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2015 COMPENSATION SURVEY

Preparing for the Next Generation of Bank Executives

WHITE PAPER

Compensation Advisors

Is the banking industry prepared to appropriately and competitively compensate CEOs and senior executives while luring millennials and Gen X'ers to executive level positions?

Examining how bank executives want to be paid reveals volumes about the state of the banking industry. Among the responses of almost 300 CEOs, human resources officers, directors, chairmen and other senior executives, Bank Director's 2015 Compensation Survey, sponsored by Compensation Advisors, reveals telling signs of aging boardrooms and executive offices. Seventy-two percent of executives indicate they highly value a solid, stable retirement benefit as part of their compensation package, compared to those that highly value equity, 50 percent, or a severance agreement, at 39 percent. (Respondents could choose multiple preferences.) As a result, the number of banks reporting that they offer a nonqualified retirement benefit has grown significantly in the past two years. Now 70 percent of respondents offer a nonqualified retirement benefit to at least the CEO or management team, up by almost one-third since 2013.

An aging leadership means the next generation of bank leaders should be waiting in the wings. This could alter the face of bank compensation over the next few years. But traditional banks have struggled to recruit younger generations who witnessed a crisis that rocked the financial system. Many millennials would rather use nonbanks such as Google or Amazon instead of their local bank. Why would a talented, 20-something business school graduate want to work for a traditional bank? As baby boomers retire and exit the banking world, these struggles will continue to impact C-suites and boardrooms in the coming years.

Perhaps more than ever, compensation plans must appeal to two sizeable generations: Baby boomers and millennials, the oldest of which, in their early to mid-thirties, are coming up through the ranks. Boards should ask: "Are our compensation plans doing what we designed them to do?" says Flynt Gallagher, president of Compensation Advisors.

Retirement Looms for Key Executives

Bank executives who participated in the survey reveal a strong preference for a retirement benefit, in addition to a competitive cash salary. Seventy-two percent of CEOs, human resources officers and other executives indicate that a retirement benefit is highly valued. As a comparison, half of those highly value equity. For private banks, this makes sense, but 70 percent of executives of publicly traded institutions say they highly value a retirement benefit, compared to 58 percent who highly value equity. It should be noted that most indicate a preference for both. "Senior executives are aging, so retirement is more important to them now than it's ever been, because they're near the end of their careers," says Gallagher.

Seventy percent of respondents indicate their bank offers a nonqualified retirement benefit, an increase of almost one-third since 2013. Half say the bank offers a retirement benefit to the CEO.

Executive Benefits Offered by Banks

70% offer a nonqualified retirement benefit to select executives.

56% offer a nonqualified deferred compensation benefit, which allows the executive to defer a cash award.

47% allocate equity grants annually to executives

The recent memory of falling stock prices and disappearing pensions, along with the improving health of the industry, has played a significant role in the rise of respondents indicating their bank offers a retirement benefit. "There is a significantly renewed interest in some kind of supplemental retirement benefit," says Gallagher.

Many baby boomers worked longer than they anticipated due, in large part, to the economic downturn, and are now ready to focus more on their golf game than their bank. An increasingly mature executive suite drove new hires in 2014. Survey respondents say 61 percent of executive hires or promotions were due to the retirement of a predecessor. This wave of executive retirements could continue for the next few years, so succession planning should be a priority for many bank boards. However, just 34 percent indicate that developing a succession plan is a key compensation challenge for their institution in 2015.

> **"To maximize the retention aspects of any plan, you really have to find out what the participants value, regardless of age."**
>
> — **Flynt Gallagher, President of Compensation Advisors**

Four Questions Bank Boards Should Ask

1. Are compensation packages tailored to the individual executive's needs?
2. Are we tying executive pay to the long-term goals of the bank?
3. Do we have a both a short-term and long-term plan in place for executive succession (not just the CEO)?
4. Are we planning for future leadership on the board?

The survey didn't specifically examine C-suite retirement. But the fact that so many hires can be sourced to a recent retiree, whether in lending, risk management or another area, underscores a point. Many banks plan, at least in part, for CEO succession, but don't look at the entire C-suite. "In the past, boards could rely on other executives to rise through the ranks and fill the CEO position," says Gallagher. But a retiring baby boomer generation—the largest portion of the adult U.S. population until millennials surpassed them this year—could create a wave of vacating executives. Northwest Bancorp. Inc., based in Spokane, Washington with $448 million in assets, expects to see five of its top executives retire within the next three years. "We've known this is coming, and we've been taking some steps to prepare for that, but it is a challenge," says Randall Fewel, Northwest's president and CEO.

