THE TODD ORGANIZATION®

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

The Todd Organization
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Overview

In recent years, executive benefits have undergone significant changes and faced intense scrutiny. This has been daunting for executives and companies, a.k.a. plan sponsors, alike.

The Todd Organization, a nationwide leader in the executive benefits field, examines these and related issues in this report, “Executive Benefit Plans: Has the Pendulum Swung Too Far?” It is a compilation of individual articles that were previously released on a bi-weekly basis from August-November 2012.

While we have always monitored trends and important developments in the executive benefits field since our founding in 1957, the changes and growing challenges in executives’ retirement plans are particularly noteworthy today. We believe you will find this paper timely and informative.

Through proper design, financing, and administration, executive retirement plans provide important benefits to shareholders and plan participants. We look forward to continuing to work with companies in all major industries on these challenges and opportunities.

For additional information on deferred compensation and related tax deferral issues, please contact your Todd consultant, e-mail us at Team-Todd@toddorg.com or call 1-440-871-7700.

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Introduction: Has the Pendulum Swung Too Far?

In recent years, executive benefits have undergone significant changes and faced intense scrutiny. This has been daunting for executives and companies, a.k.a. plan sponsors, alike. Today, both face enormous challenges and uncertainties.

These issues extend far beyond the top five or so executives named in the proxy and include most of the senior executives. As such, we address issues of concern not only to the CEO and named executives, but also to all who are defined as highly compensated by the government, i.e., those earning more than $115,000. Many of these executives, including some middle managers, are eligible for non-qualified executive benefits and need such benefits to ensure adequate retirement income.

Indeed, the retirement planning gap is daunting for many executives, particularly those who are affected by the $17,000 annual limit on individual contributions to a qualified 401(k) plan. The Todd Organization estimates that a typical executive today earning $300,000 who plans to retire in 20 years will be able to receive less than 30 percent of final pay from Social Security and maximum participation in a qualified 401(k) plan.

The “pendulum” refers to several major trends, including the following.

- ***The swing to defined contribution from defined benefit plans.*** The shift in retirement plans is from predictable, fixed payment defined benefit plans to the uncertain payouts inherent in defined contribution vehicles. This well-known, decades-long phenomenon is continuing. Companies are looking to reduce not only their compensation costs but also the variable, unpredictable costs that arise from having poorly performing pension and non-qualified defined benefit assets.

- ***The shift of compensation dollars from retirement planning to near-term wealth creation via expanded equity compensation.*** The pay-for-performance movement has led to the widespread use of stock options, restricted stock, and other equity instruments as compensation vehicles. To be sure, this has had many positive effects at many companies. For highly compensated executives not named in the proxy who for all intents and purposes cannot influence the company’s bottom line, the uncertainty of equity values may be far less desirable than securing greater retirement benefits, especially during volatile market cycles and as one approaches retirement.

- ***A reduction in retirement compensation dollars.*** At many companies, through either design or unintended consequence, retirement program dollars have been reduced over the years. The rising costs of healthcare, a tight economy, and other factors have led to less money for executive retirement programs. Furthermore, with life expectancies continuing to rise, and more executives approaching retirement age, executive retirement programs are of growing importance.

- ***Shareholder activism in the post Dodd-Frank era.*** Amid today's shareholder activism, it is more important than ever that executive benefits be strategically and effectively structured so they retain and attract quality executives. This applies not only to those executives named in the proxy, but also to key executives throughout the company.

What has been the practical impact of these pendulum shifts?

For executives it has often meant a lower amount of retirement funds and far greater uncertainty over the amount of these funds. A prudent goal is for executives to have retirement income that will replace 80 percent of their final pay, adjusted for inflation, over a 20 year or so period. For "non-proxy" executives, this challenge is now daunting.

Because of fluctuation in stock values and company performance there is also generally greater volatility in annual compensation than in years past. This, too, adds to the planning difficulties and uncertainty.

Companies, a.k.a. plan sponsors, also face great challenges in this environment. It is more difficult to retain and attract quality executives who will create maximum shareholder value. The replacement costs and business disruptions from such turnover, as well as lost opportunities for sales and income growth, significantly impact many companies.

While each company's situation is unique and merits individual analysis, there are several general approaches to ensure the best solutions for executives and shareholders, as follows.

- Ensuring that the right balance is struck in compensation between wealth creation opportunities and meeting known retirement needs. As equity compensation is usually more oriented toward wealth building than retirement planning, executive deferred compensation plans are usually a more efficient way to address retirement needs.

- Retaining and attracting executives with competitive benefit packages and avoiding the high costs of executive recruiting and other business disruptions that can occur.

- Gauging the best ways to issue equity compensation. By moving to restricted stock, for example, companies can avoid the potential of issuing options that will be under water, a situation where a compensation expense is incurred without being able to provide a compensation asset.

