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Establishing The Right Compensation package

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OBSTACLES TO ESTABLISHING THE RIGHT COMPENSATION PACKAGE

Companies are constantly struggling with how to provide just the right compensation and benefits package to reward, recruit and retain top talent. Compensation committees and executive management teams also struggle to provide just the right amount of benefits and compensation without giving away "more of the farm" than necessary.

The ramifications of missing the mark can result in a lack of employee morale, an increase in employee departures, and a decrease in competitive position in the marketplace. Once an organization gains the reputation as being "cheap" in recruiting talent, then retaining talent becomes a constant challenge.

"The cost of losing a key person is estimated to be around two to three times his/her compensation."

COSTS OF HIRING AND REPLACING A KEY INDIVIDUAL

It is extremely expensive to lose key members of executive management, a robust sales team or a successful lending group. Over the years, the industry has used formulas to help companies quantify the estimated cost of losing a key person in an organization. CFO Magazine wrote in 2014 that the cost of losing a key person is estimated to be around two to three times his/her compensation.

The loss of an important team member can also result in the following:

- Lost productivity
- Decreased employee morale as other employees need to pick up the slack
- Lost sales and revenue
- Recruiting expenses
- Additional costs of outside consultants to fill the void until a replacement is hired, trained and productive

Many companies insure the organization against a key employee's untimely death; however, they do not spend enough time in researching their own compensation and benefits plans to make sure they are appropriately competitive.

KEY COMPONENTS OF AN OVERALL COMPENSATION PACKAGE

Calibrating the elements of a compensation package for an organization is a multifaceted process. Culture and strategy of the organization often influence what to include, along with an understanding of the competing organizations' offerings. In addition, affordability is a key consideration.

Key elements of a pay package include:

- **Benefits** - Benefits provide a safety net for employees and their families during their active employment and likely after. Most benefit programs pertain to death, disability, health care, time-off and retirement.
- **Base Salary** - A base salary is paid for ongoing contribution to the organization. It is for doing what is expected on a day-to-day basis.
- **Annual Incentive** - An annual incentive is paid for accomplishing pre-established goals. It is most certainly part of a competitive package for both public and private corporations, with over 90% of organizations offering annual incentives.
- **Long-Term Performance Incentive** - Long-term performance incentive programs are found in over 90% of public companies and over 60% of private organizations. Long-term incentives typically address three objectives: retain key individuals, meet competitive standards and provide a way to reward key employees for accomplishing longer-term goals. With long-term performance plans, vesting of earned amounts is important in meeting retention goals. Three types of long-term performance programs are often established:
    - **Equity** - Equity, either in the form of restricted shares or stock options, is found in most public companies. Private companies typically shy away from equity since ownership is generally reluctant to part with shares. If equity-based programs are included in a compensation package, the awarding of shares is often based on meeting performance goals.
    - **Phantom Stock** - Because share equity is typically reserved for public companies, private organizations may use phantom stock as their long-term performance incentive program. These plans pay out based on a valuing of the corporation at the start of the program versus the value of the organization at payout time. Payments are most often made in cash.
    - **Performance Programs** - Performance programs pay out to participants based on performance of the organization towards multi-year goals. Goals may include revenue, profit, market share, customer satisfaction, return to shareholders, and a variety of other measures. Payments to participants are almost always made in cash.

- **Executive Benefits and Perquisites** - Often companies provide additional benefits and perquisites to senior managers. Several of them are described below.

Although each of the above described compensation elements needs to be looked at individually, it is important to look at the package as a whole. Strength in one area may be offset by a less competitive offering in another area.

"Determining what to include starts with the organization's culture and strategy, competitors' offerings, and affordability."

HOW DO YOU DIFFERENTIATE KEY INDIVIDUALS FROM A COMPENSATION AND BENEFIT STANDPOINT?

When looking at the long-term incentive component of an overall compensation plan, it is challenging to determine:

A. How do you draw the line on who is a key employee, and
B. What are the additional compensation benefit components the key employees should receive.

Often, the determining group in deciding who is a key employee can be either the Chief Executive Officer and President, or it could be input from the board of directors. In either case, it is important for both groups to collaborate and make sure individuals who provide current value are included in this group, as well as those that may be part of the future leadership and success of the organization.

Demographic reports indicate there will be a substantial gap of professionals in the work force once the baby boomers move through the work cycle. Some of the next generation of talent needed to fill these voids may currently be in their early 30's as those in their 50's move through the "C-suite" and ultimately into retirement.

