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Executive Compensation:
Shifting the Focus Back to the Future

Western Independent Bankers

Western Independent Bankers
Annual Conference
March 23, 2014

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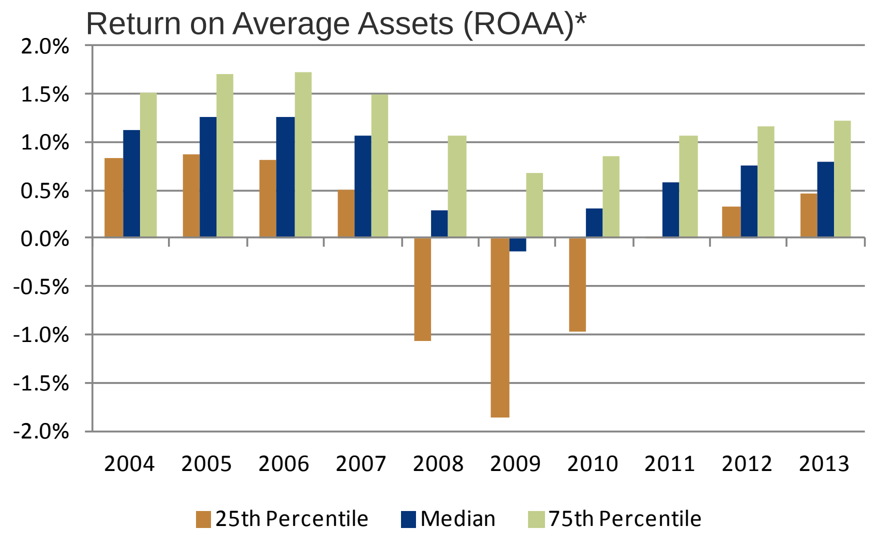
Introduction

- As some of the financial crisis dust settles, community banks are getting back to compensation discussions that are focused on the future
- The “winners” are
  - Revisiting what it means to pay for performance in a Dodd-Frank regulatory environment
  - Under pressure by investors to demonstrate pay-performance alignment
  - Increasing equity compensation awards following several years of limited grants
  - Considering acquisition of “strugglers,” but not ruling out the possibilities of being an acquisition target of a larger “winner”
- The “strugglers” are
  - Lacking the profits necessary to justify meaningful (if any) performance-based pay opportunities
  - Considering reintroduction of meaningful equity awards and change in control agreements as a means to retain key people that can either turn them into a “winner” or position the bank for a reasonable sale

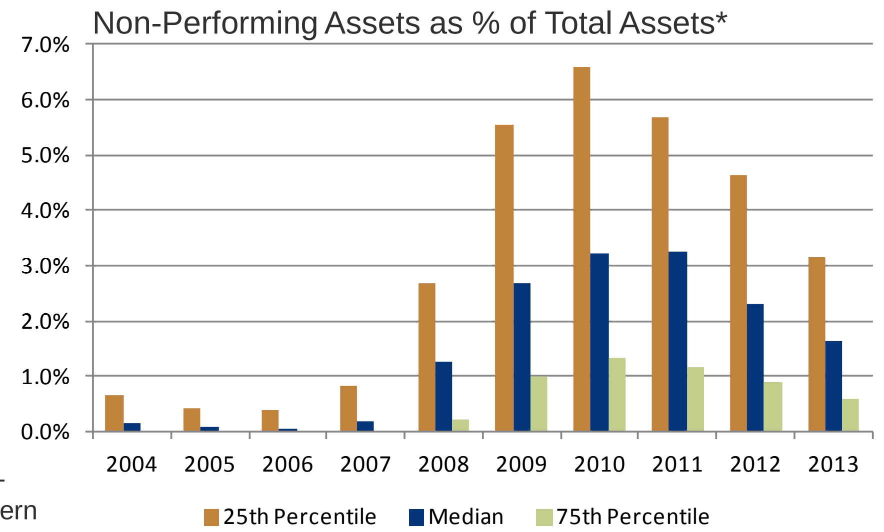
Executive Compensation Trends

Bank Performance in the Western Region

- Though significantly improved since 2009, median ROAA has returned to only 60% - 70% of pre-crisis levels



