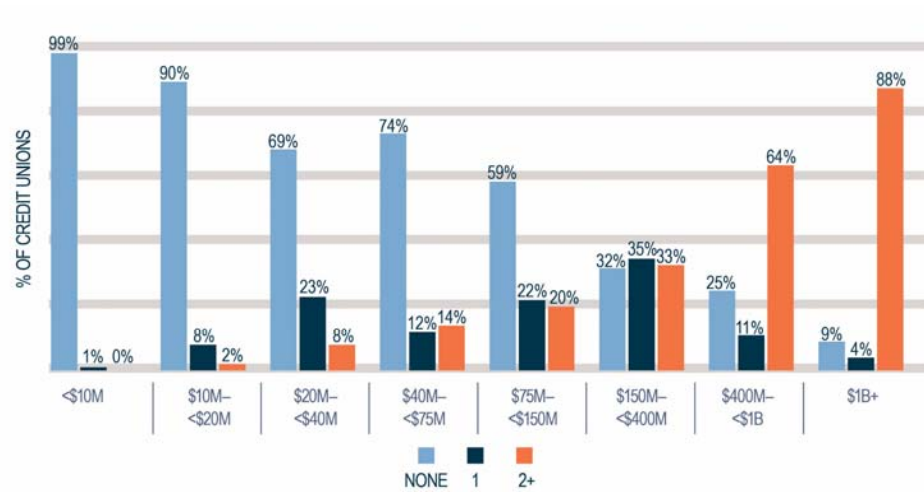
Source: 2016 NAFCU-BFB Gallagher Executive Compensation and Benefits Survey

Continuity/Succession Is a Concern

The Team is becoming more important

- Succession planning
- Regulatory concern
- Implementation of strategic goals
- Continuity of business and culture
- Members' perception

Number of Executives with NQ Plans
(excluding severance)



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Next – What Is the Peer Group Doing?

Nonqualified Plans by Executive

Total Assets:	<$10M	$10M–<$20M	$20M–<$40M	$40M–<$75M	$75M–<$150M	$150M–<$400M	$400M–<$1B	$1B+
Top Executives								
Sample Size=	55	69	91	93	91	84	63	48
SERP 457(b)	1%	3%	7%	7%	10%	28%	36%	65%
SERP 457(f)	-	-	19%	9%	23%	38%	39%	59%
Split Dollar	-	4%	9%	12%	12%	30%	28%	26%
Have but none of the above	-	-	1%	1%	5%	1%	-	2%
Not have/Not eligible	96%	89%	61%	68%	46%	26%	22%	9%

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Compensation Components

1. Base salary – competitive to market and considers experience, skills, success
2. Bonus/incentives – engage and focus
3. Benefits
4. Perquisites

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Three Key Concepts

A successful compensation package incorporates these key concepts:

1. Fair and reasonable compensation
2. Shortfall analysis
3. Compensation philosophy

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Compensation Philosophy

- Mission statement for your compensation program
- Benchmarks the competitive market and sets target percentiles for high performers, those meeting expectations, and new hires
- Strategic roadmap and consistency
- Due diligence – Repeatable!

Retaining Executive Talent

What is the value of retaining executives for career service?

- Long-term return on investment
- Strategic vision is advanced, uninterrupted
- Stronger connection to membership
- Institutional knowledge stays in-house

Common Misconceptions

- My CEO has been here a long time and wouldn't leave
- My CEO is happy here and wouldn't leave
- My CEO's salary and benefits are already excessive – it's more than my own retirement package
- There isn't anywhere else for my CEO to go

Executive Benefits: Why?

Recruit
- Better candidates
- Faster process

Retain
- Continuity
- Material impact

Reward
- Share in organization's success
- Longevity

How do we know if a benefit is too little or too much?

Begin at the Beginning

- What is the CU already giving in Benefits

Shortfall Analysis Summary

Hypothetical Illustration for Sample Credit Union

Values are based on current assumptions. Actual results may vary.

