

Reviving Bank Equity Compensation Programs

Drowning in Underwater Stock Options

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The collapse of the stock market and bank stock prices has affected more than the market capitalization of financial institutions and the portfolio values of shareholders. Falling prices have also made bank equity compensation programs ineffective at best.

Employee stock options at most banks have become virtually useless for motivating and retaining valued employees. Options give employees the right to buy bank's stock at a fixed price—the exercise price. When the market price increases above the exercise price, the options are “in-the-money.” When the market price falls below the exercise price, the options are “out-of-the-money” or “underwater.” If the market price falls far below the exercise price—say 50% or less of the exercise price—the options are far underwater and lose their effectiveness as performance motivation and retention tools.

Drowning Incentives

The Delves Group research shows that the majority of stock options granted by mid-sized financial institutions are underwater. Our experience suggests that many—perhaps most—community and mid-sized banks are saddled with stock options that are significantly underwater. As Exhibit 1 shows, this is also true for mid-sized financial institutions that have received investment funds under the Treasury Department's Capital Purchase Program as part of the Troubled Asset Relief Program (TARP). This is important to consider because banks that have accepted government investment funds will need to provide adequate incentives to management to generate positive returns on the taxpayers' and other owners' investments.

Exhibit 1 – “Underwater” Options at Mid-Sized Regional Banks Approved to Participate in Treasury Department's TARP program (please contact us for the comprehensive analysis of all TARP participants' underwater options)

Bank Name	Total Assets as of September 2008 (Millions)	3 Yr. Avg. Options Outstanding Weighted Ave. Exercise Price	Stock Fair Market Value as of 12/5/2008 ¹	Options "Underwater" Percentage	TARP Investment	
					Preferred Shares Sold (Millions)	Issued Warrants to Purchase Shares (Millions)
Berkshire Bancorp Inc.	\$ 941	\$ 9.25	\$ 4.77	48%	\$ 40	n/a
German American Bancorp	\$ 1,179	\$ 16.43	\$ 11.18	32%	\$ 25	n/a
Cascade Financial Corp.	\$ 1,552	\$ 8.96	\$ 5.02	44%	\$ 39	\$ 6
Fidelity Southern Corp.	\$ 1,760	\$ 14.46	\$ 1.90	87%	\$ 48	n/a
First Defiance Financial	\$ 1,922	\$ 18.72	\$ 7.03	62%	\$ 37	n/a
Columbia Banking System, Inc.	\$ 3,105	\$ 15.29	\$ 9.20	40%	\$ 77	n/a
Independent Bank Corp.	\$ 3,139	\$ 19.67	\$ 2.01	90%	\$ 72	\$ 11
Integra Bank Corporation	\$ 3,357	\$ 21.70	\$ 2.17	90%	n/a	n/a
Midwest Banc Holdings Inc.	\$ 3,583	\$ 13.92	\$ 2.10	85%	\$ 86	\$ 13
Taylor Capital	\$ 4,075	\$ 24.94	\$ 6.70	73%	\$ 105	\$ 1
First Midwest Bancorp	\$ 8,247	\$ 30.01	\$ 16.45	45%	\$ 193	n/a
Wintrust Financial Corporation	\$ 9,865	\$ 32.47	\$ 17.88	45%	\$ 250	\$ 38

25th Percentile	45%
Median	55%
75th Percentile	85%

¹ - Lowest daily traded value on December 5, 2008

To compound matters, a relatively low market capitalization and high “overhang” may make it difficult and maybe impossible to ask shareholders for additional shares. “Overhang” refers to total options and restricted stock as a percentage of stock outstanding. If a bank’s overhang is too high, shareholders are unlikely to authorize additional shares for equity incentives. Consequently, many banks may not have enough authorized shares nor will they be able to request additional shares for new option or share grants.

Exchange Alternatives

In this difficult situation, banks should consider a value-for-value exchange of underwater options for new at-the-money options or for restricted shares. Value-for-value exchange is determined by using a fair value model, such as the Black-Scholes Options Pricing Model. Even though an option is underwater, it still has some value. The Black-Scholes and other models can be used to calculate the value of each underwater option, the value of a new “at the money” option (option exercise price is equal to current market price) and determine how many old underwater options need to be exchanged for each new option or share of stock. Banks generally have three alternatives available for structuring an option exchange:

1. Options-for-Options
2. Options-for-Stock
3. Options-for-Cash

Options-for-Options. According to research by Equilar, most option exchange programs use this method, in which underwater options are exchanged for the new options at the current fair market value. For example, two or three underwater options may be exchanged for one new option.

