



**American Association  
of Bank Directors**



## **Today's Compensation Environment – 2007**

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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 many changes that have occurred in the past six years: The changes in the compensation marketplace continue at an unprecedented pace. This paper provides a context for community bankers to understand these changes, resulting trends in compensation, and potential implications for their own compensation plans.

## BACKGROUND

Since the Sarbanes-Oxley Act of 2002 (SOX) was legislated, we have seen no less than three additional forms of laws or regulation that have had direct or indirect impacts on compensation. In addition to SOX we have had the reforms on nonqualified deferred compensation through the American Jobs Creation Act of 2004; the implementation of stock option expensing beginning in 2006 through FASB's Statement of Financial Accounting Standards No. 123, referred to as "FAS 123R"; and most recently, the most sweeping revision in fourteen years in director and executive pay disclosure for publicly traded institutions through the Securities and Exchange Commissions (SEC) Regulation S-K which dictates pay disclosures through a company's proxy filing. All of these laws or regulations have had an impact on how compensation is viewed and managed in the marketplace. In the 2007 edition of this paper, we review trends in executive and director compensation in community banks, with particular emphasis on the following areas that continue to impact compensation.

- First, as a result of the SEC proxy disclosure requirements that took place for fiscal year 2006, for the first time we have a total compensation figure for the board of directors. The new SEC requirements require a total compensation figure for each director. This allows for a true actual total compensation figure for the first time. For purposes of this paper we have evaluated 434 banks to determine their total board compensation. The median board compensation for all banks in 2006 was \$30,193 per director. In addition, we provide a breakdown of the board compensation on a national, coast and non-coast basis.
- Second, also as a result of the SEC proxy disclosures, we now have a total compensation figure for the proxy officers. For purposes of this paper we have evaluated the principle executive officer, typically the Chief Executive Officer, for 741 banks. As detailed in the paper, on the basis of direct compensation (salary, cash incentives, and equity) CEO compensation increased by 11.5% from 2005 to 2006. The publication date of this paper is November 2007 and as a result of the current sub-prime mortgage issue within the banking industry, the general expectation is that the change in direct compensation will decrease in 2007 as compared to 2006.
- Third, we are now in the second full year of having to record an expense for stock options through FAS 123R. As expected, and detailed within this report, we are seeing many banking institutions using blends of equity as opposed to only using stock options. In 2006, nearly 1/3 of all banks granting equity utilized a combination of appreciation equity (stock options or stock appreciation rights settled in stock) and full value shares (restricted stock or performance shares). As evidenced by banks that are over \$5 billion where the use of equity blends is above 50% we expect this trend to continue for community banks in the foreseeable future.

How are these events and actions applicable to community banks?

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

## 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. The 2006 proxy season (proxies filed for fiscal-year 2006) marked the first time companies filed proxy statements with the new disclosure requirements. Below we summarize the key changes as well the SEC's October 9, 2007 report summarizing its initial review of 350 companies from various industries:

- **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. The core of the changes to the compensation disclosure requirements is the concept of a tally sheet. The tally sheet lists each component of compensation and permits the reader to “tally” all of the various elements of compensation and determine a total compensation figure. The Summary Compensation Table includes a column for total compensation. In addition to a total compensation figure, 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.
- **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

**October 2007 SEC Guidance:** Now that the SEC has reviewed the 2006 proxy statements, what have we seen with respect to compliance with their directives? On October 9, 2007, the Division of Corporate Finance of the SEC released a summary of its review of disclosures from 350 companies. A complete copy of the SEC release can be found at: <http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm>. The report discusses the principal comments provided to these companies. Two major themes have emerged – the need for succinctness and clarity in Manner of Presentation and increased analysis and disclosure in Compensation Discussion and Analysis as outlined below:

- **Manner of Presentation:** The Commission suggests that emphasis be put on material information and de-emphasize less important information. In terms of the format, the Commission stated that the Compensation Discussion and Analysis should be at the beginning of the compensation disclosure, providing context to the tables that follow. Additionally, disclosure should be clear and concise, reflecting plain English principles that effectively communicate discussion of disclosures.
- **Compensation Discussion and Analysis:** This calls for a discussion and analysis of material factors underlying compensation policies and decisions reflected in the data reported. Simply put, the Commission has asked companies to enhance their analyses of compensation policies and discussions, by stating *how* they arrived at particular levels and forms of compensation awarded to their named executives and *why* they pay that compensation, giving investors an analysis of the results of their compensation decisions.

