CAPTRUST

A THREE-STEP APPROACH TO NONQUALIFIED PLAN FINANCING:

Now is the Time to Revisit Your Strategy

SUMMARY

Nonqualified deferred compensation plans have long been an important tool for companies to attract, retain, and reward highly compensated employees. Given contribution caps and other limits on qualified retirement plans, nonqualified plans have also been an important retirement savings vehicle, helping to improve key executives' retirement readiness. While they have taken a backseat to other more pressing issues in recent years, it appears that companies are once again realizing the benefits of these flexible plans.

Given the likely growth in interest in nonqualified plans—driven by rising state and federal taxes and fueled by improved capital markets—we believe that now is a good time for plan sponsors to pause and reassess their plans. With full understanding of their plans, sponsors will be better able to make intentional choices and craft plans that provide attractive benefits without compromising corporate balance sheets or cash flow. Decisions related to informal funding—or financing—of benefit liabilities should be a main focus of this effort and require careful consideration.

April 2013

CAPTRUST Financial Advisors advocates for a comprehensive and intentional process to establish a nonqualified deferred compensation plan financing strategy. We believe the process should focus on three key, interdependent decisions; choosing an appropriate financing method, earnings hedge strategy, and target funding level. This paper defines and addresses these three decisions in detail, considering the pros, cons, costs, and benefits of the alternatives available. Understanding these choices can help plan sponsors better manage plan costs, reduce balance sheet volatility, and help secure participant benefits. We encourage you to read on for a more complete explanation of our three-step approach to nonqualified plan financing.

A THREE-STEP APPROACH TO NONQUALIFIED PLAN FINANCING:

Now Is the Time to Revisit Your Strategy

INTRODUCTION

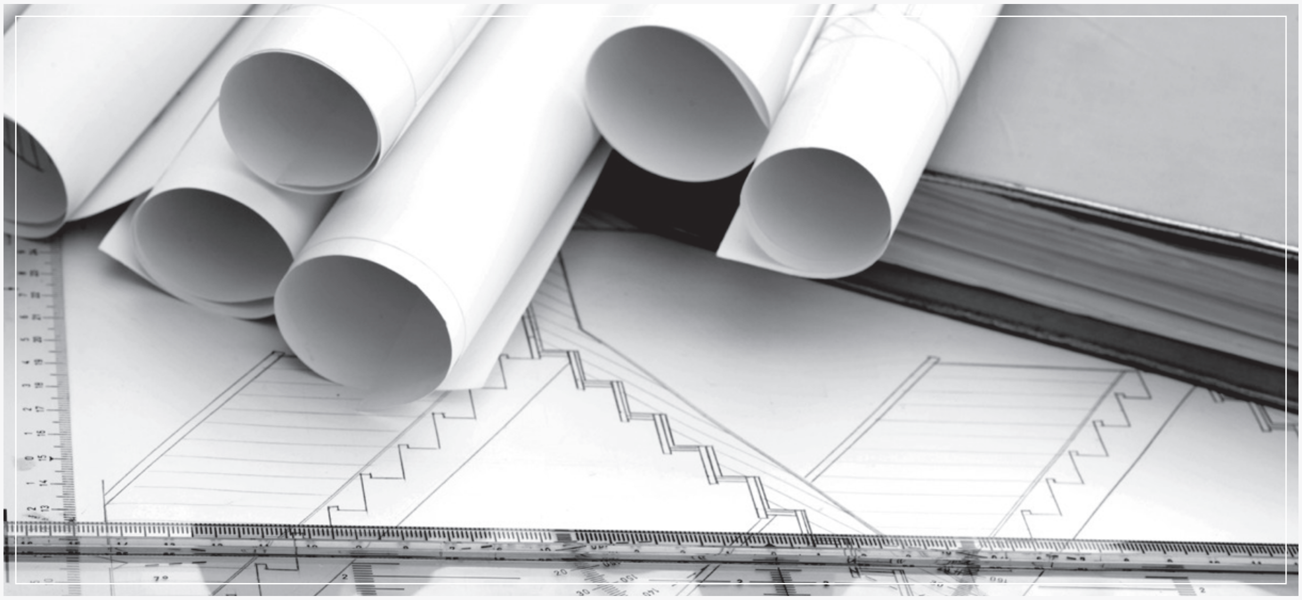
Nonqualified deferred compensation plans have long been a valuable retirement planning tool for highly compensated employees and independent contractors. The 1974 Employee Retirement Income Security Act (ERISA) and multiple subsequent tax reform acts placed severe limits on contributions and eligible compensation for qualified retirement plans, including 401(k), profit sharing, and defined benefit pension plans. Supported by a generally favorable economic climate and strong long-term capital market performance over the past four decades, nonqualified plans have become an effective tool to recruit, retain, and reward executives and help them successfully reach retirement.

The 2008 financial crisis temporarily reduced plan sponsor interest in nonqualified plans as executive salary and bonus compensation came under pressure and unemployment increased. However, our experience indicates that interest in nonqualified plans has been rekindled over the past two years. What's driving this resurgence of interest? It's too soon to know for sure, but it stands to reason that the recovering economy combined with demand from executives seeking to bolster retirement savings hit hard by the economic and market downturn are contributors. Coming out of election season and the fiscal cliff debate, it is not hard to imagine that rising federal and state income tax rates and the new 3.8% Medicare surtax on net investment income are also helping to drive renewed interest.

