

With Say on Pay Looming,

Companies Move to Further Tighten the Link

Between Executive Pay and Performance

Amid growing concern about executive retention, most U.S. companies remain focused on shareholder perceptions and the alignment between executive pay and business performance in the economic recovery.

Executive Summary

Recent years have been marked by unprecedented pressure on executive compensation as companies struggled to overcome economic and market turmoil and growing shareholder and government activism on the pay front. While average total compensation for executives at the nation's largest companies declined in both 2008 and 2009, a new Towers Watson survey of executive pay practices in midsize and large U.S. companies suggests that the pay trend may be turning this year.

- Many companies expect to make modest increases in bonus funding and larger long-term incentive grants in 2010 than last year as a result of improving business conditions and the recovery in share prices.
- Following a couple of years of widespread salary freezes/reductions and smaller or nonexistent bonuses at many organizations, the vast majority of companies say they are likely to address executive retention issues at least to some extent as the recovery picks up speed.
- At the same time, it's clear that most companies are taking a thoughtful and cautious approach to changing their executive pay programs.
- Overall, the survey shows that most U.S. companies are continuing — if not intensifying — their recent efforts to fine-tune their executive compensation programs and governance processes, respond to shareholder concerns about certain pay practices and, ultimately, strengthen the link between executive pay and performance.

- More than two-thirds of the responding companies are making changes this year to their annual incentive plans, while slightly over half are making changes to their long-term performance plans. The most common changes in both annual and long-term plans are refining performance metrics and setting tougher performance targets.

“Most U.S. companies are continuing — if not intensifying — their recent efforts to fine-tune their executive compensation programs and governance processes.”

- Relatively few of the 251 companies responding to the survey believe they're fully prepared to put their pay practices to a shareholder vote, as the new financial services reform legislation will require. It seems certain the “say on pay” requirement will only intensify the pay-for-performance imperative.

About the Survey

Towers Watson's Executive Compensation Flash Survey was conducted online between June 7 and June 14, 2010. A total of 251 U.S. organizations responded to the survey, primarily midsize and large companies spanning a broad range of industries. Over 80% of the responding companies report annual revenues exceeding \$1 billion, and over 40% have more than \$5 billion in annual revenue. Senior human resource professionals and executives at the director level and above made up the bulk of the survey respondents.

Rewarding Improved Performance

For many companies, the economic recovery brings improved financial performance, and thus more flexibility to make bonus payments and larger long-term incentive grants. As *Figure 1* shows, almost half of the companies surveyed expect to increase funding for 2010 annual incentives for executives, while about a third have made or expect to make larger long-term incentive grants (in dollar terms) this year than last.

However, the survey responses also suggest that most companies remain cautious about spending in today's fragile economic environment. Of the companies anticipating increased bonus funding, most (53%) are projecting funding increases of 20% or less. Among those making or expecting to make larger long-term incentive grants in 2010, over two-thirds (69%) said the dollar value of their grants will increase by 20% or less.

While many more companies are increasing rather than reducing the dollar value of long-term incentive grants this year, the reverse is true with regard to the number of shares companies are awarding. Many companies have seen a rebound in their share prices since early 2009. As a result, almost half (45%) of the survey respondents expect to award fewer shares under their long-term incentive programs this year than last,

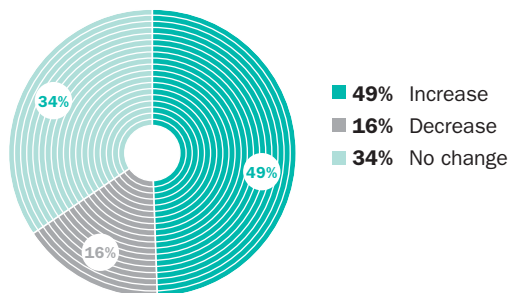
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compared to only 23% that expect to award more shares. Over half (53%) of those awarding fewer shares expect reductions of 20% or less in the number of shares granted. Of those awarding more shares, the vast majority (79%) report that the number of shares they're awarding is likely to increase by 20% or less. This suggests that companies are willing to increase the value of long-term incentive awards provided to executives, but are more likely to accomplish this by leveraging a higher stock price than by increasing the number of shares granted.

