SERP 101

Using a **Supplemental Executive Retirement Plan** (SERP) as a Retention and Retirement Tool for Credit Union Executives

D. HILTON ASSOCIATES

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SERP 101

The success of your organization relies not only on the value of the tangible assets reflected on your balance sheet, but equally on the expertise and stability of the talent managing those assets. That is why it is so important to attract and retain the highest performing senior executives to lead your organization. ***That is where a SERP comes in.***

What is a SERP?

A Supplemental Executive Retirement Plan (SERP) is a non-qualified, deferred compensation benefit, routinely used to attract and retain high performing executives. In the not-for-profit sector, a SERP is generally in the form of a 457(f) plan or a collateral assignment split-dollar plan.

Sometimes referred to as Golden Handcuffs, a SERP is an agreement between a credit union and an executive to provide retirement or retention income in return for a specified number of years of service or until retirement.

SERPs are employee specific and non-qualified, falling outside of ERISA rules, giving credit unions the opportunity to reward key executives selectively without restrictions on contribution amounts or benefit design. Typically, they do not require regulatory oversight or compliance testing.

HOW DOES A SERP WORK?

Since a SERP is a conditional promise to pay, it is subject to a "substantial risk of forfeiture." It is not taxable to the executive while the benefit accumulates on a tax deferred basis. When a SERP is distributed or is no longer subject to a "substantial risk of forfeiture," it typically becomes reportable, and therefore taxable as income to the executive.

The credit union typically controls the SERP, owns the plan investments, and carries the cash value as an asset on its balance sheet. The plan can be structured to allow the credit union to recover its initial contributions.

HOW PREVALENT ARE SERPS AT CREDIT UNIONS?

Research shows that the use of SERPs is rapidly increasing within the credit union industry.

71% OF CREDIT UNIONS OVER **$100 MILLION** IN ASSETS CURRENTLY HAVE SERPS FOR THEIR PRESIDENT/CEOS (41% IN 2013)

85% OF CREDIT UNIONS OVER **$600 MILLION** IN ASSETS HAVE SERPS FOR THEIR PRESIDENT/CEOS

68% OF CREDIT UNIONS THAT CURRENTLY DO NOT OFFER A SERP TO THEIR CEO PLAN TO DO SO IN THE NEXT TWO YEARS

58% OF CREDIT UNIONS OVER **$100 MILLION** IN ASSETS CURRENTLY HAVE SERPS IN PLACE FOR SELECT NON-CEO EXECUTIVES

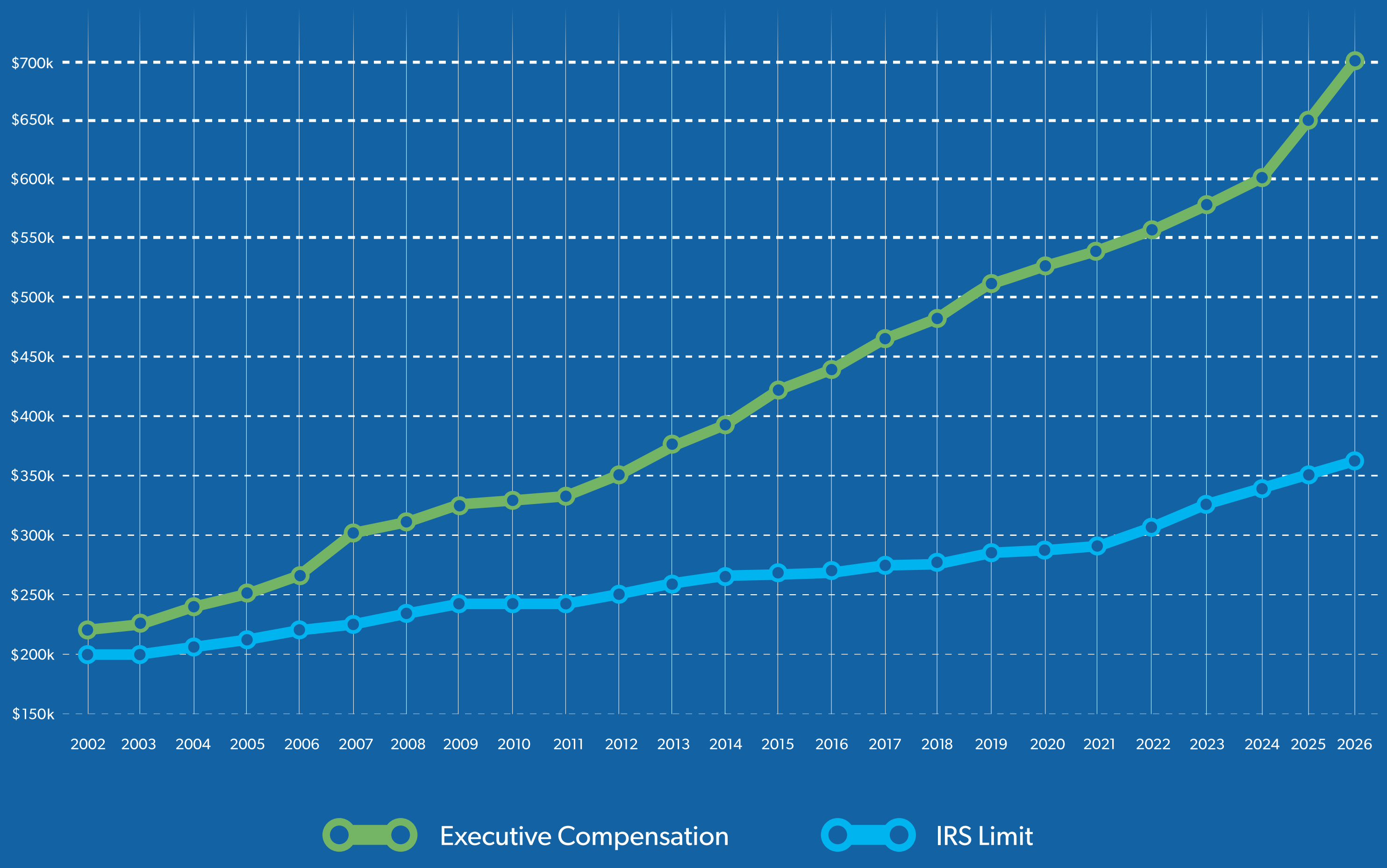
74% OF CREDIT UNIONS OVER **$600 MILLION** IN ASSETS CURRENTLY HAVE SERPS FOR SELECT NON-CEO EXECUTIVES

