



March 15, 2006

# *Supplemental Executive Retirement Plan (SERP) Design and Securitization*

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# SERP Design and Securitization

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- ❑ Basic Concepts
- ❑ Why Is This Important Now?
- ❑ Key Design Considerations
- ❑ Approaches to Securitization

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- ❑ SERP Design – Basic Concepts
  - ◆ Defined Benefit vs. Defined Contribution
  - ◆ Excess vs. “True” SERP
  - ◆ P/L Impact (FAS 87)

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## Defined Benefit vs. Defined Contribution

### **SERPs**

- Provide guaranteed level of lifetime income
- Investment and demographic risks are borne by the company
- Provide a more effective target level of retirement income
- Powerfully attract and retain key executives

### **Nonqualified Deferred Compensation**

- Allocate annually to an executive's account
- Investment and demographic risks are borne by the executive

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## Excess vs. “True” SERP

### **Unlike excess plans...**

- ◆ SERPs target to a smaller, more select group of executives
- ◆ SERPs generally offset amounts payable from other plans (e.g., Qualified DB Plan, Social Security) and are usually customized for a specific group of executives
- ◆ SERPs can have very different benefit levels or plan features for different executives
- ◆ SERPs have a wide range of design features

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## P/L Impact

- ❑ Under a NQDC Plan, annual expense equals company allocation plus interest credit on existing account balances
  
- ❑ SERPs are accounted for under FAS 87
  - ◆ PV of all future benefits eventually reflected on financial statements
  - ◆ Liability recognized over the average working career of the covered group
  - ◆ Assumptions used in determination of PV generally under company control but significantly constrained by SEC and FASB guidelines

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## Why is this important now?

- ❑ New SEC Proxy Disclosures increase the visibility of existing SERPs
- ❑ Required Expensing of Stock Options under FAS 123 makes SERPs a potentially cost effective alternative
- ❑ Frozen Qualified DB Plans have left many executives with inadequate retirement income (almost 20% of Fortune 1000 plan sponsors have frozen their plans since 2003)
- ❑ Mid-career recruitment and long-term retention remain major issues

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## Key Design Considerations

- Mid-career recruitment
- Retention and succession planning
- Performance incentives
- Cost effectiveness

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## Recruiting Mid-Career Executives

- Some examples of SERP design features that can facilitate the recruitment of mid-career executives include:
  - ◆ Front-loaded accrual formulas (e.g., 3% of FAP for service < 10 and 2% FAP for service > 10)
  - ◆ Use of an aggregate retirement income target (e.g., 60% of FAP) prorated over service to age 65
  - ◆ Benefit and/or vesting credit for industry or prior company service
  - ◆ Separate tier of benefits for mid-career hires

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## Retention and Succession Planning

- Back loaded accruals
- Extended vesting periods
- Individually tailored early retirement provisions
- Inclusion of incentive compensation definition of pensionable earnings

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## ❑ SERP Design – Offsets

Many plan designs reduce SERP benefits based on amounts received from other programs. The following is a list of common offsets:

- ◆ Qualified Plan
- ◆ Social Security
- ◆ Company Match to 401(k)
- ◆ Other Nonqualified Plans
- ◆ Former Employer Qualified Plan
- ◆ Disability Payments

Each of these offsets reduces the company cost for the plan.

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## Cost Effective Strategies

- ❑ The use of participation vs. vesting requirements can significantly reduce population to be valued (and therefore expense)
- ❑ Tailor accrual pattern for group to be valued
- ❑ Manage average age of plan(s) by judicious merger and/or splitting of SERPs
- ❑ Utilize a Cash Balance design structure
- ❑ QSERP part of benefit to lengthen amortization period
- ❑ Other strategies may be available depending on existing plan structure and demographics

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## Performance-Based SERPs

- ❑ By amendment (career contribution approach) or prospectively (future accruals to vary by performance against targets)
- ❑ Both approaches can be implemented to minimize P/L impact, but prospective approach entails more financial risk
- ❑ Assumption setting process for prospective approach can be challenging

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## ❑ SERP Design – Performance-based

The Performance-based SERP is designed as a defined contribution method similar to a 401(k) plan. Basically, the employer tracks each executive's SERP benefits as an account balance payable after the executive terminates employment.

Until the time the executive terminates employment his deferred compensation grows in two ways:

- ◆ Employer Contributions
- ◆ Earnings on Past Credits

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## Employer Contributions

The central component to a defined contribution SERP is a formula by which the employer commits to make regular credits to the executive's account.

- ❑ Credits are made as a percentage of the executive's pay with the percentage fluctuation based on previously defined measures of corporate performance.