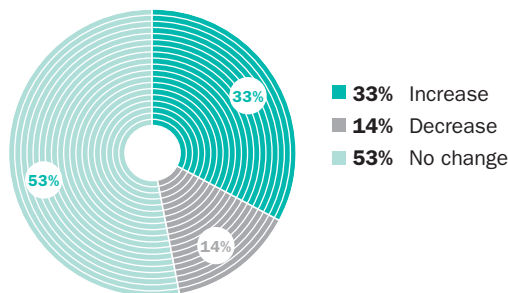
These findings regarding 2010 trends in annual and long-term incentives reflect the unevenness of the recovery. They underscore the fact that many companies continue to struggle to regain momentum in a challenging environment. They also suggest that, for the most part, executives are not being made whole for the earlier reductions in incentive compensation.

Figure 1. Trends in Annual and Long-Term Incentives, 2010 vs. 2009

Annual Incentive Funding



Dollar Value of Long-Term Incentives



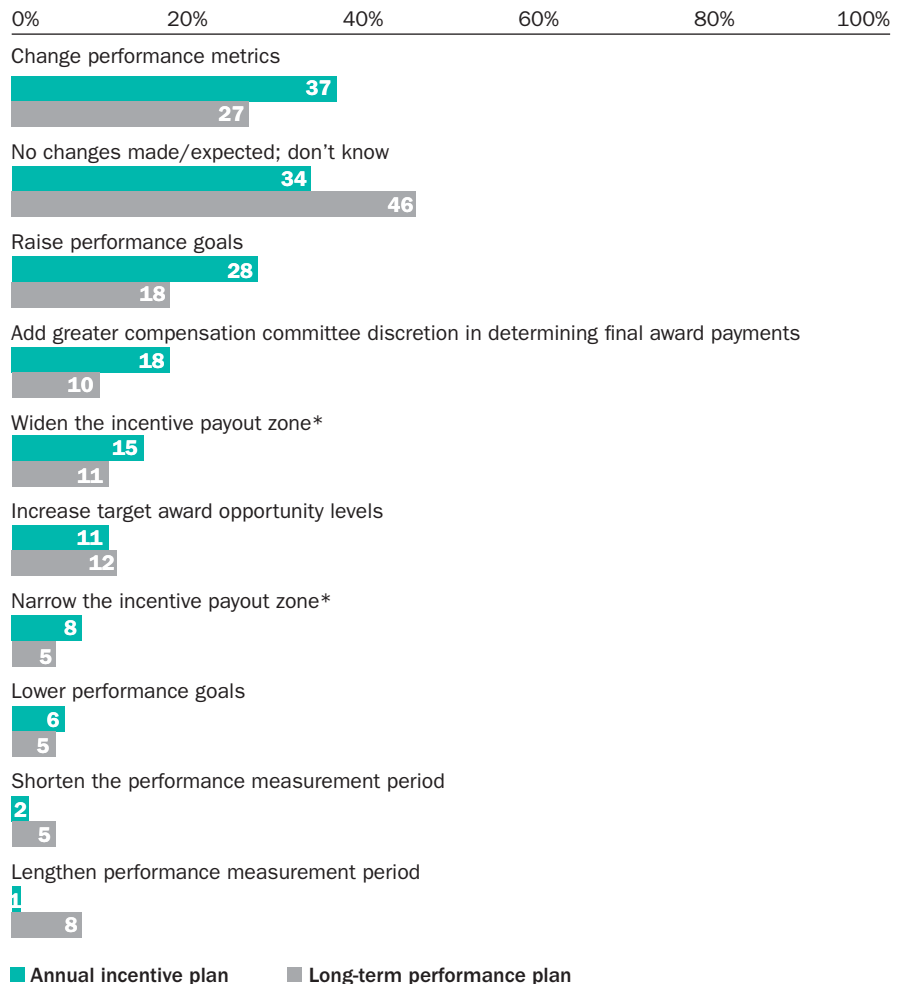
Ensuring Incentives Reward the Right Performance

