

Special Comment

Moody's Global Corporate Governance

March 2009

Executive Compensation: What to Watch in 2009

Summary

Executive pay has been a contentious issue for many years, and the current market turmoil has drawn even greater attention from the public, media, investors, and government. The focal points of this increased scrutiny have been the role of executive pay in encouraging excessive risk-taking, promoting an undue focus on the short-term, and rewarding senior management for poor performance, and in some cases unmitigated failure. The popular perception is that executive pay is both "out of control" and has become de-linked from company performance. The United States government, for its part, recently introduced tougher executive pay restrictions for firms receiving government assistance under the Troubled Asset Relief Program (TARP) through passage of the American Recovery and Reinvestment Act of 2009 (the Stimulus Act).

At the same time, current market conditions and the reduced likelihood of a quick recovery are forcing many companies to re-think executive compensation schemes going forward. As a result, we expect many firms to make some significant compensation-related changes in 2009.

This report examines expected changes to pay plans and practices, and assesses potential implications for creditors. Our key conclusions:

- Pay-related changes will put new incentives in place for management and affect employee recruitment and retention efforts that could have significant future implications for bondholders.
- We expect pay-related scrutiny to be focused most heavily on firms most closely associated with the credit crisis, including those receiving government assistance, those who have exhibited poor pay practices in prior years, or both.

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- Expected key compensation changes include: a reduction or elimination of 2008 bonuses; changes to performance targets and metrics used in both short and long-term incentive plans; modifications to equity-based incentive plans; and other changes resulting primarily from shareholder pressure.
- Given the focus on pay, the pressures on various pay elements – in particular on variable compensation, which represents roughly 85% of typical CEO pay – and the reduced likelihood of near-term stock market recovery, we expect median CEO total pay to decline for the 2008 fiscal year and possibly again in 2009.
- We see both benefits and potential risks stemming from the pay changes, including those applicable to TARP firms under the Stimulus Act; potential credit implications are unknown at this time since pay is very much contextual and must be analyzed on a case-by-case basis.

Board Compensation Committees are Under Intense Scrutiny

We expect board compensation committees to face unprecedented scrutiny from investors, the media and the government in 2009. This will be particularly acute for:

- firms most closely associated with the credit crisis (financial firms, banks, homebuilders, etc.). Firms receiving government assistance will be under the most scrutiny and now must comply with specific pay restrictions (see box);
- firms who have not shown restraint or who have exhibited poor pay practices in prior years, in particular if they have also significantly underperformed compared with peers; and
- firms falling in both groups.

Even though we expect pay-related scrutiny to be focused most heavily on firms in the aforementioned groups, given the intense focus on pay and fallout from the broad market downturn with its potential effects on recruitment and retention, we expect compensation committees will reexamine pay plans and practices and in some cases making significant changes.

Among the key challenges – particularly for firms in the hardest-hit sectors – will be retooling plans to retain and reward key executives in an uncertain and rapidly-changing environment where previous performance targets and metrics may no longer be relevant and with limited, if any visibility to 2009 and beyond. At the same time, boards must consider the associated consequences – possibly unintended – of any changes to compensation programs. Engaged, thoughtful and independent compensation committees will be better placed to weather the current storm in our view. Conversely, boards that fail to “get it right” could face adverse consequences including negative press, pressure from activist shareholders, or recommendations by proxy advisory firms to withhold votes for directors up for re-election at shareholder meetings.

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New Compensation Restrictions for TARP Firms under the Stimulus Act

The Stimulus Act, signed into law by President Obama on February 17, 2009 introduced new executive pay restrictions for firms receiving government assistance under TARP. The restrictions, if implemented as announced (exact rules are to be finalized and implemented by the Treasury Department), would apply to the top executives and the other highest-paid employees at the nearly 400 firms that have received government assistance under TARP and to any new firm requiring assistance going forward. The number of executives covered under the restrictions would depend on the amount of assistance the company received. For example, firms receiving more than \$500 million, the restrictions would apply to the top five executives and the 20 next-most highly paid employees.

Other key provisions would:

- restrict payment or accrual of any "bonus, retention award or incentive compensation", except for: (1) any bonus required to be paid pursuant to written employment contracts executed on or before February 11, 2009 or (2) payment of "long-term restricted stock" that has a value not exceeding one-third of the employee's total annual compensation, that does not fully vest during the TARP period, and that is subject to such other terms and conditions as Treasury determines are in the public interest.
- prohibit "golden parachute" (termination) payments to senior executive officers (SEOs) and the five next most highly-compensated employees;
- prohibit incentives that may create "unnecessary and excessive risks";
- require a "clawback" provision to recoup any bonus, retention and incentive compensation paid to CEOs and up to the next 20 most highly-compensated employees based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate; and
- require firms to subject pay plans to a non-binding, or advisory, shareholder vote (commonly referred to as "say on pay"). The SEC has confirmed that any TARP firm that files both its preliminary and final proxy statements after Feb. 17, 2009, must hold such a vote this year.

