Maximizing the Value of Executive Deferred Compensation Plans by Hedging Market Risk

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INTRODUCTION

According to a 2017 survey, an estimated 92% of Fortune 1000 companies now offer Nonqualified Deferred Compensation (NQDC) Plans, also known as Nonqualified Defined Contribution Plans.¹ These plans help corporations attract and retain talent, but can also create significant volatility on a company’s income statement. Executives generally can choose from a menu of market-based “notional” investments similar to the company’s 401(k) plan. When these investments rise or fall, the company’s compensation expense is directly impacted.

The most common strategies for hedging this market risk are to buy on-balance sheet taxable securities (like mutual funds) or Corporate-Owned Life Insurance (COLI).² In recent years, a third strategy appears to be rapidly gaining popularity: the use of a Total Return Swap (TRS). The purpose of this study is to evaluate the pros and cons of these three hedging options.

To do this, we conducted interviews with half a dozen Fortune 500 executives and two consultants that specialize in this area, reviewed papers and presentations on the subject, and modeled the NPV over ten years of one company’s recent switch from using securities to a TRS. In that case, the NPV gain from this switch was an estimated $93.5 million – offsetting almost two-thirds of the total liability of the company’s NQDC plan. There was also consensus among

¹ Newport Group 2017 Non-Qualified Deferred Compensation Survey
² 2013 MullinTBG study, “Executive Benefits Survey” and interviews with Fortune 500 executives
the executives, who spoke confidentially, that a TRS is the optimal solution, providing the greatest NPV, with tax-deferred gains, and superior accounting treatment of the gains.

Interviews with executives also suggest that one reason some companies may still be using COLI is that they purchased it years ago and believe it cannot be unwound without subjecting the corporation to a sizable tax hit. While this is true to some degree, according to a leading industry consultant, it is in fact possible to unwind large portions of a corporation’s COLI without tax or penalty.

THE THREE STRATEGIES: SECURITIES, COLI, AND A TRS

Per IRS rules, a company’s NQDC obligations must be an “unfunded and unsecured promise to pay money or property in the future.” Corporations thus cannot formally fund their NQDC liabilities or the executive is in “constructive receipt” and the income is immediately taxable. Many companies have however historically informally funded these obligations by buying mutual funds or other securities that track the investments the executives have selected, and holding these securities on the company’s balance sheet.

According to Kevin Mitchell, Principal at Mercer and a leading consultant in this area, the primary benefit of using securities is that they can hedge the market risk of these plans in a way that is easy to work with and understand. The main drawback, according to multiple Fortune 500 executives, is that it consumes a lot of capital that could otherwise be invested in the company’s core business. The weighted average cost of capital (WACC) for many industries is greater than 8%. Thus, if a company ties up capital in mutual funds earning 6%, its cost is more than 2% per annum over the life of the deferral. The company is effectively tying up cash in non-operating assets; cash that could otherwise be invested in its business.

In addition, for accounting purposes, the gains on mutual funds are treated as non-operating assets, recorded below-the-line in the income statement. Thus, mutual fund gains do not directly offset the NQDC plan costs (which are booked in compensation expense), and the company does not get credit from analysts for the performance of these funds, as they are not considered part of the core business. Finally, any investment earnings on those funds are immediately taxable to the company.

To avoid taxes on the earnings, some companies purchase COLI. Mitchell describes COLI as a portfolio of investments with a life insurance wrapper. “You’re paying insurance charges to get that wrapper, which lets your cash value grow tax-deferred, and ultimately, if you collect the death proceeds, [the gains are] tax-free,” he said. “The greater the return, and the greater the potential tax you’d be paying on a return, the greater the value there is to a COLI

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3 Treas. Reg. § 1.83-3(e) (2014)
4 2013 MullinTBG study, “Executive Benefits Survey” and interviews with Fortune 500 executives
5 http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/wacc.htm
6 FASB Statement 115 (FAS 115)
wrapper,” he noted, pointing out that if corporate tax rates drop to 15% as proposed by the current administration, there will likely be a significant decline in the use of COLI.

