Defining Accurate Base Pay Compensation and its Importance for the CEO

Jerry P. Nelson, Partner
Koker Nelson Gregoire & Co.

In prior articles we have discussed the need, in fact, the necessity to articulate a thorough compensation policy. While it might be as simple as saying, "We want to pay at market", in actuality, it requires drilling down much deeper to provide effectiveness, competitiveness and establishing a sound and valued credit union structure (in all things). Let's examine some of the components that fit into such a policy or strategy:

1) **Compensation Policy Specifics:** While policies can be general, their impact is extensive. The challenge is to not only find the best fit for your credit union but also your CEO. Today we'll break-down one of the most common compensation policies (establishing fair CEO base pay) and provide some detail and analysis as how to deal with it.

A) **Policy Question #1:** In comparison to the marketplace, where should we index or link our CEO's base pay? The choices are:

- Base pay—lower than market,
- Base pay—at market,
- Base pay—above market.

Pay below Market: This strategy or policy is rare and it generally only works if there exists a very aggressive bonus plan to off-set lower base pay. As an example, the CEO might agree to base pay that is only 80% of market but with an opportunity to make it up plus more, by hitting pre-approved bonus metrics. With agreement by all parties, this can work. Another sometimes used argument is that the credit union provides a very rich benefit program thereby justifying a lower base pay. From our experience, this rationale rarely works and can be fraught with problems; benefits mean differing things to different people, but pay speaks loud and clear to everyone.
Recommendation: employ this strategy only if the bonus plan can make up the difference and the CEO is totally on board with it. *[Bonus plan construction will be discussed in a subsequent article]*

Pay at Market: This is the most common approach. Why? It is easy to justify. There exists an abundance of data available for accuracy, and it is defendable to all parties.
Recommendation: **Use this approach…**unless you are confident in your abilities to construct an effective plan to justify paying base pay less than market *(as discussed above)* or a severe need exists to justify paying more than market *(discussed below)*

Pay above Market: This approach is not really that common, but when used, reflects the Board's belief that paying above market will provide an edge in hiring the best or retaining the best OR there are factors that require paying above market to attract qualified candidates. Some of the factors that might bear on such a decision are; unpopular destination, challenging working conditions, unusual or severe credit union problems, etc. The challenge comes in knowing "how much above market" will work. Most employees (including CEO's) will not leave a credit union (assuming they are relatively happy) to tackle a tough situation unless the increase is significant; probably more than 15 to 20%.
Recommendation: Use this approach only if necessitated by workforce conditions that require going above and beyond the scope of normal compensation practices. Paying the CEO higher within the pay range might be a better solution.

2) **The Importance of establishing fair CEO Base Pay:** *(The term "fair pay" is used here to denote competitive, justified and policy compliant base pay)*. Having established a compensation policy or philosophy, the next step is determining what that base pay looks like. The importance of paying the CEO fairly and competitively is far-reaching for a number of reasons.

First, and probably foremost in the thinking of most Boards, is CEO retention. If you have a good CEO you certainly want to keep him or her. *"If you won't pay your CEO competitively, someone else will"*, is an often used phrase that is not only true, but can also be incredibly painful. The task of searching for and hiring a new CEO is arduous and expensive. Head-hunters are not cheap nor is the cost of down-time in trying to find that right fit. And, that right fit almost always comes at a cost that exceeds what would have been sufficient to retain your current CEO (a phenomenon that strangely occurs more often than not).

Second, fair and competitive CEO pay sends an important message to the CEO that he/she is well thought of by the Board and regarded as a most treasured link in the credit union's success; now and in the future. We call this *"psychic income"*, and it simply conveys appreciation and respect to the CEO for doing their job in an effective manner. Interestingly, psychic income doesn't cost any more than just paying the CEO fairly, but the message is vital.

Third, fair CEO pay prevents compensation compression with the other executives or senior staff. Let me illustrate. While working with a $2 billion credit union over thirty years ago, the Board was comfortable in paying their CEO well under market. Their rationale was that 'Jim' was being paid well (in their minds) and he was such a 'good old boy' that he'd never leave the credit union. Well, in this particular instance, that was totally true! Jim loved the credit union, had been there for over thirty years, and he never would leave. But, Rick the EVP and heir-apparent would leave, as well as three or four of the other key SVP's.
Their salaries were being compressed (below market) by the low pay of their CEO, and had this aberration not been corrected, what would have happened to the credit union's management would have been devastating.

