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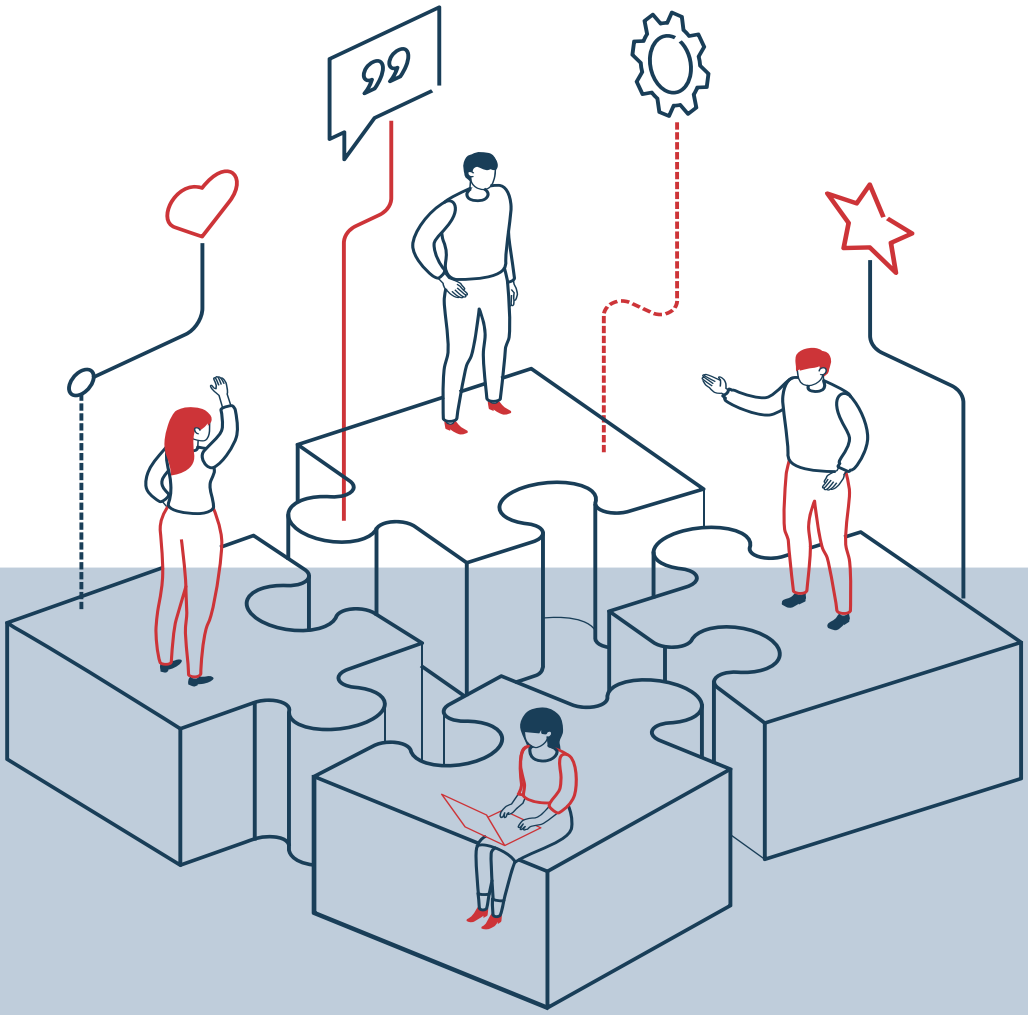
Executive Pension Plan Risk-management Guide

Key considerations for evaluating executive pensions in private equity portfolio companies



Private equity firms need to pay particular attention to the structure of executive pension plans when acquiring and managing portfolio companies on behalf of investors. It takes a strong leadership team to turn around an underperforming company and generate long-term value for investors. One of the best ways to build that team is through an attractive and, more importantly, sustainable benefits package.

This guide takes you through the process of evaluating executive retirement arrangements in private equity portfolio companies — from understanding supplemental pension plans to determining the most appropriate funding and risk-transfer strategies. We hope it will provide you with a framework for improving your risk-management processes not only during your due diligence but across the entire investment lifecycle.

