McLagan Alert
(Originally published by Amalfi Consulting)

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Today's Compensation Environment – 2010 (9th Edition)

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August 4, 2010

Introduction

This is the 9th edition of Corporate and Consumer Banking Consulting Practice White Paper on current compensation trends in the banking industry. Since beginning this annual publication (originally published by Amalfi Consulting and sponsored by the American Association of Bank Directors) we have focused on specific trends in compensation with a detailed year-over-year analysis. However, with the industry continuing to face challenges on numerous fronts, we also comment on the state of the banking industry, along with the resulting impact on compensation.

Overview

The economic environment continues to be challenging, and the banking industry continues to be troubled. In 2009, 140 banks failed, and through October 1, 2010, 129 banks have also failed. In addition, as of the second quarter of 2010, 829 banks remain on the FDIC's list of troubled institutions. Certain parts of the country are faring better than others, with banks in the Northeast and South Central performing better than those in the West and Southeast. Big banks seem to be rallying and making a comeback. Community banks with assets less than $1 billion continue to struggle. Asset and credit quality as well as capital are top priorities with industry consolidation anticipated as an emerging issue.

Simply stated, safety and soundness is certainly the rule of the day. Legislation and regulations continue to be released that focus on stabilizing and strengthening the banking industry. Initially, TARP participants were the only banks subject to risk assessment requirements and regulatory scrutiny regarding compensation plans. However, this is no longer the case. Legislation or regulations have been released by every banking industry regulatory agency, Congress, and the Securities and Exchange Commission (SEC). It does not matter if you are privately or publicly owned, thinly or publicly traded, a full SEC filer or a smaller reporting company, a TARP participant or not - *the new requirements affect nearly every banking organization in existence today.* Newly released legislation seems focused on preventing the types of compensation packages that were perceived to contribute to the recent economic downturn. And an interesting twist today is that preservation of an organization, and its inherent stability, explicitly supersedes shareholder and executive interests.

The Dodd-Frank Wall Street and Consumer Protection Act was signed into law on July 21, 2010. Guidelines, rules, policies and further instructions are expected to be released over the coming months. This legislation affects compensation matters at all public institutions, public and private financial institutions with assets greater than $1 billion, and residential mortgage banking compensation. The new law extends to organizations under the jurisdiction of the following federal regulators: Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA), Securities and Exchange Commission (SEC), and Federal Housing Finance Agency (FHFA). Some of the key initiatives of this legislation are the non-binding Say-on-Pay, disclosure of the CEO Pay Test and Pay for Performance

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exhibit, mandatory clawbacks, and the independence and authority relative to outside consultants and other advisors. This legislation includes prohibitions on certain types of compensation, further emphasizing the intention to reduce risk and excess. Your regulator now has the authority to prohibit pay practices deemed to be unsafe.

The Final Guidance on Sound Incentive Compensation Policies (SICP) was released on June 21, 2010 jointly by the Federal Reserve Board, FDIC, OCC, and OTS; it became effective on June 25, 2010. Its primary purpose is to assure that the safety and soundness of the United States' financial system is not jeopardized by incentive compensation plans. The guidance is intended to assist banking organizations in designing and implementing incentive compensation arrangements and related policies and procedures that effectively consider and manage potential risks and risk outcomes. This applies to *all* banking institutions using incentive compensation arrangements. It encompasses annual incentives or cash bonus plans as well as long-term incentive plans (which are typically equity-based), employment and change-in-control agreements, and executive benefit plans. The guidance is based on three core principles which state that incentives should: 1) appropriately balance risk and reward; 2) be compatible with effective controls and risk management; and 3) be supported by strong corporate governance.

Each banking institution providing incentive compensation arrangements should begin by taking an inventory of all of its incentive plans. Once the inventory is complete, banks must conduct a risk assessment of each plan to determine if there are potential inherent risks, then make adjustments to balance risk where appropriate, followed by monitoring incentive compensation plans on an ongoing basis, and finally, be prepared to report findings and actions taken to the appropriate regulatory agency. Supervisory reviews of incentive compensation arrangements will be conducted by the regulatory agencies as part of the evaluation of the organization's risk-management, internal controls, and corporate governance during the regular, risk-focused examination process. Results of the review will be included in the relevant report of examination or inspection. In addition, these findings will be incorporated, as appropriate, into the organization's rating component(s) relating to risk management, internal controls, and corporate governance under the relevant supervisory rating system, as well as the organization's overall supervisory rating.