For example, rather than a company discussing its compensation philosophies in great detail, the Commission suggested that it improve its Compensation Discussion and Analysis by explaining how and why those philosophies resulted in the numbers presented in the required tables. In addition, the Commission asked a significant number of companies to discuss the extent to which amounts paid under one element of compensation affected the amounts paid under other elements of compensation. Other areas in the CD&A receiving comments include:

- **Performance Targets** – This was the most prevalent disclosure area to receive comments. First, the Commission reported that they often found that companies neglected to disclose performance targets that were clearly material to compensation decisions and second, very often it difficult to understand how companies used the performance targets or considered qualitative individual performance to make compensation decisions and requested additional clarification.
- **Benchmarking** – If a company uses benchmarking and it is material to its compensation policies and decisions, it is required to “identify the benchmark and, if applicable, its components (including component companies).” The SEC often requested more detailed information about how the company used comparative compensation information and how it affected compensation decisions. In addition, the Commission wants companies to disclose the peer companies it compared itself with as well as the compensation components it used in the comparison.
- **Change in Control and Termination Agreements** – The SEC asked a number of companies to provide additional information, including an explanation as to why they structured the material terms and payment provisions in their change-in-control and termination agreements as they did. Additionally they asked companies to report how potential payments and benefits under these agreements may have influenced their decisions regarding other compensation elements.

## 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 against the board of directors (related to a contested pay package to 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 it.

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 best practice for accomplishing this objective. 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 process, 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 director and officer (D&O) liability insurance programs do not protect directors in the event of decisions that fail the reasonable person 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 set the “rules of engagement” between the board and management by describing how each compensation element applies to the eligible employee level and to 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. Annual cash incentives (cash bonuses), stock option awards, and total compensation for all eligible officers from vice president level up to CEO are targeted at the market median for expected performance and between the market median and the 75<sup>th</sup> 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 40<sup>th</sup> percentile for employees performing at expected levels. Annual cash incentives, stock option awards and total compensation for vice president level officers up to CEO are targeted at the 60<sup>th</sup> percentile of market for expected performance and the 85<sup>th</sup> 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 for each pay element.

### **Outside Expertise**

Another area that is typically legislated by state statute is the use of outside expertise or consultants. Simply put, 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 engagement specifically related to any compensation matter that is covered through 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 project 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.<sup>1</sup> 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 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.

### **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 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, America's Community Bankers, 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 banks have sought to have the continuing education for the board be accredited by RiskMetrics Group (formerly Institutional Shareholder Services - ISS); an example of this is the Bank Executive & Board Compensation conference conducted by Bank Director Magazine. In doing so, these community banks receive a higher rating by RiskMetrics Group related to the governance quotient. Whichever 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 result, the level of board compensation has been increasing: 70% of publicly-traded banks provided an increase in director compensation from 2005 to 2006. The increases were spread among committee meeting fees, board meeting fees, and equity. In banks providing an increase, the median increase in total compensation was 37%<sup>2</sup>. Across all banks, the median increase was 18%<sup>2</sup>. In reviewing these increases it is very important to note that these are impacted by the change in the SEC proxy reporting rules. For this year we are comparing board compensation in 2006, under the new proxy disclosure regulations, to board compensation in 2005, under the previous proxy disclosure regulations. As such, a portion of this increase is due to a change in the methodology which board compensation is now reported. On a going forward basis, we expect board compensation to increase approximately 5% to 10% per year.

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 1 on the following page shows the range of typical chair fees in publicly traded banks by asset size. The values are based on an analysis of proxies from 366 banks; the low and high ends of the ranges shown are at approximately the 25<sup>th</sup> and 75<sup>th</sup> 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.

