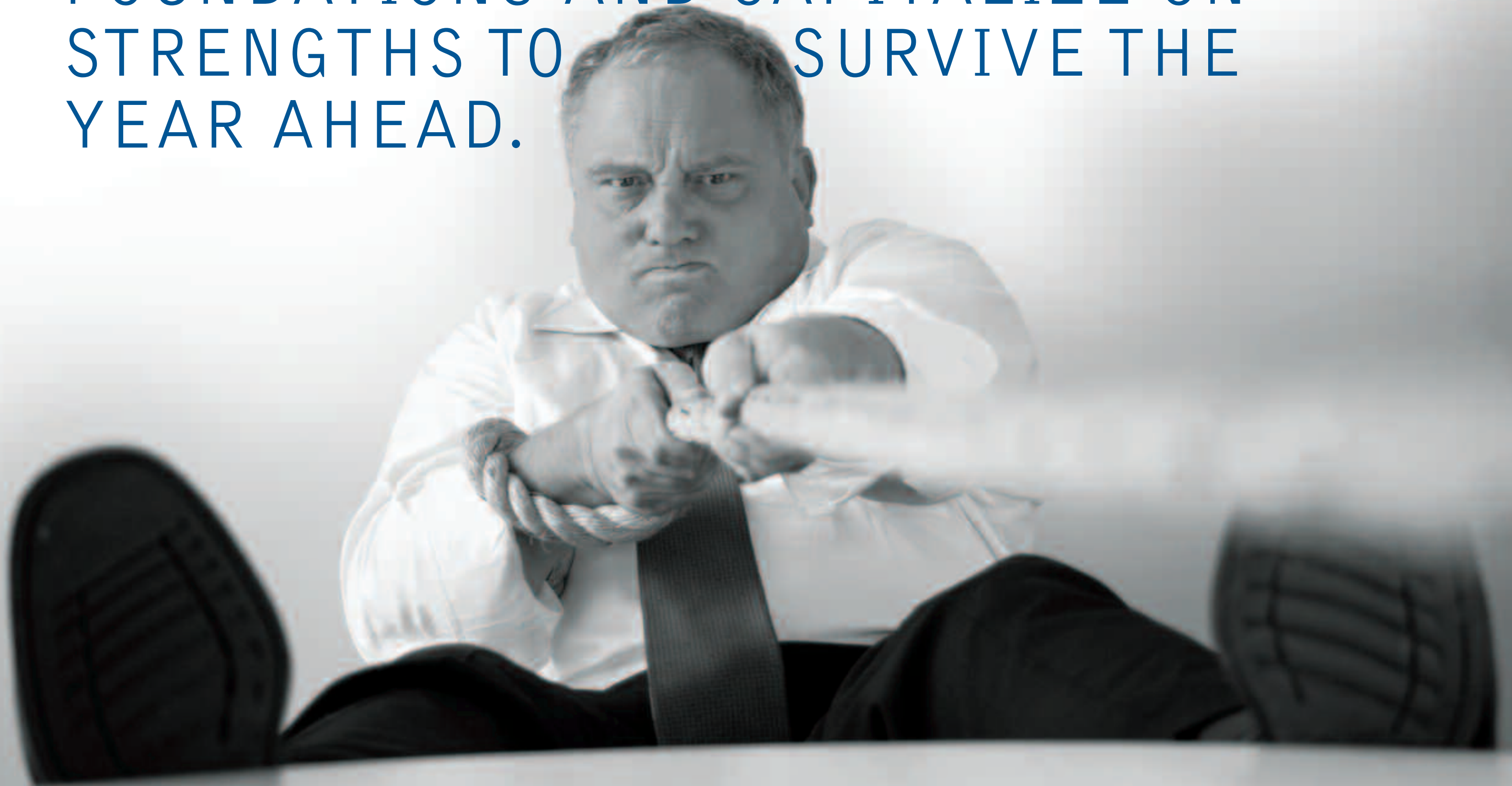
THE RESULTS OF THE ***BANK DIRECTOR* GRANT THORNTON LLP 16TH BANK EXECUTIVE SURVEY** SHOW THAT BANKERS ARE DETERMINED TO SHORE UP THEIR FOUNDATIONS AND CAPITALIZE ON STRENGTHS TO SURVIVE THE YEAR AHEAD.



TOUGHING

IT OUT IN 2009

The U.S. banking industry is undergoing a seismic stress test this year—the result of which will determine the ultimate viability and resiliency of the country's financial system. Few banks will emerge unscathed, yet the very turbulence that will crack the foundations of some institutions will present others with opportunities to grow—and even thrive.

With these events as a backdrop, *Bank Director* and Grant Thornton LLP collaborated again this year on the 16th Bank Executive Survey. The results that follow provide an assessment of how bank executives are managing the turmoil around them and outline the strategies they will take in the months to come. As many bankers expressed in subsequent interviews, they are diligently working to maintain footing in their markets and regain confidence from customers, shareholders, and regulators.

