Hedging Market-Based Nonqualified Deferred Compensation Plans

EXECUTIVE SUMMARY

- A deferred compensation plan is an arrangement between a plan sponsor (the employer) and an executive (the employee) under which a part or all of the executive’s salary and/or bonus is deferred until a future date. A nonqualified deferred compensation plan typically permits an executive to defer these amounts on a pre-tax basis and earn market-based notional (hypothetical) returns on the deferred amounts.

- An estimated 92% of Fortune 1000 companies now offer nonqualified deferred compensation (NQDC) plans. NQDC plans help attract and retain talent, and can create economic value. Executives enjoy the benefit of deferring taxes, and companies get access to additional capital that can be invested in the core business, or be used to pay down expensive debt or initiate a share repurchase program.

- NQDC plans can also, however, create volatility in a company’s income statement. Executives generally choose from a menu of market-based “notional” investments similar to the company’s 401(k) plan. As the notional investments rise or fall, the company’s compensation expense is directly impacted. This can result in a company missing earnings projections and require detailed explanations of unbudgeted executive compensation in financial statements and to a company’s analysts. Many companies choose to hedge their plan to minimize this risk.

- Historically, companies have hedged this market risk by buying on-balance sheet taxable securities (like mutual funds) or Corporate-Owned Life Insurance (COLI).

- In recent years, however, more and more large companies—including Microsoft, Cisco, BNY Mellon, and many others—have begun hedging with a Total Return Swap (TRS).

- A recent study by Columbia Business School found that in one case, the net present value of switching to the TRS was so large that it could have paid for two-thirds of the compensation owed to executives under the NQDC plan.

- This value comes largely from the fact that the TRS frees up capital that can earn higher returns in the company’s core business, but it also offers optimal accounting treatment (eliminating volatility not just in Net Income but in Compensation Expense and Operating Income), its gains are tax-deferred, and it hedges with minimal or no tracking error.

- Taken together, this strategy can materially reduce the costs of an NQDC plan without making any changes to plan benefits, administration, or design.

This white paper provides a detailed overview of each NQDC funding/hedging strategy, looking specifically at the economic value, accounting treatment, tax treatment, and hedge accuracy of each.

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2 http://atlasfinancialpartners.com/clients.html
TRADITIONAL METHODS USED TO HEDGE NQDC PLANS

Taxable Investments (Mutual Funds)

Approach: Hedge the NQDC plan liability using taxable investments like mutual funds which informally pre-fund the deferral obligation.

Accounting Treatment: FASB Statement 115 (FAS 115) addresses the accounting for investments in equity securities that have readily determinable fair values, and for all investments in debt securities. Debt and equity securities that are bought and held principally for the purpose of selling them in the near future are reported at fair value, with realized and unrealized gains and losses included in Investment or Other Income. This is the method generally used for mutual funds held as a hedge to NQDC plan liabilities.

Accounting Geography Note: Changes to the NQDC liability are recorded in Compensation Expense. Since income or earnings on mutual funds are typically recorded in Other Income, they do not eliminate volatility in Compensation Expense or Operating Income.

Tax Treatment: If a company purchases mutual funds, any realized investment earnings are currently taxable to the company.

Economic Impact: Hedging using taxable investments is expensive for two reasons. First, it ties up capital that could earn higher returns in the company's core businesses. Second, the promise to the employee is credited with tax deferred earnings while the hedge investments are subject to taxation on realized gains and income as incurred on the investments. Taxable events occur whenever the company moves funds from one investment to another in response to employee decisions to rebalance his or her deferred account, resulting in an out-of-pocket cost to the company.

Hedge Accuracy: Mutual Funds typically can hedge NQDC plans with great accuracy.

Corporate-Owned Life Insurance (COLI)

Approach: COLI is often described as a portfolio of investments within a life insurance wrapper. In exchange for paying insurance-related fees, it allows companies to generate earnings tax-free.