- Finding ways to guarantee a larger proportion of executive retirement assets is in sought after, predictable returns.

Indeed, executive benefits programs can be designed, financed, and administered so that they create shareholder value, through both direct and indirect measures.

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. 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 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 which provide 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 to 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 to find optimal distribution and re-allocation strategies. Companies can facilitate this via deferred compensation programs.

Regardless of Tax Rate Changes, Deferred Compensation Will Remain Important

The benefits of tax-deferred investing and tax-deferred compounding have long been a hallmark of successful retirement planning. This applies to both qualified and non-qualified supplemental retirement plans.

At this writing, tax rates are expected to rise in 2013, especially on high-income earners. In 2012, some worry that the benefits of executive retirement plans would be significantly reduced by deferring income into a higher tax environment, where taxes at the time of distribution would be higher. Yet, a statistical analysis and review of other important tax factors indicates that deferral will still make compelling sense.

The 2012 federal tax rate is 35 percent above $388,350, for those who are married and filing jointly. To illustrate the impact on deferred compensation plans of potentially higher federal taxes, The Todd Organization compiled the table below comparing pre-tax and post-tax net amounts, based on the following assumptions.

- A one-time investment of $10,000
- The participant is currently in the highest federal tax rate – 35 percent
- The top federal tax rates increases after one year, to 39 percent
- The investment earns 8 percent each year.

TAX RATE INCREASES TO 39%		
	After Tax Net Amount	
Distribution	Pre-Tax Contribution	Post-Tax Contribution
2 years	$6,696	$6,838
3 years	$7,232	$7,177
4 years	$7,810	$7,533
5 years	$8,435	$7,907

As the chart shows, even by deferring into a higher tax environment, the executive will have higher proceeds, in this case a modest $55 at the end of three years. At the end of 5 years, however, the executive will have over $500 more. The gap will continue to grow as time passes, further minimizing the impact of the increased tax rate. The same principles would apply to further increases in income tax rates.

The most significant drawback of higher taxes is when a decision is made to withdraw the contribution shortly after the higher rate goes into effect. Yet, federal regulations already require a minimum of two years before a deferred compensation distribution is allowed for the original election.

As the preceding chart shows, the longer the deferral period, the higher the differential from the non-qualified deferral plan versus strict after-tax investing, even with a future tax increase. The basic principle of deferral investing – having more money to invest initially on a tax deferred basis – results in significantly higher returns than by beginning an identical investment with after-tax funds.

There are other fundamental factors and planning strategies that will make deferred compensation plans compelling, even if there are significant future increases in federal taxes. These include the following.

Specifics of Who is Impacted by Higher Federal Taxes. Much of the 2012 discussion about higher taxes focuses on those currently in the two highest tax brackets, the 33 and 35 percent federal tax brackets. Yet, the 28 percent federal tax bracket, which currently goes up to $217,450 for those who are married and filing jointly, might remain unchanged in such a tax code change. Today, many middle managers, including some earning more than $115,000 (the government's definition for highly compensated) participate in non-qualified deferred compensation plans. In fact, deferred compensation plans are very important for many executives earning less than $300,000 annually.

Likely Lower Tax Rate at Retirement. Most individuals expect to have significantly lower federal tax rates at retirement, as their income will be lower. As such, the returns through deferring pre-tax results in even greater gains.

Beyond Deferred Compensation

Deferred compensation is very popular at companies, because it is a voluntary contribution that executives make. A few companies have even gone so far as to require executives to participate in deferred compensation plans in case they need to "clawback" funds under Dodd-Frank.

Deferred compensation has become an extension of 401(k) contributions, which currently cap out at $17,000 annually for executives under age 50, and $22,500 for those over 50[1]. Tax-deferred growth -- on both the pre-tax contribution and the earnings -- means participants realize significantly higher returns over time compared to an identical investment with after-tax funds.

Other executive benefits play an essential role in protecting executives and their families.

Supplemental executive retirement plans (SERPs) – Modeled after defined benefit pension plans, SERPs provide a fixed, determined benefit to eligible executives. The plans provide stability and assurance in retirement planning, important considerations as executives have a good deal of at-risk compensation. SERP plans are not universally accepted by shareholders so it may be prudent to conduct a peer group analysis as part of the evaluation process. SERPs are commonly found in industries such as healthcare, financial services, manufacturing, and banking.

Supplemental disability insurance – One of the major protections that many executives enjoy is disability coverage. It is not uncommon for a group policy to have a $10,000 per month maximum benefit limit. Another common feature is to have group long-term disability plans replace 60 percent of salary and bonus, with a maximum annual payout of $72,000, or 60 percent of $120,000. Often, though, highly-paid employees mistakenly believe that if their employer provides group long-term disability coverage, it applies to all types of income.

