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2014 COMPENSATION SURVEY

Aligning Pay with Long-Term Strategy

WHITE PAPER

Compensation Advisors

a MEYER-CHATFIELD company

Aligning executive pay with the long term interests and strategy of the bank may be one of the toughest challenges faced by bank boards today.

Most of the directors and senior executives that responded to Bank Director's 2014 Compensation Survey, sponsored by Meyer-Chatfield Compensation Advisors, feel that their bank's executive compensation programs are meeting the board's objectives, but getting pay for performance right continues to challenge bank boards. How can boards design compensation programs that will attract the high caliber employees that will enable the bank to achieve its strategic goals?

In the quest to hire talented executives to keep the bank going in the right direction—or take the bank in a new one—pay is important. But the compensation package isn't the only thing that attracts talented executives to the bank. Culture can't be undervalued.

The survey also found there has been a boom in the recruitment of experienced lenders to support organic growth plans, with pay packages in some instances going well above market. Bank boards are also seeing increased pay and benefits. Thirty-nine percent of respondents indicate that their directors will see higher pay in 2015, and almost half increased director compensation in 2013 or 2014. The majority reveals a preference for cash compensation, but how that cash is paid out is changing, with meeting fees declining slightly while the percentage of directors receiving an annual retainer grows.

Reversing a trend noted in prior surveys, benefits are rising. More than half indicate that their directors receive some sort of benefit, an increase of 30 percent from 2013. The most common benefit, reported by 34 percent of respondents, is the reimbursement of travel expenses, and almost 30 percent receive a deferred compensation benefit.

Overall, the 2014 Compensation Survey finds that while bank boards recognize the need to tie compensation to the performance of the bank in the long term, they continue to struggle with how to get the pieces in place to attract and reward the best leaders to meet the institution's strategic goals.

Does your bank take a strategic approach to executive pay?

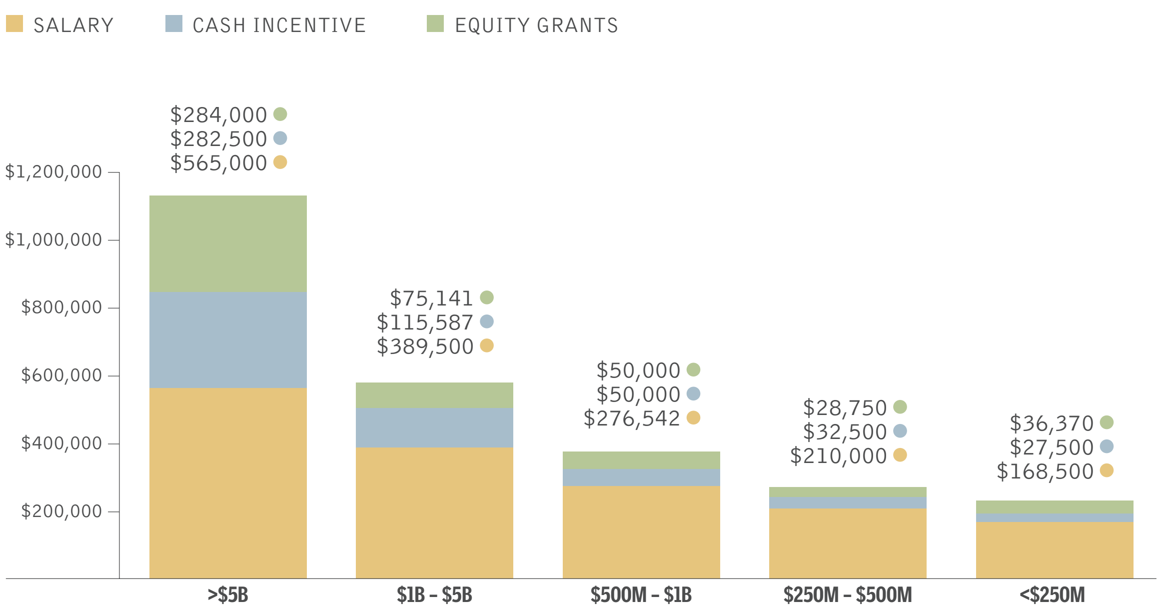
The directors and senior executives responding to the 2014 Compensation Survey say they're satisfied with their executive compensation programs, yet continue to reveal—for the third year in a row—that tying compensation to performance remains a top challenge. Flynt Gallagher, president of Meyer-Chatfield Compensation Advisors, says this reflects the uncertainty faced by bank boards in appropriately connecting executive incentives to performance measures and goals in a way that both attracts and retains talent while helping to drive the strategic plans of the bank. More than one-quarter of the respondents say that CEO compensation is not linked to the performance of the bank, and don't tie pay to specific performance indicators or the institution's strategic plan. Many boards aren't specific about the goals and objectives they expect the top executives of the bank to achieve, so incentive pay is more subjective and undefined.

