Trends and Best Practices for Compensation and Incentive Programs

2011 Pearl Meyer & Partners’ Banking Compensation Survey Findings

October 20, 2011
What We’ll Be Covering Today

- Highlights from Pearl Meyer & Partners’ 2011 Banking Compensation Survey (New York and Northeast)
- Summary of current incentive regulations
- General trends and best practices related to compensation administration and incentive plan design
The Current Economic Environment

Are things looking up?...

Jobs plan may create 1 million jobs – economists 9/9/11

U.S. Stocks Rally Amid Optimism About Global Economic Recovery 8/29/11

Bernanke-Fed to Help Restore Strong Growth, Mum on Measures 9/9/11

Or more challenging times ahead?

US stock losses hit 3% on eurozone worries 9/9/11

BofA discussing about 40,000 job cuts: report 9/9/11

Economic data suggest a stall 6/10/11

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Impact on Employment and Pay

Employment Outlook
- Unemployment rate at 9.1% in September 2011, as compared to 10.1% in September 2010

Salary Increase Budgets
- In 2010, actual budgets ended up between 2.7% - 2.8%
- In last year’s survey, 2011 projected budgets were 2.7% - 3.0%
- However, actual 2011 budgets fell in 2.8% - 2.9% range
- Similar results seen across all organizations, employee categories, regions and industries in the US according to World@Work
The Continued Pressure on Salaries

Salary Increase Budgets (Exempt Salaried)

% of Employees Receiving Salary Increases (Exempt Salaried)

* Source: World@Work (ACA) Salary Budget Surveys
The Increasing Role of Variable Pay

Avg Amount Paid (as % of Salaries)

Avg % of Eligible Employees Actually Paid

* Source: World@Work (ACA) Salary Budget Surveys
What The Future Holds

- “Managed” growth in salary levels
- More refined competitive pay strategies for certain positions
- Increased eligibility and emphasis on variable pay but more scrutiny from a risk perspective by regulators
- Incorporating long-term perspective within compensation program
“Managed Growth in Salary Levels”
2012 Projected Average Salary Increase Budgets – PM&P Banking Compensation Survey

- 2012 budgets projected between 2.8% - 2.9% across Northeast, slightly lower for New York
  - Merit generally around 2.5%
  - Additional 0.5% -1% for promotion and/or market adjustments

- Need to ensure that dollars are being used wisely to ensure that high performers are recognized – performance differentiation will be critical to ensure retention and motivation

<table>
<thead>
<tr>
<th></th>
<th>2012 Projected (including zeros)</th>
<th>2012 Projected (excluding zeros)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Execs</td>
<td>Officer</td>
</tr>
<tr>
<td>New York</td>
<td>2.4%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Northeast</td>
<td>2.9%</td>
<td>2.9%</td>
</tr>
</tbody>
</table>

2.4% – 2.6% New York
2.8% - 2.9% Northeast
2.8% - 3.1% New York
2.9% - 3.0% Northeast
What happened in 2011?
- We were expecting 1.9% and ended up at 1.8% (2.8% when excluding zeros)
- Frozen salary structures continue to exist

Salary structure adjustments for 2012 approximately 1.8%
- 2.5% when excluding 0% budgets

<table>
<thead>
<tr>
<th></th>
<th>2012 Planned (including zeros)</th>
<th>2012 Planned (excluding zeros)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Execs</td>
<td>Officer</td>
</tr>
<tr>
<td>New York</td>
<td>1.2%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Northeast</td>
<td>1.8%</td>
<td>1.8%</td>
</tr>
</tbody>
</table>

1.1% - 1.3% New York
1.8% Northeast
2.1% - 2.3% New York
2.5% Northeast
Focal point review more popular over anniversary date

Majority increase salaries effective in January (April is 2nd most popular)

Most banks do not have an automated performance management system

A combination of goals and competencies is the most prevalent approach for performance management

The key to a successful performance management program is to ensure it creates a link between the strategic objectives of the Bank and the day to day activities of the employees.
“Competitive Pay Strategies”
### Alignment with Competitive Advantage

<table>
<thead>
<tr>
<th>Competitive Advantage Groups</th>
<th>“Regular Groups”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Lenders</td>
<td>HR</td>
</tr>
<tr>
<td>Sales</td>
<td>Finance</td>
</tr>
<tr>
<td>Target Pay at 65th Percentile</td>
<td>IT</td>
</tr>
<tr>
<td>Pay at 50th Percentile</td>
<td></td>
</tr>
</tbody>
</table>

- Ensure business alignment
- Evaluate pay mix
- Assess incentive plans
  - Target Opportunities
  - Team / Individual performance
  - Higher upside opportunities
### Commercial Lenders

