

## At a Glance

**Most companies** are not planning to restore executive pay cuts or freezes made during the economic crisis in the next several months.

**Many companies** are changing their long-term incentive plans to create a stronger performance orientation.

**Respondents** have already begun to take steps to address potential Say on Pay shareholder votes and anticipated greater scrutiny of their pay plans.

# Executive Pay and the Economic Recovery

## September 2009

### About the Survey

In late September 2009, Watson Wyatt surveyed 187 HR and compensation executives at large U.S.-based organizations to understand what effect the economy is having on their executive pay programs.

Survey participants represented a cross-section of industries with median revenue or asset size of \$4 billion. Seventy-two percent were for-profit, publicly traded companies; 19 percent were for-profit private companies and 9 percent were not-for-profits.

### Executive Summary

More than 90 percent of companies expect to see greater scrutiny of executive pay plans as a result of legislation, regulation and public scrutiny, with almost three-quarters of respondents expecting the relationship between pay and performance to improve in the next two years. Most respondents are not planning to restore in the next six months executive pay cuts or freezes made during the economic crisis. However, many are making changes to their incentive plans for 2010 to increase financial goals relative to this year, change metrics to respond to new priorities, and further emphasize performance-based long-term incentive plans.

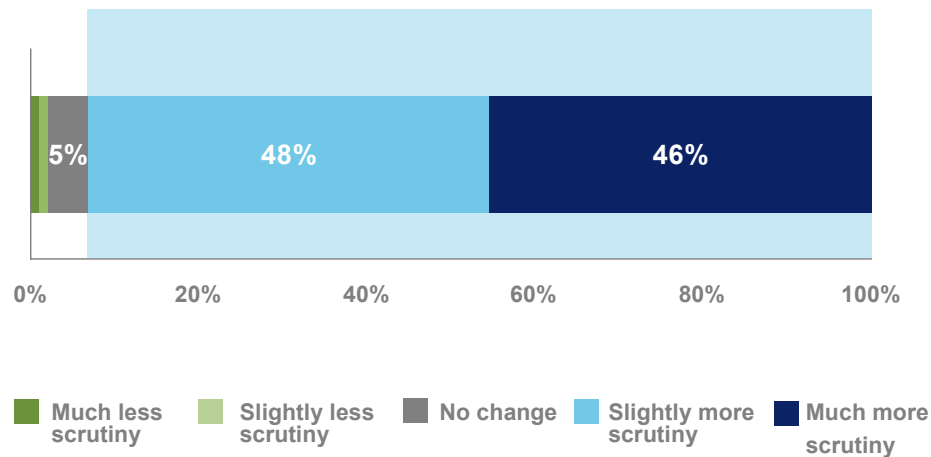
Companies are addressing implications of potential legislation and regulation head on. Most are identifying potential issues in advance and improving their CD&A to explain program rationale to prepare for possible Say on Pay shareholder votes. And there appears to be an increased awareness of the need to assess potential risk design elements of their executive pay programs as the number of companies adopting or considering adding a formal risk assessment has significantly increased in the last six months.

## Key Findings

- In the next two years, virtually all companies (94 percent) expect more scrutiny of executive pay plans, and most believe the relationship between pay and performance will improve (72 percent). Only one-quarter of respondents believe pay levels will increase for executives.
- More companies have already made or are expecting to make changes to executive pay programs to address the issue of excessive risk than reported in our March 2009 survey. Fifty-four percent (up from 30 percent) have added or are considering adding a formal risk assessment process, and 50 percent (up from 31 percent) have certified or are considering certifying in the proxy that a risk assessment has been performed.
- Companies that have made or are making changes to their long-term incentive plan vehicles (39 percent) are putting more emphasis on performance-based shares (42 percent) and performance cash plans (25 percent). Shifts to time-vested shares have dropped significantly since March (29 percent vs. 44 percent, respectively).
- Almost half (45 percent) of companies do not expect their long-term incentive grant values to change. Only 12 percent plan to decrease their next fiscal year's long-term incentive grant dollar value over this year's, compared to 33 percent in March. However, 27 percent are unclear at this time, signaling a "wait and see" approach.
- More than half of companies have frozen or are considering freezing salaries (56 percent), and about two-thirds are not planning to restore salary freezes or reductions in the next six months. Fifty-eight percent are expecting to reduce their merit budget for 2010, indicating continuing caution on the economic recovery.
- Sixty percent of companies reported having little concern regarding possible Say on Pay requirements. The majority of respondents appear to be already taking steps by improving the CD&A to explain pay program rationale and appropriateness to the company (70 percent) or identifying potential executive pay issues/concerns in advance (67 percent).
- Companies report moderate-to-significant concern about possible legislation/regulation in the areas of incentive caps (53 percent), expanded CD&A disclosures below the top 5 (53 percent) and elimination of the 162(m) performance award exemption (53 percent).
- Nineteen percent of companies have eliminated their golden parachute tax gross-up provisions, and 44 percent of companies have or are considering claw-back policies.

