d. hilton associates inc.

Establishing the Right Executive Peer Group

Executive Compensation and Cost-of-Living Indices

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D. Hilton has undertaken a longitudinal research initiative to determine the most relevant predictors of executive compensation in the credit union industry. Through this initiative, D. Hilton has concluded that organizational size, as determined by asset size, number of employees, and number of members, are the best predictors of executive compensation.

Introduction

The Importance of Fomalizing a Pay Philosophy

A key element to the health of any credit union includes establishing an effective executive compensation system. Such a system is motivational to the executive team, stays within the confines of what the board is able and willing to fund, and maintains a degree of equity within the wider market. To retain its top-level talent, a credit union must be aware and responsive to what its peers are offering in terms of base pay, incentive pay, and a comprehensive benefits package. To stay current with the market involves job market pricing and benefits benchmarking. Part of this process includes establishing a peer group (i.e., deciding who should be included in a credit union's peer group and based on what criteria).

Several criteria can be used to define a peer group including asset size, membership, cost of living, and cost of labor. But which criteria are most predictive of competitor pay throughout the industry? Should a peer group be specific to the region in which the credit union conducts business? Or would a national peer group be more representative of the job market for credit union executives? Finally, what role should cost of living play in executive compensation?

To answer these questions, D. Hilton conducted a study to determine if, and to what degree:

1. **The cost-of-living index correlates to executive base pay.**
2. **The cost-of-labor index correlates to executive base pay.**
3. **The credit union's asset size correlates to executive base pay.**
4. **The credit union's membership correlates to executive base pay throughout the industry.**

Finally, we tested to see if there were significant differences between regional peer groups and national peer groups in all four categories. By understanding which pair of indices best correlates with executive pay, we will be better able to understand and design a credit union peer group, keeping your credit union on the leading edge of competitiveness.

Methodology

Our study compared the base salaries of the traditional top three credit union executive positions, the Chief Executive Officer (CEO), Chief Financial Officer (CFO), and the Chief Operations Officer (COO) of 1,110 credit unions ranging in asset size from $6 million to $29 billion. Cost of living indices were based on the Council for Community and Economic Research's Annual Average Data. Cost of labor indices were compiled using the Economic Research Institute's Geographic Assessor. Asset sizes and membership information were based on the National Credit Union Association's 5300 Call Report database. The scale used to define the strength and direction of the correlation coefficient can be found in Table 1. Interpreting the Correlation Coefficient.

TABLE 1. INTERPRETING THE CORRELATION COEFFICIENT [1]

Negative				Neutral				Positive
-1.00	-0.70	-0.50	-0.30	0.00	0.30	0.50	0.70	1.00

TABLE 2. CORRELATION MULTIPLE INDICES AND EXECUTIVE BASE PAY [2]

	National	West	North Central	South Central	Northeast	Southeast
Chief Executive Officer						
Cost of Living	0.15	0.02	0.09	0.01	0.14	0.12
Cost of Labor	0.19	0.12	0.16	0.01	0.19	0.21
Asset Size	0.59	0.65	0.84	0.80	0.78	0.54
Membership	0.61	0.59	0.83	0.77	0.75	0.60
Chief Financial Officer						
Cost of Living	0.18	0.02	0.16	0.03	0.35	0.07
Cost of Labor	0.23	0.22	0.13	-0.08	0.44	0.07
Asset Size	0.46	0.54	0.66	0.64	0.67	0.31
Membership	0.46	0.50	0.68	0.66	0.59	0.35
Chief Operations Officer						
Cost of Living	0.23	0.16	0.10	-0.08	0.26	0.23
Cost of Labor	0.28	0.20	0.07	0.02	0.40	0.23
Asset Size	0.62	0.62	0.67	0.75	0.65	0.59
Membership	0.61	0.55	0.69	0.76	0.64	0.61

[1]Correlation is the degree to which two or more measurements show a tendency to vary together. For example, if executive base pay increases as cost-of-living increases, we say the two have a high correlation. However, if executive base pay decreases as cost-of-living increases, we say the two have a high negative correlation. When both executive base pay and cost-of-living indices increase together, we say the two have a positive correlation. If executive base pay and cost-of-living indices decrease together we say the two have a negative correlation.