- Highly competitive labor market for many banks/regions
- Incentives are critical component of total cash for these positions

<table>
<thead>
<tr>
<th>Role</th>
<th>New York</th>
<th>Northeast</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Base Salary</td>
<td>Incentive Target</td>
</tr>
<tr>
<td>Jr. Commercial LO</td>
<td>$62</td>
<td>13%</td>
</tr>
<tr>
<td>Commercial LO</td>
<td>$89</td>
<td>12%</td>
</tr>
<tr>
<td>Sr. Commercial LO</td>
<td>$123</td>
<td>15%</td>
</tr>
<tr>
<td>Top Comm’l Lending Executive</td>
<td>$161</td>
<td>18%</td>
</tr>
</tbody>
</table>
### Other ‘Hot Jobs’

<table>
<thead>
<tr>
<th>Role</th>
<th>New York</th>
<th></th>
<th></th>
<th>Northeast</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Base Salary</td>
<td>Incentive Target</td>
<td>Actual Total Cash</td>
<td>Base Salary</td>
<td>Incentive Target</td>
<td>Actual Total Cash</td>
</tr>
<tr>
<td>Top Audit Officer</td>
<td>$103</td>
<td>13%</td>
<td>$105</td>
<td>$103</td>
<td>13%</td>
<td>$113</td>
</tr>
<tr>
<td>Risk Manager</td>
<td>$146</td>
<td>17%</td>
<td>$156</td>
<td>$122</td>
<td>17%</td>
<td>$141</td>
</tr>
<tr>
<td>Credit Officer / Manager</td>
<td>$83</td>
<td>11%</td>
<td>$87</td>
<td>$92</td>
<td>11%</td>
<td>$96</td>
</tr>
<tr>
<td>Compliance Officer</td>
<td>$70</td>
<td>10%</td>
<td>$74</td>
<td>$85</td>
<td>12%</td>
<td>$91</td>
</tr>
</tbody>
</table>
More Emphasis on Variable Pay
80% of banks across the Northeast have a short-term incentive plan
- Prevalence increases as size of bank increases
- 68% of banks with assets < $250M versus 94% of banks with assets > $1.5B
- In 2006 survey, 77% of participants reporting having a short-term incentive plan

Who is eligible to participate?
- 95% of banks allow officers and above to participate
- 75% of banks allow non-officers to enter the plan

Payouts
- Overall, payouts continue to fall below target but are improving over previous years
- For 2010 performance, 2011 payouts averaged 65% of target opportunities across all employee groups (Northeast results)
Overview of Bank Regulator Incentive Guidance

New proposed regulations expand on the Agency guidance to implement and enforce Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act

The intent is to control risk related to the use of incentive compensation arrangements (ICAs) for employees at covered financial institutions

### Agency Guidance – June (FRB, FDIC, OTS, OCC)
- Effective June 25, 2010
- Impacts all financial institutions
- Principles-based guidance
- Three principles:
  - Design features should mitigate risk taking
  - Effective controls
  - Strong corporate governance
- Size and complexity of institution and ICAs considered
- Covered individuals:
  - Senior executive officers
  - Individual employees whose activities may expose the institution to material risk
  - Groups of employees who in the aggregate may expose the institution to risk

### FDIC Proposal – February (FRB, FDIC, OTS, OCC, NCUA)
- Final rules expected by June 2012
- Impacts institutions > $1b
- Prohibition of ICAs to Covered Persons that encourage inappropriate risk by:
  - Providing excessive compensation; or
  - Creating a potential for material financial loss
- Requires annual reports to appropriate regulator (s) of the structure of ICAs
- Requires policies and procedures for ICAs that are commensurate with the size and complexity of the institution
- Special rules for institutions with assets greater than $50 billion
  - Mandatory deferral of a substantial portion of ICAs to executive officers
  - Enhanced internal review and approval of ICAs for other individuals who have the ability to expose the institution to significant loss
Regulators reviewing more rigorously
  - Observation: degree of intensity varies by regulator and bank’s performance

All banks required to assess incentive compensation risk
  - Degree of analysis and reporting varies by size and complexity of programs (e.g. $1b/$50b thresholds for Dodd Frank)

Includes assessment of “excessive compensation”
  - Includes executives, employees, directors or principal shareholders (10% owners)

Requires implementation of more formal controls, processes and governance protocols to ensure compliance
  - E.g. risk adjustments, goal setting, payout approvals, board oversight