Broad-based Changes to Compensation Plans Expected

It is still too early to tell the extent to which pay plans and practices will change during 2009. For US firms we will have a more accurate sense of the scope of these changes when most firms begin filing their proxy statements in March and April. That said, a number of companies, especially those hardest-hit by the market downturn, have already made changes to plans in 2008 or have indicated they plan to make changes to their compensation plans during 2009 in response to the current market turmoil. These changes will be myriad, but we view the following as being the most significant:

Reduction in 2008 bonus levels. Many firms' annual incentive (bonus) plans, in particular formula-based plans with performance metrics tied to earnings per share (EPS), total shareholder return (TSR) or explicit share price targets, are likely to pay out below target or may be zero due to missed financial targets under formula-based plans. As a result, we expect many firms to be paying lower bonus amounts than in previous years.

Compensation committees must determine the extent to which a significant reduction or non-payment of bonuses will affect employee retention and morale and whether the company's financial condition warrants the paying of bonuses. Responses could include: lowering bonus payouts or canceling awards altogether; voluntary forfeit of awards by CEO and/or senior management; and/or paying a portion of earned bonuses in equity. Companies may also choose to make all or a portion of bonus awards on a discretionary basis, e.g. if year-end results fall short of pre-established performance goals. However, since discretionary awards do not qualify as performance-based pay, they are not deductible for tax purposes pursuant to Section 162(m) of the Tax Code.

Reevaluation of, and changes to, pay targets and metrics. We expect many firms to have difficulty setting pay targets and performance metrics used in annual and long-term incentive plans. A lack of visibility into

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economy and stock market performance creates uncertainty for both annual and long-term incentive plan design, and previously-used performance targets and/or metrics may no longer make sense in the current environment.

According to Watson Wyatt, as of December 2008, 29% of companies expected to change the performance metrics of their annual bonus plan and 21% expect to change them in their long-term performance plan.¹ Responses could include: raising or lowering performance goals relative to last year's goals; measuring performance on a relative (vs. peers) rather than absolute basis; giving greater emphasis to strategic and/or non-financial performance measures vs. purely financial or market measures; and increased use of semi-annual or quarterly measurement periods. Some firms may choose to limit performance periods under long-term plans to one year, with multi-year service periods required thereafter for receipt of awards.

Modifications to equity-based incentive plans, including stock option exchange programs. Equity-based awards granted during the last few years with service or performance criteria and that vested in 2008 or are scheduled to vest in 2009 may have limited or no value due to the extreme deterioration in most firms' share prices. A large percentage of stock options awarded in prior years are now "underwater" (i.e. the options' exercise price is higher than the current share price) or at the very least have seen significant erosion in their value. According to Equilar, nearly all (98.8%) Fortune 500 CEO stock option holdings were underwater as of December 2008.² The low likelihood of significant upward share price movement in 2009 is likely to keep options underwater and the value restricted and performance shares granted in prior years depressed for the foreseeable future.

In response, a number of firms have, or are considering, a variety of approaches to salvage the motivational and retention value of awards made in prior years, including: extending the timeframe of current plans (e.g. a three-year plan now becomes a five-year plan); accelerating vesting of grants made in previous years; making one-time special grants of new equity awards, or other techniques. Over 60 firms (namely in the technology sector) have either completed or proposed a stock option exchange program, exchanging underwater options for, e.g. a lesser amount of new options or new restricted shares. Although more companies are expected to follow suit, implementing option exchange plans is difficult due to accounting and tax considerations and shareholder approval requirements (in most cases).

Other key changes. We expect to see more firms making changes in response to shareholder pressure, including from shareholder advisory groups, and in advance of the shareholder meeting season, which we expect to be contentious. We note that some of these practices, such as "say on pay", are mandatory for TARP firms (see box on p. 3). These areas include:

- examining current policies concerning potential termination payments, that have been criticized as "golden parachutes";
- examining linkages between risk management and compensation, possibly tying awards to longer vesting periods, creating hold until/through retirement restrictions or adjusting awards downward in the event of future poor performance.
- implementing or broadening the scope of "claw back" policies, which allow for recoupment of pay under a narrow set of circumstances such as accounting fraud or other misconduct;
- limiting and improving disclosure around perquisites, including tax "gross-ups" (company-funded tax payments for a given perquisite, such as travel on corporate aircraft); and
- examining whether to institute advisory votes on pay (commonly referred to as "say on pay"). Shareholders have lodged proposals at over 100 companies seeking annual advisory votes on pay. Thus far, 18 companies, including Intel Corporation and Occidental Petroleum Corporation, have instituted such policies, and more are expected in the face of possible Congressional action to mandate advisory votes for all companies.