Why are so many Credit Unions Offering SERPs?

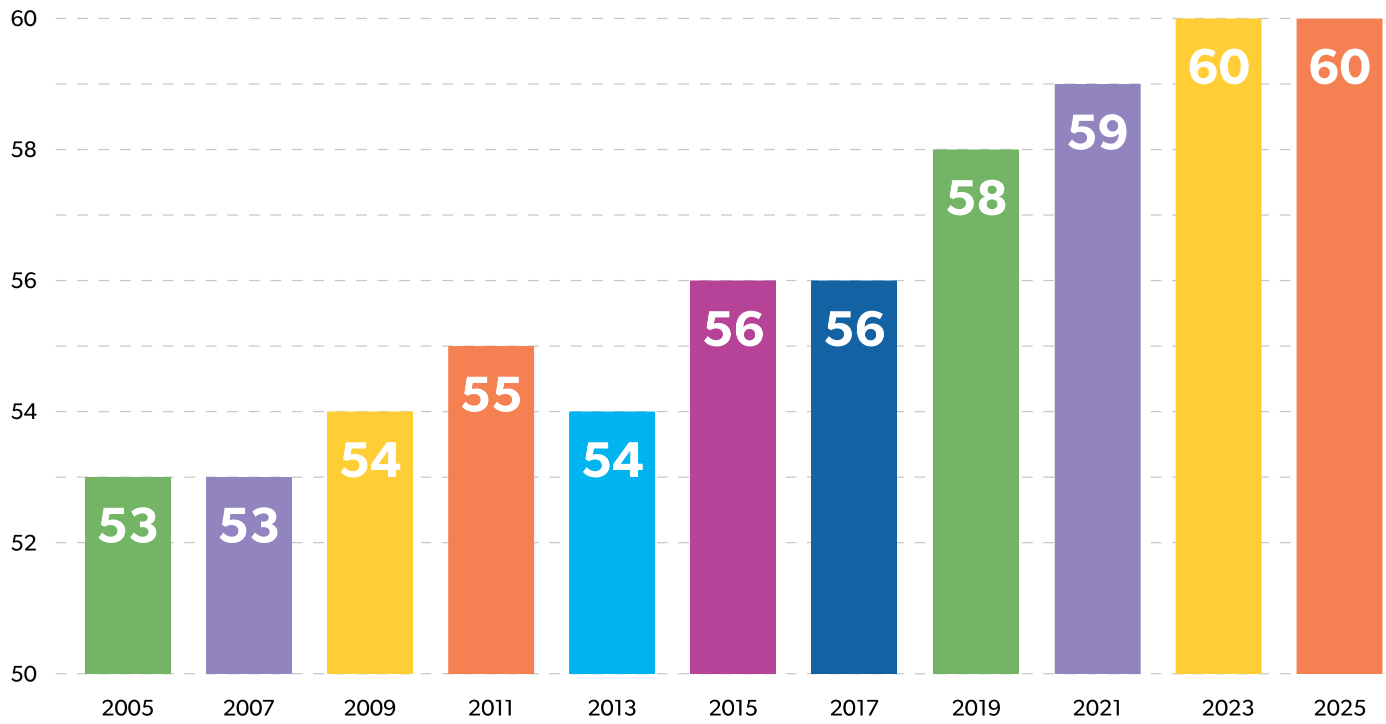
QUALIFIED PLAN LIMITATIONS

Historically, like their original sponsor groups, credit unions offered their employees traditional pension benefits. However, most employers, including credit unions, have been replacing traditional guaranteed benefit pension plans with 401(k) plans and/or other qualified benefit plans. Due to IRS (IRC 415) contribution limitations for highly compensated employees, senior executives rarely have the opportunity to participate at the maximum level needed to fund their retirements. This causes a disparity between the executive's projected retirement savings and projected retirement needs. The limits on qualified plan contributions have not kept pace with the increasing levels of executive compensation in credit unions, nor are they expected to improve in the future.

