

## **To Pay or Not to Pay?**

### *The Pros and Cons of Director Compensation in Credit Unions and Non-financial Co-operatives*

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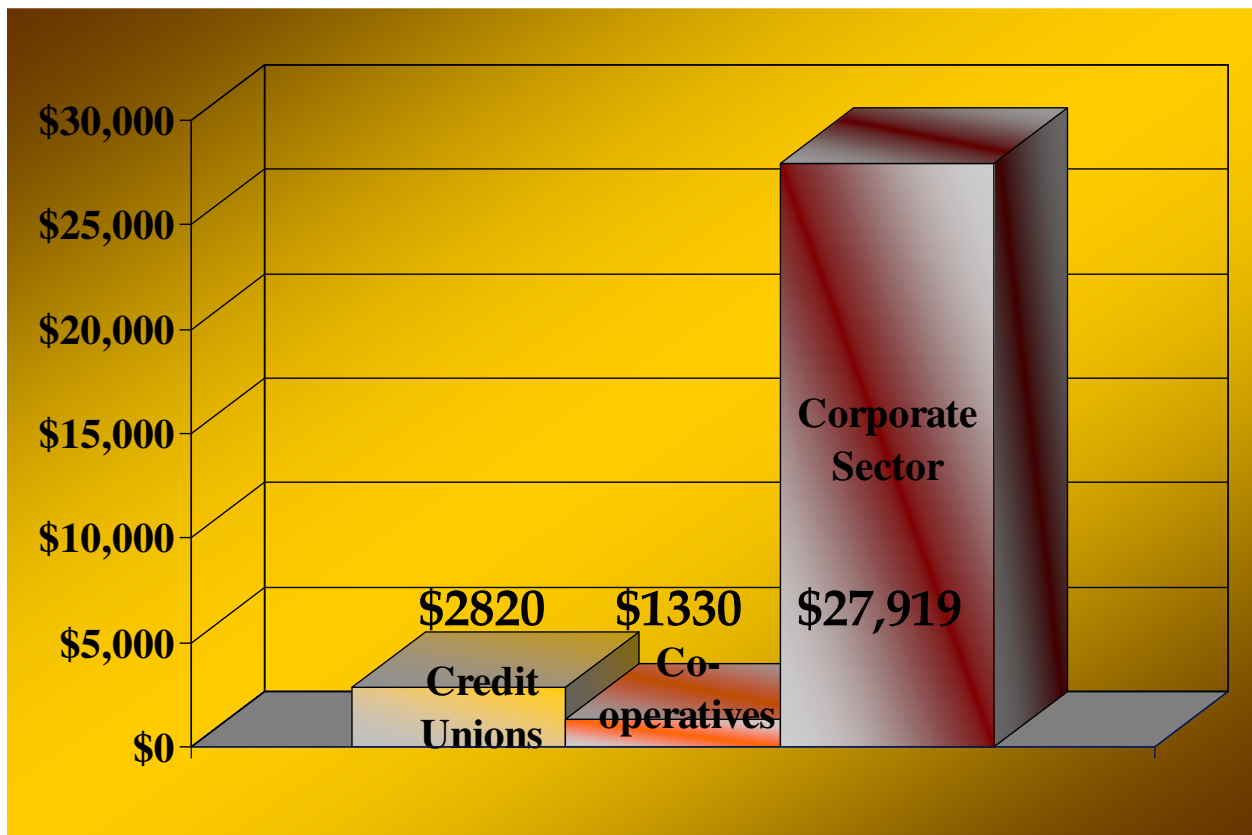
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## Introduction

The area of director compensation, regardless of sector, is a very sensitive area – for obvious reasons – the board is making a decision about paying itself. This brings with it the perception of self-dealing. The risk you face is one of significant negative reaction from members and management. This is partly because of personal philosophy about the concept of paying directors in the credit union and co-operative sector. But, more so, the sensitivity comes from the reality that often members and managers usually have not been involved in compensation decisions.