FIG. 1

Median CEO Compensation:

SALARY	$382,205
BENEFITS & PERKS	$ 22,841
CASH INCENTIVE	$108,123
EQUITY GRANTS (fair mkt value)	$215,699

Bank boards should examine succession for its senior executives, not just that of the CEO. "What's becoming apparent in the industry is that there typically is no one 'next-in-line' that's ready to fill those roles. Directors need to focus on that point to help position their franchise for greater probability of future success," says Gallagher. Already smaller in number than the boomers or the millennials, not as many members of Generation X chose to make a career in banking. "They've opted for other careers, so there's not as many qualified executives in that generation. Also, since training programs have largely disappeared from the industry, a lot of executives today are very good at one particular aspect of banking, but they're not well-rounded enough to make a good bank CEO," he adds.

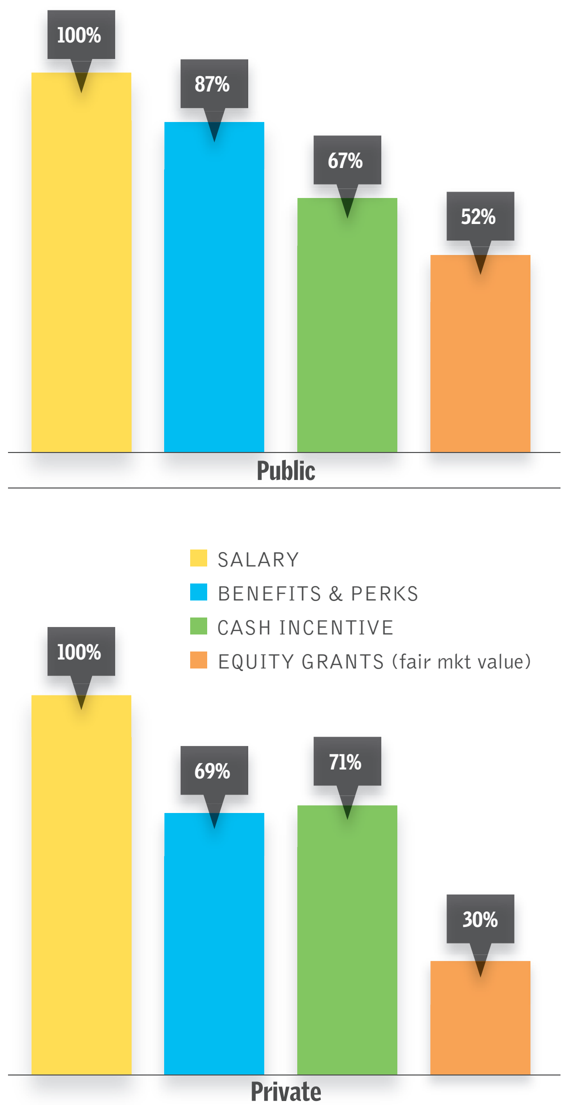
The Next Generation of Executives

It will be a sparse population of Gen Xers, along with the rising millennials, that fills C-suites over the next few years, and banks are finding themselves training up a new generation. Northwest is training millennials from ground zero. "For the right people, you've got to do what it takes," Fewel says. The bank's budget on training has increased significantly. "You've got to invest in education, because none of the banks have those management trainee programs anymore," he says.

Training millennials is one thing. Getting them to work for a bank is an entirely different matter. Almost half of respondents say that retaining key people is a top challenge, and as baby boomers retire, this means attracting and keeping a younger generation. A 2014 study conducted by Red Brick Research for consulting and research firm Millennial Branding and Upwork, an online marketplace for freelancers, found that 53 percent of hiring managers find it difficult to attract and retain millennial staff. For banks, attracting millennial talent is even more problematic. Many young adults don't even want to deposit their money with a tradi-