Figure 1: IRS 2013 Pension Plan Contribution Limitations

401(k) / Profit Sharing Limits	Individual Retirement Account (IRA) Limits
• $17,500 maximum annual deferral ($23,000 if age 50 or older) • Discrimination testing limits • $255,000 maximum compensation eligible for retirement plan contribution calculation	• $5,500 maximum annual contribution ($6,500 if age 50 or older) • Employees with adjusted gross income of $115,000 (married) or $69,000 (single) cannot deduct contributions to an IRA account if participating in a qualified retirement plan
Defined Benefit Pension Limits	**Social Security Limits**
• $205,000 maximum benefit payout • $255,000 maximum compensation eligible for retirement benefit calculation	• $113,700 maximum compensation eligible for retirement benefit calculation

Source: Internal Revenue Service: http://www.irs.gov/uac/2013-Pension-Plan-Limitations



The appeal of a nonqualified plan for highly compensated executives is easy to see. Due to contribution caps (see Figure 1), withdrawals from qualified retirement plans and individual retirement accounts—combined with payments from Social Security—are unlikely to provide sufficient income to meet an executive's expected retirement lifestyle needs. Nonqualified plans allow participants the opportunity to make pre-tax contributions up to 100% of compensation (depending on plan design), which can help bridge this gap and help improve executives' prospects for retirement readiness.

Historically, retirement committees have paid minimal attention to the design, operation, and expense associated with their company's nonqualified plan. The combination of a lack of fiduciary liability (unlike qualified retirement plans they may oversee), a smaller participant base, and a limited commitment to employer contributions has generally allowed a hands-off committee approach. However, in today's business climate, companies have heightened their scrutiny of employee benefits and expenses as they seek to remain competitive and profitable.

Probably the most important aspect of a plan to manage is a plan's informal funding—or financing. This paper presents a three-step process for financing the benefits of a nonqualified plan. It looks at the four most common financing methods used by plan sponsors today. It then discusses three earnings hedge strategies often employed to reduce or eliminate balance sheet volatility stemming from nonqualified plan benefit liability earnings and losses. Finally, it examines several target funding levels that may be used to maintain an appropriate level of financing to help provide benefit security and liquidity to pay participants their benefits in the future.

SCOPE

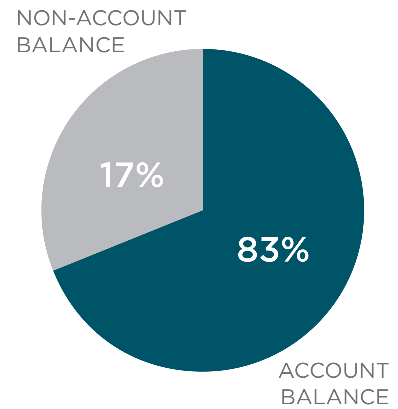
This paper's focus is the traditional nonqualified account balance plan, the most common type of nonqualified plan, representing approximately 83% of the nonqualified plan market (see Figure 2). These plans are commonly known as mirror 401(k), excess, or nonqualified defined contribution plans. They are governed by Internal Revenue Code (IRC) Section 409A, which became effective January 1, 2005, and related Internal Revenue Service (IRS) final regulations which became effective January 1, 2009. These regulations provide a framework for nonqualified plan design and operation.

Although there are similarities in financing methods for non-account balance plans — such as nonqualified defined benefit and pension plans, separation pay plans, and other types of deferred compensation arrangements that fall under the broad definition of 409A — this paper does not address those arrangements.

It is also important to note that IRC Section 409A does not govern eligible deferred compensation plans offered under IRC Section 457(b) for nonprofit organizations or 457(f) plans that use a short-term distribution exemption. Both of these popular nonqualified plan types have been excluded from this analysis primarily because of the tax-exempt status of their sponsoring organizations, which limits the cost and complexity of their financing decisions.

Finally, the focus of this paper is on public and private regular C-corporations, the most common sponsors of nonqualified plans. The unique income tax and accounting nuances of pass-through tax entities such as limited liability companies, S-corporations, and partnerships are not presented.

Figure 2: Types of Nonqualified Plans



The vast majority (83%) of nonqualified plans are account balance defined contribution-style; that is, they provide a statement of the accumulated "balance" of the participant account. The remaining 17% are supplemental executive retirement plan/defined benefit-style plans in which benefits are expressed as monthly income during retirement.

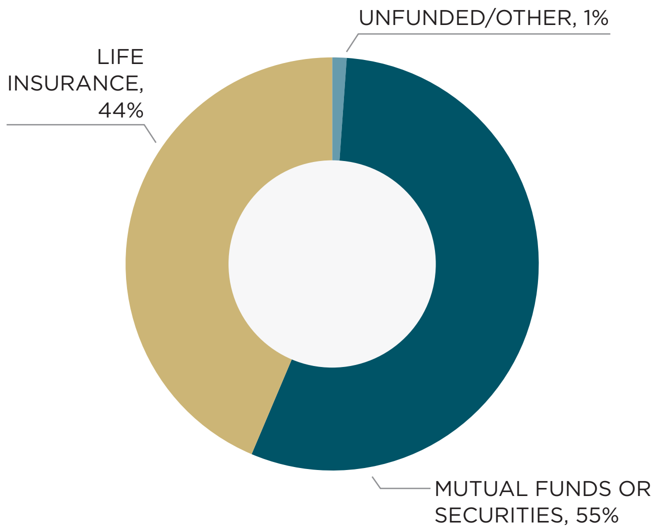
Source: Boston Research/PSCA, "A Study of Non-Qualified Plan Sponsor Attitudes and Behavior: Final Report," p.6, June 2011.

THREE-STEP PROCESS FOR OPTIMIZING PLAN FINANCING

A nonqualified plan is an unfunded and unsecured contractual benefit obligation between a plan sponsor and participants. Participant deferrals plus any sponsor contributions create an unfunded liability that is marked-to-market and can grow over time at an unpredictable rate. The plan sponsor may set aside assets to informally fund—or finance—this benefit liability. These assets provide the sponsor with liquidity to pay future benefits and some assurance to plan participants that they will receive their benefits. Assets used for this purpose carry with them tax, accounting, financial statement, and expense impacts that are often the most costly aspect of operating a nonqualified plan.

