



**American Association
of Bank Directors**

Today's Compensation Environment – 2008



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TODAY'S COMPENSATION ENVIRONMENT - 2008
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The purpose of this paper is to help community bank leaders navigate today's complex compensation environment. This paper, first published in 2002, is developed by Amalfi Consulting in conjunction with the American Association of Bank Directors (AABD). This year's version has been updated to reflect the present state of the banking marketplace in 2008; an unprecedented time by any measure. This paper provides a context for community bankers to understand these changes, resulting trends in compensation, and potential implications for their own compensation plans.

EXECUTIVE SUMMARY

In past versions of this paper the focus has been on both regulatory changes directed at executive compensation as well as changes in the compensation levels in the market. With the 2008 version of this paper, we are focused singularly on the state of the financial industry. Over the past twelve months, as measured by the stock markets, both the banking sector and the economy as a whole have experienced a dramatic decline – the SNL Bank & Thrift Index (approximately 600 public institutions) is down 40.8% on a total return basis while the S&P 500 is down a commensurate 39.2%.¹ Over the past month, the United States Congress has passed the Emergency Economic Stabilization Act of 2008 (EESA) aimed directly at providing stability to the financial markets. Given that the present time period is a unique time in American business, our goal here is to focus on its impact on compensation. In particular, what are companies doing to adjust to the times and how are their compensation programs reflecting this?

- **EESA Implications:** On October 3, 2008, EESA was signed into law². As with many laws, the meaning and significance of the provisions and their implications are still being determined. To date we have initial interpretation from the Treasury Department; however, more clarification is expected. However, any institution that participates in the EESA funding, through either a loan or an equity infusion, will have limitations placed on executive compensation. Summarized in this document, the main limitations encompass limitations on severance payments, deductibility of compensation, clawback features on compensation paid, and avoidance of “unnecessary and excessive” risk. These features, while a major focus of EESA, lay a ground work that will undoubtedly set a framework for potential future changes to regulations covering executive compensation.
- **Compensation Philosophy & Peer Group:** All forms of compensation have their basis in the compensation philosophy of the company; what is to be paid for target performance and what is to be paid for superior performance. Given the market decline, many institutions first need to reevaluate their compensation philosophy. If they were a high performing institution in the past, will that continue in the future? If a company will require several years to work out of a credit issue, it may no longer be a high performing institution. As such, the compensation philosophy may need to change. More importantly, this may suggest that the award opportunities in performance plans may need to change as well. Second, even if a company's compensation philosophy is intact, i.e., it is performing consistent with historical levels, the peer group may need to be revisited. There may be several institutions who were peers from a performance or business model perspective in the past which no longer meet those criteria. In reviewing this issue for clients, depending upon location, a quarter to half of peers have had to be replaced.
- **Performance Based Plans:** Performance based pay has already been dramatically impacted. Through 2007, cash incentives for all publicly traded banks declined 12.6%. On the basis of total direct compensation (base salary, cash incentives and equity

incentives), there was an increase in 2007 over 2006 of 3.0% versus an increase of 12.5% in 2006 over 2005. Given the change in the marketplace and its impact on compensation, what trends are emerging? A clear point is that under the concepts of pay-for-performance, since performance is down, compensation is down as well. This is an expected outcome. That said, what institutions are focusing on is what can they do with their performance plans to help direct their organization to a more profitable and stable future. At present there is a focus on the specific goals and objectives to drive performance for the coming 2009 fiscal year. In particular, there is a focus on having goals that are realistic as well as prudent given the existing marketplace. In other words, the historical measures, in general, are being closely reviewed and modified for the coming year.

- **Long-Term Equity Based Incentives:** Given how the markets have performed, one expected outcome is that many stock options are presently “underwater”. A stock option is underwater when the current stock price is less than the grant price of the stock option. For example, if the stock was granted at \$20 per share and the stock is presently trading at \$12 per share, then the stock option is underwater by \$8 per share. As of October 20, 2008, 87% of all stock options granted in 2007 were underwater³. For these same stock options, they were below the grant price by approximately 40%. This correlates with the previous point in this Executive Summary section regarding the overall decline in bank stock returns. This situation leaves a significant portion of compensation plans and stock options, effectively inoperative at present. What we are seeing are both a continuation of previous trends and evaluation of new techniques at this point in time. From a historical perspective, we are seeing a continued move to full value shares, such as restricted stock, from options. In general we suggest a blend of 50% appreciation shares (e.g., stock options) and 50% full value shares (e.g., restricted stock). Also, we are seeing a move to performance-vested equity versus equity which vests solely on the basis of time. Performance-vested equity drives pay-for-performance and, in general, if the measures are not met, the expense can be reversed. Last, we are seeing a number of institutions considering an exchange of their existing underwater options for cash, stock or new options. This is a very complicated topic which is summarized later in this document.
- **Other Forms of Compensation:** Either through a bank’s particular performance or by way of the EESA regulations, we are also seeing a review of all forms of compensation. This is primarily tied to reviews of agreements in the form of employment or change-in-control. Also, a review of executive benefits is being conducted. The fundamental notion is that all forms of compensation must be both in alignment with the bank’s future direction as well as compliant with all regulations.

As has been our message since the original publication of this paper in 2002, each organization needs to review and evaluate what is applicable to the institution. Each recommendation that supposedly solves mainstream compensation excesses needs to be viewed in its proper context – how does it apply to your institution?

State of the Industry – Financial Performance

By any measure, the banking industry is facing its most challenging environment in decades, if not ever. Recent loan losses, the credit crisis, a deteriorating housing market, and general market instability have contributed to an extremely volatile banking environment on all fronts.

The recent industry decline is clearly visible in terms of several key financial performance metrics. The following table summarizes Amalfi Consulting’s matched-sample analysis of approximately 1,100 publicly traded banks and thrifts. The table shows the median change in

each performance measure, comparing performance over the last-twelve-months (LTM) to the three-year average of the same period over 2005 to 2007.

What this analysis tells us is that across all measures, banking is in a steep decline. As compared to the three-year average of 2005-2007, the last-twelve-month performance as of June 30, 2008, defined by either return on assets or return on equity declined 25%; non-performing-assets as a percentage of assets increased 154%. Other factors that speak to the downturn are that banks located on the coasts were more severely affected than non-coast banks; and in general, the larger banks were more negatively impacted than the smaller banks.

Exhibit 1
Percent Change in Performance Measures
June 30, 2008 LTM Performance Compared to 2005-2007 Average

Asset Cut	(\$M)	n	Net					NPA's/ Assets	NCOs/ Avg Loans
			ROAA	ROAE	EPS	Interest Margin	Efficiency Ratio		
All Banks									
<\$250M	142	338	-36%	-30%	-30%	-7%	4%	113%	34%
\$250M-\$500M	363	240	-19%	-22%	-9%	-6%	4%	128%	35%
\$500M-\$1B	723	241	-21%	-20%	-8%	-6%	5%	171%	50%
\$1B-\$5B	1,820	240	-25%	-27%	-10%	-6%	3%	152%	110%
\$5B-\$15B	8,263	66	-22%	-26%	-16%	-5%	5%	200%	105%
\$15B-\$50B	20,392	19	-34%	-34%	-22%	-5%	6%	150%	176%
>\$50B	143,604	24	-45%	-49%	-38%	-6%	0%	203%	150%
All Banks	509	1,168	-25%	-25%	-14%	-6%	4%	154%	75%
Coast Banks									
<\$250M	140	225	-40%	-32%	-31%	-9%	2%	145%	125%
\$250M-\$500M	359	132	-25%	-30%	-14%	-8%	6%	318%	80%
\$500M-\$1B	710	139	-27%	-28%	-13%	-8%	6%	227%	90%
\$1B-\$5B	1,720	124	-26%	-29%	-11%	-7%	5%	193%	160%
\$5B-\$15B	8,262	29	-41%	-37%	-30%	-8%	6%	372%	140%
\$15B-\$50B	21,006	8	-32%	-44%	-24%	-8%	4%	253%	160%
>\$50B	189,229	12	-39%	-38%	-26%	-6%	0%	220%	78%
All Banks	452	669	-32%	-31%	-18%	-8%	5%	227%	100%
Non-Coast Banks									
<\$250M	143	113	-25%	-21%	-23%	-3%	4%	54%	-5%
\$250M-\$500M	365	108	-12%	-11%	-3%	-4%	1%	62%	7%
\$500M-\$1B	735	102	-14%	-13%	-4%	-3%	3%	123%	29%
\$1B-\$5B	1,897	116	-19%	-26%	-8%	-5%	1%	120%	76%
\$5B-\$15B	8,297	37	-10%	-20%	-6%	-3%	4%	153%	93%
\$15B-\$50B	18,829	11	-34%	-33%	-22%	-4%	7%	124%	176%
>\$50B	90,371	12	-52%	-54%	-42%	-6%	2%	185%	185%
All Banks	635	499	-18%	-20%	-8%	-4%	3%	114%	44%

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA)

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 was signed into law by President Bush. Under EESA the Treasury Department (Treasury) may spend up to \$700 billion to restore stability and liquidity into the United States economy by purchasing troubled assets

and investing directly on an equity basis in financial institutions. On October 14, 2008 the Treasury issued a number of notices and rules regarding executive compensation standards for financial institutions that participate in the Troubled Asset Relief Program (TARP) under EESA⁴. This section provides a high level overview of the various executive compensation standards. In general the prohibitions as of the writing of this paper include the following elements:

- Prohibition on incentives that promote “unnecessary and excessive risks”;
- Substantial new limitations on tax deductibility of officer compensation;
- Additional restrictions on any form of Golden Parachute payments;
- Clawback features on incentive compensation based on inaccurate financial information.

Capital Purchase Program (“CPP”) – Under the CPP, Treasury will provide equity capital directly to financial institutions in exchange for preferred stock and warrants to purchase common stock of the institutions. Any financial institution that participates in this program must comply with four executive compensation standards during the period of time in which Treasury holds an equity or debt position in the institution.

These standards apply to a class of officers referred to as the Select Executive Officers (SEOs). The SEOs include the Chief Executive Officer, Chief Financial Officer and the three next highest paid executive officers, generally determined based on the proxy disclosure rules.

The four standards applicable to the CPP are:

- **Prohibition on Unnecessary and Excessive Risk.** The Compensation Committee must review applicable compensation programs with the company’s senior risk officers within 90 days after Treasury acquires the equity or debt position, make such changes as are necessary and annually certify in the annual proxy compensation discussion and analysis that it has made reasonable efforts to ensure that the incentive compensation arrangements do not encourage unnecessary and excessive risks that threaten the value of the financial institution.
- **Compensation Deduction Limitations.** No tax deduction is permitted for annual compensation over \$500,000 that is considered earned during the period. There is no exception for “performance-based” compensation (thus option gains are covered). The \$500,000 limit and the compensation paid to the executive may be pro-rated for the portion of the taxable year that Treasury holds an equity or debt position in the financial institution.
- **Golden Parachutes Restrictions.** On involuntary separation, benefits are limited to 2.99 times the executive’s 5-year average W-2 compensation. Any amount above this limit is viewed as a golden parachute payment and prohibited. For this purpose, payments an executive would receive on voluntary separation in any case (such as vested retirement benefits or vested elective deferred compensation that would be payable on any termination) are not included.
- **Incentive Compensation Clawback.** Bonuses and incentive compensation must be subject to recovery or “clawback” by the financial institution if they are based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria (whether or not the executive was at fault, any misconduct occurred, or the financial statements were restated).

