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2020 COMPENSATION SURVEY
Focus on Survival

WHITE PAPER

Compensation Advisors

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The pressures brought to bear upon the banking industry as a result of Covid-19 and the related economic downturn promise to exacerbate two long-term challenges facing bank boards and management teams: tying compensation to performance, and managing compensation and benefits costs.

In early July, the U.S. remained "knee deep in the first wave" of the Covid-19 pandemic, according to Dr. Anthony Fauci, director of the National Institute of Allergy and Infectious Diseases. States paused or began rolling back their efforts to reopen businesses and public areas. Tens of millions of Americans were unemployed.

"I'm really concerned about it," said William Demchak, chairman and CEO of PNC Financial Services Group, who warned of an impending wave of loan defaults in a July interview. "I don't know that it's going to devastate us, but I think it's going to put us into a period of really slow growth." By September, newly reported cases remained above infection levels in March and April nationally. Many states were experimenting with school reopenings, and case counts were rising in the U.S.

Bank Director's 2020 Compensation Survey, sponsored by Compensation Advisors, was conducted in March and April, just as Covid-19's broad reach became clear, leading banks to embrace remote work and respond to the monumental task of issuing Paycheck Protection Program loans.

The survey highlights key concerns for bankers in this unusual environment, which will be explored in this white paper. How will bank boards evaluate CEO pay? What about director compensation and efforts to refresh the board? Finally, will banks be prepared for the impending turnover in the C-suite once baby boomers retire?

Forward-looking banks could emerge stronger from this crisis, says Flynt Gallagher, president of Compensation Advisors. "This environment is an opportunity for them, because it gives them the ability to make the changes they've been wanting to make," he says. With so many Americans unemployed, more high-quality talent is available, and he believes institutions should find a way to bring them into the organization — even if a position isn't open.

"You never go wrong when you get good people," Gallagher says.

Evaluating CEO Pay

Bank boards will need to think outside the box when it comes to evaluating their CEO's performance in 2020. This isn't business as usual. The pandemic and its economic fallout are external variables, impervious to the influence of even the best CEO. It stands to reason that standard performance metrics will not yield a fair evaluation of a CEO's performance.

Almost half of the survey respondents indicate that tying compensation to performance is a top compensation challenge. When asked how they measure CEO performance, 71% are guided by the goals laid out in the bank's strategic plan. More than half also rely on profitability metrics, such as return on assets (57%), income growth (54%) and return on equity (54%).

"I do see some of the community banks finally deciding, 'our best option is to sell the bank.' … A lot of that's going to be determined by their CEO – what's the age of their CEO and what it's going to cost them to bring in a successor."

— **Flynt Gallagher, Compensation Advisors**

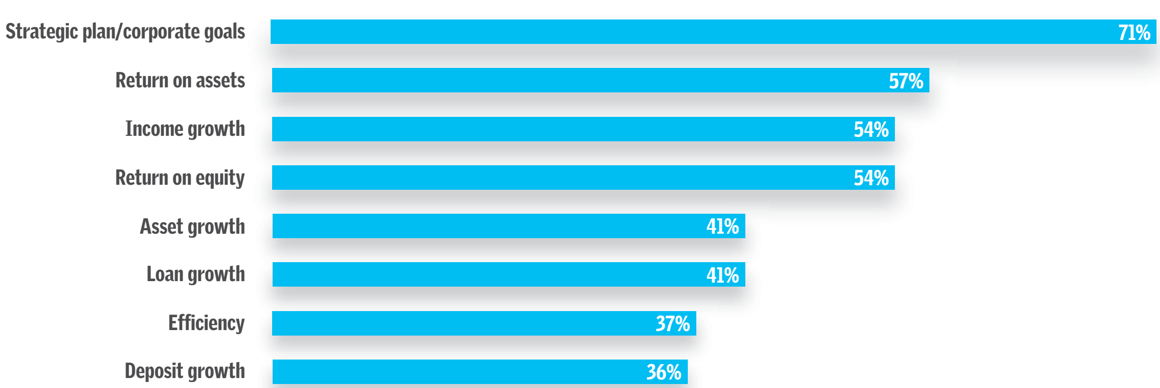
"It's complicated for the board," Gallagher says. "Most companies have adopted good performance-based plans, and that's been upended."