Accounting Treatment: If a company acquires COLI, the policy is reported on the company's balance sheet under the “cash surrender value” method. FASB Accounting Standards Codification (ASC) Subtopic 325-30 states that “the amount that could be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset.” This “cash surrender value” method will allow the value of the life insurance policy to grow on the balance sheet of the company. Once the cash surrender value of a life insurance policy exceeds the premiums paid by the company, the company will be entitled to record the annual increase as a revenue item in Other Income on its income statement.
Accounting Geography Note: Changes to the NQDC liability are recorded in Compensation Expense. Since income or earnings on COLI are typically recorded in Other Income, they do not eliminate volatility in Compensation Expense or Operating Income.

Tax Treatment: As long as the company waits until it collects the death proceeds and does not surrender its COLI early, earnings on COLI are tax-free.

Economic Impact: Like taxable investments, COLI consumes capital that could otherwise be invested in the plan sponsor’s core businesses. Accordingly, the opportunity cost of this hedging approach is high and the capital intensity of the hedge can make the plan expensive to offer under most cost of capital scenarios.

Hedge Accuracy: COLI is unlikely to function as a perfect hedge for a number of reasons. First, many plans allow participants to rebalance their accounts more frequently (e.g. daily) than a COLI policy administrator is willing to rebalance the COLI asset (e.g. monthly). Second, publicly available mutual funds and alternative investment funds cannot be used within insurance products; insurance-dedicated funds (IDFs) must be used. Not all funds that could be used as reference investments in an NQDC plan are available in IDF form and where proxies must be used there is the potential to incur tracking error. Third, if a company is using COLI to fund or hedge 100% of the NQDC liability, it effectively over-hedges the plan (COLI earnings are tax-free, while increases in the liability flow through the income statement after-taxes).

HEDGING NQDC PLANS WITH A TOTAL RETURN SWAP (TRS)

Taxable Investments (Mutual Funds)

Rather than buying COLI or mutual funds directly, a company can enter into a TRS with a bank. A TRS is an over the counter (OTC), bilateral financial contract where the counterparties agree to exchange (or “swap”) the total return (cash flows plus capital appreciation/depreciation) of an asset or basket of assets for periodic cash flows. The company pays the bank a specified rate, currently LIBOR\(^4\) plus a spread, and the bank pays the company the earnings of a basket of mutual funds, ETFs or indices. The bank then will generally hedge its position with futures or by buying the asset outright.

Accounting Treatment: The TRS Hedge is marked-to-market and thus, directly offsets changes in the NQDC Plan liability on the income statement. According to ASC 815, plan sponsors are typically allowed to record gains and losses for the swap in the same income statement line item, “Compensation Expense”, as the changes in the NQDC plan liability.

For example, assuming the value of the Total Return Swap is increasing, the employer would record the following entry:

Unrealized Gain on Total Return Swap (balance sheet) $xx,xxx
Compensation Expense (income statement) ($xx,xxx)

The employer would record the following entry for increases in the NQDC liability:

Compensation Expense (income statement) $xx,xxx
Nonqualified Deferred Compensation Plan Obligation (balance sheet) ($xx,xxx)

Accounting Geography Note: Unlike Mutual Funds or COLI, a company, in consultation with its accountants, typically records the fair value of the swap gains or losses in Compensation Expense. This eliminates the volatility in not just Net Income, but in Compensation Expense and Operating Income as well.

Tax Treatment: The TRS Hedge may be designated as a hedge for tax purposes and, accordingly, the tax treatment of gains, losses and costs of the TRS Hedge will match the tax characteristics of the underlying NQDC plan liability. Specifically, the plan sponsor can utilize the hedging rules under Treasury Reg. 1.1221-2(b)(2) and section 1221(b)(2) of the Code to defer the taxable event for gains/losses attributable to the swap until distributions are made to participants under the NQDC plan. In other words, taxable swap gains are allocated to each distribution and taxed in the year of each distribution which matches when the company receives the tax deduction for the distributions.

Economic Impact: The unfunded nature of the swap means that the after-tax deferred compensation is available for use by the company to invest in its operations for the duration of the deferrals. If the cost of the swap (typically a LIBOR-based rate plus a spread) is lower than the company’s WACC (the rate at which the company can invest this capital back into its business) the TRS will create a positive NPV for the company.

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* Investment in any floating rate instrument presents unique risks, including the discontinuation of the floating rate reference or any successors or fallbacks thereto. BNY Mellon does not guarantee and is not responsible for the availability or continued existence of a floating rate reference associated with any particular instrument. Before investing in any floating rate instrument, please evaluate the risks independently with your financial, tax and other advisors as you deem necessary.
Hedge Accuracy: The TRS typically can hedge NQDC plans with great accuracy.