While the vast majority of plan sponsors do set aside assets to finance nonqualified plan liabilities (see Figure 3), how they do it tends to be circumstantial. One plan sponsor may finance its plan with mutual funds because its nonqualified plan is supplemental to a qualified plan administered by a recordkeeper that can only offer mutual fund investments. Another may use life insurance because a life insurance agent initially sold the nonqualified plan concept. These choices are not necessarily problematic, yet they are not intentional decisions and may not provide the best long-term benefit to the plan sponsor. The best approach to nonqualified plan financing involves a comprehensive review of all possible financing options en route to a conscious, plan-specific selection.

Figure 3: What is your plan's primary funding method?



By definition, nonqualified plans are an unfunded contractual benefit arrangement. Most companies choose to informally fund or finance their nonqualified plans by setting aside assets to provide the cash to pay the future benefit liability.

Companies can finance their future benefit liability by investing in either mutual funds (or other securities) or life insurance. The best financing approach depends on a plan sponsor's unique economic situation.

Source: CAPTRUST Research

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When establishing a nonqualified plan financing strategy, a plan sponsor should focus on three key and interdependent decisions; choosing an appropriate financing method, earnings hedge strategy, and target funding level. As illustrated in Figure 4, a comprehensive financing strategy that evaluates these three decisions will help the plan sponsor better manage plan costs, reduce balance sheet volatility, and help secure participant benefits.

Figure 4: Optimizing Plan Financing

A comprehensive financing strategy should address three decisions: financing method, earnings hedge strategy, and target funding level.

STEP 1: IDENTIFYING THE RIGHT FINANCING METHOD

The first and perhaps most important of the three decisions is selecting a financing method. Ideally, a plan sponsor should select the financing method that best offsets benefit liability growth created by ongoing contributions and earnings credited to participant accounts. Failure to utilize the most appropriate financing method over time can result in negative economic consequences for the plan sponsor. In the most extreme case, a plan sponsor may find itself without sufficient liquidity to make participant benefit payments, a state that might compromise benefit security in the eyes of participants. In less severe instances, a plan sponsor may be forced to pay unnecessary or avoidable income taxes or life insurance costs. As a plan grows in size, these costs can be significant. Given likely nonqualified benefit liability growth in coming years, plan sponsors should find the right financing method now.

Four financing methods are widely used today. Sponsors generally consider any one (or a combination) of them:

- Unfinanced
- Financing with mutual funds (or other taxable securities)
- Financing with life insurance
- Using a total return swap

No single best method for plan financing exists. Economic variables particular to the plan sponsor, specifically the sponsor's marginal income tax rate, assumed earnings growth of the nonqualified plan liability, selected discount rate for comparing long-term cash flows, and long-term cost of capital influence the cost and impact of each method. Thus, plan sponsors are wise to keep their particular financial situation in mind when examining financing alternatives.

Unfinanced Plans

A nonqualified plan is unfinanced if the plan sponsor does not set aside plan contributions—participant deferrals and plan sponsor contributions—or invest assets to offset the plan benefit liability. Instead, funds resulting from participant deferrals and sponsor contributions credited to the nonqualified plan are kept by the sponsor to be invested in day-to-day business operations. When a qualifying distribution event occurs, benefits are paid from the sponsor's general cash account. This financing method is simple to administer from an accounting and tax perspective; there are no separate assets to record.

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The decision not to set aside assets to finance future plan liabilities works well for business entities and economic environments in which:

- Return on capital is expected to be consistently higher than participant earnings
- The plan liability is not significant enough to warrant financing
- The sponsor expects to have liquidity readily available to pay benefits

In calculating the true impact of a choice not to finance plan obligations in advance, the sponsor should recognize the alternative use of participant deferrals and sponsor contributions that would have otherwise been invested to directly offset the plan benefit liability. In addition, the plan sponsor must monitor unfunded benefit liability growth to make sure it does not exceed liquidity available to pay the future plan benefits. When evaluating whether or not to finance, it is important to consider participants' comfort level with a plan where the sponsor is not setting the money aside for their benefit or protecting benefits through a Rabbi Trust, which we will cover later. The unfinanced method may be a good option for highly liquid plan sponsors who consistently expect a high return on capital relative to the expected earnings from participant accounts.

For sponsors who choose not to finance their nonqualified plan, the analysis stops here: they need not consider an earnings hedge strategy or funding level. By making an intentional decision to not finance, sponsors accept liquidity risk and potential balance sheet impacts that come with it. Consciously choosing not to fund nonqualified plan liabilities demonstrates how each decision in the plan financing process creates or restricts additional choices for the plan sponsor. We have created a flow chart to illustrate this point (see Figure 7 on page 23) at the paper's conclusion.

An unfinanced plan is simple to administer and provides cash flow for company operations. To the extent company earnings outpace the earnings rate credited to participant accounts, the plan sponsor benefits. However, an unfinanced plan may create liquidity risk for the sponsor and participants, resulting in an expense to the sponsor in the event that company earnings are less than the earnings rate credited to participant accounts.

Financing With Mutual Funds

Mutual fund financing is the most common method of financing (see Figure 3 on page 5). As the name implies, this process involves setting aside participant deferrals into a portfolio of mutual funds. This allows sponsors to create a link between plan liabilities and a portfolio of investments the sponsor (or a Rabbi Trust) holds. This method is quite popular for nonqualified plans designed or intended to mirror a qualified retirement plan (for example, a 401(k) plan in a private sector company) and is often the financing method of choice when the sponsor selects as the nonqualified plan recordkeeper the provider that administers the company's qualified retirement plan. Mutual fund usage has become more prevalent as many of the large qualified retirement plan administrators have developed or improved their capabilities to administer nonqualified plans.