One prominent drawback highlighted by several executives is that COLI still requires a company to divert large amounts of capital away from its core business, and with various insurance charges of up to 1%, the net returns are unlikely to surpass the company’s WACC. In addition, earnings on the investments are – as with mutual funds – recorded below-the-line. COLI is also considered highly illiquid, and generally only recommended as a very long-term buy and hold transaction. “You have to wait until you collect those death proceeds at the back ends for those transactions to make sense,” Mitchell said.

One executive at a Fortune 500 company currently using COLI described it as a good hedge with tax benefits, but inefficient, with high fees, and lacking transparency. He recalled a stack of documents initially provided to him about the policy that stood more than a foot high. “COLI is really complex. No one really understands what we're paying or on the hook for,” he said. “No one’s talking about what's under the hood...it’s definitely a product geared towards insurance companies making money.”

Mitchell added that “COLI requires a lot more oversight than something like a mutual fund.” He frequently sees companies paying for more insurance than they need because they didn’t fund it enough, and “it’s eroding their returns rather than helping them.”

The executive at the company using COLI said if they could unwind it without suffering a significant tax hit, they would. He added that if they could do it over again, they would hedge with a Total Return Swap. This sentiment was echoed by other executives that we interviewed, many of whom are now using a TRS to hedge their plans. Other large companies use a TRS as well.

Rather than buying COLI or mutual funds directly, a swap allows a company to enter into a contract with a bank, whereby the company pays the bank LIBOR plus a spread, and the bank pays the company the returns of a basket of mutual funds. The bank then will generally hedge its position with futures or by buying the asset outright. It is profitable because the swap fee exceeds the cost of buying the asset.

Mitchell and the executives said the biggest benefit of a TRS is that the company doesn’t have to buy the assets, and can instead invest the capital in its own business. This provides greater returns. “It is capital efficient because we don’t have to actually invest in the funds, we just pay a swap fee each month plus receive/pay gains/losses on the swap,” one executive said.

Under accounting rules, the gains on the swap can also be recorded in compensation expense, above-the-line. As a result, the company gets credit for those gains with the broader

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7 2012 BNY Mellon “Hedging Nonqualified Deferred Compensation Plans”
8 http://atlasfinancialpartners.com/clients.html
market and they directly offset the cost of the plan. In addition, the gains may be tax-deferred if a tax hedge election is made.9

Executives we spoke with also praised the transparency of the swap. One noted, “you know exactly what you’re paying, and the nice thing about a derivative is you can always lift it.”

“It’s very simple, straightforward, and transparent with pricing,” said another. “I am surprised more companies aren’t doing it.”

One drawback of the swap, noted by Mitchell, is that it does not result in cash being set aside to pay the benefits when they are due. The swap also cannot be put into a Rabbi Trust, while mutual funds and COLI can, because it does not involve owning actual assets. A Rabbi Trust specifies that the assets can only be used to pay for benefits, except in the case of insolvency, and can “improve on the perceived benefit security of the plan,” Mitchell said.

In Mitchell’s opinion though, the value of a Rabbi Trust is “more psychological.” It is used primarily to protect executives against management or an acquiring company suddenly deciding that they do not see the benefits as legitimate and will not pay them. Mitchell describes situations like this as “highly infrequent,” and if an executive desires additional security, a plan can be set up with a trigger, whereby benefits are paid in full upon a change-in-control.

MODELING THE NPV OF A SWITCH FROM SECURITIES TO A TRS

One of the companies we interviewed recently switched from using mutual funds to a swap. This corporation shared information with us under the condition that we would keep it confidential, so we will share as much as possible about our analysis while respecting our agreement with this company.

We used a discounted cash flow model to evaluate the after-tax net present value for the two hedging strategies. For the swap, cash inflows included the initial after-tax deferral amount and swap gains (which occur on a monthly basis). Outflows included payments of after-tax benefits, fees for the swap, and taxes on the gains. For the mutual funds, cash inflows included the initial after-tax deferral amount and the after-tax gains on the funds. Outflows included payments of after-tax benefits and taxes on the mutual fund gains. We calculated the NPV of the cash flows over a ten-year period.

