BankDirector

Breakout 3:
The Key To Getting It Right the First Time – Lessons in Nonqualified Retention Plans

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NFP

#BBTF23

We are experiencing a dramatic workforce transformation.

The Cost of Replacing key people.

Build programs to creatively attract and retain top level talent.

In any employment environment, attracting and retaining top level talent is challenging. The costs to replace a highly compensated executive is estimated to be 200% - 400% of the annual salary associated with that position. Considering the competitiveness of the upper end of employment market, attracting and retaining key employees is of utmost importance.

THE FOCUS ON TALENT

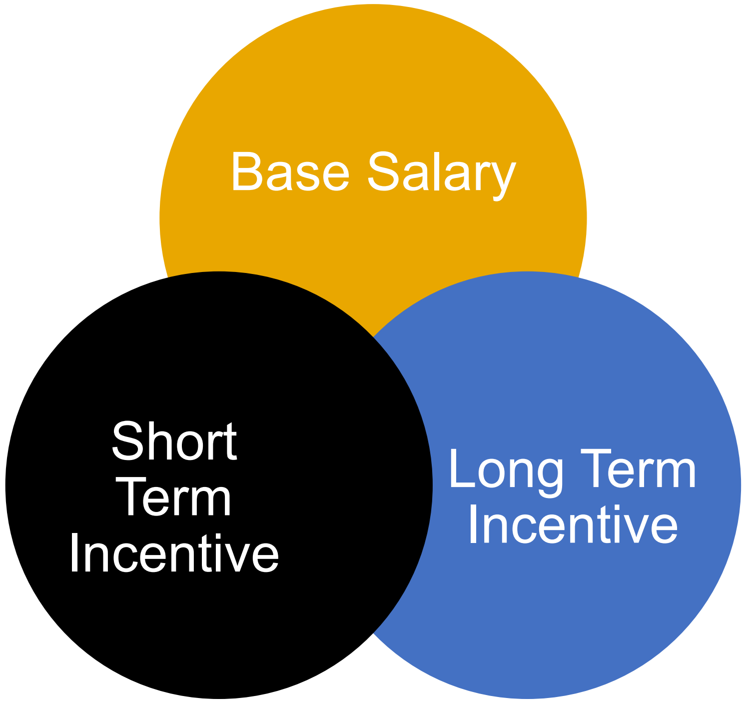
CEOs GLOBALLY		US CEOs	
Attract and retain talent	1	Attract and retain talent	1
Accelerate pace of digital transformation	2	Modify business model	2
Improve cash flow	3	Develop "Next Gen" leaders	3
Develop "Next Gen" leaders	4	Improve cash flow	4
Modify business model	5	Prepare for financial instability	5
Streamline processes	6	Employ mergers, acquisitions, divestitures	5
Focus more on sustainability	7	Streamline processes	7
Become more customer-centric	8	Accelerate pace of digital transformation	8
Lower costs	9	Mitigate cyber risk	9
Prepare for financial instability	10	Become more customer-centric	10

Note: 917 CEOs responded globally.
Source: The Conference Board® C-Suite Outlook 2022

Sources: Society for Human Resource Management (SHRM) & Center for American Progress

ROEI™: Return On Employee Investment™ How to Achieve It and How to Benefit From It; Sage HRMS White Paper

Total Cash
Compensation Package.



Comprehensive Compensation Package.

Cash Compensation

- Base salary
- Annual bonus
- Annual incentive bonus
- Long-term incentives
- Pay-for-performance

Group Benefit Plans

- Basic health
- Dental
- Vision
- Term life
- Disability

Qualified Plans

- Defined pension plan
- 401(k)
- ESOP
- Profit sharing

Nonqualified Plans

- 409A complete
- SERP
- Defined contribution
- Defined
- benefit

Equity Plans

- Stock options
- Restricted stock

Long Term Incentive

Standard Group Benefits-All Employees

Executive Benefits

Executive Benefits

Nonqualified Plans

Nonqualified
Deferred Compensation.

Otherwise known as a…

Supplemental Executive Retirement Plan (SERP)

Key Employee Incentive Plan

ABC Reward and Retention Plan

Phantom Stock Plan

Defined Contribution SERP Plan

401k Lookalike, 401k Restoration, 401k Mirror

409a Deferred Compensation Plan

Deferred Compensation Statistics.

