

Western Independent Bankers Association



Annual Conference

Scottsdale, Arizona

The Compensation Conundrum

Directors Program

March 22, 2006

Today's Program

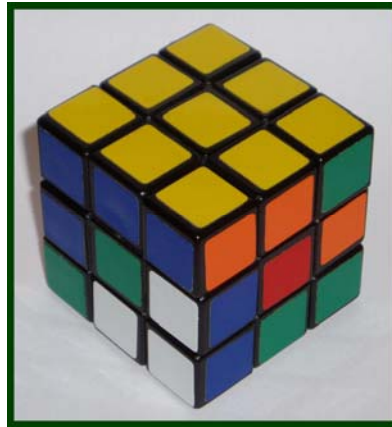
- *Charles J Thayer, Chartwell Capital Ltd.*
 - *Compensation Policy & Bank Objectives*
 - *Role of the Compensation Committee*
 - *Plan Design: Performance Considerations*
 - *Example Plan: Focus on Restricted Stock*

- *Patrick J Rusnak, Western Sierra Bancorp*
 - *"Options" for Equity Compensation*
 - *Expensing Stock Options*
 - *Restricted Stock Programs*
 - *Proposed SEC Disclosure*

Compensation Policy

- *No Other Issue has such a Profound Personal Impact on Your CEO and Every Employee.*
- One of Your Board's Most Challenging Governance Issues.
- Must Address a Wide Array of Complex Questions.
- New SEC Rules Require Everything to be Disclosed!
- More Negative Publicity on the Horizon?

***Your Compensation Committee
Faces Very Complex Issues***



**Your Committee's Challenge is to Make Certain that
All Elements of Your Compensation Program
Fit Together into a Balanced Plan that Works as a Whole**

Add it All Up – Avoid Surprises!

Your Compensation Philosophy? Linkage to Performance?

- **Shareholder Performance Expectations?**
 - Earnings per Share?
 - Return on Equity?
 - Dividends?
 - Other Expectations?

- **Executive Compensation: Plan Design?**
 - Base Pay?
 - Annual Incentives?
 - Long Term Incentives?
 - Retirement Programs?
 - Perquisites?

- **Executive & Employee Expectations/Perception?**

- **New SEC Proxy Disclosure & Shareholder Perception?**

Performance vs. Entitlement?

- **CEO Compensation**
 - CEO Pay vs. Corp Performance? Peer Group?
 - “Peer” Performance is a “C” – Not an “A”
- **Compensation Package?**
 - Base Pay? (Entitlement?)
 - Annual Incentive: (Cash – Link to Performance?)
 - Long Term Incentive: (Stock – Link to Performance?)
 - Retirement & Supplemental Plans (Entitlement?)
 - Perquisites?
- **Other Senior Executives**
 - Division of Authority Between Committee & CEO?
 - Plan’s Linkage to Corporate Performance?
 - Plan’s Linkage to Individual Performance?
- **Ownership Objectives?**
 - Restricted Stock, Stock Options, etc?
 - Cash Investment & Ownership Expectations?

Develop a Philosophical Framework

- ***NACD Blue Ribbon Commission on Executive Compensation (2003) Recommends the Following Fundamental Principles for Compensation Committees:***
 - ***Independence***
 - ***Fairness (Tested both Internally & Externally)***
 - ***Linkage to Performance***
 - ***Long-Term Value for Shareholders***
 - ***Transparency – Full & Clear Disclosure***

Sample Compensation Philosophy

- ***The bank's executive compensation philosophy is designed to:***
 - ***reward steady improvement in operational performance, thereby constantly improving shareholder value and;***
 - ***to attract, retain, and to motivate a highly qualified executive management team which is essential to the bank's long-term success.***
- ***The board of directors believes these objectives can best be obtained by linking executive compensation to the achievement of both annual and long-term financial goals and to stock ownership and stock price appreciation. To meet these objectives the bank's executive compensation plans consists of base salary and two incentive plans linked to the bank's financial performance:***
 - ***Annual Cash Incentive***
 - ***Long-Term Restricted Stock Incentive***