COMPENSATION		EXISTING BENEFIT PLANS				RETIREMENT GOAL			SHORTFALL		
Current Salary ($)	Final Salary ($)	Employer Social Security ($)	Employer 401(k) ($)	Total Existing Benefits ($)	Total %	Years of Service	Goal Total %	Total Annual Benefit ($)	Shortfall %	**Split Dollar** Annual Shortfall Amount ($)	**457(f)** Alternative Lump Sum Distribution ($)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Sample Executive, Male Age 50; 1/1/1995 Hire Date, Current Age 50, Retirement Age 65, 20 Retirement Benefit Years											
150,000	296,990	24,450	41,901	66,351	22.34%	35	**65.00%**	193,043	42.66%	**$126,692**	**$1,621,306**

- *The report is based on values provided by the credit union as of 1/1/2016.*
- *(2) Final Salary: Future compensation is based on a 5% annual inflator.*
- *(3) Employer Social Security : The full estimated monthly benefit according to the online social security quick calculator is $4,075, * 12 months/year = $48,900, divided by 2 to get the employer portion only = $24,450.*
- *(4) Employer 401(k) : 1/1/16 prior balance = $150,000; monthly contributions projected as 5% of salary; 5% interest; 2030 based on 11 months from 1/1/30 to 11/30/30; Annual Benefit = -Pmt((1+5%)^(1/12)-1 monthly rate, 20 payout years * 12 months, $536,219 retirement balance, $0 fv, begin of month payments) * 12 months = $41,901*
- *(5) Total Existing Benefits = (3) + (4)*
- *(6) Total % = (5) / (2)*
- *(9) Total Annual Benefit = (2) * (8)*
- *(10) Shortfall % = (8) - (6)*
- *(11) Split Dollar Annual Shortfall Amount = (9) - (5)*
- *(12) 457(f) Alternative Lump Sum Distribution = Present Value of 20 Years of (11), Discounted @ 5%*

Shortfall Analysis

- Projection of what benefits might be payable during retirement years
- Evaluate actual vs. projected percentage of retirement income
- If percentage of salary falls short, need to look at non-qualified executive benefit plans

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SHORTFALL ANALYSIS SUMMARY

Hypothetical Illustration for Sample Credit Union

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Target Replacement Income

What percent of their pre-retirement income is targeted?

Percentile	10th	25th	40th	Median - 50th	60th	75th	90th	Average
	45%	50%	60%	60%	60%	70%	80%	60%

Source: 2016 NAFCU-BFB Gallagher Executive Compensation and Benefits Survey

Income Targets

Peer Data | Income Targets | CEO

East Coast

Total Assets ($) (000)	Type of Plan	Forms of Benefit Payout	Total Number of Participants	CEO Income Replacement Target (%)
(1)	(2)	(3)	(4)	(5)
600,000	457(f)	Lump Sum	2	60%
600,000	457(f)	Lump Sum	2	60%
500,000	457(f)	Lump Sum	7	70%
500,000	457(f)	Lump Sum	6	60%
500,000	457(f)	Lump Sum	2	65%
500,000	457(f) and Split Dollar	Installments, Lump Sum	4	50%
500,000	Split Dollar	Installments	1	45%
400,000	457(f)	Lump Sum	3	70%
400,000	457(f)	Lump Sum	5	70%
400,000	457(f) and Split Dollar	Installments, Lump Sum	1	70%
400,000	457(f) and Split Dollar	Installments, Lump Sum	6	75%
400,000	Split Dollar	Installments	1	75%
400,000	457(f) and Split Dollar	Installments, Lump Sum	3	60%
300,000	Split Dollar	Installments	2	75%
300,000	457(f) and Split Dollar	Installments, Lump Sum	1	60%
300,000	457(f) and Split Dollar	Installments, Lump Sum	4	75%
300,000	457(f) and Split Dollar	Installments, Lump Sum	3	58%
300,000	457(f) and Split Dollar	Installments, Lump Sum	1	62%
300,000	457(f)	Lump Sum	2	70%
300,000	457(f) and Split Dollar	Installments, Lump Sum	4	70%
200,000	457(f) and Split Dollar	Installments, Lump Sum	1	65%
200,000	457(f)	Lump Sum	4	50%
100,000	Split Dollar	Installments	1	60%

Benefits data from BFB's current client database; information of this detail for Credit Unions not serviced by BFB is not available. Does not include Death Benefit Only plans.