FIG. 2

Compensation types received by CEOs



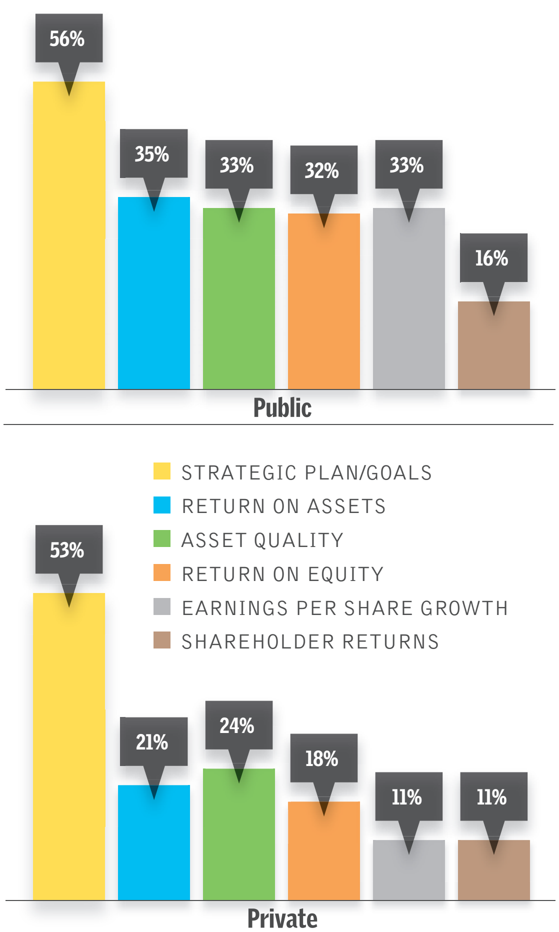
tional financial institution, much less work for one.

The varying needs of these generations—baby boomers, Gen X and millennials—means that bank boards and HR departments need to ensure that their compensation programs meet the needs of the individual employee. "To maximize the retention aspects of any plan, you really have to find out what the participants value, regardless of age," says Gallagher. As an example, an executive may want to align equity awards to meet tuition needs for children, or to care for elderly parents.

For millennials, earnings potential does still matter, but it's important to remember that these employees also value a company's cultural elements, including good relationships with co-workers, a good mentor and exciting work, according to Red Brick Research.

FIG. 3

How is CEO pay linked to bank performance?



When asked about their top compensation challenges, 45 percent of the executives and boards responding to the survey indicate, as in past years, that retaining talented employees is a challenge. Compensation and benefit costs, for 39 percent, are key concerns. Gallagher says that keeping an eye on what executives really want in a compensation package can help bank boards tackle these problems. "Make sure that if you're spending money, you're doing it wisely and efficiently, and by that I mean you're providing what the individual wants," he says. "Use your dollars effectively."

Half of the executives responding to the Compensation Survey indicate that equity is highly valued. Roughly the same number—47 percent—indicate that their bank allocates equity to executives on an annual basis. Thirty-one percent, largely from publicly traded banks, grant restricted stock. Twenty-one percent use stock options. Of the 35 percent responding from private banks who indicate their bank awards equity grants, more than half grant stock options. But Gallagher says this may not be the best choice for private banks that don't have a lot of liquidity.

"Stock options, in my opinion, are probably the least effective form of compensation for a private bank," says Gallagher. And stock options can be dangerous for a bank that doesn't plan appropriately. He tells a cautionary tale of one small Midwestern bank that saw its stock price drop significantly when several executives left and sold their shares. "Every shareholder was hurt because they didn't think ahead," Gallagher says. Synthetic equity, a deferred cash award that grows or shrinks along with the stock price or book value of the bank, doesn't impact the bank's value when the executive cashes out, making it a safer, more cost effective and more satisfying benefit that still ties to the long-term value of the institution. Just five percent of respondents indicate that their bank allocates synthetic equity.

Sixty-two percent of survey participants indicate that tying pay to performance is a top challenge for boards and executives. Gallagher recommends connecting incentive pay to a combination of short-term and long-term objectives. For the bank's CEO, the survey reveals that 55 percent of respondents tie pay to the strategic plan or corporate goals. Banks also rely on a variety of metrics: return on assets (28 percent), asset quality (27 percent), return on equity (24 percent) and earnings per share growth (20 percent). "Whatever the metric is, that's what your longer term incentive should be tied to," he says, adding that shareholder advisory firms like Institutional Shareholder Services Inc. (ISS) and Glass Lewis advocate performance-based compensation that takes a longer view.

Evaluating Director Pay

The 2015 Compensation Survey finds that board pay is rising. Meeting fees, the most common form of compensation for independent directors, at 77 percent, rose by one-third in FY 2014, to $1,000 per meeting. An annual retainer, which 61 percent report is paid to independent directors, held steady at $20,000 annually. Meeting fees are more common at banks with less than $5 billion in assets, and retainers are increasingly common as the size of the bank grows. Similar to executive pay, Gallagher advocates that the compensation committee—the decision maker on board pay for 48 percent of respondents—know what directors want and what works within the culture of the board. "If attendance is an issue, then you may not want to do some kind of retainer. You may want to do a per-meeting fee. If everybody's engaged, then a meeting fee is probably not appropriate and a retainer is great," he says. Banks considering a raise in pay need to consider the total increase and its impact on the bank's budget—the bigger the board, the larger the impact.