Driving incentive plan design changes – even for smaller and mutual banks

**Tip:** test programs against perception of risk; evaluate your programs through a new set of lenses; what is worse case scenario?
Commercial Lending Incentive Trends

- Majority of incentive plans make annual payouts
  - 81% in Northeast
  - 77% in New York

- Performance Measures
  - Loan Volume
  - Loan Profitability
  - Credit / loan quality (i.e. net charge offs, non-performing loans)
  - Portfolio yield
  - Referral/cross sells
  - Fee income

- Consider incorporating corporate performance component (i.e. net income) into framework – “we’re all in this together”

- Cap on earnings considered best practice however upside is higher than typical incentive plan (i.e. 200% - 300% of target opportunity)
Qualifiers

- Design feature that allows bank to reduce a lender’s incentive based upon one or more ‘quality’ measures (i.e. loan, credit, portfolio management)
- Example: Three qualifiers that lender must meet in order to receive full incentive.

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Description</th>
<th>Standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Charge-Offs</td>
<td>Net Charge Offs to Total Loan Outstanding</td>
<td>Less than 0.20%</td>
</tr>
<tr>
<td>Delinquencies</td>
<td>Delinquencies to Total Loans Outstanding</td>
<td>Less than 0.90%</td>
</tr>
<tr>
<td>90 Day Exceptions</td>
<td>90-Day Exceptions to Total Exceptions</td>
<td>Less than 35%</td>
</tr>
</tbody>
</table>

Failure to achieve 3 of the above qualifiers will result in no incentive compensation to be earned or paid. Failure to achieve 1 of the above qualifiers will result in a 20% reduction of the calculated incentive compensation to be earned and paid. Failure to achieve 2 of the above qualifiers will result in a 30% reduction of the calculated incentive compensation to be earned and paid.

Holdbacks / deferrals

- Risk management feature that enables bank to defer portion (15% - 20%) of lender’s incentive over a certain time period (6 months – 12 months).
Objectives of most retail incentive programs
- New customer acquisition
- Cross-selling of new accounts to existing customers
- Retention of existing accounts

Majority of survey participants offer sales/referral incentives to their retail staff (Tellers, CSRs, ABMs, BMs, back office)
- 66% New York survey
- 63% Northeast survey

Most banks pay retail incentives on a quarterly basis

Types of plans
- “Unit-Based” or “Widget”: rewarding branch personnel on individual products sales and referrals
- **Balanced Scorecard**: focuses on sales and customer focus
“Unit-Based” or “Widget” plans reward for:

- Plan participants receive incentive award for each product added / sold and incentive payouts typically vary by product
  - Strategic focus / market plan, rather than profit margin, typically drives the payout amount for each product

<table>
<thead>
<tr>
<th>Product / Service</th>
<th>Prevalence (Northeast Survey)</th>
</tr>
</thead>
<tbody>
<tr>
<td>New deposit accounts</td>
<td>84%</td>
</tr>
<tr>
<td>Customers add features to new accounts</td>
<td>73%</td>
</tr>
<tr>
<td>Referrals to other divisions</td>
<td>61%</td>
</tr>
<tr>
<td>Debit cards</td>
<td>55%</td>
</tr>
<tr>
<td>Retail Loan Sales - # of loans</td>
<td>50%</td>
</tr>
<tr>
<td>Retail Loan Sales – dollar value</td>
<td>32%</td>
</tr>
</tbody>
</table>
# Retail Incentive Trends

## Average annual award prevalence for Tellers

<table>
<thead>
<tr>
<th>Award Value</th>
<th>&lt; $250m</th>
<th>$250m - $500m</th>
<th>$500m - $750m</th>
<th>$750m - $1.5b</th>
<th>&gt; $1.5b</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; $100</td>
<td>50%</td>
<td>39%</td>
<td>38%</td>
<td>20%</td>
<td>39%</td>
</tr>
<tr>
<td>$100 - $249</td>
<td>25%</td>
<td>29%</td>
<td>25%</td>
<td>33%</td>
<td>22%</td>
</tr>
<tr>
<td>$250 - $499</td>
<td>17%</td>
<td>11%</td>
<td>13%</td>
<td>13%</td>
<td>22%</td>
</tr>
<tr>
<td>$500 - $999</td>
<td>14%</td>
<td>6%</td>
<td>20%</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td>$1,000 - $2,999</td>
<td>7%</td>
<td>6%</td>
<td>13%</td>
<td>11%</td>
<td></td>
</tr>
<tr>
<td>&gt; $3000</td>
<td>6%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Cash</td>
<td>8%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