The following table demonstrates the giant gap in director compensation vis-à-vis the Canadian corporate sector<sup>1</sup>.

*Chart One: Director Compensation Nationally by Sector*



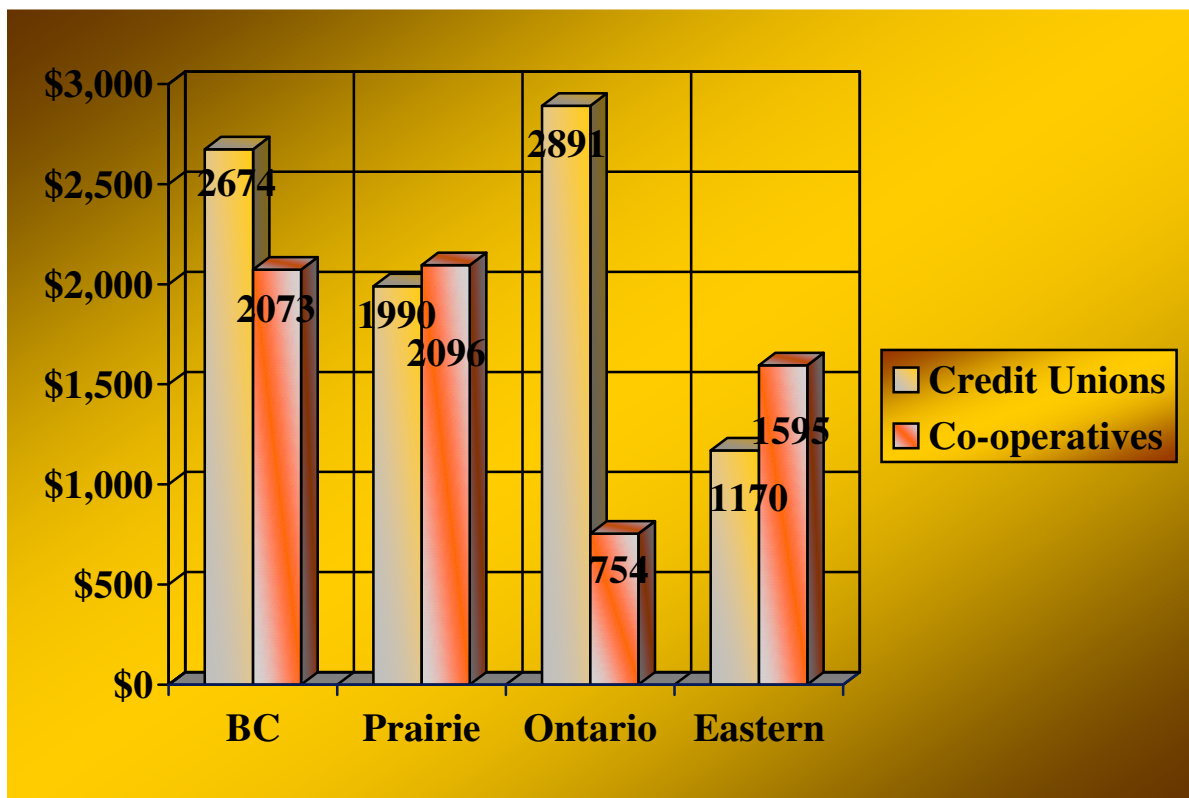
<sup>1</sup> There are a number of source for compensation data in this table: corporate sector data comes from Patrick O’Callaghan; co-operative and credit union data comes from a national governance research project completed by Brown Governance Inc., and the Canadian Co-operative Association.

On average then, private sector directors make \$232 per hour, credit union directors make \$23.50, and directors of co-operatives \$11.08<sup>2</sup>.

