Establishing The Right Compensation Package

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Key Components of an Overall Compensation Package

Designing a compensation package for a company is a multi-faceted process. The first step is to determine the culture and strategy of the company. Following that, it is important to understand what peer companies are offering in order to stay competitive. In addition, in today's post-pandemic work environment, components such as remote and hybrid work and a focus on home/work life balance have played a significant part in a compensation package.

Key elements in designing a comprehensive compensation plan include:

- **Compensation Strategy:** Compensation strategy is a philosophical statement describing how the company approaches paying its employees. It is part of the company's human resource strategy and includes its business stage, its culture and strategies, who it competes with for people, its current level of competitiveness and market target, and what its employees desire.

- **Benefits**: Benefits provide a safety net for employees and their families during their active employment and after. Historically, benefit programs have centered on medical, retirement, death, disability, and time off. More recently, benefits have embraced employee development and career path planning, physical and mental health, flexibility in location and times of work, and child and elderly care offerings.

- **Base Salary**: A base salary is paid for ongoing contributions to the company. It is paid based on what is expected on a day-to-day basis.

- **Incentive Compensation**: Companies pay annual short-term and long-term incentive compensation to strengthen communication of company goals, reward participants for accomplishing those goals, meet competitive pay practices, and to retain key employees. On average, funding an incentive plan is roughly 7% of the operating income. In the past several years, companies have started to add Environmental, Social, and Governance (ESG) measures to identify risks and determine growth opportunities around sustainability.

    - **Annual Incentive Plans**: An annual incentive is paid for the accomplishment of short-term, established annual goals. Almost 99% of public and private companies include annual incentives in their pay packages. Eligibility for executives and managers, on average, is above 90%, exempt employees 84%, and non-exempt employees 55%.

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Key Components of an Overall Compensation Package (Continued)

- **Incentive Compensation (continued):**
  - **Long-Term Incentives**: Long-term incentive programs are found in over 90% of public companies and in over 60% of private companies. Goals that are set are normally for two-to-five years and the eligibility is usually reserved for executives. With long-term performance plans, vesting of earned amounts is important for meeting retention goals.

  Four types of long-term performance plans are typically established:

  - **Equity**, either in the form of stock options or restricted shares, is found in most public companies. Private companies typically shy away from equity since ownership is generally reluctant to part with shares. Equity-based programs are typically based on meeting performance goals.
  - Because share equity is typically reserved for public companies, private companies may use **Phantom Stock** as their long-term incentive program. These plans pay out based on a valuation of the company at the start of the program and later measured at a specific time. These payments are most often made in cash.
  - **Nonqualified Deferred Compensation Plans** are implemented to recruit, retain, and reward key employees to help reduce turnover. Properly implemented plans motivate and reward employees to work towards a common company goal while retaining employees with a long-term outlook.
  - **Performance Programs** pay out to participants based on the performance of the company towards multi-year goals. Measures used may include profit, revenue, market share, customer satisfaction, return to shareholders, or a variety of other assessments. These payments are most often made in cash.

- **Pay Transparency**: Refers to a company communicating pay practices to employees and explaining how pay is determined and/or being open about the compensation provided for current and prospective employees. Pay transparency demonstrates a step towards achieving Diversity, Equity, and Inclusion (DEI). Employers that embrace the pay transparency benefit tend to earn a higher level of trust with employees. It has shown to promote respect and improves employee retention and loyalty.

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Executive Benefits and Perquisites: Often companies provide additional benefits and perquisites to senior leaders. Some benefits include supplemental life insurance, supplemental disability income insurance, long-term care insurance, financial and estate planning counseling, and club memberships.

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

Each compensation element needs to be looked at individually, but also needs to be looked at from the package as a whole.

Costs of Hiring and Replacing a Key Individual

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 struggle to provide just the right amount of benefits and compensation. The ramifications of missing the mark on the right benefits can result in a lack of employee morale, an increase in employee departures, and a decrease in competitive position in the marketplace. **Once a company gains the reputation as not providing enough of a robust package, then recruiting becomes a challenge**.

It is costly 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 a company. The cost of losing a key person is estimated to be up to 213% of an employee's salary for C-suite positions.

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

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

How Do You Differentiate Key Individuals from a Compensation and Benefit Standpoint?

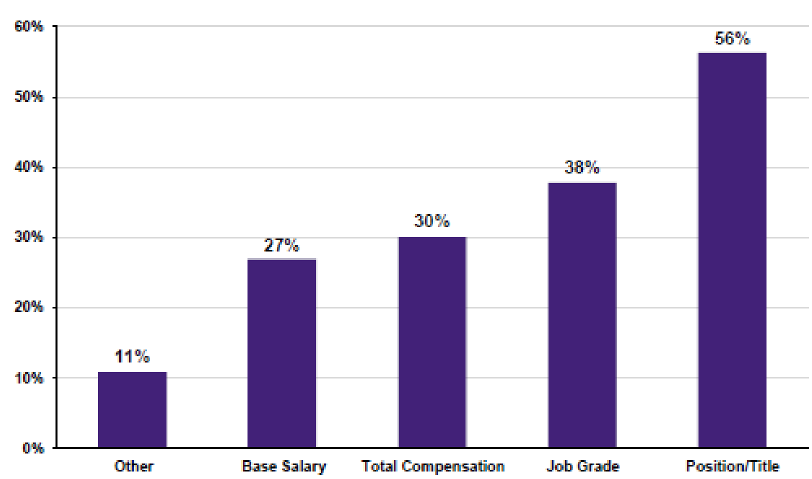
When looking at the long-term incentive component of an overall compensation plan, it is challenging to determine:

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

Often, the individuals determining who is a key employee will be the Chief Executive Officer and President, as well as 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 who may be part of the future leadership and success of the company.

