

Massachusetts Bankers Association
Banking on Communities Since 1905

2009 Executive Officers Conference
***Incentives and Key Compensation Trends in
Today's Environment***

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■ An ever changing landscape....

Several noteworthy events last week ...from the US Treasury

- **Compensation Czar appointed to have broad influence and oversight of TARP participants**
- **Final interim rules for TARP participants**
- **Five broad compensation principles for all financial companies (and presumably all companies)**
 1. Pay for Performance - compensation should properly measure and reward performance
 2. Risk – Time Horizons - compensation should be structured to account for the time horizon of risks
 3. Risk Management - compensation should be aligned with sound risk management
 4. Golden Parachutes and Supplemental Retirement Packages - reexamination is needed as to the alignment with shareholder interests
 5. Promotion of Transparency and Accountability in the Compensation Setting Process – increased disclosure requirements related to compensation and governance

■ An ever changing landscape.....

Several noteworthy events last week....

- **Proposed further legislation related to:**
 - » Say on Pay – non binding shareholder vote on executive compensation
 - » Independent compensation committee
- **Treasury supports efforts of bank regulators to incorporate broad compensation standards into supervisory process**

■ An ever changing landscape....

SEC Also Active:

- **SEC proposed updated "proxy access" rules that would give large shareholders the ability to nominate as many as 25% of all directors**
- **Updated interpretive guidance on executive compensation disclosure rules**
 - CD&I released May 29,2009
- **New disclosure rules on the horizon**
 - Enhanced disclosure of director independence
 - Board leadership structure
 - Risk and incentives
 - Compensation Consultant independence and conflicts
 - Competitive positioning and benchmarking
 - Compensation discussion for Non-NEOs

■ The Community Bank Environment

Amidst unprecedented financial, economic and business turmoil ...

...community banks need to address critical issues ...

- Financial crisis and global economic recession
- Government intervention
- Bank regulators (increased supervision/focus)
- Bank failures
- FDIC assessment
- Net Interest Margin
- Earnings pressures
- Credit risk
- Housing slump
- Plunging stock prices
- Mergers & Acquisitions

- Community banks painted with same brush as the “troubled” Wall Street Banks
- TARP vs Non TARP banks
- Intense scrutiny of compensation and bonus/incentive practices
- Changing (radical) landscape of compensation best practices – impacting all banks (and all companies)
- Continuing need to attract, motivate and retain top talent
- Generational view/differences – what motivates, attracts and retains new leaders?
- Pending shortage of leadership talent as boomers retire; most banks have limited executive “bench strength”

■ Today's Reality

■ Lower base salary budgets

- Budgets lowered from ~3.5%/4% in August, 2008 to 2%- 3% by February 2009
- In November 2008 – only 11% of banks were strongly considering freezing *executive* base salaries¹
- By February, 24% had already decided to freeze *executive* bases salaries for 2009 and 14% were strongly considering this action¹.

■ Annual bonus/incentive payouts

- Funding challenges – earnings pressures decrease pool for incentives in 2009
- Some banks funding lower pools or waiting to see how 2009 performance fares
- 2008 performance awards lowest in decade
 - » 2007 payouts trended below target
 - » 2008 payouts at threshold or not paid at all
- TARP restrictions playing a significant role
 - » Most TARP participants didn't pay awards even if funded due to regulations
 - » Typically CEO and top five executives (depends on TARP funds taken)

¹ PM&P Executive Pay in the New Economy, February 2009 Results, Banking Industry Edition

Today's Reality

Equity awards

- More selective participation – partly expense driven
- Challenge – dilution concerns; more shares to deliver target value
- Many banks balancing value with number of shares, resulting in smaller grants
- TARP limitations – restricted stock equivalent to 1/3 annual compensation; cannot fully vest until TARP funds paid back

Benefits

- Increased healthcare costs (employer and employee)
- Defined benefit plans – on decline
- Executive benefits facing increased scrutiny

Overall total compensation was lower in 2008 for many (executives in particular) and may trend even lower for 2009.

- Realities of an economic cycle
- Pay for performance does exist – despite media claims to contrary

What strategies can you use to continue to attract and retain your top performers?

TARP or No TARP? Strategies Will Vary

Note: this slide based on TARP regulations as of 06/09/09; subject to further guidance any day thereafter

TARP BANKS

- **Key Strategic Question**
 - When do you plan to repay TARP funds?
- **Base Salaries:**
 - Likely increases; unintended consequence
- **Annual Incentives;**
 - Requirement to reduce risk
 - Incentive payouts not allowed for certain executives (depends on TARP \$)
 - Continue managing plans and track performance and payouts – may be helpful information to have upon fund repayment
- **Long-Term Incentives**
 - Only restricted stock; provided award does not exceed 1/3 “annual compensation”
- **No severance pay/gross ups**

NON TARP BANKS

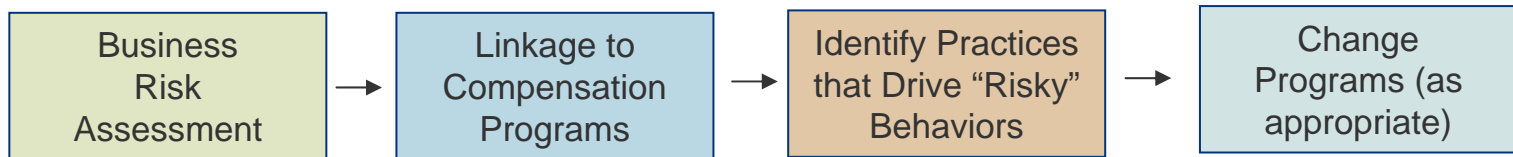
- **“Broad Principles” announced 6/10**
- **Base Salaries:**
 - Target at median (+/- based on experience, contribution, performance)
- **Annual Incentives**
 - Ensure pay-for-performance alignment
 - Conduct risk assessment
 - Focus more on long-term performance horizon
 - Consider hold backs
 - Claw backs becoming standard
 - Review and update incentive plans; mix, performance measures, leverage, etc.
- **Long-Term Incentives**
 - Focus on long-term performance
 - Ownership guidelines/holding reqts
- **Severance/termination pay**
 - Emerging practice: lower severance multiples; no gross ups