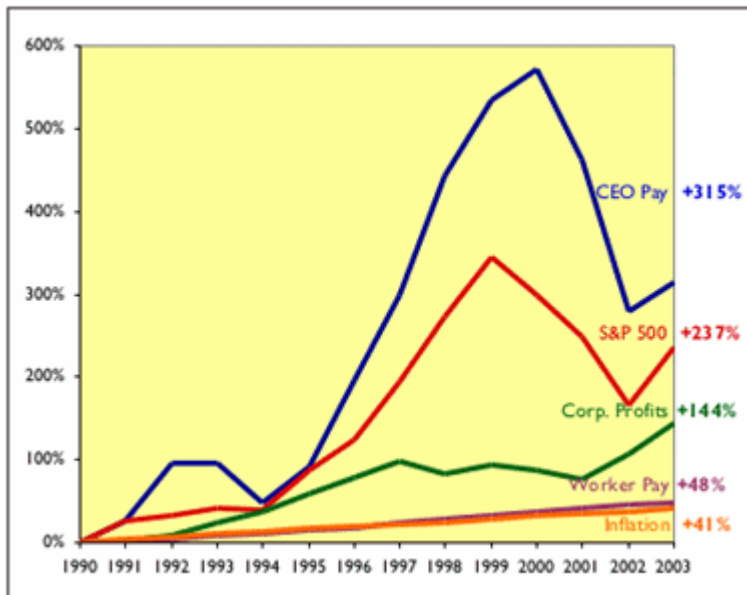
Compensation Consultants

Board Member Feedback: Frustration & Criticism

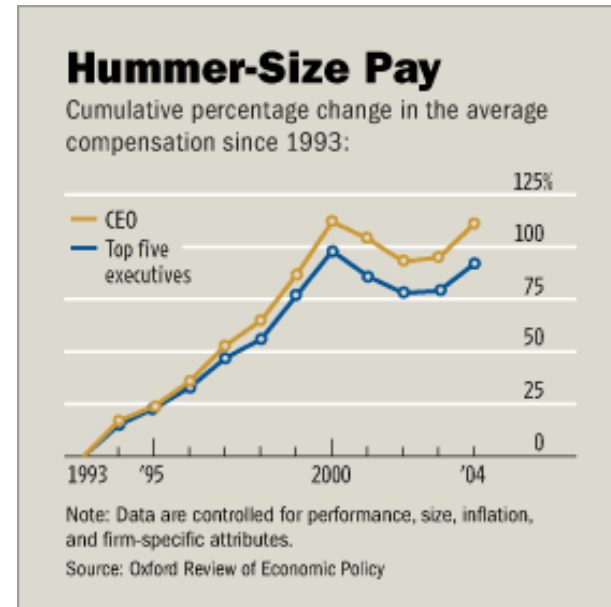
- **Pre-Packaged 'Flavor of the Day' Programs**
- **Limited Discussion & Analysis of Your Objectives**
- **Focus on "Peer" \$ Amounts**
 - **'Top-Quartile' Bias – "Lake Wobegon" Effect**
 - **Pay Linked to Size of Organization**
 - **Limited Linkage to Performance**
- **Focus on "Workarounds" & Supplemental Plans**
- **Vested Interest in Product Sales**
 - **"All Roads Lead to BOLI"**

Public Perception: The "Lake Wobegon" Effect

"Mythical Place Where Every CEO is Top Quartile!"



Business Week: Annual Executive Pay Surveys.



Wall Street Journal: 1.2006

Following the Crowd: Not the “Right Thing”

A Board Member’s Viewpoint

“In my view the executive compensation conundrum hasn't changed in twenty years. The compensation committee brings ‘objectivity’ to their process by commissioning a compensation survey. The survey discloses an array of compensation valuations ordered in percentiles.

The arguments are made that (1) if you pay below the median your executives will not perform or will leave; and/or (2) we are or aspire to be a top tier company so we have to pay top tier compensation. Committees and boards then award compensation above the old median.

Each subsequent year this is repeated. The escalation has in mathematical terms been geometric. If that chain can't be broken the pervasive gross inequality is going to have serious political and social consequences.”

Board Member: Top 20 Bank

The Other Side of the Coin

All Executive Compensation Isn't Excessive!

- **Compensation "Envy":** *"He/She makes more than I do!"*

It may be difficult for certain board members to understand why they should pay someone else more than they earn. Personal comparisons have no relationship to performance based compensation.

- **Need to Recruit:** *"Let's just promote Bob or Sue."*

Do you need to recruit an outsider to fill an important executive position? Are you willing to pay a competitive rate for a new executive; or, do you settle for "Second Best" and shortchange your shareholders?