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EXECUTIVE PENSIONS: THE WILD CARD IN ANY PRIVATE EQUITY INVESTMENT STRATEGY

Private equity investments are traditionally long-term investments in which the company being acquired is typically held in a private equity firm's portfolio for three to six years. To deliver the best possible return to investors (known collectively as limited partners, which generally consist of pension funds, institutional accounts and wealthy individuals), the firm must generate as much value as possible from that company during the holding period.

In many cases, that value comes by installing a strong management team within the portfolio company — one that can turn around an underperforming organization and steer the business through a period of rapid growth. To build that team, private equity firms look for industry leaders who can instil the culture, structure and strategies that will produce the high levels of growth expected by investors. One of the best ways to attract and retain such leaders is by offering appealing, competitive and sustainable pension and benefits packages.

But what if the company being acquired already has pension arrangements in place with its executives? These can act as "wild cards" with potentially huge impacts on your firm's investment strategy. For example:

- If a benefit isn't vested when a company is acquired, it won't be reflected in the actuarial reports — meaning millions of dollars in unplanned liability could suddenly show up on the books. This is because those reports reflect only what *has* happened, not what *will* happen over the next several years. In other words, there's a lot they don't say, which can make it difficult to accurately assess a company's vesting structures.
- Unexpected retirements can throw off cashflow projections and, if coupled with high pension payments, can bring further volatility to the valuation and planning of your firm's exit strategy, which then affects the return delivered to your investors.

When acquiring and managing portfolio companies, it is important for your firm to pay close attention to the executive pension plans of those companies.

To deliver a "win-win" — growing the company to generate maximum value for limited partners while also delivering the compensation promised to existing executives and the ones you plan to hire — you need a solid framework for identifying and evaluate pension risks so you can make the most appropriate short- and long-term decisions.

UNDERSTANDING EXECUTIVE PENSION PLANS

Before you can assess and manage the risks associated with executive pension plans, it is important to first understand how these plans are funded and secured. In general, there are two options a company can take: **individual pension plans (IPPs)**, which are subject to the

limits of the *Income Tax Act* (ITA); and **supplemental executive retirement plans (SERPs)**, which are not. Each has its own distinct features and risk considerations.

Individual pension plans

An IPP is a defined-benefit registered pension plan (RPP) for one person. Unlike RRSPs (or defined-contribution RPPs) where the executive is at risk of poor investment return, under a defined-benefit RPP, additional contributions to make up for investment losses are tax-deductible. IPPs are not as accessible as RRSP assets and are protected from creditors, and the executive may be able to exercise some degree of control over the investment choices being made.

IPPs are registered with the Canada Revenue Agency and pension regulators in certain provinces, which means they are subject to maximum funding rules and other limits set out in the ITA. Companies typically offer IPPs to maximize tax efficiency and eliminate all possible risks of non-compliance.

Supplemental executive retirement plans

Pension and benefits packages registered under the ITA are limited to providing benefits with an income base *below* executives' salary level. To better compete for executive talent, many organizations feel the need to "bridge the gap" by providing a non-registered arrangement on top of the registered plan. In these executive pension structures, an IPP serves as an underlying plan and pays for pension benefits up to the ITA limit, while a SERP pays for the pension benefits above the ITA limit.

Compliance consideration #1: Funding rules

When an executive pension is established to top-up amounts restricted by the limits under the *Income Tax Act*, the plan is generally exempt from pension standards legislation. However, if there is no underlying plan, the supplemental plan might not be exempt — and therefore subject to funding rules.

If the aim of the SERP benefit is to provide a lifetime income, the underlying plan should be a registered IPP or defined-benefit plan.

In Canada, SERPs offer the most tax-efficient way to offer retirement income for executives. Because the Canada Revenue Agency does not require SERPs to be registered, these plans are not subject to the limits of the ITA. As a result, individual executives within a portfolio company might negotiate different arrangements than their peers, such as immediate vesting or credit for additional years of service under a SERP.

