

Information as of 10/15/08

***Executive Compensation Restrictions under
TARP Capital Purchase Program***

***What They Are and
What They Mean to Community Banks***



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Executive Compensation under TARP Capital Purchase Program

The term sheet issued by the Treasury on Tuesday, October 14, 2008, regarding its voluntary Capital Purchase Program, states that top executives at recipient banks would be subject to new executive compensation rules as a condition of participation

On October 15, 2008, the Treasury issued interim final rules and guidance on this condition

Who do these limits apply to?

- ◆ *CEO, CFO and the three other most highly compensated officers who are employed by a financial institution*
- ◆ For public institutions – same group as in proxy
- ◆ For private institutions – will require determination under proxy rules applicable to public companies

When do these limits apply?

- ◆ *These are ongoing limitations*
- ◆ These limits apply at all times during the period which Treasury holds an equity position in the financial institution (or other member of the controlled group) to *each* and *every* covered executive in place during such period, so that if, for example, there are changes in the CEO position during the period, the limitation would apply to each CEO during the period he or she was the CEO
- ◆ *It appears that if Treasury sells its equity position – the limits no longer apply*
- ◆ Note that the Treasury must cease to hold 100% of the preferred and 100% of the warrants or underlying common stock for the restrictions to lapse

Unnecessary and Excessive Risk – What actions are required by Compensation Committees for Participating Banks?

- ◆ *Promptly (no more than 90 days after purchase under this program) and annually thereafter, the Compensation Committee must review incentive compensation arrangements with risk officers to ensure that the arrangements do not encourage unnecessary and excessive risk*
- ◆ For public institutions - Certify (in the Compensation Discussion & Analysis section of proxy statement) that it has completed these reviews
 - The annual review would probably be made in connection with the Compensation Committee's annual report regarding compensation information
- ◆ For private institutions - Certify that it has completed these reviews to its primary regulator

What are “unnecessary and excessive risks that threaten the value of the financial institution”?

- ◆ None of the terms “unnecessary,” “excessive,” “encourage” or “risk” are defined, and we are looking to other regulatory proscriptions for guidance but have yet to find any. “Risk” probably includes interest rate, credit and liquidity risk
 - *Washington Post (10/15/08) reports that Treasury officials have no immediate plans to define “unnecessary and excessive risk”*
- ◆ Compensation Committee must meet with risk officers to determine what risks could threaten the value of the institution
- ◆ Compensation Committee must identify features in incentive compensation arrangements that could lead executives to take such risks
- ◆ Such features should be limited to ensure that executives are not encouraged to take risks that are unnecessary or excessive
- ◆ *Assuming good faith by the Compensation Committee, there does not appear any process which creates the potential for second guessing the review of the Committee or penalties for being wrong, if second guessed*

What are “unnecessary and excessive risks that threaten the value of the financial institution”?

◆ *Unanswered Questions:*

- *Do option grants which by their nature incent actions to increase share price “encourage unnecessary and excessive risks”? **Probably not***
- *Do bonus programs which pay based on ROE or EPS per se “encourage unnecessary and excessive risk”? **Probably not***

◆ Compensation Committees will likely consider:

- de-emphasizing annual bonuses tied to short-term operating results like EPS, ROAA, ROAE, and focusing in addition on capital maintenance, liquidity maintenance, asset quality, etc.
- shifting part of compensation focus to longer-term awards which reward future performance (for loan growth with good asset quality and favorable CAMELS ratings, etc.)

When must a bank require a “clawback” of an executive bonus or incentive compensation?

- ◆ Any bonus or incentive compensation paid to the covered executives *during the period that the Treasury holds an equity or debt position under to this program* must be made subject to recovery or “clawback” by the financial institution if those payments to the covered executives were based on:
 - materially inaccurate financial statements or
 - *any other materially inaccurate performance metric*
- ◆ The “clawback” rules apply to any amounts **paid during the period** that the Treasury holds an equity or debt position under this program (regardless of when accrued)
- ◆ Note that these provisions require the “clawback” of bonuses and incentive payments ***only to the extent*** it is based on, for example, a materially inaccurate performance metric
 - For example, assume a covered executive is paid a \$100,000 bonus based on achieving a target metric. If it is later determined that the target metric was not met, but a lower metric that would have resulted in a \$60,000 bonus was met, only the additional \$40,000 should be subject to “clawback”

Additional details regarding “clawbacks”

- ◆ These provisions:
 - apply to (i) the CEO, (ii) the CFO and (iii) the three most highly compensated executive officers
 - apply to both public and private financial institutions
 - are triggered by payments made to covered executives which are based on materially inaccurate financial statements or any other materially inaccurate performance metric, not just accounting restatements
 - do not limit the recovery period
 - cover material inaccuracies relating to both financial reporting and other performance metrics

What are the limitations on involuntary termination severance payments (golden parachute payments)?

- ◆ Payments capped at 2.999x prior 5 year average of W-2 compensation
- ◆ Financial institutions must prohibit payments in excess of the limitation – *This will require amending contracts to provide for cut-back if involuntary termination occurs during restricted period*
- ◆ “Payments” determined in the same way as parachute payments under IRC 280G - include “value” of accelerated vesting of equity and accelerated vesting or increases in SERP benefits
 - *Only applies to payments or vesting “on account” of severance. Therefore, existing vested equity or payments under SERPs would not be affected.*
 - *Frequently used planning strategies such as payments for consulting services or covenants not to compete are included in value*
- ◆ “Involuntary termination” includes termination by the institution with or without cause. Also includes any severance in connection with a bankruptcy filing, insolvency or receivership

What are the restrictions on deductions for annual compensation?

- ◆ Deduction for annual compensation capped at \$500,000
- ◆ No exception for performance-based compensation
- ◆ Limitation also applies to compensation paid in a future year if right to compensation arises in current year (cannot avoid limitation by providing for payment in future years – and, if tainted, limitation remains even if Treasury no longer holds equity or debt position)
- ◆ *This loss of deduction should not be a big thing with many community banks.*

How will this impact future mergers and acquisitions?

- ◆ As noted above, limitations under this program only apply while the Treasury holds an equity position under this program
- ◆ Possible M&A scenario:
 - Seller bank has issued preferred shares and warrants to the Treasury and Treasury still holds such preferred shares and warrants. Buyer bank acquires by merger all Seller equity (including by operation of law all preferred and warrants owned by Treasury). Buyer bank then terminates Seller CEO. Seller CEO will not be subject to compensation limitations because at the time of payment, Seller CEO is no longer CEO of resulting entity (assuming also not one of three highest paid at resulting entity). However, Buyer CEO will now be subject to limitations
 - Solution: Prior to or in conjunction with transaction, Buyer Bank (or Seller bank) purchases all Treasury preferred and warrants. Neither seller or buyer CEO are subject to the compensation restrictions.

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AND NUANCES IN THIS PROGRAM,
MORE TO COME AS DEVELOPMENTS
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