Variables {x}

- Compensation philosophy
- Strategic needs
- Performance measures
- Experience
- Payment/retirement time horizon
- Credit union profile

Plans with Retention Power

- Nonqualified Deferred Compensation: 457(f) and 457(b)
- Section 83 Bonus: Restrictive Bonus Plan
- Welfare Benefit: Split Dollar

Nonqualified Deferred Compensation

Type	Features	Pros	Cons
457(f)	• Employer-funded benefit • Vesting date	• Predictable expense • Plan ends at executive's termination • Option for cost-recovery investment	Legal promise with associated ongoing expense and liability
457(b)	• 403(b) excess plan • No vesting date	• Predictable expense • Plan ends at executive's termination	IRS limits can make accruing a meaningful benefit difficult

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Welfare Benefit: Split Dollar

Features	Pros	Cons
• Tax-free income to participant • Vesting date for retention ★ Cost mitigation to institution ★ Preferential 990 reporting	• No promised benefit • Built-in cost recovery • Flexibility regarding vesting • Benefit caps	• Long term commitment – 30 year Mortgage • Interest rate is fixed

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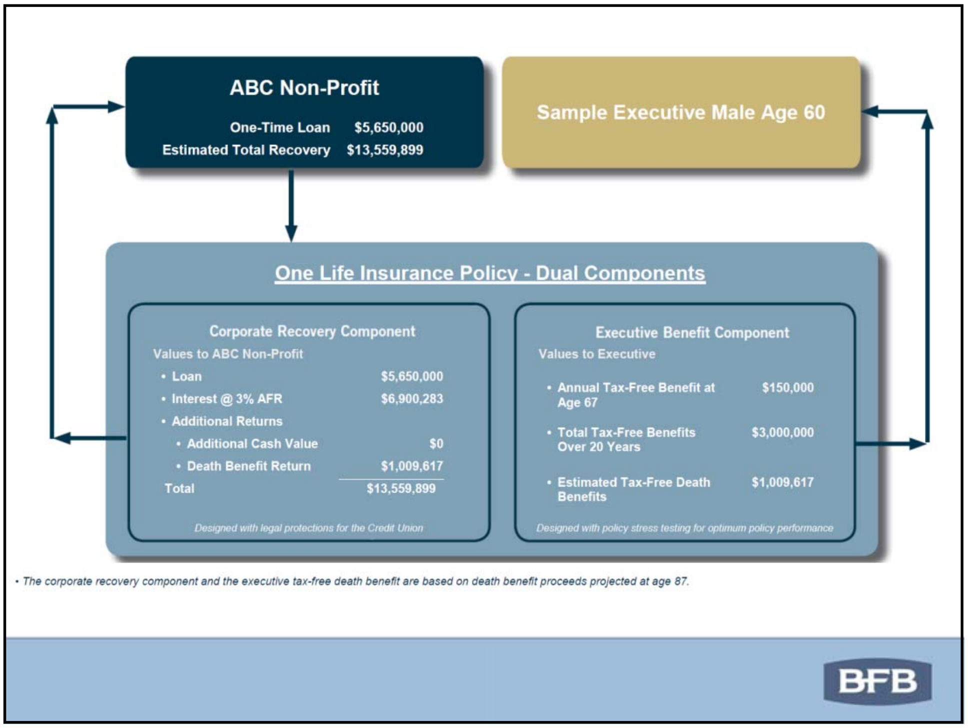

Section 83: Restrictive Bonus Plan

Features	Pros	Cons
• Deferred compensation and welfare benefit • Tax-free income to participant	• Predictable expense • Plan ends at executive's termination • Option for cost-recovery investment	Ongoing expense and bonus commitment until termination

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Other Committee/BOD Considerations

- Due Diligence should also include
  - Plan effect to the Bottom Line – EXACTLY
  - Regulatory Concerns
    - Concentration
    - Other regulatory concerns
    - Balance Sheet

Basics in Building a Plan

From the Regulator:

- Fair and Reasonable
  - Shortfall Analysis
  - Peer Group Data
- Safe and Sound
  - Funding
  - Legal Provisions - Crucial

Develop the Plan

Exec	Age	Years of Service	Retirement Age
CEO	57	20	65
CFO	47	5	Potential CEO
COO	59	25	62

Design Considerations

Executive	Factors
CEO	• Cost of plan • Flexibility in timing
CFO	• Significant enough to hold • Longer Time horizon
COO	• Rewards for years of service • Cost of plan

Meaningful and Significant

Exec	Plan	Reason
CEO	Split Dollar	**Reward** • Immediate Vesting • Financial Planning • Tax Advantaged
CFO	457(f) & Split Dollar	**Retention** • Cliff Vesting • Early Payouts • Tax Advantages/DB
COO	457(b) Plan	**Reward/Cost** • Cost efficient • Tax advantage

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The Bottom Line

ALL PARTICIPANTS

Values are based on current assumptions. Actual results may vary.

