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SERPs - A Perspective for Directors

By Allan Mosher

Supplemental Executive Retirement Plan (SERP) liabilities are increasingly on the presses radar. The interest is the effect of SERP liabilities on listed corporations and, reaction of shareholders many, seeing their own retirement plans in shambles over declining share values.

As other employees, high earning executives have the same entitlement to a pension of 2% x years of service x final average earnings. However, the resulting benefit can greatly exceed the current defined benefit pension cap of $89,237 annually. To cover this "shortfall", most corporations establish a SERP (some secured by a letter of credit) for the excess. Generally, they are unfunded with benefits paid post retirement from cash flow on a "pay-as-you-go" basis. They reduce reported profits, but if unfunded are not deductible and corporation pays income taxes on the unfunded amount. But, what about Enterprise Risk?

Enterprise Risk

Enterprise risk management involves identification of events or circumstances, assessing the level of risk and implementing a response strategy.

There are concerns:

- From a company's perspective, the liability is open ended, a potential drain on future cash flow and, shareholder concern.
- From an executive, anxiety over the security of the SERP, and potential effect on quality of retirement.

Directors (particularly those on compensation committees) should focus on the real impact of SERPs, not just the current accounting liability.

1. Letters of Credit need to remain in place through retirement.
2. Could the compounding of LCs effect renewal and/or impact a company's ability to finance.
3. Executive compensation and longevity are increasing. Are SERP reserves?
4. Shareholders are demanding increased transparency on all executive compensation.
5. The morale of executives running the company if they are concerned over the security of SERP promises.

Challenge

It is no wonder that studies have shown executive compensation to be one of the biggest challenges facing public corporations and their directors.

The irony & oxymoron, is that, corporations can secure and fund SERP liabilities through Retirement Compensation Arrangements (RCAs) under the Income Tax Act. They have not been doing because of (I) current impact to cash, and (ii) investment inefficacy resulting from the RCA's Refundable Tax Account (RTA).

Directors are caught between, the logic of funding and securing SERP liabilities, and internal rate of return. Safety and prudence, are ignored for financial performance. **However, enterprise risk management suggests that by identifying and proactively addressing risk and the opportunities that may result; value can be created for the company and its' shareholders.**

Opportunity

We have identified the risks. What if there existed an opportunity that:

1. Was balance sheet neutral.
2. Decreased the long term impact of the letters of credit.
3. Significantly reduced the cost of "pay-as-you-go" funding.
4. Offered cost recovery to shareholders.

5. Provided full security to SERP members.

Such an opportunity now exists. It is a Managed SERP Programme designed by Retirement Compensation Funding (RCF) referred to as SERP***Plus***™.

SERP*Plus*™

It is not for the lack of assets or cash flow that prevents corporations from establishing a Managed SERP programme. It results primarily from the focus on P & L, and effects on bonus and stock compensation plans. SERP***Plus***™ **preserves the status quo of existing arrangements** up to retirement but, terminally funds RCAs at retirement, thus reducing post-retirement LC and pay-as-you-go costs with greater security.

SERP***Plus***™ **is unique in that it utilizes balance sheet strength** through the establishment of a Special Purpose Subsidiary (SPS) to provide both (i) financing of net Terminal Funding costs to the RCA, and (ii) Cost Recovery to Shareholders. In return for the security of their "SERP Promise", members help mitigate the cost of funding by allowing the SPS to purchase insurance on each SERP member relative to the net cost of providing SERP benefits. The SPS is funded through asset transfers. SPS assets then flow to the Participating Pool of a major insurance company (to be professionally managed) via the individual contracts on SERP members. SERP***Plus***™ is a sophisticated but effective solution.

Benefits

What is accomplished?

1. Letter of Credit costs are reduced, and concern over post-retirement renewal diminished.
2. Terminally funding the RCA mitigates the concern of the RTA's investment inefficiency.
3. Longevity & earnings risk, can also be transferred to an insurance company using RCA structured annuities.
4. Shareholders see an executive benefit that is, balance sheet neutral, has less impact to cash, and with Cost Recovery.
5. SERP members retire knowing their benefits are secure.

The Right Thing

The C-Suite are the group within a large corporation from which SERP recommendations flow to a Board. Even though many other executives and high earning employees are likely included in a SERP, there is more concern these days in the C-Suite that, they be perceived to be "feathering their nest" at shareholders expense. This is unfair. It is more important than ever that Boards take initiative to see that SERPs are both properly secured and funded with, the shareholder's interests in mind.

Taking this responsibility off the shoulders of executives is "the right thing to do"

Al Mosher - Senior Associate
Retirement Compensation Funding Inc

About the Author

Allan Mosher is a Senior Associate of RCF. He has over 18 years experience in the financial services industry.

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888.825.2316 | almosher@rcf.ca | www.rcf.ca