Less than half tie CEO pay to the strategic plan or corporate goals, and Gallagher says that boards should always keep the strategic plan and long-term goals in mind when determining compensation for executives. These goals should be very specific and measurable, and tied to things like the successful completion of a merger or a specific growth goal. If, for example, the bank's plan is to achieve a certain size and scale within five years but the CEO's pay is tied to the bank's net income, it's unlikely that the board's goals will be met, since those long-term goals may dampen bank revenue in the short-term. "I'd recommend that the board sit down and identify exactly what it is they want the bank to achieve as a strategic objective, which executives are going to help make that happen and what each executive should do to make that happen," says Gallagher. "It's got to be very specific performance criteria."

FIG. 1

CEO Pay Snapshot

Median compensation, by asset size



Asset quality was the most common performance indicator tied to CEO pay, followed by return on equity and return on assets. Publicly traded banks are more likely to use performance indicators, but privately held and publicly traded banks are equally likely to tie CEO pay to the bank's strategic plan.

As a part of the executive pay package, opinions are mixed on the value of equity. Despite the improved health of the industry, bank stock valuations haven't returned to their pre-crisis levels. Equity lacks liquidity unless it has been issued by a publicly traded bank with an actively traded stock. Equity can also create tax implications for the executive, and that can make it less desirable than cash incentives. Less than half of CEOs value equity, according to the survey. Forty-one percent report that the bank's CEO receives equity grants, and 45 percent allocate equity grants to executives, typically in the form of restricted stock or, slightly less common, stock options.

Very few report offering synthetic equity—just 4 percent overall. But Gallagher says that synthetic equity—a deferred incentive built around a cash award that will grow larger or smaller in parallel with the stock price or book value of the bank—can be a valuable retention tool. "It accomplishes the same thing as true equity, but you don't have the issues of liquidity. The cash award will increase in value at the same rate as company value increases," he says.

Tying strategy to CEO pay better positions the bank for long term financial success and gives an incentive to better prepare for the bank's future. Retirement plans are on the rise, and give an executive a stake in the company years after his departure. A failed bank can't make good on its obligations. Since poor performance by the bank could result in a loss of retirement benefits, the CEO will make sure that his successor will be ready to take charge and that he leaves the bank in good shape. "The successors will manage the bank and ensure that the bank can continue to pay benefits," says Gallagher.

Nearly one-third of respondents cite succession planning as a top challenge. Almost 40 percent report an executive departure in 2013, and while many of these were the result of retirement, which was likely planned for and anticipated by the board, 20 percent report that the departure was due to a resignation or termination. The loss of a key executive is a predictable event, but can put the bank at serious risk. "With the talent shortage for very good executives at the top, I think you've got a real simmering issue," Gallagher says. "It's going to be a rude awakening for some community banks."

How can your bank attract talented executives?