The reality for many executives is that their company-sponsored group disability plan will provide less than 25 percent of compensation, particularly if the executive is heavily incentivized with commissions, stock options, and other forms of merit pay.

To address this, companies can offer supplemental disability coverage. One option is for companies to facilitate supplemental disability coverage through individual policies that can be obtained at group rates because of the large number of interested executives.

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[1] Annual contribution limits for 2012; limits are indexed to cost of living adjustments.

Long-term care insurance – As baby boomers age, the potential need to pay for long-term care -- that can easily cost more than $70,000 annually -- is quite a concern for many highly compensated professionals. In addition to the employee, long-term care insurance can cover a spouse, partner, parents, or parents-in-law.

Long-term care insurance plans are attractive to companies because the employer-paid premiums on behalf of employees are not included as income to the employee and are tax deductible to the company. The benefits received usually are not taxable to the employee. Companies can also carve out a select group of highly-valued employees when implementing long-term care insurance.

Death benefit plans – In death benefit plans, the employer makes a legally binding promise to pay a set amount for a set period of time if the executive dies during employment or retirement. The company typically purchases a life insurance policy on the life of the employee. The growth in the policy's value and death proceeds enable the company to recover its costs.

Deferred Comp Matches: Why They Make Sense

Approximately half of the companies offering deferred compensation plans also offer match contributions of some kind. Not surprisingly, companies with matches have higher executive participation rates, approximately 46 percent, compared with 33 percent participation in plans without a match.

Yet, there are other good reasons why companies implement these matching programs. For example, vesting provisions for matches can serve as incentives and golden handcuffs for highly compensated professionals.

The Need

Executives face many challenges in accruing adequate retirement income. A typical executive today earning $300,000 with plans to retire in 20 years will receive less than 30 percent of final pay from Social Security and maximum participation in a qualified 401(k) plan.

As executives near retirement, they tend to want to save a good deal more. This often happens if college tuitions have just been paid or the executive made a mid-career move to a new company and has to replace forfeited pension benefits from the previous employer.

Many executives anticipate being in a lower tax bracket upon retirement. So, the need to defer and have matching amounts for those deferrals is a very valuable proposition.

Issues of Parity and Fairness

Companies often provide some type of matching contribution on approximately the first six percent of pay that is deferred into qualified 401(k) plans. This is regarded as a valued form of compensation that helps meet employees' needs while helping the company retain talented professionals and attract new ones.

These same principles should apply to non-qualified 401(k)s and related deferred compensation plans. Actually, the executives who want to participate in these plans typically have a much higher percentage of their annual pay that is not set via salary. It is at risk because of such factors as commissions, individual performance bonuses, and the company's overall performance.

Furthermore, many highly compensated executives cannot make even the maximum legal contribution into the company's qualified 401(k) because federal testing rules can reduce the amount that may be deferred. And, the law prohibits company 401(k) matches on pay over $250,000. A company match in a non-qualified deferred compensation plan can make up for this disparity.

Participating in a deferred compensation plan also can provide balance and diversity to the executives' stock options and related equity programs.

Using the Match as Golden Handcuffs

With a match program, companies can institute various vesting provisions and requirements. Matches can be tied to individual, group, or company performance.

In general, the plans can be structured to require an executive to stay for a given period before receiving the match. And, for the company's protection, it can be designed so that if an executive is terminated for cause before retirement, some or all of the match will not be granted.

Because it is as a debt instrument that is on the company's books, the deferred compensation matching contribution provides added incentive for executives and participants to manage the company so that it does not take undue risk. This way their interest is aligned with debt holders and shareholders.

A Guide to Executive Benefit Technology

Whether a company offers a deferred compensation match, a series of executive benefit plans, or is just getting started with design and implementation, it is extremely important to have high-quality, advanced technology to implement a plan.

Today, many companies want a common access point for all of their executive benefit plans so they can see information specifically about both the non-qualified plan and the qualified plan. Current, aggregated data is important. Dashboard illustrations that provide clear and concise summaries of an executive's financial standing and recent changes also are in high demand.

Given the sensitivity of executive benefits information and the apparent hacking attacks many companies are suffering, protecting data is very important both for competitive purposes and avoiding embarrassment.

At the same time, because many companies run diverse operations with time-pressed executives often on the road, ensuring secure and private access to plan information becomes especially challenging.

When it comes to executive benefits technology, there are three areas where excellence should be the standard.

Customized Approach

No matter how complex the company's executive benefits or the number of participants, plan sponsors want the administration and related technology to be user-friendly. In practical terms, this usually means:

- A professionally staffed client service center that addresses the concerns of participants and plan sponsors.
- Online tools and resources to streamline plan administration.
- A full suite of communications approaches to educate executives about non-qualified plans, including webcasts, videoconferences, and teleconferences.
- Online enrollment and performance statements.