BOLI/NQDC Statistics for All Banks

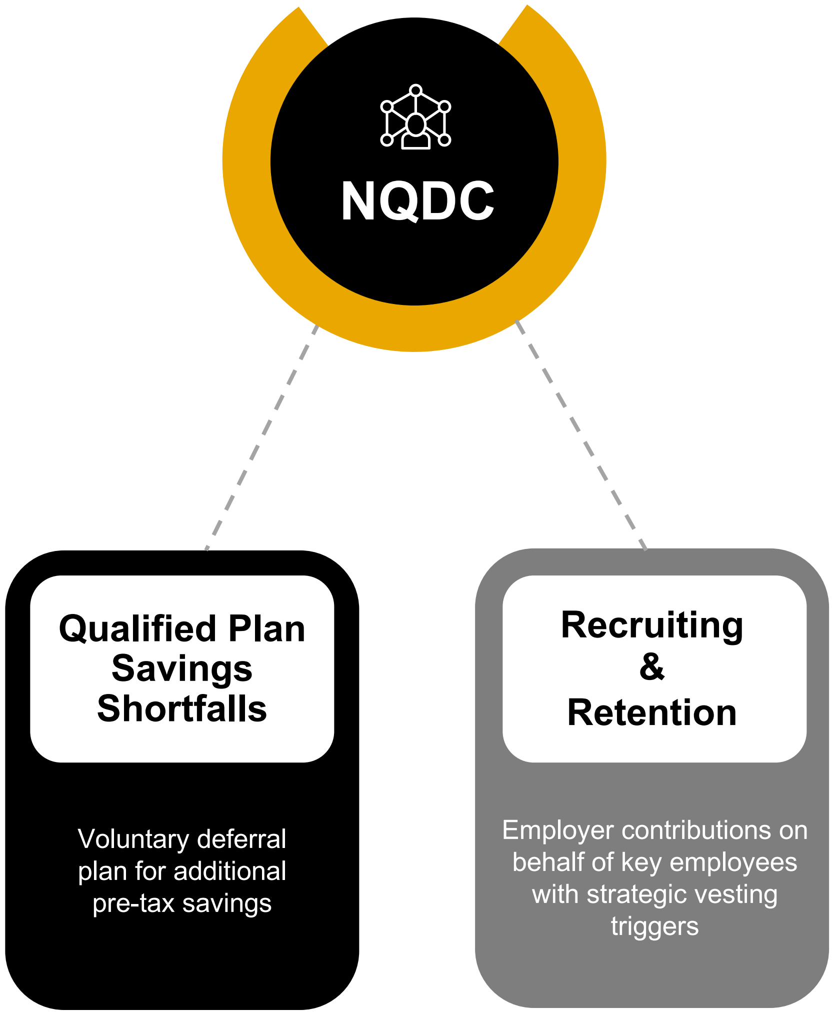
Asset Size	Banks	Banks Reporting BOLI Assets	% of Banks with BOLI	% BOLI to Regulatory Capital	Banks Reporting Def. Comp Liabilities	% of Banks with Def. Comp
Greater than $50 Billion	49	40	81.63%	11.03%	4	8.16%
$5 Billion - $50 Billion	222	177	79.73%	13.52%	147	66.22%
$1 Billion - $5 Billion	705	595	84.40%	13.84%	427	60.57%
$750 Million - $1 Billion	271	217	80.07%	15.06%	152	56.09%
$500 Million - $750 Million	497	389	78.27%	15.05%	285	57.34%
$250 Million - $500 Million	1,002	725	72.36%	15.54%	431	43.01%
$100 Million - $250 Million	1,192	731	61.33%	16.17%	399	33.47%
Less than $100 Million	793	306	38.59%	18.59%	163	20.55%
Total	**4,731**	**3,180**	**67.22%**	**15.40%**	**2,008**	**42.44%**

Source: December 31, 2022 FDIC Call Reports, Schedules RC, RC-F & RC-G

What is NQDC?

Nonqualified Deferred Compensation Plans (NQDC) are a flexible corporate sponsored solution that provide an opportunity for key executives to efficiently accumulate additional assets for future financial needs. Through this program, participants can voluntarily elect to defer a portion of their compensation, and/or receive employer-based contributions on a pre-tax basis, in excess of qualified plan limitations. The plan can solve two problems for an organization – 401k voluntary savings limitations, and retention.

One Program Solves Two Problems



NQDC Key Components.