Once the key employee group is determined, it is incumbent on the Chief Executive Officer and compensation committee to determine what additional components of compensation should be offered to the individuals. Often, equity programs are included where appropriate, in addition to various forms of nonqualified deferred compensation.

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TYPES OF NONQUALIFIED GOLDEN HANDCUFF PLANS DEFINED BENEFIT AND DEFINED CONTRIBUTION/LONG TERM INCENTIVE PLAN

Over the years, the nonqualified marketplace has offered effective retention programs for key individuals of an organization. The key options are:

A. Voluntary Deferral Plans
B. Supplemental Executive Retirement Plans (SERPs)
C. Defined Contribution Long-Term Incentive Plans

A. VOLUNTARY DEFERRAL PLANS

Voluntary Deferral Plans are the simplest plans to set up and the least costly to the organization. In a Voluntary Deferral Plan, a participant has the option to elect to defer additional forms of compensation, whether it be base salary and/or bonus into a pre-tax nonqualified deferral plan. The earnings on the deferrals will be credited interest—either based on equity mutual fund options or at some fixed rate of return tied to a key market index.

The participant notifies the corporation when he or she would like to receive the deferrals and in what payment form. When benefits are received, compensation is then taxed to the executive and deductible at the corporate level. The benefits of this plan are to provide the executive with a tax-advantaged way to save additional dollars and to facilitate personal financial planning.

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B. SUPPLEMENTAL EXECUTIVE RETIREMENT PLANS (SERPS)

Supplemental Executive Retirement Plans (SERPs) are often referred to as Salary Continuation Plans or Defined Benefit Pension Plans. In this example, a company promises a key executive a certain stream of income that is payable upon reaching an agreed-upon retirement age with the benefits payable for anywhere from 10 years, 15 years or for a lifetime. This is the most common form of nonqualified plan found in banks and provides the retiring executive with the piece of mind that he/she will have an additional source of income upon retirement.

However, compensation committees are starting to think twice about these programs as they really do not provide a current incentive to the executive to enhance individual and corporate performance, because benefits are promised regardless of individual and corporate performance.

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C. DEFINED CONTRIBUTION LONG-TERM INCENTIVE PLANS

Defined Contribution Long-Term Incentive Plans are gaining in popularity and are a growing source of nonqualified plans in corporate America. In this plan design, the company creates a supplemental "profit-sharing" plan for key executives. The compensation committee and CEO can decide upon key performance measurements at both the organization and the individual levels that will dictate an annual contribution that will go into a deferred compensation account on a pre-tax basis for the participant. If the company has a banner year, the individual may receive a higher contribution. If the individual and company have a poor year, there may be no contribution or a reduced amount.

C. DEFINED CONTRIBUTION LONG-TERM INCENTIVE PLANS (CONTINUED)

Typically, these plans have some sort of vesting schedule that provides the retention and handcuff components to the employer. These plans are most appropriate for younger key employees who may have 15 to 30 years of time left in the workforce. Providing them with a SERP would be too far in the distance for them to view the benefit's importance. The Defined Contribution Long-Term Incentive Plan provides the company with the ultimate control in contributions and in determining the length and duration of the vesting schedule.

Conclusion

Clearly designing an effective compensation plan needs to be tailored to the specific company and ages of the key employees. An organization that is more heavily staffed with executives closer to retirement age may benefit more from a Defined Benefit Pension Plan, while those with a younger group of up-and-coming executives may focus more on Defined Contribution Plans. We all know the nuances and challenges of retirement compensation plans for millennials, so being conscious of the appropriate plans for that group when they come to retirement age is pertinent.

No two plans are the same, but it is clear that people value a solid base compensation and being rewarded for a good year with a strong bonus. However, when long-term planning comes to mind, it is long-term incentive plans, such as equity options and/or Nonqualified Deferred Compensation plans, which provide the cement that keeps people tied to your organization.

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ABOUT EXECUTIVE BENEFITS NETWORK (EBN):

As the leading industry advisor, EBN specializes in the customized design, administration, and informal financing of Nonqualified Executive Compensation and Benefit Plans (Deferred Compensation Plans), as well as the procurement of Bank Owned Life Insurance (BOLI) programs to attract, retain, and reward key executive talent. We emphasize the importance of education and build long-lasting relationships with clients in all 50 states, and we have access to the highest rated insurance companies in the nation. Lastly, we believe that no two companies are alike in their needs; therefore, customization of executive benefit and compensation plans is paramount to a successful program.

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