

At a Glance

Most outside directors believe executive pay programs need to change.

Companies are reducing pay for executives, and most directors think pay opportunities will decline over the next two years.

Boards are not significantly concerned about the effects of potential legislation and guidance on executive pay.

Effect of the Economy on Executive Compensation Programs

The Board View

About the Survey

In March and April 2009, Watson Wyatt surveyed 85 outside directors of large U.S.-based companies. They shared their views on where executive pay is heading, and what effect the economy is having on the executive pay programs at the companies where they sit on the board of directors.

Executive Summary

With the ongoing economic downturn, the majority of outside directors believe American companies need to change their executive pay programs. Seventy percent of directors believe executive pay opportunity will decline over the next two years. More than one in three companies has already reduced salaries, target bonuses and/or long-term incentive award levels. However, most directors think legislation and public pressures will not lead to improved pay for performance over the next two years. Directors are placing more emphasis on performance-based plans.

Directors are also not as concerned about potential legislation/guidance as their management counterparts. Directors remain focused on more immediate concerns and have yet to make changes to their programs to address the issue of “excessive risk.”

Key Findings

- Seventy percent of directors expect executive pay opportunities to decline over the next two years to a moderate-to-great extent.
- Thirty-four percent of companies have already reduced executive pay (salaries, target bonuses and/or long-term incentive award levels) with another 6 percent planning to do so in the next six months.
- Half (49 percent) of the respondents have changed or plan to change the types of long-term incentive plans with many placing more emphasis on performance-based plans, including performance-based shares (53 percent) and performance cash plans (26 percent).
- More than half of the directors surveyed (58 percent) do not believe it is appropriate to take action on underwater stock options. Seven in ten companies have not taken any action to date.
- Sixty-eight percent of directors said their board or compensation committee is not concerned or only slightly-to-moderately concerned about the retention of high-performing executives.
- Eighty-two percent of directors do not believe legislation and public pressure will significantly improve pay for performance.
- The two areas of greatest legislative concern to board members are Say on Pay and lowering Section 162(m) limits that set the cap for full deductibility of pay.
- So far, only 18 percent of companies have added a formal risk assessment process and 10 percent have certified in the proxy statement that an assessment has been completed.

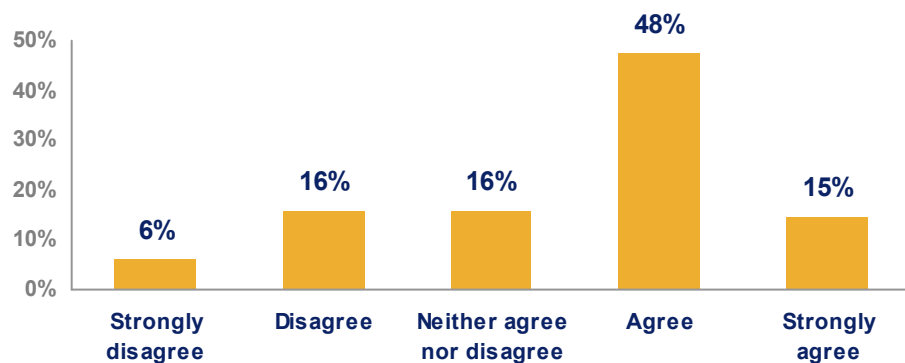
Seventy percent of directors expect that executive pay opportunities will decline at least moderately over the next two years.

Figure 1 | Please answer the following questions with regard to American companies in general.

	Not at all	Small extent	Moderate extent	Significant extent	Great extent
To what extent has the current financial crisis adversely affected the organization where you serve as an outside director?	2%	26%	31%	31%	10%
To what extent will executive pay opportunity decline over the next two years?	10%	20%	34%	30%	6%
To what extent do you think executive pay for performance will improve over the next two years as a result of legislation and public pressures?	31%	23%	28%	14%	4%

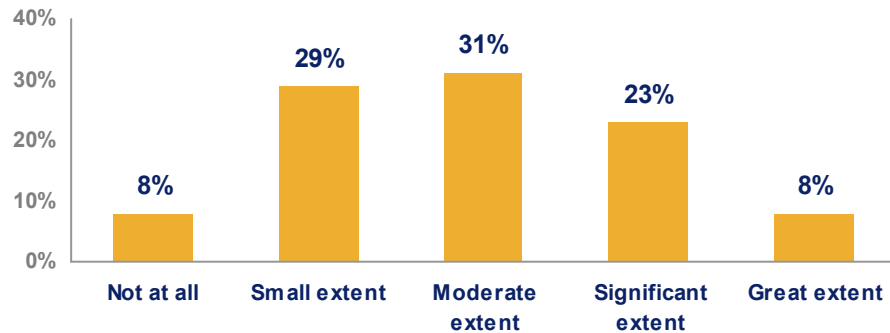
Sixty-three percent of directors believe that American companies need to change their executive compensation programs in light of the financial crisis.