Rising Executive Compensation & IRS Limitations

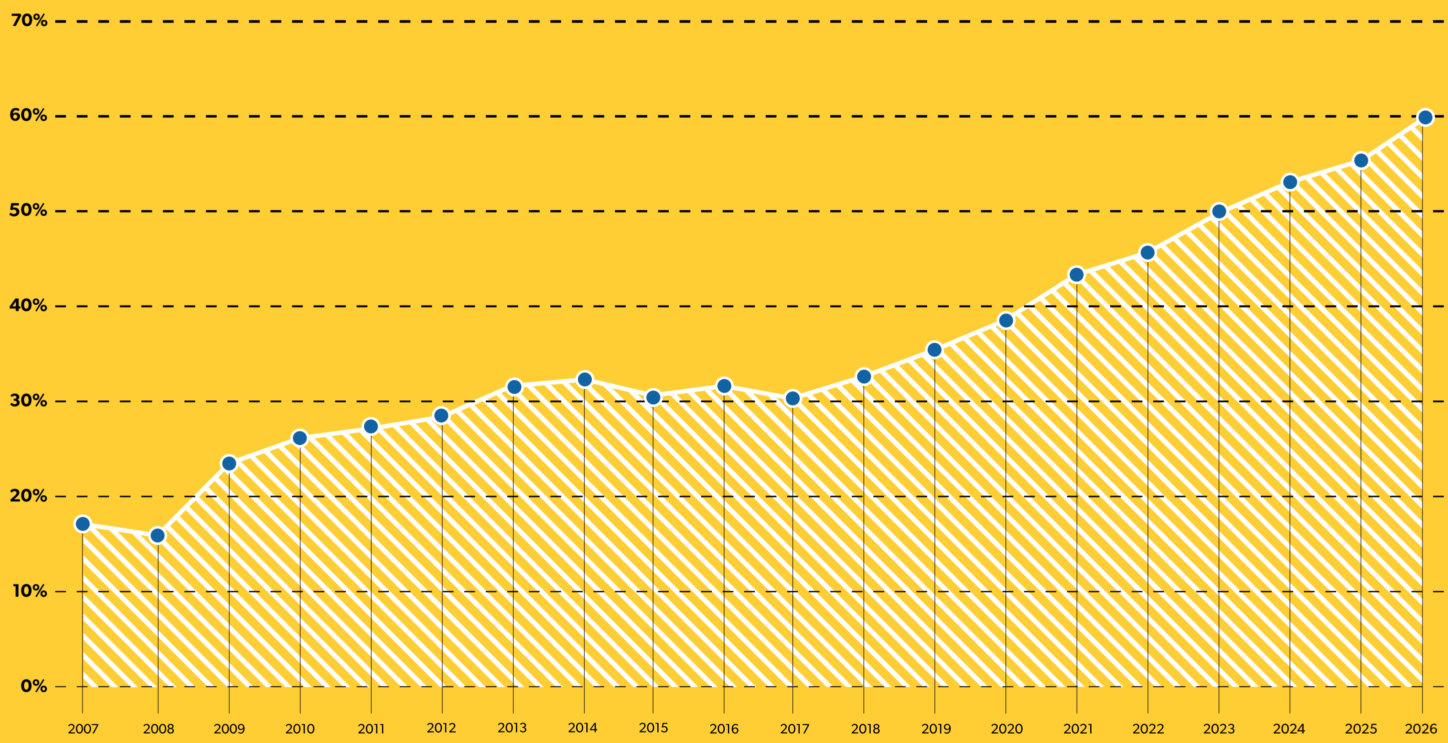


Average Age of a Credit Union CEO



A **Shortage** in the **Talent Pool**

We are in the midst of a wave of Baby Boomers who have either retired, or are approaching retirement age. As the average credit union c-suite executive continues to age, D. Hilton Associates estimates as much as **50%** of the credit union industry's executives will turn over during the next five years. This will cause the talent pool for qualified, high performing executives to sharply narrow. Meanwhile, the size and sophistication of credit unions continue to grow and strengthen, making the need to attract and retain key talent more important than ever.



Average Variable Pay Eligibility

Focus on Pay based upon Performance

Research shows that the average percentage of variable bonus or incentive pay for executives has significantly increased since 2008. Talented executives thrive in pay-for-performance systems that recognize and reward superior performance. Mirroring the qualified plans for the average employees, a SERP payout is generally tied to total compensation. Credit unions are finding that a well-designed SERP is an excellent incentive for long-term, sustainable performance. Establishing a target based on final average compensation encourages an executive to continually outperform peer credit unions.