		BENEFIT EXPENSES			INSTITUTIONAL INSURANCE	SPLIT-DOLLAR	DEATH PROCEEDS	IMPACT SUMMARY	
Period Ending Dec of	Plan Year	Annual Benefit Expenses ($)	Annual Admin. Fees ($)	Total Benefit Expenses ($)	Projected Asset Growth Income ($)	Annual Collateral Increase ($)	Corporate Recovery / Available Death Proceeds ($)	Net Gain (Loss) ($)	Cumulative Gain (Loss) ($)
(1)	(2)	(3)*	(4)*	(5)	(6)	(7)	(8)*	(9)*	(10)
2017	1	(57,238)	(12,000)	(69,238)	129,013	0	11,931,738	59,776	59,776
2018	2	(62,023)	(3,300)	(65,323)	155,942	9,285	11,880,667	99,904	159,680
2019	3	(67,175)	(3,300)	(70,475)	160,299	18,324	11,840,532	108,148	267,828
2020	4	(72,719)	(3,300)	(76,019)	165,017	(87,353)	11,811,405	1,646	269,473
2021	5	(78,682)	(3,300)	(81,982)	169,868	91,607	11,793,369	179,492	448,966
2022	6	(85,093)	(3,300)	(88,393)	174,848	137,435	11,786,518	223,890	672,856
2023	7	(91,981)	(3,300)	(95,281)	179,971	186,263	11,790,954	270,954	943,809
2024	8	(68,889)	(3,300)	(72,189)	185,234	92,493	12,041,674	205,538	1,149,347
2025	9	(10,475)	(3,000)	(13,475)	190,642	96,933	12,326,776	274,100	1,423,447
2026	10	(10,475)	(3,000)	(13,475)	196,208	102,032	12,650,534	284,765	1,708,212
2027	11	0	(3,000)	(3,000)	201,936	167,338	13,045,336	366,274	2,074,486
2028	12	0	(3,000)	(3,000)	207,832	178,097	13,452,522	382,929	2,457,415
2029	13	0	(3,000)	(3,000)	247,015	181,661	13,871,653	425,676	2,883,091
2030	14	0	(3,000)	(3,000)	221,113	184,372	14,303,012	402,485	3,285,576
2031	15	0	(3,000)	(3,000)	227,554	194,190	14,746,799	418,744	3,704,320
2036	16-20	0	(15,000)	(15,000)	1,240,673	1,110,625	17,159,497	2,336,298	6,040,618
2041	21-25	0	(15,000)	(15,000)	1,431,706	1,358,242	19,921,632	2,774,948	8,815,566
2046	26-30	0	(12,000)	(12,000)	1,651,721	2,306,681	13,557,610	3,946,402	12,761,968
2051	31-35	0	(7,500)	(7,500)	1,905,100	158,434	15,612,886	2,056,034	14,818,002
2056	36-40	0	(4,500)	(4,500)	1,369,875	358,552	0	1,723,928	16,541,930
TOTAL:		(604,750)	(110,100)	(714,850)	10,411,568	6,845,211		16,541,930	

- *Assumes asset acquisition of $8,700,000 on 1/1/2017.*
- *Assumes benefit expenses starting , January 2017.*
- *"IMPACT SUMMARY" reflects annual and cumulative gains or losses from "INSTITUTIONAL INSURANCE" and "SPLIT-DOLLAR" less "BENEFIT EXPENSES".*
- *(3) Annual Benefit Expenses includes benefit expenses for 1 executive and employee benefit expenses (LTC Plan).*
- *(4) Annual Admin. Fees includes fees associated with the benefit plan and the BFB Split Dollar plans.*
- *(8) Corporate Recovery / Available Death Proceeds are based on illustrated data or specified growth formulas provided to BFB Gallagher by the applicable asset companies. The report values are based on values using current earnings assumptions (NOT GUARANTEED), and are interpolated to approximate report period ending values.*

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The Role of the Board of Directors

Key concepts

- Understanding the market
- Understanding the options
- Understanding the needs of the credit union's executive team
- Importance of the board retaining the consultant (rather than the executives)
- Ongoing executive compensation oversight

Best Compensation Practices

- Committees must communicate effectively with the Board
- Engage consultants who report directly to the Board
- No screening or filtering by the CEO
- Inspect plan modifications
- Ensure plan documentation is compliant and terms understood
- Associate with professionals to monitor legal developments

Next Steps

- Educational session & due diligence
- Review existing plans
- Assess recruiting and retention needs
- Identify consultants
- Implementation of best practices
- Ongoing administration and compliance

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Thank you!

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More educational resources are available at www.BFBbenefit.com.