For inputs, we used publicly available figures for the company’s WACC and corporate tax rate. We assumed a mutual fund effective tax rate of 28%. The NQDC liability, as provided by the company, was roughly $150 million. We assumed a plan benchmark return of 7% (slightly higher than readers might expect, as it only includes equity and longer-duration fixed income), a 10-year LIBOR Swap Rate of 2.31%,10 and a spread of 0.9% (based on information from a swap provider).

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9 2012 BNY Mellon “Hedging Nonqualified Deferred Compensation Plans,” IRC Code Section 1221(b)
10 http://www.m-equicap.com/ 5/12/17
Over ten years, the NPV gain from having the NQDC plan itself is $19.4 million. The NPV loss from using mutual funds to hedge would have been $52.1 million. The NPV gain from using the swap is $41.4 million. Thus the NPV gain of moving from mutual funds to the swap is $93.5 million. This amount offsets almost two-thirds of the total NPV cost of the company’s NQDC plan.

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<thead>
<tr>
<th></th>
<th>NPV of NQDC Plan Itself</th>
<th>Gain / Loss on Hedge</th>
<th>Total NPV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mutual Funds</td>
<td>$19,418,209</td>
<td>-$52,122,315</td>
<td>-$32,704,106</td>
</tr>
<tr>
<td>Total Return Swap</td>
<td>$19,418,209</td>
<td>$41,401,638</td>
<td>$60,819,847</td>
</tr>
<tr>
<td>Net Benefit from Mutual Funds to TRS</td>
<td>$19,418,209</td>
<td>$93,523,954</td>
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UNWINDING COLI

As previously noted, some companies are hesitant to unwind their COLI even if they would like to, because it can trigger a significant tax hit. “The moment you liquidate it,” Mitchell says, “the IRS looks at how much you paid in premium and the value of cash surrender, and any difference in those two numbers you have to pay taxes on.”

However, Mitchell adds that there are ways to pull out much – even most – of a company’s cash value without triggering taxes. The first question to ask is whether the COLI is classified as a Modified Endowment Contract (MEC) or Non-Modified Endowment Contract (Non-MEC).

The options for unwinding MEC policies are generally not appealing. Most policies, however, are Non-MEC, and in those cases, the tax basis (which includes premiums paid, but not the gains), can be withdrawn at any time without adverse tax consequences. The size of the basis as a percentage of the total cash value varies from company to company depending on the investments in the policy, but the basis routinely constitutes more than half of a company’s COLI.

After a company has withdrawn the basis, it can take out a loan on the rest of the insurance policy. The corporation is charged interest, but the borrowed amount is also credited with interest by the insurance company. The difference between these two amounts is the net cost of the loan, and as long as “the cash value after the loan balance is sufficient to cover the insurance charges and keep the policy in force until death, the loan is never taxed, but is netted from the death proceeds when paid,” Mitchell says.
If a company wishes to unwind COLI that is in a Rabbi Trust, those assets must also be removed from the trust before they can be liquidated into cash. Most trusts allow a “substitution of assets,” Mitchell says. “What assets can be substituted depends upon how each trust document is worded/structured and what the trustee can accept.”

In certain cases, Mitchell says, where “a trust document permits it and the trustee approves,” assets in a Rabbi Trust can be replaced with a low-cost letter of credit.

CONCLUSION

Market-based NQDC Plans can be valuable tools to help corporations attract and retain talent, but when big enough, they also create significant volatility in a company’s income statement. The most common strategies for hedging this market risk are to buy taxable securities or COLI, and in recent years Total Return Swaps appear to have grown in popularity.

The experts we interviewed generally favored the Total Return Swap, due primarily to the fact that it allows a company to invest capital that otherwise would be used to buy COLI or securities back into its core business. The NPV gain over ten years of one company’s recent switch from mutual funds to a TRS is an estimated $93.5 million. This is almost two-thirds of the total size of the company’s NQDC plan. The TRS is also preferred because its gains can be recorded above-the-line for accounting purposes, and executives described it as more transparent, simpler, and easier to lift than COLI.