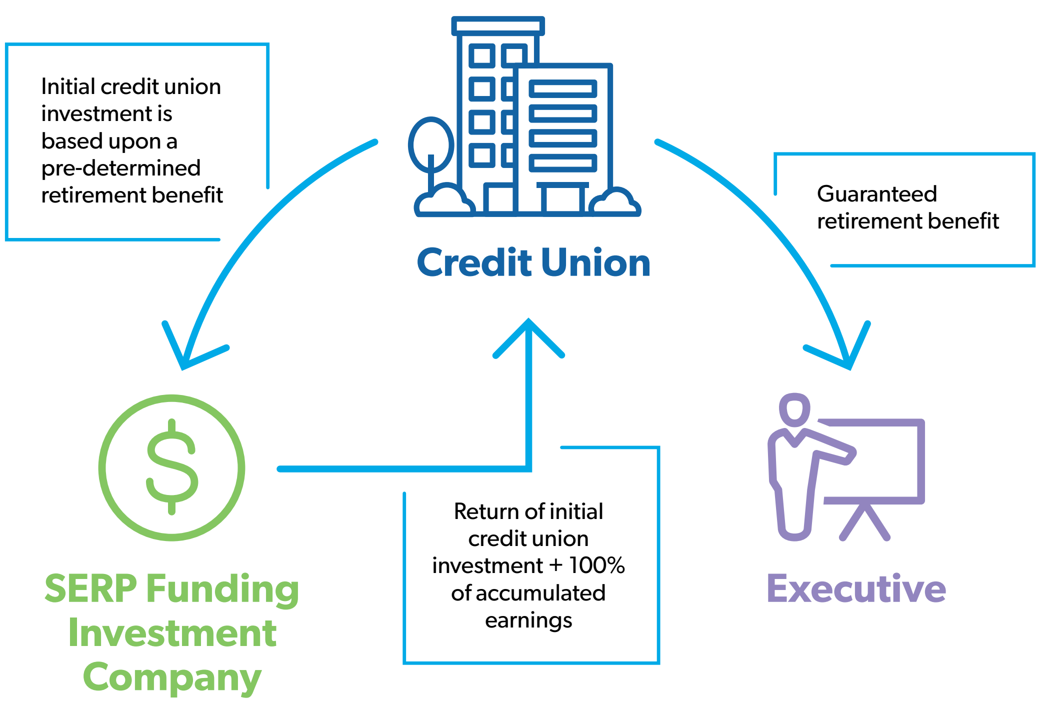
3 TYPES OF SERP DESIGNS

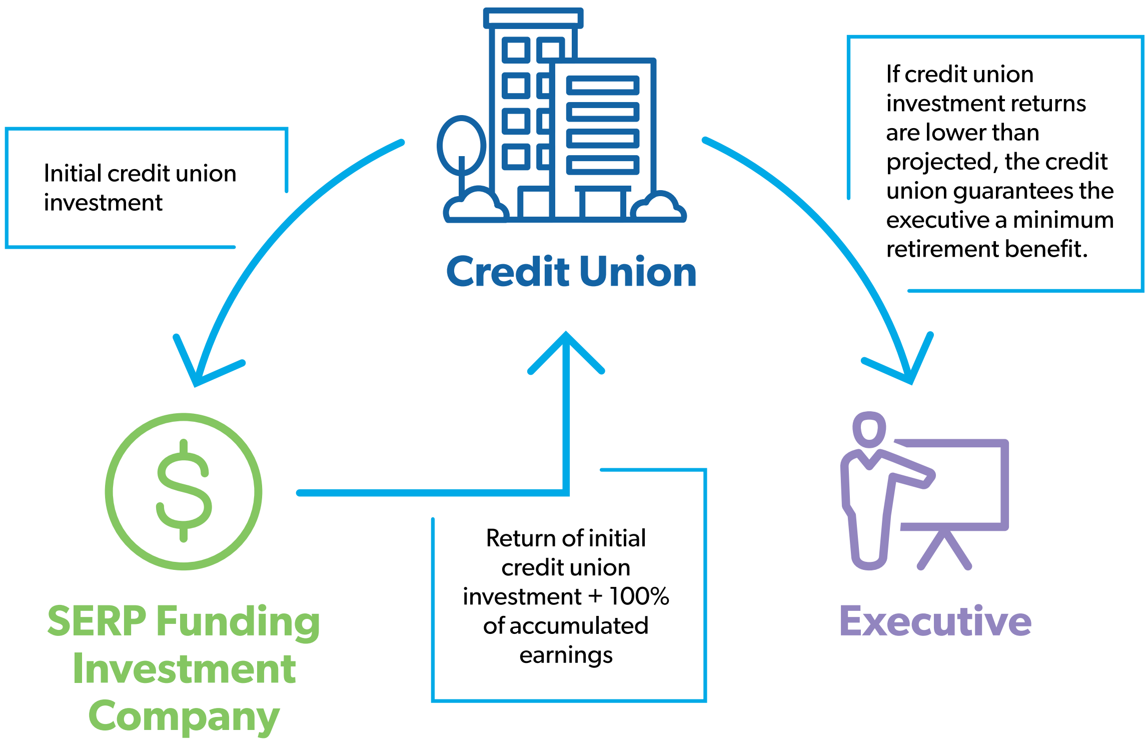
1 GUARANTEED BENEFIT

A Guaranteed Benefit promises the executive a pre-determined dollar amount or a percentage of final income at a specific time. The majority of guaranteed benefit SERPs use a compensation replacement formula. This is usually offset by any qualified employer contributions and projected Social Security payments.