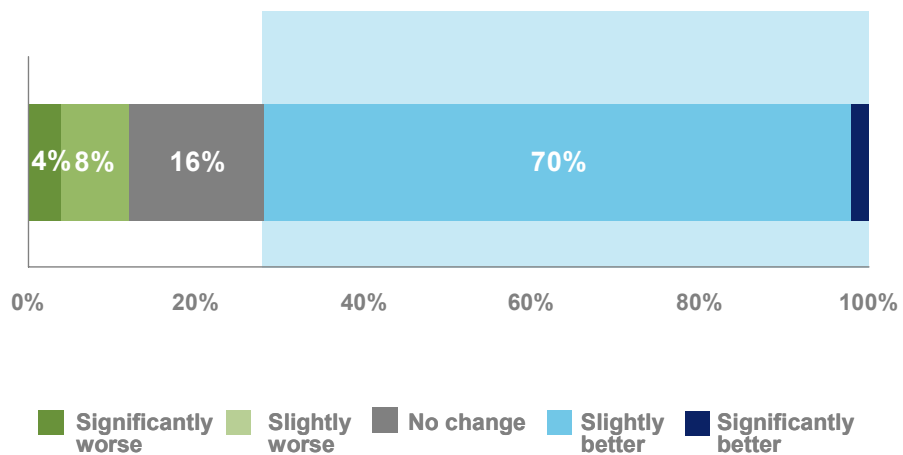
**Ninety-four percent of respondents expect even greater scrutiny of executive pay programs over the next two years.**

**Figure 1 |** As a result of new legislation, SEC regulations and public pressures, how do you expect scrutiny of executive pay plans to change in the next two years?



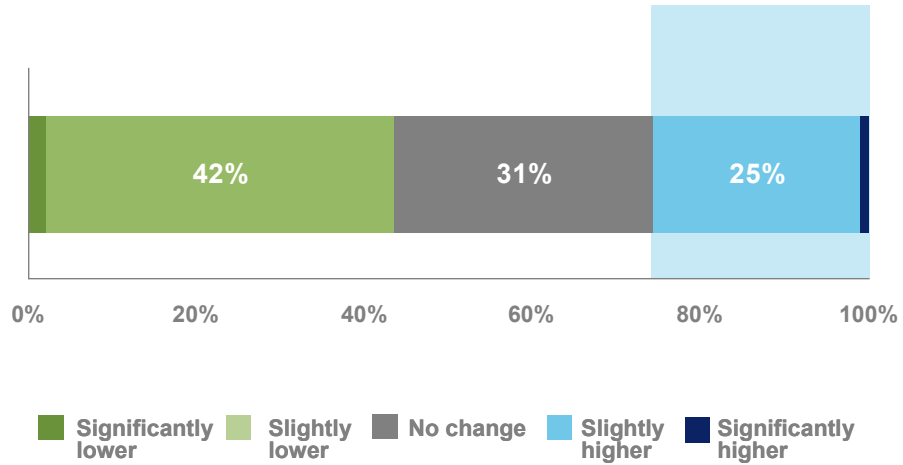
**Almost three-quarters of respondents believe the relationship between pay and performance will continue to improve.**

**Figure 2 |** As a result of new legislation, SEC regulations and public pressures, to what degree do you believe the relationship between pay and performance for U.S. companies will change over the next two years?



Only one in four respondents expects executive pay levels to increase over the next two years.

**Figure 3 |** As a result of new legislation, SEC regulations and public pressures, how will executive pay levels at U.S. companies change over the next two years?



