



PRESIDIO PAY ADVISORS, INC.

## Improving Bank Compensation Practices

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Bank compensation practices are receiving significant scrutiny and criticism lately. The combination of taxpayer-funded bailouts and significant bonuses paid to executives at failed banks has proven highly unpopular. Beyond the obvious problems with compensation practices at certain institutions (e.g., Merrill Lynch), much of the criticisms are warranted. A recent Presidio Pay Advisors study of executive pay and performance among 115 banks participating in TARP found that changes in pay from 2006 to 2008 had no relationship with changes in financial performance over this period, notwithstanding banks' claims that they pay for performance.

Moreover, many of the compensation plans relied upon by banks encourage excessive risk-taking and a focus on short-term results. While the restrictions imposed by the American Recovery and Reinvestment Act ban virtually all executive incentives at banks receiving TARP investments, this is a heavy-handed political response, and does not create a lasting foundation for improving compensation program design. We offer the following observations and suggestions as a basis for more viable and sustainable changes in program design.


### Annual Incentives

Bank loans either perform, or fail to perform, over a multi-year period of time. It typically takes several years for loans to season and for banks to be reasonably able to estimate performance over their full terms. Most banks' annual incentive plans emphasize performance measures like earnings per share, return on equity, or net income. These measures in large part reflect loan performance. Goals or targets are set each year and bonuses should be paid based on performance relative to each year's goals. There is a disconnect between the period of time used to determine annual incentives and the period of time used to determine loan performance. This creates incentives for executives to generate loans that appear profitable in the near term, even though their longer term performance may be poor.

Short of outright fraud or material misstatements, it is very difficult for banks to recover bonuses after payment, even when subsequent loan performance results in poor profitability or losses. One solution to this problem is for banks to mandatorily defer annual incentives into a pool and only pay out a portion each year. If subsequent performance is poor, (e.g., subprime loans are written-off at significant losses), executives would earn maluses (negative bonuses) that would be taken out of the deferred bonus pool.

Under this structure, if company performance remains relatively consistent or improves over time, then bonuses initially earned will be ultimately paid out in full. Erratic or highly volatile company performance will generate maluses in bad years and reduce or eliminate bonuses previously accrued in good years. This creates incentives for senior management to try to generate consistent results over time and to avoid unnecessary or excessive risks. It also aligns executive interests with shareholder interests, since executives would incur losses from poor longer-term performance, just as shareholders would.

A second area for improvement is with the selection of performance measures used to determine annual incentive payments. Earnings and return on equity can be increased by increasing financial leverage. Ramping up leverage is fairly easy for banks, since they can grow deposits to fund assets without necessarily increasing equity. Excessive leverage has proven to be the downfall of many financial companies, and incentive plans should not encourage this. Return on assets is a better measure of operating performance, since it cannot be "juiced" by increasing leverage.



Many banks are now under pressure to increase their common equity and their ability to absorb loan losses. An explicit emphasis on maintaining adequate equity capital would further strengthen incentive plans. Regulators focus on Tier 1 capital and tangible common equity levels as key measures of capital adequacy. For example, banks need to have Tier 1 Risk-Based Capital ratios equal to or greater than 6 percent to be considered “Well-Capitalized” by the FDIC. Incentives initially earned based on profits could be increased for higher Tier 1 capital ratios or reduced/eliminated for lower ratios. This would incent management to maximize profits, constrained by maintaining adequate equity capital and acceptable leverage levels.

### Long-Term Incentives

One problem with long-term incentives is the common practice of increasing the number of shares granted to offset stock price decreases and maintain constant grant values. Maintaining a targeted grant value is contrary to paying for performance. The value of annual grants should drop if stock prices fall. Grant guidelines based on a targeted number of shares rather than value would improve the relationship between pay and performance.

Another problem is an over-reliance on stock options, which have been and remain the long-term incentive of choice for most banks. There is a greatly underappreciated problem with options: they provide executives with upside opportunity for gain without a corresponding risk of loss. Executives incur no out-of-pocket costs for options they are granted and are not forced to exercise underwater options. This asymmetry between potential gains without offsetting potential losses encourages high-risk lending practices that may increase stock prices in the near term, even if unprofitable long-term.<sup>1</sup>

As a result, direct stock ownership is a better equity-based incentive. Executives holding company stock suffer losses when stock prices decline, creating a much stronger link with other shareholders’ interests. Stock holdings can be increased via grants of restricted stock rather than options, preferably with long vesting periods. Executives can also be required to hold all shares of stock they receive from either option exercises or restricted stock through retirement. This will increase their need to focus on the long-term implications of their decisions.

### Conclusion

Based on proxy statements filed in 2009, most banks’ Compensation Committees say their compensation programs are fine and no changes are needed. We believe this is a short-sighted and counter-productive response and increases the odds regulators or politicians will further set the rules for bank compensation. Thoughtful Boards of Directors should get ahead of this issue and redesign their compensation programs rather than having it done for them.

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<sup>1</sup> See “Trouble With Options” available for download at [www.presidiopay.com](http://www.presidiopay.com).





## About Presidio Pay Advisors

### Total Compensation Solutions

**Presidio Pay Advisors provides companies and their Boards of Directors with independent compensation consulting services for executives, broad-based employees, sales forces and specialty business units. Our firm combines years of traditional consulting experience with practical knowledge and close working relationships, providing clients with valuable insight into a broad range of compensation issues.**

### Independence

We believe that independence is critical to ensuring the integrity and objectivity of our work. In fact, we feel our distinct advantage is that we do not provide ancillary services such as benefits and retirement consulting. Presidio Pay's diverse background combined with a sharp focus on compensation consulting makes our firm a popular choice with companies looking for thoughtful, practical advice who are underserved or overwhelmed by larger, one-stop consulting firms selling multiple services and products. Presidio Pay is a truly independent compensation consulting firm.

### Our Approach

Every engagement is viewed as a strategic collaboration with our clients, whether it is with members of the Board of Directors, who have a fiduciary responsibility linked to project outcomes, or an internal HR team, whose job success depends on project implementation.

Drawing from experience that goes beyond that of a typical consulting firm to real-world businesses, our consultants bring technical expertise and practical application together in every engagement. Our consultants are required to be proficient in linking all elements of total rewards programs to business strategy and results, working within a wide variety of industries. This allows Presidio Pay to introduce innovations that distinguish our clients from their competitors.

Although our consulting engagements are focused on all matters related to compensation issues, our collective expertise is comprehensive, encompassing the diverse array of human resources, finance, tax, accounting, regulatory and shareholder perspectives.

### Hands-On Management

Our clients appreciate that a founding principal serves as the project manager on every project, providing direct access to the most senior individual at Presidio Pay. In addition, our principals participate in the analysis, design, and implementation phase of each engagement. And while members of our team have various strengths and contribute accordingly to project deliverables, the same principal will at all times have an intimate working knowledge of the engagement.

### Our Services

Our core services provide strategic compensation advice to the Board of Directors, senior management and the human resources team. We assist with the competitive assessment, design, implementation and communication of:

- Total Compensation Strategy
- Base Salaries and Salary Structures
- Annual Cash Incentives
- Sales Force Incentives
- Long-Term Equity and Cash Incentives
- Pre-IPO Equity Allocation
- Severance and Change-of-Control Agreements
- Career Paths and Global Leveling
- Ownership Transfer

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