- **Sales Incentives:** *"I didn't realize he/she could make so much!"*

High payouts to commission based sales people can create executive and board member backlash. Make certain you (1) understand such plans in advance and (2) your company profits from the compensation relationship.

Don't Overreact to Negative Publicity!

The Other Side of the Coin

Compensation Committees Share the Blame

- **Failure to Design Comprehensive Plans:**

Chinese Proverb: "If you don't know your destination any road will take you there!" CEO's and their boards need to agree on the "destination".

- **Focus on "One-Issue-at-a-Time":**

The "can't see the forest for the trees" problem. Addressing one issue results in disjointed programs that frequently lead to unintended consequences.

- **Failure to Ask Questions:**

Your compensation advisors work for you – ask questions until you understand the consequences of your decisions.

**Your Job is to Seek the "Right" Balance for Your Bank
It's Not an Easy Job!**

Compensation Committee's Challenge

"Navigating" Lake Wobegon "Your Destination"

- **Avoid Board/Management Conflict**
 - **Where Are You Today – Where Do You Want To Go?**
 - **Incentive Plans Linked to Strategic Plan Targets**
 - **Strategic Plan Prepared by Management**
 - **Strategy & Targets Approved by the Board**
 - **Essential to Agree on Your Bank's Destination**
 - **Link Incentive Compensation to Strategic Targets**

- **Design Compensation Plans that Balance:**
 - **Your Shareholders Performance Expectations**
 - **Management's Compensation Expectations**

**No "Right Answer" for Every Bank
Each Bank is a Unique Blend of Talent & Personality**

Compensation Committee's Challenge

"Navigating" Lake Wobegon "Your Crew Members"

- **Compensation Consultant**
 - **Helps You Design Appropriate Compensation Plans: Required to Recruit, Retain, Motivate & Reward a Quality Management Team.**

- **CPA Firm**
 - **Helps You Avoid Financial Surprises: Understand the Total Cost (Income Statement, Cash Flow, Tax & Proxy) of Every Plan Before Your Vote to Approve.**

- **Law Firm**
 - **Helps You Design Plans that Avoid Regulatory and Legal Surprises: SEC, IRS and Employment Issues are Increasingly Complex!**

Professional Guidance is Essential: Every Bank has Unique Considerations and You Should Consult with Your Bank's Advisors Prior to Making any Decisions Based on This Presentation.

Executive Compensation

Plan Design Philosophy

Establish Your Bank's Philosophy

&

Understand Your Consultant's Bias

Chartwell Philosophy

Executive Compensation Bias

- **Performance Based Plans – Establish Clear Objectives**
- **Keep Plans Simple**
 - **Plans Need to be ‘Top of Mind’ to be Effective**
 - **Able to Explain to their Spouse without Notes**
- **Reasonable Goals – Don’t Reward Excessive Risk**
 - **Focus on ‘Directional Improvement’**
- **Top Executives Sink or Swim Together (Identical Goals/Plan)**
 - **Focus on Corporate Teamwork Not Intramural Competition**
- **Mix of Cash & Stock Ownership (Cash to Pay Tax)**
- **Based on GAAP Financial Data – CPA Verification**

Chartwell Philosophy

Plan Design Bias

- **Base Pay: 50th to 75th Percentile – Not Top Quartile**
 - **Incentives Provide Upside Potential**
- **Annual Incentive: 50th to 75th Percentile (Performance Based)**
 - **Bias Toward Corporate Performance**
 - **Bias Toward Cash**
- **Long Term Incentive: 50th to 75th Percentile (Initial Value)**
 - **Bias Toward Stock Ownership**
 - **Restricted Stock Rather than Options**
 - **Vesting Linked to Corporate Performance – Not Time**
 - **Weighted Toward Financial Goals**
 - **Based on Number of Shares – Not \$ Amount**
 - **Upside Potential With Increase in Stock Value**
- **Retirement: Bias Toward Building Assets**
 - **New SEC Disclosure Rules will Produce “Surprises”**

Plan Design

Benchmark Considerations Base Pay & Incentive Targets

- **Important to Understand Compensation Landscape**
 - **Compensation Consultants?**
 - **Industry Surveys?**
- **Peer Group Selection (Size & Performance)?**
 - **Statewide Peer Group?**
 - **Regional Peer Group?**
 - **National Peer Group?**
 - **Selected Peer Group?**
- **Peer Group Ranking & Performance Expectations**

Plan Design

Annual & Long Term Incentive Performance Targets Annual Targets (Budget) Link to Long Term Targets (Strategic Plan)