- There is still a long way to go in order to return asset quality to pre-crisis levels



* Data source: SNL Financial – regulated depositories in Western Region under $5 billion in assets

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CEO Bonuses at Smaller Banks

- While CEO bonuses continue to be modest relative to pre-crisis levels, the percentage of CEOs receiving bonuses and bonus levels are on the increase in recent years

CEO Bonus as a Percentage of Base Salary*

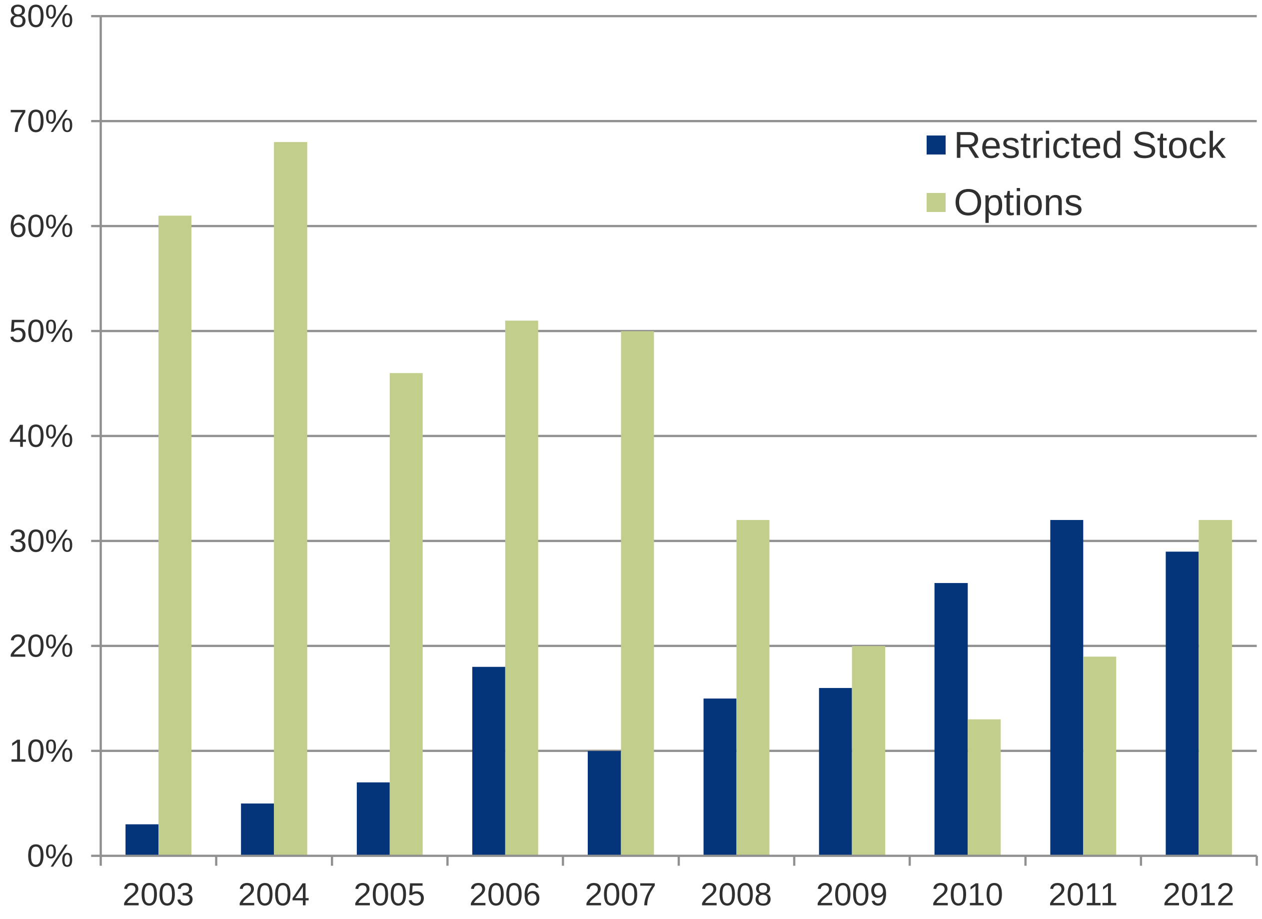
Year	25th Percentile	Median	75th Percentile
2012	0.0%	11.4%	26.0%
2011	0.0%	4.8%	25.1%
2010	0.0%	0.0%	3.1%
2009	0.0%	0.0%	0.0%
2008	0.0%	0.0%	21.7%
2007	17.1%	30.7%	47.9%

* Based on proxy disclosures of public banks in the Western U.S. with assets $200m - $1b.

