NQDC Plans: Education Considerations

NQDC plans are complex – better education around the complexities of these plans can help.

By Jason Stephens for PSCA's NQDC committee, originally published in the Fall 2024 edition of Insights

You've designed a nonqualified deferred compensation (NQDC) plan to reward your key talent – but what if they're not paying attention? According to the "2024 Newport/PLANSPONSOR NQDC Trends Survey Report," 78 percent of these plans have participation rates below 50 percent. Despite the potential, NQDC plans sometimes fail to capture the excitement of the employees they are intended to benefit. So, why are your top earners missing out? And, more importantly, what can you do about it?

Great Expectations

Plan sponsors recognize that NQDC plans are a valuable tool for high-earning employees. These plans offer an additional pre-tax savings tool and long-term growth possibilities. In addition, they can positively impact employee retention. However, many eligible employees just aren't taking advantage of the opportunity.

A recent survey conducted by the Plan Sponsor Council of America (PSCA) showed that the average NQDC plan participation rate was just 47.5 percent, compared to an average of 84 percent for 401(k) plans, according to Alight. It's not surprising then that plan sponsors often feel their NQDC plans are underused and underappreciated. Sponsors find themselves frustrated by the promise of these programs in contrast to the lack of uptake.

Key Factors Affecting Participation

Before getting too prescriptive, plan sponsors should recognize that there are some structural elements they can't control that influence participation in NQDC plans. Those factors include a continued exposure of plan balances to bankruptcy risk and heightened sensitivity to underlying economic conditions.

- *Bankruptcy risk:* Technically speaking, NQDC plans are unfunded promises to pay, leaving participants exposed to general creditor risk. While companies can set aside assets to provide security against liquidity concerns, general creditor risk cannot be eliminated. This exposure may feel too risky for some NQDC participants.
- *Economic outlook:* External factors including economic trends, stock market movements, and anticipated changes to individual tax rates all broadly influence NQDC plan demand. Plan enrollment typically occurs only once a year and is subject to the prevailing environment.

Plan sponsors should acknowledge the impact of these factors and consider participation levels within this context. This is especially true regarding bankruptcy risk, which is not a consideration in similar pre-tax-deferral programs such as 401(k)s.

What Plan Sponsors Can Control

While structural factors exist mostly outside of the plan sponsor's control, there are several levers that can be used to increase participation. Designing an attractive NQDC plan with employer contributions, flexible distribution options, and a strong investment menu are all effective ways to improve engagement. The plan sponsor can also informally set aside assets to support future benefit payments. This strategy can address potential liquidity or management concerns, although it does not remove bankruptcy risk. A well-structured plan gives employees more reasons to participate and helps them see the value of the benefit more clearly.

Reviewing participation through the lens of plan eligibility guidelines is also important. NQDC plans are limited to a select group of management or highly compensated employees as outlined under the Employee Retirement Income Security Act (ERISA). *S*ome employers choose to extend eligibility broadly within these parameters.

The incremental cost of having generous eligibility requirements is low and generally offset by goodwill earned in return. Still, employees at the lower end of the highly compensated range may not need an additional pre-tax savings tool. Typically, individuals earning $200,000 or more are more likely to participate when offered an NQDC plan. Plan sponsors can increase nonqualified plan participation rates by more narrowly defining eligibility, but to what end? Excluding employees who have been previously included could take a toll on culture and morale. For those that want to maintain generous eligibility requirements, it may be more beneficial to simply lower participation expectations instead.

The Role of Participant Education

Even the most attractive NQDC plan can fall short if employees don't understand how to use the benefit effectively. Participant education is crucial to driving engagement and ensuring employees make informed decisions that align with their financial goals. Without adequate guidance, employees risk making potentially costly mistakes, such as incurring a taxable distribution at a time when their income is high. For many NQDC plans, these decisions must be renewed annually.

Effective education often means going beyond just explaining the basics of a plan and should help employees understand how the NQDC plan fits into their overall financial picture. For example, if a participant already has significant equity exposure in other accounts, they may want to reduce risk within their NQDC account. Similarly, a participant choosing a near-term distribution option might also want to consider a more conservative investment strategy.

Defining the Three Buckets of Education

Newport/PLANSPONSOR's 2024 survey also includes these concerning statistics: of various plan functions, ranging from investment choices to website experience, NQDC plan participants report the lowest satisfaction levels related to their "understanding of the plan," with only 20 percent of respondents saying they are "very satisfied" with their plan's communication and education.

When it comes to educating employees, there are three main strategies to consider:

1. *Basic education:* This is the top-level information participants need to understand how the plan works, what it offers, and how they can enroll. It should be clear, accessible, and easy to comprehend.
2. *Advice*: In addition to education, some participants may desire personalized advice that helps them make informed choices based on their unique financial situation.
3. *Financial planning:* This goes one step further by considering the participant's overall financial circumstances, integrating NQDC decisions with other retirement savings, and investment strategies.

Most plan sponsors (73.2 percent) are already providing basic NQDC plan education, but only 31 percent offer any financial advisory of wellness services in connection with their NQDC plan, according to PSCA and PLANSPONSOR, respectively. The plan sponsor is typically leading the effort, sometimes in coordination with the plan administrator. Popular methods of education include email messages and specialized enrollment materials. Based on current participation trends, it is fair to question the effectiveness of these strategies. Advice and financial planning resources are far less prevalent, offered by less than 20 percent of plan sponsors.

Assessing Participant Education Solutions

When considering participant education solutions for your NQDC plan population, understanding the capabilities of the plan administrator is a good place to start, as most administrators do not go beyond providing basic education. Plan sponsors looking to complement those services by offering advice and financial planning solutions may need to consider a third party that understands the intricacies of the NQDC plan and can offer comprehensive and unbiased advice. The best programs should be able to easily integrate across benefits – such as 401(k)s, NQDC plans, and pensions – to help participants make decisions in the broader context of their financial well-being.

Equally important is the delivery of education. Offering flexibility in how employees can access the information – whether through virtual sessions, in-person meetings, or one-on-one consultations—ensures that participants are fully informed and comfortable with their decisions.

Optimizing NQDC plan participation requires a combination of thoughtful plan design and targeted participant education. By acknowledging the structural challenges within – and outside of – their control, plan sponsors can start to think about success in an appropriate framework. A well-communicated and flexible NQDC plan can become a powerful tool for retaining and rewarding top talent.

Jason Stephens is the nonqualified executive benefits practice leader for CAPTRUST and a member of PSCA's NQDC committee.