

## ECRonline

Executive Compensation Resources — Data. Research. Information.

### **2009 Proxy Statements Highlight the New Realities in Executive Compensation**

**By Allen Jackson and Ben Stradley, Towers Perrin**

April 23, 2009

To what extent has executive compensation been affected by the meltdown in global financial markets? While it's too soon to gauge the full impact, new data suggest that the economic crisis has created a new set of realities when it comes to executive rewards.

Despite a lot of media focus on the bonuses paid to executives at banks and other financial institutions, Towers Perrin's latest findings from a detailed examination of proxies filed by large corporations indicate that, overall, pay for performance at the executive level is working — and in highly visible ways. Executive compensation, for the most part, has not been immune from the shocks to company performance brought on by the financial crisis and the recession.

More specifically, we found:

- The trend of year-to-year increases in executive compensation has reversed, in large measure because of a reduction in annual bonuses paid for 2008 performance.
- Companies are generally holding the line on executives' salaries. Freezes in salary are widespread.
- The value of recent equity grants has declined at many companies.

#### **2009 Proxy Season Snapshot**

To understand current trends in executive pay, we analyzed executive compensation data from almost 200 *Fortune* 500 companies that had filed their proxies by the end of March for fiscal years ending between March 1, 2008 and January 31, 2009. Companies with fiscal years ending December 31 accounted for half of the total.

The median annual revenue of the companies examined was \$12 billion, with a quarter reporting revenue below \$7 billion and a quarter reporting revenue over \$24 billion. The study looked exclusively at chief executive officers (CEOs) and chief financial officers (CFOs) who had served in their roles for the past 24 months to permit year-on-year comparisons.

#### **Drop in Executive Bonuses**

What did we find in terms of changes in compensation levels? One major finding is that bonuses fell 19% for CEOs. Unlike other elements of total direct compensation (see *Exhibit 1*), bonuses are the one pay decision made by companies at the end of the year, when the depth of the stock market losses and economic turmoil were painfully apparent for all to see.



Overall, total direct compensation (TDC) fell 2% last year for CEOs and 5% for CFOs, largely due to the drop in bonuses. Base salaries for both groups of executives increased, while long-term incentives (LTIs) showed little change.

**EXHIBIT 1**

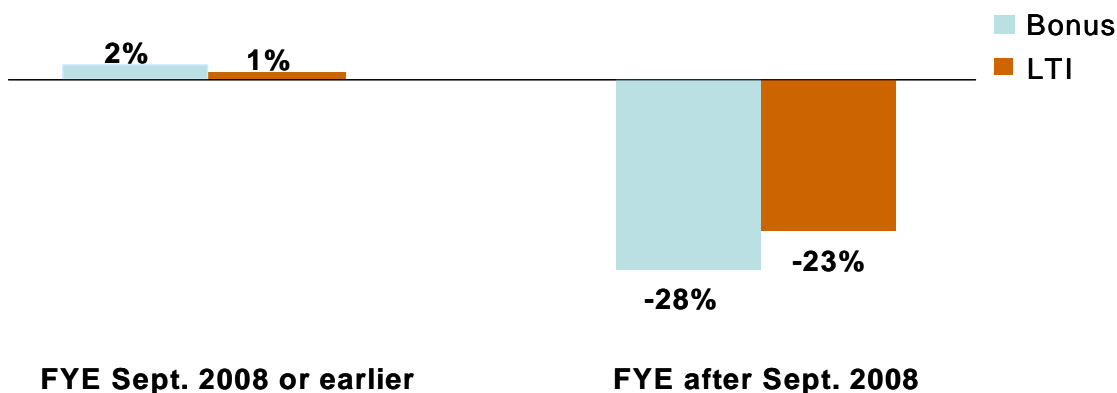
Median Percent Change in Key Elements of Executive Compensation	CEO	CFO
Base salary	4%	6%
Annual bonus	-19%	-14%
TCC	-5%	-1%
Long-term incentives (LTI): All types	-1%	1%
TDC	-2%	-5%

The fact that base salary and LTI grant values did not show much change from historical patterns is likely due to the fact that most of these decisions are made early in companies' fiscal years, generally well before last fall's collapse in financial markets.

However, the overall figures — and the underlying story — change dramatically depending on when companies made their compensation decisions, with bonuses and the value of LTI grants posting markedly steeper declines as the year unfolded. Bonuses among those companies with fiscal years ending before September 2008 were essentially flat, while bonuses were down 28% among companies with fiscal years ending in September 2008 or later. Similarly, the value of LTI grants made after September 2008 was down 23% compared to the prior year (see *Exhibit 2*).

**EXHIBIT 2**

**Year-Over-Year Change (CEO)**



Source: Equilar, Inc.

Retention is not an often-heard term in today’s market, but the decline in the value of outstanding and unvested LTI awards, while not commonly cited during the past year, should raise some concerns among directors. The data suggest that the median value of unvested CEO LTIs declined from more than three times their annual pay to little more than one times their pay — a decline of approximately 67%. So, in this respect, CEOs suffered just like other shareholders when their companies’ stock prices fell. The question is whether boards will choose to act on this concern given the heightened scrutiny of executive pay in today’s marketplace.