It is important to note that *one size does not fit all* with regard to this guidance. This means that methods for achieving balanced compensation arrangements at one organization may not be effective in restraining incentives from engaging in imprudent risk-taking at another. Each organization is responsible for ensuring that its incentive compensation arrangements are consistent with the safety and soundness of the organization. Furthermore, the guidance offers various methods for potentially balancing compensation plans. It is anticipated that several of these may ultimately become best practices within the industry and include clawbacks, deferral of payouts, longer performance periods, and adjusting awards based on the risk an employee's activities pose to an organization. If you are a TARP participating organization, the principles under this guidance are similar to those imposed under the TARP regulations.

In addition, both Dodd-Frank and SICP raise the expectations for corporate governance by squarely placing responsibility for compensation plans with the Compensation Committee. The Compensation Committee will clearly have additional work this year to ensure compliance with the new regulation and legislation.

As we have stated in prior versions of this annual publication, each banking organization must review and evaluate its compensation philosophies, plans, practices and processes to determine what is applicable and appropriate to the organization.

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The compensation programs must be suitable for the organization's unique business activities, business model, potential inherent risks, and compliant with pertinent rules and regulations.

COMPENSATION TRENDS

EXECUTIVE COMPENSATION

The downward trend in CEO compensation slowed for most banks in 2009. Overall from 2008 to 2009, the year-to-year change in CEO total compensation was 0% in publicly traded banks, which is significant when compared to recent years where increases ranged from -6.8% to 3%. From 2008 to 2009, the change in CEO total compensation ranged from an increase of less than 1% in banks with assets less than $500 million, to a *decrease* of 2.4% in banks with assets ranging from $5 to $15 billion. Banking institutions continued to struggle with the need to balance pay and performance with the desire to attract and retain key talent. Many banks discovered that having the right talent to lead their organizations in these challenging economic times is critical.

Analysis Methodology

The trends discussed in this white paper are based on our analysis of CEO compensation data reported in the fiscal year 2009 proxy statements from 731 publicly traded banking institutions. As part of our study, we utilize a matched-sample approach which tracks compensation changes for the same individual year over year. This results in a clearer understanding of how compensation is changing at an *individual* officer level. Our analysis is summarized based on median values, which reflect the middle or 50th percentile, of each element of compensation. Median values are used rather than averages, as they are less influenced by extremes and outliers. In addition, we include findings from the Amalfi Consulting National Bank Officer Compensation Survey, published in September 2010. This survey includes data reported by 196 public and private banks and thrifts nationwide. The survey covers 86 key executive and officer level positions. The data reported in the survey is effective as of April 1, 2010.

Terminology

This paper examines bank CEO compensation, which is indicative of trends in officer compensation in general. Officer compensation typically consists of five elements: salary, annual incentives (cash bonuses), long term incentives (typically equity-based), benefits (qualified and nonqualified retirement benefits), and perquisites.

The sum of base salary and cash incentives is referred to as "Total Cash Compensation." Total Cash Compensation combined with long-term incentives is referred to as "Total Direct Compensation." "Total Compensation" is the combination of Total Direct Compensation with all other forms of compensation, including benefits and perquisites.

CEO Salary Trends

While salaries increased for CEOs from 2008 to 2009, overall the rate of increase is lower than in the prior year. From 2008 to 2009, the median base salary increase for CEOs was 2.2% across 731 publicly traded banks; from 2007 to 2008, the median salary increase was 4.8%. Salary increases for CEOs at banks with assets greater than $15 billion were the lowest at 0%; the highest increase was seen at banks with assets of $500 million to $1 billion, and $5 to $15 billion. For all banks with assets greater than $500 million, salaries were found to be larger at private banks.