- Of those CEOs that received a bonus for 2012 performance, the median earned bonus as a percentage of salary was 25%

LTI – Equity Grant Trends at Smaller Banks

% of CEOs Receiving Equity Grants*



* Based on proxy disclosures of public banks in the Western U.S. with assets $200m - $1b.

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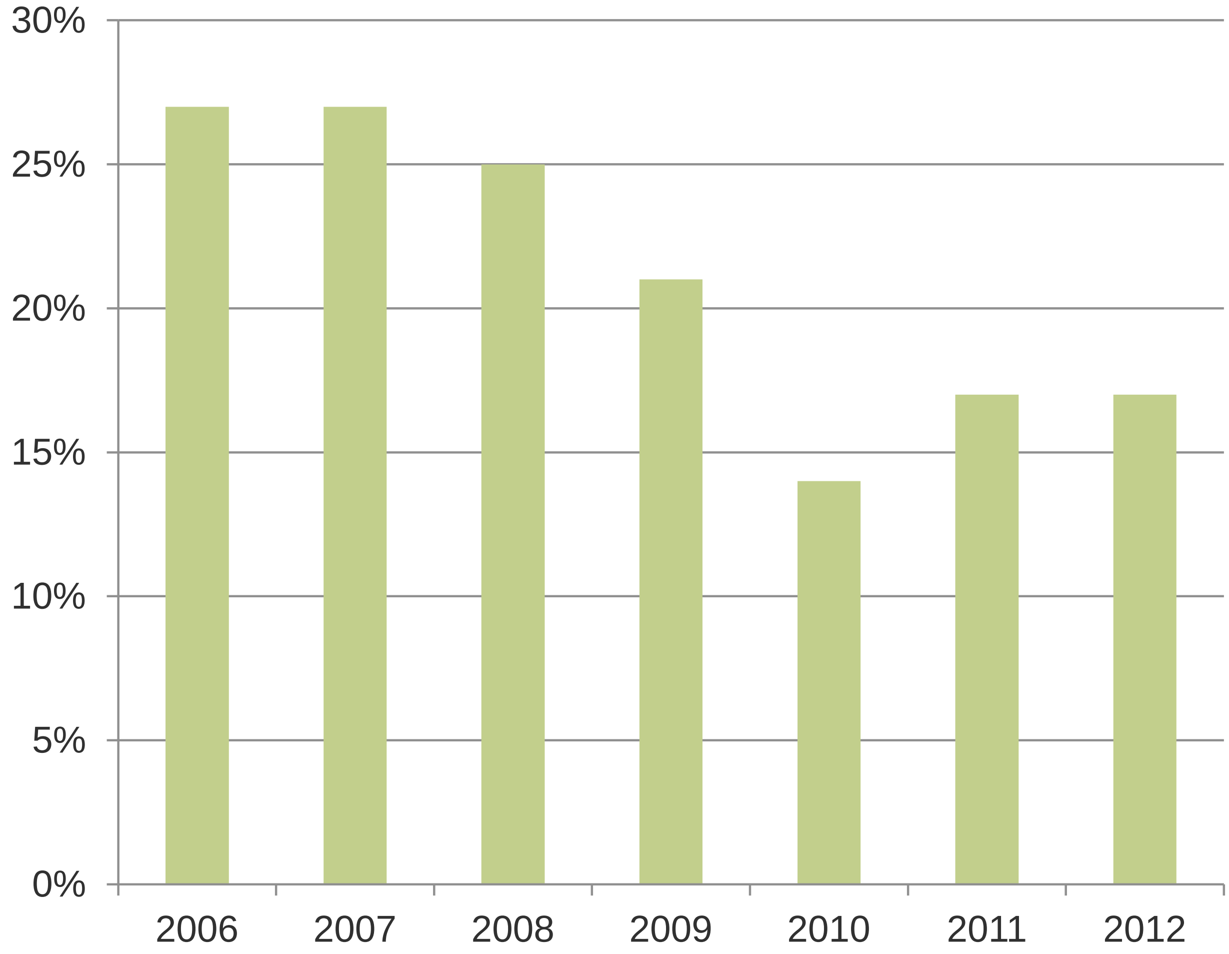
LTI – Equity Grant Trends at Smaller Banks