There are three main drivers that affect these compensation differences:

1. Many corporations are much more complex than most co-operatives and credit unions;
2. Corporate directors in some cases have been overpaid (for example, there have been a number of abuses with stock options and grants); and
3. Co-operatives and Credit Union directors are often paid too little or not at all, because of tradition and/or philosophy.

**Chart Two: Director Compensation Comparisons by Region and Sector<sup>3</sup>**



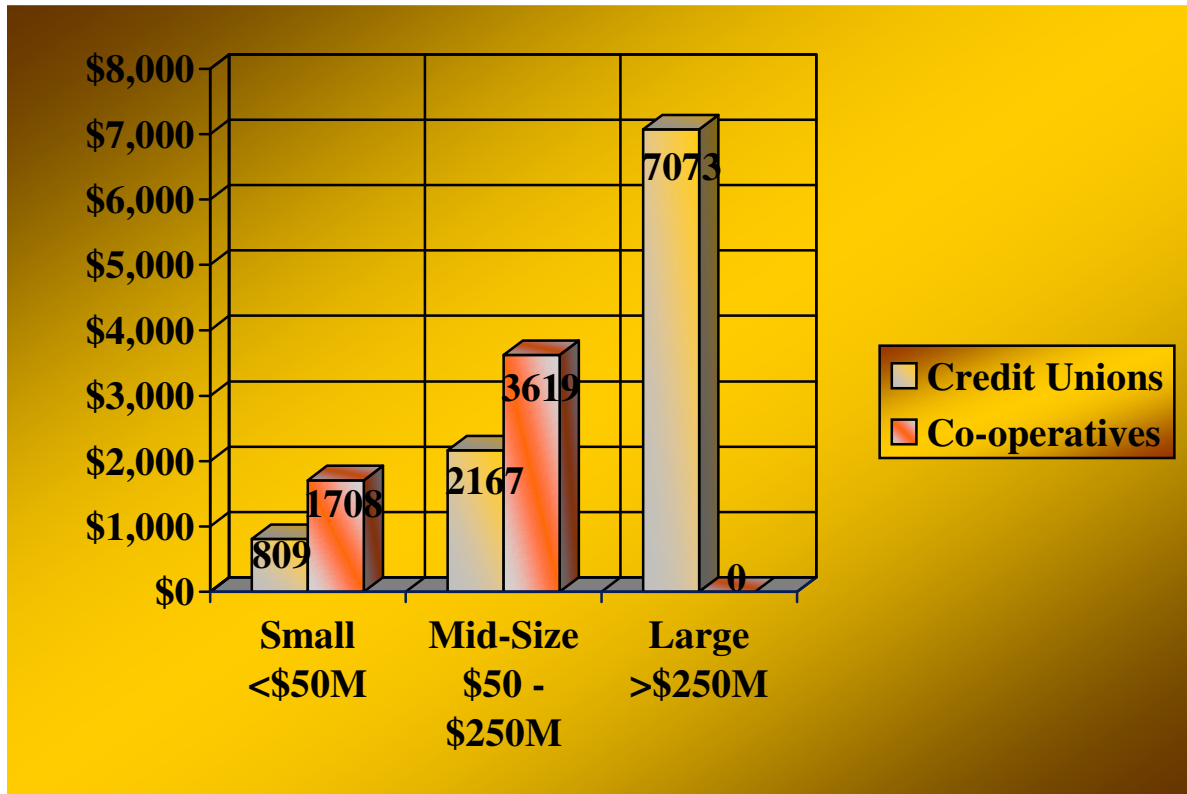
While there are significant differences by region, most of these differences are accounted for by size. Size is a major driver of director compensation levels regardless of sector.

<sup>2</sup> Based on 10.2 board meetings per year lasting 2 2/3 hours, plus 4 committee meetings per year lasting 2.5 hours per meeting (assuming the director sits on 1 committee); 2 hours preparation time per 1 hour of meeting (the standard rule of thumb for meeting preparation.) Compensation figures do not include training or any extra conference call or other meetings.