**Exhibit 1**  
**Board and Committee Incremental Chair Fees**  
**2006 Fiscal Year Analysis<sup>3</sup>**

Data Cut	Board Chair	Audit Chair	Compensation Chair	Nominating/ Governance Chair
<\$250M	700 - 5,300	400 - 2,800	580 - 4,400	0 - 3,130
\$250M-\$500M	2,250 - 12,650	550 - 5,900	1,180 - 5,200	650 - 4,200
\$500M-\$1B	4,200 - 20,700	2,450 - 8,100	2,400 - 8,050	1,350 - 8,350
\$1B-\$5B	5,050 - 29,000	3,540 - 14,100	2,700 - 12,350	3,200 - 10,650
\$5B-\$15B	17,250 - 145,500	6,100 - 30,000	7,250 - 27,150	5,100 - 31,550
>\$15B	18,100 - 81,800	11,100 - 31,100	8,450 - 29,450	2,200 - 21,450
All Banks	3,760 - 25,400	2,550 - 14,000	2,400 - 12,400	1,800 - 11,750

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 ownership requirements for equity (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 committees. 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 chairperson may be 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.

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's 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 2 summarizes board compensation for 434 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 2**  
**Board of Director – Total Compensation**  
**2006 Fiscal Year Analysis<sup>4</sup>**

Data Cut	Median Assets (\$000)	n	Fees Earned or Paid in Cash	Stock Awards	Option Awards	Total Equity	Non-Equity Incentive Plan Comp	Change in Pension Value	Other Comp	Total Comp
<b>All Banks</b>										
<\$250M	166,000	41	12,194	3,690	2,231	3,835	NA	1,414	2,000	13,533
\$250M-\$500M	359,997	85	14,829	6,072	5,468	8,765	4,828	2,855	1,430	20,666
\$500M-\$1B	678,314	105	21,402	7,990	5,496	6,752	3,966	3,395	1,797	27,883
\$1B-\$5B	2,021,091	132	28,476	14,000	7,231	13,563	22,083	3,388	2,880	36,596
\$5B-\$15B	7,808,400	54	47,833	25,660	14,087	30,781	2,903	4,144	5,324	75,547
>\$15B	29,495,316	17	52,500	46,354	57,700	69,366	NA	3,352	3,933	122,155
<b>All Banks</b>	<b>907,900</b>	<b>434</b>	<b>23,228</b>	<b>15,210</b>	<b>7,531</b>	<b>12,075</b>	<b>4,280</b>	<b>3,330</b>	<b>2,799</b>	<b>30,193</b>
<b>Coast Banks</b>										
<\$250M	159,241	26	7,912	16,621	2,972	7,223	NA	1,414	1,369	12,548
\$250M-\$500M	359,767	48	12,575	8,171	11,414	12,974	2,292	1,562	5,000	18,181
\$500M-\$1B	674,695	54	20,846	8,710	7,889	8,865	3,966	6,702	2,799	30,743
\$1B-\$5B	1,885,957	65	31,367	14,763	7,591	15,502	22,083	3,746	2,695	44,188
\$5B-\$15B	7,432,982	28	51,343	38,319	12,649	44,467	2,903	3,407	6,005	93,559
>\$15B	35,506,581	9	63,692	89,336	57,700	89,336	NA	3,352	3,933	165,764
<b>All Banks</b>	<b>851,802</b>	<b>230</b>	<b>24,245</b>	<b>18,049</b>	<b>9,173</b>	<b>15,526</b>	<b>2,903</b>	<b>3,749</b>	<b>3,856</b>	<b>34,289</b>
<b>Non-Coast Banks</b>										
<\$250M	204,865	15	13,467	1,622	2,231	2,221	NA	1,644	3,500	15,400
\$250M-\$500M	368,400	37	17,885	6,072	3,292	7,505	7,364	3,519	961	20,941
\$500M-\$1B	681,872	51	21,632	7,351	3,467	4,866	8,862	2,537	1,161	24,994
\$1B-\$5B	2,170,628	67	24,531	11,598	6,599	9,845	20,634	2,035	3,174	32,219
\$5B-\$15B	8,333,330	26	37,706	18,593	16,829	23,178	NA	4,303	4,051	60,344
>\$15B	21,822,817	8	50,557	35,000	54,307	45,133	NA	NA	4,208	67,880
<b>All Banks</b>	<b>979,174</b>	<b>204</b>	<b>22,188</b>	<b>11,549</b>	<b>5,620</b>	<b>8,981</b>	<b>7,364</b>	<b>2,589</b>	<b>1,680</b>	<b>27,981</b>

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, 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 less of a 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.

