



SOWING SECURITY

The use of supplemental employee retirement plans (SERPs) is expected to continue to increase, bringing new administrative, security and regulatory hurdles. It is up to employers to make sure the future is SERP-friendly.

By Mark Campbell

Supplemental employee retirement plans, or SERPs, have been growing in size and importance for decades. It is expected they will continue to do so. With tax limits on registered pension benefits failing to match the growth in salaries of high-performing employees, employers will look to SERPs to meet their pension obligations.

As the scope of SERPs grows, design changes will occur. Defined benefit (DB) SERPs for executives will re-emerge in response to poorly functioning defined contribution (DC) SERPs. Employers will secure their supplemental employee retirement plans. Executive SERP benefits in Canada will be

elevated to match those offered by U.S. firms. And administrative practices surrounding SERPs will be improved.

Below are predictions for SERPs in the coming years.

1. SERPs will become almost universal. The Canadian federal government persists in talking of “tax-assisted retirement savings” instead of “taxpayer-assisted capital formation,” believing the tax system to be subsidizing the accumulation of registered pension plan assets. The reality is that these assets provide much of the capital that drives the economy.

While the House of Commons Finance Committee has

recommended, yet again, that the tax limits be increased by approximately 23%, many believe that a tax limit increase of that size would be insufficient. They suggest limits be doubled or tripled.

Given the government's position, the tax limits on registered pension benefits will likely grow in line with average wage increases. Salary growth for top performers will far outstrip these increases in tax limits. As a result, by 2010, virtually all employers will be forced to sponsor a SERP to fulfill their pension promises.

2. Pure DC SERPs for executives will become rare.

Employers who have converted from DB to DC plans often followed suit with their executive SERPs. However, DC plans don't always work well. First of all, fast-track employees find their pensions out of kilter with their pay. Secondly, quantum increases in pay, particularly in late career, are not matched by quantum increases in DC account balances.

To address these issues, it is expected many companies will re-establish DB SERPs for their high-earners. Versions will include a pure DB plan solely for executives, a basic DC plan with a DB supplement applying to earnings above a threshold amount and a DB target benefit wrapped around a basic DC plan.

3. SERPs will be secured. The proportion of employers who have already secured their SERPs is steadily rising, from 20% in 1995 to 33% in 2000. According to a 2000 SERP survey carried out by Towers Perrin, the number is still higher among larger employers.

This is a good development. As demographic shifts heighten employee awareness about retirement, employees are becoming better educated. And they are coming to expect SERPs when negotiating salaries. Soon we will turn a corner where unsecured SERPs are an intolerable competitive weakness. And the absence of a security arrangement will negatively affect attraction and retention.

4. Incentive pay will be much more pensionable. This is a natural response to the steady shift towards more pay at risk, as companies focus on using employee rewards programs to align employee behaviour with new corporate strategies. Unless this incentive pay also becomes pensionable, the result is arguably a pension take-away.

However, the pensionability of incentive pay will not be universal. This is because some employers will not significantly increase pay at risk, others will increase pay at risk without making it pensionable but will provide an adjustment elsewhere (e.g., higher DB accrual or higher DC contribution rate on base pay), yet others will increase pay at risk without making it pensionable.

5. Canadian companies will provide SERP benefits to executive employees on a par with the U.S. It is already

difficult to attract Americans to Canada, or to keep Canadians from moving south due to a marked difference in the levels of pay. This disparity can be defended somewhat by the fact that one can live reasonably well in Canada on two-thirds of a U.S. pay packet. However, few executives will accept a third less in lifetime pension for the privilege of spending their later years of employment in Canada. To solve this problem, Canadian companies will have to close the pension gap, even if the pay gap remains wide. They will offer SERP benefits comparable to those provided by U.S. companies.

6. Mid-career hiring practices will be regularized. A tightening labour market plus an aging workforce will increase the necessity and frequency of mid-career hires. And pension issues will loom ever larger in recruiting. With the increased volume of mid-career candidates, current ad hoc approaches to dealing with pension issues for mid-career hires will break down. As a result, employers will adopt consistent and sensible policies to accommodate mid-career hires.

Due to tax and regulatory constraints on registered pension plans, SERPs will play a key role in executing the pension-related aspects of these policies.

7. SERPs will be used to address retention issues. Faced with increasing labour shortages, employers will also use SERPs to retain talent, particularly senior talent. Compared to registered pension plans, fewer tax and regulatory constraints apply to SERPs.

Therefore, employers will use SERPs creatively to facilitate various forms of modified employment at higher ages, such as phased retirement (gradual reduction of hours of work), stepped retirement (gradual reduction of the level of responsibility), partial retirement (reduction in hours of work) and intermittent retirement (retirement, but with occasional resumption of employment).

8. SERPs will be used to fill other pension gaps. The Canadian tax environment continues to be plagued with problems that prevent sensible pension design. These include low limits on the accrual of foreign service and restrictions on the ability of employers to recognize pensionable earnings throughout their organizations.

SERPs are only lightly regulated under tax law, and virtually unregulated under pension law. As a result, SERPs will be increasingly used to get around the problems created by troublesome tax and pension legislation.

9. Improved security options will be available. Canadian workers are anxious to have their growing SERP benefits secured in some way. Employers are also getting worried about burgeoning SERP liabilities. Yet when one considers the typically used security options,

such as the 50% taxation of a retirement compensation arrangement (RCA), it is apparent that no magic bullet is available. Better alternatives will consequently be developed.

10. SERP documentation will become standardized. As the popularity of SERPs grows, medium-sized and large companies will measure their future SERP liabilities in tens of millions of dollars. Given the size and complexity of these obligations, it will no longer make sense to scantily document them. Comprehensive and carefully crafted SERP plan texts will become commonplace.

11. SERP communication will be heightened. Current SERP communication practices vary widely, ranging from virtual secrecy to lengthy and detailed disclosure. By 2010, the needle will be swinging towards total candour. Future SERP benefits will be large and widespread, and will be communicated clearly.

12. Some employers will want to change their SERP benefits and/or security arrangements. Benefit promises and security arrangements that make sense today may be regretted tomorrow in light of tax laws, pension laws and corporate circumstances. By 2010, some employers will wish they had built escape hatches into their SERP programs.

13. Lump sum SERP payouts will become more common. Maintaining security arrangements for SERP benefits is expensive. This will make lump sum settlements attractive to employers, even if the settlements must be tax-adjusted. For example, funding through an RCA trust taxed at 50% is more expensive than making a tax-adjusted lump sum settlement. This will be especially true as personal tax rates fall further.

14. SERP sponsors will seek to recover RCA refundable tax accounts. When employers secure SERP benefits through a letter of credit held in an RCA, large refundable tax accounts build up. Negligible initially, these unproductive accounts become progressively more onerous. By the end of the decade, sponsors will seek creative ways to recover these amounts.

Employers should act now to implement SERPs that are broad in coverage, secured, carefully documented and communicated to address the retirement income needs of both current and future employees. Those who position their SERPs for the future will improve the attraction and retention of key employees, reduce costs and risks, and enhance the delivery of their pension promises. **BC**

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