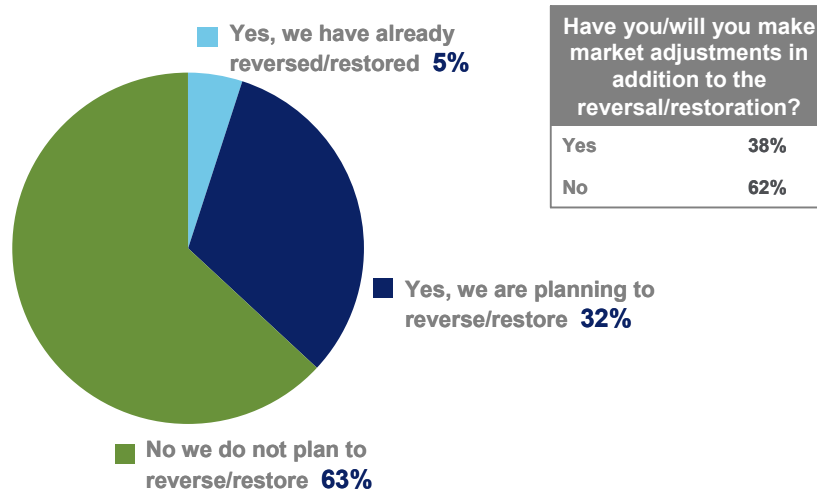
While salary freezes and reductions for executives are mostly over, companies are planning lower merit budget increases for 2010. A significant number of companies have adopted claw-back policies and eliminated golden parachute tax gross-ups, with more likely to follow.

**Figure 4 |** Since the start of the economic downturn, what changes has your organization made or does it expect to make for 2010 to your executive pay programs? (Please check all that apply.)

|   | HAVE ALREADY MADE CHANGE | CONSIDERING A CHANGE | EXPECT TO MAKE CHANGE IN NEXT 12 MONTHS | NO CHANGE EXPECTED |
|---|--------------------------|----------------------|---|--------------------|
| <b>Base Salary/Merit Increases</b>                                  |                          |                      |   |                    |
| Freeze salaries   | 49%                      | 7%                   | 3%                                      | 41%                |
| Decrease planned merit budget                                       | 38%                      | 20%                  | 5%                                      | 38%                |
| Delay planned merit increases                                       | 19%                      | 10%                  | 1%                                      | 70%                |
| Reduce salaries   | 9%                       | 2%                   | 0%                                      | 89%                |
| Increase planned merit increases                                    | 2%                       | 12%                  | 5%                                      | 80%                |
| <b>Annual Incentives</b>  |                          |                      |   |                    |
| Reduce target bonus opportunities                                   | 11%                      | 3%                   | 2%                                      | 85%                |
| Decrease the maximum award opportunity                              | 5%                       | 7%                   | 2%                                      | 85%                |
| Reduce bonus plan eligibility or participation                      | 4%                       | 3%                   | 1%                                      | 92%                |
| Increase target bonus opportunities                                 | 2%                       | 7%                   | 2%                                      | 89%                |
| <b>Long-term Incentives</b>   |                          |                      |   |                    |
| Reduce LTI plan eligibility or participation                        | 13%                      | 6%                   | 4%                                      | 77%                |
| Decrease the maximum award opportunity for performance-based awards | 5%                       | 3%                   | 2%                                      | 90%                |
| Reprice, exchange or surrender underwater stock options             | 3%                       | 9%                   | 1%                                      | 88%                |
| Require equity grants to be held to retirement                      | 1%                       | 4%                   | 0%                                      | 95%                |
| <b>Other Pay Programs</b>   |                          |                      |   |                    |
| Add claw-back or recoupment program/policy                          | 29%                      | 15%                  | 2%                                      | 54%                |
| Cap change-in-control benefits to 3X the safe harbor limit          | 20%                      | 3%                   | 1%                                      | 76%                |
| Make special retention bonuses (cash or equity)                     | 19%                      | 16%                  | 2%                                      | 63%                |
| Eliminate golden parachute tax gross-up provisions                  | 19%                      | 7%                   | 1%                                      | 74%                |
| Eliminate golden parachute agreements                               | 9%                       | 4%                   | 0%                                      | 87%                |

