Todd Carpenter is senior vice president at NFP.

COMPENSATION

Lessons in Deferred Compensation

Recently, NFP took the time to analyze several hundred executive benefit plans, and speak to bankers and consultants. With all that data, experience and untold hours of consulting on those plans, we identified some of the top issues — and unintended consequences — banks have encountered when it comes to compensation plans. Here's what we've found, keeping the identities of our sources anonymous:

Banker's Perspectives

- Lifetime benefits. "Lifetime benefits are a throwback to the unsustainable pension days. Our former CEO retired in 2000 at age 65. He's 87 and going strong, and we are expensing the full benefit every year."
- Vesting schedule. "I was wrong about the new 55-year-old CFO. He negotiated a three-year vesting schedule as part of an employment agreement and stated this was the last place he was going to work before retiring. He retired after three years, fully vested."
- Defined contribution versus defined benefit. "I wish we would have gone with a defined contribution approach versus a retirement-focused defined benefit plan. The long-time horizon is not very appealing to younger executives, and the board wished they had the ability not to contribute when times are tough."
- Interest crediting. "We tied the interest-crediting rate in our deferral plan to LIBOR +1%. I was informed later we could've had that provision 'to be determined annually at the discretion of the board' or even invested in numerous mutual funds. Flexibility from the start would have been better."
- Deferred compensation. "Our internal counsel referenced a future payment in an employment agreement subject to certain conditions. We accidentally created a deferred compensation plan. The missed Department of Labor notifications, unrecorded liabilities and missing claims language was a headache. We should've started with a complete plan from the beginning."

Consultant's Perspective

- Inappropriate discount rate. A plan document had a stated rate of 9% to value the supplemental executive retirement plan, or SERP, liability and wasn't pegged to an outside index. The audit firm did not question the rate for 10 years. The bank changed audit firms, and the new firm then determined the rate to be inappropriate for accounting purposes. This resulted in a dramatic increase in the liability that was greater than annual earnings, which triggered numerous issues.
- Offset issues. A SERP was designed in the early 2000s as a percentage of final pay, less the employer portion of the 401(k) and 50% of Social Security benefits. In the last few years prior to retirement, the executive stopped contributing to the 401(k) and missed out on the related employer match. There was also a significant market correction that resulted in a 401(k) balance that was much lower than projected, requiring the bank to record a large liability increase and the related expense to account for it.
- Death benefit. A plan was intended to allow for accelerated future benefits in the event of death while employed, but the document referenced the current liability, not future benefit. An unexpected death occurred within six months of implementing the plan. The beneficiary received $10,000 instead of $200,000. Fortunately, there was a "key man" policy on the executive, and the bank chose to honor their original intent.
- Disability. A plan's payout terms in the event of a disability were the same as if the executive retired: a lifetime benefit. An executive became disabled for six months before dying. The plan paid out $20,000 over the six months, while the retirement benefit would have been $40,000 per year for life.
- Change in control. During a plan design process, a bank wished to have maximum protection for executives recruited to start the bank, at their insistence. But they didn't completely understand the change in control language as it pertained to vesting. The bank wanted to vest 100% in the accrued liability upon change of control, to be paid out when the executive separates service. They discovered during due diligence that the plan and the payout language did not match other provisions.. This created an unexpected "poison pill," which greatly affected the purchase price. There was a lot of finger pointing.

No matter how long the compensation committee has been responsible for insurance or executive benefit plans, it's not their full-time job. A fast as the industry and regulations are changing, it is impossible for decision makers to keep up on their own.

Working with a seasoned consultant who can leverage their expertise, resources and data analytics helps compensation committees make more informed decisions that have better outcomes, control costs and ensure that the bank, its directors, officers and executives are protected for the long term.

As seen in the 1st Quarter 2023 issue of *Bank Director*