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Phantom Stock

Is it the right strategy for your executive compensation plan?

By William "Billy" Granville III

It's a brutal world out there. Between ever-expanding regulations, squeezed margins and omnipresent big banks, it's tough being a community bank. Nowhere is this felt more strongly than in the competition for key talent—those executives who could work at your bank, at a big bank, or in an entirely different industry. If you want to attract them to your bank and retain them as key performers, you have to have a competitive edge—something that sets you apart and makes your bank the most desirable employer.

Most bankers are familiar with the typical components of key executive compensation plans. But what about lesser-known components, those that are somewhat familiar but rarely seem to take center stage? As your bank is seeking to differentiate itself as the best option for highly desirable talent, consider the integral role phantom stock could play in your executive compensation plan.

What is Phantom Stock?

Phantom stock is basically a contractual deferred compensation strategy offered to top executives, with the value of the future compensation determined by the value of your bank on a "per share" basis. Designed to parallel equity shares, phantom shares allow your bank to reward executives

who perform like owners, without diluting actual ownership. Most plans are either "full-value" plans, with compensation based on the full value of the bank's stock, or "appreciation-only" plans, with compensation based on how much the stock value appreciates after the phantom award. The plan defines when the compensation is actually paid and under what circumstances—such as upon sale of the bank or executive retirement.

Phantom stock is often used by privately held companies for the same reason public companies include company stock in their compensation plans: it puts "skin in the game," with executives incurring both risk and reward, based upon the bank's success. The advantage to your bank by using phantom stock is that ownership is not diluted; the advantage to the executive is he gets to participate in a stock plan without working for a public company, and his reward is tied only to the bank, not to the general whims of the market.

What are the Pros and Cons of Using Phantom Stock?

How many times have you heard someone say, "He stayed long enough to get his bonus, then he left and went down the street to XYZ Bank"? Phantom stock helps protect your bank's investment in key talent by taking a long-term approach to that investment; the balance to this protection is that your bank must be willing to share the rewards of the investment, beyond an annual cash bonus.

Pros: A phantom stock plan is a simple and effective tool to accomplish the following objectives:

- Enhance the recruitment and retention of key executives, particularly those with highly desirable skills and knowledge
- Align the interests of owners and key executives, encouraging executives to think more like "owners" with a longer term view of success
- Share the economic value of your company with key executives without bringing them on as equity partners or requiring them to invest cash
- Reward key executives without triggering an immediate taxable event
- Share the economic value of your company with key executives while avoiding the risks inherent in having additional shareholders
- Create "Golden Handcuffs" to

incentivize key executives to remain with the bank long-term

Cons: Phantom stock plans are not right for every bank:

- Because the plan is a form of non-qualified deferred compensation, this liability must be accounted for on the bank's balance sheet; the bank creates a "book account" on its balance sheet to recognize its obligation to the plan participants
- Not all key executives will understand—or appreciate—the benefit of using phantom stock in their compensation plan, so education and communication are key if this strategy is to be successful
- Phantom stock plans are intended only for C-level and other top executives; a differently structured incentive plan is more appropriate to reward loyalty, tenure or overall performance for mid- and senior-level managers
- The plans are generally subject to the complex regulations governing non-qualified deferred compensation plans, IRC 409A; a carefully developed plan is mandatory.

Sample Plan Design

The document developed for your bank's phantom stock plan is a legal contract, just as the bank's retirement plans or employment contracts. The document will describe how the plan works and how payments are made, along with other specific details. Items covered often include:

- Who is eligible
- How shares are calculated and valued
- Vesting schedule
- Form of payment
- Structure of distribution, such as a lump sum payout vs. periodic distributions
- Non-employee-based trigger events for payout, such as change in bank ownership
- Employee-based trigger events, such as death, termination, retirement, change in responsibilities, disability, etc.
- Restrictive covenants, such as those that restrict future employment upon employment termination or that mandate confidentiality of proprietary bank information

The compensation agreement created in your plan may take many different forms, depending on how your bank wants to structure the benefit. Several examples are shown below:

- **Sample Plan Design 1:** The bank may promise to pay the executive, at a future point in time, an amount equal to the value of a fixed number of shares. *For example, the bank may promise a payment equal to 1000 shares; the payment will occur in five years, when the executive turns 60. If the bank's stock value is $50, the bank credits $50,000 to the executive's "book account" ($50 x 1000 shares). The value of the "book account" will vary, with the actual payment dependent on the share price when the payment is made.*
- **Sample Plan Design 2:** The bank may make discretionary contributions on behalf of the executive. The contributions can be incentive-based, dependent on reaching certain corporate benchmarks such as ROA, ROE or net income, and/or they can be based on individual performance criteria. The contributions are credited to executive's phantom stock account, and are used to purchase phantom stock units. *For example, the bank contributes $10,000 to the executive's account when the bank hits a specified ROA benchmark. This amount equates to 200 shares of phantom stock units, based on the bank's current stock valuation of $50 per share. The executive now has 200 shares in his account; the account balance will vary as the stock value rises or falls.*
- **Sample Plan Design 3:** The executive defers a percentage of his/her current income to purchase phantom stock units. The phantom stock units may be purchased at book-value, or the units may be priced at a discount to book-value. This is comparable to a stock purchase plan in a public company. *For example, the employee defers 5% of income and uses that to purchase 200 shares of bank stock, valued at $50 each. The employee now has 200 shares in his account; the account balance will vary as the stock value rises or falls.*

What's the Bottom Line?

The consideration of a phantom stock plan is a more complex decision than simply deciding to offer an additional reward to top executives. Here are some key questions your bank should ask as you evaluate this option:

1. How well do you believe your bank competes with other banks—and non-banks—for key talent?
2. Are you willing to take a long-term approach to key executive retention?
3. Does your bank have a strong short-term (annual or less) incentive plan in place?
4. Are you willing to let the value of your bank increase, knowing it may result in paying a non-owner more money in the future?
5. Does your bank expect significant growth over the next five to ten years?
6. If future payout is made in cash, can your bank handle the potential drain on cash flow?
7. How important is it for you that your key employees think more like shareholders?

If the answer to these questions is positive or "yes," then a phantom stock plan may be a strong option for your bank to consider, as part of a larger compensation strategy. If you answered "no" or hesitated on any of the questions, then a different option may be better for your bank. Regardless, a thorough analysis of your bank's overall executive compensation strategy can help you refine your competitive position to attract and retain the talent you need to succeed.

William "Billy" Granville III is the CEO and Managing Member of Granville Financial Group (GFG), a boutique consulting firm providing executive compensation solutions for financial institutions and corporate clientele. He may be reached at billy@granvillegrp.com.