**Most respondents are not planning to reverse or restore frozen or reduced executive salaries in the next six months.**

**Figure 5 |** Will your organization reverse/restore freezes/reductions in executive salaries in the next six months?



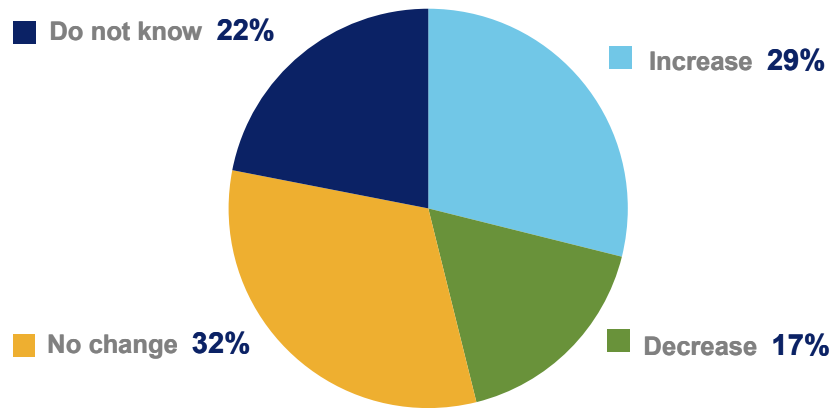
**Three in ten companies are expecting to raise performance goals and change performance metrics for next year's annual incentive plans.**

**Figure 6 |** What changes does your organization expect to make to performance goals for next fiscal year's annual incentive plan and long-term performance plan? (Please check all that apply.)

|   | ANNUAL INCENTIVE PLAN | LONG-TERM PERFORMANCE PLAN |
|---|-----------------------|----------------------------|
| Change performance metrics  | 31%                   | 16%                        |
| Raise performance goals relative to last year's actual performance  | 29%                   | 18%                        |
| Decrease bonus payout for same level of performance as this year    | 11%                   | 3%                         |
| Reduce performance goals relative to this year's actual performance | 9%                    | 3%                         |
| Widen the incentive payout zone                                     | 9%                    | 3%                         |
| Increase bonus payout for same level of performance as this year    | 4%                    | 2%                         |
| Shorten the performance measurement period                          | 3%                    | 3%                         |
| No changes  | 23%                   | 24%                        |
| Do not know at this time  | 28%                   | 26%                        |

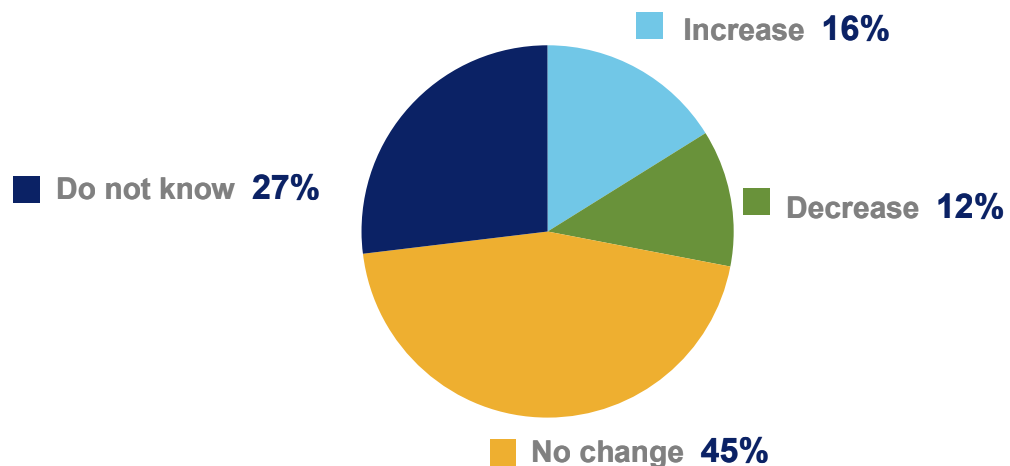
Most organizations expect next fiscal year's bonus pool to be similar or higher than 2009. However, 22 percent of companies are unsure whether bonuses will increase or decrease.

**Figure 7 |** Do you expect next fiscal year's bonus pool (2010) to increase or decrease over this year's (2009)?



Most respondents do not expect long-term incentive grant values to increase in 2010, although 27 percent are unsure at this time.