Under a standard CPP term sheet released by Treasury, the first three standards require financial institutions to agree to be bound by the standards and to alter or terminate existing benefit plans and agreements to the extent necessary to comply with the standards. The term sheet also

requires financial institutions and their CEOs to grant Treasury waivers releasing it from any claims they might have arising from the implementation of the standards.

Troubled Asset Auction Program (“TAAP”) – Under the TAAP, the Treasury will purchase troubled mortgage-related assets through an auction process. Financial institutions that sell the Treasury more than \$300 million of troubled assets (whether solely through TAAP or otherwise) must comply with three executive compensation standards during the period of time Treasury has the authority to purchase troubled assets under the TARP. The Treasury is scheduled to have this program through December 31, 2009; however, it could be extended by Treasury up to October 3, 2010.

The first standard below applies to the same CEOs referred to above in connection with the CPP. The two other standards also apply to CEOs, except that Treasury uses different wording in interpreting these standards, clarifying that the three highest paid executive officers are determined based on compensation for the then-current fiscal year.

The three standards applicable to the TAAP are:

- **No Additional Golden Parachute Agreements.** There is a prohibition on entering into, renewing, or materially modifying employment contracts that provide for involuntary severance benefits greater than 2.99 times the executive’s 5-year average W-2 compensation. This rule does not limit the payment of involuntary severance benefits under existing employment arrangements so long as they are not renewed or materially modified (e.g., increasing compensation or accelerating vesting dates).
- **Compensation Deduction Limitations.** As under the CPP, no tax deduction is permitted for compensation over \$500,000, without regard to whether the compensation is “performance-based”. Unlike the CPP, all compensation attributable to any portion of a year when the TARP authority is in effect is subject to this deduction limit.
- **Limited deduction and 20% excise tax for golden parachutes.** Generally, if involuntary severance payments (or severance payments in connection with the institution’s bankruptcy filing, insolvency or receivership) exceed 2.99 times the executive’s 5-year average W-2 compensation, golden parachute sanctions are imposed. The excess of the severance payments over the executive’s 5-year average W-2 compensation is nondeductible to the institution and is subject to a 20% excise tax imposed on the executive.

Direct Purchases of Troubled Assets Under TARP – Note in situations where the Treasury were to directly purchase troubled assets (outside of the auction process as described under the TAAP), the guidance regarding executive compensation matters are yet to be published. However, the expectation is that the rules for a direct purchase would be at least as stringent as found in the CPP or the TAAP described in this document.

Programs for Systemically Significant Failing Institutions (“PSSFI”) – Under the PSSFI, the Treasury could provide direct assistance to a failing financial institutions on terms that are negotiated on an individual company basis. In this situation, the financial institution is prohibited from paying *any* amount on an involuntary separation. As with the other standards, amounts that would be payable on a voluntary termination are not included in this prohibition. The other PSSFI compensation standards are, in essence, the same as the CPP standards.

FDIC REGULATIONS ON EXECUTIVE PAY – PART 359

In the current economic environment, an important question is what tools do the regulators have with respect to executive pay? With respect to the FDIC, their rules on executive pay and their ability to limit it, is covered under 12 C.F.R. Part 359, “Golden parachute and indemnification payments”. The FDIC's rules on golden parachute payments are triggered by a payment or an agreement to pay an insider of the bank or holding company that is contingent on or by its terms is payable on or after the termination of the person's employment or affiliation with the bank or company. There is a general prohibition on such payments or agreements to pay while the bank is considered "troubled", unless the bank obtains the approval of the FDIC or the holding company obtains the approval of the FDIC and the Federal Reserve if the payments or agreements involve the holding company. There are also exceptions in the rule for qualified retirement plans, nonqualified bona fide deferred compensation plans, nondiscriminatory severance pay plans, and other types of common benefits plans and death and disability benefits which would not require prior regulatory approvals.

If retention incentives and performance incentives by their terms are not paid or payable upon or following termination of the person's employment, then they would not be subject to the prior approval requirements of the rule. These incentives appear to be rewarding personnel to stay, not leave.

Salary increases also are not normally subject to the rule unless part of the salary increase by its terms is not paid until the person's employment is terminated, but then it might be exempted as part of a bona fide deferred compensation plan.

Change-in-control agreements where the employee is paid as a result of a change in control would be subject to the general prohibitions, assuming that the payments are by their terms paid after severance, unless prior regulatory approvals were obtained. Employment agreements that contain severance provisions may also trigger a prior approval requirement. Normally, changes that do not affect payments made following termination of employment would not be subject to prior approvals.

AMERICAN JOBS CREATION ACT OF 2004

On October 23, 2007, the IRS issued Notice 2007-86 which provided for an additional year of transition relief for nonqualified deferred compensation plans covered under Section 409A. In this notice, the IRS allowed that the deadline for complying with the final regulations (published in April 2007) is extended to January 1, 2009. The deadline for adopting plan amendments is extended to December 31, 2008 from December 31, 2007. Note plans must be operating in good faith compliance prior to this deadline. The reasonable good faith transition relief provided in 2007 was also extended through 2008. This replaced far more restrictive transitions plans previously prescribed for 2008.

As with any important legislation, please consult with your professional advisor for legal, tax, accounting or investment advice as applicable before taking any action based upon this information.

SEC REGULATIONS FOR PROXY DISCLOSURE OF COMPENSATION

The SEC's revision to the proxy disclosure regulations in 2006 required increased disclosure for both executive and director compensation. This represented a substantial increase in both the data reporting and time requirements needed to comply with the regulations. Proxy reporting for the 2008 fiscal year will represent the third year that the new rules have been in effect. Below we summarize the key points of disclosure as well the SEC's July 3, 2008 report providing additional guidance.

- **Compensation Discussion & Analysis:** The regulations require a Compensation Discussion & Analysis (CD&A) that must be filed with the SEC. First, the CD&A is a "filed document" subject to liability exposure and must be certified by the principal executive officer (typically the CEO) and principal financial officer (typically the CFO) of the filer. Second, there are now seven tabular disclosures (see below). Third, the compensation must be explained in simple, plain English.
- **Principle-Based Disclosure:** The clear message from the SEC is that all forms of compensation must be disclosed. Regardless of form of compensation, the compensation to the proxy officers must be disclosed. For the first time, the Summary Compensation Table includes a column for total compensation. The notion of a total compensation figure had historically found its basis in the use of "tally sheets" where compensation committees would tally all forms of compensation; now it is a requirement. In addition the SEC requires complete disclosure of equity compensation, performance-based and non-performance based pay, retirement plan accruals, and any other type of payment to a named executive officer. The regulations also require disclosure of payments under various termination scenarios as listed below.
- **Termination Scenarios:** Most potential benefit payments to a named executive officer must be disclosed. Specifically, proxy filers must disclose details of plans or agreements that provide for payments or benefits at, following, or in connection with any termination of a named executive officer, a change in responsibilities, or a change-in-control of the company. Additionally, any potential tax gross-up payments that are to be paid to the named executive officer must be footnoted. As an example, if an executive has an employment agreement, supplemental executive retirement plan, a deferred compensation plan, an equity plan, and a cash incentive plan that each provide for compensation and benefits in the event of a change-in-control, amounts payable under each of these different plans must be calculated and disclosed in a narrative format.
- **Tabular Disclosures:** The regulations require the following seven tables, as well as additional narrative:
 - Summary Compensation Table
 - Grants of Plan-Based Awards Table
 - Outstanding Equity Awards at Fiscal Year-End Table
 - Option Exercises and Stock Vested Table
 - Pension Benefits Table
 - Nonqualified Deferred Compensation Table
 - Director Compensation Table

SEC Updates for Proxy Disclosure of Compensation

On October 9, 2007, the SEC issued a report summarizing its initial review of 350 proxies filed under the new guidelines defined in 2006⁵. This review was the most substantial clarification of the 2006 disclosure rules. The comments focused on two major issues and areas of

improvement. First, the SEC requested greater clarity in presentation and emphasized the use of tables and figures to present complex information in a comprehensible manner. Second, it requested increased analysis and disclosure in the Compensation Discussion and Analysis along with a thorough presentation of performance goals and objectives tied to compensation.

The SEC released additional guidance on a variety of smaller issues on July 3, 2008. In addition to the July guidance, we anticipate further guidance in the areas of post-termination payment disclosure and in the presentation of equity compensation reporting; however these issues do not appear to be on the immediate horizon. We present areas of recent changes that may impact your 2008 proxy disclosure below.

- **Change in the Definition of Small Business Issuer** - The SEC has expanded the number of companies that qualify for its scaled disclosure requirements for smaller reporting companies. Therefore some organizations who historically reported a full proxy, may now qualify for the new scaled reporting option. All reporting companies in existence on February 4, 2008 make the initial determination of their smaller reporting company status as of the end of the second quarter of their fiscal year that ends after December 15, 2007.
 1. Old rules: Small company test for a “small business issuer” was
 - a. \$25 million or less in public float, AND
 - b. less than \$25 million in annual revenue
 2. New Rules: Small company test for a “smaller reporting companies”
 - a. \$75 million or less in public float, OR
 - b. less than \$50 million in annual revenue if public float cannot be calculated

To qualify as a smaller reporting company, companies should calculate public float as of the end of their second quarter (June 30th for most companies). It is interesting that, in 2008 as of the writing of this paper, this is very near the “bottom” of the market in terms of bank stocks over the past year. To calculate public float a company takes its voting common equity held by non-affiliates (for example, excluding officers & directors) and multiply that by the stock price on the date of calculation.

A reporting company that can calculate its public float and does not qualify as a smaller reporting company in its initial determination year will not qualify as a smaller reporting company in the future, unless its public float falls below \$50 million as of the last business day of its second fiscal quarter. A reporting company that cannot calculate its public float and does not initially qualify as a smaller reporting company would qualify as a smaller reporting company in the future only if its annual revenue falls below \$40 million.