Overview: The Outlook for Banking and the Economy

As this issue is readied for press, bankers are reacting to a flurry of legislative announcements and federal programs designed to jump-start the economy and bring about financial stability. In mid-February, the sweeping announcement by Treasury Secretary Timothy Geithner captured the historical importance of the moment:

"We believe that the United States has to send a clear and consistent signal that we will act to prevent the catastrophic failure of financial institutions that would damage the broader economy. … This new Financial Stability Plan will take a comprehensive approach. The Department of the Treasury, the Federal Reserve, the FDIC, and all the financial agencies in our country will bring the full force of the United States government to bear to strengthen our financial system so that we get the economy back on track."

Days after this plan was announced, President

by **DEBORAH SCALLY**

Obama's $787 billion Economic Recovery Plan, which authorized stimulus spending for nearly every major industry sector, was made public. Coinciding with these broad-based programs, the banking industry has been focusing on the administration's Capital Assistance Program (CAP), a core element of the Financial Stability Plan, as well as last fall's Capital Purchase Program (CPP), a plan that falls under the the Troubled Asset Relief Program (TARP) umbrella.

Broadly stated, the government's core philosophy is to offer various avenues for assistance in improving banks' balance sheets by injecting much-needed capital and removing troubled assets. Some bank executives, however, view the price tag of having a government benefactor as too high. For instance, the acceptance of low-cost TARP funding also means restrictions on bonuses and incentive compensation, on dividend payouts and stock buybacks, as well as possible restrictions on the uses of that capital, such as for M&A transactions. These limitations have led many bankers we have spoken with to think carefully about whether they will accept government assistance or try to manage on their own during this recovery period. Whether they were for or against accepting assistance, however, nearly all bankers we interviewed were circumspect about a near-term recovery.

"We can grow core earnings in our institution, but I'm not optimistic on the economy," says Michael Price, president of $6.25 billion First Commonwealth Bank in Indiana, Pennsylvania. "I'm not convinced we've bottomed out. The vortex is opening up—we're all worrying and we want to see this bottom out and have some stability."

Restoring confidence and optimism— a long way up

A linchpin to stabilizing the markets will be the bolstering of consumer confidence, which plummeted in March to its lowest point in five years, according to data published by the Conference Board. Moreover, as shown through results of the Bank Executive Survey, it's not just consumers who have the doldrums.

When the survey asked respondents at the close of last year about their outlook for 2009, nearly nine out of 10 bankers (86%) were pessimistic about the U.S. economy, and more than three-quarters (76%) were pessimistic about the business of banking. For the second year in a row, both sets of data represent a significant spike from the year before (Figure 1) and an enormous rise compared to 2007.

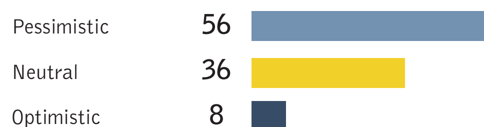
"U.S. consumer confidence is the lowest in generations," says Ray Davis, president and CEO of $8.3 billion Umpqua Holdings Corp. "When the economy comes back, consumers will come back. Government is going to have to build confidence, and the media and industry leaders all have a role," he says. "Hopefully, we'll see cracks in the clouds in '09 and we'll pull out in 2010."

figure Outlook for banking and the economy

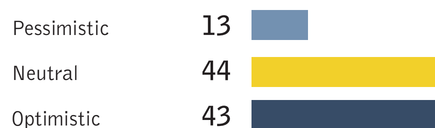
OUTLOOK ON NATIONAL ECONOMY

2009

2008

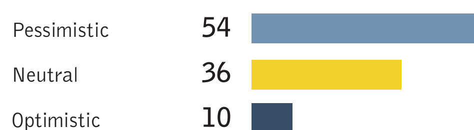


2007

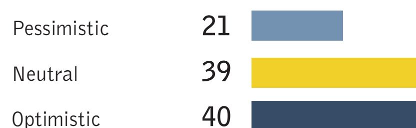


OUTLOOK FOR BANKING NATIONALLY

2008

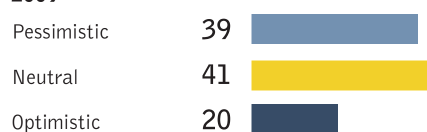


2007



OUTLOOK FOR BANKING IN RESPONDENTS' COMMUNITIES

2009



A renewal of optimism, experts agree, will lay the groundwork for a positive chain reaction, but so far, that spark has not ignited. "For the first time in the history of the survey, not a single banker was highly optimistic about the outlook for the U.S. economy for 2009, nor the national business outlook for banking in 2009," says John Ziegelbauer, national managing partner of Grant Thornton LLP's Financial Institutions practice. Bankers surveyed also believe additional leadership and action is called for: Only 15.1% agreed that the Federal Reserve is doing a good job of managing the current crisis and just 17% think Treasury is handling the situation well.

In a separate question, more than three-quarters (75%) of CEOs polled believe consumer confidence in the industry has diminished—a key factor in banks' ability to regain strength and capital to serve customers in the months ahead. In one-on-one conversations, bankers expressed frustration with the dichotomy between the crises occurring at large Wall Street banks and the day-to-day challenges faced by community banks.