Median Size of CEO Equity Grants as % of Salary*



* Includes only those CEOs that received an equity grant in the respective year. Based on proxy disclosures of public banks in the Western U.S. with total assets $200m - $1b.

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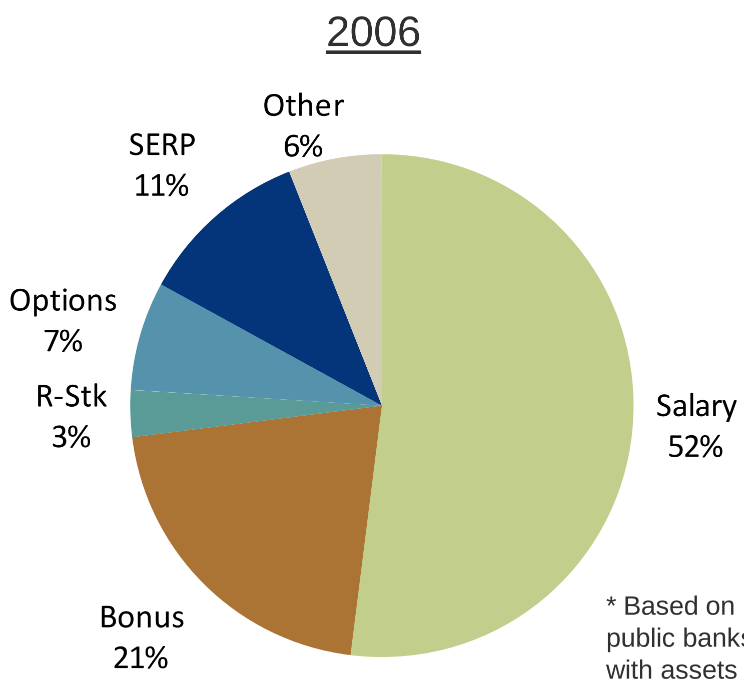
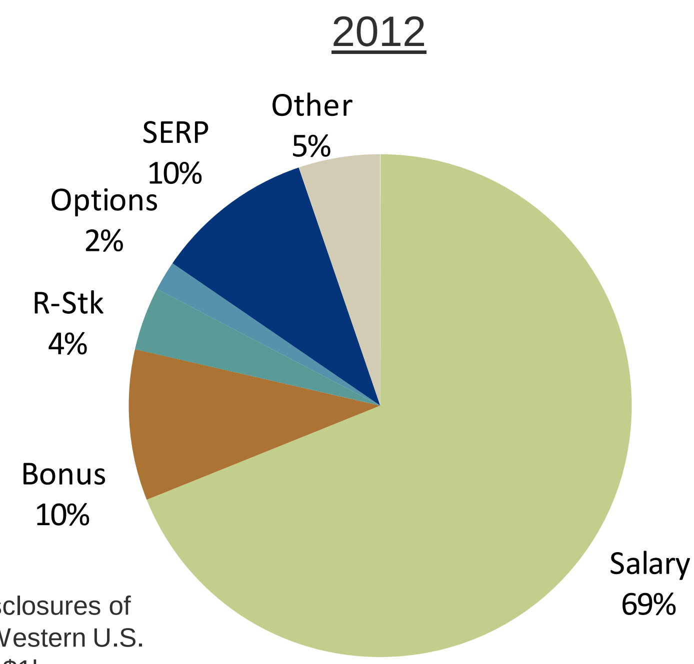
CEO Total Compensation Mix at Smaller Banks*

- The change in mix of CEO total compensation over time reflects the health of the banking industry





* Based on proxy disclosures of public banks in the Western U.S. with assets $200m - $1b.

