

10 Minutes on Compensation*

What you need to know about emerging topics essential to your business. Brought to you by PricewaterhouseCoopers.

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Refining the pay-for-performance model

Highlights:

- New compensation guidance is equal parts business opportunity and compliance.
- Compensation policies will need to focus more on long-term value creation and corporate stability.
- Companies must now consider the interaction of risk and performance across their entire organization, not just within the C-suite.
- Businesses may have to disclose more about their risk-and-reward models, as well as rethink the roles of key control functions vis-à-vis compensation.

Today's pay-for-performance model has come under increasing scrutiny from US policymakers and their global counterparts. The collective goal is to ensure that compensation packages at all public companies—not just banks and financial services institutions—don't put the long-term health of businesses and the overall economy at undue risk.

To this end, US lawmakers and regulators are looking to lessen the degree that companies emphasize short-term performance. They also want greater disclosure about how public companies' compensation policies—including those governing certain employees and business units outside the C-suite—might precipitate events that businesses don't have the financial wherewithal to withstand.

Various new pieces of federal guidance will force companies across all sectors to take a much broader view of both performance and risk. Companies that approach this as an opportunity, rather than just a compliance exercise, can derive long-term benefits from the pay-for-performance model's evolution.

Spotlight on the risk-compensation relationship— What it means for companies:

1. Companies will need to demonstrate that their compensation models are layering in risk considerations and long-term corporate stability to a much greater degree than before.
2. Boards will have to assess the compensation policies for any employee who, by virtue of his or her corporate function, could put the business at heightened risk.
3. Companies may need to consider putting compensation "at risk" for longer periods so that the timing of incentive pay and performance are not misaligned.
4. Putting compensation at risk for longer periods may pose challenges for companies in light of recent tax-rule changes.
5. Greater disclosure about risk and reward may inform shareholder views/votes on compensation decisions.

At a glance

What the new guidance does

- Emphasize stronger governance and analysis of the risk-compensation relationship
- Expand beyond the C-suite the employee compensation policies that should be reviewed and possibly disclosed
- Require proxy statement disclosure of how risk is overseen by the board and managed by senior officers
- Require companies to report equity compensation at fair value

What it doesn't do

- Set limits on compensation (except for TARP recipients that haven't repaid the government)
- Require boards to expand their direct oversight of compensation programs beyond those for top officers
- Call for additional disclosures in the Compensation Discussion and Analysis (CD&A) section of proxy statements
- Necessitate significant changes in compensation structures and policies at many companies

01

Redefining performance

In their effort to address the various complex causes of the financial crisis, policymakers have been contemplating the role corporate pay packages played. The result is compensation guidance from multiple quarters.

Collectively, the guidance aims to ensure that compensation policies do not promote behavior that could put companies—and, by extension, markets—in jeopardy. To this end, policymakers want corporate compensation plans to take risk and long-term performance into greater account.

Regulator/shareholder tension

Some shareholders have traditionally focused on short-term returns, paying less attention to long-term value creation and risk. This was particularly evident in the run-up to the financial crisis. Various companies that have fared relatively well in the wake of the crisis were criticized by shareholders (one to two years earlier) for not playing more aggressively in the subprime loan market.

Many policymakers argue that the interests of such shareholders are not necessarily aligned with the interests of the general public and the goal of market

stability. The new guidance attempts to bring those interests into balance.

Pressure on boards

Shareholders are beginning to bring about some of that balance themselves, post-crisis, giving greater consideration to the long-term corporate health of the companies they invest in. As a result, shareholders' usual pressure on boards to show a demonstrable and explicit link between pay and performance may start to shift in emphasis—so that the long view of performance is stressed as much as the short view. Indeed, certain institutional investors (e.g., pension funds) have long made this their policy.

Such pressure will be easier to apply if Congress requires public companies to grant shareholders a nonbinding advisory vote on executive pay ("say on pay"). Boards also continue to confront public pressure, with negative sentiment about executive pay potentially diminishing corporate reputation and value. And, there may be pressure from within the board itself: Although much of the new compensation guidance is directed at banks and other financial institutions, its core elements are likely to migrate to other sectors through cross-directorships and broader director education.

Current and proposed* guidance

Affecting public companies	Directed at banking and financial services companies
SEC rules	Federal Reserve Board principles*
US Treasury principles	Financial Stability Board (G20) principles
Say-on-pay bills in the House and Senate*	Mandated compensation limits and say-on-pay for TARP recipients

02

Viewing risk through a wider lens

Many of the compensation guidelines coming out of Washington focus on the top tier of executives. There are two notable exceptions: The SEC's new rules and the Federal Reserve Board's proposed principles. Both require companies to take a more holistic approach to assessing risk and reward, so that the effort is integrated across an entire organization.

Looking past the habitual sightlines

As the SEC and Fed see it, the risk-compensation relationship isn't necessarily confined to the C-suite. Rather, any employee and business unit may, depending on their role, function, and how they are paid, put a company at heightened risk—and, in turn, pose an indirect risk to the financial system and broader economy.

Those two agencies, therefore, expect companies to assess the compensation policies for non-officer employees whose individual or collective decisions create such risks. The SEC also wants companies to disclose those policies in their proxy statements if they could result in potentially harmful consequences for the companies.

