**Stybel Peabody Associates, Inc.**

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**Seat at the Table**

**A Case Study:**

**Does boosting stock as a percentage of CEO**

**compensation align the CEO’s interests with**

**traders or investors? A look at bank**

**Compensation Committees and their CEOs.**

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## Purpose of Long-term Incentive Plans

The Compensation Committee of HometownBank (the Bank) is studying the merits of increasing future stock awards to the CEO as part of a long-term incentive plan (LTIP) in 2015.

The Great Financial Recession required Hometown Bank to correct asset quality, work-out problem loans and manage a shrinking Net Interest Margin during the lowest interest rate environment in 66 years.  Additionally, the Bank’s capital is low relative to new Dodd-Frank regulatory requirements, imposing higher TIER I capital with less business risk by imposing lower loan-to-deposit leveraging with increasing regulatory compliance costs.

Hometown Bank’s 2015–2017 Business Mission is to increase profitability, improve capital and drive up future book value to enhance shareholder worth while maintaining a Safe & Sound franchise.

The purpose of the current LTIP design is to generate awards for key management and Board members commensurate with the increase in the Bank’s profitability, shareholder value and future tangible book value, which is effectively the Bank’s capital (tangible assets minus liability). Ultimately, the Bank’s strategic valuation will be expressed as a multiple of book value.

The general purpose of any LTIP is to attract and retain key management personnel, to motivate the participants in the LTIP to accomplish critical long-term objectives and finally to reward the participants for their accomplishments. Additionally, a LTIP may be a part of the compensation program for outside Board members.

An executive LTIP can help balance the risks associated with short-term incentive plans by putting focus on rewards for achieving multiple fiscal year goals. A Board LTIP will help the members focus on long range governance issues and policy decisions.

The LTIP bridges the gap between annual management short-term bonus awards and future equity payouts and the gap between annual Board fees and the Board retirement plan.

LTIP awards can be made to middle and lower level management and key contributors without the highly compensated minimum imposed by the IRS for SERP participant eligibility and can eliminate the need for a significant number of new SERPS. Awards to Board members are typically event triggered. Examples of such events include: the initial implementation of the LTIP, appointment of a new Board member, vesting of an award,

or following a merger.

## Compensation Issue for Discussion: Should the CEO’s Stock Awards Be Increased?

A Peer Group of 15 banks for Hometown Bank was developed by examining proxy disclosures for banks in the region up to two times asset size and as small as .75 asset size with similar business complexity. This conforms with shareholder watchdog guidance issued by Institutional Shareholder Services (ISS).

The base salary and short-term bonus for the CEO at Hometown Bank is at the median of the Peer Group; benefits, contracts and perks are competitive with the Peer Group.

A comparison of CEO pay-mix is shown in the following chart.

|  |  |  |
| --- | --- | --- |
| **Pay Mix** | **Peer Group CEO**  | **Hometown Bank CEO**  |
| **Base Salary** | **62%** | **70%** |
| **Short-term Incentive Bonus** | **20%** | **19%** |
| **Long-term Incentive Stock** | **18%** | **11%** |
| **Total** | **100%** | **100%** |

## LTIP Questions & Answers

1. **Do stock awards provide an effective risk management tool?**

Dodd-Frank and post-2007 recession regulations require Banks to re-examine and modify incentive risk metrics and payouts to achieve the proper balance between pay-for-performance and prudent risk management. Regulators have expressed displeasure with excessive upside leverage in short-term incentive plans, but favor long-term incentives which help balance both short and longer term business objectives.

Generally, responsiveness of incentive payouts often varies based on the specific measure or metric. Stock awards can focus a CEO and management on long-term metrics such as increasing ROE, Efficiency Ratio, Bank franchise value, and stock value or book value while being cognizant of meaningful risk control.

The Peer Group’s written compensation philosophy provides parameters for the Board’s policy for the desired amount of overall leverage within the incentive plan arrangements. Stock awards are part of every Peer Group bank’s total compensation program. That said, base salary competitiveness continues to be a major percentage of direct cash which is typical for community banks.

1. **What percentage of profits should be shared with management through incentives?**

Banks generally develop a policy to share profits with management and with the capital account (shareholders).

The Peer Group demonstrates that both short-term incentive bonus and long-term stock awards represent an annual pool of 6% to 25% of each bank’s Core Earnings with a 14% median. Stock award accruals are approximately 30% of the total incentive pool.