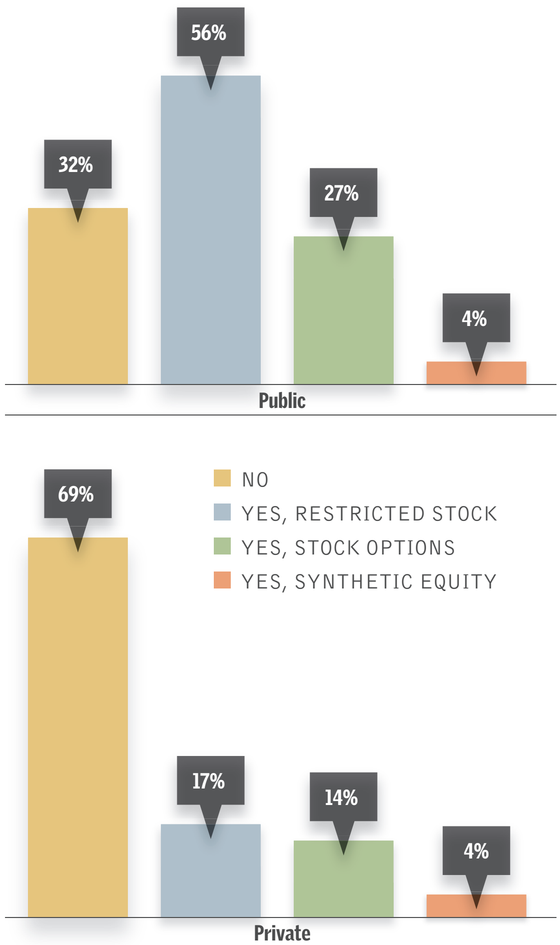
Three-quarters of the executives and board members that participated in the survey reveal that their bank promoted or hired new talent at the executive level in 2013. Lending is the focal point of new hires, at 44 percent, followed by compliance, at 29 percent, and risk management, at 26 percent. Reflecting the trickle-down effect of the Dodd-Frank Act, which places a higher risk burden on larger institutions, hires in risk management were concentrated at banks with more than $1 billion in assets. The need for loan officers is consistent across the industry, with 60 percent of respondents telling Bank Director and Meyer-Chatfield Compensation Advisors that growth and strategy fueled new hires last year.

Unlike many positions, for which pay is based on what the market will bear, competitive pay for loan officers is a lot harder to quantify. According to Gallagher, what constitutes a competitive pay package for loan officers, particularly commercial lenders, is in constant flux due to the hyper-competitiveness within the industry for quality lenders. Gallagher says that he's seen some institutions offer pay packages well in excess of market, just to lose the lender to a competing bank. "There's a real war out there to either attract or retain the lenders that banks need to execute their growth plans," he says. One survey respondent representing a bank with between $250 million and $500 million in assets agrees, saying: "Good commercial loan officers are in high demand right now, and therefore compensation for them has skyrocketed lately."

While pay packages carry a lot of weight when

FIG. 2

Are equity grants allocated to executives on an annual basis?



it comes to attracting talented executives, corporate culture can't be overlooked. The majority of respondents, at banks of all sizes, report that the culture of the organization is the top attribute that makes the bank attractive to potential hires. The stability of the company is also cited as an important factor, for more than half, followed by whether the position poses a career opportunity for the executive, at 30 percent, or whether the bank is a market leader, at 19 percent. The bank's compensation program is cited by just 13 percent as the top factor that attracts talent.

Board pay is rising. Is your bank keeping pace?

Almost half of the respondents report that their bank raised director compensation in the past two years. Median fees and annual retainers reported for fiscal year 2013 rose across the industry compared to the previous year, and almost 40 percent anticipate a raise in board pay in 2015.

Not only is director pay rising, but the way banks pay their boards is changing. Compared to compensation surveys conducted in 2012 and 2013, the data shows a slight decline in the payment of meeting fees, while also demonstrating significant growth in the number of banks offering directors an annual retainer, up by 20 percent since 2012. Gallagher says that this reflects the changing role of directors, who are spending more time outside of meetings on board issues. "Retainers have become a better way to compensate," he says. Unlike meeting fees, annual retainers better reflect the increased responsibilities of board members.