"I don't think consumers should lose confidence in smaller and regional banks. We keep doing what we've always done: taking care of the customer," says Scott Dueser, president and CEO of $3.2 billion Abilene-based First Financial Bankshares. Dueser says a lack of discipline on the part of some institutions ended up painting the entire industry unfairly. "The answer [bankers who offered subprime] should have been giving their customers was, 'No, you can't afford that house.' … It's up to the banker to [have] customers' best interests at heart."

Credit and Lending Issues

Most observers agree there is no issue more critical to the health of our nation's economy than regaining a flow of credit and liquidity to the markets. In the wake of last year's subprime mortgage market collapse, a landslide of defaults and foreclosures created extreme tightening of underwriting standards and a near halt on lending, a situation that contributed significantly to the slide in the U.S. economy. When we asked bank executives what they believed to be the three leading causes for the current crisis, their top answers were lax underwriting standards, the political mandate to increase home ownership, and the general lack of oversight of the mortgage industry (Figure 2). Perhaps more troublesome, 40% of bank executives answered that the cause for the credit crisis was an inadequate understanding of the risks.

"This is a particularly telling aspect of the survey," says *Bank Director* President TK Kerstetter. "The fact that 40% of bankers felt that financial executives did not fully understand the risks they were involved in clearly illustrates that banks and boards have a lot of work to do in the area of enterprise risk management."

Opinions of primary causes of the credit crisis — figure 2

	%
Lax underwriting standards	54
Political emphasis on increasing home ownership	46
Lack of oversight of the mortgage industry	44
Inadequate understanding of risks	40
Lack of oversight of Fannie Mae and Freddie Mac	39
Interest rates kept low for too long	18
Credit default swaps	18
Inappropriate mortgage broker commissions	18
Use of the fair value accounting standard	15
Mortgage fraud	11

Where we go from here

There are varying opinions on when the credit markets and the economy will begin to turn upward. Most executives polled in December said they did not expect the credit crisis to abate until 2010 (44%), although some (39%) believed that it might bottom out by the second half of 2009. By early spring, Federal Reserve Chairman Ben Bernanke had posited that some recovery should be noted late in 2009 with a larger turn in 2010; however many economists still believe that a longer time will be needed for recovery—until 2011, 2012, or later.

Despite differing opinions on when a turn will occur, it's widely regarded that the key to cracking the economic ice floe is a combination of a national stimulus plan along with some measure of debt restructuring. By March, several models were being debated in the nation's capital as a means to loosening the credit bottleneck and promoting further lending—as well as spending—to resuscitate the national economy.

Much of the key lies in just how quickly these plans can bolster job creation, and thus stimulate additional spending and corporate revenue, says Paul Pustorino, partner at Grant Thornton. Ironically, Americans, drowning in mortgage and consumer debt, are now fearful of the very spend-

ing that could save them, he explains, harkening back to what 20th century economist John Maynard Keynes referred to as the "paradox of thrift." To save or to spend—that is the question on many citizens' minds as the country bobbles perilously close to deeper recessionary woes.

Assistance for banks

For financial institutions, the primary aid thus far has come in the form of the TARP plan, which provides assistance for banks by injecting capital to offset bad assets and bolster capital levels. As of March, the government had granted nearly $200 billion of the $250 billion in capital allocated for the TARP program, with a second phase of the program, TARP II, involving another $100 billion of aid for consumers and businesses, nearing completion. Many executives participating in the Bank Executive Survey believe this is a mere drop in the bucket: 41% thought last December that the bailout plan would eventually cost the Treasury Department more than $700 billion.

At year-end 2008, nearly half (47%) of the executives responding to the survey told us they were interested in participating in the TARP Capital Purchase Program, although in speaking to bankers we found their opinions on the wisdom of accepting the government funds mixed (see related story, page 32).

Umpqua's Ray Davis is a proponent of the CPP and its objectives, but shudders at the political infighting that has accompanied the program. "We participated in the CPP. You had to qualify; it's only for strong banks and it's getting the machinery regreased. But it's a shame it's turned into a partisan battle," he says.

First Commonwealth's Price, however, says TARP is masking a larger problem that needs to be addressed. "We did not take TARP and raised money the old-fashioned way with common stock last October, and it was only dilutive by 10% to 11%," he says. Price maintains that TARP funds are disproportionately helping larger institutions. "If some large banks disappear, a lot of capacity would be absorbed by smaller banks, and they'd be more efficient."

Still, the number of applications for TARP funding points to a great need within the industry for low-cost capital. "I believe it is necessary to ensure the long-term health of the industry, so long as banks receiving TARP funds are properly reviewed before the funds are advanced," says Jerry S. Von Rohr, chairman and CEO of $1.1 billion Reliance Bank in St. Louis. "But those banks receiving funds must be prudent and accountable in the use of those funds. If used properly," he continues, "it will help many financial institutions survive during this difficult period."

