Third Quarter 2010 / Volume 15 Issue 1

SRC Insights

Federal Reserve Bank of Philadelphia

Pace of Bank Mergers and Acquisitions Increases as Valuations Gradually Improve

by William Lenney, Regulatory Applications Specialist Analyst

This is the fourth installment in a recurring series on national and Third District trends in bank mergers and acquisitions. The first three articles were as follows:

- "Factors Affecting Bank Acquisition Valuations," published in the first quarter 2008 issue of *SRC Insights*, discussed key factors affecting the bank acquisition valuation trend during the five-year period of January 2002–December 31, 2006. Specifically, it was noted that acquiring banks were paying a significant price-to-book premium for target banks, and that by the end of 2006, valuations were at record levels.
- "Bank Mergers and Acquisitions Slow with Economy," published in the first quarter 2009 issue, extended the original study to June 30, 2008. The deteriorating economic and financial conditions during 2007 and the first half of 2008 and the challenges of the weak housing market, subprime mortgage crisis, a slowing economy, reduced liquidity, and capital issues all led to a decline in the number of bank acquisitions and lower price-to-book premiums paid for target banks.
- "Bank Mergers and Acquisitions Continue at a Slow Pace," published in the third quarter 2009 issue updated the study for the period July 2008–June 30, 2009.[1] Bank mergers and acquisitions continued at a slow pace, and price-to-book valuations continued to decline.

For this article, the study was updated for the period July 2009–June 30, 2010, and data on 920 U.S. commercial banks acquired from January 2002, to June 30, 2010, were reviewed and analyzed. The same analytic factors used in the three previous analyses were also applied to this most recent time period. In general, the analysis found that the pace of bank mergers and acquisitions has increased, while price-to-book valuations stabilized in the second half of 2009 and showed improvement during the first six

[1] In addition to the 149 acquisitions occurring between July 1, 2009, and June 30, 2010, there were 155 government-assisted acquisitions that were not included in this study. Price-to-book data are not available for these transactions.

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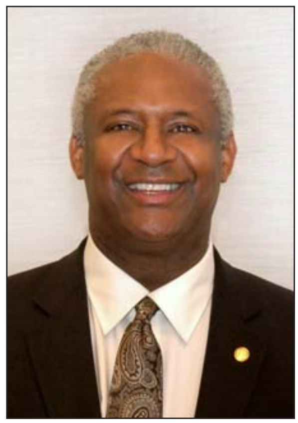
FEDERAL RESERVE BANK OF PHILADELPHIA

Supervision Spotlight

Sound Incentive Compensation Practices

by Michael E. Collins, Executive Vice President



Compensation practices and, specifically, incentive compensation received intense public scrutiny and drew significant criticism during the recent financial crisis. Misaligned incentives and problematic compensation structures were not the main causes of the crisis, but they were certainly contributing factors. Policymakers and regulators have responded by taking measures to ensure that future compensation practices are managed prudently and discourage excessive risk-taking.

Incentive compensation is a critical tool in the successful management of banking organizations in order to attract, recognize, and retain skilled employees. Organizations face the ongoing challenge of designing a compensation framework that effectively blends and balances an employee's self-interest, shareholder interests, and the organization's long-term success and profitability.

Problematic incentive compensation practices are not limited to the most senior executives. Compensation practices throughout a banking organization can incent non-executive employees, either individually or collectively, to undertake imprudent risks that can significantly and adversely affect the organization's risk profile. Because of the direct or indirect benefits banking organizations receive from the federal "safety net" protections, shareholders may be willing to accept risks that could jeopardize the organization. Ultimately, inappropriate incentive compensation practices can lead to safety and soundness problems and be detrimental to overall financial stability.

Regulatory Response

On June 21, 2010, the federal banking regulators (the agencies) issued final interagency guidance (final guidance) on sound incentive compensation practices for banking organizations. The adoption of the final guidance is fully consistent with the agencies' statutory mandate to protect the safety and soundness of banking organizations.[1] It should be noted that the guidance does not place caps or set prescriptive limits on salaries. Incentive compensation practices must be consistent with safety and soundness principles, even though this may require more conservative incentive compensation practices than are needed to only align employees' interests with those of shareholders.

The final guidance emphasizes key principles behind creating and maintaining effective employee incentives. The three main themes that emerged are balanced risk-taking, effective controls and risk management, and strong governance.

