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SUCCESSION PLANNING WHEN AN EXECUTIVE CAN'T RETIRE

Retirement can be a friend or a foe of an effective succession planning strategy. Organizations bemoan the difficulty of replacing an established and effective executive or member of senior management (collectively, an "executive") who retires, but just as often, retirement opens up opportunity for high-potential leaders and new ideas and skills. Either way, retirement is a key driver of succession processes in most organizations.

But what happens if current executives are financially unable to retire when planned? Indeed, more and more executives — not unlike the rest of the workforce — are struggling with personal retirement issues. In recent years, many employers have scaled back on generous retirement programs, creating a gap in retirement readiness for many executives.

A key driver of the reduction in benefits is the ongoing shift from defined benefit (DB) plans to defined contribution (DC) plans. DC plans generally provide a lower benefit level than DB plans, and also transfer investment risk to the employee. This trend is significant already and will only grow in importance in years to come.

Because the shift from DB to DC plans has happened gradually over time, there is often a wide range in the benefits provided within a single organization, even among executives with similar demographics.

IN THIS ISSUE, ANSWERS TO:

How to prepare for an effective succession planning process.

How retirement readiness can support succession strategies.

The role of deferred compensation in enabling retirement readiness.

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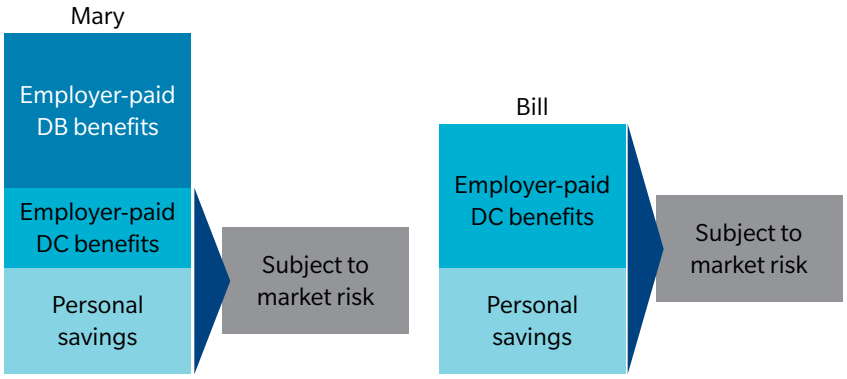
Exhibit 1 illustrates the circumstances of two executives at the same company, at similar ages and pay levels, but who have completely different levels of retirement readiness. Mary continues to participate in the company's generous DB program, while Bill joined the firm after the DB plan was closed to new entrants, creating a meaningful difference in benefit levels between the two executives. It may not be evident to the employer that Bill is far more likely to delay retirement than Mary is. Not only is Bill's level of retirement benefits lower, his entire benefit value is subject to investment risk, while Mary's DB benefits provide her a stable component of retirement income.

Exhibit 1. Retirement-Readiness Disparity Among Executives



"ORGANIZATIONS NEED TO MAKE SURE THAT PERSONAL RETIREMENT CONCERNS ARE NOT LIMITING SUCCESSION."

Delayed retirements can create important organizational risks, including:

- Inability to promote skilled, ambitious, and marketable younger executives who may instead leave the organization.
- Incumbent leaders who may be less likely to drive major change and innovation because of the complexity, effort, and time horizon involved.
- Decreased motivation among mid-level managers to engage in development activities and stretch performance.

Thus, organizations need to make sure that personal retirement concerns are not limiting succession. We discuss below how to create conversations and solutions that work for the executive and the organization.

FOUR STEPS TO A WIN-WIN FUTURE

Most executives are well-respected, talented professionals who have made important contributions to the organization. They have important business relationships, institutional knowledge, and cultural influence. Helping them prepare for retirement is not just the right thing to do for the business, it is the right thing to do in general.

However, executives also have unique retirement challenges that may interfere with the optimal timing of their transition from the organization.

