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Executive Benefit Plans: Has the Pendulum Swung Too Far?

A Series Examining the Changes and Growing Challenges in Executives' Retirement Plans -- and How to Address Them

Non-qualified Benefits Lead to Prudent Long-Term Management

Non-qualified deferred compensation plans are an integral way for many executives to meet their retirement planning needs. As discussed in the preceding issue, an executive earning $300,000 a year will typically receive less than 30 percent of final pay from Social Security and maximum participation in a qualified 401(k) plan. This makes non-qualified retirement plans very important, to this executive and many others, to ensure adequate retirement income.

Aligning Investors' Interests with Executives

The 2008 financial crisis shed light on many companies where executives, heavily incented by short-term equity programs, took undue risks. This wound up sending prominent companies into bankruptcy and burdening others with significant long-term financial problems.

> Non-qualified retirement plans, however, encourage prudent, long-term risk planning. This aligns participants' interests with debt holders and shareholders.

Here's why.

In order to be structured with the important pre-tax contributions and tax deferral compounding advantages of qualified plans, non-qualified plans require "a substantial risk of forfeiture." This means that in the event the company declares bankruptcy or becomes insolvent, participants could lose some or all of their contributions to the plan.

This pertains to both non-qualified deferred compensation plans and supplemental executive retirement plans (SERPs). SERPs typically provide a defined, fixed-benefit to executives and are often used to supplement qualified defined benefit plans. Executives often rely on these plans to be solvent 20 years or more into the future.

While the correlation between non-qualified plans and risk management would seem intuitively correct, prominent recent research also backs this up.

Recent Studies and Analysis

Writing in the February 27, 2012 edition of *The Wall Street Journal*, Alex Edmans, a finance professor at the University of Pennsylvania's Wharton School and a research associate of the European Corporate Governance Institute, discusses how defined benefit pensions and deferred compensation are effective ways to prevent executives from taking excessive risks.

Edmans says, "The research of Raghu Sundaram and David Yermack of New York University finds that CEOs with large defined-benefit pensions manage their companies more conservatively. Similarly, a paper by Divya Anantharaman and Vivian Fang of Rutgers University and Guojin Gong of

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Pennsylvania State University finds that debt compensation leads to fewer loan covenants and a lower cost of debt."

Integrating Equity Awards with Retirement Solutions

Over the years, the "pay for performance" trend has led many companies to widely institute stock option and other equity awards for wealth creation. Yet, with stock market volatility rampant, many stock options under water, and great variation in the timing of when the options can be exercised, there are significant variations in these benefits. In some cases, companies have the unpleasant situation of having incurred a compensation expense, yet they have not been able to award any actual compensation.

While executives certainly value stock options, restricted stock, other equity vehicles and the potential they provide for substantial near-term wealth creation, they also have growing concerns about stable and secure long-term sources of retirement income.

> To meet these retirement income concerns, some companies may want to re-allocate a portion of equity compensation to longer-term retirement planning in order to provide stability and assurances to executives.

A Variety of Alternatives

Companies have many strategies available to help institute both effective equity compensation and retirement programs, including the following.

- ***A hybrid approach to "pay for performance."*** Pay for performance programs inherently have risk and uncertainty to executives. In addition, once the executive achieves the criteria for an equity award, there is continued volatility and uncertainty about the award amount. To provide more financial stability to executives who have already achieved pay for performance goals, companies can allow the executive to contribute a portion of these funds to deferred compensation programs with stable, fixed-rate returns.

- ***Greater company contributions to deferred compensation plans.*** With accounting rule changes, it has become clear to many companies that there is a cost, and a risk with equity awards. For some companies, a more dependable way of providing compensation and/or reducing these risks is to re-allocate a portion of the costs going to equity awards for company matches on deferred compensation.

- ***Converting some of the gains from equity awards into fixed-payouts over a multi-year period.*** As executives' harvest gains from equity awards, they want find optimal distribution and re-allocation strategies. Companies can facilitate this via deferred compensation programs.

For additional information about deferred compensation plans, contact your Todd Consultant or visit our website at www.toddorg.com.

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