A reporting company that newly qualifies as a “smaller reporting company” is permitted to provide scaled disclosure as soon as it wishes to do so. Scaled disclosure differs from the normal disclosure requirements in the following manner:

1. **Named Executive Officers (NEOs):** Provide executive compensation disclosure for only three named executive officers (specifically including the principal executive officer but not the principal financial officer), rather than the five required of larger companies;
2. **Summary Compensation Table:** Provide disclosure for only two years, rather than the three years required of larger companies;
3. **Compensation Discussion and Analysis (CD&A):** A CD&A is not required;

4. **Tabular Disclosure:** Provide only three of the seven required tables of larger companies;
 - a. Summary Compensation Table
 - b. Outstanding Equity Awards at Fiscal Year End Table
 - c. Director Compensation Table.
5. **Disclosures:** Provide alternative narrative disclosures; and
6. **Directors Compensation Table:** Not required to include footnote disclosure of the grant date full value of equity awards in the Director Compensation Table.
- **Determination of Named Executive Officers (NEOs)** – The SEC has clarified the following two issues related to the determination of NEOs.
 1. **After an Expense Reversal:** Only previously expensed portions of awards already reported in the Summary Compensation Table (SCT) may be reversed in the table in the following year. However, an expense reversal for someone not previously considered to be an NEO may be taken into account to determine current NEO status.
 2. **Compensation for Subsidiary/Parent Services:** If a potential NEO receives compensation from both subsidiary and parent companies, both amounts should be taken into account in the determination of NEO status.
- **Benchmarking** – Companies should list companies used specifically as reference points in determining compensation such as a peer group of named organizations. If a third-party survey is used to benchmark compensation it is not necessary for the filer to list all participants in the survey, only the identification of the survey itself is necessary.
- **Emphasis on Materiality of Performance Objectives** – The SEC has emphasized that non-material performance targets are not subject to disclosure. A company may distinguish between qualitative/subjective individual performance goals and those that are quantitative/objective. If quantitative goals are used to assess subjective or qualitative assessments, such as “effective communication skills” they need not be disclosed. The SEC also re-emphasized that competitive harm is the only permissible reason for failing to disclose performance targets material to the determination of compensation.
 1. **Perquisites** – All perquisites fully reimbursed by the executive render disclosure unnecessary. Only non-reimbursed perquisites need to be considered. Note that if the sum total of all non-reimbursed perquisites is less than \$10,000, no disclosure is required.
 2. **Multi-year Footnotes to the SCT** – If the footnotes are material to the understanding of compensation, and there is no specific guidance limiting the footnotes to the most recent year (such as for perquisites), they should be provided for all relevant years.
 3. **Vesting Dates on Outstanding Equity Awards** – These may be incorporated into an additional column in the Outstanding Equity Awards Table instead of presented in footnotes to this table.

COMPENSATION COMMITTEE GOVERNANCE

The new proxy reporting rules and option backdating scandals have resulted in continuing emphasis and changes relative to governance, which had already undergone significant change in the aftermath of Sarbanes-Oxley, corporate reforms enacted by the major stock exchanges, and litigation such as the Disney case settled in favor of the board of directors (related to a contested pay package for Michael Ovitz).

In its October 9, 2007 summary, the Division of Corporate Finance identified a number of areas where companies were unclear about who made compensation decisions. Companies are required to describe the role of executive officers in determining or recommending compensation action for executives and directors. The Commission has requested companies to describe the role of the executive officer(s) in the decision making process. Further, it requested that companies detail the role compensation consultants played in the process, detailing the scope of the consultant's assignment and material instructions the company gave.

At the writing of this paper five years ago, we summarized a number of best practices related to the compensation committee. Since that time, the New York Stock Exchange (NYSE) and the NASDAQ and American (AMEX) stock exchanges have all implemented governance reforms that are consistent with those best practices. Many of the best practices originally discussed five years ago are now required by one or all of the exchanges. The following is an updated summary of the best practice guidelines.

Compensation Committee Charter

The compensation committee charter is a document that states the committee's responsibilities. It typically addresses the following questions:

- Which officers' compensation does the compensation committee review?
- Which company-wide compensation plans does the compensation committee review?
- How often is compensation compared to the outside marketplace?
- Does the compensation committee review specific company-wide goals and objectives that may drive annual or long-term incentive plans?
- What types of decisions are made solely by the committee rather than recommended by the committee to the full board?

While compensation committee charters are useful for any compensation committee, the NYSE actually requires that the compensation committee both have a charter and publish the charter on its website. While the AMEX and the NASDAQ do not require the compensation committee to have a charter, it is clearly a best practice that we support.

Reasonable Person Test

Underlying various state and federal rules for boards of directors is a "reasonable person test" or "prudent person test." This is typically related to the Business Judgment or Duty of Care requirements for board members. The reasonable person test is actually quite simple – would a reasonable person, given the same level of information, come to a similar conclusion?

If the board's conclusions and actions do not follow from a listing of reasonable facts that could be understood, then the compensation initiative could be rejected on the basis of not being "reasonable." This notion of a reasonable person test, which is required by state statute, allows board members to do two things: First, if a compensation plan is being offered to an executive without the appropriate supporting facts, the board member can vote "no" on the matter. Second, if the compensation initiative is so complicated that it cannot be reasonably understood, then the board member can ask for further clarifications until the initiative stands on its own or is modified so it is understandable. The reasonable person test allows the board member to vote "no" on matters that do not seem appropriate or are too complicated to be easily justified.

An item related to the reasonable person test is the need to review complete information. Neglecting to review relevant data is not a defense for a board that made inappropriate decisions.

This has been illustrated in the litigation against the Walt Disney Company regarding a pay package to Michael Ovitz. At issue was whether the board members acted in good faith in coming to a decision that ultimately paid approximately \$140 million to Mr. Ovitz. Shareholder advocates claimed that directors simply approved compensation proposals without reviewing all relevant information or understanding the potential financial impact. If the courts had determined that the board members did not act in good faith, then the directors would not have been indemnified under directors and officers insurance policies and may have been held personally liable for damages. The court ultimately ruled in favor of the directors, indicating that they did perform their fiduciary duty in good faith.

While this was a qualified victory for the Disney board, the court chastised the directors, noting that their conduct "...fell significantly short of the best practices of ideal corporate governance." The judge noted the difference between state law and good governance standards. Furthermore, the court also noted that many of the relevant board decisions in the case took place over a ten-year period before governance reform had taken hold; some shareholder advocates believe that future cases in today's stricter governance context will result in tougher rulings against directors. One key lesson from the Disney case is already clear to compensation committee members: for all matters of material significance to the corporation, have a full and complete discussion of all the facts and know how much compensation could potentially be paid out in all events (e.g., a change-in-control, retirement, severance). Meeting minutes should document such discussions.

Tally Sheet Review

Related to the reasonable person test is the concept of tally sheets, which are also central to the proxy disclosure requirements. In order to review all relevant information before approving compensation plans, banks must analyze agreements, benefits, and incentive plans to determine projected payments in various performance and termination scenarios. Tally sheets have become a best practice for accomplishing this objective. For SEC filing institutions, this is accomplished through the narrative on post-termination payments. They summarize payments resulting from each plan or agreement in various scenarios, and provide a total compensation figure for benchmarking.

Tally sheets enable directors to answer key questions from the proxy disclosure requirements, such as how various plan components relate to each other and the overall compensation package. In virtually every tally sheet analysis that we have completed to date, bank directors have gained valuable new information and compensation implications that they had never realized before, leading to corrective actions and design changes that better protect the bank and make the compensation plan more effective. The most common improvement areas typically identified in tally sheet analyses include Change-in-Control (CIC) costs, §409A compliance issues, equity grant processes, and the need to benchmark total compensation.

Tally sheets and thorough market updates also often include a review of plan and agreement provisions both for legal compliance and alignment with the compensation philosophy. This includes a review of controls and processes related to option grants and option dating. Such reviews are critical for protecting both the bank and individual directors. Just as some directors and officers (D&O) liability insurance programs do not protect directors in the event of decisions that fail the gross misconduct or negligence test, some policies will not protect directors in the event of inaccurate financial statements, which may result from option backdating or sloppy compensation plan administration.

More sophisticated organizations are including "wealth accumulation" analyses as part of their tally sheet review. These analyses summarize current and projected wealth accumulation and the ownership stake resulting from company payments such as equity grants and retirement plans.

Wealth accumulation analyses help companies evaluate the eventual net result of compensation decisions for executives, and they affect compensation decisions in areas such as equity grants. For example, a CEO who already has a significant equity stake and enough wealth accumulated to cover several lifetimes may not need an equity mega-grant for the sake of retention or motivation, and a large grant may be more difficult to justify in the new CD&A.

Compensation Philosophy

A compensation philosophy helps ensure that the compensation committee properly reviews compensation. It helps all parties to understand expectations and the desired competitive positioning of compensation. Simply stated, it helps to set the “rules of engagement” between the board and management by describing how each compensation element applies to the eligible employee level and the market. For instance, it outlines the philosophy for establishing base salaries, annual cash incentives, long-term incentives, executive benefits, and total compensation. It may also define the type of market data to be used in benchmarking, the targeted mix of various compensation components, and the desired link between pay and performance. The following are examples of different compensation philosophies relative to the desired competitive positioning.

- **Example 1:** Base salaries for all employees are targeted at the market median for employees performing at expected levels. Total Direct Compensation (comprised of base salary, cash incentives & equity) from vice president level up to CEO are targeted at the market median for expected performance and between the market median and the 75th percentile of market for outstanding performance. Variances from these guidelines for officers from the executive vice president level to CEO will be reviewed and approved by the compensation committee on a case-by-case basis.
- **Example 2:** Base salaries for all employees are targeted at the 40th percentile for employees performing at expected levels. Total Direct Compensation for vice president level officers up to CEO is targeted at the 60th percentile of market for expected performance and the 85th percentile for outstanding performance. Variances from these policies for the CEO, COO and CFO will be reviewed and approved by the compensation committee on a case-by-case basis.

For publicly traded banks, a compensation philosophy has become an essential addition under the current SEC regulations for proxy disclosure of executive compensation. The Compensation Discussion and Analysis (“CD&A”) includes several required topics directly related to the compensation philosophy. For example, the CD&A must discuss the bank’s rationale for using each element of compensation, the objectives the compensation plan is designed to reward, and how the bank determines the amount of each element of pay.

Outside Expertise

If a compensation committee does not have the ability to hire or fire an outside compensation consultant, it may not be fulfilling its board duties. Moreover, if the compensation committee only hears presentations regarding compensation, and particularly officer compensation, from management with no counsel from outside experts, it also may not be fulfilling its duties to seek, as necessary, outside expertise.

To quote the Conference Board, *“The Compensation Committee should retain any outside consultants who advise it, and the outside consultants should report solely to the Committee.”* In its spirit, we agree with this best practice; however, context is important. If a company is a Fortune 500 firm and has board members with compensation expertise on its compensation

committee, then yes, the compensation committee should hire and have direct control over all aspects of officer compensation.

In the context of community banking, however, we recommend a case-by-case evaluation. Often, the board may lack direct experience with today's complex compensation environment. In that context, we suggest that management may be involved with the hiring of the outside consultant. However, even in these situations, the outside compensation consultants should present all findings to the compensation committee. This structure allows the compensation committee to consult with the outside consultants regarding the exact work being presented. In addition, this gives the compensation committee the final approval authority on the compensation initiative.

