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Compensation as a Competitive Advantage

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The Headlines

Main Street Banks' New Lending Rivals: Hedge Funds and Private Equity

Fintech Use Reaching Mass Adoption Among Digital Consumers

Traditional Banking Providers Struggling With Digital Payments Strategies

Disruption

Alternative Mortgage Lenders Are Changing Home Buying

Community banks stand to gain from blockchain — if they work together

7 Reasons Millennials Are Turning to Credit Unions Instead of Banks

Three Questions

1. Is it time to bid a farewell to ARMs?
2. What are our performance expectations?
3. What does your compensation plan reward?

Farewell to ARMs?

Farewell to ARMs?

- Compensation philosophies generally state that the goal is to attract, retain, and motivate (ARM).
- ARM goals endorse the concept that a compensation philosophy should be focused on **meeting an employee's basic needs**. In meeting those needs, the assumption is that an organization's **business objectives will be realized**.
- But people are drawn to being part of something greater than themselves, therefore, is an ARM strategy really effective?

Why ARM Strategies May Be Ineffective

- **Attract.** Competitive pay is important, but it is seldom a defining factor. Compensation programs on their own rarely attract employees to organizations.
- **Retain.** Compensation is infrequently cited as the main reason for an executive's departure. A compensation strategy anchored to retention assumes security and maintenance of the status quo is critical.
- **Motivate.** Intrinsic motivation is a stronger predictor of job performance than extrinsic motivation. In other words, if organizations are not hiring the right people, compensation cannot be exclusively relied on to influence value creation.

Engagement and Alignment

Crafting a compensation program that is intimately linked with an institution's DNA, the reason they exist, and their culture can create a catalyst for long-term shareholder value creation. By focusing on engagement and alignment, pay transitions from being an external influencer to an extension of the institution and the individual's everyday functions.

Engagement-Centered Goals

- Focus on current and evolving needs
  - Current leadership
  - Identified succession candidates
  - High-potential employees
- Develop a holistic view of compensation
  - Draw on the bank's unique culture
  - Use multiple compensation components to serve different but complimentary goals
  - Incorporate both monetary and non-financial awards
- Understand market norms and best practices and how those practices may serve the institution or hinder it
  - Take a long-term view
  - Internal factors (e.g., business strategy and culture) can be more important than external factors (e.g., market data).

High-Potential Compensation

- Understanding the following will help you to design a meaningful compensation program for your high potentials:
  - Personal motivations for commitment to the organization
  - Risk tolerance
  - Appetite for growth opportunities
  - Goal versus task orientation
  - Desired degree of autonomy
  - Comfort level with accountability
  - Long-term wealth creation goals, as well as current diversification of wealth
  - Short-term compensation needs

Alignment-Centered Goals

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- Use compensation elements that unlock long-term shareholder value creation.
  - Equity awards
  - Long-term cash
- Adopt a compensation pay mix that builds in appropriate levels of risk while delivering payouts that equitably share in the upside/downside.
- Resist compensation “best practices” if they are counter to business needs or culture.
- Accept that shareholders have a rightful say in how compensation should be structured.

Alignment-Centered Goals

- Avoid ARM-centric compensation philosophies that may limit an organization's ability to unlock the value creation that could be created.
- Develop compensation philosophies centered around employee engagement and shareholder alignment throughout all levels within the organization.
- Pay particular attention to engagement issues with your high-potentials by adopting a high-touch strategy of understanding their needs and motivations.
- Unlock the hidden potential for your organization's human capital to serve as a competitive advantage.
  - Clear focus and reason
  - Consistent communication
  - Enriched experiences
  - Compensation

Dimensions of Performance

Seven Dimensions of Performance

1. **Strategy and Vision** – How well does the executive team convey the bank's vision and develop a clear guide for current and future courses of action?
2. **Leadership** – How well does the executive team motivate and energize employees to implement the business strategy and achieve the bank's vision?
3. **Innovation/Technology** – Does the executive team have a vision for the development of new/better products and services? Is there an IT strategy in place to improve the customer experience and assist in operational and risk management?
4. **Operating Metrics** – Is the bank meeting its current financial objectives? Has progress been made in achieving mid- and long-term financial performance objectives?

