An Invitation to Join a Dialogue

Most deferred compensation plans are significantly underfunded due to the inaccuracy of the underlying assumptions. Other "Design" options are dependent on the accuracy of these assumptions as well. The goal of these articles is to explore ways to spend less money … not more … and to do so more intelligently. This article discusses how the industry has recently responded to the pressure resulting from long-standing inaccurate assumptions.

The Result of Inaccurate Assumptions

As shown in our previous discussions, rates of return, volatility and life expectancies have converged to create the perfect storm relative to executive retirement benefits. Regardless of the type of deferred compensation plan, the result has been either substantial underfunding (defined benefit) or substantially less retirement income to the executive (defined contribution).

Responsible boards and their advisors are aware of these developments. How have they typically elected to respond?

Circle the Wagons

From my many discussions with leaders in the industry, I see two disturbing trends:

1. Ignore the Outcome – The most obvious example of this was the shift from defined benefit plans, where the organization was at risk for the inaccurate assumptions, to defined contribution, where the executive was at risk. Organizations have the benefit of actuaries and consultants that can quantify the impact of inaccurate assumptions, but the executive rarely does, and many organizations have not translated the impact of inaccurate assumptions into a resulting retirement income stream. This becomes a significant issue when the executive approaches, or arrives at retirement and finally focuses on this issue, many times too late to rectify.

But the more disturbing, and more recent trend has been the movement from "target-benefit defined contribution," where at least there was an attempt to translate the amount of the defined contribution into a reasonable amount of retirement income, to "industry-comparable defined contribution," where there is no attempt at such translation or a correlation to income. In other words, the organization will make annual contributions to some plan without even attempting to measure or predict the resulting retirement income.

2. Shorter Deferral Periods – Anticipated changes to the regulations concerning deferred compensation and specifically Section 457(f) has eliminated many of the tools, used in the past, to defer income recognition. Essentially the only remaining deferred compensation vehicle is one that may not be appealing to the executive … a full cliff vest with 100% forfeiture exposure until vesting. These developments have been used as a reason to dramatically shorten deferral periods. I have seen 5, 3 and even 1-year deferral periods being used.

The trend towards shorter deferral periods due to changing regulations is a red herring in my view. If organizations assume that deferred compensation is the only way to deliver a retirement benefit, and vesting and taxation are inextricably linked, then the natural result will be shorter deferral periods. Nevertheless, deferred compensation is only one of many ways to deliver a retirement benefit, as we will discuss in future articles.

Say Goodbye to Retention Value

These are disturbing trends because of the impact they will have on executive retention. Most boards agree that their organization has a responsibility to provide a reasonable retirement benefit…in exchange for an extensive period of satisfactory service.

How do we know if an annual retirement contribution will result in a reasonable retirement benefit, unless we take the responsibility and ownership of understanding the assumptions and translating the result? With hospital CEO turnover at 18%[1], how do we expect an untranslated annual

[1] American College of Healthcare Executives, March 5, 2015

contribution to be meaningful to the executive, thereby incentivizing the executive to continue with the organization?

Moreover, how does cutting a check to the executive every few years accomplish this goal? Frequent payments provide very little, if any, stickiness to the organization; In addition, if executives get the money prior to retirement, do they save it for retirement, or do they view it as additional compensation and spend it? My sense is that the answer is "both." While most executives save for retirement, it is simply too tempting not to incorporate some of this additional income, pre-retirement, into their lifestyle. If this is the case, then the target amount of retirement income (the "how much") has been compromised.

And A Word About Community Mission

Shorter deferral/payout periods, resulting in additions to executive compensation during their pre-retirement years, do not support a non-profit's community mission. We can no longer argue that these payments retain the best talent. This adds to the growing pressure by the public to justify these arrangements.

Why Does This Matter?

It does not have to be this way. In a future article, we will explore other design options for retirement that creates deferral and does not put the cash in the hands of the executive over short periods. The starting point for this discussion is an understanding of the difference between "How Much" and "How," which can expand your circle of advisors and offer numerous alternatives to consider.

Over the next several weeks, I will continue to publish a series of "bite-sized" articles, elaborating on each of these issues in cooperation with other industry experts and based on feedback I receive from the healthcare community. Please join in the discussion!

Victor V. Buzachero serves as Corporate Senior Vice President for Innovation, Human Resources and Performance Management at Scripps Health in San Diego, CA.