Balanced risk-taking. Banking organizations must ensure that their incentive compensation practices properly balance risk and reward. Incentive compensation plans should not promote short-term gains while disregarding longer-term risks, and potential risks should be considered from an enterprisewide perspective. Plans should be designed so that employees bear some of the risks associated with incented activities. This is the type of disconnect, as observed in the originate-to-distribute model,[2] that can lead to damaging consequences. Four currently-used aspects make incentive compensation more sensitive to risk: risk adjustment of awards, deferral of payment, longer performance periods, and reduced sensitivity to short-term performance. It should be noted that this list is not all-inclusive, and that depending on the situation involved, one or more may be better suited for use.

Effective controls and risk management. Compensation practices should be embedded into an organization's risk management framework. Risk management personnel should participate in the design phase of incentive compensation plans and programs. Effective internal processes and controls should be in place to support the development and maintenance of balanced incentive compensation practices. Ongoing measuring and monitoring should not only consider the balance and effectiveness of the incentive compensation practice, but they should also assess the amount of risk exposure and the actual resulting outcome. A determination should be made regarding whether awards and payments appropriately reflect the assumed risk. They should also be judged and adjusted accordingly in the event of negative outcomes.

Strong governance. Incentive compensation practices should be supported by strong corporate governance, including active oversight and review of key program or plan elements by the board of directors. The board should collectively possess a basic knowledge of financial services industry incentive practices and set the tone for the organization. It should periodically evaluate whether the compensation structures are designed appropriately and are achieving the desired effects. The board should be receiving useful, timely, and sufficient data in order to make ongoing assessments and address any potential issues or implications. It should also be directly responsible and accountable for approving incentive compensation provided to all covered employees.[3]

International views of incentive compensation have largely been harmonized, but some divergence in implementing incentive compensation principles still exists. For example, the European Parliament approved a directive that is more formulaic, while the U.S. guidance outlines a more principles-based approach.

[1] *Federal Reserve, OCC, OTS, FDIC Issue Final Guidance on Incentive Compensation*, joint press release, June 21, 2010, is available on the Board of Governors' website at <www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm>.
[2] The originate-to-distribute (OTD) model of lending is when the originator of loans sells the loans to a third party.

[3] Governor Daniel K. Tarullo, *International Cooperation and Financial Regulatory Modernization*, Before the Subcommittee on Security and International Trade and Finance, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C., July 20, 2010, available online at: <www.federalreserve.gov/newsevents/testimony/tarullo20100720a.htm>.

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Elements of a Sound Funding and Liquidity Risk Management Program, Part II

by Andrea Anastasio, Senior Specialist

Many banks experienced strained liquidity provisions during the recent financial crisis, and some banks are still working through liquidity issues. While liquidity conditions have improved at many banks during the past year, a focus on sound liquidity risk management (LRM) practices remains vitally important. On March 17, 2010, the federal banking regulators issued SR Letter 10-6, *Interagency Policy Statement on Funding and Liquidity Risk Management*,[1] to provide financial institutions with consistent interagency guidance on the principles of sound LRM. This is the second of two articles focusing on sound LRM. In the second quarter 2010 issue of *SRC Insights*, corporate governance and liquidity strategies, policies, and limits were discussed. This article will focus on the two remaining areas of an effective LRM program: liquidity risk measurement, monitoring, and reporting and contingency funding plans (CFPs).

If the recent crisis taught us anything, it is that liquidity events happen quickly, and proactive measures on management's part are critical to avoiding a severe liquidity crisis. Liquidity managers need to understand the funding vulnerabilities of their institutions and the impact that problems in other areas of the bank may have on liquidity. LRM practices that incorporate forward-looking cash flow projections, as well as stresses to these projections, will enable a liquidity manager to implement strategies early to mitigate a liquidity crisis.

Liquidity Risk Measurement

While cash flow projections are part of the LRM practices at many institutions, some banks are still relying on static balance sheet ratios to measure their liquidity risk profile. While static ratios are very useful in presenting historical information in a clear and easily understood format, they do not incorporate forward-looking projections and therefore fall short in predicting future funding vulnerabilities.

To be effective, the liquidity risk measurement process must include robust cash flow projections arising from assets, liabilities, and off-balance sheet items. Examiners review ALCO packages, including ALCO meeting minutes, to ensure that cash flow projections are an integral part of the liquidity measurement process. Pro forma cash flow statements for various time buckets, such as daily, weekly, monthly, quarterly, and annually, should be part of a liquidity risk measurement process. Because some of the cash flow projections are based on assumptions, such as those related to nonmaturity deposits, it is imperative that the assumptions are reasonable, adequately documented, and periodically reviewed and approved. The base case, or "business-as-usual," cash flow projections can be used as the base case scenario in a bank's CFP.