For public institutions, we suggest the following best practice when engaging outside expertise: The compensation committee should retain the compensation consulting expertise for all engagements specifically related to any compensation matter that is covered as part of a company's proxy statement filings. In matters where an outside consultant does work on a company's proxy statement and is requested to perform work on compensation matters for employees that are not included in the company's proxy filing, management should formally communicate to the compensation committee that such work is being performed.

Independence

Each of the three stock exchanges now requires, with minor exception, that the compensation committee be composed of independent directors. In addition, the stock exchanges require that the CEO's compensation be approved by the compensation committee or a larger independent group.⁶ For widely held banks, regardless of whether or not the bank is governed by the stock exchanges, the best practice is to have a compensation committee comprised of independent directors that is charged with the review of the CEO and executive officer compensation.

Routine Market Updates

For all community banks, we recommend that the compensation committee review market comparisons of compensation, at a minimum of every two years. This recommendation depends upon a number of factors related to what has changed since the last market update. For example, has the bank significantly changed in size, performance or markets served? Has the officer group changed significantly? Has there been a significant reorganization since the last market update? How long has it been since a total compensation review has been performed? Does the compensation committee have market data that is appropriate for the current compensation planning? While several community banks compare both the officer and board of director compensation to market on an annual basis, at minimum, we suggest that every other year is an adequate target for community banks to seek market updates. Also, and in particular in this specific marketplace in 2008, it will be important to understand the marketplace as it has changed and will continue to change through 2009.

Board Knowledge of Compensation

The Sarbanes-Oxley Act of 2002 requires that a "financial expert" be part of the audit committee of any public company. This requirement was instituted to ensure that the audit committee has the necessary skill set to properly review the financial records of today's complex financial statements. While not mandated under the Sarbanes-Oxley Act of 2002, we continue to recommend that community banks consider adopting a similar provision with respect to having a "compensation expert" on its compensation committees.

What constitutes a compensation expert? While no one individual will typically have knowledge in all areas, a compensation expert should be knowledgeable and have experience with most key compensation topics, including benchmarking, compensation philosophy, total compensation

analysis, cash incentive plans, long-term incentive alternatives and plan design, CIC cost analysis (including Internal Revenue Code §280G implications), and alternative non-qualified executive benefit strategies.

Many directors lack knowledge relative to many of the key topics noted above. If the community bank board does not have a board member with this knowledge, they may wish to add a board member who does, or develop an education program to advise the current members of the compensation committee on these matters. Board members who have experience in these compensation matters typically will have direct public company experience. These individuals may have served or may currently be serving in the capacity of a public company board member, public company officer or advisor to public companies.

Ongoing Compensation Education

With the rate of change in today's compensation environment, it is important that community bank compensation committee members keep pace with the compensation marketplace. Critical to this is developing an ongoing education plan. While there are many organizations that provide education on compensation matters, there are a number that provide compensation education programs that may be applicable to the compensation committee members including, but not limited to those offered by the American Association of Bank Directors, American Bankers Association, the Independent Community Bankers Association, the National Association of Corporate Directors, and World at Work. In addition, for publicly traded community banks, some of these institutions have sought to have the continuing education for the board be accredited; an example of this is the Bank Executive & Board Compensation conference conducted by Bank Director Magazine. The American Association of Bank Directors also supports the education of directors by providing a certification process, which can lead to potential discounts on directors and officers (D&O) insurance coverage. Whatever method is used for compensation education, the education plan should aim to ensure that a broad number of compensation topics are covered for each of the compensation committee members. We support providing some level of compensation for all-day training sessions for board members in addition to reimbursement for travel expenses.

BOARD OF DIRECTOR COMPENSATION

Board compensation remains a focus as corporate reforms, such as the recent SEC proxy reporting guidelines, continue to increase the workload and level of risk associated with board service. As a part of the analysis, we have analyzed the same banks that have been a part of the study in both 2007 and 2008. What we see is that on this matched sample basis, the median increase in board compensation was 4.4%. In reviewing this in detail, we see that board compensation is very dynamic at present. In reviewing the overall increase, we saw that approximately 2/3 of the boards increased their compensation at a median increase of 14.6%. However, in the remaining 1/3 of the banks, the boards actually decreased their compensation by approximately 13%. In reviewing the decreases in board compensation, this appears to be a decrease in the granting of equity to directors in these specific institutions. As of the writing of this paper, October 2008, our expectation is that board compensation will be flat in 2008 as well as for 2009. Given the turmoil in banking, raising board compensation is not, at present, a high priority.

Another trend among institutions that have increased their board pay is higher, differentiated pay for positions and committees that have seen increased responsibility. This includes the lead director, as well as the audit, compensation and governance committees. In Amalfi Consulting's experience, the areas we have been asked about most consistently relate to the chair fees for the lead director, the chair of the audit committee, and the chair of the compensation committee.

The next level of focus has been on the committee member fees for the audit and compensation committees.

The level of total compensation for directors varies based on factors such as ownership type, location, and asset size. We also see differentiation in chair fees based on similar factors, with the audit chair consistently paid at a level comparable to or above other committee chairs. Exhibit 2 shows the range of typical chair fees in publicly traded banks by asset size. The values are based on an analysis of proxies from 509 banks; the low and high ends of the ranges shown are at approximately the 25th and 75th percentiles, respectively, of those banks paying chair fees. These fees are in addition to other non-chair director compensation (e.g., retainer, board meeting fees, etc.). The broad ranges illustrate the fact that director pay varies significantly, and values for a given peer group or region may differ from these national ranges. Also of note, the generally lower levels of board chair amounts for banks with assets greater than \$15 billion is a by product of two factors: first, there are not that many banks in these asset size ranges, and second, many board chairs for these banks are also employees and thus do not receive director compensation.

Exhibit 2
Board and Committee Incremental Chair Fees
2007 Fiscal Year Analysis⁷

Data Cut	Board Chair Total (\$)	Audit Chair Total (\$)	Comp Chair Total (\$)	Nominating/Governance Chair Total (\$)
<\$250M	2,400 – 19,723	305 – 1,803	342 – 3,235	429 – 2,914
\$250M-\$500M	2,345 – 13,550	557 – 4,773	429 – 4,750	477 – 4,592
\$500M-\$1B	5,466 – 27,087	2,381 – 11,228	1,783 – 7,537	1,188 – 11,640
\$1B-\$5B	6,714 – 25,100	2,565 – 11,965	2,736 – 10,415	3,215 – 21,680
\$5B-\$15B	20,346 – 161,518	5,637 – 27,106	5,791 – 24,090	9,339 – 24,334
\$15B-\$50B	8,200 – 17,425	9,120 – 25,855	4,663 – 20,210	9,875 – 33,016
>\$50B	36,454 – 91,739	16,939 – 43,006	6,593 – 27,866	10,138 – 28,587
All Banks	4,031 – 24,547	2,027 – 14,204	1,701 – 10,027	1,921 – 17,852

In addition to board compensation being differentiated by type of committee, location and ownership type, other trends also continue. For banks with shareholders, there is a continued focus on equity as a component of board pay. Many larger institutions are also implementing equity ownership requirements (e.g., requiring directors to accumulate equity worth three to five times the retainer over time). Board fee deferral programs continue to be an important component of the overall package, and for larger institutions, a decrease in board retirement plans continues.

Direct compensation for a board of directors typically consists of some combination of the following four components:

- **Board Retainer:** A fixed amount that is paid to each board member. This amount is paid either once or ratably throughout the fiscal year.
- **Board Meeting Fees:** A fee that is paid to each director for attending a board meeting.
- **Committee Meeting Fees:** A fee that is paid to a director for attending board committee meetings. For example, the audit, governance, and compensation committees, as well as others, pay each committee member a fee for meeting attendance.

- **Chair Fees:** A fee that is paid to the chairperson for additional duties in performing the chair role. The director may be the chairperson of the board of directors or of a committee, such as audit or compensation.

These four types of direct compensation are typically paid in cash, equity, or a combination thereof.

In addition, many banks also provide benefits such as deferred compensation plans. Plans such as these remain appropriate and highly valued by directors; these plans typically result in only a minimal cost to the bank. In a deferred compensation plan, the director can choose to defer receipt of a retainer or fees earned to capitalize on tax advantages; the bank pays the deferred amount with interest in the future as specified in the plan. Deferred compensation plans do not directly increase the director's compensation.

Deferred compensation plans may be particularly important in nonpublic banks that cannot provide equity or otherwise have a competitive shortfall. In other words, a nonpublic bank that does not have equity may offer some other package of cash and benefits to provide for an attractive overall board compensation package.

Benchmarking Director Compensation

Benchmarking Director Compensation has become more precise under the current SEC regulations. Director compensation is now disclosed in a table similar to the Summary Compensation Table for officers.

However, board structure of community banks complicates benchmarking director compensation. Most publicly traded community banks have both a holding company, which is publicly traded, and at least one bank charter. By regulation, there needs to be a board of directors at both levels. Therefore, with existing disclosure rules, the complexity with respect to community bank board compensation is one of a level comparison. Are you evaluating only the holding company board of director compensation, or both the holding company and the bank board compensation? The reason this question is important is twofold. First, one bank may have significant board activity at the holding company and a different bank may have significant activity at the bank level. Second, the holding company board compensation is required to be disclosed in company proxy filings, whereas the disclosure of bank board compensation is often incomplete. Therefore, a community bank could have significant but undisclosed compensation paid to its bank board of directors, making comparisons much more difficult. In practice, most one-bank holding companies do disclose some level of board of director compensation at the bank level; however, the level of detail varies.

Exhibit 3 summarizes board compensation for 509 publicly traded banks, including the value of equity grants for each bank. In addition, the analysis shows geographic differences in pay for board members. As context, if a bank is in a state that is located on the Atlantic Ocean or Pacific Ocean, it is denoted as a "coast bank"; otherwise it is noted as "non-coast bank." The exhibit shows that the median total compensation paid to board members varies based upon location. This provides evidence that a bank needs to take into account its asset size and location when reviewing national compensation data.