Despite the significant efforts companies have made in recent years to better align their pay programs with business results, there is continuing pressure to fine-tune incentive plan design and calibration. Indeed, two-thirds of the companies in our survey have made at least some changes in their annual incentive programs this year, while slightly over half have made or expect to make revisions in their long-term performance plans.

“The most common actions were to change performance metrics or increase performance goals.”

As *Figure 2* shows, across both types of plans, the most common actions were to change performance metrics or increase performance goals. The next most common action was to give compensation committees added discretion to override plan formulas in making incentive payouts. These changes suggest that companies continue to be thoughtful about their incentive programs, refining their performance metrics and target goals to reflect evolving and uncertain business conditions. The findings are consistent with compensation committees’ continuing focus on mitigating compensation risk and their growing need to exercise greater discretion to ensure appropriate pay outcomes.

Figure 2. Changes in Annual Incentives and Long-Term Performance Plans



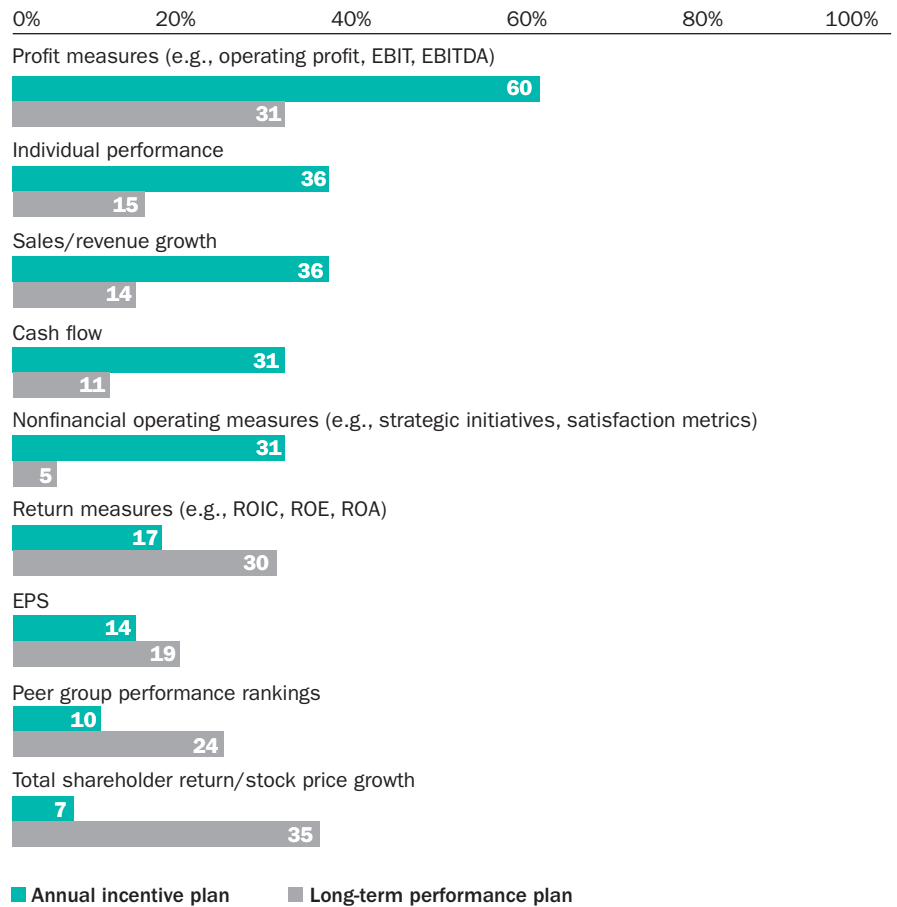
*Payout zone is the performance range (minimum and maximum) around the target goal to earn an award. An example payout zone around the target goal would be 80% at the minimum or threshold level, to 120% at the maximum performance level.

