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2016 COMPENSATION SURVEY

Do Executives Want Equity?

WHITE PAPER

Compensation Advisors

Are equity awards still effective tools that tie the interests of executive management to those of a bank's shareholders?

Equity is an important piece of the compensation pie for many banks, particularly those that are publicly traded, according to the 262 directors, CEOs, human resources officers and other senior executives responding to Bank Director's 2016 Compensation Survey, sponsored by Compensation Advisors, a member of Meyer-Chatfield Group. Forty percent say that their institution allocates equity grants to executives annually. Boards and shareholders like equity because, in theory, it ties the interests of the executive to the long-term success of the company. For executives, it's a reward that, hopefully, grows along with the value of the bank.

The survey also finds many banks preparing for the next generation of bank CEOs, but there remains a lot of work to do in this area. Almost one-third anticipate the retirement of the bank's CEO within the next five years, and responding CEOs indicate differing desires, based on age, when it comes to their compensation packages. Can banks weather the transition from a baby boomer CEO to someone who is younger—maybe even a millennial? Twelve percent of bank CEOs are now between the ages of 32 and 46, so the dawn of the millennial CEO isn't that far off. But more than one-third of respondents indicate that attracting talented millennial employees is a challenge for their bank, and they cite two factors: Millennials aren't interested in working for a bank, and their bank's culture is too traditional.

With just a few exceptions, the 2016 Compensation Survey finds that few banks have millennials serving on their board. But bank boards are also aging, and 90 percent of respondents indicate their board will see at least one director retire within the next five years. Almost half expect to lose more than three directors to retirement. As they seek new directors to fill these slots, 63 percent indicate that their board seeks to foster more diversity among its members.

The Value of Equity

Do executives still value equity? Considering how poorly bank stocks performed during and for several years after the Great Recession, it's perhaps surprising that equity is still valued. But in fact, 43 percent of directors think that not only do executives want equity awards, but the value executives place on equity compensation has increased in the past decade.

> "When a board is awarding equity, it needs to make sure that those executives they are awarding the equity to actually value the equity. If you're giving stock options to someone who doesn't want them, you're wasting them."
>
> — **Flynt Gallagher, President of Compensation Advisors**

Key Points For Bank Boards To Consider About Compensation

1. Find out what type of compensation the executive values.
2. Ensure the bank is awarding enough to retain the executive.
3. Stay on top of pay trends for key positions.
4. Stay proactive, and identify talent in advance.

Naturally, equity has more value for the executives of public institutions with a liquid stock. Seventy percent of executives from publicly held banks responding to the 2016 Compensation Survey indicate that they value equity as part of their own compensation package, even valuing it over other forms of compensation, including a cash bonus (highly valued by 68 percent of public executives), a severance agreement (57 percent) or a retirement benefit (54 percent).

Executives at private banks with illiquid stock don't value equity as much, though that's not to say that it's not valued at all: More than half of private bank executives indicate that equity is highly valued as part of their compensation package. But for these executives, 80 percent place a high value on a cash bonus, 65 percent on a retirement benefit and 44 percent on a severance agreement.

Bank boards of directors, which are ultimately responsible for setting executive compensation—and for ensuring that pay packages are reasonable but still attractive enough to recruit and retain talented executives—largely see eye to eye with executives, as indicated in the survey. But it's important to remember that while the majority value equity, it's certainly not universally beloved. "When a board is awarding equity, it needs to make sure that those executives they are awarding the equity to actually value the equity. If you're giving stock options to someone who doesn't want them, you're wasting them," says Flynt Gallagher, president of Compensation Advisors.

In addition to attracting and retaining highly qualified talent, banks also use equity to ensure that executives keep the long-term interests of the organization—and its owners—in mind. Are equity

FIG. 1

How effective are stock options or equity grants as tools to tie YOUR interests to those of shareholders/owners?