Financing future plan obligations with mutual funds works well for business entities and situations in which:

- Assets are not large enough to create a material income tax impact for the sponsor
- The plan is shorter term in nature with benefits expected to be paid in the next three to five years
- The sponsor does not expect to pay income tax because of long-term net operating loss carryforwards
- The sponsor offers a tax-exempt employee stock ownership plan in which it is a majority shareholder

From an accounting perspective, the mutual funds the sponsor (or Rabbi Trust) holds are normally reported at fair market value with annual recognition of realized and unrealized gains and losses per Financial Accounting Standards No. 159 (FAS 159). This accounting treatment adds a layer of complexity absent from the other financing methods. From a tax perspective, any realized gains, dividends, or interest are taxable to the sponsor at ordinary income tax rates.

This financing method creates potentially large cash flow considerations for the sponsor due to the tax expense on earnings, dividends, and interest realized from the mutual fund portfolio each year. This is an important consideration for plan sponsors expecting significant growth in plan liabilities either due to broadly rising capital markets or an influx of participant and plan sponsor contributions. Although the income tax paid is eventually recovered when the nonqualified benefit is paid to the participant, this may not occur for several years. Meanwhile, the sponsor generates no earnings on the cash flow to pay the income tax while waiting to recoup taxes paid.

While we often see mutual funds used as a financing vehicle for nonqualified plans designed to mirror a qualified retirement plan, they can be used in a number of other ways that we will discuss in greater detail in the next section on earnings hedge strategies. Plan sponsors should opt to finance with a mutual fund portfolio because it makes sense economically—not because mutual funds are their recordkeeper's preferred choice.

A plan financed with mutual funds can be aligned with a qualified plan as part of a comprehensive retirement benefit for key executives and is easy to understand and monitor. This financing method provides investment flexibility and a straightforward linkage between assets financing the plan and participant balances. However, earnings on the mutual fund portfolio are taxable each year to the sponsor, which may require additional cash flow to support the plan. Taxes payable may become a significant consideration as the plan grows in size.

Financing with Life Insurance

A plan sponsor choosing to finance with life insurance uses participant deferrals and any sponsor contributions to purchase life insurance policies on the lives of key employees. The sponsor (or a Rabbi Trust) is the owner and beneficiary of the resulting portfolio of life insurance policies. Typically, the policies purchased are either traditional cash value life insurance paying a fixed interest rate or variable universal life policies with a range of subaccount investment options available. Plan contributions pay the cost of insurance and policy expenses and the remaining cash value earns either a fixed interest rate or generates earnings based on how the investment options utilized in the policies perform.

Purchasing life insurance to meet future plan liabilities works well for business entities and situations in which:

- Income tax cash flow on a mutual fund portfolio would be material to the company
- The plan is long-term in nature (more than five to seven years)
- The sponsor is comfortable with life insurance policy costs
- The sponsor commits to a review of the life insurance portfolio every two to three years

The cash surrender value of life insurance policies is accounted for on the plan sponsor's balance sheet according to Financial Accounting Standards Board (FASB) Technical Bulletin 85-4. The cash surrender value and earnings are used to finance future nonqualified benefit payments and to hedge nonqualified plan earnings growth. The two primary considerations when selecting life insurance as a financing vehicle are the income tax and accounting benefits. Earnings in a life insurance policy accumulate tax deferred and cash can be withdrawn from the policy income tax free as partial surrenders up to the income tax basis and then as a loan. When an insured dies, the plan sponsor (or Rabbi Trust) receives the policy's death benefit proceeds income-tax free. Gains are not taxed so long as the life insurance policy stays in force until the insured dies. The income tax arbitrage of using tax-free earnings and death benefit proceeds to pay out tax-deductible nonqualified plan benefits is a central criterion for selecting this financing method.

However, a higher level of complexity and requirement to monitor the life insurance policies accompany the income tax and accounting benefits. While most plan sponsors understand they should select only high-quality insurance carriers, insurer ratings can change over time. Therefore, it is important to manage this counterparty risk by reviewing ratings periodically to ensure they continue to comply with the sponsor's criteria. Further, retirement committees often do not understand how life insurance policies work or how to identify associated costs of ownership. In many cases, advice regarding the purchase of life insurance used to finance plan benefits comes from a life insurance agent who may not be in a position to provide an independent perspective due to life insurance policy sales commissions.

Although using life insurance financing can yield significant economic advantages, these advantages come with a cost. Plan sponsors should consider institutionally priced life insurance policies, design them with an appropriate amount of insurance, and review policy expenses every two to three years to ensure that policy expenses are reasonable over time. If neglected, these expenses can create an unnecessary drag on policy performance.

There are a number of factors that influence how a life insurance portfolio is optimized, but the most important ones include:

- policy pricing;
- commission structure;
- amount of life insurance purchased;
- underwriting program used;
- investment expenses; and
- quality of investment options available.

The fundamental question a plan sponsor must answer is whether it is cheaper to pay income tax on mutual fund earnings or to pay life insurance costs.

A plan financed with life insurance receives the benefits of tax-deferred earnings, tax-free distributions to fund nonqualified plan benefits, and tax-free death benefit proceeds. These features create an attractive income tax arbitrage since the plan sponsor pays out tax-deductible benefits with income-tax-free earnings withdrawn from the life insurance portfolio. However, financing with life insurance is less flexible and more complex than other financing methods and requires a longer-term commitment to fully realize the tax benefits. A sponsor considering financing with life insurance must be mindful of insurer ratings and policy costs—the cost of insurance and any contract expenses—as well as any underwriting and contract limitations.

The fundamental question a plan sponsor must answer is whether it is cheaper to pay income tax on mutual fund earnings or to pay life insurance costs.

Financing with a Total Return Swap

Financing with a total return swap is a relatively new approach to nonqualified plan financing. A plan sponsor using this approach engages a financial institution such as a bank or insurance company to act as a swap provider. The sponsor transfers the risk of hedging the earnings on plan liabilities to this third party for a fee. The fee is usually based upon the London Interbank Offered Rate (LIBOR) plus a premium and is charged against the "face value" of nonqualified plan liabilities—calculated as total plan contributions net of plan distributions.