To gain insight on how regulators should alter their general guidelines to provide more stability, we asked bank executives what type of adjustments they felt should be implemented. More than half (52%) agreed that regulators should readjust the weightings of certain assets and credit exposures; fewer (36%) felt regulators should tinker with Tier 1 capital definitions. We also asked whether loan pricing and terms should be modified to reflect the current environment. With regard to adjustable rate mortgages (ARMs), an overwhelming number of bank executives (81%) believe that repricing ARMs will not have an adverse effect on loan losses in the coming year, despite the volatility some experts argue may occur as a result.

The impact of accounting

Accounting revisions have also been a hotly debated topic as a possible shot in the arm to improve banks' balance sheets and the future flow of credit. When we asked bank executives whether they believed fair value accounting was the most appropriate method for banks to use to recognize the value of their financial assets held for sale or trading in earnings, 60% of bankers disagreed.

"The move toward more fair value information reporting is ultimately a positive one for investors," says Grant Thornton's Ziegelbauer. "FAS 157 was developed in response to investor demand for more consistent, higher quality information. However, application of fair value accounting becomes more difficult when liquidity in the market dries up. Some of the assets held by banks are not being traded actively, or are traded under distressed circumstances. Many banks feel that marking their assets to reflect such distressed sales exaggerates the size of asset writedowns and the resulting hits to bank regulatory capital."

The FASB has proposed additional guidance related to how fair value accounting should be applied in situations where trades are occurring in inactive markets or under distressed circumstances and has proposed changes to the rules governing the timing and measurement of other-than-temporary impairment. Taken together, Ziegelbauer affirms, these are very important changes for the banking industry.

Lay of the land

Looking deeper into banks' performance measures, we asked bank executives to report on specific aspects of their loan portfolios (Figure 3). Nearly all areas reported significant changes in performance from previous years, with the largest jumps noted in the anticipated increase of delinquencies (78% anticipate an increase, compared to 53% who anticipated increases last year); commercial loan losses (66%, compared to 41% the year before); consumer loan losses (54%, compared to 27% last year); and residential loan losses (44%, compared to 28% last year). Moreover, bank executives anticipated upticks in foreclosures, refinancings, and credit card fraud for 2009. In addition, when we spoke to several CEOs, many admitted the

fault lies in the industry's willingness to loosen underwriting standards at a time when more discipline—not less—was needed. "Banks as a whole got too loose on lending, and they need to get back to good credit standards," states First Financial's Dueser.

In essence, nearly every aspect of a bank's core lending structure has been rocked by the fissures that emerged from the stricken subprime business. Perhaps worse, the fallout has tainted the reputation of community banks everywhere—an unsavory situation that Main Street bankers and lobbyists for the industry are working hard to eradicate. As the American Banker Association stated in testimony before the House Committee on Financial Services earlier this year:

> "Certainly, some FDIC-insured banks did become caught up in the mortgage bubble, but the great majority did not. Furthermore, banks are negatively affected when the economy in their local communities deteriorate[s]. But it is important to recognize the sound underpinning that banks still provide for the economy …"

In the months ahead, messages like this, along with the voices of thousands of community bankers, will be strongly urging Congress for measures that legitimately come to the aid of a weakened industry. "Our biggest challenge this year will be to avoid significant loan losses," says Roy L. Harmon Jr., president and CEO of $686 million Bank of Tennessee, based in Johnson City. "The economic stress will cause even some of our 'best' customers to run out of cash," he says, adding, "It will be very difficult to balance the needs of customers and extend additional credit in light of regulatory pressure to maintain and improve credit quality."

Funding the Bank

Running a close second to credit and asset quality issues this year are bankers' concerns about how to generate adequate funding in a recessionary economy. While some observers have suggested that banks could see an increase in deposits as consumers move away from declining returns on mutual funds, a more likely scenario is that consumers will simply have less discretionary funds to deploy due to debt burden and rising unemployment, thus creating net deposit shrinkage. In addition, with securitization markets tightened or closed, liquidity is a primary concern.

Funding, therefore, is a key issue, according to 44% of bank executives who heartily agreed that finding adequate resources is currently a challenge for their bank. Accordingly, nearly half (48%) reported that they expect core deposit balances to remain flat or decrease this year.

Anticipated lending portfolio changes for 2009 — figure 3

	% Increase	% No change	% Decrease
Commercial loan demand	27	28	45
Commercial loan losses	66	30	4
Consumer loan demand	14	36	50
Consumer loan losses	54	42	4
Core deposits	52	35	13
Credit and payment card fraud losses	48	49	3
Customer refinancing of loans	35	54	11
Documentation fraud losses	17	76	7
Number of delinquencies	78	20	2
Number of foreclosures	59	36	5
Residential mortgage loan demand	18	36	46
Residential mortgage loan loses	44	50	6
Source of liquidity	16	61	23
Use of derivative financial instruments	8	60	32

Sources for funding

As bankers look to expand their funding base to support the extension of new credit in the year ahead, the Bank Executive Survey asked respondents which sources they would be more likely to tap and how those sources would be deployed.