In addition, because SERPs are not subject to the limits in the ITA, they can provide accelerated accrual rates or enhanced contributions. This feature is especially important to executives who are hired by a company later in their careers and, as a result, have a shorter expected tenure.

Your private equity firm needs to be aware of two kinds of SERPs: unfunded and funded.

Unfunded SERPs

Unfunded SERPs come in the form of supplemental executive retirement arrangements (SERAs), which are often referred to as "pay-as-you-go" plans because benefits are paid out of the company's general revenue. Under a SERA, executives depend on the company's financial income to pay for their retirement benefits. Their benefits are *not* protected in cases of insolvency or bankruptcy — and unexpected or multiple simultaneous retirements can cause a company's cashflow requirement to increase dramatically.

Defined-contribution SERAs typically involve notional accounting of contributions and investment income. In these pay-as-you-go arrangements, the employer sets aside a "book reserve" in its financial statements to reflect SERP liabilities and also provides third parties with notice of the claims of SERP members. As credited services grow, SERP liabilities and the book reserve will also grow.

Compliance consideration #2: Salary deferral rules

Excessively generous SERA benefits could be subject to salary deferral rules. If the SERP benefit essentially mirrors the underlying registered pension plan in everything but its tax limits, that benefit is considered reasonable by the Canada Revenue Agency and will not be subject to salary deferral rules.

However, companies that have frozen or converted their defined-benefit plans to defined-contribution plans — but are still following the defined-benefit formula for its supplemental executive pensions — may want to conduct a compliance review.

In some cases, specific assets are set aside to provide future SERP benefit security. As these earmarked assets are not set aside in a trust, however, they continue to be part of the general assets of the company and cannot be protected from creditors.

Funded SERPs

Executives often negotiate to have their SERP benefits pre-funded or secured because they are worried they might lose promised unfunded benefits if the company gets in financial trouble. Funded SERPs typically come in the form of retirement compensation arrangements (RCAs), the most common tax vehicle for pre-funding a supplemental executive pension.

An RCA segregates company assets through a trust, protecting the funded benefits from creditors if the company is insolvent or going through bankruptcy. Because the ITA does not regulate the type of investments that may be held in RCAs, they can include cash, debt, obligations, shares, life insurance policies and annuity contracts.

Perhaps the important consideration as it relates to RCAs is the 50% refundable tax that must be paid on all premiums and contributions. The taxed amount is held in a refundable account and does not generate any investment returns, immediately cutting the overall returns in half. In determining the returns from RCA-secured assets, actuaries generally take into account the non-investable portion paid as refundable tax.

An alternative to pre-funding a SERP via an RCA is to purchase a **letter of credit** to secure the SERP payments. A letter of credit offers a promise from a financial institution to pay for an agreed-upon amount if the company defaults on its SERP payment.

A letter of credit is not considered a funding method because no assets are being accumulated to meet the pension obligations. However, it does provide benefit security for a SERP in exchange for a relatively modest cashflow requirement over a short term. While a letter of credit is not very difficult to set up (as it is a standard offering from a bank), it does come at an additional cost to the company. There is also the risk that the bank won't sell the letter or could increase its price drastically if the company is in financial trouble.

Although funded SERPs are ideal for larger companies, a lack of understanding of how to set up RCAs — and the time and effort required to do so for every executive — causes many companies to opt for the simpler pay-as-you-go approach.

RISK CONSIDERATIONS: PRE-CLOSING PROCESS

Executive pension liabilities need to be evaluated and managed at all stages of the investment cycle, both before and after acquiring a portfolio company.

During the investment screening and due diligence work that makes up the pre-closing process, most private equity firms will simply ask for and review the company's actuarial report. Depending on how that report is structured, however, it likely won't reflect all the risk factors you'll need to take into consideration.

To uncover all the hidden risks and liabilities, you need to account for the following during the pre-closing process: industry benchmarking, future volatility and leverage.

