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Reprinted from SNLFinancial

The New Mandate for Compensation Decision-Making

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External forces such as new legislation, regulatory guidance, and shareholder and media scrutiny have necessitated the largest thought overhaul the industry has seen in many years. The overall message is clear: Banks will change the way they consider compensation, either voluntarily or by mandate. Regardless of the catalyst for change, the potential for fresh thinking is a promising prospect. How the industry responds to these new ideas is yet to be seen, but it is clear that competitive market practices will be driven for years to come by the decisions currently being made.

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However, the need for action does not conflict with a well-reasoned, conservative approach. Decision-making processes need to be more methodical, more creative, and better documented than ever before. This new expectation is addressed to varying degrees in the TARP Interim Final Rule, the amended SEC disclosure requirements, the October 2009 Federal Reserve Board guidance on incentive compensation, and the House and Senate financial industry reform bills. Many of these initiatives are awaiting final release or passage as of this writing. While each potentially affects a distinct subset of financial institutions, the intent is to reform the compensation considerations of the entire industry.

The new, process-oriented approach to compensation decisions applies to many of the pressing concerns currently facing banks. Retention, motivation, market benchmarking, incentive practices, and risk evaluation are all areas that will potentially need to be reconsidered in the current market. We discuss these concepts in more detail in light of industry trends gathered from the proxy statements of publicly-traded financial institutions as well as observations from our work with bank clients across the nation.

The Emerging Concern

A primary concern in the current banking environment is executive retention and motivation. Banks are realizing poorly focused leadership or executive turnover are just as likely to impact long-term profitability as poor asset quality. How can organizations creatively address the need for retention and motivation in the face of the current regulatory environment and performance concerns?

Formal performance-based incentive plans are still considered an industry best practice. In uncertain market conditions, it may be prudent to make wider use of discretion in determining final payouts; however, it is still crucial to communicate specific goals and opportunity levels. This allows executives to know they can be financially rewarded under certain conditions while still protecting the bank in the event of unanticipated circumstances. Even if payouts are likely to be modest, establishing some level of incentive opportunity may be helpful in motivating and retaining executives.

Strategic equity grants may also be a useful retention and motivation device for some organizations. Full value equity such as restricted stock or restricted stock units has the added benefit of aligning the long-term interests of executives and shareholders. Market data from proxy statements continues to reflect the shift toward full value shares in the banking industry. Of CEOs receiving equity in 2009, 69% received full value equity, up from 58% and 52% in 2008 and 2007, respectively. Of those same CEOs, the percentage receiving appreciation-based equity decreased significantly from 75% in 2007 to 60% in 2009. This trend is likely to continue, especially considering the regulatory guidance and compensation restrictions facing some banks.

What is My Market?

Another area for new thinking is in the evaluation of market data. In response to changes in the market, many of Amalfi Consulting's clients have re-examined their approach to establishing peers and assessing benchmark data. Understanding the significant changes in market data is the key to appropriately incorporating it into the decision-making process.

Peer Selection: Banks have several new considerations in establishing a peer group, among them the TARP participation of potential peers. Nearly every peer group will still include organizations that are participating in TARP, but banks need to be aware of the distinct differences in market data between participants and non-participants. TARP participants will likely have a different relative weighting of compensation components, with fewer cash incentives and possibly limits on their equity grants. Some TARP participants may also have increased base salaries to offset bonus restrictions. Depending on asset size, 2009 total compensation for CEOs at non-TARP banks ranged from 5% to 28% higher than at participating banks. There may be other compelling reasons to include or exclude banks that are TARP participants. This is illustrative of the types of issues that should be considered in selecting a peer group.

The peer group selection process also requires more complete documentation than in the past. For public companies, the SEC has made it clear that proxy disclosure surrounding peer selection methodology has been inadequate. More regulation requiring compensation committee independence and say-on-pay votes at all public companies is also likely forthcoming, and those banks with complete compensation process documentation will be in a more favorable position on both fronts. Some banks, both public and private, have also received requests from regulators for information reflecting compensation benchmarking and decision-making justification. Thorough documentation of how peers were selected and

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why they constitute a relevant comparison will likely continue to be a focus of both shareholders and regulators.

Market Changes: Even the data itself suggests that a new process is imperative. Compensation data from 2009, especially incentive awards, reflected the financial state of the industry in general.

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Based on Amalfi Consulting's matched sample analysis of over 650 public banks, CEO salaries in the banking industry increased 1.9% at the median from 2008 to 2009. Compare this to respective salary increases of 4.8% and 5.2% in 2008 and 2007, both of which were also relatively poor years for bank performance. More than 60% of CEOs received no cash incentives for 2009, and at the median, both total cash compensation and total direct compensation (i.e. cash + equity) did not increase over 2008 levels. These trends are also reflected in industry survey data. From a benchmarking perspective, it is difficult to establish baseline market compensation levels in such a historically poor year across the industry.