Executives expect core deposits to remain the most prevalent funding source for 2009 (according to 94%), just as they have for the past four years of the Bank Executive Survey (Figure 4). These are closely followed in popularity by Federal Home Loan Bank advances (77%), also in line with previous years' results. The survey shows a slight drop-off in the number of CEOs who anticipate using brokered deposits this year (40% compared to 45% in 2008), and a significant increase in the anticipated issuance of preferred stock (18% compared to only 4% who issued it in 2008). Another change in funding noted this year is an increase in anticipated loan sales in 2009 (by 32% of respondents), compared to what was anticipated by bank executives in 2008 (24%) and what they actually used in 2008 (28%). In addition, those who responded from larger institutions and those who were more optimistic about the national outlook for banking were also more likely to antic-

4. figure — Funding sources used and anticipated

	% Plan to use in 2009	% Used in 2008
Core deposits	94	95
FHLB advances	77	85
Brokered deposits	40	45
Loan sales	32	28
Issue preferred stock	18	4
Issue common equity	10	5
Issue trust-preferred securities	4	4
Sales/leaseback transactions	4	1

ipate using loan sales as a funding vehicle in 2009.

Several bankers we interviewed say their overall funding plan remains the same as always. "During our 45-year history, our equity capital funding has come from retained earnings, and that will be our source for 2009," says Thomas Legan, president and CEO of $1.1 billion Coppermark Bank in Oklahoma City. Legan says funding for loans and investments has historically come from customer deposits, with a small portion from FHLB advances, which will continue to be the bank's approach in 2009.

In addition, and possibly as another solution for funding constraints, at least a small percentage of privately held institutions considered it likely they would undergo a public offering in the next three years (Figure 5). Compared to years past, a larger than expected percentage of private institutions (16%) said such a scenario was likely, and 25% of mutuals answered in the affirmative.

For nonpublic banks, including mutuals, access to capital is limited, concedes Grant Thornton's Ziegelbauer. "Even though pricing for IPOs might not be that good right now, many banks will be evaluating going public in the next few years in order to capitalize on growth opportunities," he explains.

Strategies for Growth and Success

Despite daily hyperbole about financial collapses, Wall Street greed, and rubber-stamp boards, the majority of U.S. banks are going about business as usual. In fact, as Mark Twain might have said, reports of the industry's early demise are greatly exaggerated.

Further countering that all U.S. banks have been pulled into the vortex is the fact that some banks actually may be better positioned in the months ahead. In reality, pockets of opportunity often open up after failures occur, in the form of increased loan demand, retail footprint, or a strategic alliance or acquisition.

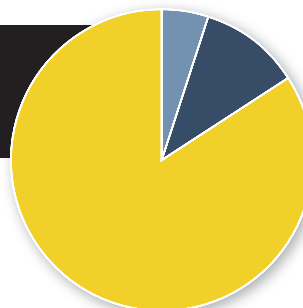
In the spirit of looking at opportunities ahead, we asked this year's bank executives to rate key measures of loan activity within their current bases of business. Interestingly, when looking at anticipated loan demand, this year's results show a distinct skewing toward the poles. That is, we found a higher number of executives reporting both increases and decreases in consumer, commercial, and residential mortgage loans and noted that fewer had no expected changes. When we analyzed these findings by public, private, and mutual institutions, we saw no discernable correlation between ownership structure and loan demand, with the exception of mutual bank executive respondents, who clearly anticipate higher levels of residential mortgage loan demand when compared with other financial institutions. One additional noteworthy finding: Bankers clearly anticipate an uptick in refinancings in the year ahead, perhaps understandably in conjunction with near-record lows on interest rates.

Retail delivery and acquisitions

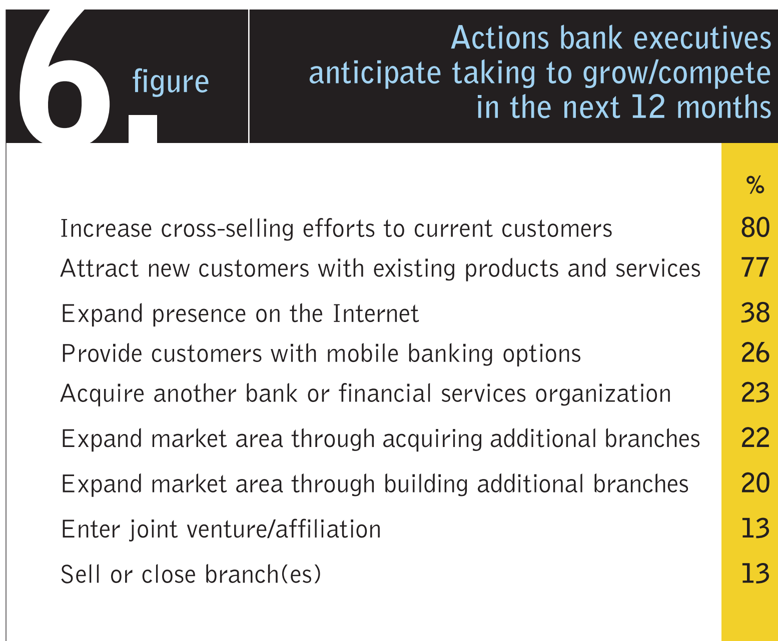
In terms of strategic growth, most investment bankers believe 2009 will not likely see an increase in mergers or acquisitions, although many say it could be an opportune