Collateral position management. Liquidity managers must be aware of their bank's collateral positions, including the value of pledged assets and the amount of unencumbered assets that can be pledged if necessary. Management needs to be aware that the pledging of collateral may take time, especially if physical delivery of the collateral is required. Therefore, it is best to have collateral in place well before the need to borrow against it arises.

Management reporting. Liquidity risk reports should be provided to management and the board of directors on a regular, timely basis. The scope of these reports is dependent on the complexity of the bank's operations and risk profile. Liquidity reports should be clear and include pertinent information, including, but not limited to, the following:

[1] SR Letter 10-6, *Interagency Policy Statement on Funding and Liquidity Risk Management*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm>.

- Cash flow gaps
- Cash flow projections
- Asset and funding concentrations
- Critical assumptions used in cash flow projections
- Key early warning or risk indicators
- Funding availability
- Status of contingent funding sources
- Collateral usage

If the liquidity risk position of the bank increases, the frequency of management reporting should increase. Examiners review liquidity reports and committee meeting minutes to determine whether management is adequately informed of the liquidity risk profile of the bank on a regular, timely basis.

Contingency Funding Plans

Contingent liquidity events are unexpected situations that may be institution-specific or may arise from external factors. Over the past few years, some banks experienced liquidity shortfalls when problems in other areas of the bank had a direct impact on their ability to maintain and/or procure funding. Asset quality deterioration can affect a bank's ability to attain credit-sensitive funding, such as FHLB advances and fed funds. Banks that fall below well-capitalized, or that are subject to a formal enforcement action that contains a capital provision, typically are prohibited from renewing or obtaining brokered deposits. These are examples of institution-specific events that should be incorporated into CFPs, if appropriate. Examples of external events that may impact liquidity are disturbances in the payments systems and dislocations in the financial markets.

CFPs provide a framework for managing unexpected liquidity events and ensuring that the bank's sources of liquidity, including contingent liquidity resources, are sufficient to fund the bank's commitments under stressed scenarios.

It is imperative for all banks to have a CFP that is commensurate with its size and complexity (see chart on following page). CFPs provide a framework for managing unexpected liquidity events and ensuring that the bank's sources of liquidity, including contingent liquidity resources, are sufficient to fund the bank's commitments under stressed scenarios. CFPs have been recommended by regulators for many years. However, there are banks that still do not have appropriate and/or effective CFPs. A recurring examination finding is improving the CFP. The interagency policy statement outlines the required elements of effective CFPs. The following table contains these elements, as well as typical weaknesses noted by examiners.

The CFP should be a living document and should be frequently reviewed and updated as necessary. When early warning triggers are encountered, action plans must be set into motion. It is imperative to take measures early to avoid a critical liquidity situation. Liquidity managers who are slow in recognizing impending liquidity strains often have a difficult time getting through them.

If you have any questions on liquidity management or liquidity risk management, please contact Andrea Anastasio (andrea.anastasio@phil.frb.org) at (215) 574-6524 or Mark Kemmerer (mark.kemmerer@phil.frb.org) at (215) 574-6156.

Contingency Funding Plans

CFPs Should:	Common Weaknesses Noted by Examiners:
Identify stress events • Institution-specific and systemic	Stress events do not adequately address the risk profile and/or funding vulnerabilities of the bank.
Assess levels of severity and timing • Various levels of stress severity • Early-warning indicators • Red flags • Comprehensive actions plans	The plan does not contain enough levels of stress scenarios. Action plans may not be realistic.
Assess funding sources and needs • Quantitative stressed cash flow analyses • Erosion of funding under alternative stress scenarios • Alternative contingency funding sources	Stressed cash flow analysis does not contain realistic and/or documented assumptions.
Identify potential funding sources • Alternative sources of readily-assessable contingency funding • Advance planning and periodic testing of these sources	Management is not testing its backup funding sources.
Establish liquidity event management processes • Crisis management teams • Communication and reporting • Communication with counterparties, credit-rating agencies, the media, and other liquidity stakeholders	The CFP does not specify the individuals responsible for communicating with various stakeholders.
Establish a monitoring framework for contingent events • Establish an early recognition system (event triggers)	Event triggers have been encountered, but management has not taken proactive measures.

From The

Examiner's Desk

Compliance with the Unlawful Internet Gambling Enforcement Act of 2006

by Dmitry Shub, Assistant Examiner, and Jared Denisco, Assistant Examiner

On May 20, 2010, federal banking regulators issued SR Letter 10-11, *Interagency Examination Procedures for Reviewing Compliance with the Unlawful Internet Gambling Enforcement Act of 2006* (UIGEA SR Letter), to provide institutions with the guidance necessary to ensure compliance with the Unlawful Internet Gambling Enforcement Act (UIGEA or act). The final rule implementing the UIGEA was issued jointly in a Federal Register notice by the Department of the Treasury and the Federal Reserve Board of Governors. Compliance with the rule is required as of June 1, 2010, postponed from the original date of December 1, 2009. This article will provide an overview of the rule, detail policy and procedure requirements, and discuss some important aspects examiners may focus on when reviewing compliance with the act.