[2]The West Region includes Alaska, California, Hawaii, Nevada, Oregon, and Washington. The North Central Region includes Idaho, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Montana, Nebraska, North Dakota, Ohio, South Dakota, Wisconsin, and Wyoming. The South Central Region includes Arizona, Arkansas, Colorado, Louisiana, New Mexico, Oklahoma, Texas, and Utah. The Northeast Region includes Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, and Vermont. The Southeast Region includes Alabama, Florida, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, Washington D.C., and West Virginia.

Asset Size and Membership, Better Predictors

The results of our study indicate that across all three positions (CEO, CFO, and COO), cost of living indices and cost of labor indices, almost uniformly, demonstrated a weak positive relationship with executive base pay. That is, the cost of living and the cost of labor of a location are not good predictors of executive base pay. In some cases, there was virtually no relationship at all. This held true when testing on a national scale and when isolated by region. Only in the Northeast U.S. was there anything other than a weak positive relationship (or no relationship). For the CFO and COO positions, there were three instances of a moderate positive relationship in the Northeast region, which may suggest a greater emphasis on these indices in that region, perhaps due to the higher-than-average cost of living. Significantly, these results suggest that cost of living and cost of labor indices are not good predictors of executive base pay and should not be included in an executive credit union peer grouping. Conversely, asset size and membership, almost uniformly, demonstrated a strong positive relationship with executive base pay. That is, the asset size and membership of a credit union were good predictors of executive base pay. Again, this held true when testing on a national scale as well as when isolated by region. In no instance were asset size and membership not a good predictor of executive base pay. These results suggest that asset size and membership are good predictors of executive base pay and should be included in an executive credit union peer grouping.

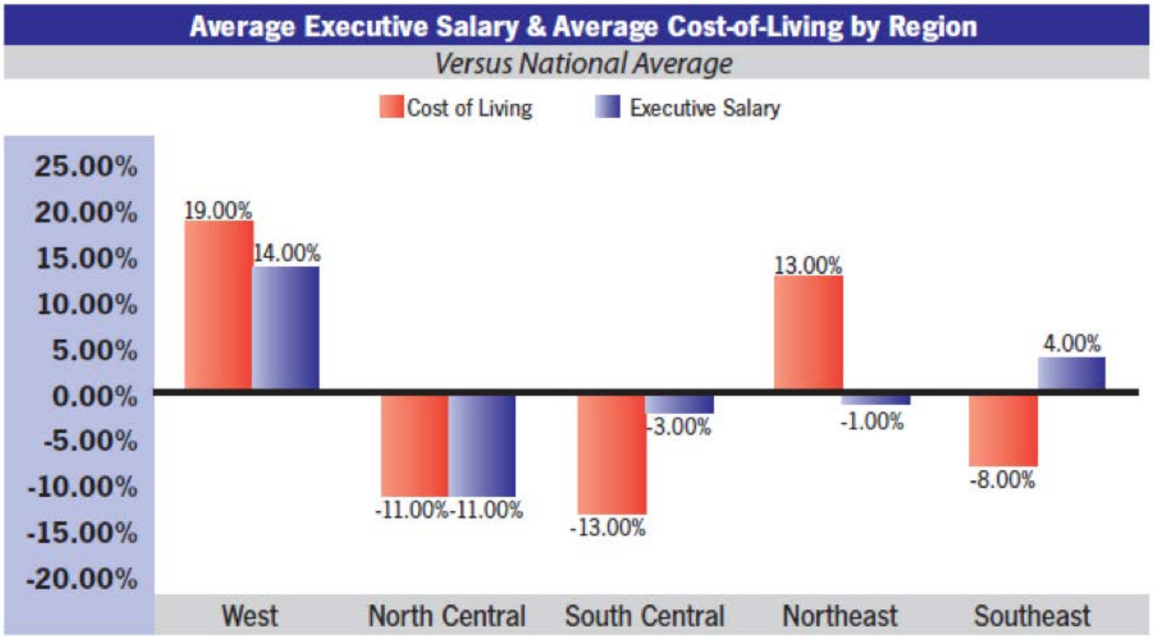
Do Cost-of-Living Indices Matter?

