SNL's 2007 Executive Compensation Trend Analysis

By any measure, the banking industry is facing challenging times. Recent loan losses, the credit crisis, and the deteriorating housing market have added an extra measure of complexity to the already dynamic executive compensation environment. Recently filed proxy statements for the 2007 fiscal year have helped shed some light on how the challenging market has impacted executive paychecks, revealing a number of significant trends. While the compensation trends reflect the market downturn, the more important question is how should executive compensation change to take into account this challenging marketplace?

Financial Performance

Over the course of 2007, there was a dramatic decline in the financial performance of the banking marketplace. As an example, the SNL Bank and Thrift Index declined a total of 24% on the basis of total shareholder return (TSR) in 2007. This index is a measure of approximately 600 banks and represents a broad cross section of the marketplace. The industry decline was also seen relative to other financial measures. For example, on the basis of both return on average assets (ROAA) and return on average equity (ROAE), the same index declined over 40% compared to the prior three-year average. In terms of asset quality, 2007 nonperforming assets as a percent of total assets increased 93% compared to the prior three year average. A similar trend was seen relative to loan loss reserves, net interest margins, and efficiency ratios, among other measures. Clearly, few banks have been able to escape the downturn. While the industry slump is still being analyzed, its impact upon executive compensation is already being felt.

CEO Compensation Trends

With the 2007 proxy season behind us, we have analyzed more than 680 bank and thrift proxy statements in collaboration with SNL. The following trends have emerged that reflect the past fiscal year.

- **Salaries**: On a matched sample basis (meaning a year-to-year comparison of the same individual), CEO salaries increased 5.0% at the median from 2006 to 2007, compared to an annualized increase of 6.7% over the previous two years. In evaluating the increase in base salary it is important to note that most of these increases occurred during the first half of 2007, prior to the decline in the banking marketplace. The expectation is that the increase in base salary for 2008 will be significantly lower than in 2007; we estimate that this figure will be in the 2% to 3% range, at most.

- **Total Cash Compensation**: One of the most interesting, and arguably most expected, compensation trends occurred relative to annual cash incentive plans. Industry wide, cash incentives as a percent of base salary fell from a median of 27.1% in 2006 to 16.8% in 2007—a decrease of 38%.

  Even more indicative of the past year, 59% of CEOs received a lower bonus in 2007 than in 2006. In addition, the prevalence of CEOs receiving no bonus payout whatsoever increased from 15.6% in 2006 to 23.9% in 2007 across the industry; almost 25% of CEOs received no cash incentive award in 2007.

  In looking at total cash compensation (salary plus bonus or non-equity incentive compensation) we see a somewhat mixed picture. First, for all bank CEOs on a matched sample basis, total cash compensation actually increased 3.1% from 2006 to 2007. However, in the previous year, the increase was more than 14%. An important question, is how does total cash compensation increase when cash incentives decreased so much? Two factors explain this phenomenon. First, base salaries increased 5% year-over-year. Second, base salary is, in general, larger than the cash incentives. Thus, while cash incentives decreased substantially, this was mitigated by the increase in base salaries which, again, occurred prior to the market downturn.

- **Total Compensation**: As a direct result of the new SEC proxy reporting rules which went into affect in 2006, we now have an ability to review a total compensation figure. This figure takes into account total cash compensation, the expensed value of any equity, the expensed value of any pensions and nonqualified benefit plans, as well as the value of perquisites.

  For 2007, the reported CEO total compensation in the banking marketplace increased 4.2% at the median over 2006 levels on a matched sample basis. This is almost entirely based on the increase in base salaries, as previously noted. Compared with the change from 2005 to 2006 when total compensation increased 33.8%, the 4.2% increase for 2007 is a marked decrease. It is important to note, however, that total compensation differences from 2005 to 2006 include the effect of changes in the SEC proxy reporting requirements; therefore, the actual total compensation increase from 2005 to 2006 is likely inflated to some extent.