Credit risk was especially difficult to assess when Gallagher and I spoke in June. The culprit: the widespread use of forbearance and loan modifications promoted by the prudential regulators and embraced by banks as a way to support their customers. It's only a matter of time before the bill for those comes due.

Gallagher recommends that boards ask different questions to assess CEO performance. How did the bank perform compared to peer institutions facing similar issues? Did it have the talent it needed to weather the storm? How did underwriting hold up? Did the bank have the technology to serve customers digitally and allow employees to work remotely?

FIG. 1

Is your CEO's performance measured by any of the following? *Most popular options displayed.*



The buck stops with the CEO. Did they position their institution to withstand the inevitable onslaught, or were they washed away in the looming storm?

"In evaluating performance, most boards are going to have to look at: How was the bank managed during this time? How were credit quality issues addressed or managed so they didn't get out of hand? Was there a lot of proactive work that's not over the top?" says Jeff Fairchild, senior compensation consultant at Compensation Advisors. "Some banks immediately went out and started changing the terms of the loans without even knowing quite yet whether they needed to. So, was it too proactive? Was it not reactive enough?"

Forty-one percent of survey respondents say they evaluate asset quality when measuring CEO performance; 20% examine metrics around credit risk.

Gallagher also recommends examining the CEO's response to pressures on profitability. The Federal Reserve is unlikely to raise interest rates any time soon, which will squeeze net interest margins for the foreseeable future.

"There's no ready fix for that," Gallagher says. "That's going to depress performance moving forward."

The best-positioned banks will be those with diversified revenue streams, generating income from both fee-based businesses as well as their portfolios of earning assets. Executives with the foresight and ability to do so will examine new ways to achieve the bank's strategic goals.

The name of the game is long-term sustainability, which should influence how the board evaluates performance. "Performance targets encourage leaders to hit performance targets," writes London Business School finance professor Alex Edmans in "Grow the Pie: How Great Companies Deliver Both Purpose and Profit," adding: "But they don't encourage them to create value."

Skin in the Game

Tying compensation to long-term stewardship of the company typically includes some type of equity award — be it stock options, restricted stock units or some similar form of ownership.

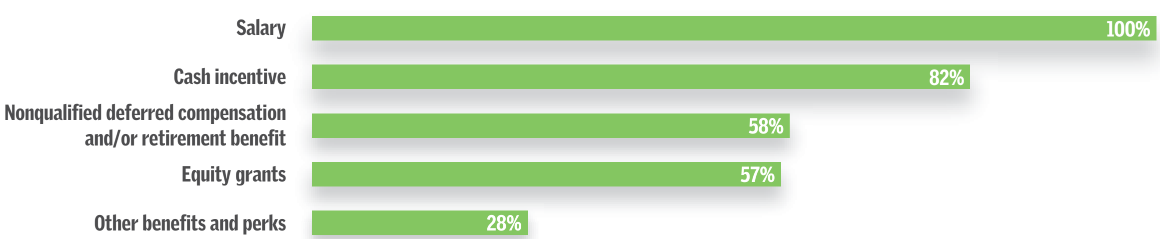
More than half of survey respondents indicate that their bank awarded equity grants to the CEO for fiscal year 2019. The fair market value of these grants ranged from $10,000 to $6.4 million, at a median of $227,093.

"Ownership at that top level is important," Fairchild says.

Yet, today's environment makes equity grants less attractive, given the correction in bank stocks. Boards should thus be especially thoughtful when it comes to granting equity at a devalued rate, which could dilute existing shareholders, Fairchild says. Some banks may instead opt for alternatives

FIG. 2

CEO Pay *CEOs received the following types of compensation in FY 2019*



CEO Compensation Amounts, FY 2019 *Median values*

Salary	Cash incentive	Equity grants (fair mkt value)	Benefits & perks	Total CEO compensation
$378,063	$146,273	$227,093	$49,600	$649,227

to true equity. Fifty-eight percent of respondents say their bank awards the CEO a retirement benefit and/or deferred compensation.

"When you talk about deferred and long-term compensation, one thing that was discovered after the 2008 financial crisis was that banks with certain benefits in place weathered through it a little better, because the focus was more on long-term franchise value than it was on 'my annual bonus' or 'my stock grant,'" Fairchild says. "It goes back to a discussion I usually have with my clients about the importance of a balanced compensation portfolio, and keeping it balanced in short-term and long-term viewpoints."