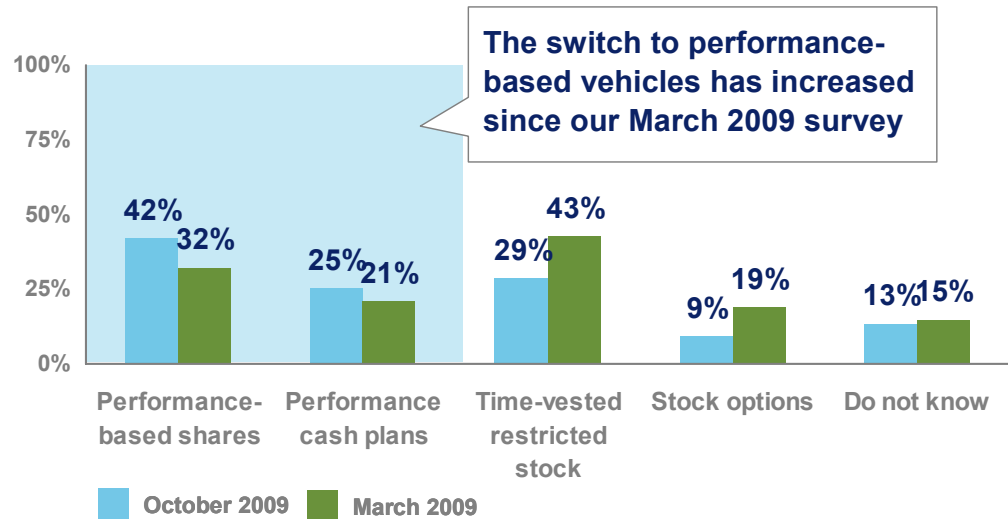
**Figure 8 |** Do you expect your organization's 2010 long-term incentive grant dollar values to increase or decrease over this year's grants?



**Thirty-nine percent of companies continue to review their long-term incentive plan vehicles and are shifting toward more performance-based plans.**

**Figure 9 |** Has your organization changed, or does it plan to change, the types of long-term incentive plan vehicles used in your executive pay program for 2010? If yes, how have/will the plan vehicles change?

|   | September 2009 |
|---|----------------|
| No changes made or planned                        | 49%            |
| Have already made changes in 2009                 | 20%            |
| Are planning to make changes in late 2009 or 2010 | 19%            |
| No grants made in 2009                            | 1%             |
| No grants to be made in 2010                      | 1%             |



Companies are indicating a modest level of concern around potential legislation/regulation, particularly possible caps on incentive compensation, expanded CD&A disclosures and the elimination of the performance award exemption under the \$1 million tax rule (162m).

**Figure 10 |** How concerned is your organization about the effects on your executive compensation programs from the following areas of potential legislation/regulation? (Please check on the scale of 1 to 5 for each.)

|   | Very little concern<br>1 | 2   | 3   | 4   | Significant concern<br>5 |
|---|--------------------------|-----|-----|-----|--------------------------|
| <b>Expanded CD&amp;A disclosures below top 5</b>                                      | 28%                      | 19% | 28% | 17% | 8%                       |
| <b>Elimination of the 162(m) - \$1 million cap rule – performance award exemption</b> | 29%                      | 17% | 28% | 18% | 7%                       |
| <b>Cap on incentive compensation</b>  | 26%                      | 20% | 24% | 20% | 9%                       |
| <b>Cap on deduction of stock options at the expensing amount</b>                      | 37%                      | 17% | 26% | 15% | 6%                       |
| <b>Assessing executive programs for “excessive” risk</b>                              | 33%                      | 25% | 27% | 10% | 5%                       |
| <b>Say on Pay</b>   | 31%                      | 29% | 23% | 14% | 2%                       |
| <b>Deferred compensation limits</b>   | 38%                      | 26% | 22% | 11% | 3%                       |
| <b>Brokers no longer allowed to vote unvoted shares as of 1/1/2010</b>                | 44%                      | 22% | 26% | 6%  | 2%                       |
| <b>Golden parachute limits</b>  | 46%                      | 24% | 21% | 7%  | 2%                       |
| <b>Expanded claw-back coverage</b>  | 40%                      | 33% | 17% | 8%  | 2%                       |
| <b>Disclosure of executive compensation consulting fees</b>                           | 54%                      | 25% | 16% | 3%  | 2%                       |

There is a much greater awareness of the need to consider risk in executive pay programs now, compared with our March 2009 survey.