> "Despite regulatory and shareholder pressures, few companies today effectively track compensation versus shareholder value or performance, and I think it is imperative they do so. When a board actually looks at that comparison, it's an eye-opener, and helps them determine what's appropriate for their institution as they move forward."
>
> **— Flynt Gallagher, President of Compensation Advisors**

FIG. 4

Board Pay Snapshot

Median meeting fee, independant director	$ 1,000
Median meeting fee, chairman	$ 950*
Median retainer, independant director	$20,000
Median retainer, chairman	$24,000

*Independent chairmen are more likely to receive a meeting fee, and banks with independent chairmen (61 percent) tend to be smaller. This likely caused the median meeting fee for chairmen to be lower than that for independent directors.

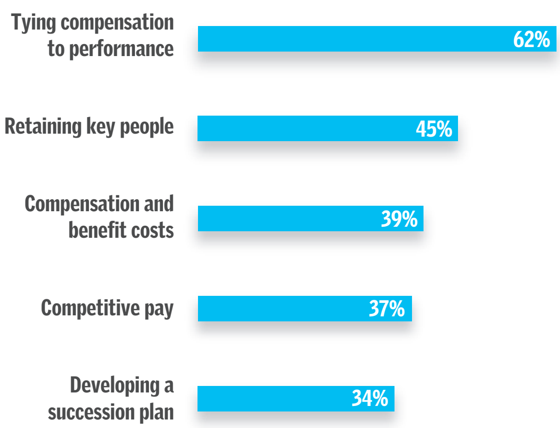
Committee Fees

	Meetings/yr.	Members	Member fee
Executive	6	5	$625
Audit	5	4	$550
Compensation	4	4	$550
Governance/Nominating	4	4	$600
Loan	12	5	$300
Risk	5	5	$825

Almost three-quarters indicate that independent directors receive committee fees, based on attendance at committee meetings. Forty-two percent indicate that equity compensation is awarded to directors; the median equity compensation for

FIG. 5

What are your top compensation challenges for 2015



independent directors ranges from $3,000 for banks under $250 million in assets to $50,000 for banks above $5 billion. Equity compensation is, unsurprisingly, more common at publicly traded banks. Fifty-five percent award additional benefits to board members, the most popular of which are deferred compensation, for 34 percent of respondents, and travel expenses, for almost one-quarter.

Board pay is important, but the biggest question that bank boards and compensation committees need to ask themselves is whether their compensation plan is helping the bank achieve its goals. "Despite regulatory or shareholder pressures, few companies today effectively track compensation versus shareholder value or performance, and I think it is imperative they do so. When a board actually looks at that comparison, it's an eye-opener, and helps them determine what's appropriate for their institution as they move forward," says Gallagher.

About the Survey

Bank Director's 2015 Compensation Survey, sponsored by Compensation Advisors, explores the compensation issues faced by bank boards, and tracks salary and benefit data for senior executives and boards. The survey was completed online by 281 independent directors and senior executives in March and April 2015, including chief executive officers and human resources officers, from banks of all sizes nationwide. Additional data on CEO and board compensation was supplemented using data from 90 bank proxy statements for FY 2014. Independent directors and chairmen accounted for 44 percent of respondent data, and CEOs accounted for 20 percent. Sixty percent of the combined proxy and respondent data came from publicly traded banks, and almost half from banks with more than $1 billion in assets.

About Compensation Advisors

Since 2005, Compensation Advisors has served the community banking industry providing guidance on the latest compensation and hiring developments. As industry experts they convey insightful strategies and solutions to help retain, recruit and reward critical talent at all levels. Compensation Advisors 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 Designs, Base Salary Reviews (company-wide), Risk Assessments, Regulatory Updates and Compensation Committee Governance.

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

Median Salary for a Bank CEO in FY 2014

$382,205

The number of banks offering a nonqualified deferred compensation plan has grown 40% since 2013.

25%

don't tie CEO pay to performance indicators.

28%

plan to increase board pay this year

61%

hired or promoted new executives in 2014.

20

Median hours per month directors spend on bank board activities

Top areas for new hires:

1. Lending
2. Technology & information security
3. Risk management
4. Compliance

53%

don't have stock ownership guidelines for board members

Source: Bank Director's 2015 Compensation Survey