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Withdrawals made from investment products during the first 15 years could result in unfavorable LIFO taxation under IRC Section 7702(f)(7) “force-out” rules. Withdrawals in excess of cost basis may be taxable. Lapsing a policy with an outstanding loan results in the loan, and any accrued interest, being treated as a distribution, which may be taxable. Modified endowment Contracts (“MEC’s”) are taxed differently and are not suitable for this program if surrenders or loans are anticipated. Please check policy illustrations to see if the policies being considered are MEC’s. Certain changes to a non-MEC policy could result in the policy becoming a MEC. Professional tax advisors should be consulted. Any loans, withdrawals or partial surrenders will reduce cash values and death benefits.

Mutual Funds & Variable Universal Life Insurance Policies: Before investing, investors should carefully consider the investment objectives, risks, charges and expenses of the variable product and its underlying investment options. The current contract prospectus and underlying fund prospectuses provide this and other important information. Please contact your representative or the Company to obtain the prospectuses. Please read the prospectus carefully before investing or sending money.

Past performance cannot predict future results. The purpose of this discussion outline is to present the issues and plan mechanics associated with a taxable investment and corporate owned life insurance financing strategy. The insurance products shown in this report are representative of the market and are based on a hypothetical investment yield which is not guaranteed.

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Best Compensation Practices

Originally published in the February 2013 issue of Credit Union Business Magazine

Written by James S. Patterson and C. Daniel Sherman of the law firm Sherman & Patterson, Ltd; and Tom Telford, Area Senior Vice President at BFB Gallagher

By carefully managing executive compensation, a credit union's board of directors can minimize the risk that executives, members, the public, or regulators will complain about or challenge how they compensate top management.

We have discovered what does and doesn't work after years of working on executive benefits for tax-exempt organizations. Here are some ideas your organization should consider adopting.

Develop a Compensation Philosophy

A compensation philosophy is a formal document that codifies the credit union's guiding compensation principles and objectives and establishes performance targets. It should be signed by the board chair and added to board minutes. The philosophy should:

1. Identify a peer group of employers
2. Target positioning within the peer group
3. Specify the balance between guaranteed and incentive compensation
4. Define the mix of cash compensation and benefits

Once approved, the board should regularly review their compensation philosophy document to ensure that compensation practices continue to conform to its guidelines. The board should not set the compensation philosophy aside and ignore it.

Benefits of a Documented Compensation Philosophy

Having a documented compensation philosophy helps to establish consistency in compensation levels that can be especially helpful as positions open up and new executives are hired to fill those slots. It also creates a measure of fairness that reduces the risk of a disgruntled executive suing the organization for employment discrimination. The philosophy is helpful when board members change as it gives them a strong basis on which to continue the status quo or to make necessary changes in compensation.

Seek Comparability Data

Knowing the compensation levels and practices of a peer group is critical for setting executive compensation to achieve the objectives stated in the philosophy. The board should not rely on just one source of data. Instead, it should review two or three reputable sources and compare the data it receives. A board's analysis of compensation levels may involve averaging, or sometimes eliminating an outlier if results seem skewed. It is important to compare similarly sized credit unions, and comparable positions within those credit unions. If the board uses a consultant to find the comparability data, it should verify that the consultant is providing reliable data. The board should not rely solely on comparability data provided by the executive team.

Require Regulatory and Tax Compliance

Boards should ask legal staff or consultants to confirm that the plans and their funding vehicles comply with all applicable regulations. An audit is the wrong time to find out that regulatory review or approval was required before the plan was implemented and the funding assets acquired, or that benefits were taxable earlier than expected or subject to penalties. The 46 states that have state credit union charters each have their own set of credit union laws and regulations that must be followed and federally insured state-chartered credit unions must understand and comply with all federal regulations and standards as well. On the other hand, federal credit unions do not need to comply with the state credit union laws in the states where they are headquartered; they are covered only by federal law and regulations.

Review Compensation Annually

Although a compensation package may be fair and consistent with the standards set forth in the compensation philosophy document, some executives will still perceive they are underpaid or have inferior benefits. Annual reviews can help avoid the surprise and disappointment of an executive resigning to accept a better offer, or discovering that after many years a plan is woefully over or under-funded. Executives should be given an opportunity to ask questions or raise concerns. With all of its various compensation components—salary, incentive compensation, benefits, and perquisites—an annual review is a good opportunity to look at the big picture and see how all of the components interrelate.