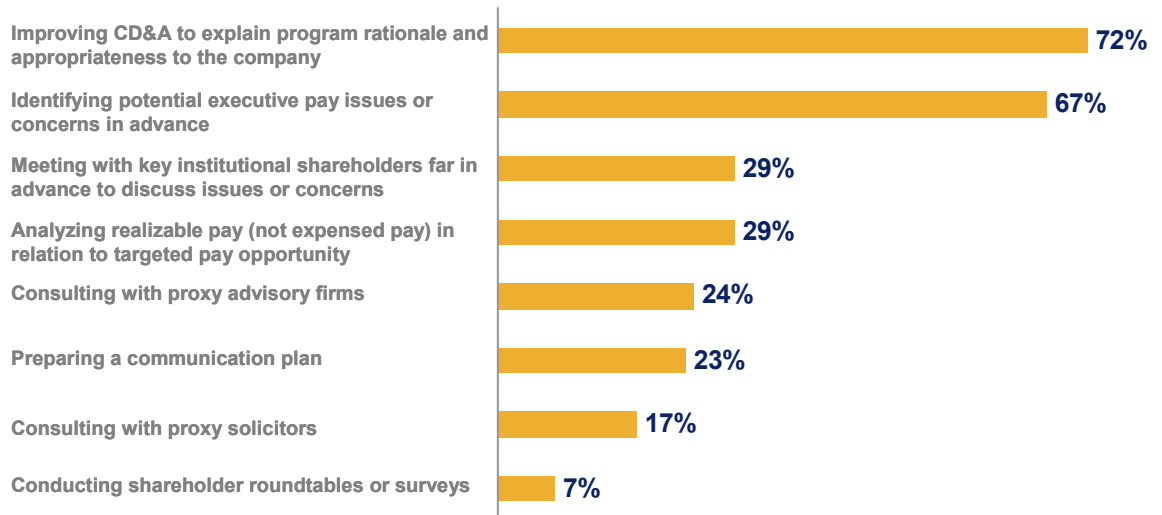
**Figure 11** | Has your organization made or does it expect to make any of the following changes to its executive compensation program to address the issue of “excessive risk?”

|  | HAVE ALREADY MADE CHANGE | CONSIDERING A CHANGE | EXPECT TO MAKE CHANGE IN NEXT 12 MONTHS | NO CHANGE EXPECTED |
|--|--------------------------|----------------------|---|--------------------|
| Add a formal risk assessment process                           | 12%                      | 14%                  | 28%                                     | 46%                |
| Certify in the proxy that a risk assessment has been performed | 7%                       | 16%                  | 27%                                     | 50%                |
| Add claw back  | 21%                      | 6%                   | 9%                                      | 64%                |
| Cut back or eliminate stock option grants                      | 14%                      | 4%                   | 9%                                      | 73%                |
| Create special Risk Committee                                  | 5%                       | 2%                   | 18%                                     | 74%                |
| Eliminate/reduce SERPs   | 11%                      | 2%                   | 6%                                      | 80%                |
| Increase incentive portion of the pay mix                      | 2%                       | 4%                   | 11%                                     | 82%                |
| Increase equity vs. cash portion of incentives                 | 3%                       | 2%                   | 10%                                     | 84%                |
| Require longer equity holding requirements                     | 2%                       | 1%                   | 12%                                     | 85%                |
| Increase stock ownership guidelines                            | 5%                       | 1%                   | 9%                                      | 86%                |
| Change pay philosophy to not more than 50th percentile         | 8%                       | 1%                   | 5%                                      | 87%                |
| Reduce maximum payouts on incentive plans                      | 3%                       | 1%                   | 8%                                      | 88%                |
| Require mandatory deferral of cash incentive payouts           | 4%                       | 1%                   | 7%                                      | 89%                |
| Extend equity vesting  | 3%                       | 2%                   | 4%                                      | 91%                |
| Institute a bonus bank   | 3%                       | 1%                   | 4%                                      | 92%                |
| Decrease the incentive portion of the pay mix                  | 0%                       | 2%                   | 4%                                      | 94%                |

In March 2009, only 30% expected to add a risk assessment, compared with 54% now.

## Companies are taking steps to proactively prepare for possible Say on Pay voting by identifying potential issues in advance and improving the CD&A to explain program rationale.

**Figure 12 |** What are you doing/planning to do to prepare for possible Say on Pay non-binding shareholder vote? (Please check all that apply.)



### Conclusion

Companies have moved beyond the short-term frenetic activity to control the cost of executive pay that was prevalent at the beginning of the year in response to the economic crisis. Now, they are looking to best address the increased scrutiny and regulatory proposals that their executive pay programs are likely to face.

Respondents are taking a measured approach to defining their pay programs including assessing risk elements, emphasizing pay for performance, reviewing performance metrics, adding claw backs and readdressing non-core elements such as tax gross-ups.

With more regulation and pressure from shareholders likely, companies need to build a sound case for their pay programs. They should focus their attention on strengthening performance-based incentives, balance risk and rewards, and be proactive in meeting with key stakeholders to openly discuss their pay program rationale.

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