Figure 3 shows which performance measures are receiving added emphasis among those companies reporting changes in measures. Consistent with the focus on pay for performance, the most common shift is putting more emphasis on profit measures, such as operating profit, EBIT and EBITDA. The next most common trend for annual incentives is an increased emphasis on individual performance and revenue growth, as would be expected in an economic upturn. Interestingly, an almost equal percentage of companies (31%) are focusing on cash flow, indicative of cautious investment and capital spending. The heightened attention to nonfinancial measures reflects the ongoing interest in linking annual incentives to corporate activities, such as strategic initiatives, customer satisfaction, employee engagement and other “citizenship” measures including environmental stewardship, safety and workforce diversity, among others.

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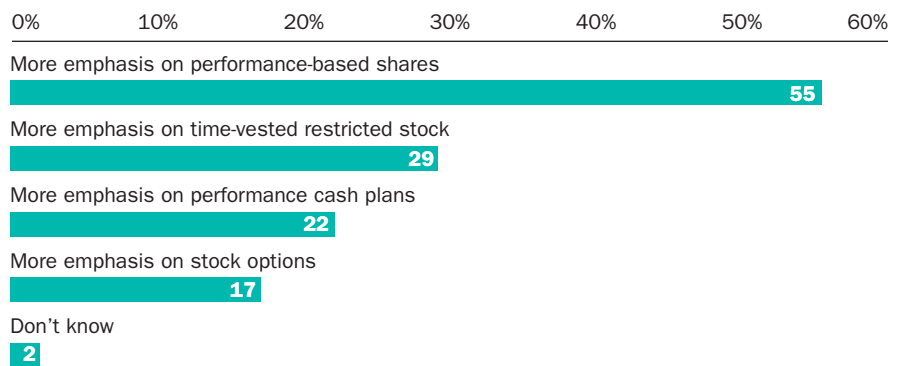
A sharper focus on performance is also evident in the changing mix of long-term incentive vehicles. Consistent with the gradual trend in recent years to place more emphasis on performance plans and less on stock options, over half (55%) of the companies reporting changes in long-term incentive vehicles are putting added emphasis on performance-based shares (Figure 4). However, two-thirds of the companies surveyed are making or planning no changes in their long-term incentive mix this year.

Figure 3. Performance Measures Receiving Added Emphasis*



* Data shown are the percentages of those companies that are changing their performance measures for their annual incentives or long-term performance plans.

Figure 4. Most Common Changes in Long-Term Incentive Vehicles*



*Data shown are based on the subset of companies (33%) making changes.