Figure 2 | To what extent do you agree that American companies in general need to change their executive compensation plans to respond to the pressures from the financial crisis and the new government regulations for financial services/government-aided companies?



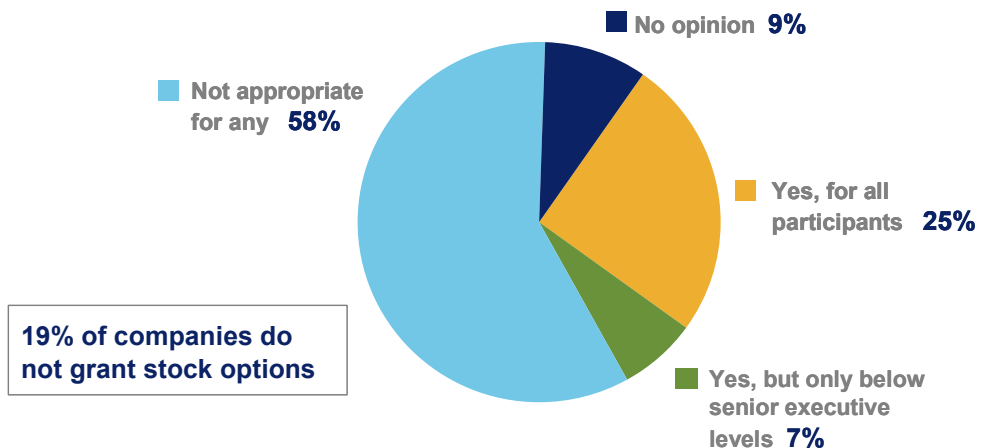
Directors are only moderately concerned about retaining high-performing executive management, given the current economic crisis.

Figure 3 | To what extent is the board or compensation committee concerned about retention of high-performing executive management given the current economic conditions?



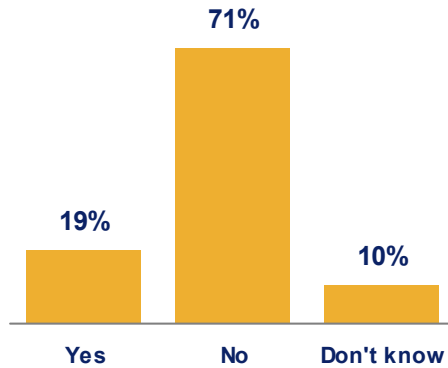
Underwater options are at a historical high, but most directors do not believe it is appropriate to take actions such as repricing or exchanging them. This is likely to vary by industry.

Figure 4 | Do you believe it is appropriate to take some action on underwater stock options (such as repricing, cash buy-out, exchange for other equity or voluntary surrender) for senior executives and/or for all stock option participants?



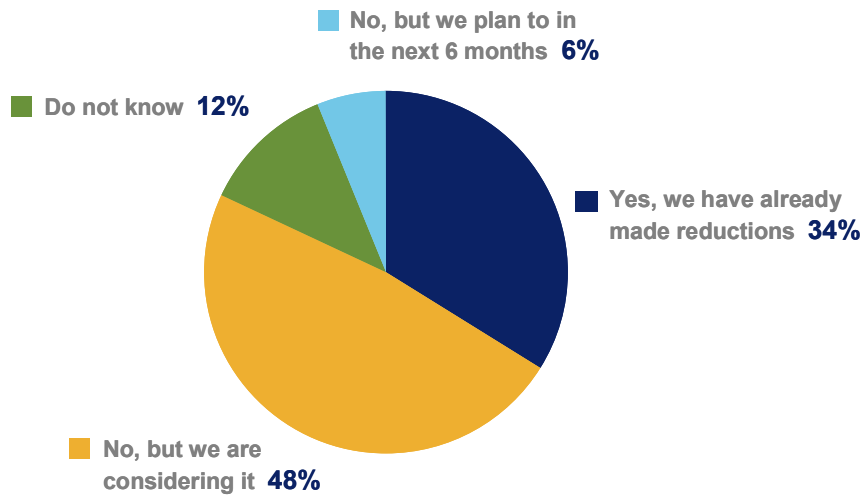
Only 19 percent of respondents have already taken action on underwater options.

Figure 5 | Has the company already taken some action or is expected to take some action on underwater stock options in the next 12 months?



Four in ten companies have reduced executive pay or plan to in the next six months.