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Exhibit 1 – Public CEO Compensation Median

Asset Size	n	Median Assets ($M)	Salary	Bonus	Total Cash Comp	Equity (Grant Date Value)	Total Direct	Other	Retirement Benefits	Total Comp
All Banks										
<$500M	231	284	196,166	0	202,550	0	207,435	22,237	0	246,550
$500M-$1B	177	693	263,700	0	280,000	0	282,480	27,894	0	366,051
$1B-$5B	226	1,786	367,954	0	401,202	0	433,731	36,858	2,780	552,871
$5B-$15B	60	8,703	639,500	53,129	764,137	257,000	1,085,867	68,116	0	1,342,558
>$15B	37	51,555	915,491	0	1,142,000	2,000,013	3,332,188	93,003	332,734	4,072,939
All Banks	731	869	280,000	0	300,000	0	320,000	29,378	0	399,627
Coast Banks										
<$500M	126	271	199,174	0	200,875	0	204,127	22,332	0	253,759
$500M-$1B	105	690	280,000	0	283,434	0	293,290	28,051	0	390,494
$1B-$5B	116	1,793	375,813	0	411,992	0	486,643	40,773	23,176	633,383
$5B-$15B	23	9,146	691,346	242,551	950,000	296,687	1,218,400	65,261	8,841	1,609,323
>$15B	18	64,574	989,264	0	1,038,650	1,369,758	3,470,344	133,776	719,588	4,054,891
All Banks	388	792	280,000	0	294,895	0	323,574	30,847	0	415,901
Non-Coast Banks										
<$500M	105	294	193,000	0	204,679	0	208,562	21,882	0	240,704
$500M-$1B	72	712	246,455	0	261,982	0	264,350	27,393	0	332,125
$1B-$5B	110	1,786	359,200	0	400,000	0	402,113	31,599	0	481,449
$5B-$15B	37	8,697	623,077	0	734,167	250,000	1,014,000	70,970	0	1,200,775
>$15B	19	51,123	900,000	600	1,264,645	2,347,188	3,332,188	67,674	155,851	4,266,395
All Banks	343	957	275,000	0	306,000	0	315,205	28,228	0	389,053

Source: Amalfi Consulting Proxy Database

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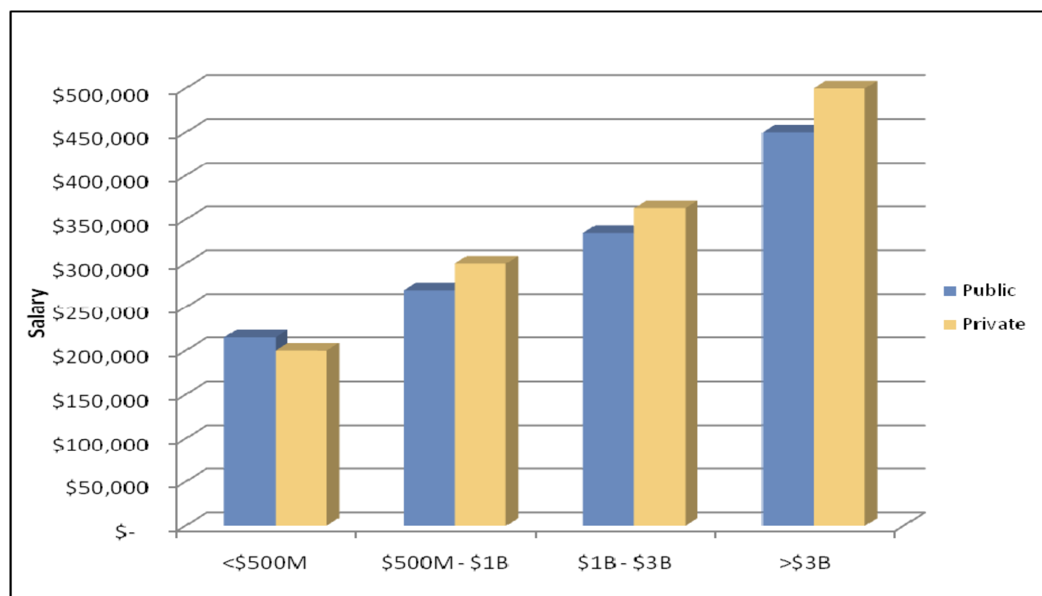
Exhibit 2 – Change in CEO Compensation Median Percent Change – Matched Sample Basis

		Salary		Total Cash		Total Direct		Total Comp	
Asset Size	n	'07 to '08	'08 to '09	'07 to '08	'08 to '09	'07 to '08	'08 to '09	'07 to '08	'08 to '09
<$500M	231	4.5%	2.3%	2.0%	0.3%	2.2%	0.0%	3.0%	0.8%
$500M-$1B	177	5.0%	3.0%	2.1%	1.0%	1.6%	0.0%	1.6%	-0.4%
$1B-$5B	226	5.0%	1.7%	0.0%	0.0%	-2.3%	-0.9%	-1.7%	-0.7%
$5B-$15B	60	5.9%	3.3%	0.7%	1.4%	-7.7%	-4.3%	0.5%	-2.4%
>$15B	37	2.9%	0.0%	-29.4%	0.0%	-12.7%	-2.4%	-6.8%	-1.9%
All Banks	731	4.8%	2.2%	0.9%	0.0%	0.1%	0.0%	0.7%	0.0%