On the other hand, now could be an ideal time for certain banks to award equity grants to CEOs who aren't expected to retire any time soon. Assuming proper stewardship of the bank, they can expect to see their bank's stock price climb — a scenario that may be less attractive to long-tenured CEOs with an eye toward retirement.

"It is really complicated right now; we've seen such a rise and decline in stock prices over the last 12 years," Gallagher says. "Everybody had regained confidence in using company stock as a way to build wealth and reward people." That confidence has been upended again by the coronavirus crisis.

Succession Planning

The Covid-19 pandemic has accelerated the digital transformation of banking. Gallagher believes we could witness a related evolution in bank C-suites, given that 14% of bank CEOs are over the age of 65, and 59% are between 56 and 65 years old, according to the survey.

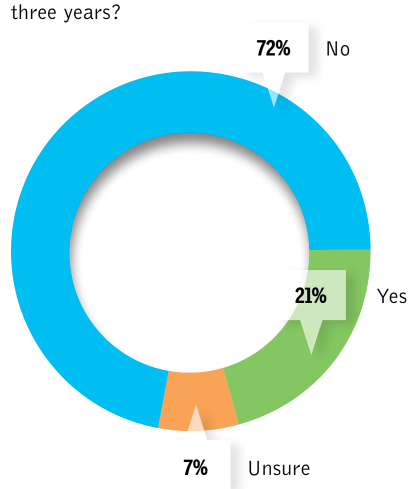
Respondents indicate that their CEO has served in that position for a median of nine years. Twenty-one percent expect their CEO to step down within the next three years.

"Banking's going to change radically," Gallagher says. Some CEOs aren't ready to change, even if the status quo threatens their institution's survival. "In those instances, you're going to see boards actually push the CEOs out and bring in forward-thinking, younger executives who are more readily

FIG. 3

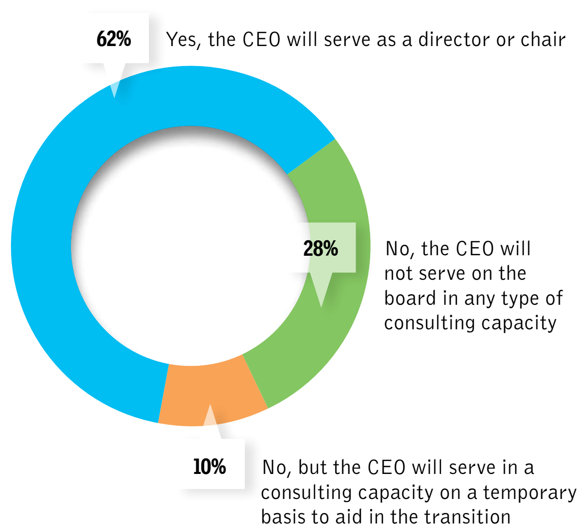
CEO Succession

Do you expect your CEO to step down within the next three years?



When he or she retires, do you expect the CEO to serve on the board?

Only asked if the CEO will step down in three years.



adaptable to a changing environment," he says.

The past few months have seen banks use technology to ramp up business lending and encourage retail customers to interact digitally rather than visit branches. These changes won't stop with a Covid-19 vaccine.

A core challenge facing boards managing these transitions is putting together an attractive and fair compensation package for the incoming CEO — particularly if they're considering an external hire.

"Internal people never come up to market as fast as external people," Fairchild says. "When you work at a company for 20 years, even as you climb the ladder, your pay doesn't keep up with external people being hired in." Boards should investigate how the level of pay they're offering compares to the market to ensure they attract the best talent to lead the bank.

Banks in the midst of a leadership transition also face a cultural challenge during this time, especially if the former CEO stays on the board. Respondents to the survey who indicated that their CEO will step down in the next three years were then asked whether the former CEO will remain on the board; more than 60% answered in the affirmative.

"I think it's a bad thing for the former CEO to be on the board," Gallagher says, especially if that executive has outsized influence. Too often, he adds, the new CEO wants to make changes to improve the organization but finds that the old CEO — now a director — is opposed, convincing the rest of the board to resist the change.

But most importantly, boards should have a plan in place for CEO succession. It's the board's responsibility to oversee that executive's performance and ensure continuity of leadership. Last year's Compensation Survey found that 37% lacked a successor or potential successors for the CEO position.