Their identity may be wrapped up in their work. They may lack a clear picture of a post-retirement future. Or they may fear losing financial security or status by retiring. To clear away ambiguity and define the right timing and next steps, a well-designed process should answer four questions:

1. Where am I financially and what employer-sponsored wealth-accumulation vehicles can help support my objectives?
2. What's my picture of post-retirement life?
3. What does the organization need from me?
4. What activities and timing will optimize my personal transition and succession planning for my organization?

Proactive employers will assist their executives in answering these questions as a benefit to the executive but also to support effective succession and transition in the leadership ranks. The process is a partnership between the executive, the employer, and third parties, applied with appropriate sharing and confidentiality.

1. Where Am I Financially?

The first step to supporting an effective retirement transition is a clear understanding of one's financial situation. Executives vary significantly in how well they understand the wide range of investment and retirement programs that help to fund retirement. In particular, executives may not fully understand their pension and/or 401(k) options, executive retirement and deferred compensation benefits, or the ideal sequencing of different funding sources (qualified plans, nonqualified plans, IRAs, Social Security benefits, health savings accounts, other investments, etc.).

Access to a financial planner, modeling tools, and detailed retirement program information are critical. Simply providing information and tools on an employer website is not enough. These scenarios are complicated and involve tax implications and trade-offs in programs and decisions. For valued executives who impact succession planning, employers should make the investment and provide access to external financial advisors who help to document and structure retirement planning.

"EXECUTIVES MAY NOT FULLY UNDERSTAND THEIR PENSION AND/OR 401(K) OPTIONS, EXECUTIVE RETIREMENT AND DEFERRED COMPENSATION BENEFITS, OR THE IDEAL SEQUENCING OF DIFFERENT FUNDING SOURCES."

2. What's My Picture of Post-Retirement Life?

While understanding one's financial status is key, retirement is much more attractive when the future lifestyle looks tangible and engaging. Often, executives are interested in maintaining a level of professional involvement and leadership but need to determine how best to achieve it.

Retirement planning workshops, perhaps combined with personal coaching and spouse involvement, can help to reduce concerns and make future direction more clear. Executives who understand their financial situation and their post-retirement goals are motivated and prepared to help craft the right retirement plan. Third-party assistance can ensure the executive's preferred level of confidentiality.

3. What Does the Organization Need From Me?

Often, both the employer and the executive wonder about the other's preferences regarding retirement. Such conversations are important, but will not happen if they are not scheduled or lack a process for effective discussion. The employer should take the lead to ensure these conversations happen, to both honor the executive and understand the options and considerations for the future.

We recommend structuring and communicating these meetings as follows:

- Meetings are a normal part of leadership succession process, held periodically for all eligible positions. "Years to retirement eligibility" is one trigger, but others could be used as well (for example, significant role change/demand).
- Meeting attendees are the executive, the executive's boss, and a representative from HR (for example, CHRO, head of talent management).
- Meeting objective is an open exchange, not a performance review or negotiating session.
- Meeting follows a simple agenda: the executive's current intentions regarding retirement, the organization's preferences/needs, and the resulting dialogue.

"VOLUNTARY DEFERRED COMPENSATION (VDC) PLANS FOR EXECUTIVES REMAIN VERY PREVALENT — OVER 80% OF FORTUNE 500 COMPANIES SPONSOR VDC PLANS."

The length and tone of these meetings will differ depending on situation, but the key is that a conversation occurs that enables future planning. This dialogue will lead directly to better decisions about retirement and succession.

4. What Are the Next Steps for Personal and Succession Transition?

The final step in the process is to translate dialogue into tangible action plans and approximate dates. For example, an executive may decide his or her retirement window is three years from now, ideally remaining in the same role but with openness to arrangements that promote effective transition. Making this decision allows the executive to make personal financial preparations for that date. For the organization, it puts into action related succession and leadership development activities that increase knowledge transfer and organizational stability.