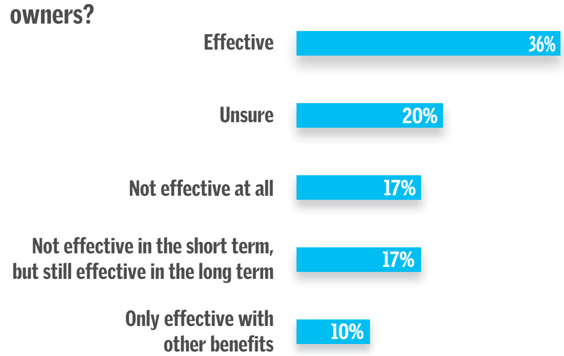
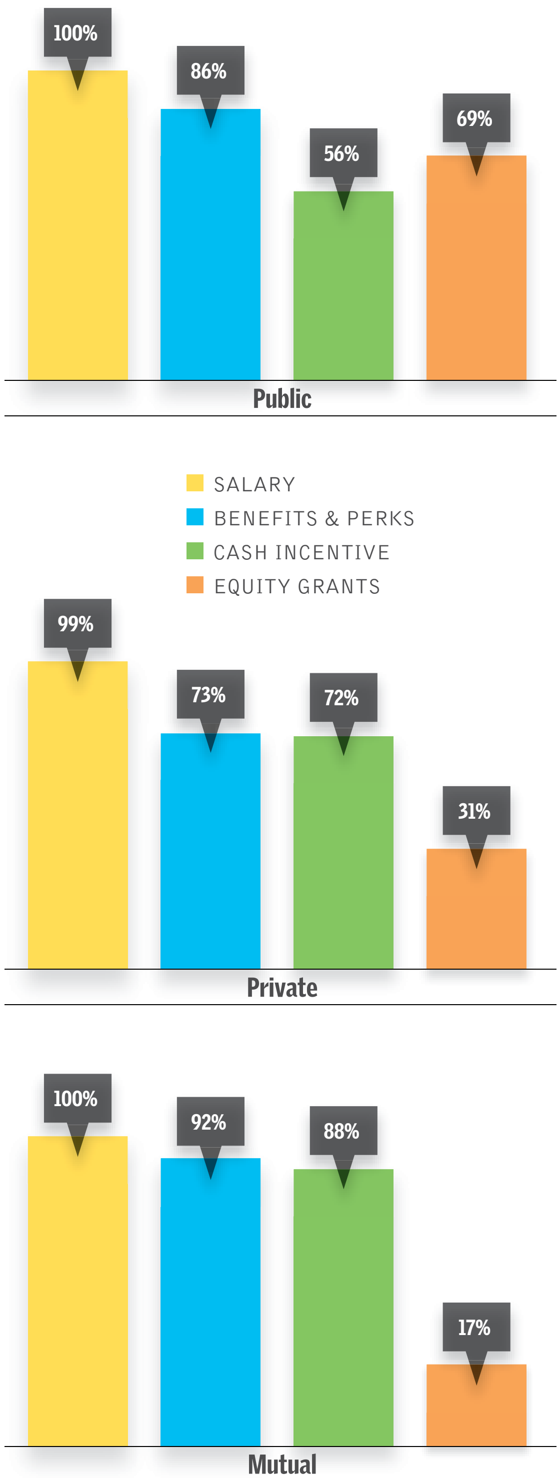


FIG. 2

Compensation types received by CEOs (FY 2015):



awards still an effective way to tie the executive's interests to that of the bank? It's on this point that both executives and directors are mixed.

For executives, thirty-six percent say that stock options or equity grants are an effective way to tie their interests to that of the organization. Seventeen percent say that equity is completely ineffective, another 17 percent that equity is an effective long-term tool but ineffective in the short term, and 10 percent say equity is only effective with other forms of compensation. Twenty percent are unsure.

