

2009 Spring Directors' Conference

Executive Compensation in Today's Turbulent Times

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June 5, 2009

■ The Community Bank Environment

Amidst unprecedented financial, economic and business turmoil ...

- Financial crisis
- Global economic recession
- Government intervention
- FDIC assessment
- Bank regulator concerns (consolidation, pressure)
- Bank failures
- Earnings pressures
- Credit risk
- Housing slump
- Plunging stock prices
- Mergers & Acquisitions

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

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

Hot Trends & Issues In Today's Environment

- ❖ **Optics and Scrutiny**
- ❖ **Compensation Governance**
- ❖ **Disclosure**
- ❖ **Incentive Plan Risk**
- ❖ **Long-Term Performance Horizon**
- ❖ **Pay for Performance**
- ❖ **Total Compensation**
- ❖ **Executive Benefits and Separation Arrangements**

- **Public and Media**
 - Outrage at the banking industry in general
 - Painting a broad brush; “Big” Wall Street Banks vs. Community Banks
 - Public relations challenge for some banks
- **Politicians and Government**
 - Responding to constituents; running scared
 - Legislation and bills by the dozens
- **Shareholders**
 - Increased knowledge, activism - proxy disclosure/CD&A creates more opportunity for critique and criticism
 - “Windows” on the Boardroom
 - Non binding investor vote on executive compensation (Say on Pay)
 - » Mandated for TARP banks
 - » Obama Administration, Congress and others pushing for similar requirements for all publicly traded companies.
- **Shareholder Advisory Firm Influence (e.g. Risk Metrics/ISS)**
 - Significant influence on investor votes
 - » RMG Against votes drove significantly lower shareholder support on Say on Pay proposals
 - Must understand if you are seeking new stock plan or have Say on Pay.

■ Compensation Governance

- **NASDAQ/NYSE Requirement for Compensation (Audit and Governance) Committee charter and independent members**
- **Key Compensation Committee Responsibilities**
 - Evaluate CEO performance
 - Develop executive compensation philosophy (pay-performance link)
 - Review competitiveness and effectiveness of executive compensation and board compensation practices and policies
 - Review and approve CEO and NEO compensation, benefits, employment agreements
 - CEO succession planning
 - Committee/Board evaluation
 - Recommend board compensation
 - Prepare Compensation Committee Report in proxy (including approval of CD&A)
 - Emerging: Conduct executive compensation risk assessment
- **Committee Best Practices/Requirements**
 - Independent members
 - Director driven process
 - Materials provided in advance; discuss at one meeting - decide at another
 - Annual meeting schedule/calendar
 - Access to outside counsel/advice; consultant retained by and reports to Committee; work for management directed and approved by Committee
 - Executive session at every meeting
 - Ongoing education
 - Committee analyzes compensation relative to performance

■ Disclosure (public banks)

■ SEC Disclosure – Increased Importance

- Clarity and completeness expected
- Stock Plan, Say on Pay and Director votes refer to CD&A; evaluated by shareholder advisory firms (e.g. RMG, Glass Lewis)
- It tells your “story”; documents your philosophy, programs and decision making process for shareholders
 - » Requires well thought out compensation philosophy
 - » Summarizes philosophy, practices, decisions of Board/Committee decisions

■ Requirements

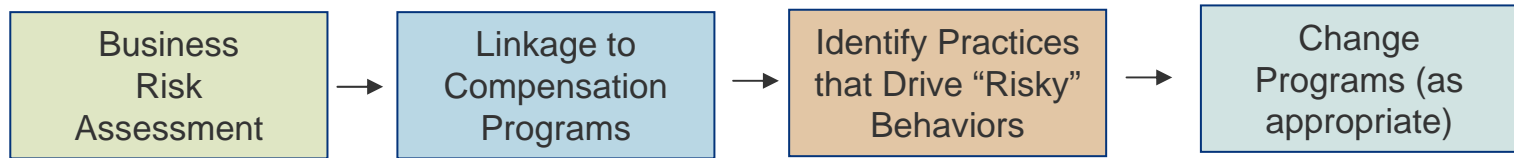
- More rigorous communication and examination of overall program
- Analysis and decision making process; not just program explanations
- Clarification of roles and responsibilities in compensation decision process (management, consultant)
- Disclosure of specific performance goals and results (competitive harm exclusion is tough hurdle)
- Peer group (criteria and list of banks)
- Internal pay relationships and differences in pay decisions

■ Incentive Plan Risk

- **Blamed for Financial Crisis**
 - Incentives/compensation practices that motivate unnecessary and excessive risk taking
 - Wall Street practices – not typical practice
 - » Highly leveraged pay models; big rewards for big risks
- **Emerging Best Practice**
 - All TARP participants required to perform analysis (*government focus*)
 - All financial companies likely will be expected to perform analysis (*regulator focus*)
 - Ultimately all public companies will likely be required to conduct similar reviews (*SEC focus*)
- **Process**
 - Who should conduct the assessment?
 - » Emerging role of Senior Risk Officer
 - Frequency/time line
 - » Annual/semi annual for TARP banks
 - SRO review with Compensation Committee
 - CEO certification

■ Incentive Plan Risk

■ Scope



■ 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?