Source: Amalfi Consulting Proxy Database

Exhibit 3 – CEO Median Salary Public vs. Private



Source: Amalfi Consulting 2010 National Bank Officer Compensation Survey

Annual Incentive Trends

In 2009, annual incentives were a rarity for CEOs of public banks with 61% receiving no cash bonus payout. This was the third consecutive year of declining bonuses, and 2009 had the largest percentage of CEOs without a payout. For other senior executives, 63% in private banks and 50% in public banks received cash bonus payouts. These trends applied to all banks and were not simply a factor of TARP participation. Bonus payouts differed by regions, with the Northeast and South Central sections of the country faring much better. The Southeast and Western regions were hardest hit and continue to struggle with recovery.

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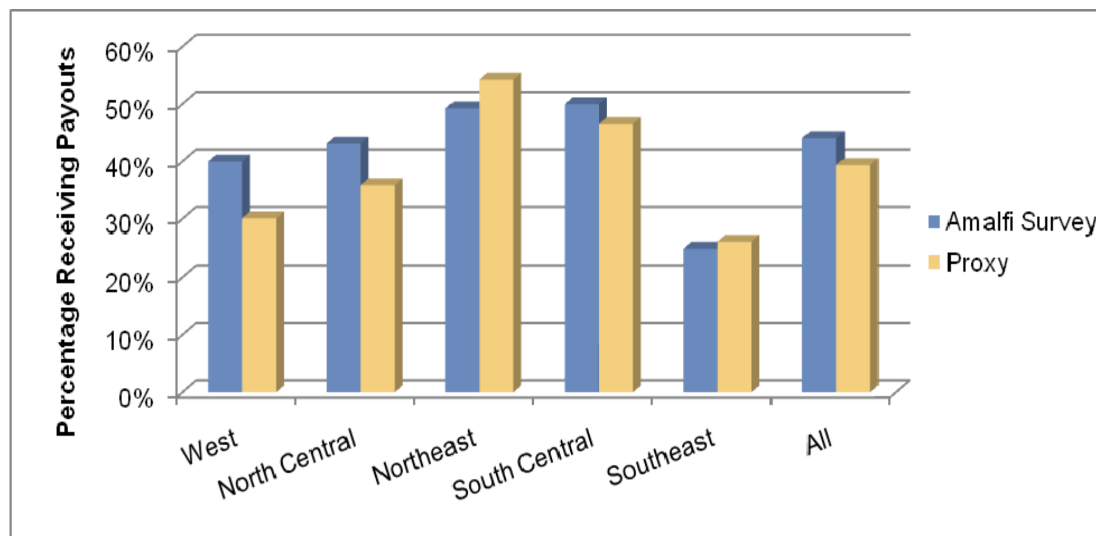
Exhibit 4 – CEO Bonus

Asset Size	n	CEO Bonus as % of Salary (median) 2009	Prevalence of CEOs Receiving No Bonus 2009
<$500M	231	0%	59%
$500M-$1B	177	0%	66%
$1B-$5B	226	0%	62%
$5B-$15B	60	9%	45%
>$15B	37	0%	59%
All Banks	731	0%	61%

Source: Amalfi Consulting Proxy Database

Exhibit 5 – Percentage of CEOs Receiving Bonus Payouts by Region



Source: Amalfi Consulting Proxy Database & Amalfi Consulting 2010 National Bank Officer Compensation Survey

Long–Term Incentive Trends

Equity has always been a key component of executive compensation, particularly in publicly traded and larger institutions. However, in 2009, median CEO total direct compensation in 731 public banks was unchanged over the prior year. Total direct compensation for the CEOs in public banks with assets of $1 to $5 billion was reported to be down nearly 1%; in banks with assets of $5 to $15 billion, it was down 4.3%; and in banks with assets greater than $15 billion, it was down 2.4%. In these public banks, the median percent change in CEO salaries was an increase of 2.2%; cash bonuses were unchanged, and equity grants were down with an aggregate result of no change in CEO total direct compensation year-over-year. For all banks with assets greater than $500 million, CEO salaries and total direct compensation is higher at private over publicly traded banks.