The first part of our study included testing the correlation between our various indices and executive base pay in the credit union industry. Our results showed that the cost of living in a particular area and how much an executive is paid share a weak to no relationship. From this, we concluded that because the cost of living is a poor indicator of executive base pay, it should not be a factor in determining an executive peer group. So, the question that arises is: does the cost of living matter at all?

To many within the credit union industry including HR professionals, C-Suite Executives, and Boards of Directors, the cost of living is an important consideration when determining executive pay, particularly if the credit union is in an unusually expensive city. For example, if a CEO in San Francisco is doing the same level and quality of work as a CEO in Phoenix, shouldn't he or she earn enough additional income to make up for that disparity?

Well, perhaps they should, but the numbers do not always justify a one-to-one comparison. In the West, for example, a top tier executive team member can expect to earn on average 14% more than their national peer. Unfortunately for him or her, it is 19% more expensive to live in the West. This difference, you could say, is the cost associated with living in what many deem to be a more desirable location. On the other hand, if you are an executive in the South Central Region you'll enjoy a cost of living that is 13% lower than the national average, while your base salary averages only 2% below the national average. If you are in the North Central Region, you will average a salary that is 11% below and a cost of living that is 11% below the national average. So, while the cost of living may still have an impact, the numbers can be misleading.

TABLE 3. AVERAGE EXECUTIVE SALARY & AVERAGE COST-OF-LIVING BY REGION



Conclusion

Our ongoing study continues to reaffirm the strong relationship between credit union asset size and executive compensation and the weak relationship between cost of living and cost of labor indices and executive compensation.

The results are significant for anyone actively recruiting for or hoping to retain top tier executives in their credit union. The absence of a relationship between cost of living and cost of labor indices with credit union executive base pay means that it is simply inadequate to rely on these measures when establishing an executive peer group. A better set of indicators are credit union asset size and membership. Both are significantly better predictors of executive base pay in the credit union industry.

While there are noteworthy differences between executive base salaries among U.S. regions, these differences may not be as considerable as cost of living indices would have you believe. Because it costs 35% more to live in Los Angeles does not mean an executive is earning 35% more than the national average. As a result, it is best to be mindful, but wary, of cost of living indices.

In the end, industry professionals with a vested interest in retaining and recruiting executives must do three things. First, focus on the skill set required to do the job well. Regardless of the statistical measure used to establish compensation, the ultimate goal is to find and retain a candidate who helps achieve the goals of the credit union. Second, reduce the risk of losing an executive by defining your peer group appropriately. It does the credit union an injustice to define a peer group too narrowly, by region for instance, when the job market for an executive position is on the national level. On the other hand, if your credit union is in an area with a high cost of living, a regional peer group may add value. Third, deliver pay from the credit union's perspective. Regardless of the external market, a credit union should deliver pay according to its own strategic goals and in line with its financial position.

For Additional Assistance

D. Hilton compensation and SERP clients have access to our compensation consultants to assist with budget planning, performance management issues, market pricing of jobs and general human resource issues. If you are not a current compensation client, D. Hilton's Compensation Practice can create and implement compensation and incentive plans that allow you to attract and retain high performers.

For more information about D. Hilton's compensation consulting services, please call: John Andrews at (800) 367-0433, ext. 124 or visit our website at www.dhilton.com

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