12 | 2012
workspan
The Magazine of WorldatWork©

Executive Retirement Readiness

Optimizing the Succession Pipeline

Prepare your executives now for a prosperous retirement.

Succession planning is a critical process for most organizations, ensuring that the right bench strength is in place, and identifying and grooming key talent to move into executive roles. But what happens if current executives are financially unable to retire when planned?

Indeed, more and more executives, not unlike the rest of the workforce, are struggling with personal retirement issues. In recent years, many employers have scaled back on generous executive retirement programs, creating a gap in retirement readiness for many executives. These gaps can result in fewer and slower retirements among current executives— and may create important organizational risks, including:

- Inability to promote skilled, ambitious and marketable younger executives who may instead leave the organization
- Incumbent leaders whose proximity to retirement may reduce their motivation to drive major change and innovation because of the complexity, effort and time horizon involved
- Decreased motivation among midlevel managers to engage in development activities and stretch performance because of limited promotional opportunities that would reward those efforts.

Let's look at some key forces contributing to the decline in executive retirement readiness, how market practices are evolving in response to this issue, and actions that employers can take to optimize the effectiveness of their executive retirement programs and link them to succession planning efforts.

By Doug Frederick, Heidi O'Brien and Bruce Barge, Mercer

The Brewing Dichotomy

Employers have continued to shift from defined benefit (DB) plans to defined contribution (DC) plans This shift has two key implications for employees: 1) employer-paid benefit levels are lower (DB plans typically provide a more generous benefit than DC plans); and 2) employees are increasingly subject to investment risk (in a DB plan, the employer assumes the risk of investing assets to meet the promised benefit). Because the shift from DB to DC plans has happened gradually, there is often a wide range in the benefits provided within a single organization. This has a real impact on retirement readiness, an essential complement to succession planning. Employers must adapt their strategies accordingly.

How Have Executive Retirement Benefits Changed?

In addition to the basic qualified plans (pension and/or 401(k)) provided to all employees, the majority of organizations provide nonqualified plans to executives. These plans became popular because of IRS limits affecting qualified plans, such as pension and/or 401(k) plans. Some nonqualified plans simply allow executives to defer their pay on a pretax basis, and some plans provide employer contributions or accruals.

While the prevalence of employer-paid nonqualified plans has remained fairly constant over the years, benefit levels from these plans have declined as plans shift from DB to DC, and as employers scale back more generous programs in light of increased shareholder, government and media scrutiny of all forms of executive pay. As illustrated in Figure 1, 77 percent of Fortune 500 companies still provide employer-paid nonqualified benefits to new-hire executives. However, only 33 percent of Fortune 500 companies provide a nonqualified DB plan to new hires compared to 51 percent in 2007.

In addition to providing employer contributions and/or accruals into nonqualified plans, many employers sponsor voluntary deferred compensation (VDC) plans. VDC plans are nonqualified plans that allow executives to defer their own pay on a pretax basis (similar to a 401(k) plan, but without IRS limitations on the amount that can be deferred).

> While the prevalence of employer-paid nonqualified plans has remained fairly constant over the years, benefit levels from these plans have declined as plans shift from DB to DC.

VDC plans are prevalent; more than 80 percent of Fortune 500 companies offer such plans to their executives, although many employers saw lower VDC plan participation during the economic downturn because of lower annual incentive payouts and other financial concerns. However, we are seeing a reversal of this downward trend as annual incentive payouts return to more normative levels.

The combination of lower employer-paid value and lower historic participation in VDC plans does not bode well for executive retirement readiness and smooth succession planning. Communication is critical in addressing this issue for two key reasons: 1) many executives do not understand how much they need to save in order to retire as planned; and 2) many underestimate the economic merits of pretax deferral, especially in a changing — and potentially increasing — tax-rate environment.

How Much Do Executives Need to Save?

How much income an individual needs to meet retirement objectives depends on a number of factors, but income replacement of 70 percent to 80 percent of annual cash compensation is the common rule. For example, an executive with $400,000 of preretirement income needs sufficient savings/benefits to generate $280,000 to $320,000 in annual income each year for the rest of his/her lifetime. For those fortunate enough to have participated in generous DB plans for many years, the DB program alone may generate 50 percent or more of final average cash compensation after a full career. But for many without DB plans, reaching that 70 percent to 80 percent threshold is becoming increasingly difficult.

A relatively competitive 401(k) program, and associated nonqualified plan, would provide executives a total contribution of approximately 6 percent of cash compensation. Assuming an executive's individual savings rate is 10 percent of cash compensation annually, what level of income replacement does this combined 16 percent savings rate yield?