5. figure — Likelihood of going public within three years

Very likely	5%
Somewhat likely	11%
Not at all likely	84%



time for well-positioned banks to buy or to undergo a merger of equals in a mutually beneficial, no-premium transaction (see Special Report, page 47). According to the survey, 23% of bank executives (with a slightly higher percentage of larger institutions) reported they would likely grow through the acquisition of another bank or financial services organization in 2009; 13% reported interest in pursuing a joint venture or affiliation with a related financial services company, such as a real estate company or brokerage firm (Figure 6).



6. figure — Actions bank executives anticipate taking to grow/compete in the next 12 months

	%
Increase cross-selling efforts to current customers	80
Attract new customers with existing products and services	77
Expand presence on the Internet	38
Provide customers with mobile banking options	26
Acquire another bank or financial services organization	23
Expand market area through acquiring additional branches	22
Expand market area through building additional branches	20
Enter joint venture/affiliation	13
Sell or close branch(es)	13

Divestitures of branches or other assets may provide opportunities for other institutions. Thirteen percent of bank executives said they'll likely sell or close branches in 2009; 22% told us they expect to expand their market by purchasing additional branches. One in five executives anticipate expanding their market area by building additional branches, although this percentage is drastically lower than what we've seen during the last four years of the study, where as many as 50% or more banks expected to build additional branches in the year to come.

In general, banks aren't planning on large-scale expenditures for additional ATMs, nor are they looking to invest in ventures outside their current market areas. Data from respondents indicates a more conservative approach overall, with banks concentrating the lion's share of their efforts on cross selling current customers or attracting new customers with their current low-cost products and services.

Next-generation needs

Most bankers understand, however, that while a conservative expenditure attitude is necessary in a down economy, to remain on the leading edge, they must keep abreast of future needs. Much attention has gone lately to the so-called Y-Generation of customers—those who are contemplating banking services as they move into early adulthood—and the shifts in products and marketing that will be needed to serve them. When our survey asked executives whether their institution had begun to take steps both internally and externally to meet the banking needs of the future generation of customers, a whopping 85% answered affirmatively. About 34% of larger banks and 21% of smaller banks are taking steps to invest in mobile banking, for instance, as a chief means to reach 20-something, on-the-go customers.

"Banking on mobile phones is one service for members of future generations who don't want to come into the bank," says First Financial's Dueser, who explains that his bank also invested in a software program to allow people to transfer funds and look up balances on their cell phones. "They can't pay bills [with it]," he says, but "that is the next step." Dueser also says they are gearing more advertising toward the Web, where younger generations naturally receive more and more of their information. CEO Ray Davis, long known as an innovator in branch technology, says today Umpqua branches, or "stores," offer customers a unique experience in which they can interact with a virtual customer service rep that comes to life when you touch a [lobby] screen. "We are always looking at the next generation," Davis says.

Risk Management

It's an understatement to say that risk management will test the mettle of every bank executive and board member this year. Risks within the financial services industry are pervasive—credit portfolio risk, liquidity risk, regulatory risk, legal risk, market risk—each nearly boundless, as the shadows cast by the current economic crisis continue to broaden. Being able to identify, analyze, measure, and mitigate those risks will remain a full-time job.

While many of today's financial services executives gained valuable knowledge from the lessons of the past, most are facing problems they've never seen before. Unlike the real estate downturn in the 1980s, or even the tech bubble of the 1990s, today's exotic investment structures, such as the credit default swaps that ended up corrupting international banking titans like Bear Stearns, Lehman Brothers, and Merrill Lynch, have created dangers far more complex and insidious than anything previously encountered.

Thus, all bank executives and their board members, whether they are on Wall Street or Main Street, must be vigi-

figure 7 High-risk concerns for 2009 (with 2008 comparisons)

	2009 % All	% Small	% Large	2008 % All	% Small	% Large
Credit risk	48	43	58	37	33	47
Interest rate risk	35	38	32	39	38	41
Portfolio/market risk	33	31	35	20	16	24
Reputational risk	18	17	21	21	19	24
Online security	17	16	19	41	39	45
Regulatory compliance	16	14	20	45	47	42
Operational risk	11	10	14	28	29	28
Legal risk/shareholder suits	2	2	3	5	5	4

lant about portfolio management risk and continue to ask questions about areas they don't understand. Old-fashioned lenders, well versed on the Four Cs of credit (character, capacity, collateral, capital) may feel that today's market, with its unknown triggers for systemic risk, is an alien world. But as shareholders will readily attest, profitability is still the aim; thus, bankers who have a talent for identifying smart, strategic opportunities—and who can exercise prudent risk management—will wind up operating a healthy enterprise on the other side of this downturn.