The credit union typically funds the SERP with either a single lump sum investment or annual contributions, which accumulate on a tax-deferred basis. 80 % of SERPs are designed with a single lump sum investment. The targeted distribution may be based upon assumptions, such as projected compensation and life expectancy, or payouts for a specific number of years of service. The guaranteed benefit design accounts for more than half of all SERPs.

- The initial credit union investment is based upon a predetermined benefit.
- The initial investment and any excess earnings are returned to the credit union at the time of distribution.
- The executive receives a guaranteed retirement benefit at distribution.
- This plan design has proven to be the most retentive tool to make it harder to recruit executives to another organization.





2 GUARANTEED BENEFIT / DEFINED CONTRIBUTION

This approach is designed as a combination of a "guaranteed benefit" and a "defined contribution" plan, with an initial single lump sum investment. Ideally, the investment grows at the projected net rate of return. However, if returns are lower than projected, the credit union would guarantee the executive a minimum retirement benefit. The guaranteed "floor" protects the executive against lower than projected returns.

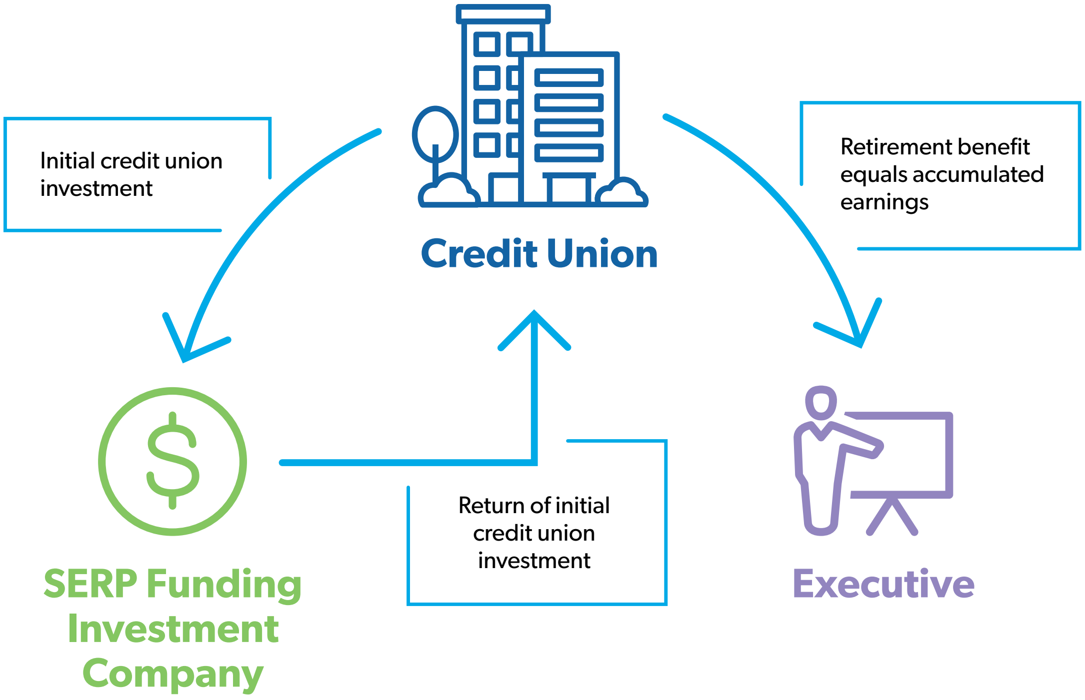
At distribution, a return greater than projected can be split between the executive and the credit union. D. Hilton Associates is finding an increase in plan designs using the combination approach for recently hired c-suite executives.

- The initial credit union investment is based upon a predetermined benefit.
- The initial investment plus a percentage of any accumulated earnings is returned to the credit union at the time of distribution.
- The executive receives a guaranteed benefit plus a percentage of accumulated earnings at distribution.

3 DEFINED CONTRIBUTION

A defined contribution does not guarantee the executive a specific benefit, but instead allows the executive to receive the earnings from a single lump sum contribution. Due to past volatility in the financial markets and insurance account performance, fewer plans are being designed as defined contributions.

- The initial credit union investment is typically based upon a predetermined benefit.
- The initial investment is returned to the credit union at the time of distribution.
- The executive receives the accumulated earnings at distribution.
- This plan design is the least retentive tool to ensure that your executive stays at their current position.



What is the Process?