Overview

The overall spirit of the UIGEA SR Letter is for financial institution participants in designated payments systems (institutions) to identify and prevent restricted transactions passing through the various payment systems, such as bets and wagers in connection with Internet gambling websites. The joint rule outlines the following five designated payment systems (DPS) that are covered by the act:

1. Automated clearing house systems
2. Card systems
3. Check collection systems
4. Money transmitting businesses
5. Wire transfer systems

The rule requires certain participants in the DPS to establish policies and procedures that are reasonably designed to identify and block or otherwise prevent or prohibit restricted transactions that involve Internet gambling. A participant is defined as "an operator of a DPS, a financial transaction provider that is a member of, or has contracted for financial transaction services with, or is otherwise participating in, a DPS, or a third-party processor." It is important to note that institutions are only required to establish policies and procedures in relation to commercial customers, as the act excludes individuals.

The rule exempts certain participants from the requirement to have policies and procedures in place, but exempt participants are not specifically identified. Instead, all participants in the DPS are exempt from the requirements unless they are specifically named in the rule as "non-exempt," the full list of which can be found within the SR Letter. In general, non-exempt participants are those with a direct account relationship to commercial customers.

Participants without direct relationships are generally exempt; however, there are no exemptions for card system participants. This is due to the unique nature of card systems that allows transaction coding to occur in real-time. By having the system code transactions in the proper category, the participant can effectively segregate restricted transactions during the authorization process.

Regulatory and rule-making agencies have acknowledged the difficulty of monitoring for restricted transactions; therefore, the rule focuses on prevention by requiring payment system participants to conduct due diligence on commercial customers.

Policies and Procedures

Institutions must establish policies and procedures that are designed to identify and block or otherwise prevent restricted transactions. The act applies to all commercial accounts, requiring due diligence to be performed on commercial customer relationships opened on or after June 1, 2010. Procedures should be established that would require, at account opening, the determination of whether the customer poses minimal risk of engaging in Internet gambling activities. If there is determined to be minimal risk, for example, if the commercial customer has no Internet presence, no further due diligence is required.

It is important to note that the act also applies to existing accounts. Written notice that accounts must not be used for restricted transactions should be provided; however, there is flexibility regarding the method for providing the notice. It could be included in account document mailings, provided as a separate notice, or placed on the institution's website. If placed on a website, the notice should be clearly visible and may not be placed in a password-protected area of the site.

If the institution cannot determine whether the account holder poses minimal risk of engaging in Internet gambling activities, the institution must obtain certification from the customer that it is not engaged in these activities or must provide the following three items: commercial license from state or tribal authority (or "reasoned legal opinion") authorizing participation in activities; written customer commitment to advise of changes in authority; and third-party certification that the customer's systems are observant of legal limits.

An institution must also have policies regarding actual knowledge of restricted transactions. Actual knowledge is narrowly defined in the rule as information from law enforcement and/or a regulatory agency. Procedures to address actual knowledge of restricted transactions include, but are not limited to, continued transaction processing, suspicious activity report filing, and account review. The rule does not specify when transactions must be limited, or accounts closed, only that the institution should have procedures in place. The appropriate federal financial institution regulator has discretion to impose requirements in the course of supervision or within the context of an enforcement action.

As of June 1, 2010, institutions following the rule's examples of policies and procedures should have provided the required notice to commercial accountholders. Institutions planning to obtain verification that a customer is not involved in Internet gambling should have obtained the necessary statement from the customer by the same date. For all commercial accounts established on or after June 1, 2010, including accounts for existing customers, institutions should follow established due diligence policies and procedures.

Risk-Focused Examinations

Examinations of compliance with the act will be risk-focused. The scope of the examination may include risk factors, such as the number of commercial accounts the institution maintains for commercial customers engaged in the business of Internet gambling. When conducting an examination, examiners may review any relevant risk assessments and audit reports relating to UIGEA and determine who is responsible for compliance. Policies and procedures may be reviewed for compliance with all aspects of the act, especially as pertaining to acquiring documentation for customers that present more than a minimal risk. Examiners may also ensure that the proper notices have been delivered to commercial customers.