### Equity

Second, 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) 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 3**  
**Board of Director – Benefits Prevalence**  
**2005 Fiscal Year Analysis<sup>5</sup>**

Data Cut	Median Assets (\$000)	n	Equity Plan	Deferred Comp Plan	Retirement Plan	Life Insurance	Health Insurance	Stock Purchase Plan	Restricted Stock / Full Value Stock Plan
<\$250M	195,503	57	49%	21%	11%	9%	7%	4%	7%
\$250M-\$500M	373,719	104	52%	33%	11%	13%	6%	1%	5%
\$500M-\$1B	701,915	140	64%	34%	19%	9%	1%	0%	16%
\$1B-\$5B	1,860,463	159	68%	42%	11%	8%	8%	1%	16%
\$5B-\$15B	8,205,747	50	86%	46%	12%	2%	6%	2%	20%
\$15B-\$50B	22,240,178	20	85%	55%	20%	15%	0%	5%	30%
>\$50B	103,649,501	20	65%	65%	5%	10%	0%	5%	40%
All Banks	852,026	550	64%	38%	13%	9%	5%	1%	15%

### OFFICER COMPENSATION

With all of the activity concerning governance, where does officer compensation stand? Officer compensation typically consists of five elements: salary, annual incentives (salary and annual incentives are collectively called "cash compensation"), long term incentives, officer benefits, and perquisites.

## CEO Compensation Increases

The compensation for CEO's increased from 2005 to 2006. On the basis of year-over-year increase in direct compensation (base salary, cash incentives and value of equity), CEO compensation increased 11.5%. From a purely base salary perspective, CEO salaries increased 5.1% from 2005 to 2006. The compares with a general industry salary increase of 3.9% for executives and officers.<sup>6</sup> For the 2006 fiscal year, we have not displayed the increase in total CEO compensation due to the changes in methodology in SEC reporting in 2006. The 2006 CEO compensation includes the increase in pension and supplemental executive retirement plans (SERP) and above market deferred compensation interest where it was not required in 2005.

On a going forward basis, particularly for the 2007 fiscal year, we expect lower compensation increases. In particular, the 2006 fiscal year was in advance in the broad decline in total shareholder returns for financial institutions as a result of the sub-prime mortgage issues. As of November 7<sup>th</sup>, the SNL Bank Index was down 12.91% over the previous twelve months and the SNL Thrift Index was down 25.17%.<sup>7</sup> In other words, based upon 2007 performance, we expect next years increases to be substantially lower then what we are seeing in increases from 2005 to 2006.

### Exhibit 4 CEO - Median Total Compensation Increases 2005 to 2006 Fiscal Year Comparisons<sup>8</sup>

Data Cut	Median Assets (\$000)	n	Salary	Total Cash	Total Direct
<\$250M	168,327	48	5.2%	11.1%	5.2%
\$250M-\$500M	368,400	120	5.2%	12.5%	10.6%
\$500M-\$1B	726,848	162	5.6%	14.9%	12.9%
\$1B-\$5B	1,903,964	180	5.5%	13.2%	15.6%
\$5B-\$15B	8,002,403	54	5.0%	10.8%	7.7%
\$15B-\$50B	25,633,310	16	5.7%	31.0%	24.3%
>\$50B	130,770,954	20	0.0%	43.7%	31.2%
<b>All Banks</b>	<b>859,281</b>	<b>600</b>	<b>5.1%</b>	<b>13.5%</b>	<b>11.5%</b>

## 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. 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.

## Long-Term Incentives

Long-term incentives (LTI) refer to either cash or equity plans that provide for rewards based on long-term results. This area of compensation has seen significant activity in the past few years as a direct result of the FASB pronouncement on stock option expensing (FAS 123R). Many publicly traded banks are putting in place omnibus equity plans that provide for the grant of multiple alternative equity devices based on the situation.