1 EVALUATE CURRENT COMPENSATION ADEQUACY

To design an effective SERP, D. Hilton Associates first reviews the entire executive compensation and benefits package to determine peer market competitiveness. This review is designed to ensure that the credit union's compensation philosophy is at an appropriate level to meet retention goals, while also enhancing performance management. When making decisions about staying with a current employer or making a career change, executives frequently tell D. Hilton Associates that they consider base pay, variable (bonus/incentive) pay, and retention and retirement programs as a total package. In our many years of experience, no portion of a compensation program should be considered in isolation.

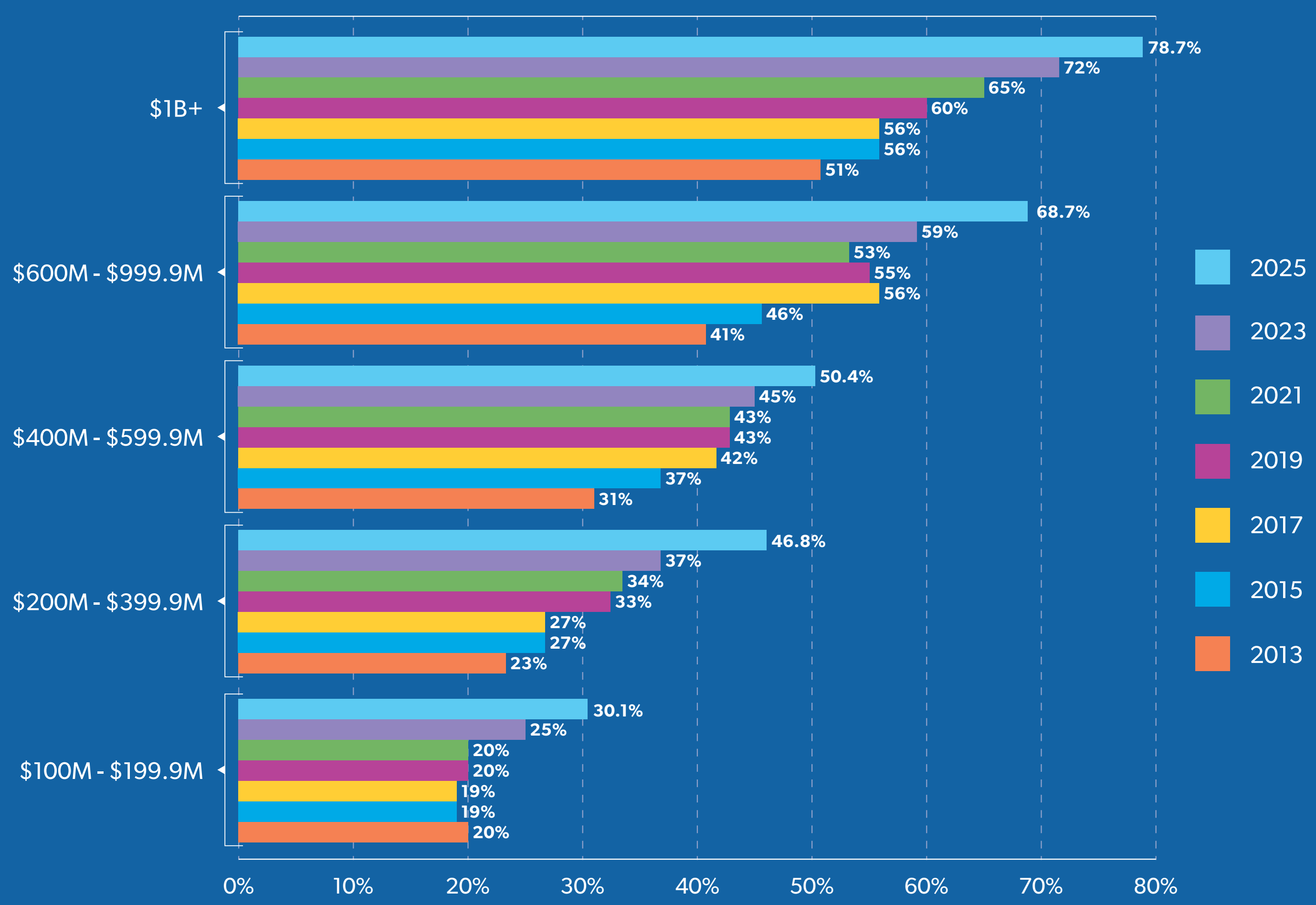
Using the real time information gathered through our Executive Recruiting and Compensation practices, as well as our other proprietary research, D. Hilton Associates brings a multi-faceted perspective to this process. Our unique view of current industry practices, plus our understanding of how the various elements of compensation plans work together, help an organization enhance executive performance and retain its best talent.

2 DEFINE AND DESIGN SERP PARAMETERS

Once a pay philosophy has been evaluated and established, D. Hilton Associates will work with the Board of Directors to define and design the SERP parameters. Just as each credit union is unique, so is each executive's SERP. The key to a successful retention tool is customizing it to meet the needs of the c-suite executive. Critical questions that must be explored include:

Carefully evaluate assumptions your organization will include in plan design and illustrations:

- Executive's Birth Date
- Date of Hire/Promotion
- Projected Distribution Ages or Dates
- Current Base Salary
- Average Percentage of Annual Salary Increases
- Life Expectancy or Longevity Post Distribution
- Current Variable Bonus or Incentive Pay
- Average Percentage of Variable Bonus Pay
- Average Percentage of Variable Incentive Pay
- Employer Qualified Plan Contributions 401(K), 457(B), Social Security, Guaranteed Benefit, etc.
- Distribution Schedule
- Discount Rate



Plan Offered To Non-CEO Executives

How will your credit union fund the projected retirement benefit?