## NQDC Hedging Plan Strategy Comparison

<table>
<thead>
<tr>
<th></th>
<th>TRS Hedge</th>
<th>No Hedge</th>
<th>Corporate Owned Life Insurance</th>
<th>Mutual Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Creates Liquidity</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Economic Value</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(positive cash flows, earnings &amp; low cost)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Optimizes Capital Structure</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Potential Tax Benefits</td>
<td>✓</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Minimizes Income Statement</td>
<td>✓</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Volatility and/or Tracking Error</td>
<td>✓</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Administration</td>
<td>✓</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
</tbody>
</table>

## Mechanics of the TRS

The figure below illustrates the structure of an NQDC TRS hedge which is an exchange of returns between a plan sponsor and a bank swap counterparty (referred to as the swap provider in the Figure). In effect, the plan sponsor is simply renting the swap provider’s balance sheet at a rate equal to LIBOR plus a spread, thus gaining exposure to the swap provider’s balance sheet assets synthetically. In return for these interest payments, over the term of agreement, the plan sponsor will receive any gains of the underlying reference asset. These payments from the swap provider will offset the increased value of the NQDC liability.

As new deferrals occur, or amounts are distributed, or employees make NQDC plan reallocation decisions, the swap notional is adjusted accordingly to mirror the NQDC plan’s liabilities. A deferral distribution triggers a tax deduction for the plan sponsor and creates a taxable event attributable to the amount of swap gains distributed, net of the LIBOR-based costs.

The NQDC plan administrator (or benefit recordkeeper) will continue to manage and track the liability information and required transactions needed to administer the NQDC plan, communicate account information to the participant, support implementation of participant deferral decisions, and track the tax, accounting, and other information needed to effectively manage all aspects of the plan. The swap facilitation provider will manage and track the required transactions needed to administer the swap, communicate this information to the swap provider, communicate net exposure and P&L to the plan sponsor, and track the tax, accounting, and other information needed to manage all aspects of the NQDC plan and TRS Hedge.

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1. Employee defers compensation
2. Recordkeeper collects benefits-related information and provides Company with statements, accounting and distribution information
3. Swap facilitation provider receives investment allocation information and aids the Company in generating trade instructions for swap providers. Also provides Company with net exposure statements, accounting and distribution/tax information
4. Company periodically pays swap fee in exchange for a benchmark return on NQDC Plan
5. At plan maturity or termination of employment, benefits deferred +/− return paid by Company to employee. Upon payment, company realizes cumulative gains/losses on the swap, net of interest paid to swap provider, and realizes tax deduction for compensation amount

Benchmarks must be based on publicly-available investment alternatives.
In the figure below, the net present value (NPV) over 10 and 40 years of the TRS is compared to: leaving the plan unhedged, funding the plan with taxable investments (mutual funds), and funding the plan with COLI. The COLI policy invests in funds that mirror the reference investments utilized by plan participants. The all-in insurance-related costs of COLI are assumed to be approximately 100 bps per annum of the funded amount, resulting in a net earnings rate of 5.0%, no upfront premium load, and a maturity consistent with a structure that is redeemable only upon death of the insureds. All other parameters are the same in both scenarios.

**SUMMARY NPV RESULTS OF NQDC HEDGING ALTERNATIVES**

<table>
<thead>
<tr>
<th>10 Year Deferral Period:</th>
<th>NQDC Plan</th>
<th>Gain / Loss</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unfunded / Unhedged</td>
<td>$23,216,302</td>
<td>($411,441)</td>
<td>$19,774,861</td>
</tr>
<tr>
<td>Taxable Mutual Fund Investments</td>
<td>$23,216,302</td>
<td>($411,441)</td>
<td>$19,774,861</td>
</tr>
<tr>
<td>NQDC Total Return Swap™ Solution</td>
<td>$23,216,302</td>
<td>$21,565,044</td>
<td>$44,781,346</td>
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</table>