A greater percentage of public executives versus private executives believe equity is wholly effective, at 51 percent compared to 30 percent, respectively. "We feel very strongly that the executives should be aligned, on a long-term basis, with the shareholders," says Jerry Korde, a director at Valley National Bancorp, a publicly traded bank holding company with $22 billion in assets headquartered in Wayne, New Jersey. "Also, for the retention of some key people, we feel that equity is important."

Gallagher says that equity isn't the only way to tie an executive's long-term interests to that of the bank, and it might not be the best option for the bank's shareholders, either—particularly for banks with less liquid stock. If an executive needs to convert her shares of bank stock into cash, she may sell at a time that's not convenient for the bank. If the sale drives down the stock price for the bank, shareholders will undoubtedly be dissatisfied. "The first thing a board needs to address is the exit strategy for every stock grant they award. How is the individual going to convert that stock to cash when they need it?" Gallagher says. Alternative plans, such as deferred compensation or synthetic equity,

FIG. 3

Median CEO Compensation (FY 2015):

SALARY	$345,000
BENEFITS & PERKS	$ 25,474
CASH INCENTIVE	$ 51,732
EQUITY GRANTS (fair mkt value)	$227,807

can benefit the executive without negatively impacting the value of the bank should the executive need to convert the award to cash. (Synthetic equity is a deferred cash award that rises and falls along with the bank's book value or stock price.) Six percent of respondents—all from private institutions—indicate that their bank allocates synthetic equity annually to executives.

"Remember, stock is designed, from the executive's perspective, to do two things. Reward and retain [the executive]—that's the vesting period; if they leave then they forfeit it. If an executive is unsure of how he will convert that to cash, it minimizes that retention aspect," says Gallagher.

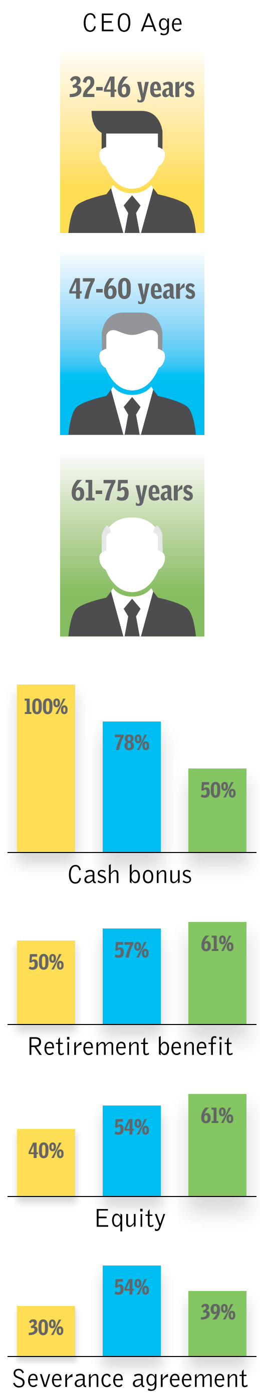
Thirty-seven percent of survey participants say the bank offers a nonqualified deferred compensation benefit to senior executives, delaying part of that executive's compensation—and the related taxes—to a later date.

Seventy-eight percent of executives, including 74 percent of bank CEOs, indicate their preference for a cash bonus as part of their compensation package. Overall, 64 percent of bank CEOs received a cash incentive in FY 2015. The median cash incentive was $51,732 overall, ranging from a median of $15,000 for banks under $250 million in assets to $582,500 for banks above $5 billion.

Year after year, respondents to the Compensation Survey indicate that "tying compensation to performance" is their top compensation challenge. Banks today use a variety of metrics to link CEO compensation to performance, including the strategic plan or corporate goals (38 percent), net income (36 percent), return on assets (36 percent) and asset quality (34 percent). Twenty-one percent tie CEO pay to efficiency, which is an increasing concern for the industry.

FIG. 4

What forms of compensation and benefits do you highly value for yourself?