<sup>3</sup> Data source: BC and Prairies Credit Union Central of British Columbia; Ontario and Eastern, Brown Governance Inc., and the Canadian Co-operative Association.

There is a significant difference in director compensation by asset size. Asset size is the best indicator of the scale of your business beyond number of employees or even revenues. The implication is that when setting compensation at your organization, the peer group organizations that are best to use are those in the same asset size. And small credit unions and cooperatives should not be afraid to pay versus their peers. The following table will illustrate this<sup>4</sup>.

*Chart Three: Director Compensation Comparison by Asset Size*



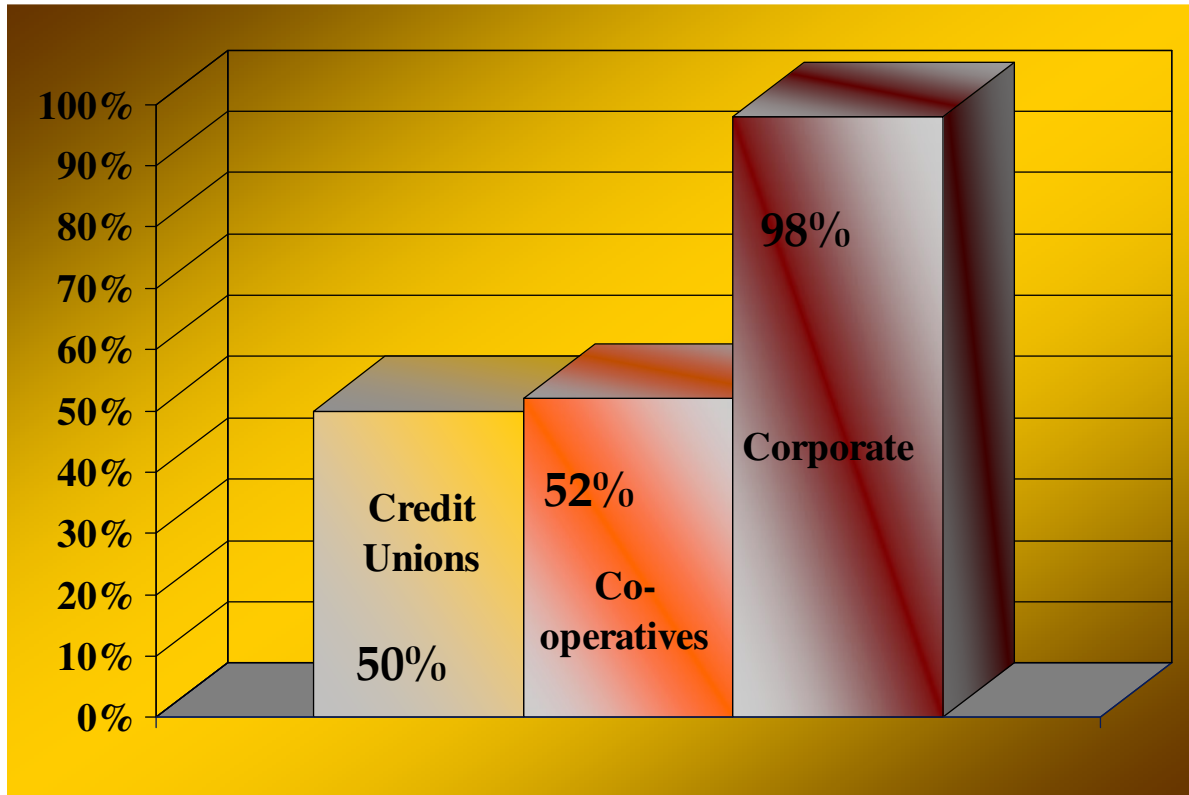
While the above illustrates how much directors are paid, “how much?” is really the second question you should answer. The first is: “Should we pay?”