The ratio of underwater options exchanged for new options depends primarily on how far underwater the options are, and the remaining term before the options expire. For example, the exchange ratios for options-for-options programs can be set based on the following schedule, but it’s important to remember that each bank will have a different set of circumstances; therefore different ratios will apply (See Exhibit 2):

Exhibit 2 – Sample Exchange Ratios for Options-for-Options and Options-for-Stock

Sample Bank	Number of "Underwater" Options	Exercise Price	Black-Scholes Value of All Options	Current Stock Price	Options "Underwater" Percentage	Options "Underwater" Percentage Range	Options-for-Options Exchange Ratio	Options-for-Shares Exchange Ratio	Number of New Options	Number of New Shares
Bank A	1000	\$ 13.92	\$ 585	\$ 2.10	84.91%	75-99.9%	4 for 1	7 for 1	250	143
Bank B	1000	\$ 9.25	\$ 1,119	\$ 4.77	48.43%	20-60%	2 for 1	4 for 1	500	250
Bank C	1000	\$ 18.72	\$ 1,978	\$ 7.03	62.45%	60-75%	3 for 1	5 for 1	333	200
Bank D	1000	\$ 16.43	\$ 3,473	\$ 13.18	19.78%	0-19.9%	no exchange	no exchange	0	0

An option-for-option exchange is probably the easiest exchange alternative to explain to employees and execute. If possible, it is desirable to structure these programs as “value neutral,” in which the value of the new option grant is roughly equal to the value of the old but at an exercise price that’s more attainable given the realities of the current market. These programs also often avoid additional charges under FAS 123(R) and can be structured to maintain or significantly reduce stock overhang, and should be perceived as friendly to shareholders.

Options-for-Stock. Another common way of structuring an option exchange is to exchange underwater options for restricted shares. For instance, five underwater options could be traded for one share of restricted stock—the number of restricted shares granted is generally much less than the number of stock options exchanged.

This approach ensures that an equity incentive retains its effectiveness even if stock price declines further, since restricted stock cannot sink underwater. Banks with high levels of equity overhang may find this approach appealing because the exchange ratio of existing underwater options for restricted shares is generally high (5:1 or 7:1), which results in a more substantial reduction in equity overhang.

At the same time, future incentives to increase the stock price are lessened under this approach. Lastly, employees may perceive that the exchange is unfair given the high exchange rate. Employee perception of a fair exchange is critical because participation in option exchange programs is voluntary.

Options-for-Cash. The least common alternative is to exchange underwater options for a cash payment. The cash payment is very simply equal to the current value of the underwater options (See Exhibit 3). The most significant challenge associated with this exchange alternative is the availability of cash to pay option holders. The second biggest issue with a cash exchange is the loss of a powerful incentive. The underwater options may be gone, but so is the incentive to increase the stock price.

Exhibit 3 – Options-for-Cash Exchange Alternative

Sample Bank	Number of "Underwater" Options	Remaining Option Term	Exercise Price	Current Stock Price	Options "Underwater" Percentage	Options-for-Cash Exchange Amount
Bank A	1000	3	\$ 13.92	\$ 2.10	84.91%	\$ 130
Bank B	1000	5	\$ 9.25	\$ 4.77	48.43%	\$ 1,320
Bank C	1000	7	\$ 18.72	\$ 7.03	62.45%	\$ 150
Bank D	1000	2	\$ 16.43	\$ 11.18	31.95%	\$ 390

Although it requires the use of cash, this exchange alternative allows for the greatest equity overhang reduction.

A Balancing Act of Managing Stakeholder Objectives

There are three main stakeholders whose objectives must be considered when deciding on the right underwater stock option exchange alternative, its design, and implementation: the bank, employees, and shareholders.

The bank's main objectives are to reduce its high equity overhang rate, increase the value proposition of its currently worthless equity incentives, restore employee alignment with shareholder interests, increase employee motivation and morale, and decrease the risk of possible top-talent attrition. Employees' main objectives are to restore the value of their current equity position in the bank and earn financial rewards based on future bank stock performance. Finally, shareholders' main objectives are to increase their return on investment and to protect themselves from any further equity dilution.

The three main stakeholders have some common objectives. Reducing the equity overhang, which in turn reduces further equity dilution, is common ground for all three parties. Second and equally important is to restore the value proposition of the equity incentive plan, which in turn increases employee motivation, morale, and retention, and restores alignment of employees' interests with those of the shareholders.

Exchange Alternative Design Considerations

Option Holder Eligibility

The bank must decide which option holders should be included in the underwater option exchange program. Some shareholder groups argue against including executive officers and directors in the exchange program, citing a need for a long-term relationship between these individuals' compensation and the long-term value of the bank's stock. However these senior level leaders typically hold substantial amounts of underwater options. Excluding them can undermine two of the main program objectives—overhang reduction and improved motivational retention of the bank's most important employees.

Given that most programs will require shareholder approval, banks should proceed carefully in determining senior executive participation in the exchange program. Consider offering less favorable exchange terms to senior executives (higher exchange rates, lower cash payments, and/or longer vesting requirements for new awards), and/or separating the shareholder approval process into multiple proposals so that investors can decide on directors and/or officers without jeopardizing the program for broad-based employees.