Industry benchmarking

To determine whether or not changes need to be made to a company's existing pension strategy, you should first obtain proprietary research and data on what other companies in the same industry as the portfolio company are offering their executives and how that compensation is being delivered.

This will reveal if the company's executive pensions are (or are not) typical of their specific industry — and what you will need to do to bring them into alignment with best practices.

Future volatility

Portfolio valuation is an important part of any private equity firm's due diligence. But unexpected changes in executive retirement dates (and the resulting unexpected payments), conditional vesting periods and other promises that are not reflected in the company's actuarial reports because they have yet to be vested can all result in significant, unanticipated impacts on cashflow, making it difficult for you to achieve future exit valuations and timings.

To make the valuation process more transparent, you'll need to fully understand what has been agreed upon between the portfolio company and its executives — as well as the probabilities of the unexpected taking place.

Other sources of potential future volatility include:

- **Longevity risk** – essentially the "risk" that the executive will live beyond the pension plan's life expectancy assumptions
- **Business risk** – systematic and unsystematic risks associated with the market (interest rates, inflation) and the company's business operations (investment decisions, operations, corporate governance)

Other ways to do your due diligence:

Portfolio managers may want to assess how SERP liabilities affect important financial metrics such as the asset coverage ratio and loan-to-value ratio.

They should also ask questions such as:

- What is the expected working level of cash for the business over the next five years? How quickly and to what extent can cash be generated? Is there a need for borrowing and, if so, at what rate?
- How are decisions made for using funds to decrease liability? How quickly can decisions be made?
- How do retired executives give feedback? How do stakeholders give feedback?
- How will investors evaluate risk transfer (i.e., buy-out liability)? What would be investors' biggest concern in a downside scenario?

Leverage

In a pay-as-you-go, unfunded SERP, executive pension plans can be thought of "inside debt": the company is essentially borrowing from itself to deliver the promised compensation. You therefore need to evaluate all the possible scenarios of interest movement and how such fluctuations might affect the balance sheet.

The SERP liability reflected on the balance sheet is calculated with assumptions of salary increases, retirement dates and discounting interest. If these rates change within the deal's lifecycle, the book reserve for SERP liability will change. (If interest rates drop, for example, the increase in liability would affect the balance sheet.) Notably, because most SERPs are unfunded, there is no asset to counter such interest movements.

RISK CONSIDERATIONS: POST-CLOSING PROCESS

Post-closing, your firm is likely to be more involved in the day-to-day governance of your portfolio companies than public company shareholders, largely because you have a more direct interest in the company's short-term performance. The faster the company can be turned around, the more long-term value will be generated for you and your investors. As part of this hands-on approach, you often need to consider what you will do with the executive pension plans of the companies you have acquired.

During the first 100 days after closing, a rapid assessment of executive pension liability will lay the groundwork for near- and medium-term growth and improvement. By following a three-phase management approach involving **planning**, **strategy development** and **execution**, you will be better positioned to address your liabilities and implement the right risk-transfer strategies with the most appropriate scale and timing, ultimately paving the way for a successful exit strategy.

Planning

In this first phase, you need to understand where the pension plan sits in relation to the portfolio company's short- and long-term goals, then identify whether specific risk-transfer activities could add value to the company.

Transferring risk

If you want to get some or all of the SERP liability off your books, you may consider "de-risking" the SERP by transferring risk out of the plan to an insurance company in return for a lump-sum premium payment. The process for transferring risk out of a SERP (whether funded and unfunded) is typically done through an annuity purchase or, more rarely, a longevity swap.

- **Buy-out annuities** should be considered only if you want to be released from *all* liability risks, balance-sheet obligations and plan-administration burden. As a SERP is a contractual arrangement not subject to federal regulation, you'll likely need to obtain written consent from the SERP members before purchasing this annuity.

- With **buy-in annuities**, the insurer assumes the longevity and investment risks under the pension plan, while you remain liable for SERP payments and administration — meaning the payment relationship between the company and its plan members is not affected.