The answer is only 35 percent after 20 years. And after 30 years of savings at 16 percent, the projected income replacement level is still only slightly above 50 percent, well below the more comfortable 70 percent to 80 percent targeted level. As illustrated in Figure 2, a savings rate of 25 percent or more annually (from employer and employee contributions combined) over 30 years is expected to provide income replacement of 80 percent. But an increasing portion of this 25 percent must come from the executive's own savings, which are highly subject to market fluctuations.

What these numbers don't take into account are the nuances of individual situations: how much has been saved, how much more/less needs to be saved given spousal income, whether more or less than 70 percent to 80 percent may be needed given relocation post-retirement to another area and so on.

Thus, it is critical that executives have access to modeling and planning tools to understand how much savings is needed based on their personal situation, and how their savings requirements differ under various scenarios (differing investment returns, differing retirement ages, etc.). As employers scale back on their portion of the retirement value, it is more important than ever to arm executives (and all employees) with the tools to determine how they can meet their retirement objectives.

Tax Rates and the Economics of Pretax Deferral

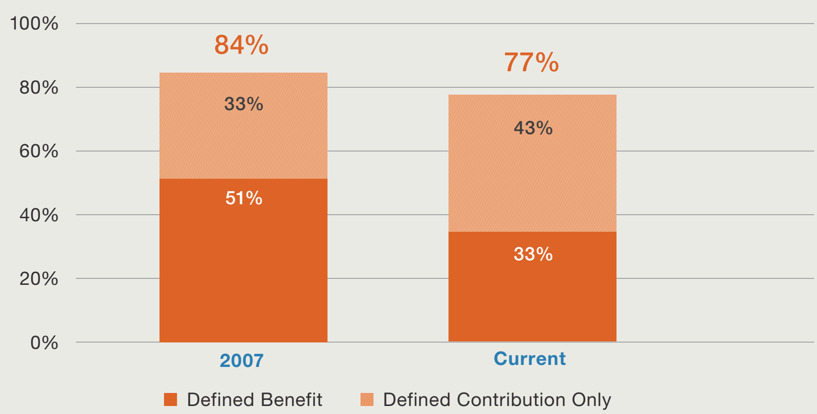
Potential tax rate changes are a meaningful source of confusion for many executives in determining whether to defer pretax compensation into a VDC plan. Whether deferring makes economic sense depends mainly on two factors: 1) years of deferral (how long the deferred compensation will remain in the plan); and 2) expectation of future tax rates.

If there is a long time horizon or if tax rates are expected to be lower at the time of benefit payment rather than at the time of deferral, deferred compensation is extremely advantageous. If tax rates remain constant, the merits of pretax compounding make deferred compensation attractive as well. However, many do not realize that deferred compensation can be advantageous even when post-retirement tax rates are higher than tax rates at the time of deferral.

Figure 3 illustrates the advantage and disadvantage of pretax deferral relative to investing after-tax compensation, based on various deferral periods and future tax rate scenarios. As expected, the advantage of deferring is greatest with longer deferral periods and lower/constant post-retirement tax rates. Even with higher post-retirement tax rates there is still, in many cases, an advantage to deferring, because of the value of compounded tax-deferred growth. As a general rule, a 1 percent increase in post-retirement tax rates can be offset by an additional one year of deferral. Those with a shorter deferral timeframe should be sure to review the impact of expected rising tax rates before choosing to defer. But for those with longer deferral horizons, the economics of pretax deferral are more than likely to be favorable, even if tax rates rise.

Another consideration is the individual's income level at the time benefits are paid (often at retirement).

Figure 1 | Prevalence of Employer-Paid Nonqualified Plans Among Fortune 500



Source: Mercer's Executive Benefits Research Tool

Figure 2 | Retirement Income Replacement Resulting in Various Savings

Years of Savings	Annual Savings as a Percent of Compensation			
	5%	10%	20%	25%
5	2%	5%	9%	12%
10	5%	10%	20%	25%
20	11%	22%	44%	54%
30	16%	33%	66%	82%

Assumes 7 percent annual pretax investment return

Figure 3 | Relative Gain: Pretax Deferral vs. After-Tax Investment

After-Tax Gain From Deferral			
Deferral Period	Tax Rate at Deferral/Distribution		
	40%/35%	40%/40%	40%/45%
5	20%	10%	1%
10	32%	22%	12%
15	46%	35%	23%

Assumes 7 percent investment return; annual earnings on after-tax investment 50 percent ordinary income/50 percent capital gains

For most individuals, income drops significantly at retirement. So even if tax rates in general are higher at retirement, the individual may be in a lower effective tax bracket at that point because of the decline in aggregate income. To help executives understand potential outcomes, VDC plan sponsors should provide executives with access to modeling tools on the plan website, so that executives are fully informed when choosing whether to defer pretax or invest after-tax compensation.