Provider's Knowledge and Skills

To keep up with continuous changes in plans pertaining to variations in investment values, allocations, or distributions, plan sponsors often want to work with firms that have experience in the specialized area of non-qualified plan administration. With stricter compliance issues and regulations that must be carefully watched, expert technical administration and systems are essential.

For accounting and financial reporting purposes, it is also important that technology applications on non-qualified benefits are integrating with the corresponding systems and processes at companies. The plan provider should have well-established relationships with the insurance companies and mutual funds that are involved with the executive benefits to ensure timely and accurate information.

Solid Infrastructure

Another critical area to address is an ample, scalable data center for the technology. Required items include a power supply that is not interruptible, backup power, and fire protection (through an inert gas suppression system).

Total Plan Management

While high-quality, advanced technology is important to implement and administer plans, companies also find it helpful to take a total plan management approach to their qualified and non-qualified retirement plans. Regardless of how the pendulum swings on executive benefits in the coming years, total plan management seems likely to become the common, standard practice for administrative excellence.

Total plan management often includes the following.

Integration of qualified and non-qualified plans. Because companies want to streamline their information and systems, they prefer solutions that will provide information about qualified, non-qualified, and equity plans at a common access point. With a single location for important information, plan sponsors and plan participants can easily access it, reducing lost time, confusion, and potential errors.

Anticipating and addressing corporate transactions. Mergers and acquisitions temporarily can result in a company managing different plans with different provisions. It is important to anticipate this to ensure continuity and consistency in this key component of compensation that could vary significantly among members of an executive team. By planning for these issues and quickly addressing them head-on, companies will ensure a smooth transition while retaining important executives.

Comprehensive evaluation and management of plans. Many companies maintain several non-qualified retirement plans instituted at different times for different divisions with varying provisions. By evaluating, managing, and communicating this information completely, including monitoring investment performance, companies will ensure that the plans make sense for sponsors and participants.

Enrollment season. Once a year, typically in a company's fourth quarter, non-qualified plan participants have an opportunity to change their deferral allocations. Many companies want to make sure this time includes access to the plan provider in meetings, over the web, or by phone. This often will be the most significant action the company takes on its executive benefits during the year.

Participant service. With a call center staffed with helpful experts throughout the day, companies can underscore the value of executive benefits and make sure they are meeting executives' needs. Questions about plan allocations and retirement objectives also can be answered. If a participant dies, spouses, loved ones, and beneficiaries can obtain helpful guidance and plan overviews.

Simplifying the complex. Non-qualified plans cover complex tax and regulatory matters, and they are important in financial and accounting reports. For executives, whether during the annual review process or other inquiries, the language can be arcane and daunting. As such, companies find it best to receive communications that are accurate, clear and concise, i.e., in plain English.

Single point of contact. For an efficient and smooth process, companies benefit from a single point of contact to answer their inquiries. This person should be backed up by a skilled, multi-discipline team.

Thinking Years Ahead

It is important that plan sponsors and providers should periodically take a long-term, visionary view of the economic landscape so executive benefit plans will thrive and pass the many tests of time.

The very foundations of America's financial system were shocked in 2008. Many prestigious and highly leveraged institutions, once perceived as immune to downfall, fell or had to be rescued.

So, it is more important than ever to work with financial firms that have the highest credit ratings and a long history and firm commitment to their industry.

Because of the numerous changes and uncertainties in the financial world, companies can know that their executive benefits plans make sense today and tomorrow by following these core principles:

- ***Safety and security is paramount.*** With all the market fluctuations, executive turnover, and the changing business dynamics and focus of successful corporations, some things remain clear. First, baby boomers will continue to age. With current shortfalls in savings, they will want to earn and save greater amounts for retirement. In all likelihood, they will place even greater value on executive retirement plans in the years ahead.

- ***Anticipate change.*** It is important to use systems and procedures that are ready for changes in the markets and executives' preferences in retirement plans. This includes being ready if the company faces a takeover, friendly or hostile. Employing a rabbi trust with clear provisions provides important peace of mind now and in the future.

- ***Financing plans.*** To maximize shareholder value and promote prudent asset-liability management, companies that have not financed executive benefits should do so. This applies to both public and private companies.

Since pioneering the non-qualified retirement plan industry in 1957, The Todd Organization has seen many changes in the field. We know that providing customized, value-driven plans that help companies retain and attract teams of quality executives will continue to be important. As in the past, we are committed to focusing on this business.

However the pendulum swings, in the near term and long term, we understand that executive benefits are important for generating maximum shareholder value, meeting executives' needs and those of their families, and helping companies manage their business smoothly and effectively.

We look forward to continuing this work with companies in all major industries, helping them focus on growing their business and meeting their missions.