Exhibit 3
Board of Director – Total Compensation
2007 Fiscal Year Analysis⁸

Data Cut	Median Assets (\$M)	n	Fees Earned or Paid in Cash	Total Equity	Change in Pension Value	Other Comp	Total Comp
All Banks							
<\$250M	174.3	67	12,731	4,444	2,682	1,532	13,693
\$250M-\$500M	368.3	103	16,220	5,945	2,272	1,174	19,033
\$500M-\$1B	719.0	135	21,347	8,130	5,730	1,990	26,514
\$1B-\$5B	1,633.6	126	27,715	10,000	2,828	2,333	36,555
\$5B-\$15B	7,756.1	36	48,078	34,953	4,076	8,018	75,558
\$15B-\$50B	17,186.9	19	57,083	28,118	NA	4,910	78,513
>\$50B	142,543.0	23	71,000	79,627	1,143	2,105	163,851
All Banks	790.0	509	22,758	10,883	3,372	2,152	28,208
Coast Banks							
<\$250M	173.9	44	10,609	6,092	NA	526	12,570
\$250M-\$500M	378.9	51	15,498	6,453	2,272	2,000	18,622
\$500M-\$1B	757.8	78	21,262	10,178	6,816	1,958	28,897
\$1B-\$5B	1,569.2	65	28,607	10,419	3,476	1,648	39,778
\$5B-\$15B	8,096.2	21	55,111	52,850	11,997	8,018	109,717
\$15B-\$50B	16,707.0	8	62,131	29,293	NA	14,955	97,895
>\$50B	197,656.0	13	70,708	157,500	1,143	718	219,729
All Banks	791.3	280	23,833	13,100	3,830	1,943	28,915
Non-Coast Banks							
<\$250M	182.8	23	14,818	3,535	NA	3,282	16,483
\$250M-\$500M	365.1	52	16,497	5,435	2,272	777	20,964
\$500M-\$1B	686.1	57	21,861	3,739	5,519	2,102	25,707
\$1B-\$5B	1,661.1	61	26,814	8,981	567	2,657	31,194
\$5B-\$15B	7,677.5	15	31,889	16,763	NA	8,261	62,801
\$15B-\$50B	17,186.9	11	49,957	26,944	NA	4,125	73,335
>\$50B	91,487.2	10	73,929	58,715	NA	4,327	137,428
All Banks	790.0	229	21,900	8,775	2,847	2,640	26,514

Outside of these general trends on board compensation, what other factors are impacting board compensation? Other factors affecting board compensation are director independence or objectivity, increased emphasis on equity compensation, and total compensation increases. We discuss each of these factors below.

Compensation Independence

First, for public banks there is a continued trend away from any form of compensation that could potentially impact a director's ability to be a disinterested third party. Several years ago, there were banks that provided a form of a retirement benefit for directors who had significant service with the board. These plans, in essence, provided a motivational element for the director to stay on the board. The concern with this is that a director who speaks his or her mind may risk losing a retirement benefit. The subtle motivation would be to not disagree with other board members or management.

While the use of retirement benefits for a board member is decreasing, a board fee-deferral plan is still common in today's environment. In this type of plan, a board member may defer board fees, earn interest and, when they leave the board, receive the account value.

Another form of compensation that may impact a board's ability to be independent is performance-based compensation plans. These plans typically provide for some level of bonus to be paid if certain specified goals are achieved. While there is debate on these types of plans, the concern is that board members may not vote or speak their mind on an issue if they know they may receive a reduced performance-based bonus. Performance-based compensation for boards, while not common for publicly traded institutions, is more prevalent in closely held or privately owned institutions, but has been reducing in prevalence in recent years.

Equity

As expected, more compensation is being provided to board members in the form of equity (e.g., stock options, restricted stock, stock appreciation rights, etc.). By providing a fixed level of equity, either through restricted stock grants or stock options, the director is, in effect, motivated to increase shareholder value. This has been considered acceptable as compensation, as the director typically receives the same amount of equity regardless of bank performance. Given the recent stock option expensing requirements for publicly traded institutions (discussed later in this paper), we expect a continued shift to restricted stock grants and/or a balanced use of restricted stock and appreciation instruments (e.g., options) awarded to directors.

Director Benefits

Benefits continue to play a role in director compensation packages. While some benefits are declining, such as retirement plans, life and health insurance, deferred compensation plans remain prevalent. In their simplest form, deferred compensation plans allow directors to defer taxes on compensation that they have already earned.

**Exhibit 4
Board of Director – Benefits Prevalence
2007 Fiscal Year Analysis⁹**

Data Cut	n	Median Assets 2007 (\$M)	Equity Plan	Deferred Comp Plan	Retirement Plan	Life Insurance	Health Insurance	Stock Purchase Plan	Restricted Stock / Full Value Stock Plan
<\$250M	67	174.3	60%	21%	15%	4%	4%	0%	19%
\$250M-\$500M	103	368.3	58%	35%	23%	15%	8%	1%	32%
\$500M-\$1B	135	719.0	67%	41%	20%	13%	4%	1%	33%
\$1B-\$5B	126	1,633.6	71%	48%	11%	11%	6%	4%	37%
\$5B-\$15B	36	7,756.1	81%	53%	17%	8%	11%	0%	72%
\$15B-\$50B	19	17,186.9	74%	53%	16%	11%	0%	16%	63%
>\$50B	23	142,543.0	87%	91%	9%	4%	4%	4%	87%
All Banks	509	790.0	67%	42%	17%	11%	6%	2%	38%

OFFICER COMPENSATION

With all of the activity concerning governance, where does officer compensation stand? Officer compensation typically consists of five elements: salary, annual incentives, long term incentives, officer benefits, and perquisites. When the base salary is combined with cash incentives you have a total figure referred to as "Total Cash Compensation". When you add long term incentives to Total Cash Compensation you get "Total Direct Compensation". Last, when you

add everything else, such as perquisites and executive benefits, to Total Direct Compensation you have “Total Compensation”.

CEO Compensation Increases

We predicted in the 2007 edition of this paper that the increases in CEO compensation would be much lower than in 2006; with the 2007 proxies filed, that is exactly what was reported. While Total Direct Compensation increased 13.8% in 2006, the overall increase in Total Direct Compensation was only 3.3% in 2007. From a purely base salary perspective, CEO salaries increased 5.3% from 2006 to 2007. In reviewing the increase in Total Direct Compensation, it is clear that the increase is primarily due to the increase in base salaries. Exhibit 5 shows that the value of annual cash incentives decreased in 2007 in line with the overall decline in bank performance. On a going forward basis, particularly for the 2008 and 2009 fiscal years, we expect lower compensation increases.

Exhibit 5 CEO - Median Total Compensation Increases 2005 to 2007 Fiscal Year Comparisons¹⁰

Asset Cut	Median Assets (\$M) n		Change in Compensation: 2005 to 2006				Change in Compensation: 2006 to 2007			
			Salary	Bonus	Total Cash	Total Direct	Salary	Bonus	Total Cash	Total Direct
<\$250M	194	45	4.8%	27.9%	10.2%	7.6%	5.4%	-5.5%	3.9%	3.2%
\$250M-\$500M	386	119	6.2%	15.4%	14.2%	11.3%	5.7%	-3.4%	4.7%	3.9%
\$500M-\$1B	710	159	5.8%	9.1%	15.7%	12.2%	6.3%	-6.9%	4.5%	4.1%
\$1B-\$5B	1,880	174	5.4%	-4.3%	11.2%	15.5%	4.8%	-25.0%	0.0%	-1.5%
\$5B-\$15B	7,920	49	5.0%	-2.6%	9.3%	9.5%	4.9%	-20.4%	-1.0%	0.1%
\$15B-\$50B	21,130	17	10.0%	-17.8%	14.2%	11.4%	3.5%	-1.0%	3.2%	-3.6%
>\$50B	141,792	19	2.7%	14.8%	48.9%	36.5%	3.5%	-50.0%	-23.0%	-7.8%
All Banks	889	582	5.5%	3.0%	13.8%	12.5%	5.3%	-12.6%	3.3%	3.0%

Cash Compensation

Banks continue to benchmark their base salaries to market on a periodic basis. In addition, banks are structuring their annual cash incentives to be more motivating and rewarding, while also providing a good return to the banks and shareholders.

As previously mentioned, performing routine market updates is becoming critical to community banking. There are a number of reasons why it is important to benchmark the officers to the market: merger and acquisition activity, hiring of new officers that may impact internal equity, or bank expansion into new banking areas such as investments. Whatever the reason, most community banks are benchmarking to market every one to two years.

With respect to the annual incentive plans, the continuing trend is for more structure; this means that the plan provides for different levels of payout, or a tiered structure, based upon employee position and responsibility level. As Exhibit 6 below highlights, only 21% of annual incentive plans are completely discretionary. The remainder of the plans has a formalized structure to their design. Each tier usually has its own eligibility, goals, objectives, and potential payout. In addition to becoming more structured, annual incentive plans are also being benchmarked to ensure that the plans are providing incentive payouts and total cash compensation amounts that are commensurate to the market.

**Exhibit 6
2007 Annual Incentive Plan Structure**

Asset Size	N	Annual Incentive Plan Type – Prevalence		
		Performance Based	Discretionary	Bonus Pool
<\$250M	15	40%	47%	13%
\$250M-\$500M	48	77%	27%	6%
\$500M-\$1B	59	69%	12%	22%
\$1B-\$5B	62	71%	23%	8%
\$5B-\$15B	28	89%	14%	0%
\$15B-\$50B	8	75%	13%	13%
>\$50B	8	88%	25%	0%
All Banks	228	73%	21%	11%

Long-Term Incentives

Long-term incentives (LTI) refer to either cash or equity awards tied to either long-term performance results or annual results with a long-term vesting horizon. While equity has always been a major component of executive compensation, especially at publicly traded and larger banks, more organizations have begun to manage cash compensation expenses (which have a dollar-for-dollar expense valuation) by shifting more of the “at risk compensation” to the form of equity, which can be more efficient to the organization. From Exhibit 7 below we see that grant frequency will vary substantially based on institution. For banks that are larger than \$1 billion in assets, they are generally making equity grants each year. This contrasts with banks that are less than \$500 million in assets, who make equity grants once every three years.

**Exhibit 7
2005-2007 Frequency of Equity Grants**

Asset Size	n	Equity Grant Frequency - % of CEOs Receiving Equity		
		Prevalence of CEOs Receiving Equity in <u>Only One</u> of Past Three Years	Prevalence of CEOs Receiving Equity in <u>Two</u> of Past Three Years	Prevalence of CEOs Receiving Equity in <u>Each</u> of Past Three Years
<\$250M	18	72%	28%	0%
\$250M-\$500M	63	62%	24%	14%
\$500M-\$1B	109	39%	23%	38%
\$1B-\$5B	143	24%	30%	46%
\$5B-\$15B	46	11%	28%	61%
\$15B-\$50B	16	6%	31%	63%
>\$50B	20	0%	0%	100%
All Banks	415	33%	26%	42%

Equity compensation has already seen significant attention in the past few years as a direct result of the FASB pronouncement on stock option expensing (FAS 123R). There are trends that continue to occur that are a direct result of the new accounting rules. For example, there continues to be a shift to the use of a combination of both full value shares (restricted stock) and appreciation shares (stock options or stock-settled SARs).

The use of restricted stock has increased in prevalence over the past several years. Although, we observed significant increases in the use of restricted stock from 2004 to 2006, we did not see the same increase in the use of restricted stock grants from 2006 to 2007. We do note that stock options have remained slightly more popular for banks and continue to be an efficient form of an incentive (i.e., delivering more value compared to cost) despite the expense to the bank.

A combination of equity types provides a “balanced” approach to performance and incentives. Stock options recognize stock price appreciation with greater leverage when the stock price increases, but greater risk if it does not increase. Restricted stock provides more “ownership” focus. It is less risky and retains some value even when the stock price declines.