Financing with a total return swap works well for business entities and situations in which:

- The sponsor wants to neutralize earnings hedge risk
- The sponsor is comfortable with the complexity of a swap transaction
- The company is comfortable with the credit quality of the swap counterparty
- The minimum benefit liability amount required will be met

By employing this method, the plan sponsor is able to transfer the risk that plan earnings will outpace company assets and allow the company to retain participant deferrals and any plan sponsor contributions for other purposes. The plan sponsor can invest the remaining cash in business operations or in investments to offset the swap provider's fee. In one strategy, the plan sponsor uses a portion of the deferrals to cover its deferred tax cash flow while investing the balance to cover the swap fee.

Operationally, the plan sponsor and swap provider settle or "true up" the swap monthly or quarterly. If plan liabilities generate earnings during the prior period, the swap provider delivers the earnings to the plan sponsor. If plan liabilities lose value during the prior period, the plan sponsor delivers the lost earnings to the swap provider. Plan distributions under this method are paid from the sponsor's general account and include the earnings received from the swap provider.

In addition to removing the earnings hedge risk, the swap introduces some favorable income tax treatment. IRC Section 1221(b)(2) and Section 1.1221-2(b) of the Treasury Regulations describe how gains received from a swap provider are not taxable to the plan sponsor until the benefit is distributed to plan participants. The plan sponsor benefits from the deferred tax payment on the earnings and taxable earnings are offset against the future deduction for the payment of the nonqualified plan benefit liability.

The plan sponsor's primary risk with this financing method is the risk of the swap provider becoming insolvent, another form of counterparty risk. Similar to not financing plan liabilities in advance, choosing total return swap financing simplifies this analysis by eliminating the need to implement an earnings hedging strategy or determine an appropriate funding level.

The plan sponsor's primary risk with this financing method is the risk of the swap provider becoming insolvent.

Total return swaps are a new and interesting method of financing nonqualified plan benefits. They provide a direct earnings hedge and some appealing tax benefits. However, these benefits require a plan sponsor to be comfortable with the credit quality of the swap issuer and the complexity of a swap transaction. In addition, swaps generally require a significant minimum benefit amount.

PARTICIPANT RISKS

Nonqualified plans are unfunded for ERISA purposes and represent a contractual benefit obligation between the plan sponsor and participant. The sponsor owns the assets purchased to finance the future benefit liability and, therefore, can use them for purposes other than paying the nonqualified plan benefit liability. As a result, a participant is inherently exposed to three risks when deciding to participate in a nonqualified plan:

- **Liquidity Risk.** A sponsor that does not finance the nonqualified benefit liability in advance is opting to pay plan benefits from current cash flow or an equity line when a qualifying distribution event occurs. In the event the sponsor has cash flow or liquidity problems when a distribution is required, the participant may not be paid in a timely manner.

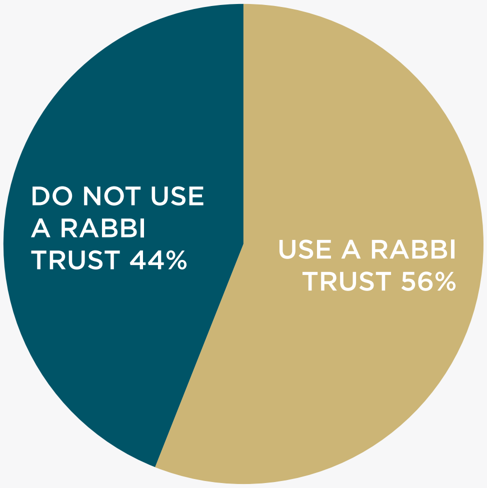
- **Management Repudiation Risk.** In the event there is a conflict between the plan sponsor and participant at the time of a qualifying distribution event, the sponsor may not wish to pay the participant's benefit. In this instance, the participant would have to rely on contract law—rather than the kind of fiduciary protections received by qualified plan participants—to receive the benefit.

- **General Creditor Risk.** A participant in a nonqualified plan is considered an unsecured general creditor of the sponsor. As a result, in the event the sponsor becomes insolvent prior to or at the time a benefit payment is due, the participant would stand in line with other unsecured general creditors to receive payment.

RABBI TRUST AS A SECURITY MECHANISM

A Rabbi Trust is an irrevocable grantor trust, receiving its name from its first use in 1981 when a Brooklyn synagogue financed a nonqualifed plan benefit for one of its Rabbis. Rather than the plan sponsor purchasing assets to finance the nonqualified benefit, a third-party independent trustee with a fiduciary responsibility to the trust beneficiaries (i.e., the nonqualified plan's participants) purchases and owns the assets. Since a Rabbi Trust is a grantor trust, the assets and income tax consequences of the assets are accounted for on the plan sponsor's balance sheet although they cannot be used for any purpose other than paying nonqualified plan benefits. Rabbi Trusts are utilized in more than half of nonqualified plans (see Figure 5).

Figure 5: Nonqualified Plan Usage of a Rabbi Trust



Source: Boston Research/PSCA, "A Study of Non-Qualified Plan Sponsor Attitudes and Behavior: Final Report," p.32, June 2011.

If 100% of the benefit liability amount is deposited into a Rabbi Trust with a third-party independent trustee acting as fiduciary for plan participants, liquidity and management repudiation risk for plan participants is reduced or eliminated. However, use of a Rabbi Trust does not eliminate general creditor risk. Nonetheless, from a participant's perspective, use of a Rabbi Trust is an attractive plan feature and often increases participation rates.

