Protecting the Nest Egg

Trustees need to understand why many executive retirement plans are underfunded, underperforming

By Vic Buzachero and Dale Edwards

Early in your education, you learned the difference between cause and effect. Cause is why something happens. Effect is what happens or, better stated, the consequences.

Unfortunately, cause and effect are often confused in business, particularly when it comes to retirement benefits planning. This often leads to executives earning significantly less retirement income than was originally designated by their boards and what the executives expected.

The effect

The vast majority of employer-sponsored retirement benefit plans, regardless of their form (defined benefit, defined contribution and so forth), are significantly underfunded and underperforming, resulting in increased costs to the employer or decreased benefits to the executive.

Our own audits of over 30 health care system retirement plans over the past two years show an average of 30 percent to 50 percent underfunding or underperformance.

With a fiduciary responsibility to both the organization and executives, boards are surprised and concerned when they learn the plans they had approved are not performing as anticipated.

False assumptions

As often happens with cause and effect, there have been many misconceptions about the causes of this retirement crisis. The most common false assumptions have to do with:

Who bears the risk? For example, "This crisis was caused by employers carrying the risk through defined benefit plans." False assumptions like this lead to false solutions, such as: Shift the risk to executives through defined contribution plans. However, research shows that such shifts have worsened the problem through lower rates of return, higher costs and, thus, poorer performance.

Complexity: "Plan complexity created this problem." False solution: Create simplified plans that pay executives cash, both before retirement and at frequent intervals. However, plans like these provide no retentive value and place the unresolved risks on executives.

No manageable cause: "There is nothing an employer can do." False solution: The employer pays an executive a market-comparable defined payment and ignores the results. This false assumption is the most disappointing of all in terms of underperformance, and the solution runs contrary to the wishes of most boards. In their fiduciary capacity to the organization and executives, most boards desire to offer a reasonable retirement benefit to retain and reward executives for excellent service.

True causes

Three root causes explain the truth of retirement plan underfunding and underperformance: investment volatility, plan costs and life expectancy.

Investment volatility is the rate of return of market investments adjusted for the timing of those returns. It also can be known as internal rate of return. Unfortunately, most retirement plans assume an average rate of return, which can be (and has been) wildly different from actual results. Investment volatility has caused retirement plans to be substantially underfunded.

Plan costs include plan fees, charges and commissions. They also include taxes, which may be a cost to the executive, depending on how a retirement plan is designed. High costs often have caused the net retirement results of plans to be substantially lower than expectations.

Life expectancy, especially among executives, is increasing dramatically. This trend causes lengthier retirement periods and thus additional strain on finite retirement resources.

Ask yourself this question: If these

three causes had not been an issue over the past several decades, would we be seeing effects like we are today? If investment returns had been stable, costs low and life expectancy constant, would we be seeing underfunded and underperforming retirement plans? Clearly, the answer is no, providing further evidence for the roots of these effects.

How we got here

There is a difference between "how much" and "how." Compensation consultants have served us well in determining the "how much." For instance, it is reasonable for an organization to provide a retirement benefit equal to 2 percent of final average salary for each year of service — up to a maximum of 60 percent for 30 years of service.

But once the "how much" has been determined, the conversation pivots to "how?" How will the organization provide the benefit? Because compensation consultants were key players in determining the "how much" and have established a relationship with the board and its compensation committee, trustees may find it convenient to ask them the "how" question as well. But is this a disciplined approach? Just as compensation consultants are expert in determining the "how much," other experts in the benefits industry have particular expertise in exploring all of the available options for plan design.

Such experts can be better than the first group at recommending products that manage the risk associated with each assumption embedded in the plan (basically, the "how"). Numerous products have been designed to address the root causes of the retirement income crisis, and a select group of benefit brokers is especially experienced at guiding an organization and its board through the process.

Benefit brokers

Benefit brokers specialize in advising, designing, implementing and administering executive benefit plans. As experts, they are familiar with current tax codes and their implications; some are further specialized in the nonprofit market. They represent multiple concepts, products and companies, thereby providing numerous options and solutions for executive benefit plans.

Benefit brokers are generally compensated by a combination of commissions and fees depending on the types of products utilized. There are a number of qualified benefit brokers in the marketplace that can be accessed through a simple Internet search. In selecting the right benefit broker, the board should begin by asking the following questions:

1. Who has the requisite expertise in identifying and managing the true historical causes of retirement benefit underperformance? Can these experts educate the board on various design options, along with their attendant risks, as well as product options designed specifically to temper these risks?
2. What are the true and total costs of implementing a proposed plan, both for the organization and the executive? Are there ways to reduce these costs?
3. How will investment volatility affect the plan's cost? Are there ways to mitigate this volatility?
4. What is the impact of increasing life expectancy on the proposed plan? Are there products that lessen this risk?
5. Are there ways in which the retirement benefit can be structured to provide better stewardship of the organization's resources? Can the organization's balance sheet be leveraged?
6. How will the benefit be portrayed to the community on Internal Revenue Service Form 990 (for tax-exempt organizations)? Can it be done in a manner that is consistent with the organization's community mission?
7. How will the decisions the board makes today be monitored and measured to ensure that the objectives and expectations of the board and the executive are met?

A responsibility

How do you ensure that your executives enjoy a comfortable retirement? By focusing on the real causes of the benefit crisis: investment volatility, plan costs and life expectancy. As board members with a fiduciary responsibility to the organization and its executives, you are putting your hospital or health system at risk of losing key talent or of hurting your executives financially during retirement if these issues are not reviewed and resolved now. **T**

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