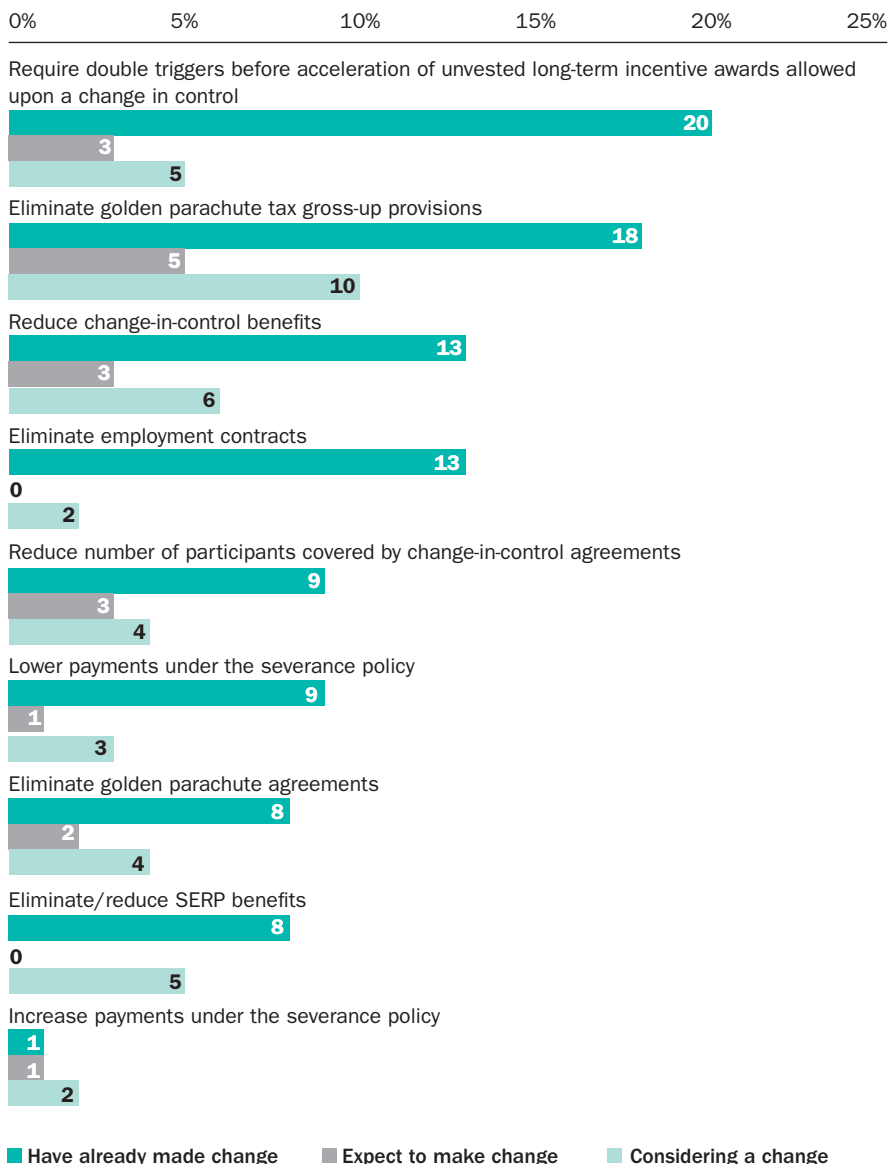
Reductions in Perks, Parachutes and Other Reward Programs

Despite growing shareholder concerns and scrutiny of nonperformance-based compensation, including guaranteed payments under employment agreements and executive perquisites, the survey responses point to most companies continuing to move cautiously in this area. Takeaways of any sort can raise fairness issues for executives with existing employment agreements and also can heighten retention risks in some cases. Our survey confirms that companies are paying more attention to retention issues in the recovery, with only about one in 10 respondents reporting that executive retention is not an issue for their company.

“Moving away from single-trigger CIC vesting of long-term incentives and eliminating tax gross-ups on parachute payments are the most common areas of change.”

Figure 5 shows the changes companies are making or considering with regard to pay programs such as severance, change-in-control (CIC) protection, employment contracts and supplemental executive retirement plans (SERPs). As noted, relatively few companies report changes in these programs in 2010, which could be attributed to the fact that many respondents have already made changes over the past few years. Moving away from single-trigger CIC vesting of long-term incentives and eliminating tax gross-ups on parachute payments are the most common areas of change.

Figure 5. Other Expected Changes in Executive Pay Programs



Although many companies have been rationalizing perquisites for some time now, about a third (37%) of the survey participants report having eliminated or reduced executive perquisites in the past two years. Of these companies that have cut back perquisites over the past two years, almost two-thirds (63%) took no action to replace the lost value to executives. This reflects an overall negative sentiment toward perquisites and the pressure to reduce costs during a time of reduced profits. Of those replacing lost value, increasing executives' base salary was the most common approach, followed by making one-time cash or stock payments and introducing cash allowances.

