EXECUTIVE BENEFITS WITHIN THE RESPONSIBLE EXECUTIVE COMPENSATION FRAMEWORK

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In light of the ongoing scrutiny of executive rewards, companies should regularly assess all elements of executive remuneration to ensure executive pay and benefits support the attraction and retention of executives, yet minimize risk to the company. Executive benefits, particularly nonqualified retirement plans, can play a core role in an executive's total compensation package and should be evaluated regularly.

In this *Perspective*, we offer Mercer's point of view on ensuring that executive benefits are responsible in today's environment, best meet a company's executive talent needs, and minimize risk to the company. We recommend three key steps to best accomplish this objective:

- Review external competitiveness
- Understand the impact on total compensation
- Ensure proper governance and oversight

This *Perspective* explores each of these key steps and discusses actions that employers can take to achieve responsible executive benefits practices while maximizing the return on investment from these programs.

REVIEW EXTERNAL COMPETITIVENESS

Understand the Changing Landscape

Determining appropriate benefit levels requires a careful balance: benefits should be meaningful enough to be competitive, but not so generous that the company incurs uncompetitive costs or is exposed to criticism for excessive benefit levels. Companies should monitor their programs regularly. Because the competitive landscape continues to evolve, the market positioning of an employer's program likely will shift over time, even if the program itself has not changed. Approximately one-third of publicly traded companies have made significant changes to their executive retirement programs in the past three years. The key components of change in the market landscape include:

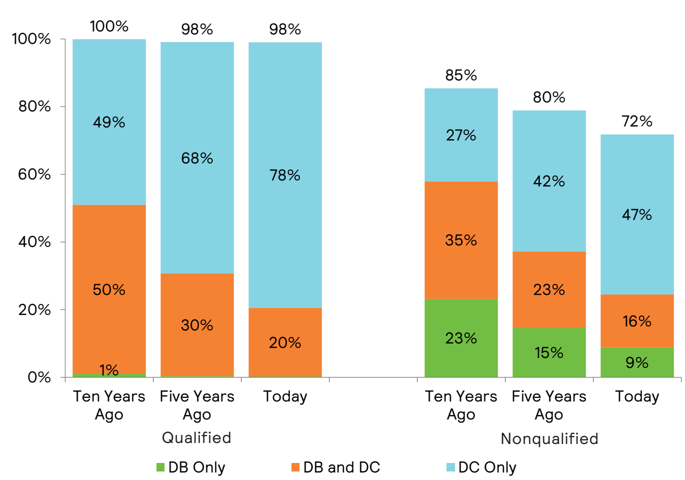
- *Ongoing shift to defined contribution (DC) plans*: market practice for both qualified and nonqualified plans has migrated away from final average pay defined benefit (DB) plans to either less generous DB plan formulas (e.g., cash balance or career average) or a DC-only philosophy.

- *De-risking of DB obligations*: As companies strive to de-risk qualified DB plans, they continue to explore plan design changes, better asset and liability linkage, and options to remove liabilities from the balance sheet. These activities have greatly impacted the nonqualified plan landscape.

- *Renewed focus on voluntary deferred compensation*: Given lower employer-paid benefit levels, coupled with higher tax rates (on ordinary income and investment income), there is renewed interest in voluntary deferred compensation programs. These programs aid in financial wellness by supporting executive pre-tax wealth accumulation and tax planning strategies.

The following chart illustrates the 10-year trend for employer-paid qualified and nonqualified retirement plans (open to new entrants) among Fortune 500 companies. Prevalence of employer-paid nonqualified plans has decreased in the past 10 years – 85% of Fortune 500 companies provided an employer-paid nonqualified plan in 2006 versus 72% in 2016 – and there has been a noticeable shift in structure (move to DC plans) and benefit level (lower than ever before). This shift is similar to the change in qualified plans over the same period:

Prevalence of Retirement Programs (Open to New Entrants)
Ten-Year Trend for Fortune 500 Companies



Source: Mercer's Executive and Broad-based Employee Retirement Tool (EBeRT), which contains details on qualified and nonqualified retirement programs for over 1,100 US companies

In addition to employer-paid nonqualified plans, voluntary deferred compensation plans remain very prevalent. Over 80% of Fortune 500 companies provide these plans, which permit executives to defer their own pay in excess of 401(k) limits. The plans typically permit the deferral of base salary and annual cash incentive with the ability to notionally invest in an array of 401(k)-type mutual funds. Attractive plans also allow for maximum participant flexibility with regard to distribution options (within the constraints of IRC Section 409A). As employer-paid benefits continue to decrease, the focus on voluntary deferred compensation plans continues to rise.

Determine Process for Benchmarking

Since the competitive landscape is shifting, companies should validate program competitiveness in conjunction with a review of executive compensation to understand how total pay stacks up relative to market and whether changes are needed. Companies can pursue a range of approaches to evaluate their programs, depending upon the degree of review that is warranted.