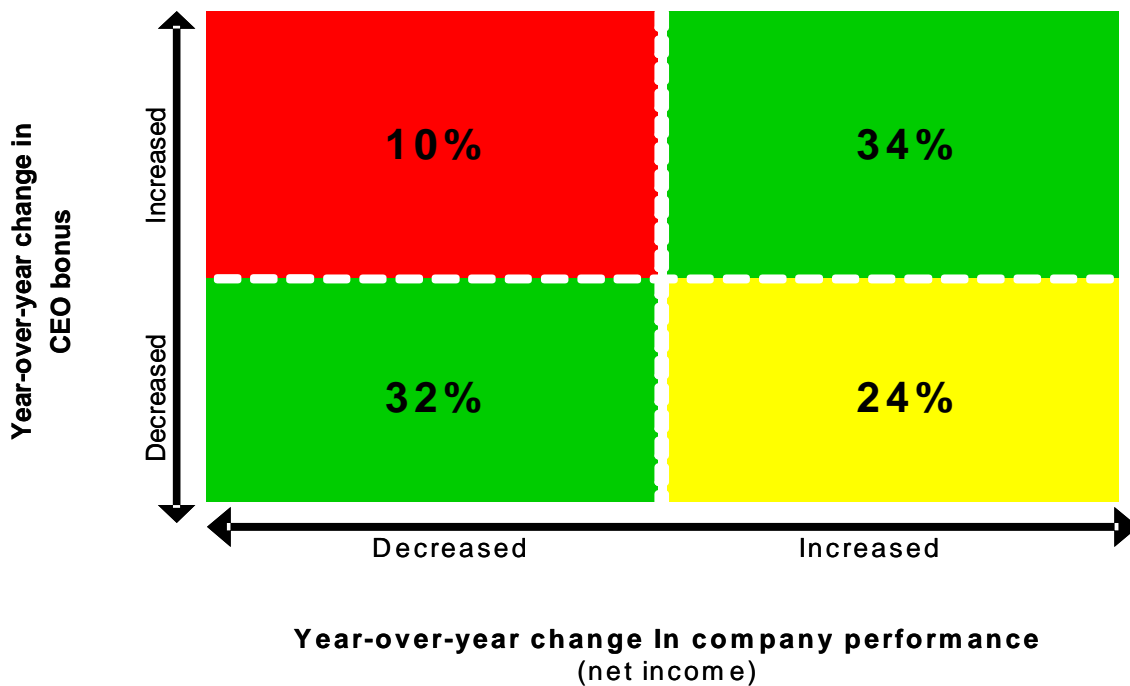
**Pay for Performance: A Reality for Most Companies**

Despite the public skepticism about the link between executive pay and company performance, we found CEO bonuses for 2008 performance were aligned with business performance at most companies. Bonuses at nearly two-thirds of the companies were directionally consistent with their year-over-year change in net income, with CEOs of better performers getting paid more and CEOs of companies with declining net income getting paid less (see *Exhibit 3*). Evaluating this alignment is much more complex than this simple test, but it does indicate a directional consistency.

---

**EXHIBIT 3**

**Pay-for-Performance Linkage**



Source: Equilar, Inc.

Of particular note is that there appeared to be a slightly conservative bias in determining bonuses, with 24% of companies paying lower bonuses despite increased income levels. In contrast, 10% of the companies examined actually paid their executives bigger bonuses when the organization's net income declined year over year.

Consistent with pay for performance, the magnitude of the change in CEO bonuses tended to correspond with changes in net income for the industry. Not surprisingly, the median for bonuses in the financial industry fell the most, by 100%, while net income in the industry fell by 40%. Over half the CEOs in the group (14 of 17) actually received zero bonus. CEOs in consumer products and materials saw median bonuses drop 38%, while net income for the industry fell 35%. Utilities was the only industry in which bonuses for over half of the CEOs increased.

### **Size Matters on the Downside, Too**

Towers Perrin's annual proxy analyses have consistently shown that size matters in executive compensation, with CEOs at the largest companies getting paid the most. That has not changed, but this year's report found that CEOs in the largest companies on average took bigger hits in the downturn than CEOs at smaller organizations. For example, median TDC for CEOs at companies in the top quartile of the sample (with revenues in excess of \$24 billion) fell by 17%, the most for any group of companies.

What happened to pay mix? Executive pay in 2008 continued to consist mostly of LTIs (62%), with the remainder split between bonus payments (18%) and salary (20%).

However, this year's proxy data suggest that the TDC mix shifted slightly in 2008 as bonuses shrank, both for CEOs and CFOs. Our own consulting experience and a series of Towers Perrin pulse surveys conducted in October and January also indicated that bonus payments dropped. It is important to note, though, that relatively few companies changed the structure of their bonus plans. This means that the plans are working as they were designed to work — and opportunities to earn bonuses generally have not been reduced, only the amounts paid.