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.

Based on the “Newport/PLANSPONSOR Executive Benefits Survey: 2022 Edition” the following chart illustrates that Position/Title is the leading way to determine who is eligible to participate in a nonqualified deferred compensation plan. In previous years, compensation was more of the determining factor, but more recently position/title has increased in popularity to avoid privacy concerns.



Source: “Newport/PLANSPONSOR Executive Benefits Survey: 2022 Edition”

Types of Nonqualified Deferred Compensation Plans (continued)

There are a several plan designs that are used for implementing a NQDC plan for a company, these include:

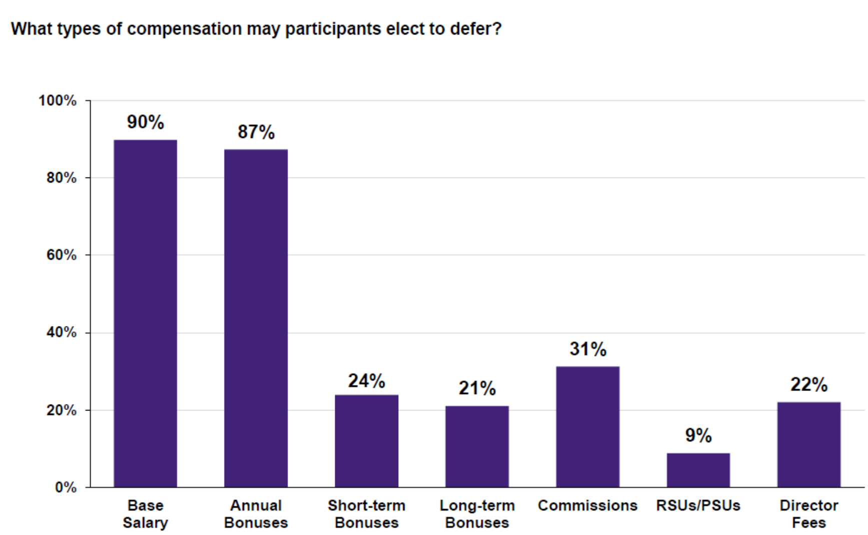
A. Voluntary Deferral Plans
B. Supplemental Executive Retirement Plans (SERPs)
C. Defined Contribution Long-Term Incentive Plans
D. Intermediate Incentive Plans (Deferred Bonus Plans)

A. Voluntary Deferral Plans

Voluntary Deferral Plans are the simplest plans to set up and the least costly to the company. 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, on a tax-deferred basis.

The participant notifies the company when he/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.** Market conditions and communication of the plan typically impacts the amount of participation.

The following graph from the "Newport/PLANSPONSOR Executive Benefits Survey: 2022 Edition" shows that of those that responded say that base salary (90%) and annual bonuses (87%) are the two most common forms of deferrable compensation in NDQC plans.



Source: "Newport/PLANSPONSOR Executive Benefits Survey: 2022 Edition"

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 a nonqualified plan found in companies and provides the retiring executive with the piece of mind that he/she will have an additional source of income upon retirement.

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C. Defined Contribution Long-Term Incentive Plans

Defined Contribution Long-Term Incentive Plans are very popular 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 company 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.

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. 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.

"An Intermediate Incentive Plan is to reward key employees for their individual contribution for achieving the company's short-term business strategies and goals."

D. Intermediate Incentive Plan ("Deferred Bonus Plan")

The objective of an Intermediate Incentive Plan is to reward key employees for their individual contribution for achieving the company's short-term business strategies and goals set by the Compensation Committee to increase the company's profitability. This plan is similar to a cash incentive plan; however, contributions are paid in subsequent years, often three-to-five years from the date of the grant. Intermediate Incentive Plan metrics are determined by a Compensation Committee and can be measured both financially, such as revenue growth or maximizing profit; or non-financially, with goals that align with the company strategy, such as meeting safety or quality assurance hurdles or the development of a new product. This plan provides greatest "pay for performance" flexibility and each contribution has its own vesting schedule (i.e. 5-year rolling vesting).

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Conclusion

Designing an effective compensation plan needs to be tailored to the specific company and ages of the key employees. A company 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 an intermediate or long-term defined contribution plan. There are many nuances and challenges of retirement compensation planning for each generation. Being conscious of the appropriate plans for different generations is imperative.

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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 company.

About Executive Benefits Network (EBN)

As a 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 and Corporate Owned Life Insurance (BOLI/COLI) 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. 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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