Five Compensation Considerations

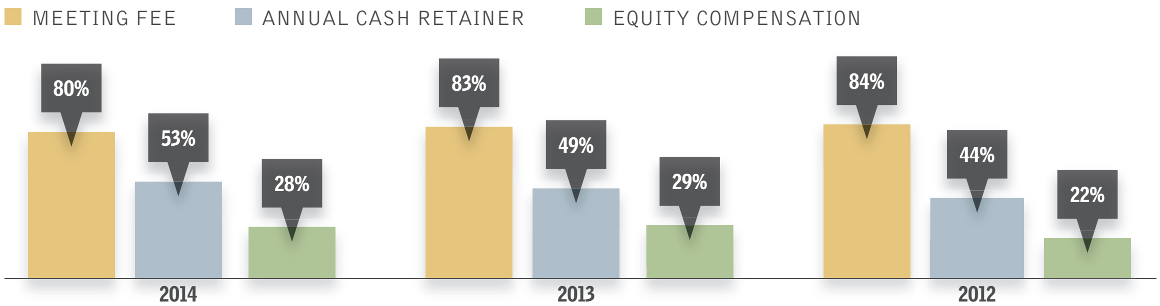
1. Executive performance goals should be clearly defined and tied to the bank's strategic plan.
2. Make sure the bank is planning for the future and has a succession plan in place. Forty-two percent of executive hires were driven by executive departures in 2013.
3. Competitive pay is critical to attract and retain key talent, but it is not the determining factor. Culture can be the intangible that drives talent to—and from—an organization.
4. The board must determine its own pay – not the CEO.
5. Evaluate whether the board's pay is fair and aligns with market practices.

More than half of the chairmen and independent directors responding to the survey feel that their compensation is fair, but more than one-quarter are dissatisfied. Most of those who feel that board pay is unfair represent banks with less than $500 million in assets, a group of institutions that have struggled since the financial crisis in a harsh regulatory environment which resulted in rising board responsibilities and liability. These

FIG. 3

Director Compensation Snapshot

Compensation Types Received by Outside Directors



Independent director compensation (median), by asset size

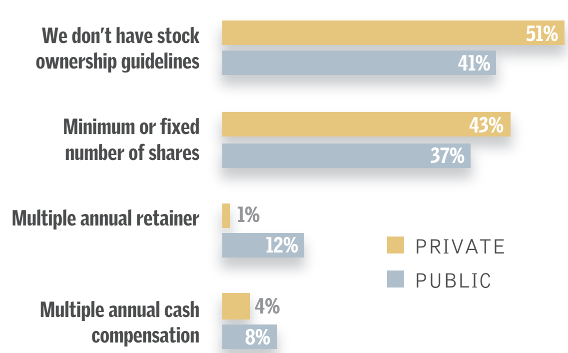
	All banks	>$5B	$1B – $5B	$501M – $1B	$250M – $500M	<$250M
Fee per board meeting	$750	$1,125	$950	$750	$550	$600
Annual cash retainer	$20,000	$50,000	$23,000	$11,100	$10,200	$7,200
Equity compensation	$28,500	$45,000	$15,500	$10,000	$10,000	$3,300

boards are more reliant on meeting fees and less so on annual retainers. For banks with less than $500 million in assets, 85 percent offer meeting fees to outside directors and 40 percent offer an annual retainer. Larger banks are more inclined to opt for annual retainers: two-thirds of banks with between $500 million and $5 billion in assets, and almost three-quarters of banks above $5 billion, offer an annual retainer.

The percentage of banks offering equity compensation for their board members remains steady, at 28 percent for independent directors industry-wide and 46 percent at publicly traded banks. Also consistent with the 2013 survey, this year finds that yet again half of bank boards do not have stock ownership guidelines for directors, which typically determine the minimum number or total value of shares that a board member should own and establish a time frame in which to acquire the shares. Gallagher says it's a best practice to have these guidelines in place, even at community banks with boards comprised of the bank's founders and owners. "Stock ownership guidelines give you a vested interest to make sure that the decisions you're making are in the best interests of shareholders, because you are one," he says. "So you understand how shareholders view [the board's] decisions." The most prevalent stock ownership requirement is a minimum or fixed number of shares.

FIG. 4

What are the requirements included in the stock ownership guidelines for your directors?