Similar Qualified Plan Features

- Pre-tax contributions
- Tax-deferred growth
- Self-directed contribution amounts and investment allocations
- Payroll-deduct contributions

Enhancements

- Full employer discretion
- No contribution limits
- Compensation specific elections
- In-service distribution options
- Multiple account opportunity
- Limited regulatory requirements (no annual testing or 5500)

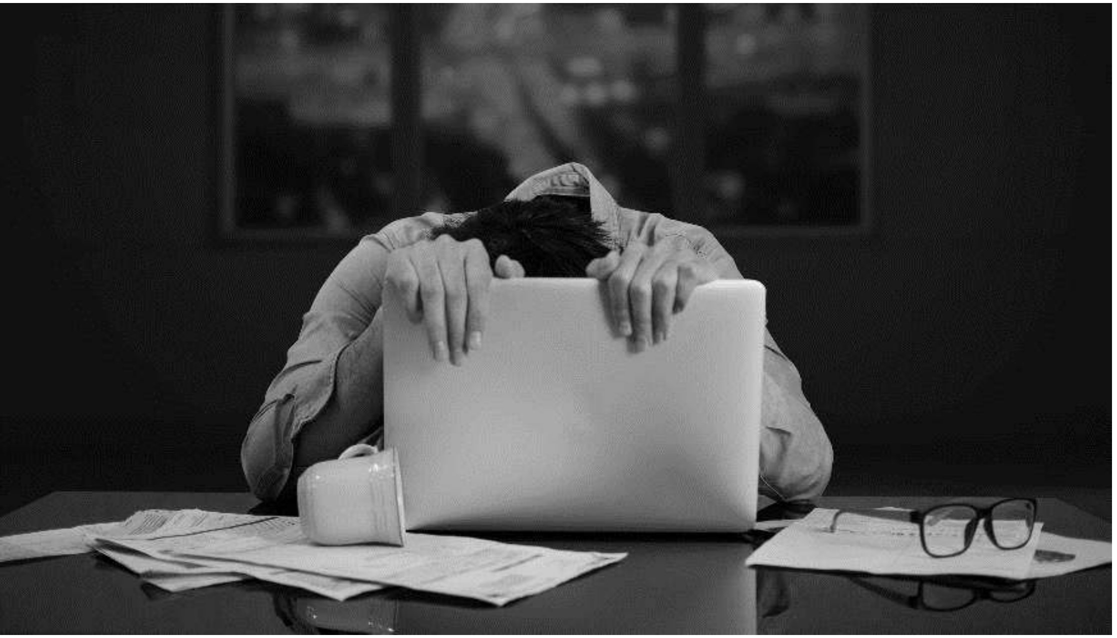
Considerations

- Governed by 409A
- Subject to general creditor risk
- Top-hat eligibility rules
- Annual enrollments
- Tax recognition at distribution (employee and employer)


Unintended Consequences
Lessons in deferred compensation.

Potential Issues to Monitor

Viewpoints from a banker.



Defined contribution versus defined benefit.

"I wish we would have gone with a defined contribution approach versus a retirement-focused defined benefit plan. The long-time horizon is not very appealing to younger executives, and the board wished they had the ability not to contribute when times are tough".

Lifetime benefits. "Lifetime benefits are a throwback to the unsustainable pension days. Our former CEO retired in 2000 at age 65. He's 87 and going strong, and we are expensing the full benefit every year."

Accidental plan. "Our internal counsel referenced a future payment in an employment agreement subject to certain conditions. We created a deferred compensation plan on accident. The missed DOL notifications, unrecorded liabilities and missing claims language was a headache. We should've started with a complete plan from the beginning."

Viewpoints from a banker.

Change in control. During the plan design process, the bank wished to have maximum protection for the executives recruited to start the bank at their insistence. The CIC language was not completely understood as it pertains to vesting. The bank wanted to vest 100% in the accrued liability upon change of control to be paid out when the executive separates service. During due diligence it was found the plan actually referenced the future benefit and the payout language did not match other the provisions. This created an unexpected “poison pill” which greatly affected the purchase price. Lots of finger pointing.

Viewpoints from a banker.

Vesting schedule. "I was wrong about the new 55-year-old CFO. He negotiated a three-year vesting schedule as part of an employment agreement and stated this was the last place he was going to work before retiring. He retired after three years, fully vested."

Interest crediting. "We tied the interest-crediting rate in our deferral plan to LIBOR +1%. I was informed later we could've had that provision be 'to be determined annually at the discretion of the board,' or even invested in numerous mutual funds. Flexibility from the start would have been better ."