<table>
<thead>
<tr>
<th>40 Year Deferral Period:</th>
<th>NQDC Plan</th>
<th>Gain / Loss</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unfunded / Unhedged</td>
<td>$57,955,335</td>
<td>$0</td>
<td>$57,955,335</td>
</tr>
<tr>
<td>Taxable Mutual Fund Investments</td>
<td>$57,955,335</td>
<td>$0</td>
<td>$57,955,335</td>
</tr>
<tr>
<td>Corporate-Owned Life Insurance (COLI)</td>
<td>$57,955,335</td>
<td>$5,833,267</td>
<td>$64,788,602</td>
</tr>
<tr>
<td>NQDC Total Return Swap™ Solution</td>
<td>$57,955,335</td>
<td>$5,833,267</td>
<td>$64,788,602</td>
</tr>
</tbody>
</table>

**40 Year Deferral Period - COLI w/ SWAP OVERLAY:**

<table>
<thead>
<tr>
<th>NQDC Total Return Swap™ Solution</th>
<th>Gain / Loss</th>
<th>Total</th>
</tr>
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<tbody>
<tr>
<td>$57,955,335</td>
<td>$5,833,267</td>
<td>$64,788,602</td>
</tr>
<tr>
<td>Corporate-Owned Life Insurance (COLI)</td>
<td>N/A</td>
<td>($38,207,551)</td>
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<tr>
<td>TOTAL COLI w/ SWAP OVERLAY:</td>
<td>$57,955,335</td>
<td>($32,374,284)</td>
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</tbody>
</table>

In the figure below, the attribution (sources) of the NPV gains/losses for the 10 year deferral period are shown.

**10 YEAR NPV ATTRIBUTION ANALYSIS**

<table>
<thead>
<tr>
<th>NQDC Total Return Swap™ Solution</th>
<th>Unfunded / Unhedged</th>
<th>Taxable Mutual Fund Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>NQDC Program:</td>
<td>$23,216,302</td>
<td>$23,216,302</td>
</tr>
<tr>
<td>Hedge:</td>
<td>($48,698,925)</td>
<td>($30,490,602)</td>
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<tr>
<td>Gain / (Loss) from Hedge / Investment</td>
<td>$0</td>
<td>($81,445,671)</td>
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<tr>
<td>Cost of Hedge</td>
<td>($23,131,989)</td>
<td>$0</td>
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<tr>
<td>Pre-Tax Gain / (Loss) of Hedge</td>
<td>$25,566,938</td>
<td>$0</td>
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<tr>
<td>Taxes</td>
<td>($4,001,892)</td>
<td>($10,226,774)</td>
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<tr>
<td>Total Gain / (Loss) Hedge</td>
<td>$21,565,044</td>
<td>$0</td>
</tr>
<tr>
<td>Total</td>
<td>$44,781,346</td>
<td>$23,216,302</td>
</tr>
<tr>
<td></td>
<td>($17,965,541)</td>
<td>($17,965,541)</td>
</tr>
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</table>

**40 YEAR NPV SUMMARY**

<table>
<thead>
<tr>
<th>NQDC Total Return Swap™ Solution</th>
<th>Unfunded / Unhedged</th>
<th>Taxable Mutual Fund Investments</th>
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<tr>
<td>NQDC Program:</td>
<td>$57,955,335</td>
<td>$57,955,335</td>
</tr>
<tr>
<td>Total Gain / (Loss) Hedge</td>
<td>$53,833,267</td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>($102,803,085)</td>
<td>($102,803,085)</td>
</tr>
<tr>
<td>Total</td>
<td>$111,788,602</td>
<td>$57,955,335</td>
</tr>
<tr>
<td></td>
<td>($44,847,754)</td>
<td>($44,847,754)</td>
</tr>
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**How Companies Committed to Funding their NQDC Plans Can Benefit from the TRS**

Legally a company cannot formally fund an NQDC plan—assets must be subject to the claims of general creditors or executives are in "constructive receipt" and will be taxed currently. However, as discussed above, companies have often funded informally using mutual funds or COLI. In these cases, assets are frequently set aside in a Rabbi Trust that specifies they can only be used to pay benefits, except in the case of an insolvency.