Consider the Multiplier Effect

An executive's benefits are often tied to base salary. A defined benefit SERP, for example, may specify that the executive receive payments of 1.5 times base salary on a certain date. If base salary increases, this will directly increase the SERP payments. SERP benefits may also be based on total compensation (i.e. base salary plus incentive compensation), which significantly increases the complexity of managing the changes in the projected SERP benefit. Incentive compensation plans can be designed with large variances in possible awards, creating an even greater impact on the executive's SERP benefit. A board needs to be aware of these multiplier effects as it analyzes appropriate levels of base salary and incentive compensation for its SERP participants.

Establish a Subcommittee for Executive Compensation

Compensation issues are complicated. As credit unions increase in size and complexity, the board should consider establishing a compensation committee or executive committee to oversee compensation issues for the board. The board should choose committee members based on their experience with and interest in compensation issues. A committee can dig more deeply into and address more knowledgeably compensation details that are too tedious to be addressed in a typical full board meeting. The committee members should receive materials well in advance of the meeting so they have adequate time for analysis and are prepared for discussion.

Committees Must Communicate Effectively with the Board

Although such committees can add significant value to the board, their role is to administer the board's policy, not to create the policy itself. Effective communication between the compensation committee and the board is critical. Benefit levels can get out of control and create division when compensation committees fail to communicate effectively with other board members. At the end of each year, the committee should give the board a full report that reminds the board of the compensation philosophy it approved; that clearly and accurately discloses compensation levels of its executive team and relates that compensation to peer data; and provide minutes that summarize the committee's discussions throughout the year.

Engage Consultants Who Report Directly to the Board

Consultants live and breathe compensation and benefits, whereas most board members have only a general understanding. A specialist's review can ensure the credit union's compensation dollars are being used efficiently and that plans are fulfilling board and executive expectations. Consultants retained by, and reporting directly to the board, help ensure that the board is receiving accurate, unbiased and unfiltered information. Consultants help boards understand complicated concepts, such as the nuances of comparability data.

No Screening or Filtering by the CEO

Boards received clear direction through NCUA's Rule 701.4 in January of 2011 that the NCUA is concerned about senior executives, especially chief executive officers, having too much influence over the executive compensation set by the board. The NCUA clarified that the board must set executive compensation without any "screening" or "filtering" from the CEO. In most areas of credit union governance, boards appropriately follow the CEO's direction. With executive compensation, however, board members need to analyze consultants' recommendations, lead out and make decisions without any pressure from the CEO. In the past, many boards allowed the CEO to set compensation for the other executives, but more and more boards are realizing that they need to take a more active hand in setting compensation for the other senior executives as well.

Inspect Plan Modifications

Before approving a plan modification, the board should understand the reasons for the change, their costs and the impact of the changes to benefits. As it reviews suggested changes, the board should meet in an executive session to ensure that executives and any board members with a personal stake in the outcome do not participate in the final decision. The board should also document its intent as it approves changes to plans, so it is clear to future board members and executives why the board approved the change.

Ensure Plan Documentation Is Compliant and Terms Understood

A plan sponsored by a credit union is subject to state and federal regulations, as well as a number of provisions under the Internal Revenue Code—Section 457(f) and Section 409A to name two. Since 409A's inception in late 2004, the Internal Revenue Service has issued more than 1,000 pages of guidance under that section alone. Having plan documentation prepared by a benefits attorney minimizes chances for regulatory or tax violations or for disagreements with executives or beneficiaries. Periodic professional review ensures that law changes are incorporated into the documents in a timely manner.

In a recent review of a SERP designed with annual payments following termination, we discovered that the board and executive believed that the SERP benefit would be taxed as the credit union paid the benefit each year. We explained that taxation under Section 457(f) occurs when the substantial risk of forfeiture lapses (e.g. retirement date attained during employment), regardless of when the credit union pays the benefit. This resulted in a significantly lower projected net benefit than previously anticipated, and required some difficult discussions for all parties involved.

Associate with Professionals to Monitor Legal Developments

The legal environment is fluid. Regular consultation with compensation professionals helps keep boards informed and prepared for the changing landscape. For example, the Internal Revenue Service in 2007 indicated it would issue guidance under Section 457(f) of the Code, but despite some occasional rumblings, the IRS has yet to issue any guidance. If and when the IRS does issue guidance, boards will need to review their plans to ensure compliance with the new rules.

Summary

Compensation best practices bring comfort to boards and executives in knowing that their executive compensation is competitive, compliant and an appropriate use of credit union resources.

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