Risk pockets outside the C-suite

Which compensation structures outside the C-suite merit a risk assessment will vary from company to company. And, within a given company, pay models and attendant risks may vary from business unit to business unit.

An industrial company with a large pension fund, for instance, would need to look carefully at the compensation structure for in-house employees who manage the fund's assets and liabilities. Fund-manager compensation models are markedly different from compensation models for executives and the employees responsible for core operations. Likewise, compensation policies covering "traders" that execute hedging strategies—say, for a utility company—are distinct from other pay models, carrying their own set of risks.

All of which underscores the need for companies not only to view the risk-compensation relationship through a wide-angle lens, but also to peer closely at specific areas. In so doing, companies can ensure that appropriately tailored metrics and risk management practices are in place throughout the business.

03

Presenting a more detailed picture

Although the new guidance coming out of Washington won't radically change compensation structures or policies at most companies, it does require that businesses give them a good deal more thought—as well as potentially disclose more about them.

Show, not just tell

Under the SEC's new rules (which apply to the 2010 proxy season) and the Fed's proposed principles (due to be finalized this year), boards and their companies will need to do more than just say they have aligned compensation with risk considerations and the goal of long-term stability. They will also have to show that they have a process for achieving that alignment.

For their part, banks and other financial institutions will have to submit to the Fed their compensation policies and practices. If the Fed is unsatisfied with a compensation plan and the rationale for it (e.g., if it thinks pay incentives are skewed to rewarding short-term growth at the expense of long-term stability), it could require that the bank or financial institution modify the plan.

As for public companies in general, they will have to evaluate their risk-and-reward approach more thoroughly to

determine whether the compensation package of any employee (not just the top five) could encourage risky actions that might seriously harm the business.

Focus on performance targets

The SEC wants companies to disclose performance targets, if they would be meaningful to investors. Those targets should be disclosed regardless of whether the corresponding incentive payments are ultimately made. As for companies that do not disclose targets, due to confidentiality concerns, the SEC expects them to nonetheless explain how and why they set certain performance targets, and to give their rationale for other key compensation decisions.

Setting performance targets in today's highly fluid economy can be challenging. Companies that find themselves adjusting performance goals and metrics will need to keep the new compensation guidance in mind. In doing so, they may also find themselves making greater use of nonfinancial metrics (e.g., market share, customer loyalty), since qualitative targets may be less apt to encourage risky employee behavior.

04

What companies should be doing

The overlapping nature of the various new pieces of guidance means that companies can kill two (or several) birds with one stone. For instance, in complying with the new SEC rules, a company may find it's also indirectly satisfying certain requirements of other new compensation guidance (e.g., the US Treasury principles issued in June 2009). Companies and their boards can begin taking the following measures now:

Understand the processes and control functions around compensation decisions for employees outside the executive officer group: Although the compensation committee needn't expand its direct oversight beyond the top group of officers, it should nonetheless know which governance processes are in place and understand how risk is aligned with compensation throughout the organization.

Modify control functions to strengthen governance of compensation practices: Companies should strengthen the involvement of risk management, internal audit, general counsel, and human resources in monitoring the risk-compensation relationship across the business.

Increase dialogue across the board: Greater inter-committee coordination could help strike the right balance

between responsible risk-taking and stable, long-term performance.

Defer an appropriate proportion of incentive pay over a period that is aligned with the time it takes for corresponding profitability and results to materialize: Deferred compensation should be contingent on future performance, not just on continued employment.

Take into account recent tax-rule changes that limit permissible forms of deferred compensation: Companies planning to defer equity payouts for longer periods may find this somewhat challenging in light of recent tax-rule changes.

Ensure that payouts for achieving short-term goals support the company's strategy for building long-term value: Companies should consider qualitative measures of performance (e.g., R&D initiatives, brand health) and adjust performance metrics to reflect risk considerations.

Use the CD&A to foster dialogue with shareholders: Companies may find that treating the CD&A as a genuine communication tool (instead of a mere compliance exercise) will result in shareholder say-on-pay votes that are more constructive than reactive.

Upcoming 10Minutes topics

Creating more value from HR

The link between effectively deployed talent and business results has never been more apparent than in the past year. Strong leadership enabled many firms to perform better than their competitors. 10Minutes discusses ways that companies can improve their approach to recruiting and managing pivotal employees by better aligning HR models to the strategic goals of the business.

The changing face of financial reporting

Standard setters have proposed fundamentally changing the way public companies gather and display financial data for investors and the general public. While some welcome the changes, critics say the proposal is costly and, in large part, unnecessary. 10Minutes discusses the pros and cons.

Global infrastructure

As part of their plans to stimulate their economies, many countries, including China, Mexico, Australia, and the US, have announced their intention to step up spending on roads, rail, and other projects. The renewed focus on infrastructure is creating opportunities for business and investors. 10Minutes talks about the challenges in financing and executing projects on time and on budget.

From crisis mode to sustained efficiency

With the strength of the recovery remaining uncertain, companies have yet to ease up on cost-reduction measures. In fact, many are going to the next level, re-thinking operating models and structures to see how various functions can deliver even more value at lower cost. 10Minutes looks at how companies are embedding lessons from the crisis into more disciplined management of corporate performance.

How PwC can help

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