While the verdict is in in the corporate sector (fully 98%<sup>5</sup> do) the jury is still out on the question in the credit union and co-operative sector. Based on the data, while one half answers “yes” to director compensation, clearly the other half says “no.”

<sup>4</sup> There are not sufficient non-financial cooperatives over \$250M in assets to make this meaningful.

<sup>5</sup> Source: The Conference Board of Canada directorship practices research

*Chart Four: Director Compensation Comparisons - % That Pay by Sector*



## The Pros and Cons

How should your board answer that question? Begin by understanding the various pros and cons.

### *Pros:*

1. ***Attracting Skills and Experience:*** Compensation is often needed in order to attract the skills and experience necessary to govern today's complex organizations.
2. ***Diversity:*** If your organization wants the strength that comes from a diverse board then it must be able to attract people for whom it would be a financial hardship to give up time without being compensated.
3. ***Enhanced Accountability*** The theory is "you get what you pay for." And the question becomes: what signal are you sending by not paying director compensation? Many would argue you are sending the signal that they are not expected to add much value – their time and contribution are not worth paying for. Therefore, they do not really have an expectation of accountability. They may show up, give their two cents, eat their sandwiches and go home! So, the argument is, if you want accountability – pay for it.

## Cons

1. **Principle of Volunteerism:** Some argue that directorship in a credit union or co-operative is a form of community service. It is giving back to your community and there should be no expectation of payment for that. Having said that, where does one draw the line at what community service is? Individuals serve communities every day, for example, employees of police and fire departments, health care workers, teachers, employees of co-operatives and credit unions – we would never expect not to pay for these services – why would we think of directors, the leaders of these organizations – any differently?
2. **The Cost:** Another argument against director compensation is that the organization may have limited resources to pay. Every dollar spent on director compensation is a dollar that could be spent elsewhere, for example, in member service, employees, quality, etc. The question then becomes: does governance add value? Is it worth paying for? Good governance is much like an insurance policy – it pays off on rainy days. When an organization runs into operational or ethical failure, a good board intervenes and more than earns its keep!

## The Drivers of Board Compensation

### *External and Environmental Drivers*

While the pros and cons listed above may be somewhat philosophical in nature, there are some external and environmental drivers that affect director compensation. These drivers are trends that are to a large extent out of the control of the organization. And, the overwhelming tendency of these drivers is to push director compensation up. Clearly then, they cannot be ignored. The drivers are:

1. **Competition:** There are increasing competition, mergers, acquisitions and a lot of pressure on the bottom line and performance. The effect is to put upward pressure on the compensation of executives and directors because they are the ones responsible for performance. There is an old credit union slogan that says, “not for profit, but for service.” It should say, “not for profit, not for loss, but for service!” An organization cannot continue to serve its communities without profitability. Organizations in every sector are experiencing tremendous pressure to achieve tangible, bottom line results.
2. **Governance Reform:** Governance reform has introduced new regulations, standards and guidelines on board members in every sector. These expectations also serve to drive compensation upward. As more is expected in accountability, more compensation is expected.
3. **Cultural Norms:** We live in a culture of low trust and instant communication. People want and expect more information. They want it now, and they expect you to prove the validity of the information and the decisions behind that information. The implication is one of disclosure. The perceived increase in risk in rapid, full disclosure also drives compensation expectations upward.
4. **Supply and Demand:** Due to the increased demands on directors, people serve on fewer boards. The perception is that supply is down. When supply is down, price goes up. That is simple economics. Is the supply actually down? Not necessarily. In this post-Enron era, with the tremendous interest in corporate governance, many

people without board experience are stepping up to the plate to serve as directors. However, perception can still drive increases, and in this case it is.