Hot spots of risk

Within the broad scope of risk management this year, certain areas are more worrisome than others. In an effort to ascertain which risks executives find most troublesome, the Bank Executive Survey asked respondents to rate the relative level of risk among eight categories. Credit risk far outstripped the other categories listed with 48% of executives rating it as a high-risk area (Figure 7). This finding became more acute as institution size grew: 58% of large banks rated credit risk as a high risk, compared to 43% of smaller banks. Behind credit risk were concerns about interest rate risk (rated by 35% as high risk) and portfolio risk (rated by 33% as high risk). In particular, portfolio risk saw a jump in relative risk concern compared to last year, when only one in five bankers felt it was a high-risk category. Interestingly, concerns about online risk appeared to drop, but upon reflection, this may be due to the relative rise in attention to other areas, rather than to actual diminishment of perceived online risk. In interviews, bankers say online security is still a moving target, but with proper oversight, it can be managed.

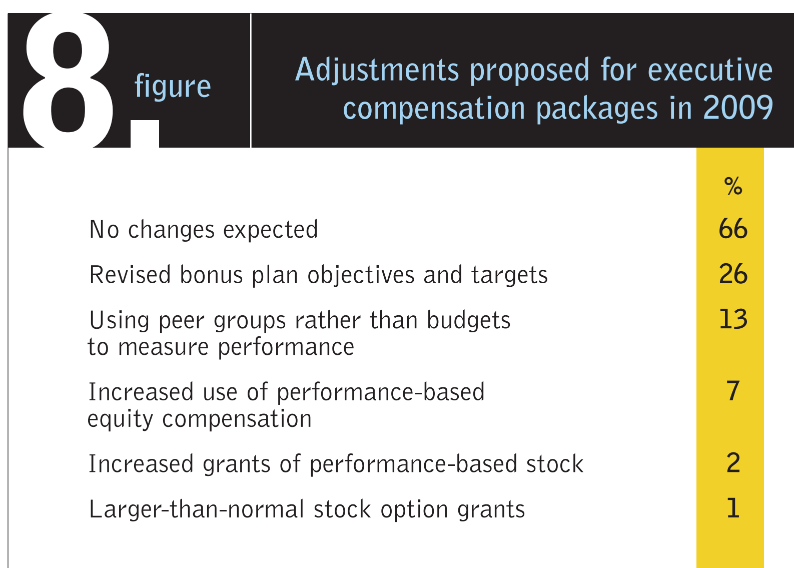
"With the ever-increasing use of technology, even as risk continues to grow due to increased usage, proper controls and regular review of these controls will limit these risks," says Ronald D. Paul, chairman and CEO of $1.5 billion Eagle Bancorp, Bethesda, Maryland.

However, along with most experts, Scott Dueser maintains online security is still a ripe area for fraudsters. "No matter how much you warn people [about fraud, customers will] tell you 'I did it anyway,'" he laments. "We try to educate [customers] and if there is really a question of fraud involved in a transaction, we won't do it." Adds Umpqua's Davis: "As sophisticated as banks get, people who want to steal are just as smart."

As a general overview, a greater percentage of large banks rated all risk categories higher compared to their small-bank counterparts. The one exception was interest rate risk, which garnered a greater percentage of attention from smaller banks.

Compensation

The topic of executive compensation, on a slow simmer for years, has officially reached a boiling point among corporate—and political—circles. In February, in conjunction with the financial stimulus law, the Obama adminis-



8. figure Adjustments proposed for executive compensation packages in 2009

	%
No changes expected	66
Revised bonus plan objectives and targets	26
Using peer groups rather than budgets to measure performance	13
Increased use of performance-based equity compensation	7
Increased grants of performance-based stock	2
Larger-than-normal stock option grants	1

tration recommended a salary cap of $500,000 on executive pay for corporations that receive government assistance; almost immediately, a more stringent form of the cap appeared in the Senate version of the bill. Title VII of the final legislation is even broader, and includes restrictions on compensation for all senior executive officers (any individual who is one of the top five most highly paid executives of a public company as well as the top 20 highest-paid employees) and defines compensation caps according to a sliding scale related to the amount of TARP funding received. The act also outlines the provisions necessary for proxy disclosures related to senior officer compensation. Thus, while not the primary intent of the legislation, the long-festering issue of executive compensation excesses became an easy target for political scrutiny and, as such, its regulation became an extension for any party obtaining capital assistance.

While barrages of criticism have been aimed mainly at megabanks, this unwanted publicity reached community bankers as well, who are understandably frustrated at the entire industry being painted with the same brush. "As a community bank," says Patricia Clausen, president and CEO of Northside Community Bank, a $550 million institution in Riverwoods, Illinois, "it is difficult to separate yourself from the image of the 'Wall Street banker' with salaries and bonuses on steroids."

Bankers' reactions

Umpqua's Davis says the best way to counter compensation concerns from those outside the bank is to make sure pay is indeed in line with performance. "We do incent people, and the vast majority of incentives are based on financial performance. In the last two years, top executives [here] received zero bonuses."