Over the last three years, restricted stock has increased in prevalence; we believe this is primarily due to the fact that stock options must now be expensed. However, stock options remain 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 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 can include additional performance vesting criteria linked to other key financial performance measures (e.g. EPS, ROE). The table below shows the prevalence of various types of LTI grants to CEOs of publicly traded banks from 2004 to 2006. We discuss long-term incentive alternatives in more detail later in this paper.

**Exhibit 5**  
**CEO Equity Prevalence by Year**  
**2004, 2005, & 2006 Fiscal Year Comparisons<sup>9</sup>**

Data Cut	Median Assets (\$000)	n	% of Banks Granting Full Value Equity			% of Banks Granting Appreciation Equity		
			2004	2005	2006	2004	2005	2006
<\$250M	162,637	79	2%	8%	10%	20%	22%	16%
\$250M-\$500M	359,997	149	6%	9%	11%	37%	38%	19%
\$500M-\$1B	717,437	198	9%	15%	21%	48%	46%	36%
\$1B-\$5B	1,900,376	211	14%	18%	26%	62%	54%	44%
\$5B-\$15B	8,026,508	61	37%	42%	49%	71%	70%	62%
\$15B-\$50B	25,633,310	20	27%	47%	60%	53%	63%	55%
>\$50B	121,351,065	23	43%	52%	74%	71%	76%	91%
<b>All Asset Sizes</b>	<b>820,084</b>	<b>741</b>	<b>13%</b>	<b>19%</b>	<b>24%</b>	<b>50%</b>	<b>48%</b>	<b>37%</b>

## 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 later 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 limitations<sup>10</sup> 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 referred to as 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, 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 6**  
**CEO – Total Compensation**  
**2006 Fiscal Year Analysis<sup>11</sup>**

Data Cut	Median Assets (\$000)	n	Salary	Bonus	Total Cash Comp	Total Direct Comp	Total Comp
<b>All Banks</b>							
<\$250M	162,637	79	156,250	25,313	175,000	188,571	213,170
\$250M-\$500M	359,997	149	200,000	47,612	240,000	246,025	296,846
\$500M-\$1B	717,437	198	243,237	73,492	320,467	346,911	420,024
\$1B-\$5B	1,900,376	211	350,000	151,250	498,438	585,055	711,137
\$5B-\$15B	8,026,508	61	625,992	466,125	1,001,320	1,252,500	1,721,273
\$15B-\$50B	25,633,310	20	845,542	745,650	1,603,728	2,918,969	3,397,714
>\$50B	121,351,065	23	995,000	3,036,000	3,958,708	7,882,543	11,404,841
<b>All Banks</b>	<b>820,084</b>	<b>741</b>	<b>262,500</b>	<b>93,204</b>	<b>345,300</b>	<b>377,048</b>	<b>482,907</b>
<b>Coast Banks</b>							
<\$250M	160,792	41	157,000	30,000	180,434	185,428	209,632
\$250M-\$500M	359,997	87	208,000	60,000	270,000	284,192	345,384
\$500M-\$1B	702,764	109	248,719	84,537	336,200	360,960	455,123
\$1B-\$5B	1,843,312	101	353,625	190,350	530,000	626,757	824,791
\$5B-\$15B	7,550,298	30	644,700	537,575	1,105,563	1,538,151	2,458,852
\$15B-\$50B	28,482,370	9	975,000	866,098	1,687,125	3,011,563	3,247,663
>\$50B	199,946,230	13	1,000,000	5,713,000	6,240,000	18,898,703	21,706,841
<b>All Banks</b>	<b>752,984</b>	<b>390</b>	<b>262,521</b>	<b>100,000</b>	<b>350,000</b>	<b>398,213</b>	<b>528,662</b>
<b>Non-Coast Banks</b>							
<\$250M	165,509	38	146,468	21,250	163,029	190,100	217,483
\$250M-\$500M	362,858	62	187,341	35,801	214,500	228,162	265,318
\$500M-\$1B	741,611	89	240,000	58,504	292,500	317,567	394,617
\$1B-\$5B	1,998,385	110	349,538	132,525	454,280	535,504	652,202
\$5B-\$15B	8,225,134	31	553,846	306,200	800,052	1,156,109	1,304,986
\$15B-\$50B	22,784,249	11	828,600	679,751	1,500,000	2,700,213	3,595,962
>\$50B	96,503,000	10	970,009	2,500,000	3,194,051	6,211,830	7,053,622
<b>All Banks</b>	<b>895,992</b>	<b>351</b>	<b>262,500</b>	<b>70,000</b>	<b>332,500</b>	<b>360,266</b>	<b>451,737</b>