5. **Professional Directors:** Directorship is being thought of as more of a profession, particularly in the private sector. Professional colleges (for example, The Directors College) and a myriad of governance courses and seminars are expanding. Director training budgets are on the incline. With professional training and experience, comes the expectation of compensation.
6. **Performance Expectations:** More directors are being asked to step down from their positions for lack of participation and performance reasons. Directors are clearly expected to perform – again, with performance expectations comes compensation expectations.
7. **Management Performance:** Directors are choosing to step down when they lose confidence in management. Directors are taking their liability risks seriously. With liability risk comes the expectation of compensation.
8. **Board Evaluation:** More and more boards are evaluating their performance. The evaluations are being taken quite seriously in director renewal. Once more, we see the performance expectation which then drives the compensation expectation.

Another way of looking at these drivers of director compensation is as a scorecard. In the table below, the drivers on the left hand side are pushing compensation up, while those on the right hand side are pushing compensation down. Looked at on balance, clearly the drivers on the left outweigh those on the right.

<b>Upward Drivers of Compensation</b>	<b>Downward Drivers of Compensation</b>
↑Level of skills and experience	↓Shareholders (members), employees, public and other stakeholders want to keep compensation down
↑Scarcity of skills and experience required	↓Measure of value added and value linkage that compensation represents (it is hard to directly measure the value boards add)
↑Attracting most capable leaders	↓Affordability and corporate expense control
↑Increased time commitments	
↑New regulations raising the bar: certifications and accountability	
↑Legal liability: shareholder litigation; court precedents; D&O liability insurance costs	

## Personal Drivers

There are also a number of personal drivers. Why is it after all that people agree to sit on boards? The following table is a comparison of the benefits and costs to board service – a personal ledger or scorecard of sorts. You can see that the benefits of board service have decreased, while the costs have increased in recent years; the net of which is that directors are looking for compensation to offset the loss of benefits, increased time commitment and risks of the position.

Benefits	Value Now Versus Before	Costs	Value Now Versus Before
Contacts (Importance)	↓	Risks:	
Business Development	↓	- Reputation	↑
Prestige/Affiliation	↓	- Legal	↑
Learning/Experience	= or ↓	Time and Effort	↑
Self-fulfillment	=	Expertise and Experience	=
Indirect Rewards	?	- Additional Time/Effort	↑
Financial Rewards	?	Required Investment	↑

Source: *20 Questions the Board Should Ask About Director Compensation*, Canadian Institute of Chartered Accountants, 2004

With these three sets of drivers – philosophical, external environmental and personal, we can understand why there is a lot of pressure being placed on compensation.

## 10 Steps Your Board Can Take

If your organization has decided that it should pay, and as well, how much it will pay, the next set of questions to be answered are, what step will we want to consider taking next to ensure appropriate compensation design and disclosure? The following outlines the key things your organization should be thinking about:

1. **Decide:** A decision should be made on who will deal with the compensation issues. Will it be the board as a whole, an individual, a consultant, or a board committee? Generally a board committee is tasked with this project, particularly the HR/Compensation Committee. Other committees that take on this task in some organizations are the Executive Committee or the Governance Committee.
2. **Agree:** Once you have decided which committee will be responsible for the task, ensure that there is agreement at the board level on the mandate, composition, function and objectives of the committee.
3. **Align:** Look at where the organization is headed over the next three to five years. Strategic direction will affect all aspects of board renewal, including compensation.

Make sure that your compensation strategy is aligned to the strategic objectives of the organization.