- If bank performance continues to improve, we would expect CEO total compensation mix at smaller banks to shift closer to the 2006 mix
  - Relative weighting between restricted stock and options will likely stay closer to 2012 (2 to 1, restricted stock to options)

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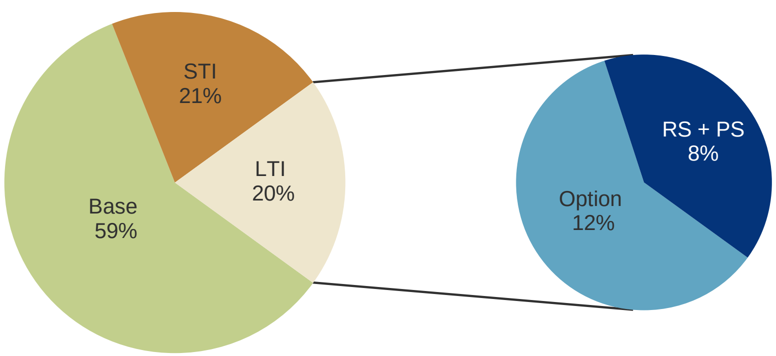
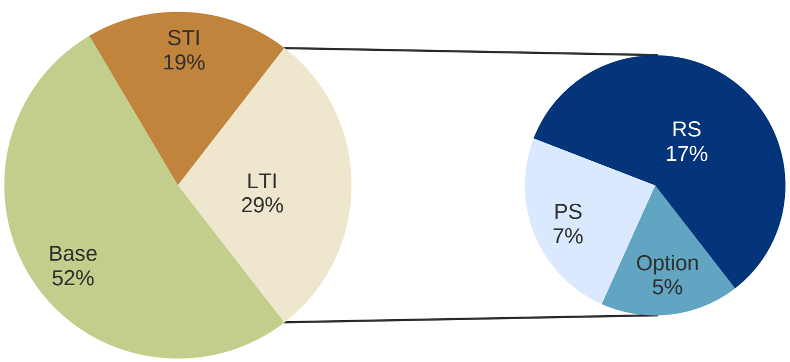
CEO Compensation Mix at Regional Banks*

- Shift in mix of total direct compensation & portfolio of LTI instruments
  - Regional banks have increased the allocation to LTI compensation and shifted from an options-dominated LTI mix to predominately full-value equity awards
  - The use of performance-based equity has increased significantly among regional banks in recent years

2007 Pay Mix



2012 Pay Mix



STI = short-term incentive
LTI = long-term incentive
RS = restricted stock
PS = performance shares

* Based on proxy disclosures of public banks nationally, with assets $3.5b - $15b.

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Designing Effective Performance-Based Pay Arrangements