- **Large versus Small Banks**: The decline in compensation was most visible at the larger financial institutions. Case in point, while total compensation for the entire group increased 4.2%, for banks over $20 billion in assets, their total compensation decreased 15.0%. This compared to the previous year where their compensation increased more than 34%. In addition, as one reviews total compensation across the asset spectrum, approximately 60% of CEOs in banks over $5 billion in assets saw a decline in their total compensation during 2007. In contrast, 64% of CEOs at banks with assets less than $5 billion saw increases in total compensation, with a median increase of 5% on a year-over-year, matched sample basis.

- **Coast versus Non-coast Banks**: As is typically the case, there are differences in compensation trends between coast banks and those of non-coast banks. For purposes of comparison, we define coast banks as institutions that are located in states that border either the Atlantic or Pacific oceans. Thus, while New York and California are coast banks, Texas and Illinois are defined as non-coast banks. In terms of base salary, coast banks had a median

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matched sample increase in base salary of 5.8%, whereas non-coast banks had a median salary increase of 4.1%. On the basis of total cash compensation, coast banks had an increase of 3.7% as compared to non-coast banks at 1.9%.

Managing Compensation During Turbulent Times

Given the present market downturn, there are a number of aspects of executive compensation that need to be taken into account. First, the present decline in variable compensation is to be expected. As bank performance declines, so do the payouts under the various compensation programs. Second, the present marketplace is not a typical environment for reviewing and setting executive compensation. Consequently, there are a number of areas to review in terms of your bank's compensation programs, as highlighted below.

- Salaries: As previously noted, the increases in base salaries for 2007 at 5% were made primarily before the present market downturn. With stock prices down 24%, ROAA and ROAE down 40%, and nonperforming assets nearly doubled since 2006, banks should be critically reviewing increases in base salaries. Our expectation is that there will be many institutions that will not increase base salaries during 2008, while the remaining institutions will provide modest increases in the 2% to 3% range. It is important to note that any change to base salaries has a ripple affect, often impacting other aspects of compensation such as incentive plan payouts and retirement plan formulas.
- Annual Cash Incentives: With the current market, an important question to ask is, "How should the goals change in our incentive plans?" Many banks are asking this question in the aftermath where many incentive plans motivated behaviors which were based on growth or profitability with no linkage to fundamental credit issues.

  A key theme for annual incentive plans is, "What gets measured, gets done." With that concept, the annual incentive plans should be integrally tied to the bank's strategic plan. The important question is whether or not the bank's strategic plan has been modified to take into account the current marketplace.

  We are currently seeing more incentive criteria assessing bank-wide performance, more measures scored relative to peers, and for some institutions, a switch from cash to equity in order to motivate long-term performance and foster retention.
- Long-Term Incentives (Equity): This area of 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).

With the present market, there have been a number of institutions that have been taking different approaches to their use of long-term equity based incentives. One approach is to have the equity vest on a performance basis tied to long-term goals. For example, over a three-year vesting period, if the bank hits a long-term goal, or goals, the equity will vest. A second concept is that the annual incentive plan will be tied to annual goals whereas the long-term plan will be tied to achieving long-term objectives. Last, some organizations are managing 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.

There is no one-size-fits-all solution that will work for every institution. Rather, each bank needs to evaluate compensation program alternatives relative to its own situation and in its own context. We are currently seeing a number of institutions changing their compensation programs to meet the needs of the current market. The programs need to motivate individuals and provide for managed growth in the current credit environment, while at the same time providing a return for the shareholders.

Competitive, well-designed compensation plans will play an important role in helping to move banks back to a market upswing. Bank directors, executives, and compensation managers need to understand the underlying issues and trends in compensation to make informed decisions. Last, now more than ever is the time to be proactive in your compensation plan design. Now is the time to ensure that your plans are aligned with your institution's goals and objectives and are motivating to officers, which will help ensure retention of your key talent.

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