The Talent Gap

Sixty percent of respondents expect to see their bank's CEO (31 percent) and/or other senior executives (47 percent) retire within the next five years. The median age for bank CEOs is 58 years, and more than one-third are between the ages of 61 and 75 years. Forty-five percent of respondents indicate that their bank has a detailed succession plan for both the CEO and senior executives, with both a long-term and emergency transition plan. Sixteen percent have a detailed plan for the CEO, but not for other senior executives.

As the intensive bank training programs of the past have fallen to the wayside, financial institutions will find it increasingly difficult to replace key positions—especially the CEO. Gallagher says that training programs of the past produced the type of well-rounded banker needed to lead the bank. Now, talent is more focused on specific areas of the business.

"At smaller institutions, $1 billion [in assets] and below, they don't necessarily have the skill level internally to step into a CEO position," says Gallagher. "These banks generally don't have a good mentoring system and training program, whether it's informal or formal, to develop talent in-house. They have to look outside [the bank]."

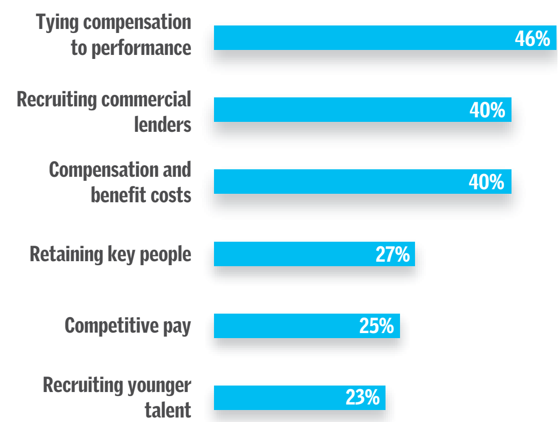
With the banking industry eying the next generation of CEOs, the survey reveals that preferred compensation varies based on the age of the CEO. As a general rule, younger CEOs prefer a cash bonus compared to their older peers, while older CEOs indicate a greater desire for a retirement benefit and/or equity.

Gallagher says that banks with

management succession issues should ensure that the form of compensation vests over a longer

FIG. 5

What are your top compensation challenges for 2016?



period of time. For instance, stock options typically vest in three to five years but that could be extended to as long as 10 years. "The idea is to keep them around and make sure they're available when you have a need for them to step into a new position," he says. Also, "match the form of compensation to what the individual values." A retirement benefit may not be a meaningful way to retain a 40-year-old employee who won't retire for at least 25 years, for example.

Right now, Generation X is moving into the C-suite, but the millennials—who now outnumber baby boomers—should be nipping at Gen Xers' heels. However, 34 percent of survey respondents indicate that they struggle to attract millennial talent. For these banks, 60 percent say that millennials aren't interested in working for a bank. Fifty-four percent say that their bank's culture is too traditional. Just 15 percent blame the bank's compensation programs.

Another one-third say that they're satisfied in their ability to attract millennials and of these, 71 percent cite culture as a reason they're successful in their efforts. Compensation is important when it comes to attracting talent—48 percent cite that their compensation programs are aligned with millennials' interests—but like other industries, banks are finding that this new generation of workers cares more about culture than money—at least for now.

This issue of talent—retiring boomers, and a limited pool to replace them—promises to get worse before it gets better. In fact, Gallagher hints that it's driving some mergers. "They're adding talent, whether it be for succession or a line of business, like commercial lenders. To acquire lenders some banks are doing the M&A transactions just to get those quality lenders," he says. Forty-three percent of respondents say that there aren't enough talented commercial lenders in their bank's market. "Talent, whether it be at the executive level or some kind of rainmaker capacity, is a driving force in mergers."

Don't Forget the Board

It's not just executive teams that will see retiring leadership. Almost half of bank boards expect to see three or more members retire within the next five years, according to the survey.