¹ Watson Wyatt, *Effect of the Economy on Executive Compensation Programs*, December 2008.

² Equilar, Inc., *Executive Compensation Trends*, December 2008.

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Examples of Recent Pay-Related Changes

Ingersoll-Rand Company: Among various other changes to the compensation plan, the company revised the long-term compensation program to change the current one-year performance period under the long-term plan to three-year overlapping performance periods beginning in 2009.

Starbucks Corporation: Cancelled fiscal 2008 bonuses for named executive officers and is seeking shareholder approval for a one-time stock option exchange program for employees other than executive officers and directors at the company's annual meeting on March 18, 2009, which would cancel certain stock options in exchange for the grant of a lesser amount of new options with lower exercise prices.

UBS AG: Among numerous other changes to the compensation plan, UBS linked variable cash compensation for the Group Executive Board to a "bonus/malus" system, whereby a maximum of one-third of the cash component of the bonus will be paid out at year's end "subject to positive business development". The remainder will be held in escrow in a bonus account. Should UBS's results be poor, a negative award, or malus, can result and the bonus account will decline. The account can also decline if regulations are grossly violated, if unnecessarily high risks are undertaken or if individual performance targets are not met.

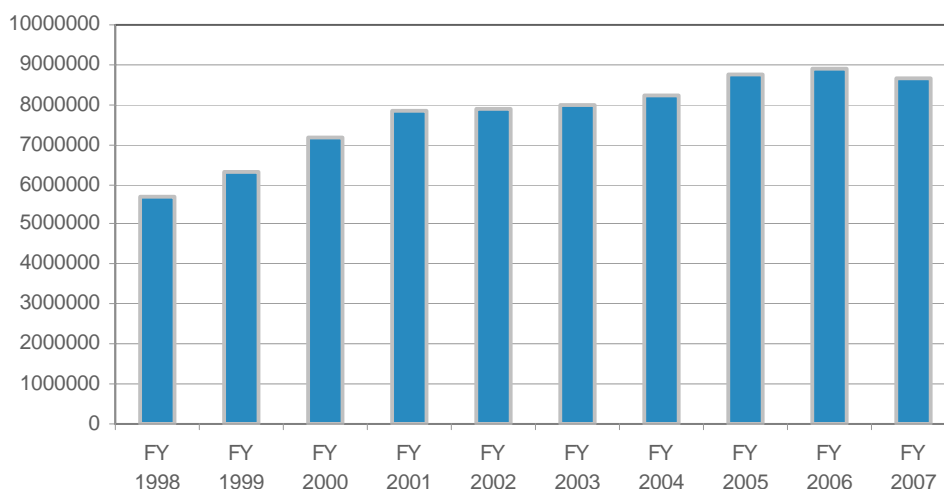
Xerox Corporation: Prioritized core cash flow and earnings per share as the primary annual incentive performance metrics "in consideration of the challenging and unpredictable economy" and set performance targets for the first half of the year only. Separate performance measures and targets for the second half of the year are expected to be finalized and approved in July, with each six-month period performance being calculated separately.

Source: Equilar, Inc. and Moody's research.

CEO Pay Levels Expected to Decline at Most Firms

Given the number of aforementioned pressures on various pay components – in particular on variable compensation, which represents roughly 85% of typical CEO pay – and the reduced likelihood of near-term stock market recovery, we expect median CEO total pay to decline for the 2008 fiscal year and possibly again in 2009 (see Chart One).

Chart One: Median CEO Total Pay, S&P 500, 1998-2007



Note: total pay is the sum of base salary; bonus, FAS 123 grant date fair value of long-term incentives, and all other compensation. FY 2007 measurement period is through August 2007.

Source: Equilar, Inc. and Moody's analysis.

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Pay Changes Carry Potential Benefits and Risks

Moody's sees both benefits and potential risks stemming from the pay changes. Executive pay is incorporated into our credit analysis of rated issuers because compensation can be a determinant of management behavior that affects indirectly credit quality. Therefore, we believe it will be important to assess these changes since they put incentives in place for management and can affect employee recruitment and retention efforts and could have significant future repercussions for bondholders. Also, pay targets and metrics can provide an important window into management's confidence in hitting the numbers in 2009 and beyond. Credit implications are unknown at this time since pay is very much contextual and must be analyzed on a case-by-case basis.