Seven Dimensions of Performance

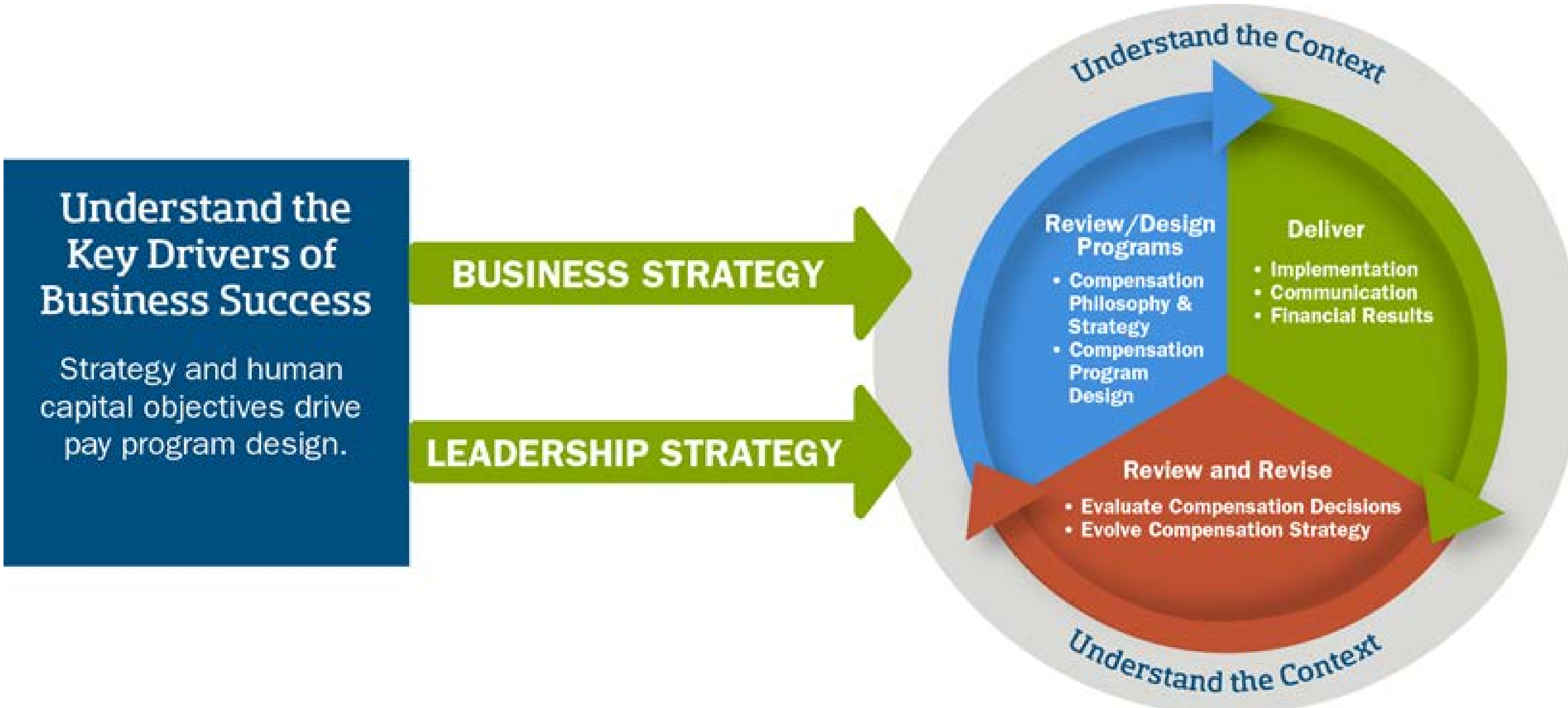
5. **Risk Management** – Is the bank adequately managing its risk and receiving satisfactory regulatory reviews?
6. **People Management** – To what extent do the CEO and senior executives take steps to improve and expand the capabilities of their direct reports? Do their management styles convey a high level of ethics and respect for employees?
7. **External Relationships** – How well does the executive team interact with shareholders, the board, customers, regulators, media, and other stakeholders?

Aligning Compensation

Aligning Compensation

- While it is important to understand market norms regarding pay levels and practices, information is most impactful when followed by additional questions:
  - What implications do those practices have for us?
  - How can we use compensation in a way that draws the right talent and behaviors that ensure success?
- Assessing whether or not an executive compensation program is working requires determining the program’s degree of alignment with the bank’s business and talent strategies.

Aligning Compensation



Aligning Compensation

- **Step 1: Define Path to Success**
  The ultimate goal of all banks is to create value for stakeholders over the long term. But in the interim, “success” can be defined as the effective execution of the bank’s chosen strategy.

Strategy	Measure of Success
Acquisition	Higher returns through market share and economies of scale
Exit/Liquidity (e.g., Sale, IPO)	Maximize growth through joining forces or capital infusion
Organic Growth	Stable and growing returns
Niche	Profitability through higher margin business

Aligning Compensation

- **Step 2: Consider Compensation Implications**
  Compensation committees should consider whether the compensation structure is helping execute the strategy and deliver results.

Strategy	Challenges	Considerations
Acquisition	Financial results during the acquisition stage are highly variable	Does the annual plan include qualitative measurement to account for variability? Are there adjustments or exclusions for incentive calculations? Is there greater weight on equity compensation to reward long-term results?
Exit/Liquidity (e.g., Sale, IPO)	Short-term profitability and results related to franchise value are important	Does the annual plan focus on profitability and results related to franchise value (e.g., deposit and loan growth)? Is there greater weight on equity compensation to align interests? Are implications of the change-in-control agreement terms clear?
Organic Growth	Results are driven through increases in market share and cost reduction	Is the annual plan focused on profitability and moderate growth in key areas? Does the annual and long-term plans reward the status quo or does it reward innovation? Is wealth accumulation through equity, retirement benefits or both?
Niche	Achieving profitability through higher margin business	Is the annual plan appropriately customized for business lines? Is differentiation in compensation required to hire and retain specialized talent?

Compensation Alignment

- **Step 3: Tailor the Program**

  Compensation may be tailored in a number of ways including:

  - Pay mix
  - Pay leverage
  - Equity opportunities
  - Benefits/perquisites
  - Contractual arrangements (e.g., change-in-control agreements)
  - Non-financial methods
    - Training, development, and mentoring
    - Developmental opportunities
    - Time-off, flexible work schedules
    - Recognition programs

Compensation Alignment

- **Step 4: Revisit and Refine**
  Compensation committees should test the outcomes of the compensation program annually and refine as necessary:
  - Did the program achieve the desired results?
  - Did the program provide enough differentiation for low/expected/outstanding performance?
  - Do participants:
    - Value the program?
    - Believe that the program is straightforward?
    - Have a reasonable idea of the compensation that has/will be received?
    - Provides a fair reward for the performance achieved?
  - If stock was used, did the payout result in greater share ownership?

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