Grant Eligibility

Once participant eligibility is determined, the next step is to decide which underwater stock options should be included in the exchange program. Some options that are only slightly underwater still provide a reasonable incentive to increase stock price, and therefore should not be exchanged. Determining where to set the price floor for grant eligibility is not based on a uniform formulaic approach. Each bank will have different considerations based on its distribution of underwater options and the key objectives of the exchange program.

Exchange Ratios

The number of new option or shares exchanged for underwater options is often the most important element of an exchange program from a participation point of view. Employees often focus on the number of shares they will end up with after an exchange. Please see Exhibit 2 for various sample exchange ratios.

Accounting Expense

The new program generally does not generate an additional accounting expense. It is not possible to eliminate the accounting expense for the underwater options. The company will be required to continue recognizing that expense, even though the options are traded in for new options. However, it is possible and advisable to avoid additional expense for the new options or shares. As long as the value of the new options does not exceed the value of the old underwater options, as valued immediately prior to the exchange, there is no additional expense. If the value of the new options or shares exceeds the value of the old options, the excess value must be expensed and amortized over the new vesting period of the new options.

Compensation Committees must be aware of the accounting impact when structuring an exchange plan.

Option Holder Tax Treatment

In the option-for-option exchange alternative, employees maintain control of the taxable event because options are taxed at exercise. In the option-for-shares exchange alternative, employees lose control of the taxable event since the current market value of the shares is taxable income to the recipient when the shares vest. In the option-for-cash approach, employees also lose control of the taxable event since cash is taxed to the employee upon receipt.

Vesting of New Awards

Vesting is another critical plan design issue that influences the motivational and retention effectiveness of the new options, and the perceived value of the exchange to employees. Vesting can be handled in the following three ways:

Map Vesting

Under this approach, vesting for the new shares exactly matches the remaining vesting for the old shares. This is the best approach from the employee point of view because it recognizes the employees' previous service.

Complete Vesting Reset

This approach completely resets vesting on the new shares and is therefore the least attractive approach from the employee point of view. However, this approach has the greatest retention benefit for the company.

Partial Vesting Reset

This approach completely resets vesting on 100% of the new shares, but it also shortens the new vesting period. This approach represents a middle ground because it recognizes the employees' previous service and also provides the company with an additional retention benefit (See Exhibit 4 for examples of all three vesting approaches).

Exhibit 4 – New Award Vesting Approaches

"Underwater" Option Grant Vesting Period	"Underwater" Option Grant % Vested Before Exchange	Vesting of New Awards	New Vesting Period	New Award Vesting % Remaining
3	33%	Map Vesting	2	67%
3	33%	Complete Vesting Reset	3	100%
3	33%	Partial Vesting Reset	2	100%

Program Implementation

Because underwater option exchange offers are complex, they must be explained and presented in significant detail and with clarity (See Exhibit 5 for a summary of factors driving the underwater option exchange alternative selection). Each participant's elections must be accurately recorded and the results must be communicated clearly and effectively. Many

companies use third-party organizations to administer and communicate the exchange program to ensure that they remain at arms length and do not influence participation decisions.

Underwater options exchange programs are treated as a tender offer under SEC rules. Any information that would influence an employee’s decision to participate must be publicly filed. Employees have 20 business days to make a decision. Generally, all communications are put in place before the plan is presented to participants because any new information on the program or any change to the original material may require a tender offer amendment, which restarts the 20-day decision period.

Exhibit 5 – Summary of Factors Driving Underwater Option Exchange Alternatives Selection

PRIMARY FACTORS DRIVING OPTION EXCHANGE ALTERNATIVE CHOICE	UNDERWATER OPTION EXCHANGE ALTERNATIVES		
	Option-for-Option	Option-for-Stock	Option-for-Cash
Sample Exchange Rate ¹	3 to 1	5 to 1	Black-Scholes Value
Reduction in Equity Overhang	Low - Medium	Medium - High	Highest
Use of Cash	No	No	Yes
Prevents Future Underwater Options	No	Yes	Yes
Easy to Communicate to Employees	Yes	No	No
Motivational Impact	High	Medium	Low
Employee Participation	Voluntary	Voluntary	Voluntary
Requires Shareholder Approval	Yes	Yes	No
Potential Upside/Downside Based on Stock Performance	Yes	Yes	No
Retention Impact ²	High	Medium	Low
Additional Accounting Expense (Company)	Possible	Possible	Possible
Control of Taxable Event (Employee)	Yes	No	No

¹ - Exchange rate will largely depend on each company's individual circumstances.

² - Assuming no additional vesting is added on the new stock option/stock grant or cash payment.

Conclusion

Despite the continuing uncertainty in the financial industry and stock market at large, equity incentives still play an important role in business success, employee morale, retention of top talent, and recruitment of new talent.

An increasing number of banks are considering underwater options exchange programs to revive drowning stock-options programs. Perception of stakeholders—the bank, its shareholders, and employees—is critical to the success of underwater exchange programs. Banks that take action with responsible strategies for resolving underwater options stand to bolster the faith of employees and shareholders in the institution's long-term financial outlook.