- A **longevity swap** should be used only if you want to eliminate longevity risk but are comfortable retaining all other defined liability risks. Any payments made are based on longevity assumptions agreed upon between the parties, with the insurer protecting against the increasing lifespans of the plan members.

If you do choose to transfer SERP risk in this way, be aware that it can bring significant tax consequences. The pension approach used by the portfolio company will play a large role in determining who pays that tax. For example:

- For an RCA trust, after an executive has retired, he or she pays tax on the trust income in the year it is received. The amount paid to the retiree generates a tax refund to the trust.
- For retiree-owned SERA annuities, the retiring executive pays tax on the premium in the year the annuity is purchased — but the company can choose to reimburse the executive and write off that payment as a business expense, resulting in a tax deduction.
- For employer-owned SERA annuities, the company is taxed on the taxable portion of the income paid, while the retiring executive is fully taxed on income received.

If its contracts allow, the company can settle its financial obligations with a **lump-sum settlement** (also called an executive cash-out). This option comes with similar tax consequences as an annuity purchase, though the amount of capital required may differ (i.e., the cash-out amount is not necessarily equal to the premium required to purchase an annuity).

For all these reasons, most private equity firms will opt to keep the SERP liability on their books rather than settling or transferring risk.

Other planning considerations

At this stage, you will also set your risk tolerance and risk limits in preparation for the next two post-closing phases. These limits will depend on factors such as investment horizon (how long you intend to hold the portfolio company) and absolute-return targets.

In addition, you will want to look at what the "true" cash flow (including transaction costs and tax implications) looks like for each risk-transfer strategy and how will it translate to absolute returns. You should also look for chances to capture mispriced asset value or deal with access risk. As most executive pensions are related to final earnings and adjusted for cost of living, earning escalation and inflation increases pose a risk for both the company and its executives.

Strategy development

Building off the work done in the planning phase, you must now decide when and how you will manage your SERP liability. That involves evaluating the portfolio company's working level of cash by conducting cashflow and financial analyses to determine materiality of impact on the balance sheet, as well as testing the timing and sensitivity of the various liability-reduction and risk-transfer strategies.

When it comes to testing, the first step is to lay out all the options and then estimate the potential costs and impacts of both keeping the liability risks and transferring them to another party.

It's all about finding balance — between true costs and benefit security, for example, and between the cost of analysis with the value derived from that analysis. The next step is to build a model of discount rates, salary escalation, expected retirement dates and choices at retirement (i.e., cash-out versus annual payments), exploring the advantages, disadvantages and consequences of each factor.

Based on these tests and analyses, you will be able to recommend a strategy with the greatest probability of generating the expected value and return for investors. Maintaining the highest level of transparency is critical during this phase, as well-planned communication can help you make smarter, more strategic decisions that increase both pension fund and company performance.

Execution

Finally, you must enact the chosen risk-transfer strategy to help the portfolio company achieve significant, measurable and sustainable results. This is all about fulfilling pension promises while generating value in the exit phase of the deal's lifecycle.

One of the biggest challenges you should plan for when executing a risk-transfer strategy is communication: not only with executives who are (or will be) receiving the pensions but also with stakeholders and investors more broadly. The key is to explain clearly and accurately how you made your decisions as well as the value of the chosen strategy, eliminating any possible sources of confusion. For example, when there are tax consequences, everyone involved needs to know the costs and who is paying for what. Misinformation could lead to litigation that might have been easily avoided.

GUIDING PRINCIPLES OF AN EXECUTIVE PENSION PLAN RISK-MANAGEMENT FRAMEWORK

Based on the pre- and post-closing risk factors and considerations discussed above, we have developed three guiding principles for building an effective executive pension plan risk-management framework. To realize short- to medium-term value-creation opportunities for your portfolio companies, you will want to focus on good governance, transparency and sustainability across all stages of the investment cycle.

1. Ensure good governance

Good governance is all about good management — not only of people but processes, too. Current practices in the pension industry focus too much on the "mechanical" aspects of a pension settlement and not enough on strategic design. A better approach is to map out and build a strategy *before* making any decision.