Each of these approaches addresses a critical question:

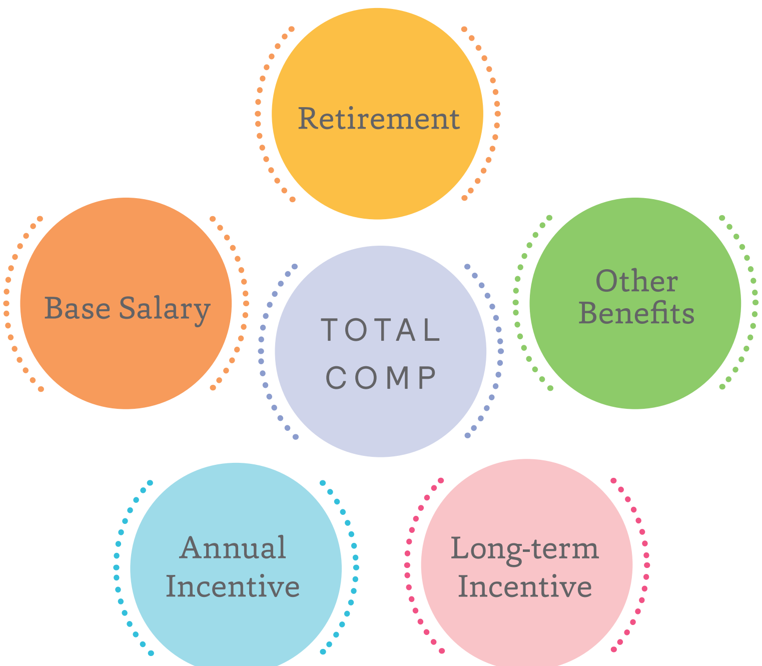
PREVALENCE OF BENEFITS	ANNUALIZED BENEFITS	CUMULATIVE BENEFITS
How do the structure and design of the company's benefit programs compare to market?	What current compensation value should be assigned to retirement benefits?	What is the ultimate retirement value provided to executives, and how does that compare to market?
This can be helpful in identifying outlying practices that may be priorities for further review (e.g., company may have a DB plan while all of its peers have DC plans).	This provides an annual value to add to salary, short-term, and long-term incentives, so that total remuneration can be compared to market.	This enables a comparison of cumulative benefits (i.e., income replacement or lump sum value) earned over an entire career.

Companies should also be mindful of non-retirement benefits that could draw increased attention, such as executive perquisites, severance, and change-in-control benefits. The majority of publicly traded companies have scaled back in these areas, largely in response to heightened shareholder scrutiny. Employers that continue to provide generous or atypical benefits must ensure they can adequately justify the business rationale for these programs.

UNDERSTAND THE IMPACT ON TOTAL COMPENSATION

Quantify Impact on Total Compensation Levels

Executive retirement benefits should always be considered in light of total executive remuneration rather than viewed in isolation. Simply evaluating compensation or benefit levels in a vacuum does not provide the complete context for decision making. For example, generous retirement benefits may be defendable at a company whose other pay components are below market. However, these same benefits may be inappropriate at a company where other pay components are competitive.



While the focus of this *Perspective* is on retirement benefits, it is important to consider executive health and welfare benefits and perquisites ("Other Benefits") when reviewing executive remuneration. For large companies (over $5B of revenue), approximately 65% provide one supplemental employer-paid health and welfare benefit, and 77% provide at least one executive perquisite.

Evaluate the Pay Mix

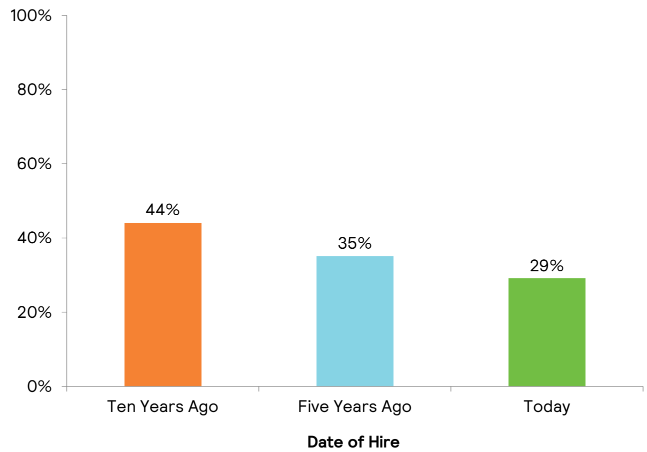
Aside from understanding the *level* of benefits and total remuneration, the relative *mix* of compensation components is critical in determining whether the pay strategy is appropriate and properly balanced. Because retirement benefits are a form of fixed pay, they have an impact on the overall weighting of fixed vs. performance-based compensation. This impact should be considered when setting and evaluating the level of other pay components to ensure that decisions are made based on a holistic view of the rewards program. A review of the pay mix allows the company to understand the relationship of pay components to one another, and presents an opportunity to reallocate pay elements to better balance attraction, retention, and motivation without necessarily changing the targeted total rewards spend.

It is also important to understand that pay mix will vary by executive. Just like incentive targets vary by position, the same may be true of benefits based on executive age and tenure. For example, retirement benefits for executives that are grandfathered under a legacy DB plan may be much larger than retirement benefits for executives participating in the new DC plan. This leads us to the next point, internal equity and consistency.