3) **The Components of CEO Pay:**

A) **Base Pay:** With a plethora of reliable survey sources and 990 data available (including TruComp990), the challenge is not so much in an ability to obtain data as it is to be able to analyze the data.
A few suggestions:

I. Index data, as closely as possible, to the asset size of your credit union. While this sounds easy on the surface, it can be somewhat problematic in practice. Many times salary data is provided in large ranges of asset size (say, $500 M to $1 B, or $1B to $2B). A Board may find it difficult to determine what the best asset category fit is. If, as an example, a credit union is barely into an asset category range, should they move to the higher category, or should they stay (for a while) in the lower category? A couple of possible solutions: Try and find sources that might drill down more closely to your credit union's actual asset range (TruComp990 data can provide that closer and more accurate view) or develop a policy that might say; "when the credit union falls into the next asset category, the CEO will automatically become part of that category (higher)" or they may choose to implement a time restraint. "The credit union must be in the new asset category at least one year before the compensation structure will change." Having an asset category policy relieves confusion, uncomfortableness, or possibly hurt feelings.

II. Index data to the most relevant geographic location. Every location within the United States has a geographic index that is a composite of wages for that location and the cost of living there; typically displayed as a percentage of the national average. As an example, data collected on a national basis is a melting pot of all of that data; it reflects the national average (100%). However, if your credit union

resides in New York City or San Francisco (as examples), those salaries will be upwards of 25% more than that average. The opposite is true of many of the southern states where their geographic index is often less than 90% of the national average. Sometimes credit unions may have branches in different cities within the same state or even different states. In such cases, the geographic index could be vastly different. This will be of significant importance when hiring, retaining or transferring employees to different locations.

III. Pay grades are generated based on the midpoint value of the market data (typically at the median of the collected data). Pay grades are then crafted with a minimum and maximum value (the control points). To maintain the integrity of the pay grade, employees pay should always fall between those two control points. Pay grades or ranges, especially for CEO's and other Executives, need to be of sufficient breadth to allow for effective and strategic movement or placement within the range. While many pay grades have ranges of between 35 to 50% (minimum to maximum), CEO's (and executives) should be higher, 60% to 75%. This allows the Board the flexibility to reward high performing CEO's (who may also be well experienced) without restricting their base pay because of a limited pay grade ceilings or if, when needed, be able to hire the 'right' CEO without worries of violating the integrity of the pay grade. This provision isn't intended for all employees or for those not performing at high levels, but for CEO's that are doing their job very well as evidenced by their performance review scores and stout credit union financial performance.

B) **CEO Pay:** With market sensitive pay grades constructed, the question that many times troubles Boards is, "Where, within this pay grade, should our CEO be paid?" This is not always an easy question, in fact, it often creates a great deal of angst. Let me list a couple of thoughts.

I. CEO's are CEO's for a reason; they are very good! To be promoted to a CEO, previous performance had to have been stellar and demonstrated results at the highest level. With that in mind, CEO's, if not at the midpoint of the pay grade, should be elevated to that level fairly rapidly. It's okay for new CEO's to be under midpoint for a season (while they areproving their abilities to the Board), but that season needs to be relatively short---two to three years at the most (unless performance problems surface).

II. Once at midpoint, the CEO's salary movement should be based on an aggressive merit matrix that combines A) Leadership Performance, B) Credit Union Financial Performance, C) Member Service Feedback and D) Strategic Initiative Attainment. Pay grades organically move each year based on inflation or other market conditions, so the merit matrix needs to not only reflect the organic movement but should provide additional percentages of merit pay that is motivational for high performing CEOs.

III. Lastly, periodically review Peer Groups. Check the pay of peer group CEOs (easily available from TruComp990) to determine if your CEO's pay is competitive and relevant. Assuming all things are equal in terms of credit union performance, if the CEO has a compa-ratio of 100%, while the peer group average is 110%, you may find yourself in a less than competitive posture and it may require some compensation action.

I've asked Board members on several occasions, "What is the most valuable position in the credit union?" Many times the answer is, "Our tellers, our member service reps., or loan officers." While all of these positons are important, they are all clearly secondary to the most important position, that of CEO. The CEO is the definitive leader, the coach, the captain, the motivator and the foremost champion of the credit union. By ensuring proper CEO compensation, the Board is making that statement loud and clear!

In subsequent articles, we will discuss the intricacies of CEO Bonus plans and effective CEO Performance Reviews.