## Average annual award prevalence for Branch Managers

<table>
<thead>
<tr>
<th>Award Value</th>
<th>&lt; $250m</th>
<th>$250m - $500m</th>
<th>$500m - $750m</th>
<th>$750m - $1.5b</th>
<th>&gt; $1.5b</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; $100</td>
<td>25%</td>
<td>21%</td>
<td>6%</td>
<td>17%</td>
<td>6%</td>
</tr>
<tr>
<td>$100 - $249</td>
<td>8%</td>
<td>12%</td>
<td>8%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$250 - $499</td>
<td>33%</td>
<td>21%</td>
<td>24%</td>
<td>8%</td>
<td>19%</td>
</tr>
<tr>
<td>$500 - $999</td>
<td>17%</td>
<td>13%</td>
<td>6%</td>
<td>17%</td>
<td>19%</td>
</tr>
<tr>
<td>$1,000 - $2,999</td>
<td>17%</td>
<td>21%</td>
<td>18%</td>
<td>33%</td>
<td>25%</td>
</tr>
<tr>
<td>&gt; $3000</td>
<td>8%</td>
<td>17%</td>
<td>29%</td>
<td>17%</td>
<td>31%</td>
</tr>
<tr>
<td>Non-Cash</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Retail Incentive Trends

Balanced Scorecard
- Focuses on sales and customer services
- Allows for different types of goals (bank, team, individual) and weightings
- Assign target incentive opportunity (as percent of base salary) and range (threshold to maximum)
- Can focus on monthly, quarterly or annual goals
- **Example:** Assumes CSR with $36,000 base salary and 7.5% incentive target

<table>
<thead>
<tr>
<th>Performance Measure</th>
<th>Weighting</th>
<th>Incentive Payout Opportunity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Threshold (50% of target)</td>
</tr>
<tr>
<td><strong>Deposits</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>* Individual DDA deposit $$ production</td>
<td>50%</td>
<td>$675</td>
</tr>
<tr>
<td>* Individual time deposit, savings and MMA $$ production</td>
<td>30%</td>
<td>$405</td>
</tr>
<tr>
<td></td>
<td>20%</td>
<td>$270</td>
</tr>
<tr>
<td><strong>Loans</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>* Consumer loans (originate) &amp; mortgages (refer)</td>
<td>30%</td>
<td>$405</td>
</tr>
<tr>
<td>* Business loans – enterprise (originate) &amp; commercial (refer)</td>
<td>20%</td>
<td>$270</td>
</tr>
<tr>
<td></td>
<td>10%</td>
<td>$135</td>
</tr>
<tr>
<td><strong>Service Quality</strong></td>
<td>20%</td>
<td>$270</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td></td>
<td>$1,350</td>
</tr>
</tbody>
</table>
Mortgage Originator Incentive Trends

Incentive Framework
- Base + Commission (60%)
  - Base salaries typically range between $25,000 - $35,000
  - Commission Only (46%)

Reward for production / volume
- Purchase Money Mortgages: 40 bps – 60 bps
- Internal refinances: 25 bps – 40 bps
- External refinances: 40 bps – 60 bps

Commission rates (basis points) vary based upon…
- Loan size
- Type of loan
- Achievement of production loans

Only 33% of survey participants with mortgage originators have a draw on earnings
- More prevalent with new hires for certain period of time (i.e. first 6 months of employment)
Incorporating Long Term Performance into Compensation Programs
Incorporating Long Term Perspective in Your Compensation Program

27% of participants have a formal LTI plan (50% in NY survey)
- 15% of mutual banks in Northeast
  - 56% have phantom/synthetic plan while 39% have cash plan
- 51% of stock banks in Northeast

Rationale behind focusing on long-term performance:
- Mitigates risk taking by aligning payouts more closely with time horizon of risk
- Aligns with regulators’ interests for holdback/deferral of compensation (i.e. payments made in future)
- Rewards long-term value and soundness of institution
- Provides means for implementing claw back (if necessary)

Potential techniques
- Ensure meaningful portion of compensation rewards multi-year performance
- Holdbacks/deferrals where short term incentive is heavily weighted
- Payment in stock – pay part (or above target) in stock
- Shift overall pay mix toward long-term
- Stock ownership/retention policies
- Claw back policies
Hoping for Better Times Ahead

According to this survey the compensation here is "competitive."

Competitive means not the highest. So we could get paid more if we worked at another company?

Should we continue working as hard as we can or should we back off to a more competitive level?
Kristine Oliver is a Vice President in the banking industry practice at Pearl Meyer & Partners which has a significant focus on the Northeast/Mid-Atlantic community banking industry. For more information about regarding banking compensation consulting services, please visit www.pearlmeyer.com/banking.

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