STEP 2: SELECTING AN EARNINGS HEDGE STRATEGY

Two primary factors drive the growth of nonqualified plan liabilities: contributions and earnings. The financing method selected offsets these variables to differing degrees. On one hand, unfinanced plans are openly exposed to both contributions and earnings growth as no assets are informally set aside by the sponsor and the benefit owed to plan participants grows unchecked. On the other hand, plans using a total return swap hire a third party contractually bound to offset earnings growth for an annual fee. Plan sponsors using mutual funds or life insurance to finance nonqualified plan liabilities may want to carefully consider an earnings hedge strategy.

The earnings hedge is an important tool to help limit financial statement impact caused by differences in asset and liability earnings rates. Traditional hedging strategies include:

- Mirroring plan liabilities with an identical asset portfolio
- Mapping, whereby similar but not identical assets are purchased
- Investing corporate assets in a discretionary investment strategy that is independent of plan liabilities

Mirror Hedge Strategy

A plan sponsor executes a mirror hedge, as its name implies, by purchasing assets that are identical to the investment options plan participants select for their nonqualified plan balances. These purchases occur simultaneously with participant deferrals. This strategy can provide a near-perfect hedge against earnings credited to nonqualified plan accounts. The mirror strategy is often used when mutual funds are used as a plan's financing method—although it can also be used with life insurance financing.

Mirroring is simple to administer, easy to understand, and provides a direct earnings hedge if the plan is fully funded and properly administered. However, it does require careful coordination of asset and liability transactions. Employing a mirror hedge strategy also means that the plan sponsor is allowing nonqualified plan participants to direct the investment of a potentially significant corporate asset.

Mapping Hedge Strategy

When utilizing a mapping hedge, the plan sponsor invests participant deferrals and sponsor contributions into similar but not identical investments in order to hedge nonqualified plan earnings. Mapping creates an imperfect hedge to nonqualified plan earnings because different investments with different performance results are used in the asset and liability environments. The difference between plan liability earnings and sponsor asset earnings introduces the potential for financial statement volatility. For example, if nonqualified plan liabilities grow at a faster rate than the assets the sponsor purchased, the sponsor will incur an expense. Conversely, if nonqualified plan liabilities grow less than the assets the sponsor purchased, the sponsor will record a net earnings gain. Mapping can be used with both the mutual fund and life insurance financing methods.

A plan sponsor might select a mapping strategy when it cannot invest in an option available in the nonqualified plan liability menu. This could occur when the plan sponsor wants to offer participants a menu of choices identical to its qualified plan but has chosen a life insurance financing method in which those choices are not available. As a result, the plan sponsor generally selects investments that are in the same asset class with similar characteristics in an effort to match the earnings pattern of invested assets as closely as possible.

Mapping provides most of the same benefits and considerations as mirroring. One important difference to note is that because the investments used are similar but not identical to those plan participants selected, the hedge is imperfect and may result in financial statement volatility to the extent the mapped portfolio outperforms or underperforms the earnings rate credited to participant accounts.

Discretionary Hedge Strategy

When deploying a discretionary hedge strategy, a plan sponsor utilizes an investment consultant, asset manager, or in-house committee to take discretion over the investments it chooses to hedge plan liability growth. In this instance, the plan sponsor invests participant deferrals and sponsor contributions independently of how the participants direct their nonqualified plan account balances. Based upon the conversations CAPTRUST is having with plan sponsors, it appears that the discretionary hedge strategy is gaining traction in the market as sponsors begin to evaluate participant investment performance relative to that of professionally managed investment portfolios.

Plan sponsors are beginning to realize that selecting a mirror or mapping strategy allows nonqualified plan participants to dictate a potentially substantial corporate asset's management. In many cases, the executives who participate in nonqualified plans are busy, distracted, or don't always have the knowledge or desire to actively manage their nonqualified plan account balances. In the end, if participant investment choices perform poorly and the plan sponsor is mirroring or mapping to the same underperforming investments, the corporate asset performs poorly as well. Plan sponsors have good reason to be concerned about following their participants' investment behavior as it has been well documented that investor returns lag market returns. One recent study suggests that over the past 20 years the average equity investor trailed the S&P 500 Index by 3.96% annually, and the average fixed income investor underperformed the Barclays Aggregate Index by 5.36%.[1]

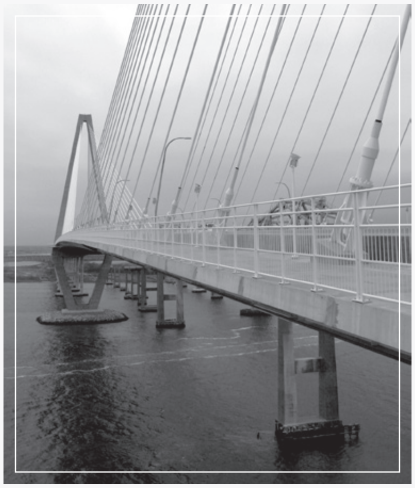
Decoupling the corporate asset from the participant's selected options allows the plan sponsor to invest in an appropriate asset allocation portfolio, complete with a portfolio benchmark, investment policy statement, and periodic monitoring. The plan sponsor retains investment earnings greater than those credited to the nonqualified plan. They can be used to offset plan costs and potentially have a positive financial statement impact. Conversely, if investment earnings are lower than earnings credited to the nonqualified plan, the sponsor bears the risk of an additional expense.

A plan sponsor employing a discretionary hedge strategy accepts a higher volatility of the hedge between investment earnings in the portfolio financing the plan and participant earnings. This strategy requires a higher level of oversight from the plan sponsor than mirroring or mapping and comes with additional investment management costs.

[1]DALBAR, Inc., "Quantitative Analysis of Investor Behavior," p.17, March 2013.

STEP 3: TARGETING THE RIGHT FUNDING LEVEL

The third and final step in developing a comprehensive nonqualified plan financing strategy is to determine the optimal target funding level. By deferring a portion of their income back to the plan sponsor each year, participants impact the company in two ways: they create additional liability and provide additional cash. With a financing method already in place, the plan sponsor must decide what portion of the additional cash should be directed to the earnings hedge strategy and what portion should be allocated toward plan financing expenses and income tax. Three general funding approaches bear consideration: full, after-tax, and death benefit cost recovery.