UIGEA and Bank Secrecy Act/Anti-Money Laundering (BSA/AML) operations. Financial institutions may choose to incorporate UIGEA policies and procedures within the BSA/AML compliance function, and federal regulators may examine these for compliance during a BSA/AML examination. While examiners may test for compliance during the BSA/AML portion of the examination, UIGEA examinations are not covered by the Federal Deposit Insurance Act mandate for BSA examinations. It is important to note that no matter how compliance is handled operationally, UIGEA compliance is not within the legal scope of BSA/AML requirements, including the AML program rule. The act does not supersede other requirements, such as AML requirements for risk assessment, customer due diligence, and reporting suspicious activity.

Summary and Important Dates

The act seeks to effectively prevent the transfer of funds that would be used for conducting illegal online gambling through commercial accounts. Responsibility for the identification of these transactions generally falls on the institution that has direct contact with the suspected commercial customer. Compliance with the rule is required as of June 1, 2010, postponed from the original date of December 1, 2009.

For more information on complying with the UIGEA, contact Special Advisor Robert Tillman (robert.tillman@phil.frb.org) at (215) 574-4155. ☐

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SR 10-11 Interagency Examination Procedures for Reviewing Compliance with the Unlawful Internet Gambling Enforcement Act of 2006
SR 10-10 Interagency Guidance on Correspondent Concentration Risk Cross
SR 10-9 Release of the Revised Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering Examination Manual
SR 10-8 Suspicious Activity Report Filing Requirements for Banking Organizations Supervised by the Federal Reserve
SR 10-7 Comments to the Basel Committee on Banking Supervision Regarding Proposals to Strengthen the Resiliency of the Banking Sector
SR 10-6 Interagency Policy Statement on Funding and Liquidity Risk Management
SR 10-5 Interagency Guidance on Obtaining and Retaining Beneficial Ownership Information
SR 10-4 Clarification of the Risk Weight for Claims on or Guaranteed by the Federal Deposit Insurance Corporation
SR 10-3 FFIEC Retail Payment Systems Booklet

All SR Letters are available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/>.

Pace of Bank Mergers and Acquisitions Increases as Valuations Gradually Improve *...continued from page 1*

months of 2010 (Figure 1). There were 149 acquisitions from July 1, 2009, to June 30, 2010, compared to only 29 acquisitions from July 1, 2008, to June 30, 2009. Factors that may have an effect on the price-to-book valuation include target location, asset size, bank rating, and geography.

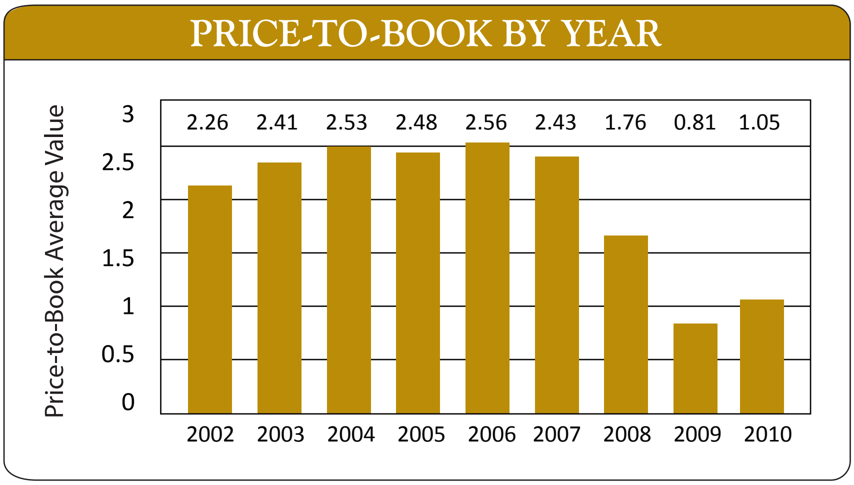

Figure 1

Interstate vs. Intrastate

The price-to-book valuations appear to vary regarding whether the acquisition is interstate or intrastate. Interstate bank targets received a higher price-to-book premium during the most recent period. For the July 2009–June 30, 2010 period, interstate targets received a 1.14 average price-to-book premium compared to intrastate targets that received a 1.02 average price-to-book premium. This was consistent with the January 2002–June 30, 2008 period, when interstate bank targets received a 2.53 average price-to-book value, while intrastate targets only received 2.31. In contrast, in the July 2008–June 30, 2009 period, interstate banks only received a 1.17 average price-to-book premium, while intrastate banks received a 1.39 average price-to-book value. The data indicate that during economic contractions, it is likely that acquirers are more willing to stay near home, but during economic recoveries there is the propensity to pay a premium to expand into new markets and other geographic locations.