- Single Lump Sum Investment or Annual Investments
- Recovery of Credit Union Investments or No Recovery
- Target Percentage of Final Projected Salary or Total Compensation
- Target Specific Dollar Amount at Distribution or Retirement
- Target Specific Initial Lump Sum Investment

What are the plan objectives?

- Recruitment
- Retention
- Reward
- Retirement
- Restoration of Qualified Plan Shortfalls
- Funding for Retirement Health Care

What type of plan does your credit union want to offer the executive?

- Guaranteed Benefit
- Defined Contribution
- Combination Guaranteed Benefit/ Defined Contribution

3 DEVELOP THE DEFERRED COMPENSATION AGREEMENT

D. Hilton Associates will work with your credit union to summarize the plan's terms and specifications to then be given to the credit union's SERP attorney for drafting of the deferred compensation agreement. We can assist with a recommended list of attorneys familiar with credit union SERP design.

Issues typically addressed in the deferred compensation agreement:

- Internal Revenue Recitals and Restrictions, 409(A), 457(f) and NCUA Rule 750
- Substantial Risk for Forfeiture
- Constructive Receipt
- Terms and Conditions of Benefit Payout
- Tax Liability Issues
- Board of Directors Hold Harmless Clause
- Change of Control
- Benefit Payout in the Event of Pre-Retirement Death
- Benefit Payout in the Event of Pre-Retirement Disability
- Termination "for cause"
- Termination "without cause"
- Arbitration Arrangements
- Periodic Review to Competitiveness and Relevance
- State Specific Employment Laws
- Payout Distribution Dates
- Formula for Benefits Calculated including Offsets for Other Qualified Plans or Severance Payments
- Credit Union "claw back provisions"

4 PLAN ADMINISTRATION

D. Hilton Associates always recommends an annual review and evaluation of the SERP performance and design. There is also a need to ensure compliance with tax changes that may occur, as well as address changing compensation trends within the industry. Our experience in executive recruiting shows that an annual review of executive compensation plans is a strong benefit for credit unions by keeping key executives in place. For this annual review, we meet with the credit union's decision makers, either in person or by conference call. As an added benefit, D. Hilton Associates will provide the credit union with custom compensation benchmarking in advance of this meeting.

What regulations should I know about?

Internal Revenue Code 457(f)

Internal Revenue Code 457(f) addresses the use of SERPs in the not-for-profit sector. Because these plans are non-qualified, they allow for select employees to receive SERPs. There are no contribution limits to these plans as long as the contributions are deemed "reasonable." The earnings in the plan grow tax deferred until distribution, then they are taxed as ordinary income to the executive. To grow tax deferred, the IRS requires that the design of the plan include "a substantial risk of forfeiture" (the executive leaves and they forfeit the SERP) and that the employer be the fiduciary in the plan administration and oversight.

Internal Revenue Code 409A

Internal Revenue Code 409A establishes clearly defined trigger points at which SERP distributions should be made to an executive. Examples of these payment events might include separation from service, disability, death, change in control or a specified date(s). The executive must be prohibited from participating in the oversight and/or administration of the SERP to avoid a taxable event.

NCUA Rule 750

NCUA Rule 750 provides the NCUA broader authority to indemnify a SERP contract in the event that a change of control is the result of poor executive judgment (i.e., conservatorships). While the NCUA recognizes the need for SERPs in the credit union industry, the NCUA can "claw back" SERP payments from executives in the case of extraordinary circumstances to protect the National Credit Union Share Insurance Fund.

The D. Hilton Associates Difference

1 We Set the Industry Standard.

Since 1985, D. Hilton Associates Inc. has been launching new initiatives and pioneering consulting and outsourcing processes for the credit union industry. We are the largest and most experienced company of our kind.

2 We are Independent.

At D. Hilton Associates, we base our recommendations on your credit union's unique situation and needs. We are not affiliated or associated with any other credit union service provider. This ensures you that our recommendations are entirely independent and reliable. We pay no fees to or from organizations and receive no fees from endorsements.

3 We Work Exclusively with Credit Unions.

D. Hilton Associates specializes in the credit union industry, so we really know your business. We devote our full energy to providing you with specialized expertise in each practice area.

4 We Offer a Large In-House Staff.

Your credit union can rest assured that it is partnering with our full-time, in-house professionals that have outstanding credentials in all of our practices. Our practice leaders offer you practical solutions to your credit union's concerns and challenges.

5 We Value Our Client Relationships.

Our goal is to create and foster a long-lasting partnership with you. D. Hilton Associates believes in accommodating your schedules and goals, rather than requiring you to accommodate our schedules and goals. We know you are in the business to serve, and we respect and support your need to provide exceptional service.

