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The Elements of a Compensation Plan: What a Board Needs to Know

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Reviewing compensation within an organization is an integral part of the board's duties, but it can be challenging to get right. There are a number of reasons for this.

Philosophy

Compensation committees need to determine the bank's philosophy regarding compensation. Will it be a zero-sum equation where paying more compensation creates fewer dollars for management and/or the shareholders, or an abundance mentality where paying for performance generates shareholder value? Having tension between the two is healthy for setting compensation practices correctly while maintaining balance.

Regulatory

One facet that overlays any compensation structure is regulatory constraints. Over the last decade, there have been three major regulatory pronouncements affecting how banks can structure compensation.

The first is the **adoption of the Internal Revenue Code Section 409A**, which prohibits the acceleration of payment of deferred compensation.

The second major regulation originates from the **Dodd-Frank Act**. Essentially, mortgage compensation incentives can only be paid based upon: (i) the dollar volume of the mortgage loans made; or, (ii) the transaction volume generated by the mortgage lender. However, the incentives can vary as to how much is paid to each lender on either method.

The third regulation adopted is the Interagency Guidance on **Sound Incentive Compensation Policies** effective June 25, 2010. In the guidance, policy steps are set forth that require incentive compensation to be structured to balance the risk to the institution of such incentives, and the guidance dictates that boards are responsible for reviewing this.

Delivery

In what form will your bank deliver compensation? The following are some major ways that banks pay their executives.

Non-statutory stock options

Non-statutory options (NSOs) can be granted to just about anyone. It is not unusual for a participant to fail to realize that not only must they have sufficient funds to purchase the stock, but that there will be ordinary taxation on the gain in stock value from the exercise price for the shares compared to the fair market value of the shares at exercise. In addition, the participant will also owe Social Security and Medicare taxes on the gain.

Incentive stock options
Incentive Stock Options (ISOs) have the benefit of being taxed as capital gains upon the sale of the purchased shares for the gain over the exercise price. However, there can be one surprise in the way of alternative minimum tax (AMT).

Restricted stock
Restricted stock has become more popular as a delivered component of compensation since restrictions come with the grant of the shares. Unlike options, which do not have restrictions once the options become exercisable, restricted shares often carry a restriction as to when they can be sold. This avoids the potential of a quick sale that can occur with options, leading to volatility in the stock price and negative news when investors and others learn of executive sales of stock.

Deferred compensation
Many banks will use nonqualified deferred compensation to recruit, reward and retain key executives in various formats because plan design can be very flexible, structured as defined contribution or defined benefit plans. With closely-held organizations, the shareholders are not subjected to dilution of ownership with deferred compensation as it is accrues through the financial statements. Also, unlike the equity components previously mentioned, shareholder approval is not required. Programs of deferred compensation require board approval. There are various types of deferred compensation programs including, but not limited to, Supplemental Executive Retirement Plans (SERPs), deferred incentives, deferred grants, phantom stock, stock appreciation rights and elective deferrals.

BOLI
While it might appear that deferred compensation is expensive because the entire value of any program generates expense to the bank, often bank-owned life insurance (BOLI) is utilized as an asset to offset or recover the cost incurred by the deferred compensation. This happens in two ways. First, the interest earned while the BOLI contracts are owned informally counterbalance the expense of a deferred compensation program. Second, if the participant meets an untimely death, the death benefit the bank receives in addition to the return on its investment is available to offset the additional expense to complete the accrual of the deferred compensation benefit, so that such benefit can be paid in full to the employee's beneficiaries.

While the components of compensation are numerous, banks can use the various components for certain tiers of executives within the organization. Further, no single component discussed is superior to the other. Each has its advantages and disadvantages, and can be tailored to the bank's needs.


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