- **Potential Performance Targets**
 - **Return on Assets?**
 - **Return on Equity?**
 - **GAAP Earnings?**
 - **Earnings per Share?**
 - **Asset Quality?**
 - **Specific Accomplishments?**
 - **Personal Goals?**

- **“Balanced Scorecard”**
 - **Select Targets that Match Your Bank’s Goals**
 - **Weight Targets Required to Achieve Max Payout**

Plan Design Performance Targets

- **The Most Important Job for both Management and the Board is to Agree Upon Realistic Strategic Performance Targets:**
 - **Not too high (unachievable without excessive risk) or too low (your shareholders deserve an appropriate return).**
- **Multi-Year Financial Models Serve an Important Role in the Planning Process but it is Not a Substitute for a Strategic Plan.**
- **Financial Models and Market Analysis help Management and Your Board Establish Realistic Performance Expectations.**
- **Your Strategic Plan Identifies and Prioritizes the Actions Required to Achieve the Performance Targets Established by Your Management and Approved by Your Board.**
- **Link Incentive Compensation Plans with Strategic Targets.**

Plan Design

Long Term Incentive Considerations

- **Traditional Plan: Stock Options Vesting over Time**
 - **Vesting Not Based on Corporate Performance**
 - **'Performance' Vesting Based on Stock Price**
- **Performance Targets**
 - **Financial**
 - **Personal**
- **New GAAP Accounting – Expensing Options is Complicated**
- **Trend Toward Restricted Stock – Performance Vesting**
- **Trend Toward 'Corporate' Performance Linkage**
- **"Golden Handcuffs": Replenish Vested Shares with New Grants
Create Unvested Future Value**

Plan Design

Retirement Plan Considerations

New SEC Disclosure Rules!

- **Trend to Supplemental Plans - "SERP"**
 - **Congress Sets Limits – Consultants Design "Workarounds"**
 - **Tax Planning Tends to make These Plans Very Complex**

- **Key Questions:**
 - **Amount of Retirement to Pre-Retirement Income?**
 - **Pre-Retirement Base include Incentive Payments?**

Example Bank Plan

Executive Compensation Example

- **Base Pay:** \$100,000
- **Annual:** Incentive Max: 30% of Base
Payout Range 0% to 30%
Cash Payout based on GAAP
Cash Required to Pay Tax on Vesting Stock
- **Long Term:** Incentive Max: Value 30% of Base
Restricted Stock Plan – Performance Vesting
Assume \$30 per share value
\$30,000 Potential = 1,000 shares/year
Initial Plan 5,000 Shares over 5 Years
Vesting Range 0% to 100% of Shares

Example Bank Plan

Performance Benchmarks?

Where You Are – Where Do You Want To Go?

Example of a High Capital – Low ROE Bank
ROA x Leverage = ROE

Is Growth Restricted by a Low Growth Market?
Is Performance Impacted by Poor Asset Quality?
Is a Plan to Reach National “Peer” Realistic?

	Sample Bank	National Peer*
ROA	1.25%	1.47%
Leverage	x8	X9.8
ROE	10.0%	14.4%
Dividend Payout	40%	45%
Retained Capital	6.0%	7.9%
Capital Ratio %	12.5%	10.2%

****FDIC Peer \$500-\$1 Billion Assets 2005***

Example Bank Plan

Sample Strategic Plan Targets ***Assume National Peer is Realistic Target***

ROA: Focus on Profitable Growth
Increased Leverage: Assets Grow Faster Than Capital
ROE: 45% Improvement (Higher ROA & Leverage)

	Year 1 Base	Year 2	Year 3	Year 4	Year 5
ROA	1.25%	1.30%	1.35%	1.40%	1.45%
Leverage	8.0x	8.5x	9.0x	9.5x	10.0x
ROE	10.0%	11.1%	12.2%	13.3%	14.5%
Dividend 40% Payout	4.0%	4.4%	4.9%	5.3%	5.8%
Retained Capital	6.0%	6.7%	7.3%	8.0%	8.7%

Example Bank Plan

Max Potential Payout Matrix All Incentive Targets Achieved

Potential incentive payouts that could occur if the maximum incentive is earned each year and the stock appreciates 12% annually.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total Value
Base Pay + 4%/Year	\$100,000	\$104,000	\$108,000	\$112,000	\$117,000	-
Annual Cash Bonus	\$30,000	\$31,000	\$32,000	\$34,000	\$35,000	\$162,000
Total Cash	\$130,000	\$135,000	\$140,000	\$146,000	\$152,000	-
LT - Shares	1,000	1,000	1,000	1,000	1,000	5,000
LT - Value	\$30,000	\$34,000	\$38,000	\$42,000	\$47,000	\$235,000*

* Plus Dividend Income on Vested Shares

Example Bank Plan

Typical Incentive Payout Calculation ROE Target Based on Directional Improvement to "Peer"

Calculation of Incentive Payouts* at Various Performance Levels.