Let's say your firm is thinking of settling financial obligations through a lump-sum buy-out. Before your actuary calculates the buy-out amount and proposes it to the company's executives, you should seek advice on your options and understand *all* potential outcomes as early as possible in the investment process, rather than proceed blindly with the buy-out and deal with the consequences as they happen.

Some processes of the portfolio company being acquired may need to be changed to improve the way they are managed. Under current practices, actuarial valuations are conducted every one to three years. As a result, the numbers they present do not fully reflect the company's situation and have very little relevance to managing risks in the here and now.

As part of good governance, you should strive to implement real-time reporting on a pension plan's financial health (if the value-of-cost can justify doing so). More frequent reporting and analysis can help you take preventive measures in a timely manner, especially if you opt not to use annuity-based de-risking strategies.

Finally, managing executive pensions in a responsible way means having systems to keep track of many different changing variables that could create volatility in pension liability, including valuation assumption discount rates, mortality rates and the cost of borrowing. Keeping value-of-cost and value-of-risk always in mind, your first step should be to prioritize risks, then identify the ones that could have the biggest impact and determine how you will respond to unexpected events.

2. Maintain transparency with investors

Most limited partners are passive investors, relying on the managers of the underlying funds to keep them updated on the status of their investments. Being open and transparent about the risks and opportunities associated with a portfolio company's executive pay and pensions will make it easier for your firm to manage the disruptive risks and strategies that will translate into sustainable business growth.

You should develop a communications plan for disclosing your intentions and informing investors about a wide range of issues, including how future risks will be managed (as they relate to the exit strategy) and whether the timing of SERP payments will have a direct impact on the return on investment. This type of information can made available to investors through a dedicated data room (whether physical or virtual) or periodic written updates. You also need to ensure company executives fully understand the risks involved with various pension funding strategies and options.

For even more transparency, firms might also consider integrating the processes for executive pension analysis directly into their risk-assessment processes (if they do not do so already).

3. Focus on sustainability

Your firm invests other people's money and makes decisions about where to do so, essentially acting as "stewards" for a large amount of assets. That makes you responsible for delivering long-term, sustainable investment performance and ensuring all stakeholders get the value they expect to receive. To deliver sustainable portfolio performance, it is important to go beyond actuarial numbers alone and consider both the upside and downside risks of a broad range of strategies for the stewardship of the assets entrusted to your firm.

The Marris + Miller approach to SERP management

With the three core principles of good governance, transparency and sustainability at the heart of our own work, we guide our private equity firm clients through the following four-stage process for managing SERPs:

1. **Discovery** – discussing options for liability transfer, capital requirement and exit scenarios
2. **Strategy** – presenting our liability valuation and research, as well as our recommended transfer strategy and exit direction
3. **Decision** – performing an in-depth analysis of transfer costs and disclosures
4. **Management** – working with the company's legal team to prepare the final agreement (including reconciliation and buy-in/buy-out disclosures) and stakeholder communications plan

CONCLUSION

In the end, the success of the private equity firm depends on the success of the portfolio company, which itself depends on the performance of the executives. A strong executive pension plan, if set up and managed correctly, can help attract and retain executives who will deliver the performance needed to turn around a struggling organization.

With stronger governance and more transparency in managing the executive pensions of acquired companies, private equity firms will be better able to assess both value creation (by mitigating disruptive risk) and funding and risk-transfer strategies for sustainable business growth — ultimately leading to greater value and returns during the exit stage of the investment cycle.

While there are many ways to evaluate risk, it is easy to get "stuck" in the numbers, especially when looking at actuarial valuation reports. The principles laid out in this guide will help you develop the framework for a risk-management strategy that gets at the heart of what it takes to deliver both performance and value that, over the long term, provide a win for everybody involved.

The right guidance and advice can make all the difference. For more information about executive pension risk management, email us at private_equity@marrismiller.com or book a meeting at https://marrismillerscheduling.as.me.

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