Sixty-seven percent say their board has a plan in place to identify prospective new directors. Gallagher indicates that boards should also determine whether director compensation is enough to attract new directors, particularly given the increased liability and responsibility held by boards today. "It's going to impact their ability to attract new directors and keep directors. Today, the compliance burden is just incredible, and it's getting worse," he says.

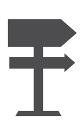
Responding directors indicate that they spend a median of 20 hours per month on board-related

FIG. 6

Succession Planning

60%

expect the CEO or other senior executives to retire within 5 years



45%

have a long and short-term succession plan for the CEO and all senior executives

Median CEO age

activities, which could include time spent for meetings, education or business development. In 2011, the survey found that directors spent a median of 15 hours on board activities.

Over the years, the survey has indicated a moderate shift toward an annual cash retainer for board members, in addition to or in place of a board meeting fee, in recognition of this increased burden. However, meeting fees remain popular, particularly at banks with less than $5 billion in assets. Seventy-two percent of banks pay a board meeting fee to outside directors, while 65 percent pay an annual cash retainer. The median meeting fee is $1,000, with a median number of eight meetings annually for holding company boards. The median annual cash retainer is $20,000.

As boards look for new talent, they will likely seek new skills as well, particularly in technology, which has become increasingly important for an industry that's becoming progressively digital. But they're also eyeing diversity: Sixty-three percent say their bank will actively seek to create a more diverse board within the next two years.

About the Survey

Bank Director's 2016 Compensation Survey, sponsored by Compensation Advisors, a member of Meyer-Chatfield Group, examines trends in executive and board compensation, including the compensation related issues faced by boards and senior executives. The survey tracks salary data for CEOs, chairmen and independent directors. The survey was completed online by 262 directors, chief executive officers, human resources officers and other senior executives from U.S. banks in March 2016. Additional data on CEO and board compensation was supplemented using data from the proxy statements of 105 publicly traded institutions for fiscal year 2015. Independent directors and chairmen accounted for 42 percent of respondent data, and CEOs accounted for 30 percent. Fifty-nine percent of the combined proxy and respondent data came from publicly traded banks, and 46 percent from banks with more than $1 billion in assets.

FIG. 7

How would you describe your bank's efforts to recruit millennial employees to your bank?

About Compensation Advisors

As thought leaders since 2005, Compensation Advisors, a member of Meyer-Chatfield Group, has served the community banking industry providing guidance on the latest compensation and hiring developments. The firm works with financial institutions across the United States delivering executive and director compensation reviews, pay-for-performance incentive plan structures, equity allocation plans, benefit plan design structures, base salary reviews (company-wide), risk assessments, regulatory updates and compensation committee governance. As industry experts Compensation Advisors conveys insightful strategies and solutions tailored for every bank client's success. For more information, please visit www.compensationadvisors.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 print and digital editions of *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.

BOARD PAY SNAPSHOT

Non-executive chairman

Compensation types

- 67% Annual cash retainer
- 61% Board meeting fee
- 31% Equity compensation
- 17% Deferred compensation/benefits

Cash compensation amounts

$700
Median meeting fee

$25,000
Median retainer

Committee Fees

	Meetings/yr.	Members	Member fee
Audit	5	4	$600
Compensation	4	4	$600
Executive	4	5	$490
Governance/nominating	3	4	$600
Loan	14	5	$250
Risk	4	5	$650
Technology	4	3	$150

The median holding company board has 10 members and meets 8 times.

The median lead bank board has 9 members and meets 12 times.

20hrs
Median hours per month directors spend on bank board activities

48%
Don't offer benefits for outside directors

Outside director

Compensation types

- 65% Annual cash retainer
- 72% Board meeting fee
- 36% Equity compensation
- 21% Deferred compensation/benefits

Cash compensation amounts

$1,000
Median meeting fee

$20,000
Median retainer

Source: Bank Director's 2016 Compensation Survey