Phantom Stock versus SARs. "Had we known the advantages of Phantom Stock over SARs we would have considered that design more. With relatively flat growth in our stock price the SARs had little retention value."

Viewpoints from a banker.

10-year installments. “Our bank is located in a state with high personal income tax rates and several of our executives are planning on retiring in FL, TX etc.

We were not aware that by allowing substantially equal installment payments over 10 years or more that participants might be able to lower their tax burden. Payments structured this way are taxed in the state of residence when paid, not in the state in which the income was earned.”

FICA. “We failed to withhold FICA as our executive vested”

DOL Notification. “We were unaware of the Department of Labor notification requirement for a NQ plan”

Executive Benefits

Observations from a consultant.

Offset issues. The SERP was designed in the early 2000s as a percentage of final pay, less the employer portion of the 401(k) and 50% of Social Security benefits. In the last few years prior to retirement, the executive stopped contributing to the 401(k) and missed on the related employer match. There was also a significant market correction that resulted in a 401(k) balance that was much lower than projected; requiring the company to record a large liability increase and the related expense to account for it.

Observations from a consultant.

Poison Pill Administration Clause. A current client acquired another bank with existing BOLI and benefits. While transitioning the administration from the acquired banks vendor to NFP the client uncovered the following.

…..may terminate this agreement upon ninety (90) days prior written notice ……..however, the Bank agrees not to cause or direct the insurance company service revenue to be paid to a party other than XYZ and its affiliates for a period of three (3) years….unless for cause

Executive Benefits

Observations from a consultant.

Disability. The plan's payout terms in the event of a disability were the same as if the executive retired: a lifetime benefit. An executive became disabled for six months before dying. The plan paid out $20,000 over the six months, while the retirement benefit would have been $40,000 for life.

Death benefit. The plan was intended to allow for accelerated future benefits in the event of death while employed, but the document referenced the current liability, not future benefit. An unexpected death occurred within six months of implementing the plan. The beneficiary received $10,000 instead of $200,000. Fortunately, there was a "key man" policy on the executive, and the company chose to honor their original intent.

Observations from a consultant.

Inappropriate discount rate.

Example 1-The plan document had a stated rate of 9% to value the supplemental executive retirement plan (SERP) liability and wasn't pegged to an outside index. The audit firm did not question the rate for 10 years. The bank changed audit firms, who then determined the rate to be inappropriate for accounting purposes. This resulted in a dramatic increase in the liability that was greater than annual earnings, which triggered numerous issues.

Example 2-Two different plans, two different rates, two problems. Split Dollar versus SERP

Observations from a consultant.

Guidance. NFP

NFP

Reasonable Discount Rates

This communication regarding various market index rates is being provided in support of our commitment to provide our clients with ongoing technical assistance. NFP Executive Benefits updates and distributes quarterly.

Inappropriate discount rate continued.

Example 3- One plan, two rates, three entities, $400,000+

Finseca

The Washington Report

Business Uses Edition

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Former CEO Wins SERP Lawsuit: The Importance of Clear Drafting

Authored by Jim Earle, Christopher P. Stock, and Brianna Hourihan at Troutman Pepper.

Market Trend: In a recent case, *Campbell v. Royal Bank Supplemental Retirement Plan*, a Pennsylvania federal court was tasked with determining whether a SERP properly determined the applicable discount rate to calculate a participant's benefit amount. In applying a *de novo* standard of review, the court awarded a former CEO additional SERP benefits plus attorney's fees. The case explains the standard of review applicable to disputes over top hat plan benefits and illustrates the risks when a *de novo* standard is applied.

Current Trends.

Trend 1

Immediate need

Trend 2

Maximum flexibility

Trend 3

RSU and PSU deferral

Trend 4

LTI Options

Executive Benefits

The key to getting it right, the first time.

As fast as the industry and regulations are changing, it is impossible for decision makers to keep up on their own. Working with a seasoned consultant who can leverage their expertise, resources, and data analytics helps compensation committees make more informed decisions that have better outcomes, controlled costs and ensure that the organization, its directors, officers and executives are protected for the long term.

Executive Benefits Experience.

2,400+
corporate clients in 49 states with participants in 90 countries

102,000+
insurance policies under administration

124,000+
participants in plans we administer

37,000+
executives insured with individual disability

4,300+
executive benefit plans

$20B+
assets in plans we administer

$8.3B+
plan liabilities we administer

180+
individuals committed to our clients

All information as of December 31, 2021.

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