Figure 6 | Has the company reduced salaries, target bonuses and/or long-term incentive award levels?



Roughly half of respondents' companies have changed or plan to change the types of long-term incentive plans, with most placing more emphasis on performance-based plans.

Figure 7 | Has the organization changed, or does it plan to change, the types of long-term incentive plan vehicles used by the organization's executive pay program?

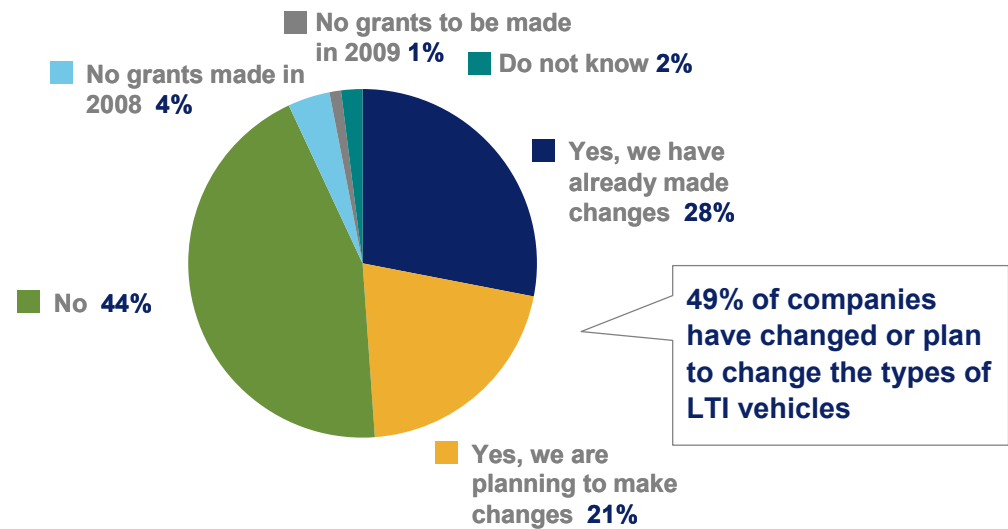


Figure 8 | How have the plan vehicles changed? Will the company's changes be a temporary or permanent program change?

Plan vehicle changes			
More emphasis on performance-based shares	53%	Temporary	15%
More emphasis on time-vested restricted stock	32%	Permanent	53%
More emphasis on performance cash plans	26%	Unsure	33%
More emphasis on stock options	21%		
Do not know	8%		

About 30 percent of companies are changing performance metrics for their long- and short-term incentive plans.

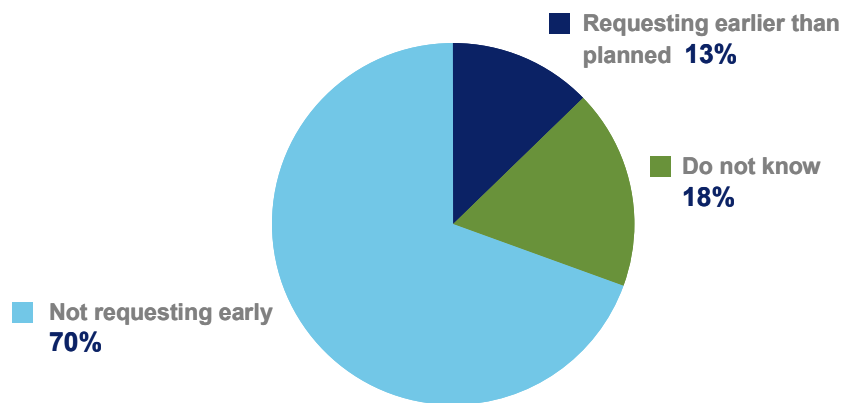
Figure 9 | What changes does the organization expect to make to performance goals for the **current fiscal year's** annual bonus plan and long-term performance plan?

	ANNUAL INCENTIVE PLAN	LONG-TERM PERFORMANCE PLAN
Change performance metrics	30%	27%
Raise performance goals relative to last year's actual performance	28%	24%
Lower performance goals relative to last year's actual performance	22%	20%
Make performance goals similar to last year's actual performance	20%	20%
Widen the incentive payout zone	19%	11%
No changes	8%	7%
Do not know at this time	16%	8%

Companies are split fairly evenly on where they are setting their goals relative to the previous year's performance

Only 13 percent of respondents expect to approach shareholders early for additional shares to fund their long-term incentive plans.

Figure 10 | Does the organization expect to request additional shares from shareholders to fund its long-term incentive equity plans earlier than planned?



HR and compensation executives (from the March 2009 survey) are more concerned about potential legislative issues than are board members.