More board members report that they receive benefits, reversing a trend noted in past surveys. Fifty-four percent of respondents report that the board receives benefits, with travel expenses the most common.

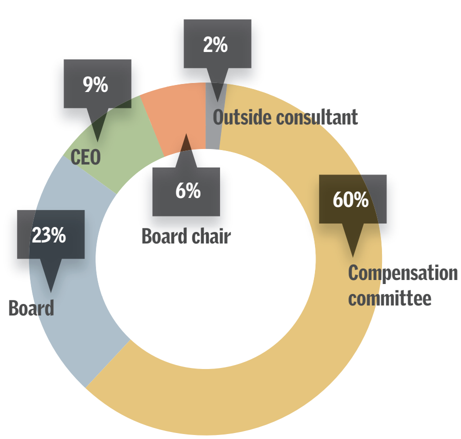
Who's responsible for board pay?

More banks are delegating director compensation levels to the board's compensation committee, rising to 60 percent from 44 percent in 2013. Almost 30 percent delegate director pay to the board or the board chair, and many of these may rely on the recommendations of the compensation committee or a consultant. However, 10 percent of the industry relies on the bank's CEO to set director compensation, and Gallagher says this is a big mistake that can create a toxic relationship between the board and the CEO. If the board gives the CEO a bad review or disagrees with an executive decision, the CEO could retaliate by cutting board pay. "Boards should set their own pay with no say from the CEO," he says.

When determining director pay, Gallagher says that boards should look at the size of the bank as well as how involved the board is in running the institution. Additionally, boards should look at the total amount spent on board compensation compared to peer institutions, not just pay per director,

FIG. 5

Who is primarily responsible for setting director compensation levels at your bank?



as the directors of banks with smaller boards typically contribute more to the oversight of the bank.

"Today you have to be more educated and understand banking more so than in the past," says Gallagher. "Directors need to be compensated for that."

About the Survey

Bank Director's 2014 Compensation Survey, sponsored by Meyer-Chatfield Compensation Advisors, focuses on trends in executive hires as well as board and executive pay. More than 300 independent directors and senior executives, including chief executive officers and human resources officers, at banks of all sizes across the United States participated in the online survey. Independent directors and chairman accounted for 37 percent of the data, and CEOs accounted for 15 percent. Director pay data was also collected from the proxy statements of 99 publicly traded institutions. Based on regional definitions from the U.S. Census Bureau, 35 percent of the data came from banks in the Midwest, one-third from banks in the South, 23 percent from banks in the Northeast and 9 percent from banks in the West. More than half of the combined proxy and respondent data came from publicly traded banks.

About Meyer-Chatfield Compensation Advisors

For more than 20 years, Meyer-Chatfield has been a trusted partner to America's financial institutions — providing compensation advisory services and Bank Owned Life Insurance. Meyer-Chatfield teaches clients how to meet financial goals, manage benefit liabilities and enhance shareholder value. As industry experts they deliver unique strategies and solutions. For more information, please visit www.meyerchatfield.com.

About Bank Director

Since 1991, Bank Director has served as a leading information resource for the directors and officers of financial institutions. Through its quarterly *Bank Director* magazine, executive-level research, annual conferences, and its website, BankDirector.com, Bank Director reaches the leaders of the institutions that comprise America's banking industry.

COMPENSATION TRENDS

39%
expect director compensation to increase in 2015.

20%
raised board pay in 2014.

Director pay is shifting from per-meeting fees to **annual retainers.**

Loan officers are in high demand.

Executives prefer **cash bonuses** to equity incentives.

Top Five Compensation Challenges

1. Tying compensation to performance
2. Retaining key people
3. Compensation and benefit costs
4. Competitive pay
5. Developing a succession plan

Boards are **less worried** about regulatory compliance: the percentage of respondents citing this as a top challenge **dropped** by almost **50%** since 2013.

The median mandatory retirement age for bank boards: **72**

The number of banks offering a non-qualified benefit has risen **21%** since 2013.

Growth and **strategy** drove **59%** of **executive hires.**