Full Funding

The full funding approach takes the cash the participants defer or that the plan sponsor contributes and directs all of it into the financing method. Additional corporate cash is used to pay the annual income tax resulting from the deferred wage expense deduction as well as all expenses associated with the selected financing method. With this approach, the plan sponsor intends for the fair market value of the plan assets to be equal to or greater than total plan liabilities. Most plan sponsors using mutual funds for financing utilize the full funding approach while plan sponsors financing with life insurance usually do not. For unfinanced plans or plans financed with a total return swap, plan sponsors need not pay attention to funding levels.

The full funding approach, when combined with a mirror or mapping earnings hedge, translates into a neutral financial statement impact as it allows for a straightforward matching of plan assets and plan liabilities. Another advantage to this approach is greater participant security since benefits are 100% financed. The key downside to full funding is it requires the plan sponsor to increase its cash flow in order to cover asset expenses and the annual income tax due to the deferred wage expense deduction.

After-Tax Funding

The after-tax funding approach takes the cash wages participants defer or the sponsor contributes and uses a percentage of them to purchase assets to finance the benefit. The balance is used to pay the deferred wages' current income tax liability. For example, a regular C-corporation with a $1,000,000 nonqualified plan contribution in a 40% marginal income tax bracket could use $400,000 of the cash to pay the current income tax on the $1,000,000 deferred wages and invest the $600,000 balance. The sponsor then accrues the $400,000 current tax expense as a pre-paid tax asset on its balance sheet and therefore has a combined $1,000,000 of assets (i.e., $600,000 invested and $400,000 deferred tax asset) to finance the $1,000,000 benefit liability. With this approach the plan sponsor intends for the fair market value of the plan assets to be equal to or greater than the after-tax nonqualified plan benefit liability.

When combined with a mirror or mapping earnings hedge, the after-tax funding approach does not neutralize financial statement impact. Although the performance percentage is matched between the asset and liability accounts, the account values do not rise proportionally due to the absolute difference in the two amounts. Assets are significantly less than liabilities. However, the upside to this approach is that it improves plan sponsor cash flow since it retains cash to help cover asset expenses and the additional annual income tax due to deferred wage expense deductions.

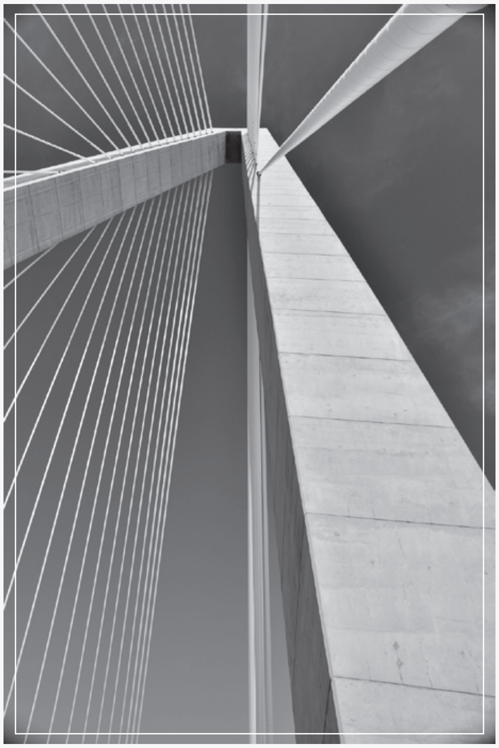
The after-tax funding approach takes the cash wages participants defer or the sponsor contributes and uses a percentage of it to purchase assets to finance the benefit.

Death Benefit Cost Recovery

Death benefit cost recovery is applicable only to the life insurance financing method. Unlike the prior approaches in which the primary focus is on the fair market value of the plan assets, this approach focuses on the present value of the future life insurance death benefit proceeds. The plan sponsor intends for the present value of future death proceeds to be equal to or greater than total plan liabilities.

Operationally, the plan sponsor's objective is to ensure that enough life insurance is in place as well as to be certain all life insurance policies remain in force until each insured dies. This is accomplished through the combination of periodic payments and sufficient investment returns. The higher the returns each year, the lower the required payments and vice versa. Typically, the premium payment needed will be less than the amounts participants deferred, which allows the excess cash to be used to pay the additional income tax. This, in turn, is favorable for company cash flow. Conversely, this approach tends to have a negative financial statement impact as the plan sponsor must book the life insurance cash surrender value instead of the present value of the future death benefit proceeds.

The effort required to frequently review life insurance projections as well as the dependence on key assumptions such as the discount rate and assumed age of death create additional considerations for plan sponsors choosing this approach.



CONCLUSION

No "one size fits all" financing method, hedging strategy, or funding level exists for every plan sponsor. The sponsor's economic assumptions, the nonqualified plan's design, asset security mechanisms, liquidity requirements, and tolerance for risk and complexity are all factors that must be considered. For sponsors with a nonqualified plan already in place, we recommend performing an economic benefit analysis of the current financing strategy with an eye on plan costs, asset funding, and benefit security. All of these variables can make establishing a financing strategy seem overwhelming, especially in the absence of independent and objective assistance such as that provided by CAPTRUST Financial Advisors. However, this seemingly daunting task can be managed through the use of this simple three-step process:

- Identify the right financing method
- Select an earnings hedge strategy
- Determine an appropriate funding level

As shown in Figure 6, each option available within the three steps has advantages and disadvantages that should be carefully evaluated. Once the steps have been addressed, however, the plan sponsor will have a tailored financing strategy that best fits its needs.