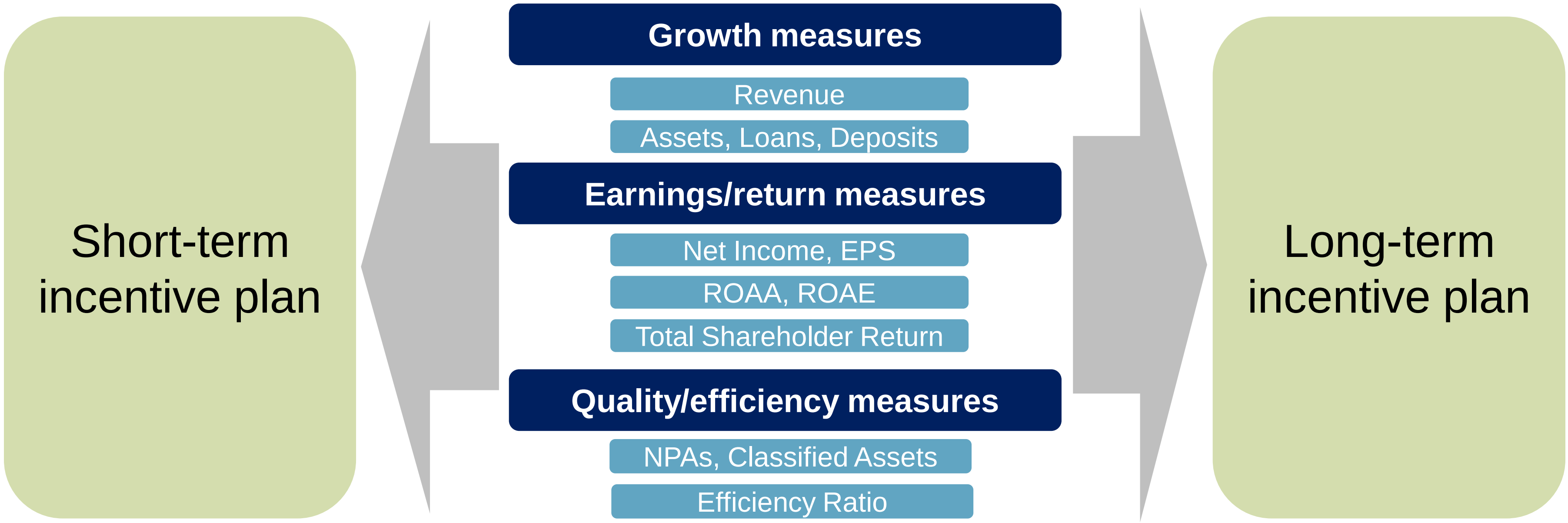
The Basics

- Performance and payout horizons
  - Short-term incentives (STI) are commonly earned and paid annually
  - Long-term incentives (LTI) are earned/paid based on periods longer than a year (e.g. performance measured over a 3-year period)
- Definition of "performance"
  - What measures?
  - Based on corporate, unit or individual performance?
  - What perspective – absolute or relative to peers?
  - Rigor of goals (threshold, target, stretch)?
- Definition of payout opportunity
  - What percentage of total pay opportunity should be performance-based?
  - How much payout leverage (threshold to maximum)?
- Risk management considerations
  - Design, operation, oversight, etc.

Our Board is wrestling with the effectiveness of our selected performance measures … what should we consider?

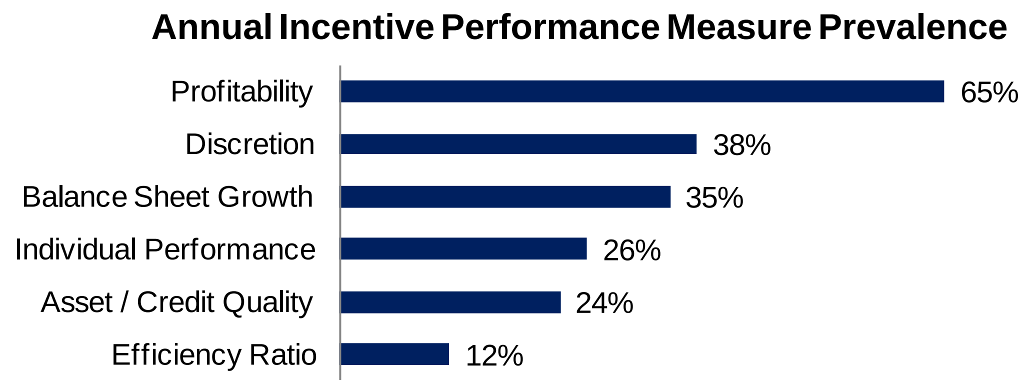
Establishing the Performance Metrics
Dynamic Tension

- Dynamic tension is the interdependency of the performance metrics utilized in short- and long-term incentive plans, or how they work together to create short- and mid-term incentive dynamics that drive long-term sustainable results
- Regulators, shareholders and shareholder advisory groups are holding Boards of Directors accountable for the development, oversight and communication of holistic, balanced incentive strategies that make effective use of dynamic tension