Retirement and Succession Success

Organizations have typically relied on retirement as an essential complement to succession planning, enabling the right people to move into key roles while allowing recognition of past service and contributions. As retirement readiness becomes more challenging, employers need to understand the implications for succession planning and adapt their strategies accordingly. Obviously, the right retirement and succession decisions will differ based on individual and organizational factors. However, the following actions can help employers and executives be better prepared and provide more options to meet individual and organizational goals.

Organizations have typically relied on retirement as an essential complement to succession planning, enabling the right people to move into key roles while allowing recognition of past service and contributions.

1 Provide robust communication and tools. As discussed throughout this article, clear communication and access to modeling tools are critical in helping executives understand the magnitude of their own savings responsibility. Even if an employer has a VDC plan, it must be well-communicated or executives may not take full advantage of the program. Thus, having educational materials and modeling tools available on the plan website is important, so that participants (and/or their advisers) can understand how changing tax rates and other factors have an impact on their benefits, and so that participants are able to make the best decisions for their individual situations. Some employers provide executives with access to financial advisers, who can further help executives determine the proper approach to reaching their desired retirement income level.

2 Assess employer-provided value. While many employers have reduced benefits to save costs and better align with a changing market, the implications of those reductions are causing some to rethink their approaches. To help mitigate the impending problems with retirement readiness and succession planning, some organizations are considering improvements in employer-paid retirement value. While we don't see a wholesale return to DB plans on the horizon, there are some employers who are choosing to amplify their DC programs to alleviate future succession planning issues.

This may take the form of an across-the-board increase in 401(k) contributions, the adoption of a nonqualified DC plan for executives, or individual executive agreements with contributions that vest in a particular year. Those contributions would serve two purposes: 1) promoting executive retention to the vesting date; and 2) better enabling the executive's retirement and a smoother succession/transition for the talent bench below that executive.

Employers who are considering increasing executive retirement benefits must strike a careful balance: more meaningful benefits can alleviate retirement readiness concerns, but benefits that are too generous (especially relative to rank-and-file programs) can draw scrutiny. It is important not only to understand how benefits stack up relative to market practice, but to gauge the impact of those benefits on the total executive pay package and how the package stacks up to market comparators.

3 Review bench strength and related risks. An understanding of retirement readiness must be balanced by knowledge of the potential successor group, including the number, level of readiness and capabilities of these future leaders. The succession planning process must provide that

go To read a *workspan* article about this topic, visit www.worldatwork.org/workspan.

information and allow informed discussion of questions such as:

- Which leadership roles are most critical to the organization's future success and what is the retirement status of incumbents in those roles?
- Which future leaders are potential flight risks because of trained advancement opportunities?
- Are pay, equity and retirement programs (and related vesting) sufficient to promote retention of key incumbents and successors?
- Does the organization need to better understand what matters to career and retention decisions for key leaders and succession candidates?

Conclusion

The objective is to bring together information from succession planning with the design of retirement/rewards programs and communications, enabling effective decisions for the welfare of valued employees and the business.

If anything, companies must adapt to a new reality, as the decline in employer-paid retirement benefits has created an emerging generation of employees who face steep challenges in achieving retirement readiness. Employers have a critical responsibility to educate them on how to achieve retirement readiness given their increased savings responsibility. The sooner an organization addresses — and, if necessary, retools — its retirement programs, communication and succession planning strategies, the better prepared the organization will be to adapt in an increasingly challenging environment successfully. The overarching goal is to develop and retain executive talent for the future — and ensure that those leaders are more than ready for successful retirement. ws

Doug Frederick is a partner and leader of Mercer's U.S. executive benefits group in Louisville, Ky. He can be reached at doug.frederick@mercer.com.

Heidi O'Brien is a partner in the executive benefits group at Mercer in Los Angeles. She can be reached at heidi.obrien@mercer.com.

Bruce Barge is a partner in the talent management practice at Mercer in Los Angeles. He can be reached at bruce.barge@mercer.com.

resources plus

For more information, books and education related to this topic, log on to **www.worldatwork.org** and use any or all of these keywords:

- Retirement readiness
- Retirement planning
- Executive retirement benefits.