6 We are the Most Qualified Firm in the Business.

No other individual or group offers the breadth and depth of both analytical and operational services available through D. Hilton Associates. Our unique blend of credit union expertise and technical expertise offers you the option of sole source support through our variety of interrelated practices.

LEADERSHIP

Debra J. Hilton, SPHR, SHRM-SCP

President, D. Hilton Financial Services
Executive Vice President, D. Hilton Associates, Inc.

Debbie Hilton specializes in the design, implementation and management of Supplemental Executive Retirement Plans (SERPs). A professional money manager since 1983, Hilton joined D. Hilton Associates in 1996 after successfully selling her money management practice. While working with credit unions in the recruitment and retention of senior executives, she recognized the important relationship between total compensation, SERP design and investment performance as an integral retention tool.

As an Independent Registered Representative with LPL Financial, Hilton established D. Hilton Financial Services in 1999 for the express purpose of facilitating the implementation and ongoing oversight of executive retirement plans. She has been instrumental in the implementation of more than $2 billion in retention, retirement and compensation plans for credit union executives. The firm has consulted with more than 900 credit union clients nationwide in the development of SERP solutions.

She has been recognized with numerous professional accolades including Registered Rep Magazine's "Top 100 Independent Advisors in America" and "Top 50 Independent Broker/Dealer Women Advisors", as well as Top Financial Advisor for LPL Financial for the previous five years.

Hilton maintains the FINRA Series 7, Series 24, Series 63, Series 66, and Life and Health Insurance licenses and The Society for Human Resource management has recognized her as a Senior Professional in Human Resources (SPHR). She holds a bachelor's degree from The University of Houston.

Brian J. Kidwell, SPHR

Executive Vice President

Brian Kidwell is an Executive Vice President and is a thought leader across the organization. His specialties include executive succession planning, 457(f) SERP design and maintenance, executive recruiting analytics, compensation and benefits analysis, qualitative and quantitative research, organizational assessment and strategic planning. Kidwell is responsible for the development of D. Hilton's Member Migration Model – an exclusive research tool used for customer segmentation, behavior analysis and lifetime value.

Prior to joining D. Hilton, Kidwell worked as a consultant focusing on consumer behavior business strategy. Kidwell holds a Bachelor's degree in Management from Texas Tech University and a Master's degree in Business Administration from Texas State University, and the designation of Senior Professional in Human Resources (SPHR) from the Society of Human Resource Professionals. Kidwell is also a published author in major consumer research journals and trade publications.

John W. Andrews, CCP, CSCP, SPHR

Executive Vice President

John Andrews joined D. Hilton Associates in 1986, a year after the company's inception. He is considered a thought leader in the credit union industry regarding executive compensation and pay-for performance programs. His extensive knowledge in governance and his passion for working with nonprofit organizations has made him a fundamental part of the D. Hilton team.

Through his leadership, D. Hilton's Compensation Practice has become the industry leader in custom designed salary administration and performance evaluation systems. D. Hilton is renowned for accumulating the most current industry salary and incentive data available on the market. He is also responsible for the development of D. Hilton's Annual SERP Survey and Quarterly Compensation Impact Reports, considered best in industry.

Andrews received a bachelor's degree in Communications from the University of Tulsa, and went on to Emerson College to pursue his master's degree in Business and Organizational Communication. Prior to joining D. Hilton, Andrews worked with KPMG Peat Marwick, the Center for Coastal Studies and the National Association of Insurance Women. Andrews holds the designation of Senior Professional in Human Resources (SPHR) from the Society of Human Resource Professionals, as well as the Certified Compensation Professional (CCP) and Certified Sales Compensation Professional (CSCP) designations from the WorldatWork Association.

David M. Hilton, Ph.D.

President

David Hilton, founder and President of D. Hilton Associates Inc., is renowned for his insight on industry trends and his company's ability to offer innovative solutions to help credit unions stay competitive in the market's constantly changing conditions. Hilton began his career in banking and then joined a large Long Island, New York credit union during a time when the industry was known for its plain vanilla approach to financial services.

During his tenure at the organization, Hilton rose to the number two position and became known for process improvement and technology innovation. Knowing his ultimate goal was to become a chief executive, however, he began to field offers from credit unions around the country. He was 30 years old when he accepted a CEO position for a troubled New Jersey based credit union and within 24 months, had returned the organization to profitability.

Realizing that he loved problem solving and working with Boards, he decided to establish D. Hilton Associates Inc. as an executive recruiting firm in 1985. Since its inception, the firm has been involved with many of the high profile executive job placements in the nation.

Today, the firm employs consultants that provide executive recruiting, executive and staff compensation, variable pay design, succession planning and 457(f) SERP development to credit unions throughout the United States. Clients range from $50 million in assets to more than $15 billion.

Hilton holds a bachelor's degree in Accounting from City University of New York, a master's degree in Business Administration from New York Institute of Technology and a doctorate in Organizational Management from Walden University, Minneapolis, Minnesota.

d. hilton associates inc.

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