With the present market, many banks are reevaluating their use of long-term equity based incentives. For example, as of October 20, 2008, 87% of options granted to CEOs in 2007 were underwater. On this date, trading prices were 40% below grant prices at the median, meaning that the stock price would need to increase at least 40% before the option had any value to the executive whatsoever. As a result, banks that granted these options have lost much of the motivational value and retention benefits that this equity was intended to provide.

Given the overwhelming number and degree to which options are underwater, along with continued uncertainties in the market, many banks are finding reasons to turn toward restricted shares. There are at least two main reasons for this. First, even if stock prices continue to fall, there will exist at least some value in restricted shares; thereby preserving the retention benefit of equity. Second, a grant of stock options when prices are severely depressed could create a windfall situation for executives when prices eventually do go back up. With many bank stocks being arguably oversold in this market, boards have been approaching options with caution. With investor scrutiny higher than ever, boards do not want to appear opportunistic, nor do they wish to unduly or excessively reward their executives when and if prices eventually do recover.

Although historically less prevalent, the concept of performance *vested* equity awards is gaining in popularity. In this scenario, equity awards are granted and subsequently vest at a later point in time based on predetermined performance goals. For example, after a three-year vesting period, if the bank achieves a specified level of profitability over the period, then all or a portion of the equity will vest.

The table below shows the prevalence of various types of LTI grants to CEOs of publicly traded banks from 2005 to 2007. We discuss long-term incentive alternatives in more detail later in this paper.

Exhibit 8
CEO Equity Prevalence by Year
2005, 2006, & 2007 Fiscal Year Comparisons¹¹

Asset Cut	Median Assets		% of CEOs Receiving Full Value Shares			% of CEOs Receiving Appreciation Shares		
	(\$M)	n	2005	2006	2007	2005	2006	2007
<\$250M	194	52	10%	8%	2%	28%	21%	13%
\$250M-\$500M	386	134	13%	10%	7%	39%	17%	19%
\$500M-\$1B	710	187	13%	19%	17%	45%	37%	33%
\$1B-\$5B	1,880	207	21%	28%	29%	54%	41%	46%
\$5B-\$15B	7,920	58	39%	46%	59%	67%	67%	59%
\$15B-\$50B	21,130	18	67%	67%	56%	67%	56%	72%
>\$50B	141,792	26	52%	74%	65%	86%	96%	85%
All Banks	889	682	21%	25%	24%	50%	39%	38%

Officer Benefits

In designing officer benefit programs, there is typically a focus on three types of benefits: supplemental executive retirement plans (SERPs), deferred compensation arrangements, and officer life insurance. The biggest impact in this area of compensation is the legislation through the American Jobs Creation Act of 2004. This act will have a short-term impact by requiring many banks to amend their current deferred compensation or SERP plans to be compliant. Please refer to the more detailed review in this document.

There are two general types of officer benefits: nonqualified retirement benefits and officer life insurance. The two main types of nonqualified retirement benefits used today in community banks are supplemental executive retirement plans (SERPs) and deferred compensation arrangements. A SERP is an arrangement that provides supplemental retirement benefits in addition to what is provided from the bank's qualified retirement plan. The two reasons to put a SERP in place are (i) to make up for the qualified plan limitations¹² on all employee retirement benefits, and (ii) to provide a retention device to ensure the officer stays with the bank. In contrast to a SERP, which is usually a company-provided benefit, a deferral plan allows the officer to defer his/her own salary and/or cash incentive amounts. These amounts are credited with interest and usually paid to the officer at retirement or a specific time in the future.

Officer life insurance is often provided via a "split-dollar arrangement." In this context, the bank owns an individual insurance policy on the life of the officer and endorses a portion of the death benefit to the officer's estate. In this "endorsement method" of split-dollar insurance, the bank directly owns all of the policy cash value and may retain some of the death benefit.

Perquisites

Officers typically have a number of perquisites that may be made available to them. While the list of perquisites includes automobiles, country club memberships and employment agreements, the main area of change relates to agreements. As a direct result of the level of merger activity in the past few years, institutions that are most likely to be involved in any potential change-in-control (CIC) have been updating their agreements. When looking at all forms of CIC agreements and plans that would pay out in the event of a merger or acquisition, we recommend that the total cost, including any payments for excess parachute payments, be less than three to five percent of any potential deal value.

The pertinent code sections for agreements is covered under the notion of *excess parachute payments* as defined by the Internal Revenue Code §1.280G and 4999. These code sections determine what, if any, excise taxes are owed by the officer and what amounts, if any, are not deductible to the bank.

It is difficult to predict future trends in perquisites following implementation of the new proxy regulations, which require more disclosure and explanation of perquisites than in the past. On one hand, greater scrutiny and concern over shareholder reaction may lead to reduced perquisites. On the other hand, greater disclosure and richer data on competitive practices may result in higher perquisites as banks match what their peers offer. However, we generally expect (and advocate) reducing and simplifying perquisites. It simplifies the plan and the task of disclosure and explanation, and shareholders and staff employees generally react favorably.

Location

As is the case with board of director pay, total compensation for CEOs varies depending upon size, region and whether or not the bank is located on a coast. The exhibit below shows that the median total compensation paid to bank CEOs varies significantly based upon location. Again,

this provides evidence that a bank needs to take into account its particular location when reviewing national compensation data.

Exhibit 9
CEO - Total Compensation (median values)
2007 Fiscal Year Analysis¹³

Data Cut	Median Assets (\$M)	n	Salary	Bonus	Total Cash Comp	Total Direct Comp	Total Comp
All Banks							
<\$250M	194	52	169,128	8,218	190,008	190,633	219,678
\$250M-\$500M	386	134	205,475	19,134	234,008	240,592	282,819
\$500M-\$1B	710	187	257,211	43,845	310,048	335,000	417,964
\$1B-\$5B	1,880	207	355,625	91,739	451,484	533,950	653,371
\$5B-\$15B	7,920	58	623,693	197,500	832,650	1,416,163	1,708,696
\$15B-\$50B	21,130	18	855,654	558,250	1,385,217	2,298,013	2,661,023
>\$50B	141,792	26	962,625	925,000	1,988,462	9,780,295	10,071,836
All Banks	889	682	279,066	47,065	350,770	383,903	495,564
Coast Banks							
<\$250M	196	32	174,392	12,938	195,093	196,861	221,050
\$250M-\$500M	390	77	224,711	27,000	245,129	251,675	287,405
\$500M-\$1B	740	109	265,000	61,680	346,756	360,833	455,142
\$1B-\$5B	1,688	100	363,063	112,843	464,937	601,560	733,791
\$5B-\$15B	8,096	27	650,000	200,000	999,600	1,703,000	2,038,153
\$15B-\$50B	21,719	9	975,000	731,500	1,831,500	2,301,450	2,755,639
>\$50B	204,693	14	1,000,000	1,610,782	2,743,407	15,483,566	15,941,169
All Banks	835	368	278,960	50,000	357,613	402,760	511,982
Non-Coast Banks							
<\$250M	187	20	147,851	5,370	166,665	169,531	206,453
\$250M-\$500M	363	57	195,300	13,000	218,400	224,980	265,009
\$500M-\$1B	704	78	243,984	33,878	277,500	305,779	360,029
\$1B-\$5B	1,984	107	349,900	69,620	438,750	514,700	607,361
\$5B-\$15B	7,846	31	600,000	180,000	773,525	1,201,307	1,433,472
\$15B-\$50B	20,668	9	811,625	516,500	1,328,125	2,294,576	2,615,452
>\$50B	91,487	12	868,476	831,000	1,744,462	5,697,732	7,317,644
All Banks	1,008	314	281,966	39,847	342,367	359,846	471,852

STOCK OPTION ACCOUNTING AND LONG-TERM INCENTIVE ALTERNATIVES

Equity grant practices are changing significantly as banks respond to the requirement to expense stock options. On December 16, 2004 FASB released its final accounting pronouncement with respect to equity - Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (referred to as "FAS 123R"). All companies are now required to expense stock options.

One impact is that the grant-date value of equity must be expensed over its vesting period. What will be the other effects? In short, there will be a significant amount of change. In the past, stock options were used more than other equity devices, because there was no expense associated

with them. Now, because all equity devices have an expense, all forms of equity will be reviewed and utilized according to their merits. Amalfi Consulting has seen three trends emerge to date in response to FAS 123R.

- First, full-value shares (typically in the form of restricted stock but can also be performance shares) have been used more frequently in combination with more traditional appreciation shares in the form of stock options. The purpose is not to provide more compensation, just equity compensation in a different form. Providing the same level of compensation with different equity devices makes relative valuation of each equity device extremely important. Option pricing models (e.g., based on the Black-Scholes or binomial pricing model) are the most common approach to determining how many restricted shares to grant in order to replace the value of options, however some firms are applying additional sophisticated techniques to take into account relative risk.
- Second, performance-based equity grants have become more common, particularly in institutions with significant long-term objectives (generally publicly traded). The performance-based equity can be delivered through options or restricted stock that vests based upon attainment of goals, or through the use of performance shares (shares that are only issued after attainment of goals). Using performance conditions on full-value shares ensures that compensation fluctuates with performance over time, so that executives are not rewarded merely for “seat time”.
- Third, stock appreciation rights settled in stock (“Stock SARs”) are becoming more common as a less dilutive alternative to stock options. Stock SARs represent the right to receive any increase in stock price between the grant date and exercise date, with the increase amount paid in full-value shares. Because they are settled in actual equity shares, the accounting treatment for Stock SARs is identical to that of stock options. Because settling Stock SARs involves issuing only enough shares to cover the appreciation (as opposed to one share for every option granted), Stock SARs require lower share authorization and overhang than plans that use only stock options.

FAS 123R requires that stock options be treated as a compensation expense, but how does that impact the income statement? Stock options do not have an easily defined, objective value at the time of grant, so what can be recorded as an expense beginning on the date of grant? According to FAS 123R, the fair market value of the stock option on the date of grant is to be determined (e.g., based on the Black-Scholes or binomial pricing model) and expensed over its vesting period. Exhibit 10 below provides an illustration that assumes that the stock option is a fixed-priced stock option with time-based vesting; e.g., stock options granted at market value that vest over a three-year period.

Exhibit 10
Example of Stock Option Accounting under FAS 123R

Accounting for a Stock Option Grant of 10,000 Options	
a. Number of stock options granted	10,000
b. Stock price at date of grant	\$30
c. Face value of option on date of grant (a x b)	\$300,000
d. Black-Scholes value on date of grant	25% (\$7.50)
e. Fair market value at date of grant (c x d)	\$75,000
f. Number of years of vesting	3
g. Annual pretax expense of stock option (e / f).	\$25,000

In the preceding example, the critical component is determining the fair-market value utilizing, in this example, the Black-Scholes valuation method. This calculation takes an option that inherently has no value at the date of grant and estimates the value using option pricing theories. While this calculation is the source of much controversy, it is the most common valuation method for stock options. While there are other methods for determining the fair market value, such as the binomial method, they are also controversial; the stock option has no inherent value at the time of grant (prior to any appreciation), and the value of future appreciation is uncertain.