Assess Internal Equity and Consistency

Given the material change in the landscape over the past ten years, benefit levels/programs can vary greatly based upon executive tenure due to legacy/grandfathered plans. The chart below illustrates the percentage of executives still participating (i.e., accruing benefits) in a nonqualified DB plan based on hire date. As companies compare benefit levels, internally among executives as well as externally against market, the value of these legacy/grandfathered plans needs to be considered.

Percent of Executives Still Accruing Benefits in a Nonqualified Defined Benefit Plan for Fortune 500 Companies



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ENSURE PROPER GOVERNANCE AND COMPLIANCE

While nonqualified plans continue to be highly prevalent, ongoing governance is not always in the forefront of employers' minds. Board compensation committees tend to have rigorous oversight processes for executive pay programs, and internal plan committees typically have thorough processes for the oversight of the company's qualified pension and/or 401(k) plans. However, many employers do not apply the same methodical ongoing oversight processes to their nonqualified plans, which may lead to several issues:

- Lack of market alignment
- Lack of executive appreciation/understanding of the benefit
- Plan operational/compliance risk
- Inefficient plan financing

One reason nonqualified plans are often omitted from retirement plan governance is the difference in fiduciary requirements between qualified and nonqualified benefit plans. Nonqualified plans are not required to have formal fiduciary oversight.

However, unlike qualified plans, nonqualified plans are subject to IRC Section 409A rules that impose restrictions on the timing of deferral and distribution elections (among other things) and impose harsh penalties (*on executives*) for violations. Mercer recommends establishing a thorough governance structure that coordinates with oversight practices for other compensation and benefits programs. This can help minimize risk and ensure plans are being operated, communicated, and delivered as intended.

Mercer believes there are four key components of good ongoing governance:

1) Assign Committee Oversight
   - Responsible for ongoing oversight of the plan's activity
   - Apply same prudence and care as applied to compensation and qualified plan oversight

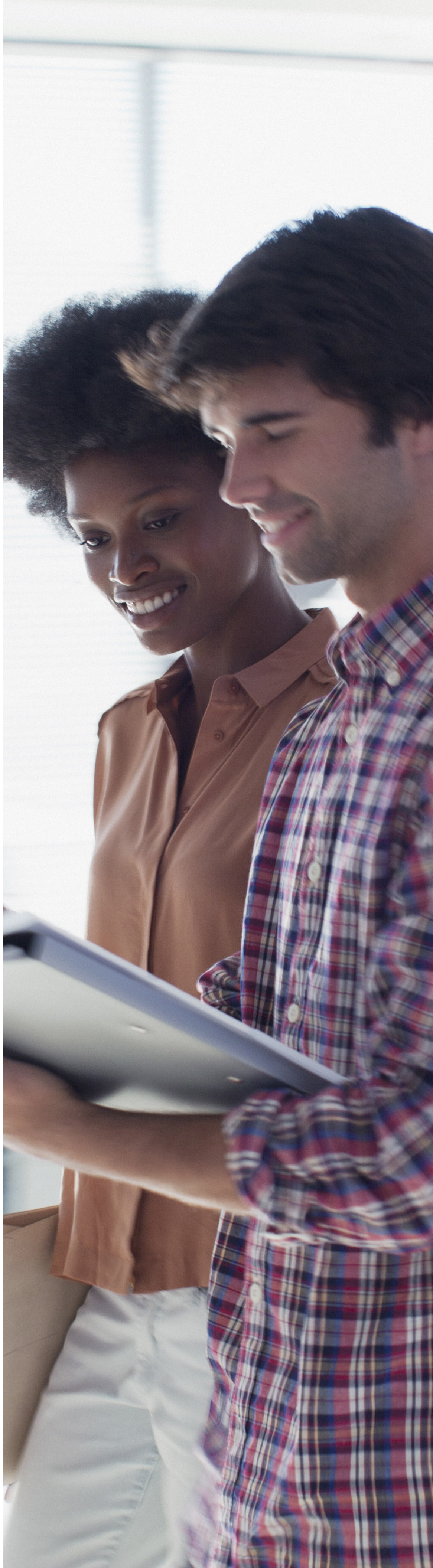
2) Review Plans Holistically
   - Do not focus on the plan in isolation; evaluate market positioning regularly as part of total rewards package
   - Assess communications to ensure executives understand and appreciate the program's value

3) Conduct Operational Reviews
   - Ensure plan is being administered in compliance with IRC Section 409A and other regulatory requirements

4) Monitor Financing Strategy
   - Evaluate informal funding assets relative to the company's financial objectives
   - Regularly monitor to ensure asset strategy is consistent with objectives

CONCLUSION

Executive benefits can be a critical and strategic component of the overall executive remuneration package. Employers should give careful thought to the impact of benefits on the level and mix of total executive pay, and ensure the programs effectively support the company's objectives. The benefits landscape shift underscores the need to ensure programs stay current with market practices and do not expose the company to unnecessary scrutiny or competitive imbalance. Establishing a proper governance structure is critical to minimizing potential risks and maximizing the employer's return on investment for the program.



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