A Smart Approach to Supplemental Retirement Plans is Good Business

by **Barry N. Koslow, JD** President/CEO, MKA Executive Planners

SNAPSHOT

Recent economic upheaval has led to increased criticism of senior executive compensation with calls for reform and change. New approaches are emerging that more definitively tie compensation to organizational goals creating a win-win for all.

THE CURRENT ECONOMIC crisis has brought a new focus on compensation and whether true or not, a mounting criticism on the way that senior executives are compensated. In addition to the focus on salary and bonus, benefits, especially those dealing with executive retirement programs, have become subject to much criticism based on greed – sometimes real, sometimes perceived.

The spotlight on what critics have called over the top salaries, bonuses, fringe benefits and retirement programs has caused advisors, consultants, shareholders and directors/trustees to pause and take a second look at compensation programs at their companies and institutions. This is occurring not only at the large organization, but at mid-size and smaller ones as well. The activity has become, in some instances, ready-fire-aim, rather than a thoughtful analysis of what compensation is appropriate.

Executives are Often Victims of Biases Among Constituencies

THE STAKEHOLDERS IN ANY organization are diverse. A short list includes owners, shareholders, community, customers, employees, and directors/trustees, as well as federal, state and local governments, not to mention the media. It is not unusual for stakeholders to have conflicting interests and points of view. Concerns about executive compensation can truly be in the eye of the beholder, creating a focal point that not only creates potential ill will across a number of stakeholder groups, but can mask other issues such as organization mission, vision and its goals (financial or otherwise).

The supposed new paradigm is that compensation should be aligned with organization goals in such a manner as not to distort mission or promote activities that meet short-term targets at the expense of the long-term mission. The biggest areas of concern are bonus programs, incentive plans, termination packages and retirement arrangements. It should come as no surprise that this is not a new concept, just one that has been off target in highly visible situations.

Directors and trustees of organizations, both for profit and not for profit, should be designing bonus and incentive programs (whether cash or equity) that meet long-term goals with payouts or credits for achieving the intermediate steps that attain them. There should be oversight to confirm results and a method of payback (sometimes called "clawback") if the initial results are not confirmed. The degree of complexity of a bonus or incentive plan will vary with each organization and cannot be covered in an article such as this. Many consultants are rethinking their approach to this area of compensation and will be proposing new models in the near future.

Retirement programs have a somewhat different role. They are for the most part intended to be post-retirement security. They are unlike bonus, incentive or stock programs, such as options, which are meant to align executive interest with those of shareholders and often have a shorter time frame than an executive's retirement date.

Over the last decade, the United States has seen a dramatic change in retirement plans as we switch from defined benefit (a specific benefit, generally a percentage of salary based on the number of years of service) to defined contribution (a specific percentage of pay is contributed, often at the discretion of the employer). Defined contribution plans are generally in the form of 401(k) Plans, which allow personal contributions (sometimes matched by the employer by formula or discretion).

Executives Face Poor Replacement Income Ratios at Retirement

TYPICALLY, DEFINED BENEFIT plans work best for the long-term, older employee, while defined contribution plans work better for the younger more transient employee. Defined benefit supplemental plans are also used to recruit and retain senior executives, especially those with a limited number of years until retirement. Because of qualified pension plan limitations, short periods of service and promotion from lesser positions, senior executives are generally faced with replacement income ratios that are less than one-half of the average employee at their organization.

In the past these programs may have focused on the executive's need, desire or what the competition provides, rather than on a formula that ties the executive's retirement situation to income replacement ratios that are the equivalent to the typical organization employee.

A New Model with Potential For A Win-Win

A NEW MODEL MIGHT provide an income replacement ratio that is similar to that of the average employee in the organization with "add-ons" that are earned based on achieving subsets of the organization's goals, including financial, product mix, service mix, etc.

While this new approach might require more attention and planning than the traditional supplemental retirement plan, it has the advantages of providing a specified level of security along with additional benefits that reflect the success of the organization. It also provides recognition of the continuing increase in public transparency and reputation risk by giving the decision makers a program that is reasonable in approach and tied to organization long-term goals. MKA

BARRY N. KOSLOW, JD*
PRESIDENT/CEO

Barry is the founder, President and CEO of MKA Executive Planners, a nationally recognized firm with expertise in benefits and insurance programs for financial institutions and tax-exempt organizations. At MKA, we have over 35 years experience working with executives, with a particular focus on retirement and deferred compensation.

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mka Executive Planners

12 Gill Street, Suite 5600
Woburn, MA 01801
781-939-6000
800-332-2115