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## Employer Contributions *(continued)*

Example:

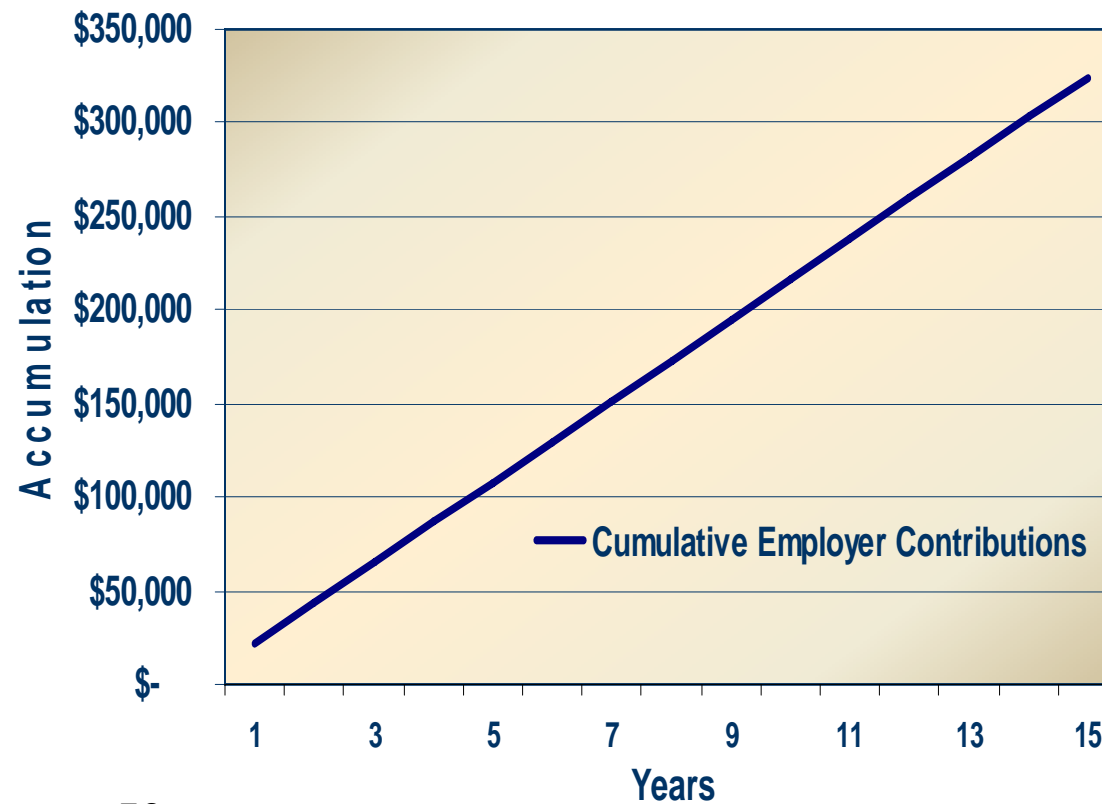
- ❑ 2% of pay is targeted as annual credit for satisfactory performance, based on ROE, which is targeted to be 16%.
- ❑ The SERP formula could provide for annual credits equal to one-eighth (1/8) of ROE times the executive's base pay.
- ❑ A minimum percentage could be established, such as 1% of pay if the employer wants to ensure some minimal accrual toward supplemental retirement benefits.

**Note:** Vesting – The employers' contributions would be subject to vesting.

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## Employer Contributions *(continued)*



- Executive age 50
- Formula 2% of base pay earning 7% annual
- Salary \$150,000

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## Earnings on Past Credits

The employer may secure significant accounting benefits by tracking each executive's benefits in the form of deferred shares of employer stock. If this is done, no expense arises from appreciation in their value.

An employer may instead opt to pay SERP benefits in cash, or to measure the earnings on SERP accounts by a measure other than stock price.

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## Earnings on Past Credits *(continued)*

Many choices for crediting interest or earnings to the executive's account exist.

Some of the most common are:

- A fixed or market interest rate, such as prime;
- A corporate performance measure such as a percentage of ROE; or
- A mutual fund investment selected by the employer (often to mirror 401(k) plan choices).\*

\* Could allow executives to self-direct.

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## Approaches to Securitization

- QSERP
- Rabbi Trust
- Secular Trust
- Other

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## QSERPs: “Ideal” Securitization Method and Reduction of SERP Expense

- ❑ SERP benefits are transferred to QSERP by simultaneously amending the SERP to reduce benefits and the Qualified DB Plan to increase benefits for executives.
- ❑ 401(a)(4) General Test provides a means to prove QSERP complies with nondiscrimination rules.
- ❑ Complete transfer of liabilities is not usually possible, but for amounts transferred complete security and tax sheltering is obtained.
- ❑ FAS 87 expense is reduced due to amortization period arbitrage.
- ❑ Other financial benefits include reduction in Medicare taxes and potential excise taxes under 280G.



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