THE INCREASING IMPORTANCE OF VOLUNTARY DEFERRED COMPENSATION PLANS

As employer-paid benefit levels continue to decline, executives shoulder increasingly more responsibility for their own retirement readiness. Voluntary deferred compensation (VDC) plans for executives remain very prevalent — over 80% of Fortune 500 companies sponsor VDC plans. VDC plans provide executives with an additional pre-tax savings opportunity over and above the 401(k) savings opportunity. Given the impact of reduced employer-paid benefits, coupled with higher tax rates, these plans now play

a critical role in supporting executive wealth accumulation. Exhibit 2 summarizes the recent increases in tax rates that affect the economics of pre-tax deferral.

Exhibit 2. 2013 Tax Changes That Affect the Economics of Pre-Tax Deferral		
Taxpayers earning $200K+ ($250K+ jointly)	2012	2013
Medicare tax on investment income[1]	0.0%	3.8%
Taxpayers earning $400K+ ($450K+ jointly)	2012	2013
Medicare tax on investment income[1]	0.0%	3.8%
Federal income tax	35.0%	39.6%
Dividends and long-term capital gains	15.0%	20.0%

[1] Applies to capital gains, dividends, interest, and bond income, but not deferred compensation

These higher tax rates have further strengthened the economic advantages of pre-tax deferral for high-income earners. Exhibit 3 compares the economics of pre-tax deferral relative to investing after-tax compensation, based on various deferral periods and future tax-rate scenarios. As expected, the advantage of deferring is greatest with lower/constant future tax rates. But even with the expectation of higher post-retirement tax rates there is still, in many cases, an advantage to deferring pre-tax, due to the value of compounded tax-deferred growth. As a rule of thumb, a 1% increase in future tax rates can be offset by an additional one year of deferral.

"EVEN WITH THE EXPECTATION OF HIGHER POST-RETIREMENT TAX RATES THERE IS STILL, IN MANY CASES, AN ADVANTAGE TO DEFERRING PRE-TAX, DUE TO THE VALUE OF COMPOUNDED TAX-DEFERRED GROWTH."

Exhibit 3. Advantage of Pre-Tax Deferral Versus After-Tax Investment[2]			
Increase in retirement value due to deferral			
Deferral period	Tax-rate change at retirement		
	5% decrease	No change	5% increase
5	21%	11%	1%
10	34%	23%	12%
15	49%	37%	24%

[2] Assumes individual earns $400,000 annually, and is subject to 5% state income tax, 50% equity and bond blend with 7% and 5% annual investment returns, respectively.

With the increased focus on pre-tax deferral, how can employers optimize the effectiveness of VDC plans? Two of the most critical elements are plan design and communication. The plan design should provide sufficient flexibility for the timing and form of benefit payments, and provide an attractive array of investment options. Plan designs have evolved in the wake of IRC Section 409A regulations, and the most effective plans now strike a balance between providing participant flexibility and minimizing unnecessary complexity and compliance risk.

Communication is a critical aspect of a successful plan, but is often the most overlooked aspect. Even the best-designed plan will not be successful if executives don't understand and value the program. Enrollment meetings and/or webinars to explain the program are often very effective in promoting participation. Clear descriptions of the plan are critical, rather than simply referring executives to a detailed plan document or lengthy plan description. Access to online modeling tools on the plan website is

important so that executives can model expected outcomes under a range of scenarios and assumptions. The more executives take advantage of the savings opportunities available to them, the more likely they are to achieve retirement readiness at the desired time.

CONCLUSION

To summarize, it benefits both the business and its executives to follow a process for retirement planning and communication. Retired executives are more likely to be ambassadors for the organization, reinforcing relationships with the community, with key customers and within the employee culture. Succession takes place more smoothly and effectively, with better engagement and retention of high-potential future leaders. Finally, it provides the employer with a better understanding of how to structure executive retirement benefits to best fit key needs.

Hands-off approaches to retirement and succession will not work in today's environment of reduced benefits and high leadership demands. Follow a proactive process that engages senior leaders and drives tangible transition plans. The payoff comes in both leadership and business sustainability.

Additional resources

To learn more, we encourage you to visit our library of *Perspective* articles and visit Delta CEO & Board Effectiveness website.

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