#### AMERICAN JOBS CREATION ACT OF 2004

On October 23, 2007, the IRS issued Notice 2007-89, which suspends the reporting requirements imposed by Internal Revenue Code Section 409A<sup>12</sup> (“§409A”) for amounts deferred during 2007 under a nonqualified deferred compensation plan that has been operated in compliance with the requirements of §409A<sup>13</sup>. This Notice also provides interim guidance on the reporting and withholding requirements for amounts includible in income as a result of a violation of the requirements of §409A.

As previously noted, Notice 2007-89 is intended as interim guidance only. The Notice indicates that the IRS and Treasury Department are currently formulating general guidance with respect to income inclusion requirements, reporting and withholding requirements and other related issues, and comments are requested on all aspects of these requirements. Amalfi Consulting will continue to keep you apprised of any developments as they occur.

Please visit <http://www.irs.gov/pub/irs-drop/n-07-89.pdf> if you would like to obtain a complete copy of Notice 2007-89.

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.

## **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 7 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 7**  
**Example of Stock Option Accounting under FAS 123R**

<b>Accounting for a Stock Option Grant of 10,000 Options</b>	
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.

### **Share-Based vs. Liability-Based Awards**

Because stock options are now treated as an expense under FAS 123R, many have asked if other LTI vehicles are becoming more prevalent. In particular, will cash-based stock appreciation rights (SARs) be used more? SARs, like stock options, track the appreciation in stock price and have an income statement expense impact. If settled in cash, SARs do not require issuance of shares and, therefore, do not result in share dilution. However, SARs settled in cash are considered liability-based awards, and are expensed based on a value that fluctuates over time (i.e., with changes in stock price).

This accounting treatment for cash-based awards is in sharp contrast to the accounting treatment for stock options, which have an expense fixed at the grant-date value under FAS 123R. The expense of an option (or any LTI instrument settled in actual equity shares) is determined on the date of grant and does not fluctuate with stock price. Whereas the expense associated with a stock option is fixed at the time of grant, a SAR has potentially unlimited accounting expense; the SAR is revalued periodically, and the expense eventually equals the full appreciation in the stock price.

In the preceding example (Exhibit 7), we illustrated how a grant of 10,000 stock options would have an income statement impact of \$75,000 over a three-year period. If the 10,000 shares were actually in the form of SARs settled in cash, what would the expense be? Assume that the stock increased 10% per year over each of three years. In that case, the impact to the income statement would be \$99,300 if the SARs are settled after three years, as shown in the exhibit below.

### Exhibit 8

#### Example of Cash-Based Stock Appreciation Right Accounting

Accounting for a Grant of 10,000 Cash Settled SARs	
a. Number of SARs granted	10,000
b. Stock price at date of grant	\$30.00
c. Annual increase in the stock price	10%
d. Stock price at end of year 3	\$39.93
e. Expense over three years (d - b) x a	\$99,300
f. Stock price at end of year 5	\$48.32
g. Total Expense over five years (f - b) x a	\$183,200

Over a three-year period or a five-year period, the grant of 10,000 SARs results in a greater accounting expense than that of an equivalent stock-option grant, assuming 10% annual price appreciation and a typical Black-Scholes valuation as a percentage of stock price. The above exhibit also shows that for each dollar increase in stock price, there is eventually an associated dollar of expense for SARs. However, if the stock price does not increase significantly or decreases, an actual stock option may be more expensive than a SAR. While this is a result of the respective accounting treatment, we suggest that adopting a SAR instead of a stock option for this reason would be a counter-intuitive approach. Projecting little or no increase in stock price for several years is the exact opposite consequence that granting any type of equity is attempting to motivate, and it may indicate that appreciation-based shares are inappropriate.