Total Asset Size of Targets

During the 2002–June 30, 2008 period, the total asset size of target financial institutions had an impact on the acquisition price, as the price-to-book ratio appeared to increase with the total asset size of the acquired institution. However, from July 1, 2008, to June 30, 2009, large target institutions received a lower price-to-book premium than smaller target institutions. Banks with assets exceeding $1 billion received a 0.88 average price-to-book ratio, while banks with less than $1 billion in assets received an average of 1.02 price-to-book premium. This trend continued in the July 2009–June 30, 2010 period, as banks with assets exceeding $1 billion received a 0.76 average price-to-book ratio, while banks with less than $1 billion received an average 1.04 price-to-book premium. This valuation cycle is consistent with the deleveraging theme that has been occurring during the past two years.

CAMELS and RFI/C Rating

Strong composite CAMELS and RFI/C ratings and core deposit levels continue to demonstrate a solid relationship to higher price-to-book values. In theory, financial institutions that have solid overall performance should expect to receive a higher price-to-book premium. As solid overall performance commonly results in composite CAMELS or RFI/C ratings of strong or satisfactory, it is not surprising that examination and inspection ratings correlate and correspond to price-to-book premiums paid. This fact was evident in the 2002–June 30, 2009 analysis and again proved to be the case with the recent data.

The average price-to-book premiums paid during the January 2002–June 30, 2009 time period for 1- and 2-rated banks were 2.57 and 2.42, respectively, while 3- and 4-rated banks received 1.96 and 1.87, respectively (Figure 2). During the last 12 months, 1-rated banks received 1.50, while 2-rated banks received 1.28. The average price-to-book premiums for 3-and 4-rated targets were 1.03 and 0.84, respectively, while 5-rated targets received an average 0.75 times book value. Although the premiums paid were consistently lower during the past 12 months versus the historical average, higher-rated banks continued to consistently receive a higher price-to-book premium than lower-rated banks.

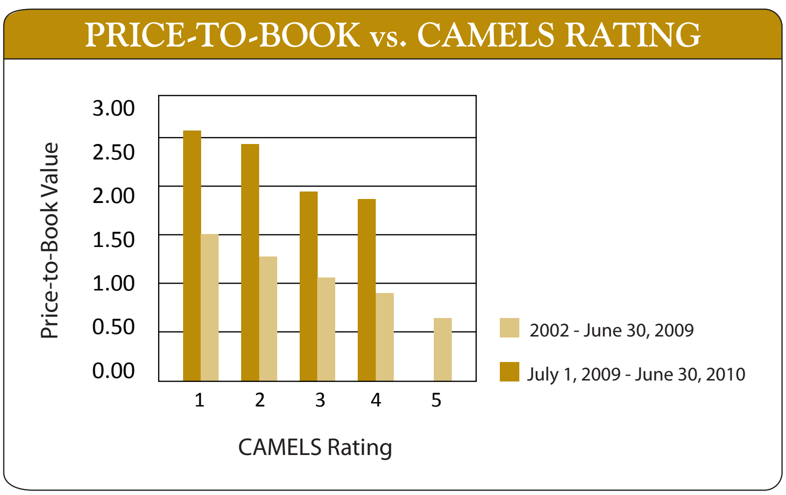

Figure 2

Core Deposits

In the prior studies, target banks with a high percentage of core deposits received a higher price-to-book premium. This continues to be the case, as banks with core deposits over 20 percent received a 2.30 average price-to-book premium, while banks with core deposits of five percent or less only received a 1.14 average price-to-book value. This continued trend shows the importance of the stability of deposits.

Valuations by District

Geography still plays an obvious role in price-to-book values as well, but the ratios in each region have changed noticeably. The targets in the Dallas, Boston, and St. Louis Districts received the highest average price-to-book ratios—1.44, 1.25, and 1.18, respectively—from July 1, 2009 to June 30, 2010 (Figure 3). The most significant valuation deterioration occurred in the San Francisco and Atlanta Districts during the same period compared to the July 2008–June 30, 2009 period. The average price-to-book premium paid for targets in the San Francisco District declined from 2.15 to 0.99, while valuations in the Atlanta District fell from 1.75 to 0.84. Although targets in the Dallas District received the highest average price-to-book premiums, they also experienced a significant decline.

Some Districts showed improvement. Average price-to-book premiums increased in the Chicago, Cleveland, New York, Richmond, and St. Louis Districts during the July 2009–June 30, 2010 period. Chicago had the most significant increase, as the average price-to-book premiums in the District improved from 0.80 in the July 2008–June 30, 2009 period to 1.03 in the July 2009–June 30, 2010 period.