Equity has historically been granted on a more discretionary than formulaic basis. While this trend continues, it is more prevalent in banks with assets less than $500 million, and decreases as an organization's asset size increases. Furthermore, once banks reach $500 million in assets, the prevalence of equity plans with both

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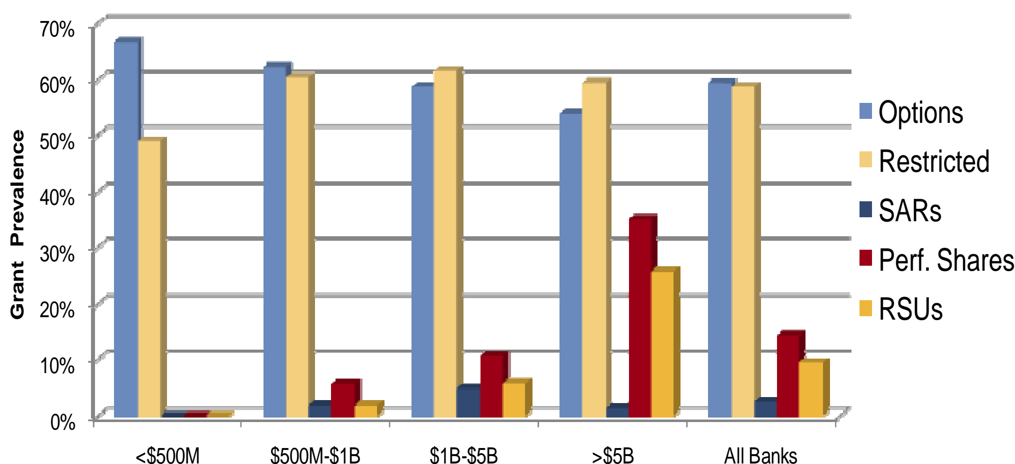
performance-based grants and discretionary components increases, with the highest prevalence of this combined approach in banks with assets of $5 to $15 billion. We expect to see more banks make equity a part of their formalized performance-based plans in response to regulatory guidance and TARP. On the other hand, annual incentive plans continue to be more formalized than equity or long-term incentives, reflected in the decreased prevalence of "discretionary plans only" as asset sizes reach $500 million and more.

Stock options and restricted stock continue to be the most common types of equity granted in today's environment. 2009 was the first time that full value equity (e.g., restricted stock) grants exceeded appreciation-based grants (e.g., stock options) for CEOs. The larger the bank's asset size, the greater the full value equity being granted. This shift to restricted stock is the result of a number of extenuating circumstances, some of which include: TARP restrictions, declining stock prices, insufficient authorized available shares, and a reaction to the number of underwater options and their corresponding expense to the bottom line. In addition, in the absence of cash bonuses, it is a greater challenge for an executive to come up with the cash necessary to exercise stock options. Another driving force has been the desire of boards of directors to make grants that will provide a retention feature; this is an area where underwater options have failed.

Exhibit 6 – CEO Grant Prevalence by Type
For CEOs Receiving Equity



Source: Amalfi Consulting Proxy Database

There is a distinct correlation between a bank's asset size and the frequency of equity grants. The larger the asset size, the more frequently a bank grants equity to its CEO. It continues to be critical to evaluate and benchmark equity grants over a multi-year period rather than a single year as a result of unusual occurrences, such as: equity granted for signing bonuses; cycles of poor performance and no resulting grants; years in which there are no shares available to grant; or the lack of an approved plan in place. Using multi-year periods, such as three years, help to smooth over any such anomalies.

