2009 Compensation Plans

An Early Look

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In the 2008 / 2009 bonus process, we have seen significant changes to deferral plans, most notably, substantially more compensation deferred. Employee perception is a mixed bag: with stock prices depressed across the market, this may be a time when employees see more potential upside in performance driven / long-term awards; however, in some cases, employees have seen historic awards lose value, and may be skeptical as to their value proposition.

Firms have altered their deferral plans primarily to preserve capital in the short-term, as well as to further link pay to multi-year performance. What follows focuses on changes in pay plans for rank and file employees, and deliberately excludes plans that were only used for executive pay. Furthermore, though the changes have been most apparent at large global banks, they remain relevant across the industry as employees at these firms constitute a large percentage of the overall population. The areas where plans showed the most change were as follows:

1. Eligibility Criteria
2. Deferral Calculations
3. Max Cash Provisions / Vesting Schedules
4. Award Vehicles
5. Performance Criteria / Claw Back Provisions

ELIGIBILITY CRITERIA

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Many firms are including a broader set of employees in their mandatory deferral programs. Traditionally, a substantial bonus amount would mark the threshold for participation, however, early signs point to significantly lower bonus thresholds at many firms; some have even cut their thresholds by more than half. Some firms have implemented a "max cash" provision, which will be covered below.

RATIONALE

For firms that have a shortage of cash, this is a sensible approach. Having a larger number of employees receive deferred compensation does reduce current cash needs for firms.

CHALLENGE

The overall impact of this isn't enormous from the firm perspective—a large percentage of the bonus pool is typically assigned to highly paid staff in the first place. It is important to consider the cost of administrating these awards, versus the short-term cash savings. Consider an employee with a 50K bonus that is now subject to a deferral. If 20% of this award is deferred, and vests in three tranches, the firm now needs to administer three vesting events at a par value of $3,333. The combination of administrative complexity, as well as the creation of cash flow problems for relatively lowly compensated employees may not add up.

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DEFERRAL CALCULATIONS

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The majority of firms continued using a tax-table approach, deferring incremental compensation at higher percentages. In many cases, the percentage deferred at each band has increased, or at the very least remained the same. Some firms have ratcheted up the percentages for higher paid employees, while leaving lower paid staff subject to historic deferral rates. Again, max cash provisions are related to this topic, and have seen broad use.

RATIONALE

Increasing deferral percentages is an effective way to defray current cash expenses. Firms have been able to preserve scarce cash reserves in a meaningful way using this method.

CHALLENGE

Not all firms have an unlimited supply of shares available. In some instances, firms needed to either go against the grain and decrease their deferral percentages, or defer into cash or phantom share plans, based on the scarcity of available RSUs.

MAX CASH PROVISIONS / VESTING SCHEDULES

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In several cases, firms have instituted max cash provisions, whereby a certain bonus threshold will trigger an automatic deferral of all incremental dollars. We have seen 100% deferral rates applied to sizable portions of bonuses for employees with relatively modest year-end awards. There has been little consistency in changes to vesting schedules: some firms have increased the length, while others have shortened it. There is a small but noticeable trend towards performance-based vesting, rather than the more conventional time-based method.

RATIONALE

Firms saw little choice, especially if they wanted to deliver bonuses of any significance. It appears that employee expectations were appropriately managed, and the outcry has been minimal. In order to free up cash flow for employees getting capped, some firms have accelerated vesting of historic awards—the only problem with this is that at many firms historic awards are at an all-time low, and cash-starved employees are reluctant to sell accelerated shares at such low prices

CHALLENGE

The greatest challenge in using these max cash provisions is the false sense of security they give firms. One has to question whether firms overshot the mark with pay last year, taking some comfort in deferring pay into the short term future, when things would "surely get better." The question remains whether firms will have made sensible bonus decisions, or merely pushed the problem out another year or two.

AWARD VEHICLES

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Firms are being creative in their approach to deferral vehicles. One firm is using a pool built from defunct loans and mortgage-backed debt to fund deferred compensation for highly paid staff. Another firm will award deferred cash in lieu of stock if the share price drops below a certain value. Several firms are switching from a single-vehicle deferral plan to one that utilizes stock, deferred cash, and in some cases, even options. The latter, which had previously fallen out of favor with employees and employers alike, will help some firms deal with this stock shortage (since these are often settled in cash, rather than shares). Generally considered more risky than stock and less cost-efficient

for firms based on updated accounting regulations, options may have regained some of their luster as a potential market rebound looms on the horizon.

RATIONALE

From a firm perspective, many of these decisions have come down to a matter of living to fight another day. There is also a decided emphasis on holding award recipients more accountable for performance going forward. From an employee perspective, with significantly depressed share prices, both stock and option awards are poised to yield enormous returns should the economy bounce back in a reasonable period of time.

CHALLENGE

Deferred cash used to feel like a second-rate proposition, as employees watched share prices soar. In the current climate, deferred cash may be more palatable, but employees will be concerned about the "time value" of cash that is delivered in the future. As firms consider options or other leveraged performance-linked plans, appropriate care must be taken in pricing these. Options struck at current share price levels may create excessive cost exposure for firms, even with a modest bounce back.

PERFORMANCE CRITERIA / CLAW BACK PROVISIONS

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Policies around the actual delivery of deferred awards may become stricter in some cases. Several firms plan to institute claw back provisions, which would cancel delivery of some or all of an employee's deferred award if performance guidelines are not met. Claw backs may apply to deferred cash awards, or even stock / options. While this has existed somewhat more broadly in executive compensation, the use of claw back provisions for rank and file employees is potentially complex to measure and administer, particularly when it comes to cash awards.

RATIONALE

Having been burned by paying out based on current year revenue, firms are now desperate to safeguard against a similar event. Firms can take greater comfort in knowing they now have a hedge against future events, particularly with respect to asset classes that have a long settlement time horizon.

CHALLENGE

While performance vested and retractable awards are sensible for executives and business leaders, it remains to be seen how well this will play out with the rank and file employees. A reasonable question to ask would be: should infrastructure employees bear the risk of having an award clawed back, when they may not have any direct drive on firm performance? The other concern is the complexity and administrative chore that will come on the back of these programs.

CONCLUSION

There is no doubt that in the presence of bonuses dropping sharply, firms deferred a greater percentage of these bonuses than ever before. While a handful of firms are still making adjustments, the market trends are clear: deferral percentages were up, thresholds were lowered, new vehicles and vesting schedules were deployed, and several firms instituted max cash and claw back provisions. These developments resonate beyond the issue of deferred compensation—they will likely have influence over the future of buyouts, retention and sign-on awards, and other pay practices, as well.

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McLagan is currently producing the 2009 Equity Deferral / LTIP / Onboarding Study, which explores these topics in greater detail, including analysis of industry deferral percent per comp dollar, max cash limits, specific claw back provisions, vesting / forfeiture / retirement provisions, and much more. McLagan works with many of our clients to design impactful pay programs.

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