The highest price-to-book premium paid in the nation from July 1, 2009, to June 30, 2010, was Green Dot Corporation's purchase of Bonneville Bancorp in the San Francisco District for 2.43 times book value. Bonneville Bancorp also had the highest core deposit ratio of all targets. The lowest price-to-book premium over the last 12 months was 215 Holding Company's purchase of White Rock Bank from BancMidwest Corporation for 0.17 times book value for $1.3 million.

Institutions acquired in the Third District received a 0.86 average price-to-book premium in the July 2009–

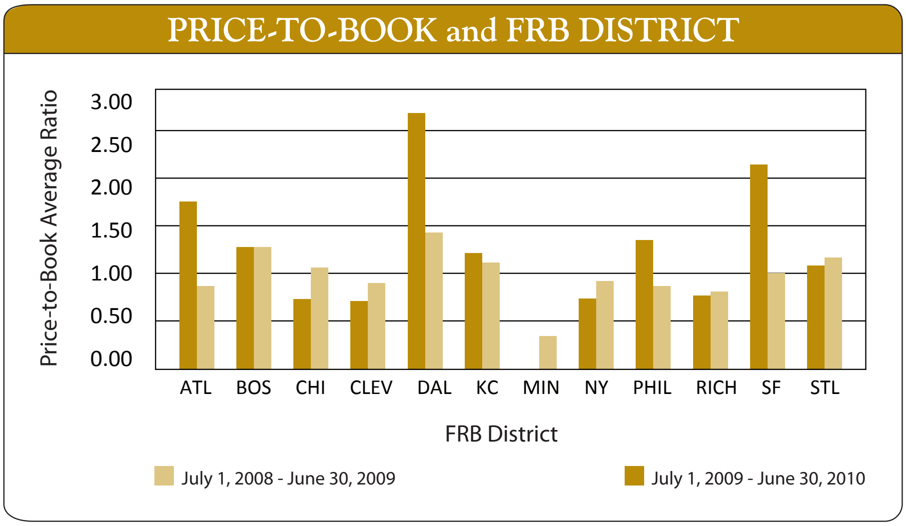

Figure 3

June 30, 2010 period, which was a significant drop from the 1.37 average during the July 2008–June 30, 2009 period. The highest price-to-book premium paid in the Third District during the July 2009–June 30, 2010 period was the Bank of Princeton's $5.5 million acquisition of MoreBank, which was priced at 1.19 times book value.

Conclusion

During the past year, the pace of acquisitions has increased, while price-to-book premiums paid for targets have gradually improved. Acquiring institutions are more willing to pay a higher price-to-book premium for out-of-state targets, as institutions look for opportunities to expand their operations geographically. Smaller targets command a higher premium compared to larger targets, as it appears that acquirers want to grow in smaller conservative increments. Institutions that had strong overall performances and ratings are still considered more valuable. Similarly, banks with high core deposits continue to receive a higher average price-to-book premium.

Warren Buffet, known for his investment wisdom, once said, "I don't look to jump seven-foot bars; I look around for one-foot bars that I can step over." In the bank acquisition business, it appears that this same wisdom applies. While institutions are increasing their desire to expand, they are also looking on a smaller scale now as compared to the mid-2000s. ☐

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chosen is likely to be more successful in promoting risk-appropriate compensation practices," adding that "we fear that a formula-based approach applicable to all covered employees may spawn efforts to circumvent the rules through creative new compensation practices, whereas our requirement that the banks internalize sound principles for incentive compensation and apply them to all such arrangements places a continuing responsibility on the firms themselves."

Implementation

To implement the recommendations contained in the final guidance, the agencies will analyze incentive compensation practices at large, complex banking organizations, building on a horizontal review of incentive compensation practices at large banking organizations that was performed by the Federal Reserve over the past year.[4] The agencies will review the practices and work through the supervisory process to improve areas in which potential deficiencies exist.

Covered banking organizations will be subject to enhanced disclosure and reporting of executive compensation with specific attention to incentive compensation that could lead to risk-taking and material loss to the organization.

All banking organizations should revisit and review their incentive compensation practices. As part of its regular examination process, the Federal Reserve plans to review incentive compensation practices and evaluate whether a banking organization has incorporated the recommendations contained in the final guidance.

[4] A horizontal review is defined as "a coordinated examination of practices across multiple firms," (www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm).

The agencies will also review incentive compensation practices at smaller banking organizations for consistency with safety and soundness principles. The supporting risk management, internal controls, and corporate governance will also be reviewed.