Equity Efficiency

Different accounting treatment for cash-based and share-based incentives has a direct impact on the efficiency of different award types. Efficiency refers to the value received by the executive relative to the accounting expense incurred by the bank. The ideal grant would result in a low bank expense combined with a high value received by the executive. Cash-based synthetic equity, such as SARs settled in cash as well as phantom stock, must be expensed based on fluctuations in share value until settled. For these instruments, the value expensed will always eventually equal the value received by the officer, as the expense is linked to fair market value. There is a one-to-one relationship between expense and value when these SARs are settled.

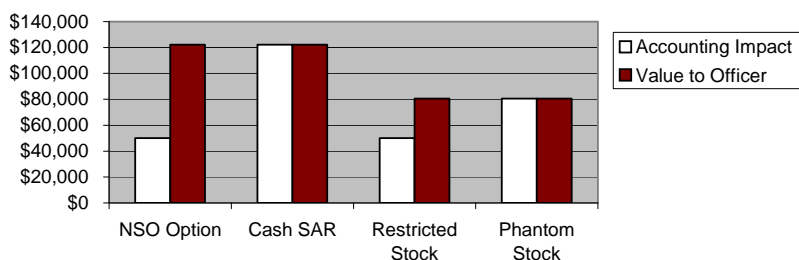
In contrast, grants settled in actual shares of equity have an expense fixed at the grant-date value per share. As a result, equity-based awards can be very efficient (high appreciation leading to a value received by the executive that is much higher than the bank's expense) or very inefficient (price depreciation on options leading to no value being received by the executive, despite a high expense to the bank).

For banks with the ability to grant actual shares, the most efficient approach (assuming stock price increases) will generally consist of making grants settled in actual shares rather than in cash. The table and chart below in Exhibit 10 illustrate the efficiency associated with four types of LTI awards, assuming 10% annual price appreciation. The bar chart shows that the accounting impact is equal to the value provided to the officer for the two types of synthetic equity (Cash SAR and Phantom Stock). In contrast, the officer's value is much higher than the accounting cost for the stock options and restricted stock.

Exhibit 11 Comparison of Typical Equity Instruments Over Time

Equity Grant Assumptions	Grant Date	Year 1	Year 2	Year 3	Year 4	Year 5
Stock Price (10% appreciation per year)	\$10.00	\$11.00	\$12.10	\$13.31	\$14.64	\$16.11
Black-Scholes valuation as % of stock price	25%					
Stock option economic value per share (\$10.00/4)	\$2.50					
Equity Grant in economic value	50%					
Officer base Salary	\$100,000					
Economic value of equity grant (\$100,000 * 50%)	\$50,000					

Description			Restricted	Phantom
	NSO Option	Cash SAR	Stock	Stock
Equity Type	Stock	Cash	Stock	Cash
Economic value of equity device	\$2.50	\$2.50	\$10.00	\$10.00
Number of shares to equate to \$50,000 of economic value	20,000	20,000	5,000	5,000
Accounting impact over five year vesting period	\$50,000	\$122,102	\$50,000	\$80,526
Value to officer at end of five years	\$122,102	\$122,102	\$80,526	\$80,526



Banks are still exploring how compensation planning will change as a result of the requirement to treat stock options as an expense. We expect to see the following outcomes related to stock option expensing in the coming years:

1. The amount of equity, on an economic basis, will not decrease. The expensing of stock options will not result in equity grants disappearing.
2. There will be more grants of full-value shares (such as restricted stock) in combination with appreciation instruments (such as stock options).
3. The prevalence of stock-settled SARs will increase to minimize share dilution.
4. Banks with goals that extend beyond the current fiscal year will consider implementing equity strategies that span multiple years.
5. There will be an increased use of performance-based equity (either in the form of performance-based granting or performance-based vesting).
6. The amount of shares reserved for equity plans will decrease over time.

Combined Grants of Restricted Stock and Stock Options

Because of the expense associated with stock options, grants of restricted stock now appear in a more favorable light. Exhibit 12 below illustrates different share issuance requirements and the value received by the executive based on the type of equity granted. Note that the value on the date of grant (and the bank's associated expense) is identical for the stock option and restricted stock grants illustrated; the table simply compares the resulting share issuance and the value received by the executive at 5 and 10 years.

Exhibit 12

Projected Value of Different Types of Equity Grants

Assumptions	Stock Option	Restricted Stock
a. Amount of equity granted	3.33 stock options	1 restricted share
b. Price of stock on date of grant	\$30	\$30
c. Face value on date of grant (a x b)	\$100	\$30
d. Black-Scholes Valuation (% of stock price)	30%	100%
e. Fair market value on date of grant (c x d)	\$30	\$30
Increasing Stock Price Scenario		
f. Assumed increase in stock price per year	10%	10%
g. Stock price at end of fifth year	\$48.32	\$48.32
h. Value of equity at end of fifth year	\$60.99	\$48.32
i. Stock price at the end of tenth year	\$77.81	\$77.81
j. Value of equity at end of tenth year	\$159.21	\$77.81
Decreasing Stock Price Scenario		
f. Assumed decrease in stock price per year	-10%	-10%
g. Stock price at end of fifth year	\$17.71	\$17.71
h. Value of equity at end of fifth year	\$0.00	\$17.71
i. Stock price at the end of tenth year	\$10.46	\$10.46
j. Value of equity at end of tenth year	\$0.00	\$10.46

The above exhibit shows that the equity device with the highest value depends upon the stock price appreciation. If the stock price is consistently increasing, then stock options will provide the most motivation and wealth to the individual. The grant of options will also be highly efficient, in the sense that the individual receives a value that exceeds the expense to the bank. If the stock price is declining, then restricted stock will provide the most motivation to the individual and will be more efficient from an expense standpoint.

The preceding exhibit also shows that if only stock options are used in a declining stock-price environment, then the individual is not directly impacted (the individual does not experience a tangible loss in value, whereas shareholders do). At the date of grant, the stock option has no value. If the stock continues to decline, there is still no value. The individual has not lost any value in this scenario. However, when restricted stock is used and the stock price declines, the individual has lost value in their restricted stock.

Based on the preceding analysis and other factors, we continue to recommend that banks with stock provide a combination of both traditional stock options and restricted stock (as well as authorizing other alternative LTI instruments to enable future flexibility). Providing grants that blend full-value and appreciation-based equity has a dual benefit: the individual is motivated to increase the stock price, thus providing value to the options, while at the same time ensuring the stock does not decline and erode the value of the restricted stock. Also, the restricted stock helps provide continued motivation if the price *does* decline below the grant price, whereas underwater options provide limited motivation and retention value. This balanced grant approach should help address the concerns that the individual is not directly impacted by a falling stock price. Furthermore, blended grants help balance the risk-taking incentive often associated with stock options with the long-term perspective and alignment of interests associated with ownership of full-value shares.

Potentially Lower Share Allocation in Equity Plans

We believe that the increasing prevalence of restricted stock grants and stock-settled SARs will eventually reduce the total number of shares that banks need to authorize in their equity plans. A bank needs fewer shares of restricted stock to provide the same value previously delivered through stock options. Whereas the value of a stock option is based on future appreciation, the value of a restricted share is based on the full underlying stock price. For the typical community bank, a stock option is worth approximately 25% of the stock price using the Black-Scholes pricing model.

For example, to provide a grant worth \$10,000 at a stock price of \$10 per share, the typical bank would need to grant 4,000 stock options (\$10,000 grant / \$2.50 value per option). This, in turn, would require having 4,000 shares allocated in the long-term incentive plan. In contrast, the bank could provide the same \$10,000 targeted value by granting only 1,000 shares of restricted stock.

As mentioned previously, we expect an increase in combined grants of both stock options and restricted stock, but the increased use of restricted stock will nevertheless decrease the number of shares required to provide competitive equity grant values. Shareholders will generally view this outcome favorably, because it lowers dilution to existing shareholders. In addition, combined grants help ensure that the individual is focused on keeping the stock price, at a minimum, from declining, because the individual is negatively impacted by price declines. As shown in Exhibit 12 below, banks are clearly using combined grants of appreciation equity and full value equity. In 2007, similar to 2006, nearly 1/3 of all banks used a combination of equity; with banks over \$5 billion using combinations in a majority of equity grants.

Exhibit 13 CEO Equity Use by Type of Equity 2007 Fiscal Year Analysis¹⁴

	Assets (\$M)	n	Appreciation Equity Only	Full Value Equity Only	Using Both Types of Equity
Median					
<\$250M	194	7	86%	0%	14%
\$250M-\$500M	386	31	68%	16%	16%
\$500M-\$1B	710	85	62%	27%	11%
\$1B-\$5B	1,880	123	52%	23%	25%
\$5B-\$15B	7,920	45	24%	24%	51%
\$15B-\$50B	21,130	14	29%	7%	64%
>\$50B	141,792	24	29%	8%	63%
All Banks	889	329	50%	21%	28%

Overhang and Run Rate

Any decrease in the shares allocated in a bank's equity plan will directly impact overhang. Overhang is a measure of potential dilution associated with equity-based incentives, and it is defined as the total outstanding and authorized shares as a percentage of total common shares. For example, if a bank had 100,000 outstanding but unexercised options, 100,000 remaining shares authorized for future issuance under its LTI plan, and one million common shares, the bank's overhang would be 20% (200,000 outstanding and authorized LTI shares divided by one million common shares).

The run rate and the proxy five rate are two closely related measures of a bank's equity plan. The run rate refers to the percentage of shares being given annually as LTI grants, and it is calculated as the total number of shares (or options) granted in a year divided by total common shares. The proxy five rate measures the allocation of equity grants to the top executives and other plan participants, and it is calculated as the total number of shares (or options) granted to the proxy officers in a given year divided by the total number of shares granted to all individuals. Exhibit 14 below shows the overhang, proxy five, and run rates by asset size in public banks. Please note this analysis is for the 2007 fiscal year.

Exhibit 14
Overhang, Proxy Five Grants & Run Rate
2007 Fiscal Year Analysis¹⁵

Data Cut	Median Assets (\$M)	n	"Overhang" Equity as a % of Total Common Shares	"Proxy Officer" Grants as % of Annual Grant	"Run Rate" Annual Grant as % of Common Shares	"Run Rate" Annual Grant as % of Common Shares (for orgs granting equity)
<\$250M	194	24	8.3%	0.0%	0.00%	1.63%
\$250M-\$500M	386	76	10.3%	9.1%	0.05%	0.40%
\$500M-\$1B	710	83	11.7%	33.2%	0.36%	0.84%
\$1B-\$5B	1,880	99	10.1%	22.2%	0.67%	0.71%
\$5B-\$15B	7,920	36	10.9%	21.4%	0.69%	0.69%
\$15B-\$50B	21,130	10	11.7%	21.7%	0.83%	0.83%
>\$50B	141,792	10	11.0%	15.6%	1.22%	1.24%
All Banks	889	338	10.6%	22.1%	0.43%	0.73%

Option Backdating

Not only are banks reviewing the mix and value of equity grants to reflect accounting changes, they are reviewing and documenting their grant process to reflect the SEC's proxy disclosure regulations and recent option backdating scandals. The new disclosure regulations require public filers to describe how they determined award value and grant timing, as well as the Compensation Committee's role in the process. The SEC has made it clear that various forms of backdating options are illegal. The regulations, as well as recent scandals and the increasing scrutiny of media and shareholders, have led many banks to re-examine their policies and controls relative to equity grants. We anticipate higher future scrutiny of this issue from auditors and those reviewing compliance with Sarbanes-Oxley.