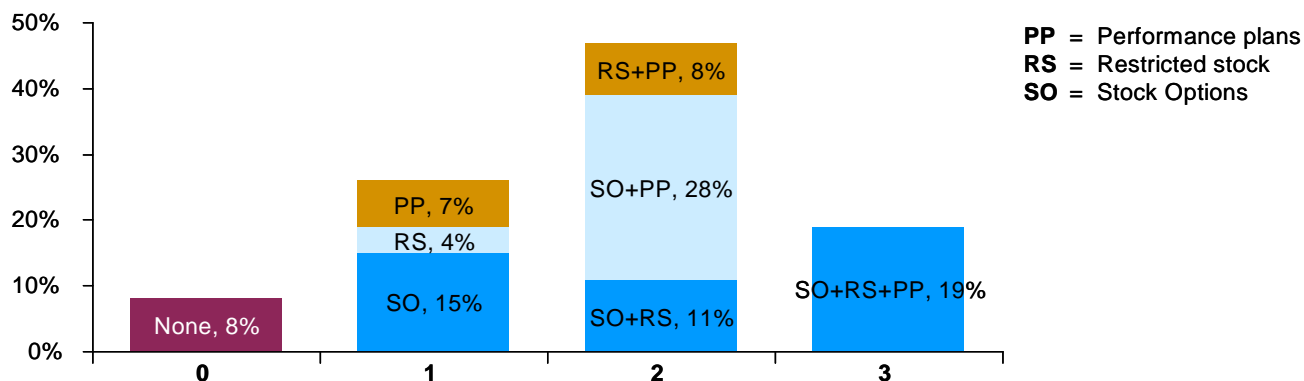
While companies have reduced their use of stock options over the past five years, this year's proxy analysis found that options continue to play a leading role in LTI formulas for top executives. Stock options accounted for 43% of the average LTI mix for CEOs in 2009, while restricted stock accounted for 20%, and the remaining 37% consisted of performance plans.

Keep in mind, though, that stock option grant values are calculated at the time they are made and equal to the values companies report on their income statements. In the vast majority of cases, these options are now far underwater, and many executives may be looking at these options today as essentially worthless.

The most common LTI portfolio at Fortune 500 companies last year was a combination of options and performance plans (28%), while 19% provided three types of plans (performance, restricted stock and options) and 15% offer stock options alone (see *Exhibit 4*). These patterns, nonetheless, underscore the continuing shift toward a more diverse LTI mix in recent years.

## EXHIBIT 4

### Number and Types of LTI Received



Source: Equilar, Inc.

### Executive Pay by the Numbers

Since no discussion of executive pay is complete without a look at some of the numbers for specific types of compensation, here are some of our top-line findings in that area:

- CEO salaries ranged from zero to \$8.1 million.
- The annual bonus range was smaller than in past years, with a maximum award of \$17.5 million in 2008, down from \$44 million in 2007. Among those disclosing targets, the actual short-term incentive paid 84% of target.
- The number of CEOs receiving no LTI payment fell to 8% from 13%. The largest LTI award was \$71 million, up from \$55 million.

### What's in Store for 2009

To get a sense of likely 2009 trends in executive compensation, we examined the Compensation Discussion and Analysis disclosures filed by the compensation committees of 135 *Fortune* 500 companies. For this group, we found:

- 44% are freezing executive salaries.
- 10% are reducing executive salaries, with the most common approach a 10% reduction below 2008 levels.
- 16% saw executives forgo — or compensation committees reduce — payouts of earned incentive awards in 2008.
- 14% announced that 2009 annual or LTI awards will be reduced or eliminated.
- 7% are curbing pay for directors.

These findings suggest that many companies are struggling to strike the right balance between risk and reward. They're wrestling with pay-for-performance issues, along with risk tolerance, goal setting and other challenges in an environment of great uncertainty where defining meaningful targets is much more difficult than usual.

One quarter (25%) of the companies studied modified their 2009 annual bonus programs or LTI awards. Another 19% shifted the LTI mix to balance retention and performance pay. More than half of the companies in this group introduced restricted stock or increased their emphasis on it.

We also found that companies are looking ahead and preparing for the time when the shock of the financial crisis wears off, the economy improves and executives realize that they have employment alternatives. There is also a recognition that, even in a bad economy, high performers are still in demand. Accordingly, 18% of companies made supplemental equity grants, special bonus awards or both to their executives.

Clearly, there is a new set of realities taking shape in executive compensation, and the dust has yet to settle.



## **ABOUT TOWERS PERRIN**

Towers Perrin is a professional services firm that helps organizations improve performance through effective people, risk and financial management. The firm provides innovative solutions in the areas of human capital strategy, program design and management, and in the areas of risk and capital management, insurance and reinsurance intermediary services, and actuarial consulting.

Towers Perrin has offices and alliance partners in the world's major markets. More information about Towers Perrin is available at [www.towersperrin.com](http://www.towersperrin.com).

## **ABOUT ECR**

ECR is the data collection and analysis, research and information services unit of Towers Perrin's market-leading Executive Compensation consulting practice.