Particularly in this environment, with its inherent constraints on profitability, banks without a plan may opt to sell. "I do see some of the community banks finally deciding, 'our best option is to sell the bank,'" says Gallagher. "A lot of that's going to be determined by their CEO — what's the age of their CEO and what it's going to cost them to bring in a successor." Unfortunately, given the state of bank valuations, they won't be getting as much for their bank, leaving these boards caught between a rock and a hard place.

Board Compensation Challenges

The changes brought on by Covid-19 clearly impact the board. And while it's probably the last thing on directors' minds as they navigate this crisis, board compensation should be examined to ensure it's attractive enough to prospective board members who would add the skills the board needs today.

"It's become increasingly difficult to attract board members, for a lot of reasons," Gallagher says, including the liability burden as well as the time required of someone who could also be busy with their own career. "It's difficult to fully compensate someone for their time as a director," he continues. "If you're going to pay them for the time they put in, the skills they bring to the board — they'd be unaffordable."

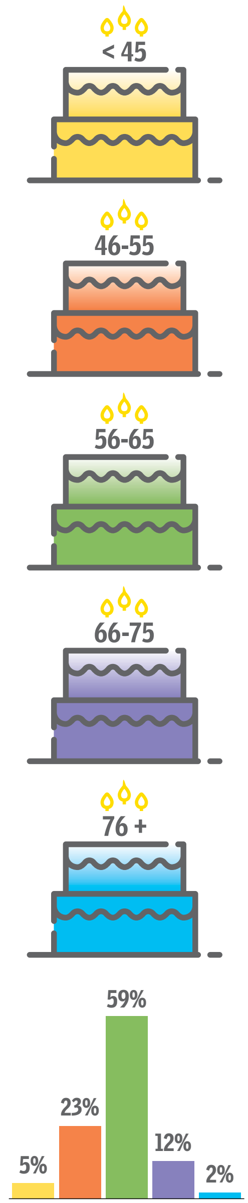
Meanwhile, boards will also be under pressure to maintain their current pay levels during the downturn.

Awarding equity compensation could be one way to attract younger board members, Fairchild says. Roughly half of respondents, primarily at public banks, say their board awards equity to outside directors, at a median of $30,000 for FY 2019.

Another option would be to reduce

FIG. 4

CEO Age & Tenure



CEO Age

9

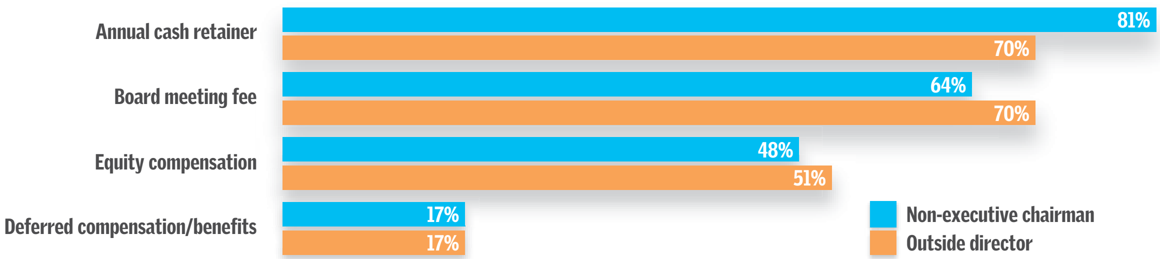
Median years as CEO

15

Median years working at the bank

FIG. 5

Non-executive chairs and outside directors receive the following types of compensation.



Director Compensation Amounts, FY 2019 *Median values*

By title	Non-executive chairman	Outside director
Fee per board meeting	$1,000	$1,000
Annual cash retainer	$36,000	$24,000
Equity compensation	$25,393	$30,000

the size of the board by asking legacy board members to retire so new ones can join. This way, the level of individual pay could be increased while total compensation stays stable.

Either way, it's vital that boards gain new perspectives and skills to weather the future.

"You have a number of board members who have been on the board for 30 or 40 years," says Gallagher. Directors responding to the survey have served for a median of 12 years, but multi-decade tenures are common. "These directors should step down, because banks need to change the way they're thinking and be more open to new ideas and new approaches," he says.

"Out with the old and in with the new."