* Assume \$100,000 base pay (4% Annual Increase) and maximum annual bonus of 30% of base and maximum long-term vesting equal to 1,000 shares per year.

ROE	Year 1	Year 2	Year 3	Year 4	Year 5
MAX/Target	11%	12%	13%	14%	14%
MIN/Threshold	10%	10%	10%	10%	10%
<i>Actual ROE</i>	<i>11%</i>	<i>11%</i>	<i>10%</i>	<i>14%</i>	<i>15%</i>
Payout Earned	100%	50%	0%	100%	100%
Annual Bonus	\$30,000	\$15,500	\$0	\$34,000	\$35,000
LT - Shares	1,000	500	0	1,000	1,000

Plan Design

Some Thoughts on Board Member Compensation Board Benchmarks?

- **Annual Retainer: Paid in Stock – Immediate Vesting**
 - **Example: If \$15,000 is Target Annual Retainer
Stock Price per Share Equal \$30
Then 500 Shares is Paid as Retainer
Adopt a 5-year Plan – 500 Shares Each Year**
 - **Board Members Get a “Raise” if Shares Increase in Value**
- **Meeting Fees: Paid in Cash**
 - **Incentive to Attend Board & Committee Meetings**
 - **Cash to Pay Tax on Stock Retainer**

Plan Design

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Patrick J Rusnak

***Chief Operating Office
Western Sierra Bancorp***

“Options” For Equity Compensation

- ***Expensing Stock Options***
- ***Restricted Stock Programs***
- ***Restricted Stock Accounting***
- ***Proposed SEC Disclosure***

Charles J Thayer

Charles J. Thayer is Chairman and Managing Director of **Chartwell Capital Ltd.**, a private investment firm that provides specialized advisory services to executive management and board members of commercial banks, corporations and institutional investment clients.

Chartwell Capital's investment banking services focus on merger and acquisition advisory services for financial institutions. The **American Banker** and **Bank Director Magazine** both ranked Chartwell among the nation's Top Financial M&A Advisors in 1998 and 2001.

The **American Association of Bank Directors** named Thayer to its Board of Advisors in 2004. The AABD is a national non-profit organization serving the information, education and advocacy needs of financial institution directors. He is also a founding board member of the **National Association of Corporate Directors** Florida Chapter.

Thayer's combination of executive management and board experience brings a unique perspective to Chartwell's advisory services. He served on the board of **Republic Bank** (NASDAQ) in Florida from 1999 until 2004 and continues to serve as a board member of **BB&T Bank (Florida)** following BB&T's 2004 acquisition of Republic Bank. He currently serves as a board member of the **Louisville Community Development Bank** in Kentucky (1996-present) and for the national **Cystic Fibrosis Foundation** (1980-present).

Previous board service includes **CogenAmerica** (NASDAQ) (1996-1999), an independent multi-state cogeneration power producer headquartered in Minnesota, and **Sunbeam Corporation** (NYSE) (1990-1997), an international consumer products company. He served as Chairman and interim CEO of Sunbeam in 1993. John A. Byrne (Business Week) described Thayer as Sunbeam's "most knowledgeable director". Thayer also served as an advisory board member of **Keefe Managers** (1989-2002); a New York based bank stock hedge fund founded by Harry V. Keefe.

Prior to organizing Chartwell Capital in 1990, Thayer had a twenty year career in commercial banking. Thayer served as Executive Vice President and Chief Financial Officer of **Citizens Fidelity Corporation** (NASDAQ), Kentucky's largest bank holding company until its acquisition by **PNC Financial** (NYSE) in 1986. Following the acquisition Thayer was elected Executive Vice President of PNC (1987-1989) with management responsibility for finance, merger and acquisitions, investor relations, strategic planning, and PNC's capital markets subsidiary, serving as Chairman of **PNC Securities Corp.**

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