Compensation Practices Should Embrace:

- **Risk Management**
 - Ensuring compensation programs do not motivate unnecessary or excessive risk taking
 - Implement controls, process, design features to mitigate
- **Long-Term Horizon of Performance and Rewards**
 - Reward based on the long-term value and soundness of the institution
 - Review mix, leverage and design features to ensure a long-term view of performance
- **Pay for Performance**
 - Ultimately ensure pay and performance are aligned
 - Use appropriate balance of performance measures
 - Reward short and long-term performance

■ Address Risk Management in Compensation

- Highly leveraged incentive plans are partially to blame for the financial crisis but not a common structure in community banks
- TARP participants must conduct a risk assessment semi-annually
- However ALL financial companies (and all public companies) are expected to assess risk in compensation plans.
- **Process**



- Use a team approach – risk officer, internal audit, human resources, legal, etc.
- All plans have risk – make sure the focus is on “excessive” and/or “unnecessary” risk
- Potentially risky measures can be counterbalanced by internal processes and incentive design features

■ Address Risk Management in Compensation

Questions to ask:

- Do incentive plan metrics reflect the company's business strategy?
- What incentive measures are tied to potentially "risky" behaviors?
- Is there an appropriate balance and mix of performance metrics?
- Is the leverage (upside and downside) appropriate?
- Is there appropriate focus on long-term/sustained performance?
- Are there protections/controls in place to avoid excessive payouts?
- Do the payouts align with shareholder interests?
- Does performance and resulting rewards align with market practice?

Think Long-term

- **Along with highly leveraged incentives, the focus on short-term results are much to blame for the financial crisis**
- **Compensation practices should be adjusted to:**
 - Place more focus on longer term, sustainable performance
 - » adjust the “mix” of total compensation
 - Ensure reward periods match the timeframe required to determine whether a decision/action was successful
- **Short-term incentive techniques**
 - Consider “holdbacks”/bonus banking - retain a portion of earned bonus or equity and subject to future risk if the performance is not sustained in future years.
- **Long-term incentive techniques**
 - Extended vesting of awards
 - Stock ownership and retention guidelines
 - Hold until or past retirement requirements

■ Ensure Pay for Performance

- **For TARP participants, compensation restrictions limit pay for performance – base salary and restricted stock are guarantees**
- **For all companies PFP can be a challenge:**
 - Economic environment
 - Influences out of control of management (e.g. stock price, rates)
 - Optics and perceptions - media/public/shareholders
 - Disclosure limitations
 - Regulatory mandates
 - Piecemeal view
 - vs. risk management (no risk pay is the opposite of pay for performance!)
- **Balance is the key to effective pay for performance**
 - Short-term and long-term
 - Absolute and relative
 - Bank, team and individual
 - Formula and discretionary

Example “unacceptable” practice: do not use a single (or the same) measure(s) in both short and long-term plan.

■ Ensure Pay for Performance

- **Performance measures should:**
 - Link to business strategy and goals
 - Be balanced (e.g. growth, profitability, operational, expense, shareholder)
 - Motivate the right behaviors/results
- **Performance guideposts should raise the bar, but be realistic**
 - Minimum – lowest level of acceptable performance – guideline 80% of time
 - **Target – reflects budget/expectations – guideline 60-70% of time**
 - Stretch – stars are in alignment – guideline 60-70% of time
- **If the Bank's ability to predict is limited, consider:**
 - Relative measures
 - Longer term performance horizon
 - Providing the Committee with some discretion but define expectations upfront

■ Ensure Pay for Performance

- **Remember incentives are not guaranteed payments**
 - 1-2 years in 10, incentives won't pay out
 - “Good things” not captured by short-term incentive plan measures should be recognized in long-term incentive plan payouts
 - If you don't have a long-term incentive plan, too much pressure can be placed on the short-term plan to pay out. Consider:
 - » Special recognition awards for high performers/contributors
 - » Consider deferring/holding back some of annual awards to recognize sustained performance over multiple years – eases some of the cyclical swings
 - » Consider long-term cash incentive plan key contributors
 - » Consider special equity grants for high performers

■ In Summary

- **Compensation (and incentive pay in particular) is under increased scrutiny**
- **The issues are complex**
- **Practices are evolving and changing**
- **At minimum, all banks should:**
 - Review incentive plans and total compensation programs to ensure they do not motivate and reward inappropriate risk taking
 - Ensure incentives focus on driving sustained, long-term performance that supports your unique business goals and strategies
 - Ensure performance is measured using a balanced portfolio of performance measures
 - Ensure total compensation program is clearly aligned with both company performance and interests of shareholders
- **Public banks should:**
 - Focus more attention on proxy/CD&A disclosure which remains the primary means for explaining your compensation programs and decisions
 - Recognize that shareholders, media and public now have more information and greater voice in executive compensation

QUESTIONS?

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Additional Complimentary Resources on www.pearlmeyer.com/banking

- Trends and Issues
- Client Alerts
- Research Reports
- Webcasts – two posted on Risk Assessment Process; Next is 6/30/09 on TARP regulations