About the Survey

Bank Director's 2020 Compensation Survey, sponsored by Compensation Advisors, surveyed 265 independent directors, chief executive officers, human resources officers and other senior executives of U.S. banks to understand trends around the acquisition of talent, CEO performance and pay, and director compensation. The survey was conducted in March and April 2020, throughout the Covid-19 pandemic. Compensation data for directors and CEOs for FY 2019 were also collected in April from the proxy statements of 98 publicly traded banks. Fifty-three percent of the total data represent financial institutions above $1 billion in assets; 59% are public. A plurality of respondents (39%) are 56 to 65 years old, while just 11% are 45 or younger.

About Compensation Advisors

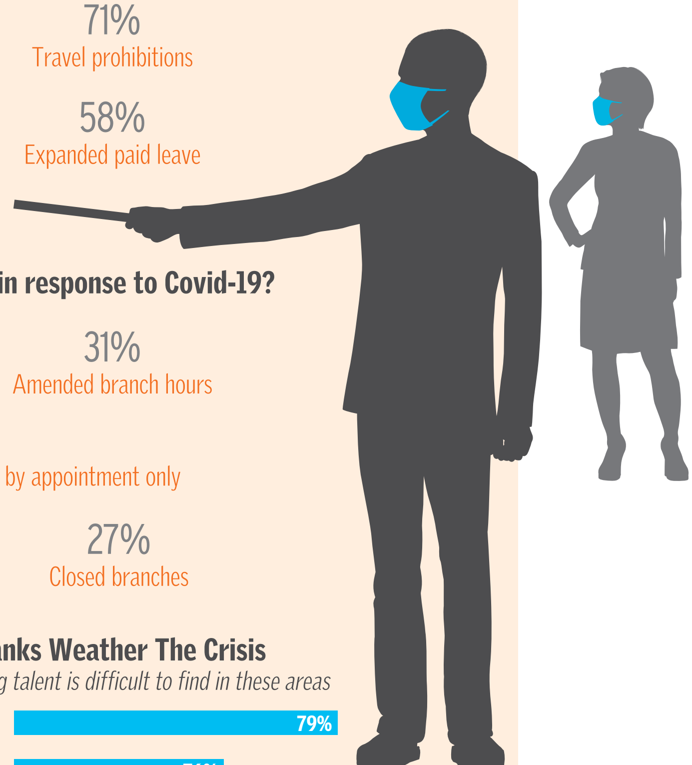
Compensation Advisors serves the financial industry by providing guidance on compensation and hiring developments. They offer LINQS+, a solution that delivers executive, director and shareholder benefits. Other deliverables include executive and director compensation reviews, pay-for-performance incentive plans, equity allocation plans, benefit plan design structures, risk assessments, regulatory updates and committee governance. www.compensationadvisors.com.

About Bank Director

Since its inception in 1991, Bank Director has been a leading information resource for senior officers and directors of financial institutions. Chairmen, CEOs, CFOs, presidents and directors of banks and financial institutions turn to Bank Director to keep pace with the ever-changing landscape of the financial services industry. For more information about Bank Director, visit www.bankdirector.com.

COVID-19's IMPACT ON THE WORKPLACE

The 2020 Compensation Survey was conducted as the banking industry began to feel the effects of the coronavirus crisis, shifting employees to remote work and adjusting bank operations. While Covid-19 will be temporary, its impact could be long-lasting.



Has your bank instituted or expanded any of the following in response to the Covid-19 pandemic?

92%
Telecommuting/remote work

71%
Travel prohibitions

80%
Flexible/staggered schedules

58%
Expanded paid leave

Has your bank closed branches in response to Covid-19?

81%
Introduced drive-thru-only service

31%
Amended branch hours

78%
Conducting in-person meetings by appointment only

3%
Made no changes to branch service

27%
Closed branches

Talent Helps Banks Weather The Crisis

Percentage indicating talent is difficult to find in these areas

Technology/digital	79%
Lending	76%
Information security	72%
Risk	72%

Do Benefits Align With A Post-Covid World?

Percentage offering the following benefits to at least some employees

Access to external training/education	99%
Internal training programs	96%
Health and/or wellness perks	87%
Telecommuting/ work-from-home options	85%
Flexible scheduling	82%
Collaboration tools	40%
Childcare (on-site or reimbursement)	12%

Source: Bank Director's 2020 Compensation Survey