The primary purpose of a Rabbi Trust is to protect executives against management or an acquiring company deciding that they do not see the benefits as valid and refusing to pay them. While this is rare, some companies still prefer to provide executives with this protection, and many of these companies can still benefit substantially from using a TRS to hedge their plan.

One option, which gives executives additional protection without actually funding the plan upfront, is to set up a “springing” rabbi trust. In this case, the trust is created but minimally funded before a transaction, and then “springs” into full funding as a condition for the closing of any merger or sale. The company could then use a TRS to hedge the plan as well.

Alternatively, if a company is already funding its plan and using a Rabbi Trust, it may be able to replace the assets in the trust with a letter of credit from a large bank. The letter of credit essentially enables the plan sponsor to fund their NQDC plan using a bank’s balance sheet instead of its own, in a way that trustees and fiduciaries are comfortable with. Fiduciaries for one major bank determined that a letter of credit used to fund the Rabbi Trust was at least as protective of plan liabilities as mutual funds (the letter of credit is “money good”).

Another option is for the plan sponsor to fund the trust with treasury shares or operating assets of the company as a replacement for the COLI or mutual funds. Possible assets the plan sponsor can use are corporate real estate, intellectual property, plant, equipment, factored receivables or leasing agreements.

Each of these options would eliminate the cost of tying up capital in a Rabbi Trust. They would also avoid the need for the company to come up with more capital than what is generated by the after-tax deferral from the participant, as with COLI (if a participant defers $10 million, the company would have to buy $10 million of COLI, but would only have approximately $7.5 million from the amount deferred, due to the tax deduction).

**Additional Limitations of COLI**

As a hedge of NQDC plan liabilities that are diversified across a range of funds, COLI has a number of notable limitations—while there are ways to reduce the severity of the limitations, they are difficult to eliminate entirely.

- COLI is a long-term investment, the full benefit of the policy is only realized when death benefits are paid. A deferred compensation obligation has a shorter duration, typically from 5 to 15 years. It is conceivable that a plan sponsor will continue to carry COLI on its balance sheet for many years after the NQDC obligations are met and will, at that point, be exposed to fluctuations in the value of the COLI assets.

- The life insurance component of the COLI policy is not free. The plan sponsor will typically need to pay up-front premium loads and on-going fees to finance the death benefit and other policy-related expenses.

- The costs of COLI are difficult to predict. Ongoing insurance-related charges are dependent on a number of factors such as the demographics of the group and indirectly, the performance of the assets inside the policy. Performance below expectations will increase the cost of the death benefit because the cost of insurance is dependent upon both the difference between the aggregate death benefit less the cash value of the policy as well as the demographics of the population insured.

- Financial services firms who include their own funds within their NQDC plan options will be limited or even precluded from doing so within the COLI due to insurance-related tax rules.

- Non-public investment funds, especially alternative investments, are difficult to support and are rarely found in plans hedged with COLI.

**Things to Consider if You Already Have COLI**

- Other hedging alternatives can be used to augment existing COLI if the Company does not want to make continued purchases.

- COLI can be converted to an investment strategy that can be managed by a plan sponsor’s Treasury Department while alternative hedges can be added as an overlay to hedge the NQDC plan liabilities.
CONCLUSION

Total Return Swaps have become an increasingly popular tool for hedging nonqualified deferred compensation plans because of their ability to reduce income statement volatility, free up corporate balance sheet capacity and provide optimal tax and accounting tax treatment. A Total Return Swap may not be practical for every issuer due to factors such as deferred compensation plan size, company WACC rates, tax consequences from liquidating current hedging methods, and Rabbi Trust restrictions. However, for many plan sponsors this hedging alternative is the most practical, economical and efficient. The use of Total Return Swaps, we believe, will become the preferred method for companies to hedge their deferred compensation liabilities. Plan sponsors will be well-served to consider such a program with their bank, legal counsel, and tax and accounting advisors.

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Clifford R. Eisler is a Principal of Atlas Financial Partners in New York.


ABOUT ATLAS FINANCIAL PARTNERS

Atlas Financial Partners (ABF) is a leader in the design, implementation, funding, hedging and ongoing administration of NQDC Plans. ABF pioneered the development of the NQDC Total Return Swap™ program, a proprietary, low-cost offering that dynamically hedges income statement volatility created by NQDC plans.

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