EXECUTIVE COMPENSATION IN SIX STEPS

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It’s no surprise that executive compensation is a hot topic these days, however, the focus on executive compensation is not limited to firms on Wall Street. While the amounts of compensation, bonuses, and perquisites found in higher education may pale in comparison to those in the for-profit world, they elicit mixed responses within the academic community. The ability to recruit, retain, and reward key employees is as essential in higher education as in the corporate sector, and is largely accomplished through the use of a variety of executive compensation arrangements.

Marketplace characteristics and competitive pressures, the public’s demand for accountability and disclosure, and the changing legislative and regulatory environment all have an impact on the design of an effective executive compensation program. On the legislative front, the introduction of IRC Section 409A by the Internal Revenue Service has had a major impact on the design of executive compensation programs. IRC Section 409A governs all nonqualified deferred compensation plans, a key component of any executive compensation program. Independent colleges and universities also must determine executive compensation in accordance with §4958 intermediate sanctions provisions.

A sound executive compensation program begins and ends with good governance and a well-established compensation philosophy, policies, and practices in line with the institution’s overall goals and objectives. Good governance practices must include peer-group analysis and a review of the total compensation package (including perquisites such as housing and car allowances along with business and entertainment expenses) and must provide for performance measurements that clearly define success. Good governance practices should also be well documented and adhere to all legislative and regulatory requirements. Now more than ever, good governance must include adherence to the three C’s: compliance, coordination and communication.

The Three C’s

Compliance with the legislative and regulatory requirements surrounding executive compensation and nonqualified deferred compensation plans is critical in order to avoid intermediate sanctions, fines, and potential disqualification of the plans themselves. Coordination of all arrangements established throughout the university—whether for a star faculty member, university president, or athletic coach—should be centrally managed and maintained to ensure all arrangements are in line with the overall executive compensation policies and practices of the institution. And, Communication throughout the organization is critical so that no surprises or inconsistencies in policy and practice are present.

Development of a comprehensive executive compensation program should be looked at as a joint venture among key stakeholders. These include members of an institution’s board of trustees and senior administrative officials such as the business officer, the human resources director, and the institution’s legal counsel.
Executive compensation can be divided into four general components: base salary, standard employee benefit plans, supplemental short- and/or long-term incentive compensation plans, and perquisites. Focusing on the supplemental plans, tax-exempt and governmental institutions are limited in comparison to their for-profit counterparts in what can be provided key employees. There are several types of executive compensation arrangements commonly used in the higher education marketplace. In general, public institutions tend to have more options than private institutions because they are exempt from certain ERISA reporting and disclosure requirements and IRS coverage and nondiscrimination rules.

Designing an effective executive compensation program can generally be broken into the following six steps.

1. **Analyze existing benefit plans and executive compensation arrangements.** One of the first things you will want to do is review the benefits provided under the standard package of employee benefit plans that will be offered to the key employee. Analysis of the base retirement and tax-deferred savings plans is necessary in order to identify gaps in coverage and opportunities that maximize benefits provided under the available limits. In other words, do the math. Addressing what is needed or desired can only be accomplished after determining what is already being provided.

   For existing executive compensation arrangements, you will want to determine if the programs still meet their primary objectives and remain in compliance with current regulatory and legislative requirements. You will also want to analyze the administrative requirements and costs of the benefit program to ensure that it remains affordable and efficient.

   Finally, as with any employee benefit plan, you will want to ensure that the executive compensation package that is being offered or considered is not only adequate, but also understood and appreciated by the key employee.

2. **Establish primary plan objectives for executive compensation program.** This step basically asks the question, why are we considering development of a supplemental executive compensation package? Is it simply to provide the key employee with additional retirement contributions above and beyond those provided by the standard employee benefit plans? Is it to restore benefits lost under these standard plans due to the IRS limits placed on compensation or nondiscrimination testing? Is it to provide the key employee with additional salary deferral opportunities? Or, is it to attract or retain the services of a key employee or to reward performance? The answer to these questions will help identify the most appropriate executive compensation arrangement for the circumstance.

3. **Identify optimal plan design features.** Once you have determined the plan’s primary objective, you will want to gauge the relative importance of certain design features from an institutional perspective. A common consideration is the issue of public disclosure and/or Form 990 reporting. In the case of a highly recruited athletic coach, these issues generally tend to get played out in the local media and are difficult to manage. However, the type of plan selected will determine when or how the compensation is disclosed. (Note: all public/governmental institution information is subject to state open records laws, and private/tax-exempt institutions must
disclose all compensation on IRS Form 990.) Other considerations include determining the importan
t of protecting the benefit from the institutions’ creditors, whether future service requirements are required, and when benefits are to be made available.

4. **Determine tax and distribution strategy.** Of great importance to both the institution and the key employee is the tax liability and distribution strategy associated with the executive compensation plan selected. Although tax-exempt and government employers do not have the same tax incentives as for-profit organizations when establishing executive compensation arrangements, some plan designs have bookkeeping requirements that must be considered. The institution also must determine the importance of employer control of the assets and benefit distributions prior to and after vesting or before retirement. Of particular concern to the key employee are the individual tax consequences of the benefits during the accumulation phase, upon vesting, prior to distribution, and following separation from service. Rules vary by plan type and must be analyzed carefully.

5. **Select appropriate financing methodology.** Depending on the type of executive compensation plan under consideration, an institution will need to base its financing strategy on projections of future assets, benefit liabilities, and cash flows. Simply put, how is the institution going to pay for or account for the benefits promised? Common financing arrangements include:

- Cash/lump-sum settlement (pay as you go)
- Shadow account (defined interest and earnings assumptions)
- Institutionally owned annuity/mutual fund accounts
- Institutionally owned life insurance policy
- Use of Rabbi Trust, Employee Trust

From the key employee’s perspective, various funding arrangements tend to involve a tradeoff between the level of security provided on the underlying benefits and the amount of tax deferral that can be achieved. Certain executive compensation arrangements have maximum contribution limits placed on them with the benefit of spreading out the tax liability over time upon distribution while others provide for unlimited contribution amounts but are heavily taxed upon vesting or distribution.

6. **Establish guidelines for periodic review and evaluation.** It is critical to review executive compensation arrangements on an annual basis to ensure they remain consistent with the institution’s overall compensation philosophy, policies, and practices and are in compliance with applicable laws and regulations.

While the focus of this article centered on the types of executive compensation packages most commonly used in higher education, the annual review should take into consideration the total compensation package: base salary, benefits, short- and long-term incentive programs, and perquisites. It is also important to ensure that all executive compensation plans are well documented, including the decision-making process and procedures that went into their
development. And finally, good governance requires involving all of the key stakeholders (human resources, finance/business office, and legal counsel) and clear communication between senior leadership and the institution’s governing body.

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