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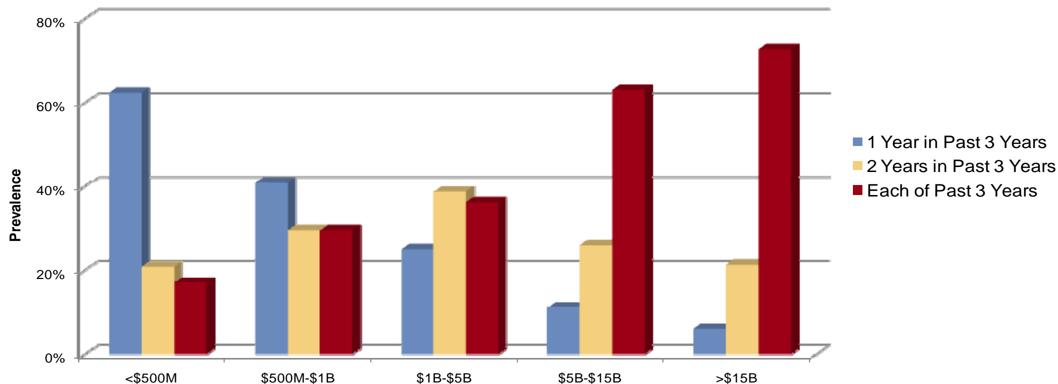
Exhibit 7 – CEO Equity Grant Frequency
Percent of CEOs Receiving Equity



Source: Amalfi Consulting Proxy Database

The use of incentive plan performance metrics continues to evolve in the current environment. Adoption of quality measures has increased since 2008 and is expected to rise as banks respond to recent regulatory and legislative changes. The application of asset and credit quality metrics brings balance to incentive plan arrangements. The median number of annual incentive plan performance measures increased from three in 2009 to four in 2010. The top four annual incentive plan performance metrics for 2010 are various measures of profitability (e.g., net income, earnings), (core) deposit growth, loan growth, and asset or credit quality. The top long-term incentive plan performance metrics for 2010 are profitability, asset or credit quality, and deposit growth.

Board of Director Compensation Trends

While there has been a significant increase in director and board responsibility, director compensation continues to be static overall. Banks that have implemented salary freezes and been unable to pay executive incentives have been hesitant to increase director compensation in spite of the increased workload, liability and responsibility.

Overall in 2009, director cash compensation increased 0.6% at the median across all banks. One-third of banks reported an increase in cash compensation levels from 2008 to 2009, and 27% reported a decreased cash compensation level over the same period. Fewer banks reported increased cash compensation, and more reported decreased cash compensation levels from 2008 to 2009. The larger banks, those with assets greater than $15 billion, reported the largest increase in director cash compensation.

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Exhibit 8 –Board of Director Compensation

Assets	Total Board Comp ($)
<$500M	16,319
$500M-$1B	24,518
$1B-$5B	35,739
$5B-$15B	69,882
>$15B	123,137
All Banks	27,804

Source: Amalfi Consulting Proxy Database

Exhibit 9 – Change in Director Compensation
Median Percent Change – Matched Sample Basis

		Median Change In Cash Fees		% of Banks Increasing Cash Fees		% of Banks Decreasing Cash Fees	
Asset Size	n	'07 to '08	'08 to '09	'07 to '08	'08 to '09	'07 to '08	'08 to '09
<$500M	73	2.5%	0.8%	47%	29%	21%	23%
$500M-$1B	77	5.0%	-1.3%	51%	31%	13%	34%
$1B-$5B	97	5.5%	0.0%	52%	33%	13%	29%
$5B-$15B	25	2.5%	1.3%	44%	36%	16%	20%
>$15B	21	5.9%	4.3%	52%	48%	14%	14%
All Banks	293	4.6%	0.6%	49%	33%	15%	27%

Source: Amalfi Consulting Proxy Database

As reported in Amalfi Consulting's flash survey conducted July 2010, 65% of banks did not make material changes to director compensation; and 25% have increased and 10% have decreased director compensation. The predominant categories of banks making increases include non-TARP participants, banks with less than $1 billion in assets, and mutual or private organizations. Those banks making general increases in director or chairperson compensation have used cash more frequently than equity. In addition, more banks increased annual retainers and meeting attendance fees than other elements of compensation. For board committees, there generally have been no material changes overall except for moderate increases in meeting fees for audit and compensation committees. Director compensation is expected to increase once profitability returns to the sector and the economy recovers.

The rate of change in the banking industry has been stunning, and compensation is no exception. Adapting to the increased demands of new legislation and regulations in such a challenging environment will require the thoughtful, informed, and fact-based attention by compensation committees and risk officers. ■

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McLagan, an Aon Hewitt company, is the premier compensation consulting and performance benchmarking firm focused exclusively on the financial services sector. Its proprietary surveys are the gold standard for compensation and performance data for banks. With 5 locations in the US, and 6 outside the US located in the major money centers, it is a global resource servicing banks of all sizes from the world's largest corporate and consumer banks to regional and small community banks as well.

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