We do not anticipate significant problems with this issue in community banks. We have rarely seen any practices that formally resemble backdating, and the steps needed to prevent problems are relatively straightforward. However, banks need to be aware of the potential problems and take any steps needed to avoid the problems. The consequences of backdating are severe, ranging from public disclosure in the press, to investigation and enforcement action, to restated earnings and shareholder lawsuits. In addition, while this issue has focused on "stock option" backdating, our recommendation is that a bank's process regarding backdating, and avoiding it, should encompass all forms of equity; not just stock options.

In reviewing the backdating issue, it is important to note that backdating could refer to many practices other than intentional deceit and manipulation relative to when a grant was made. Other related practices to avoid include the following:

- Grants before employment (suspicious part-time classification or restating start date).

- Poor administration of equity grants, including suspicious “unanimous written consent” or poor documentation of delegated authority to approve grant date.
- Choosing to make a grant “as of” an earlier date (at least without legal review for full compliance).
- “Spring-loading,” or making a grant just before material good news is released.
- “Bullet-dodging,” or making a grant just after material bad news is released.

To avoid these issues, we support best practices such as those listed below:

- Use pre-determined grant schedules adopted prior to the beginning of the plan year. Provide for grants on a fixed periodic basis (e.g., quarterly, annually), and define rules for determining equity grant prices on those pre-determined dates.
- When determining a pre-determined schedule, avoid blackout periods to prevent grants when executives have material, non-public information.
- Document policies and controls associated with determining grant date and price.

Underwater Stock Options

It is not news that the financial services industry is experiencing a market downturn and a marked decline in stock price. As a result many stock option grants are significantly underwater and not expected to rebound to their original strike price anytime soon. This leaves many banks asking “how can we stop the bleeding”, referring to the expense they continue to record for stock option grants that are underwater. The short answer to this question is that under the accounting rules of FASB Statement 123(R) (FAS 123(R)) they cannot stop the bleeding, only alter its timing. In addition to the accounting expense, banks also struggle with the retention of key employees when one of their primary retention vehicles, stock options, is now considered worthless.

Of the several alternatives that may be chosen to make a difficult situation better, three top the list:

- 1. Cash or stock tender for underwater options:** The organization would submit a tender offer of cash or stock to the employee in exchange for cancelling the underwater stock options. The offer usually consists of cash or stock with equal value to the current fair market value of the underwater options.
- 2. Repricing of options/Modification of grant:** The organization would reprice/modify the existing underwater options so that the strike price of the options would be equivalent to the current market price of the stock.
- 3. Exchange of underwater options with restricted stock:** The organization offers to replace/exchange the underwater options with restricted stock. In a fashion similar to a cash or stock tender, the amounts offered would typically be equal to the fair market value of the underwater options at the time of the exchange.

Before the Board chooses one of these three options it should carefully take into consideration a variety of factors that could impact their course of action. There may be specific equity plan limitations, applicable SEC tender offer rules, stock exchange listing requirements, shareholder approval concerns, and accounting issues. We outline the three most common solutions as well as advantages and disadvantages of each alternative in the table below. Once a bank performs its due diligence it will be in a better position to determine the right course of action that will ideally benefit the company, employee and shareholder.

Approaches to Addressing Underwater Options

Scenario	Accounting Treatment	Impact on Employees	Impact on Equity Plan	Shareholder & Governance Issues	Other Issues
<p>1. Cash or Stock Tender for Underwater Options</p>	<p>Pros: The cancellation associated with the tender offer would require immediate recording of any unamortized expense associated with the option grant assuming that no vesting periods apply to the stock offer. The immediate recording of all the unamortized expense would remove the need to do so in following years.</p> <p>Cons: The cash or stock payment would be a hit on earnings for the current fiscal year; however, the expense associated with the payment would be reduced based upon the fair market value of the options at the time of settlement.</p>	<p>Pros: Assists with employee morale issues since some value is provided to the employee.</p> <p>Cons: If employee ownership is a goal of the plan, a cash offer approach reduces ownership potential. Also, with either a cash or stock settlement, the wealth building opportunity of options is removed.</p>	<p>Pros: Options purchased with cash and returned to the equity plan pool for future grants may extend the life of the plan.</p> <p>Cons: If cancelled options do not return to the option pool, the life of the equity plan may be shortened.</p>	<p>Pros: Avoids the issues associated with repricing.</p> <p>Cons: Shareholders may perceive this action as a bailout for poor performance.</p> <p>This is approach is more tolerated as a course of action for rank and file employees than for executive management.</p>	<p>Requires compliance with tender offer rules. Tender offers involve a complicated filing procedure with the SEC and may be an expensive process.</p>
<p>2. Repricing of Options/ Modification of Grant</p>	<p>Pros: Repricing would be treated as a cancellation and re-grant of the options. Under a repricing, the fair market value of the original underwater options is assessed on the date of the repricing. This amount would be applied towards a reduction of the expense of the replacement options.</p> <p>Cons: No reduction of expense with respect to the original option grant. The organization would continue to record the initial expense associated with the underwater options, plus any additional expense of the repriced options. The expense of the repriced options is reduced by the fair market value of the underwater options at the time of the repricing.</p>	<p>Pros: Repricing underwater options to at-the-money options reinstates the retention and motivational purpose of the option grant. May incent employees to focus efforts on increasing the organization's stock price.</p> <p>Cons: If the stock price continues to drop, the organization is back to a situation where the retention and motivation component of the option grant is lost. Employee inequities result where some employees exercised options and failed to sell the shares before the stock price declined. They do not get any benefit from the repricing.</p>	<p>Pros: Since a repricing does not require any new shares, this approach conserves the shares available for future grants from the employee equity pool.</p> <p>Cons: Unlike a restricted stock value-for-value exchange, there is no savings on the number of shares used. Repriced options count twice against the plan's §162(m) periodic per-person option grant limit.</p>	<p>Pros: None.</p> <p>Cons: Likely to elicit a strong negative response from shareholders. Under most stock exchange rules (e.g., NYSE, NASDAQ), shareholder approval is required unless plan <i>expressly allows</i> repricing without shareholder approval. Institutional investor groups also discourage this course of action.</p> <p>This approach is more tolerated as a course of action for rank and file employees than for executive management.</p>	<p>Often stock plans will explicitly prohibit a repricing of options without the approval of shareholders. Even if plans do allow for repricing without shareholder approval, there is a risk of lawsuit. If shareholder consent is sought, requires compliance with tender offer rules.</p> <p>Rationale for repricing must be discussed in CD&A if named executive officers are included.</p>

Approaches to Addressing Underwater Options

Scenario	Accounting Treatment	Impact on Employees	Impact on Equity Plan	Shareholder & Governance Issues	Other Issues
<p>3. Exchange of Underwater Options with Restricted Stock</p>	<p>Pros: Under this scenario, the fair market value of the underwater options at the time of the exchange would be applied towards the expense associated with the new restricted stock grant. If the exchange was a value-for-value exchange there would be no additional expense to the organization.</p> <p>Cons: If the value of the restricted stock grant exceeds the fair market value of the underwater options at the time of the exchange, there would be an expense above the amount the organization is recording for the current underwater options.</p>	<p>Pros: Restricted stock, as a full-value equity vehicle, will provide employees with value even if the stock price should continue to decline. The restriction period also provides an employee retention advantage to the organization.</p> <p>Cons: Restricted stock provides less wealth-building opportunity compared to options. The tax treatment of restricted stock is also less flexible for employees as they are taxed upon vesting or lapse of restrictions.</p>	<p>Pros: The exchange is likely to result in a reduction of the number of shares awarded and extend the life of the equity plan pool.</p> <p>Cons: None related to the equity plan.</p>	<p>Pros: Avoids the issues of repricing described below.</p> <p>Cons: Shareholders may perceive this action as a bailout for poor performance</p> <p>This approach is more tolerated as a course of action for rank and file employees than for executive management.</p>	<p>Requires compliance with tender offer rules. Tender offers involve a complicated filing procedure with the SEC and may be an expensive process. The equity plan would also need to allow for awards of restricted stock.</p>



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References

¹ SNL Bank & Thrift Index measured on the basis of one-year total shareholder return as of October 22, 2008. The S&P 500 Index is measured on the same basis as of October 22, 2008.

² For a complete description of the Emergency Economic Stabilization Act of 2008, please go to:
www.house.gov/apps/list/press/financialsvcs_dem/essabill.pdf

³ Amalfi Consulting, analysis of 252 banking organizations stock option grants for grants made in fiscal year 2007.

⁴ For a complete description of the guidance provided by the Treasury on October 14, 2008, please go to:
www.treasury.gov/press/releases/hp1208.htm

⁵ A complete copy of the SEC release can be found at:
<http://www.sec.gov/divisions/corpfin/guidance/execomdisclosure.htm>

⁶ For the NYSE, the CEO compensation must be approved by the compensation committee or the compensation committee plus all other independent directors. For the Amex or the NASDAQ, the CEO compensation must be approved by the compensation committee or by a majority of independent directors on the company's board of directors.

⁷ Amalfi Consulting, Proxy study of 509 publicly traded banks conducted with proxy statements for fiscal year 2007.

⁸ Amalfi Consulting, Proxy study of 509 publicly traded banks conducted with proxy statements for fiscal year 2007.

⁹ Amalfi Consulting, Proxy study of 509 publicly traded banks conducted with proxy statements for fiscal year 2007.

¹⁰ Amalfi Consulting, Proxy study of a matched sample of 682 publicly traded banks utilizing proxy statements showing compensation data for 2005, 2006, and 2007 fiscal years. We excluded CEOs receiving a decrease in salary or an increase greater than 35%, as these changes likely coincided with a change in role or responsibility from year to year or as a result of partial year reporting.

¹¹ Amalfi Consulting, Proxy study of 682 publicly traded banks utilizing proxy statements for fiscal year 2007.

¹² The 415 plan limitations limit the amount of compensation that can be considered when computing defined benefit amounts.

¹³ Amalfi Consulting, Proxy study of 682 publicly traded banks utilizing proxy statements for fiscal year 2006.

¹⁴ Amalfi Consulting, Proxy study of 682 publicly traded banks utilizing proxy statements for fiscal year 2007. Of the 682 banks in the study, 329 granted equity in 2007.

¹⁵ Amalfi Consulting, Proxy study of 338 publicly traded banks utilizing proxy statements for fiscal year 2007.