4. **Obtain Buy-in:** Set out to proactively obtain the buy-in of management and members on the board compensation strategy and levels.
5. **Help:** Get the right help to ensure the best approach is taken. You may want to hire an outside advisor. This is a very sensitive subject and it is important to get it right the first time. Don't scrimp on getting the help you need.
6. **Choose:** Make sure the right peer comparators are chosen. A tendency in setting compensation is to choose more complex peers in order to raise compensation. Even compensation consultants may recommend the wrong peers in an effort to please you as their client! Spend some time ensuring you make the best choice of peers.
7. **Balance:** Find the right balance of compensation. It is as problematic to underpay as it is to overpay. When you underpay, people tend to not be as accountable as they ought. When you overpay, people have a tendency to be in it for the money rather than the service.
8. **Monitor:** Monitor the implementation of your compensation strategy. Track for backlash and outstanding, nagging questions. Seek periodic feedback and reviews. Don't be afraid to correct mistakes.
9. **Disclose:** disclose the way in which the compensation was set. The annual report, the corporate website, the annual general meeting or other ongoing communications are all good vehicles for this type of communication. Don't communicate once and expect your job is done – you may need multiple communications methods, and you may need to communicate multiple times.
10. **Listen:** Listen to your members and stakeholders for reaction in addition to active engagement in obtaining feedback on your decisions.

## Explain and Disclose

Member engagement and education will also serve to help in your decision-making process. Remember, compensation is a “hot button” issue for members because they see those dollars as coming out of their own pockets. They need to be able to see how the board brings value to the organization and as a result this will add dollars to their pockets!

How much engagement really depends on the degree of change you are making. You will need to put more effort into communications if you are paying directors for the first time. For example, you may want to strike a task force that includes members, or communicate through newsletters, at the AGM, annual reports, nominating packages, websites, surveys, etc. Engaging your members in the governance dialogue will help them understand how careful they should be in choosing members to sit on the board. As you start paying and communicating the rationale, they will understand more fully the seriousness of the job.

When all is said and done, it will be important to fully communicate your compensation decisions in your annual report. The test of your information is simple – given the same

information that you have, would management and membership make the same decision that you have? Here is what you will want to disclose:

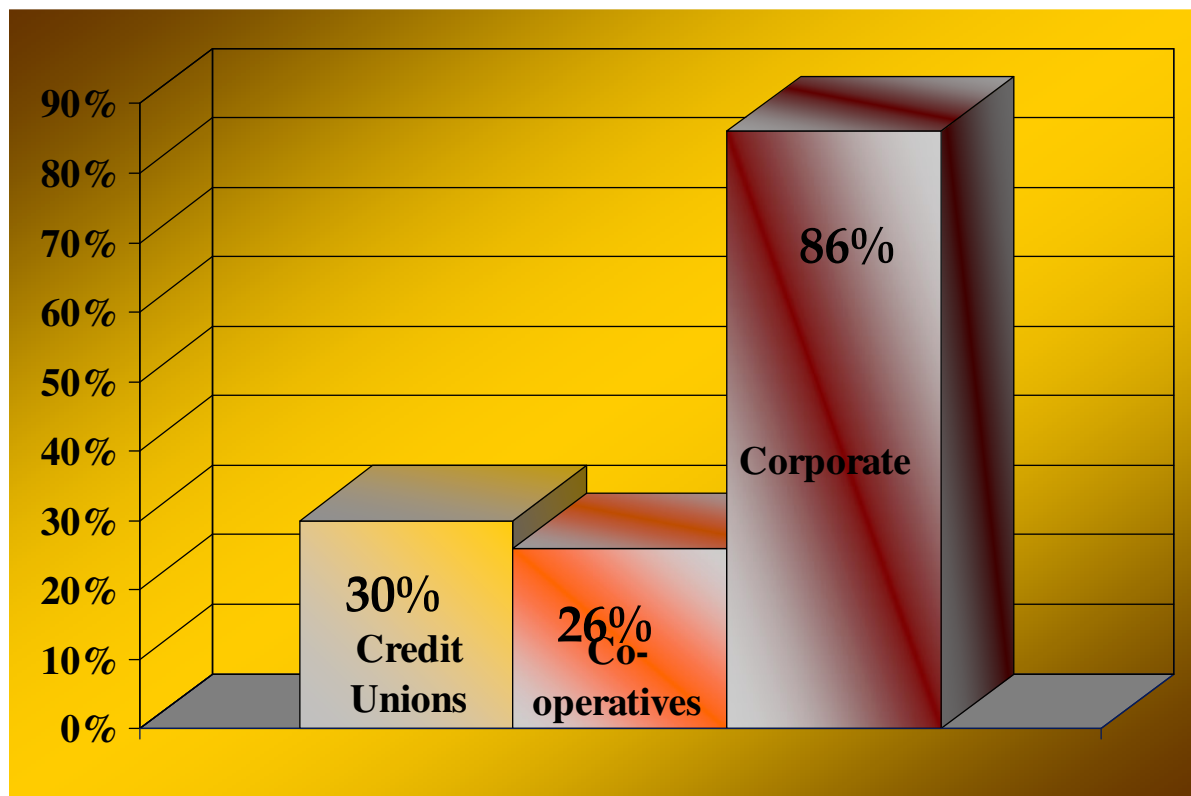
- ✓ **Why:** Disclose the compensation strategy and philosophy. This includes why you have decided to pay and the rationale for arriving at the amounts.
- ✓ **What:** Disclose the amount and form of director compensation (i.e. retainer and fees; per meeting; per diem; chair; committees; other non-cash perks.)
- ✓ **How:** Disclose the compensation committee – the members, their role and the scope of their responsibilities (this is something that should be done for all committees – not just the compensation committee)