#### 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 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).

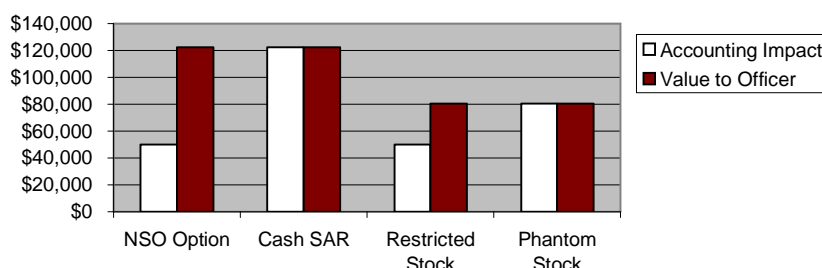
For banks with the ability to grant actual shares, the most efficient approach (assuming stock price increases) will generally consist of making grants settled in actual shares rather than in cash. The table and chart below in Exhibit 9 illustrate the efficiency associated with four types of LTI awards, 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 9 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	NSO Option	Cash SAR	Restricted Stock	Phantom 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 10 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 10 Projected Value of Different 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
<b>Increasing Stock Price Scenario</b>		
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
<b>Decreasing Stock Price Scenario</b>		
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 11 below, banks are clearly using combined grants of appreciation equity and full value equity. In 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 11**  
**CEO Equity Use by Type of Equity**  
**2006 Fiscal Year Analysis<sup>14</sup>**

	Assets	n	Appreciation Equity Only	Full Value Equity Only	Using Both Types of Equity
<b>Median</b>					
<\$250M	147,713	16	50%	19%	31%
\$250M-\$500M	388,138	36	56%	22%	22%
\$500M-\$1B	738,170	91	55%	22%	23%
\$1B-\$5B	2,008,484	119	54%	22%	24%
\$5B-\$15B	8,026,508	45	33%	16%	51%
\$15B-\$50B	31,854,773	15	20%	27%	53%
>\$50B	140,190,842	21	19%	0%	81%
<b>All Banks</b>	<b>1,319,093</b>	<b>343</b>	<b>48%</b>	<b>20%</b>	<b>32%</b>

### 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 12 below shows the overhang, proxy five, and run rates by asset size in public banks. Please note this analysis is for 2005 fiscal year in contrast to 2006 fiscal year. In banks below \$5 billion in assets, each of the three measures is, in general, inversely proportional to asset size. For example, overhang is highest in banks with assets under \$250 million, and lowest in banks between \$1 billion and \$5 billion. This may be due in part to smaller banks relying more heavily on equity compensation during growth years and attempting to give executives a larger ownership stake. The proxy five percentage is lower in large banks in part because large banks often extend eligibility for long-term incentives to more individuals; there are simply more executives in large banks, so the proxy five percentage is lower because of a larger total grant to all employees.

**Exhibit 12**  
**Overhang, Proxy Five Grants & Run Rate**  
**2005 Fiscal Year Analysis<sup>15</sup>**

Data Cut	Median Assets (\$000)	n	Equity as a % of Total Common Shares	Proxy Five Grants as % of Annual Grant	Run Rate - Annual Grant as % of Common Shares
<\$250M	169,898	108	12.7%	58.7%	2.6%
\$250M-\$500M	369,829	167	12.4%	46.0%	1.2%
\$500M-\$1B	709,779	196	10.6%	52.3%	1.0%
\$1B-\$5B	1,838,210	197	10.4%	39.3%	0.9%
\$5B-\$15B	7,751,883	65	11.8%	29.3%	1.0%
\$15B-\$50B	26,952,189	24	10.7%	22.0%	1.0%
>\$50B	107,197,380	22	12.6%	13.2%	0.9%
<b>All Asset Sizes</b>	<b>743,849</b>	<b>779</b>	<b>11.1%</b>	<b>42.5%</b>	<b>1.0%</b>

### 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.
- Disclose the rationale for grants on a given date.
- File Form 4 reports on equity grants promptly with the SEC (within the required two business days). This may require more advance notice of any grant recommendations for Section 16 officers to the person responsible for reporting.
- Document policies and controls associated with determining grant date and price.