Concerns over a "one-size-fits-all" approach raised during the comment period were addressed with several provisions to reduce burden on smaller banking organizations. The size and nature of a banking organization will be given proper consideration—processing and monitoring techniques should be commensurate with the size and risk profile of a bank. Smaller banking organizations would likely employ less extensive and less formalized policies, procedures, and systems than their larger counterparts. The scope and assessment of incentive compensation practices should be tailored to an organization's size, complexity, business lines, and risk tolerance.

Regulatory Reform Bill

The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ushers in substantive and procedural changes pertaining to executive compensation and governance. While the central focus is on banking organizations, some provisions apply to nearly all publically-traded companies.

One of the key provisions involves shareholder vote on compensation disclosures, or as it is more commonly known, "say on pay." Companies will be required to grant shareholders a non-binding vote on pay policies as well as "golden parachutes" in the context of a transaction.

Covered banking organizations will be subject to enhanced disclosure and reporting of executive compensation with specific attention to incentive compensation that could lead to risk-taking and material loss to the organization. Amendments to proxy disclosure rules now require greater transparency. This includes disclosure of the median total compensation for all employees and the CEO's annual compensation, information intended to draw attention to egregious or disproportionate packages.

Compensation committee members must meet new independence standards and consider the independence of their compensation advisors. Disclosures revealing whether employees or directors can purchase financial instruments that hedge downside risk in their stock compensation programs are also required.

The reform law also calls for organizations to develop "clawback" policies. In the event that material misstatements (regardless of misconduct) result in restatement of financials, the law mandates recovery of erroneous excess amounts of incentive compensation paid to executive officers in the previous three years.

Compensation committee members must meet new independence standards and consider the independence of their compensation advisors.

Conclusion

A recent report released by the U.S. Treasury Department has determined that 17 companies that received TARP funds distributed "ill-advised" bonuses totaling some $1.6 billion. The financial crisis demonstrated that misaligned compensation practices can exacerbate risks, deepen losses at banking organizations, and undermine public confidence. It is important that we learn from this experience and take action to prevent or mitigate future crises.

Throughout the process, regulators have been mindful of both the public and financial industry concerns. The resulting guidance should enhance the overall resilience of the system while retaining enough flexibility for a bank to design and implement an effective and prudent compensation plan that is suitable to its individual objectives. ☐

INCENTIVE COMPENSATION

On June 21, 2010, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC) issued final guidance to ensure that incentive compensation arrangements at financial organizations reflect the associated risks and are consistent with safe and sound practices.

Because improperly structured compensation arrangements for both executive and non-executive employees may pose safety and soundness risks, the guidance applies not only to top-level management, but also to other employees, either individually or as part of a group, who have the ability to materially affect the risk profile of a banking organization.

In consultation with the other federal banking agencies, Federal Reserve staff will prepare a report after the conclusion of 2010 on trends and developments in compensation practices at banking organizations.

Who To Call

Your institution may need to contact an officer, manager, or staff member in the Supervision, Regulation, and Credit Department, but you may not know whom to contact. The following list should help you find the correct contact person to call. Financial institutions that have an appointed central point of contact should generally contact that individual directly.

Contact names appearing in bold are the primary contacts for their areas.

Community Regional Supervision	
William W. Lang, SVP	215-574-7225
Elisabeth V. Levins, AVP	215-574-3438
Cynthia L. Course, AVP	215-574-3760
Stephen J. Harter, Manager	**215-574-4385**
Jacqueline Fenton, Manager	**215-574-6234**
Lorraine Lopez, Manager	**215-574-6596**
Adina A. Himes, Manager	**215-574-6443**
H. Robert Tillman, Special Advisor	215-574-4155
Consumer Compliance & CRA Examinations	
William W. Lang, SVP	215-574-7225
Constance H. Wallgren, AVP	215-574-6217
Robin P. Myers, Manager	**215-574-4182**
Robert Snarr, Manager	**215-574-3918**
Consumer Complaints	
Federal Reserve Consumer Help Center	888-851-1920
Regulations Assistance	
Regulations Assistance Line	**215-574-6568**
Enforcement	
A. Reed Raymond, VP	215-574-6483
Eric A. Sonnheim, AVP	215-574-4116
Joseph J. Willcox, Manager	**215-574-4327**
Regulatory Applications	
A. Reed Raymond, VP	215-574-6483
William L. Gaunt, AVP	215-574-6167
James D. DePowell, Manager	**215-574-4153**
Retail Risk Analysis	
Christopher C. Henderson, Retail Risk Officer	**215-574-4139**
Discount Window and Reserve Analysis	
Vish P. Viswanathan, VP	215-574-6403
Gail L. Todd, Credit Officer	**215-574-3886**

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