To examine this topic more closely, we asked what changes or adjustments banks had proposed for executive compensation packages next year in light of declining industry earnings. A little more than a quarter of the respondents said their bank had undergone revised bonus plan objectives and targets; 13% said they would use peer groups instead of budgets to measure performance. But by and large, two-thirds (66%) of banks did not expect to make any revisions to their executive plans (Figure 8), although out of a list of compensation topics bank CEOs were asked to mark as high priorities, revisions to bonus and incentive plans garnered the largest share of responses (32%).

"The impact of the new and emerging executive compensation and corporate governance rules will have a dramatic impact on how compensation plans are designed and pay delivered," explains Henry Oehmann, director, National Executive Compensation Service, Grant Thornton, who says we will continue to see more speculation as to the impact of these limits, caps, and reporting requirements on other regulated and nonregulated industries. For banks that can afford to go outside of TARP for capital, it may be worth it to avoid such egregious compliance, but for others, it will simply be part of the price paid to survive in the coming year.

Strategic Planning

Even when the bank is deflecting daily bullets, the vital importance of strategic planning cannot be overstated. It is specifically during times of crisis and volatility that the bank's experienced leaders must be able to look beyond the minutia and ensure the institution is following a well-thought-out blueprint to carry it successfully into the future.

So despite what is going on at the front line, it is critical to take time for proper strategic planning. Yet, when we asked executives how well this function is being performed, an alarming third (31%) admit they are not spending enough time on it.

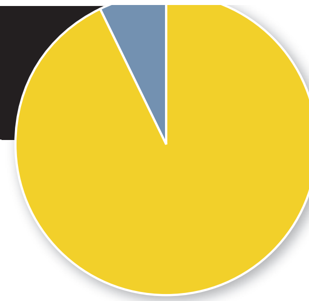
"It is never acceptable for directors and officers to allow strategic planning to fall by the wayside," says *Bank Director*'s Kerstetter. "No matter what else is going on inside or outside the institution, the need for setting prudent corporate direction is one of the most important functions a board can perform."

One example of the need for forward thinking is in relation to the movement by the SEC (under its previous chair) to retire U.S. GAAP and adopt International

9. figure

Do you include the board in your strategic planning process?

Yes	92%
No	7%



10. figure

How boards participate in the strategic planning process

	%
Review the annual budget and quarterly goal targets	80
Assist/approve corporate goals prior to the setting of strategies and tactics	66
Provide input for the bank's situational/competitive analysis	54
Develop the strategies and tactics	17
Develop the annual budget	6

Financial Reporting Standards (IFRS) by as early as 2014. In order to proactively plan for both domestic and international tax issues related to this conversion, a three- to five-year planning horizon that involves assessing an institution's tax function and business or legal structure may be needed. While IFRS is now the primary accounting standard used globally, the United States is one of the few countries that has not taken aggressive steps to adopt it. Moreover, according to the Bank Executive Survey, IFRS is not resonating on many respondents' radar: While 13% of the institutions surveyed do not expect IFRS to apply to their institution, nearly a third (28%) reported that IFRS is not yet a significant issue for their bank. More than half (51%) responded that they were not familiar with IFRS.

"While U.S. adoption of IFRS may be inevitable, it may not be catastrophic for banking institutions," says Dorsey Baskin, partner in the National Professional Standards Group for Grant Thornton. "Given the existing extent of convergence between applicable U.S. standards and IFRS and the ongoing efforts of the FASB and IASB to converge standards that remain out of sync, the full adoption of IFRS many years in the future could turn out to be more of a whimper than a bang."

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The role of the board in planning

In addition to ensuring the bank is spending adequate time on strategic planning, it is equally important to make sure time is spent on quality objectives and that such sessions involve all relevant directors and officers. For example, the vast majority of CEOs (92%) polled say they include their board in the strategic planning process (Figure 9). Of those, executives say, nearly 80% review the annual budget and quarterly goal targets; two-thirds (66%) assist or approve corporate goals prior to setting strategies and tactics; and a little more than half (54%) provide input for the bank's situational analysis (Figure 10). These findings demonstrate that while the majority of boards are involved with these basic functions, there is room for many more to step up to the plate.

Conclusion

Overall, bankers are realistic about their prospects to operate profitably and see the industry grow and thrive in the coming year. Yet while they are much more pessimistic than in years past, they are far from defeated. Community bankers, in particular, have faith in the guiding principles that have kept their customers and communities strong for decades, and executives we spoke with are committed to retrenching and getting back to basics to survive the current firestorm around them. Building capital to strengthen each institution's foundation will be job one—even if, in some cases, it's attached to some level of governmental oversight and intervention. Just as important will be bankers' keen analysis of asset quality and keeping a firm hand on underwriting, especially at a time when political pressure will be applied to play a role in offering liquidity and support to the nation's economic stimulus plan.

Bank Director *and Grant Thornton LLP wish to thank the hundreds of bankers who participated in this year's study, which helps provide meaningful analysis and education for all bank executives and directors who receive this publication.* **|BD|**