Figure 11 | To what extent is the compensation committee/board concerned about effects on the company’s executive compensation programs from the following areas of potential legislation/guidance?

	Little or no concern		Moderate to great concern	
	Executives	Board of directors	Executives	Board of directors
Say on Pay	44%	54%	57%	46%
Lowering 162(m) deduction limits below \$1 million	52%	57%	48%	43%
Deferred compensation limits	55%	67%	46%	33%
Golden parachute limits	66%	72%	34%	28%
Expanded CD&A disclosures	51%	74%	50%	26%
Expanded clawback coverage	66%	76%	34%	24%
Executive programs cannot include “excessive” risk	57%	77%	43%	23%
Capping executive salaries under TARP-type programs	65%	78%	36%	22%
Adopting international accounting standards	59%	82%	41%	18%

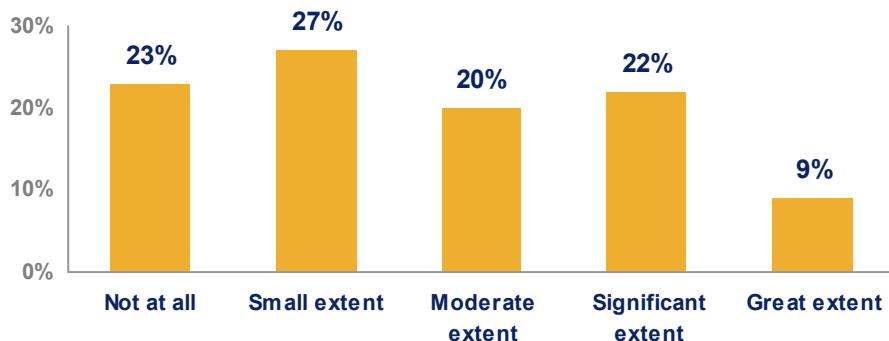
Companies are beginning to take steps to assess and address possible “excessive risk” built into their executive compensation program structures.

Figure 12 | Has the company made or does it expect to make any of the following changes to its executive compensation program to address the issue of “excessive risk”?

	Have already made change	Expect to make change in next 12 months	Considering a change	No change expected
Adding a formal risk assessment process	18%	5%	20%	57%
Curtailing stock option grants	15%	1%	4%	79%
Certifying in the proxy that a risk assessment has been performed	10%	4%	32%	54%
Adjusting pay mix to mitigate pay risk	8%	4%	20%	68%
Requiring mandatory deferral of cash incentive payouts	5%	1%	5%	88%
Instituting a bonus bank (deferral of cash where value rises and falls)	3%	1%	8%	88%
Reducing maximum payouts on incentive plans	1%	0%	11%	88%

Director opinions are split fairly evenly regarding the importance of satisfying Section 162(m) to allow for full deductibility.

Figure 13 | To what extent is it important to design executive compensation programs that satisfy the requirements of Section 162(m) to allow for full deductibility of pay (\$500,000 cap for TARP aid companies; \$1 million cap for all other companies)?





Conclusion

Directors who serve on corporate boards believe changes need to be made to the U.S. executive pay model. Concerns over retaining executive management have been lessened due to the current economic situation, and companies are holding executives to the same standard as their broad employee base by freezing or lowering pay. Outside directors also expect companies to adjust executive pay to be more performance-based, but not necessarily because of legislation and public pressure.

Outside directors are also not as concerned as management is about potential legislation and guidance as a whole, but Say on Pay and lowering the Section 162(m) deduction limits are of moderate-to-great concern for more than 40 percent of directors. Legislation such as TARP has opened up a new world of regulation, and as these concepts catch hold outside of those industries currently relying on government assistance, they could have a significant impact on the design and governance of executive pay programs. But for now, directors appear to be more focused on immediate tasks of managing through the recession.

Watson Wyatt Worldwide

Watson Wyatt is the trusted business partner to the world's leading organizations on people and financial issues.

Our client relationships, many spanning decades, define who we are. They are shaped by a deep understanding of our clients' needs, a collaborative working style and a firm-wide commitment to service excellence.

Our consultants bring fresh thinking to client issues, along with the experience and research to know what really works. They deliver practical, evidence-based solutions that are tailored to your organization's culture and goals.

With 7,700 associates in 33 countries, our global services include:

- Managing the cost and effectiveness of employee benefit programs
- Developing attraction, retention and reward strategies that help create competitive advantage
- Advising pension plan sponsors and other institutions on optimal investment strategies
- Providing strategic and financial advice to insurance and financial services companies
- Delivering related technology, outsourcing and data services

For more information about executive compensation consulting services, call Watson Wyatt at 800.388.9868 or visit watsonwyatt.com.