## **SUMMARY**

The compensation environment for banks continues to be in a state of change. Examples of the changes include increasing and restructuring of board pay due to governance issues, restructuring of executive pay due to stock option expensing, and refinement of compensation and benefit plans due to the American Jobs Creation Act and as a result of SEC disclosure requirements.

Each bank needs to evaluate how the emerging trends relate to its own circumstances. Some changes, such as those required by the SEC's revision to proxy disclosure for SEC filers and the American Jobs Creation Act, have been mandated; banks need to comply. Other changes, such as increases in board pay or the impact of stock option expensing, allow for a variety of responses. For example, closely held, stable banks with few recruiting or retention issues may have relatively low motivation to change their existing compensation structures. However, the need to review compensation strategies is critical at this time for publicly traded banks, banks that have significantly changed in size or performance, and banks experiencing retention or turnaround issues. All banks need to be aware of the emerging trends and their potential impact.

We believe that a compensation philosophy is the starting point. This statement provides a framework to pay compensation that is both motivating to officers and fair to shareholders. This philosophy guides the design and benchmarking of each compensation element.

Another key to effective compensation is a strong, clear linkage between the performance-based incentive plans and a strategic planning process that defines the bank's direction. Award criteria and incentive-related goals must be aligned with long-term strategic objectives. The best-designed compensation plans will ultimately fail if there is not a sound strategic planning process as a foundation.

Competitive, well-designed compensation plans are critical to a bank's long-term success. Community bank directors and executives need to understand the underlying issues and trends in compensation to make informed decisions; this paper provides an overview to help directors and executives navigate the changing compensation landscape.



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*With a wealth of peer data and a focus of 10 years on the compensation issues of the banking industry, our consultants possess the expertise you need to enhance your total compensation program. We are proven experts in providing compensation planning for banks. Our banking focus means that, no matter how unique your bank's situation may be, we have encountered similar challenges that we can draw upon to develop and implement programs that will help you succeed.*

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## References

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- <sup>1</sup> 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.
- <sup>2</sup> Amalfi Consulting, Proxy study of a matched sample of 274 publicly traded banks conducted with proxy statements for fiscal year 2005 and 2006. Of the 274 banks included in the matched sample, 193 increased board compensation.
- <sup>3</sup> Amalfi Consulting, Proxy study of 366 publicly traded banks conducted with proxy statements for fiscal year 2006.
- <sup>4</sup> Amalfi Consulting, Proxy study of 434 publicly traded banks conducted with proxy statements for fiscal year 2006.
- <sup>5</sup> Amalfi Consulting, Proxy study of 550 publicly traded banks conducted with proxy statements for fiscal year 2005.
- <sup>6</sup> 2006-07 Salary Budget Survey, World-at-Work, [www.worldatwork.org](http://www.worldatwork.org)
- <sup>7</sup> SNL Financial LC, SNL Bank Index and SNL Thrift Index are market indices tracked by [www.snl.com](http://www.snl.com)
- <sup>8</sup> Amalfi Consulting, Proxy study of a matched sample of 600 publicly traded banks utilizing proxy statements showing compensation data for 2004, 2005, and 2006 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.
- <sup>9</sup> Amalfi Consulting, Proxy study of 741 publicly traded banks utilizing proxy statements for fiscal year 2006.
- <sup>10</sup> The 415 plan limitations limit the amount of compensation that can be considered when computing defined benefit amounts.
- <sup>11</sup> Amalfi Consulting, Proxy study of 741 publicly traded banks utilizing proxy statements for fiscal year 2006.
- <sup>12</sup> Final Treasury 409A Regulations, published April 10, 2007. For full text, see <http://www.treas.gov/press/releases/reports/td9321.pdf>.
- <sup>13</sup> The Treasury and the IRS issued Notice 2007-78 on September 10, 2007 and Notice 2007-86 on October 23, 2007 which extend Section 409A's documentary compliance deadline to December 31, 2008.
- <sup>14</sup> Amalfi Consulting, Proxy study of 741 publicly traded banks utilizing proxy statements for fiscal year 2006. Of the 741 banks in the study, 343 granted equity in 2006.
- <sup>15</sup> Amalfi Consulting, Proxy study of 779 publicly traded banks utilizing proxy statements for fiscal year 2005.