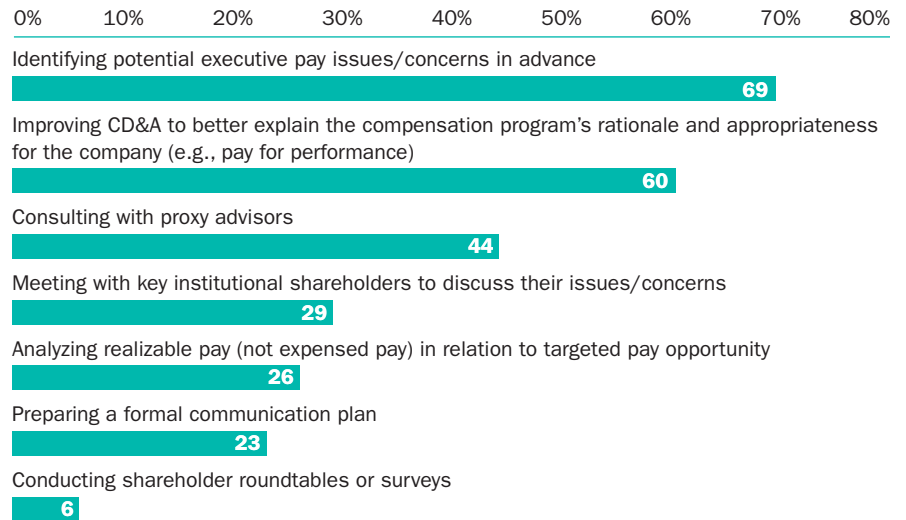
Readiness for Say on Pay

Under the new financial services reform legislation, all public companies (except for small companies and certain others) will be required to hold periodic say-on-pay votes, possibly beginning as soon as the 2011 proxy season. Conducting nonbinding shareholder votes on company pay practices seems certain to intensify the pressure for changes in programs that have been unpopular with investors and proxy advisors. However, based on our survey, it appears that relatively few U.S. companies (12%) feel very well prepared to put their executive pay programs up to a say-on-pay shareholder vote. Another 46% said they were only somewhat prepared.

Figure 6 shows the steps companies are taking to prepare for the say-on-pay era. Topping the list is carefully reviewing executive pay programs to anticipate and address potential shareholder concerns, followed by improving company disclosures to better explain the rationale for programs and how pay aligns with performance. Companies are also moving to establish enhanced communications with institutional investors and proxy advisors.

Over half (59%) of the survey respondents believe that proxy advisory firms already have substantial influence on executive pay decision-making processes in U.S. companies. However, 42% said guidelines established by proxy advisory firms have had no or minimal impact to this point on the design of their executive compensation programs.

Figure 6. How Companies Are Preparing for Say on Pay



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The influence of proxy advisory firms and institutional shareholders on executive compensation programs has increased steadily over the past few years and is likely to increase further in a say-on-pay environment. As a result, companies should be prepared for even closer scrutiny of their executive pay plans and policies, and will need to step up their communication with these groups through direct dialogue and even better proxy disclosure to be assured of strong support.

Managing Compensation Program Risk

While no companies this year disclosed that their pay programs pose material business risks, it's clear that most survey participants are taking compensation program risk management seriously. New Securities and Exchange Commission rules require companies to assess their pay programs, disclose if those programs pose material risks and, if so, describe steps taken to mitigate pay risk. As *Figure 7* shows, most companies are taking action on many fronts to better manage program risks.

More Information

To learn more about the survey and how Towers Watson helps companies mitigate compensation risks and strengthen the links between executive pay and performance, please contact your local Towers Watson consultant.

About Towers Watson

Towers Watson is a leading global professional services company that helps organizations improve performance through effective people, risk and financial management. With 14,000 associates around the world, we offer solutions in the areas of employee benefits, talent management, rewards, and risk and capital management.

Figure 7. Company Actions in 2010 to Manage Pay Program Risks