Compensation Structure: Recent market conditions also have had an impact on the structure of total compensation received by executives. Because of TARP restrictions and performance conditions, executives have increasingly received a higher percentage of compensation through fixed pay (salary) and less through variable pay (cash incentives and equity). For some banks, this was the result of conscious compensation design changes; for others it was a result of low or no incentive pay. On average in 2009, CEOs at banks between $500 million and $1 billion in assets received 74% of their total compensation through salary and only 8% through cash and equity incentives. Compare this to an average of 55% through salary and 28% through variable pay in 2007. The same trend is true in larger banks. CEOs at banks between $5 and $15 billion in assets received 50% of total compensation through fixed pay in 2009 on average, up from 40% in 2007. For many organizations, a move toward higher guaranteed compensation in the form of salary is not in their best interest. Trends reflected in market data will need to be reconciled with each bank's desired compensation mix and actual performance.

The Big Question: How do banks move towards a time of recovery with market data that still reflects a time of retraction? One benchmarking technique that is still available in establishing baseline market compensation is to pay attention to the incentive award opportunities. Target and maximum award opportunities for each proxy executive are often reported in proxy statements filed with the SEC. With some additional research and modeling, incentive opportunity data can be used to estimate market total compensation levels assuming achievement of target and maximum performance levels.

Pay for Long-Term Performance

The realization of the last few years is that short-sighted performance plans lead to short-sighted decision-making that may not be aligned with long-term organizational success. Banks are increasingly thinking of compensation with long-term horizons, whether through multi-year performance periods or through an enhanced emphasis on full value equity in incentive planning.

Reconsidering incentive plans in light of the desire to motivate for long-term performance management poses some practical problems for banks. Many banks are struggling to set medium and long-term performance goals at a time when even short-term performance conditions are difficult to predict. Others are designing incentive plans that are airtight from a risk perspective but are so complicated that participants and managers do not understand them – thus losing the desired motivational value.

One alternative is to create a plan that evaluates performance over successive or rolling multi-year periods. Another option is to maintain simpler, more traditional annual performance plans but pay a portion of the award in equity, the vesting of which is subject to future safety and soundness triggers. Regardless of design, it is important to leave an element of discretion in performance plans to account for unforeseen circumstances.

The "R" Word

Risk is the current industry hot topic – and another primary consideration in the new compensation world. The quick answer to the issue of risk in compensation design is to declare, "All performance plans must include a consideration of asset quality." This statement is true for most banks, but stopping there misses a principal lesson from the recent industry challenges. The key to the appropriate consideration of risk is not only to include the right metrics; it is also to thoughtfully contemplate the risks posed by compensation plans in their entirety. What is the worst case scenario? How are the risks in one plan offset by the design of a different plan? Is there a risk of under-motivation? Do the plans encourage so much risk aversion as to stifle long-term profitability?

Banks and regulators are arriving at the important conclusion that risk is defined and tolerated differently by every organization. Differences in capital structure, business model, appetite for risk, and ability to manage risk necessitate different compensation design considerations from one bank to another. To appropriately consider risk is not to eliminate it or confine it, but rather to fully understand it and make conscious decisions about its appropriateness in light of a holistic view of the institution.

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Individual Solutions for Individual Situations

It is clear that every bank needs to have its own particular compensation evaluation process. Unique business models, market conditions, performance conditions, time horizons, and strategic goals necessitate unique solutions at each bank. What the solutions do need to share is regulatory compliance and a thorough process by which the decisions were made.

Aside from portions of the TARP regulations, much of the guidance and legislation handed down in the past year does not prescribe a hard and fast set of compensation policies, such as minimum performance periods or specific performance metrics. While this principles-based view acknowledges that every bank and every situation has its own distinct characteristics, it also increases the work in store for each organization's decision-makers. The onus is on banks to identify areas of vulnerability within their own compensation plans and devise strategies for mitigating them – all while motivating goal achievement. One-size-fits-all plans are neither appropriate from a broad-based regulatory standpoint nor conducive to long-term organizational success.

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A Challenge and an Opportunity

The best banks will consider the current environment an opportunity rather than a burden in spite of new considerations, additional complexity, and more steps to compliance. Yes, compensation decision-makers have a more difficult job ahead. But more methodical, process-oriented decisions will only enhance the value realized by the bank through compensation practices. Shifting the compensation paradigm away from an annual focus toward longer-term thinking is in the best interest of both institutions and their shareholders. And a thorough understanding of institutional compensation risk is a requisite factor in developing an effective compensation policy. The new mandates afford banks the opportunity to regard compensation with a higher level of thinking, and organizations that are proactive in this environment will be rewarded in the coming years.

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