■ Long-Term Performance Horizon

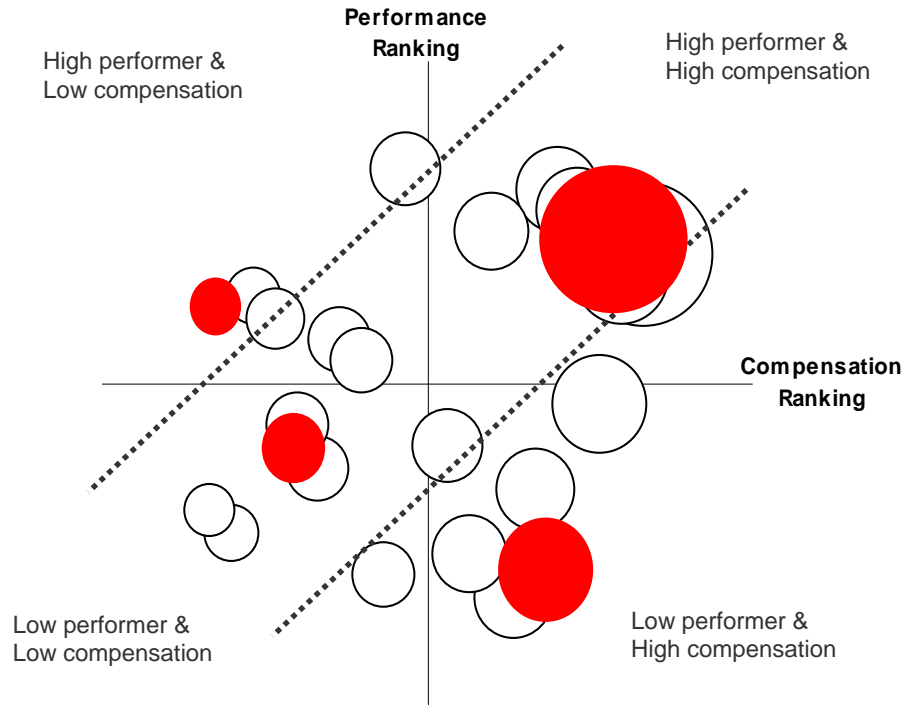
- **Another key criticism coming out of financial crisis**
 - Wall Street traders focused on short-term results; high risk investments that went bad longer-term
 - Reform push to place more focus on long-term/sustained performance
- **Ways to address**
 - Ensure significant portion of compensation is based on long-term, sustained performance
 - Ensure reward periods match the timeframe required to determine whether a decision/action was successful.
 - Retain a portion of earned bonus or equity and subject to future risk if the performance is not sustained in future years.
- **Specific techniques**
 - Reshuffle the “mix” of total compensation
 - » Include both short and long-term incentives
 - » Focus the majority of incentive pay on long-term horizon
 - Consider incentive “hold backs”
 - » Retain a portion of incentive pending sustained performance
 - Institute ownership/holding requirements

- **The Challenges:**
 - 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!)
- **A Key to Effective PFP – BALANCE!**
 - Short term and long-term
 - Absolute and relative performance views
 - Bank, team and individual
 - Formula vs. discretionary
- **Performance measures should**
 - Link to business strategy/critical goals
 - Be balanced (e.g. growth, returns, profitability, shareholder, expense, operations)
 - Focus on the right behaviors/results
 - Be limited - to create focus but not so limited to drive risky behavior

- **Target performance goals should raise the bar, but be realistic**
 - Minimum/threshold – represents lowest level of acceptable performance (*achieved 80% of time*)
 - Target typically reflects “budget” /expectations (*achieved 60% - 70% of time*)
 - Stretch goals should be challenge – “raise the bar” (*achieved less than 20% of the time*)
- **Payouts**
 - Don't lose track of original intent: short term performance rewards short term results
 - » If short-term results not there – no payout
 - » Most banks paid no bonus (or threshold) payout for 2008 performance
 - » Building and investing for the future should be recognized with future annual incentives and long-term awards; resist pressure to reward future potential success today.
 - » Payouts are cyclical – and should vary year to year (1-2 years of every 10 will result in no bonus)
 - Long-term incentives are the most effective way to keep eyes on the long-term

Pay for Performance – Is it Working?

CEO total direct compensation relative to 3-Year TSR An Illustration of banks between \$1b - \$15b Assets



■ Total Compensation

- **Focus on the Total Package and Mix**
 - Different components focus on different needs
 - » Fixed vs. variable
 - » Annual vs. long-term
 - » Reward vs. benefit
 - Total a holistic view of compensation
 - » What is overall “message” of the compensation package? Is it the right message?
- **Conduct Tally and Scenario Analysis**
 - How do all the elements add up together?
 - How does total compensation vary under different termination scenarios?
 - » Change in Control
 - » Termination (voluntary and involuntary)
 - » Retirement
 - » Disability
 - How does total compensation vary under different performance scenarios?
Dynamic Pay Modeling
 - » What is the total potential upside/downside rewards of all elements of performance-based compensation?
 - » What is the executive’s payouts (and the company's actual total exposure) at the extremes of performance?

Executive Benefits and Separation Arrangements

- **Decreasing use of perquisites**
 - Replace perqs with other elements of compensation
 - Post retirement perqs under fire
- **Non qualified benefits**
 - Alignment between qualified and supplemental plans
 - Many banks eliminating (eliminated) defined benefit pension plans
 - Performance-based SERPS and Deferred Compensation Plans
- **Employment agreements**
 - Pressure on severance benefits – Eliminated for TARP participants
 - Emerging Trends - sunset provisions – do long-tenured executives really need contracts – sunset clause after certain number of years and after wealth accumulation
- **Change in control provisions**
 - Double triggers
 - » Require both CIC and termination (no “walk aways”)
 - » For equity acceleration
 - » Avoid automatic full vesting of performance equity awards – consider partial vesting structure that reflects time and pre-CIC performance
 - Although traditionally common among banks, 280g gross ups are under increased scrutiny and not considered acceptable practice in today’s environment
 - Enhanced SERPs (under CIC) may be considered excessive

■ In Summary

- Executive compensation is under increased scrutiny
- Expectations about executive pay are high
- Issues are complex
- The world as we know it IS 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



THANK YOU!

QUESTIONS?

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