Figure 6: Evaluating Financing Policy Choices

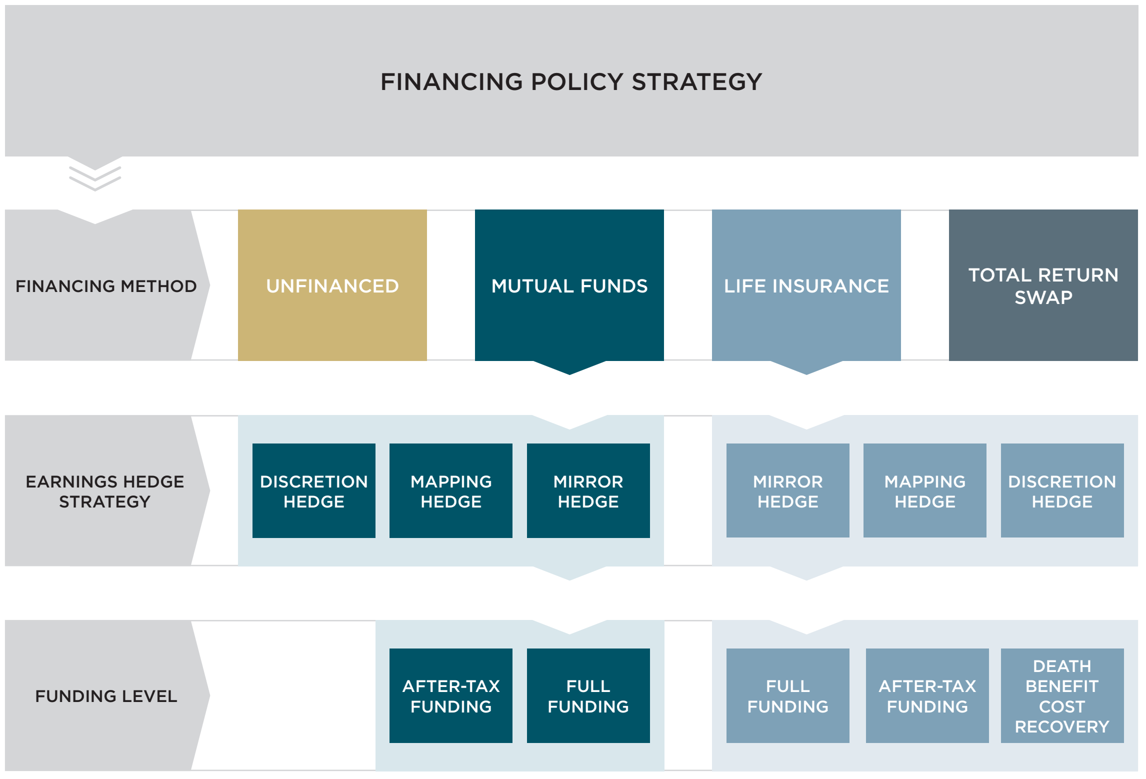
	COMPLEXITY	INCOME TAXATION	LONG-TERM FINANCIAL IMPACT	LONG-TERM CASH FLOW IMPACT	MONITORING IMPORTANCE	CRITICAL FACTOR
UNFINANCED	Low	High	Favorable[2]	Unfavorable	Low	Return on Equity
MUTUAL FUNDS	Medium	High	Neutral	Unfavorable	Low	Income Tax
LIFE INSURANCE	High	None[1]	Favorable	Neutral	High	Monitoring
SWAP	High	Low	Neutral[3]	Favorable	Medium	LIBOR rate

[1] When properly designed and maintained until death claim
[2] Assumes ROE exceeds plan benefit earnings
[3] Assumes cash from plan deferrals is used to pay income tax and remainder is invested to offset the swap provider fee.

CAPTRUST and Nonqualified Plans

CAPTRUST Financial Advisors has been advising plan sponsors on the design and implementation of ERISA plans for 25 years and applies its best practices to nonqualified deferred compensation plan development. We advise companies that collectively have more than $1.25 billion in nonqualified benefit liabilities and can help guide you through the process of evaluating the choices at each step of the plan selection process. We believe clarity is crucial to achieve successful outcomes and thus recommend plan sponsors start developing a financing strategy with a written nonqualified deferred compensation plan financing policy statement that comprehensively documents and memorializes the plan's practices and priorities. CAPTRUST has created a template that you can utilize to help draft a new financing policy statement. Please contact us to get started.

Figure 7: Financing Policy Strategy Decision Tree



Source: CAPTRUST Research

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Jason leads a team of specialists charged with the oversight of nonqualified plan client portfolios. He actively consults with current and prospective clients regarding plan design features, investment fulfillment, and ongoing monitoring procedures. An ERISA technical expert, Jason spent 10 years helping qualified plan sponsors deal with similar issues before joining the nonqualified executive benefits team. He earned the Accredited Retirement Plan Specialist (ARPS) designation through the Society of Professional Asset-Managers & Record Keepers (SPARK) and his Certified Investment Management Analyst (CIMA®) designation at the Wharton School of the University of Pennsylvania. Jason also successfully completed the requirements established by the American Society of Pension Professionals & Actuaries (ASPPA®) to earn the Qualified Plan Financial Consultant (QPFC) credential. Jason received a Bachelor of Science degree in business administration from the University of North Carolina at Chapel Hill.

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Nick joined CAPTRUST's nonqualified executive benefits team in 2010 and is primarily responsible for nonqualified plan implementation and financing with a focus on life insurance financing solutions. He most recently comes to us from the Principal Financial Group, where he was a manager of client service in their nonqualified group supporting pre- and post-sale efforts. Nick has analytical expertise with variable universal life, universal life, and whole life insurance products. He graduated from North Carolina State University with a Bachelor of Arts in business management and a master of business administration from Southern Illinois University.

At CAPTRUST, we believe a well-structured nonqualified plan is characterized by its capacity to effectively adapt to change as it occurs. Our comprehensive advisory services are designed to integrate and align your nonqualified and qualified plans to build a total retirement solution for your highly compensated employees, independent contractors, and directors.

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