1. **Who are the intended participants in the LTIP?**

A review of the Bank’s Peer Group shows that it is usual for the CEO and key executives reporting to the CEO to participate in a LTIP. Additionally, there is a clear trend to include other key contributors and management. Board members may participate.

The Peer Group demonstrates all CEO’s participate in stock awards.

1. **Is the intent to make LTIP grants and awards on an annual basis, or other basis such as front load?**

An annual award process for executives enables grants and awards to track with Bank performance. Periodic awards are more common for Board members.

Equity awards (stock and options) can be one-time or periodic but do increase shareholder dilution.

LTIP phantom shares track Bank tangible book value, which is a common measure of community bank strategic value and is consistent with strategic future value.

A larger one-time front loaded award is typical to reflect a significant executive or Board event or success.

The Peer Group demonstrates CEO one-time front loaded stock awards supplemented by periodic stock awards. LTIP phantom shares tracking book value show annual Peer Group prevalence.

1. **How should LTIP grants or awards be determined? Past performance? Salary relationship? Other?**

In order for a LTIP to be effective, annual allocation to executives should be based on meeting the Bank’s strategic performance objectives with consideration given to the participant’s role. Targeting a percentage of

executive base salary is the common award methodology. Additionally, the Executive awards should be made similar to the peer group, including direct cash-to-equity pay-mix.

The Peer Group demonstrates CEO stock awards ranging in compensation value of 3 to 10 times annual base salary, with base salary positioned at median.

1. **Should LTIP grants and awards be time vested, performance vested, or immediately vested?**

In addition to using Bank performance to allocate grants or awards, Bank performance can be used to vest (own) awards. If the agreed-to future performance is met, the awards are granted. If the agreed-to future performance is not met, grants or awards can be reduced or forfeited. Performance vesting is complicated and can be perceived as a take-away.

The most common approach is to allocate awards based on achieving annual objectives with simple vesting (ownership) over a three year (or more ) period for each annual grant.

1. **What is the desired value relationship between the annual Short-term Incentive Plan and the LTIP?**

A contemporary design will set the intended value of the LTIP equal to or somewhat above or below the annual incentive plan award opportunity and will be expressed as a percentage of annual base salary (e.g., 0% to 30%) for Senior Executives and lesser percentages for other key contributors. The balance between incentivizing short-term and long-term risk taking is key. Sometimes community banks reduce the short-term incentive opportunity percentage range if a very significant LTIP award is considered.

Board fees and LTIP awards can be balanced over time to achieve a desired pay-mix and risk control.

The Peer Group shows LTIP awards potential value is 70% to 115% of median CEO short-term bonus of 25% of base salary.

1. **What types of LTIP stock awards should be made?**

Historically, stock options exceeded the awards of restricted stock; both dilute current shareholders’ interests. Approximately three stock options must be awarded to equal one share of restricted stock.

The financial recession of 2007 changed shareholder outlook on stock options, which became criticized as mere lottery tickets. The WSJ and other financial publications opined that restricted stock is the preferred award to make an executive a stakeholder.

The executive’s personal tax consequence of options is favorable compared to restricted stock.

The Peer Group demonstrates that 60% of equity based awards are restricted stock with 3 year vesting and 40% are options. Phantom stock appreciation awards are utilized based on non-equity awards that pay out appreciating Bank book value.

1. **What about accrual liability?**

Bank annual GAP accrual liability must be taken into consideration when awarding LTIP stock, options and phantom appreciation shares. Accrual liability is expensed and then extinguished when an award vests and is paid out. Only stock value or estimated appreciation (if any) is expensed and the liability is reversed on the Bank’s books when an award is paid out. A contemporary design will model alternative LTIP award future accrual expense and compensation value.

The Peer Group shows a strong prevalence for CEO restricted stock awards as opposed to options.

## LTIP Design Overview

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| --- | --- | --- |
| **PROs** |  | **CONs** |
| * Simple to design and administer
* Easy to understand
* Based on one easily measured metric
* Proxy for rewarding Bank franchise value
* Additional compensation
* Retention and Attraction tool
* Reduces need for SERPS
* Bank can compete for management and board talent against stock banks and mutual banks
* Facilitates mergers
 |  | * May not address all critical strategic issues
* Somewhat mechanical approach
* Single metric may not be entirely appropriate
* May not focus participant efforts appropriately at all times
* New compensation expense
* May be a limited retention tool only
* May require rebalancing or reducing other pay programs
* May result in no future value if Bank does not grow
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