Potential benefits/Moody's would view positively:

- more focus by compensation committees on re-thinking pay practices and creating pay structures that make sense for the particular company at this time, potentially coupled with improved, "plain English" disclosure about the compensation committee's thought process and why certain targets and metrics were chosen.
- changes to performance targets and metrics that place a greater focus on achievement of strategic or operational goals, cash flow, or other creditor-friendly measures. We note however that greater emphasis on qualitative factors can make it harder for outsiders to evaluate the compensation scheme.
- examination of linkages between risk management and pay practices, possibly tying awards to longer vesting periods, creating hold until/through retirement restrictions or mechanisms to adjust bonuses or long-term performance plans downward in the event of future poor performance.

Potential risks/Moody's would view negatively:

- changes that create unbalanced pay structures, particularly "mega-grants" of stock options or restricted stock at historically low share prices, that may be granted in lieu of salary reductions or bonuses, or as one-time special retention awards.
- similarly, evidence of a greater emphasis on shareholder-friendly pay structures and/or performance metrics, such as aggressive EPS, TSR or share price targets that may promote an excessive focus on the share price, a "swing for the fences" mentality, or that may otherwise encourage a greater risk appetite that we believe is optimal from a creditor standpoint.
- changes that create less focus on pay for performance, such as payment of bonuses that may rely too heavily on the discretion of the board, obviously low performance targets that are designed to ensure a guaranteed payout, awards that do not balance upside potential with downside risk or that rely too heavily on service, rather than performance-based vesting requirements.

In particular, we would view these elements negatively at companies where we have expressed previous concerns about compensation or corporate governance.

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Top Five Issues for Investors to Consider

Although there are many possible changes that issuers may consider making to their compensation plans, we believe the five issues listed below merit special attention for investors since they may heighten credit risk. When one or more of the following is evidenced, investors may wish to examine more closely the issuer's compensation policies by reviewing the CD&A section of the proxy statement.

1. Clear evidence of a pay for performance disconnect, that could include payment of large bonuses in the face of poor performance or other examples mentioned in this report.
2. A shift away from using a balance of performance metrics to increased use of shareholder-friendly pay metrics such as EPS, TSR or share price targets.
3. Changes that create unbalanced pay structures, including outsized equity awards that may promote excessive risk-taking.
4. Loss of key personnel, since compensation plans may not be achieving desired recruitment and retention objectives.
5. Heightened levels of headline risk due to unfavorable media, investor or government attention concerning an issuer's pay practices that may result in considerable management distraction.

TARP Firms

We see both benefits and potential risks stemming from the pay restrictions under the Stimulus Act, and potential credit implications are unknown at this time. As potential benefits, the pay caps could spell greater management accountability to investors. For example, amended pay plans could encourage senior executives to take a longer-term view, particularly if new equity awards are tied to long vesting periods, have deferred exercise or hold-through-retirement restrictions attached, or if other policies that help create a long-term focus are put in place.

However, the rules as currently stand raise concerns about a potential pay-for-performance disconnect in two key respects: 1) it could lead to a large increase in salaries, which are generally not conditional on the executive achieving performance goals and 2) the prohibition on incentive compensation other than in the form of "long-term restricted stock" limits the company's ability to tie awards to the achievement of key performance objectives. The restrictions could also have a negative effect on recruitment and retention of key talent or lead to other unintended consequences.

We also view the compensation restrictions as providing one of many incentives for firms to repay TARP assistance as quickly as possible (or avoid new or additional TARP funding), and that the restrictions are one of the unique features in TARP preferred stock that align most stakeholders in wanting to see the stock redeemed. We have not taken the view that TARP preferred stock is permanent capital and therefore assign these securities Basket B treatment under our hybrid rating methodology, which grants these securities 25% equity credit for the purposes of financial leverage calculations.³

³ See Special Comment: Moody's Assessment of the U.S. Government's Preferred Stock Investment in Banks, November 2008 (112802).

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Moody's Related Research

Special Comment:

- Corporate Governance in the Credit Crisis: Key Considerations for Investors, November 2008 (112847)
- Expanded Disclosures on U.S. Executive Compensation Offers New Clues for Creditors, June 2008 (109705)
- Analyzing Unexpected CEO Departures and Severance Payouts for Signs of Weak Governance, December 2007 (105930)
- US Homebuilder Compensation: Structure and Magnitude May Promote Short-Term Volatility, November 2007 (105962)
- A User's Guide to the SEC's New Rules for Reporting Executive Pay, April 2007 (102762)
- U.S. Executive Pay Structure and Metrics, June 2006 (97887)

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