If people understand why a decision was made, how a decision was made and what the decision was (i.e. the specifics of the decision), they are much more likely to support that decision. Disclosing the why, what and how of director compensation is to show respect to your membership and engage them in the decision.

## Compensation Committees of the Board

One of the trends in governance is for boards to strike a Human Resources/Compensation Committee. Chart five shows that currently 86% (and growing) of boards in the private sector, 30% of Credit Unions and 26% of Co-operative boards do have such a committee.

*Chart Five: The New Compensation Committee*



The primary purpose of striking board committees is to deal with sensitive and complex issues. In the case of director compensation there are both sensitive and complex. A compensation committee may be the solution to your decision on who will deal with these issues. Aspects of this committee include:

- ✓ All members of the committee should be independent. Two ways of answering this question are: is the person's living dependent on the organization? And, do they have a material interest in the organization (contracts, salaries, landlord, corporate lawyer or real estate agent for the organization, etc.)
- ✓ At least one member of the committee should be skilled in compensation issues – they should know how to design and disclose compensation plans.
- ✓ There should be at least one member of the committee skilled in media relations and strategy in order to assure appropriate disclosure.
- ✓ These committees are often supported by outside experts in compensation design and strategy.
- ✓ On average, this committee often meets up to four times per year in all sectors.

## **Concluding Thoughts**

How do you make the decision to about compensating your directors? Begin with dialogue. Be intentional in weighing the pros and cons. Do not simply follow tradition. Don't decide not to pay just because you never have, or pay just because others are! Spend time analyzing which governance reforms you will embrace, including compensation reforms. Understand how much time directors will spend at board and committee meetings and in preparation for them. The rule of thumb is that a director will spend two hours in preparation for every one hour of meeting time. Be clear on the expectations for committee service, training and value added they are to bring to the table.

Director compensation is not the head of the dog - it is the tail. Boards cannot let compensation "wag" their governance decisions. Compensation is a means toward an end. The end is fairly compensating those who serve your credit union or cooperative by bringing real value, skills, experience, time and passion to the table.

Should you not be able to tell my own bias on this issue, it is this – "a labourer is worth his (and her) wages!" Director compensation is a value exchange. The compensation you place on a job is a clear signal of the value placed and value expected of the job.

Our final advice is:

1. Do not be afraid to pay directors their worth; but
2. Make sure you are able to explain the rationale;
3. Make sure you communicate clearly, openly, fairly, objectively and two-way; and
4. Remember the "explain and disclose test" - given the same information that you have, would management and membership make the same decision that you have?