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Article 2

PHANTOM STOCK OPTIONS MAY BE BETTER THAN THE REAL THING

In recent years, many bankers have cast an envious eye at the option-laden, stratospheric compensation packages received by the CEO's at companies in other sectors of the economy. Of course, high tech companies led the pack with USA Today reporting pre-crash packages in 1999 exceeding $1 billion in annual compensation for the CEO's at such relative upstarts as America Online (Steve Case, $1.1 billion) and Yahoo (Timothy Koogle, $1.7 billion — YAAAHOOO!!). Median compensation for the 200 highest paid CEOs in 1999 included $2.8 million in pay (including the valued of restricted stock awards), $1.7 million in profits on stock options exercised, and $10.2 million change in paper value on stock options, and a total, median of over $17.6 million.

Very few bankers of any stripe made the list and, not surprisingly, none of those who did were community bankers. In fact, community bankers are much less likely than their corporate peers to receive any stock options. According to Grant Thorton's 2000 Community Bank Survey, just 17% of all community bank offer stock options to management only and another 20% offer them to management and other employees. The most common reason for this reticence is fear of diluting value for existing shareholders. Those community bankers who were granted options in recent years also rarely have had reason to cheer. The paradox has been that while most community banks are more profitable than ever, their stock has been out of favor. With bank stocks of all types declining while stocks in other companies skyrocketed, most bank executives found their options hopelessly "under water" with little chance of surfacing in the foreseeable future.

Since stock options have normally been viewed as a means to attract, retain, and reward management for enhancing corporate performance over the long term, many community bankers are in a quandary about how to achieve these objectives when the stock market is behaving so irrationally. Repricing of these options is not seen as a viable choice. Shareholders are likely to complain. Some banks have simply increased cash compensation. While this approach may keep the executives happy in the short term, it also immediately increases the bank's expenses and provides no long-term incentive for the executive to remain with the institution.

So, what is a community bank - either stock or mutual - to do to meet both the short and long-term objectives previously thought best addressed by awarding options? A non-qualified phantom option plan may be the answer. The institution allocates "phantom option" units to the desired group of executives and directors. These phantom units have a theoretical strike price, which is probably different from the price of the institution's stock. The value of these units is tracked over some agreed upon measurement period, such as 10 years. The means of the determining the annual value might be professional valuations or a group of indices, such as earnings per share, return on assets, return on equity, or some designed percentage increase in the "real" stock price. At the end of this period, the gain in the phantom units is calculated. The executive is then entitled to receive a cash payment equal to the gain and payable at his or her "benefit age," which is often but not always retirement. The payment can be made in lump sum or over a period of years.

Since any non-qualified benefit plan is in reality a contract between the executive and the institution, it is extremely flexible and can be designed to achieve whatever the desired objectives might be. Furthermore, this plan does not dilute shareholders. It does not require shareholder approval. The benefits are directly related to the achievement of designated objectives - - regardless what the stock market is doing. Moreover, it can be informally funded in such a manner as to offset all costs on an annual, after-tax basis and to recover all costs over the life of the participants. In other words, if properly designed, this plan is a win (for the bank) - win (for the shareholders who keep and reward competent management) - win (for the executive) deal.