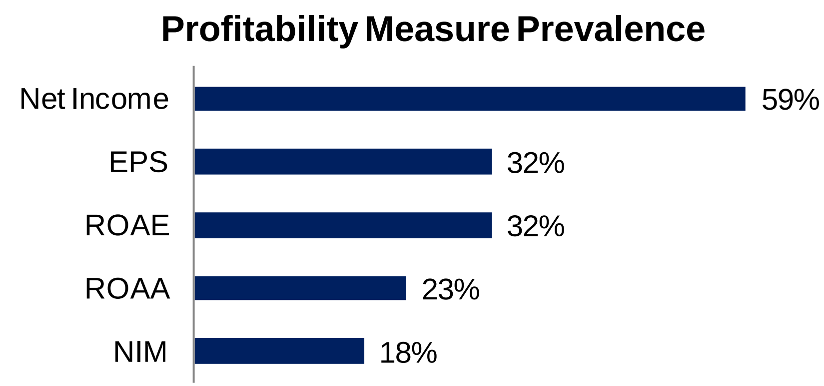


Annual Incentive Plan Performance Metrics Prevalence at Western U.S. Banks*

- Not surprisingly, profitability measures top the list of most prevalent performance measures in annual incentive plans at community and regional financial institutions



- Of those institutions reporting profitability metrics, 59% use net income, followed by EPS and ROAE at 32%; banks often choose to use more than one profitability metric in their annual incentive plans



* Based on proxy disclosures of 33 public community and regional financial institutions.

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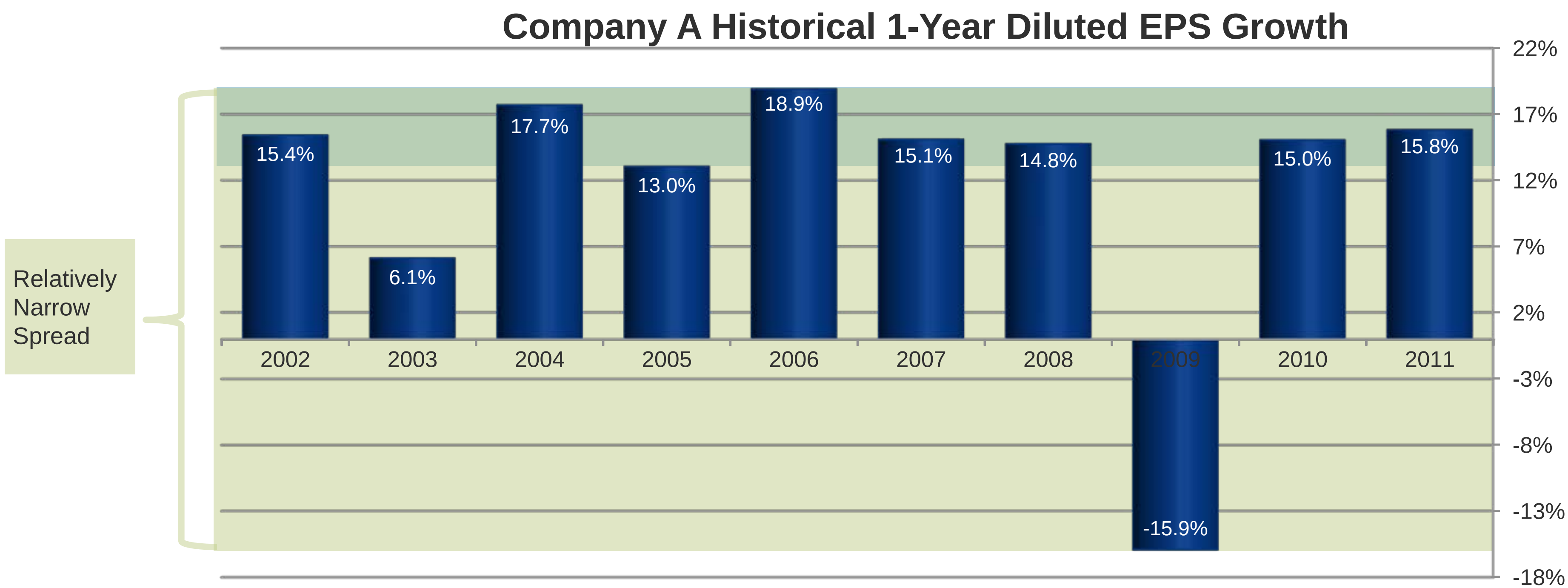
We tend to set our incentive plan goals based on our budgets/forecasts … how can the Board evaluate the level of rigor represented by the goals?

Measuring the Rigor of Performance Goals: Internal Perspective

- To understand the feasibility (rigor) of various levels of goal achievement, we can look at a Company's own historical performance relative to the annual incentive plan metric (e.g. diluted EPS growth)

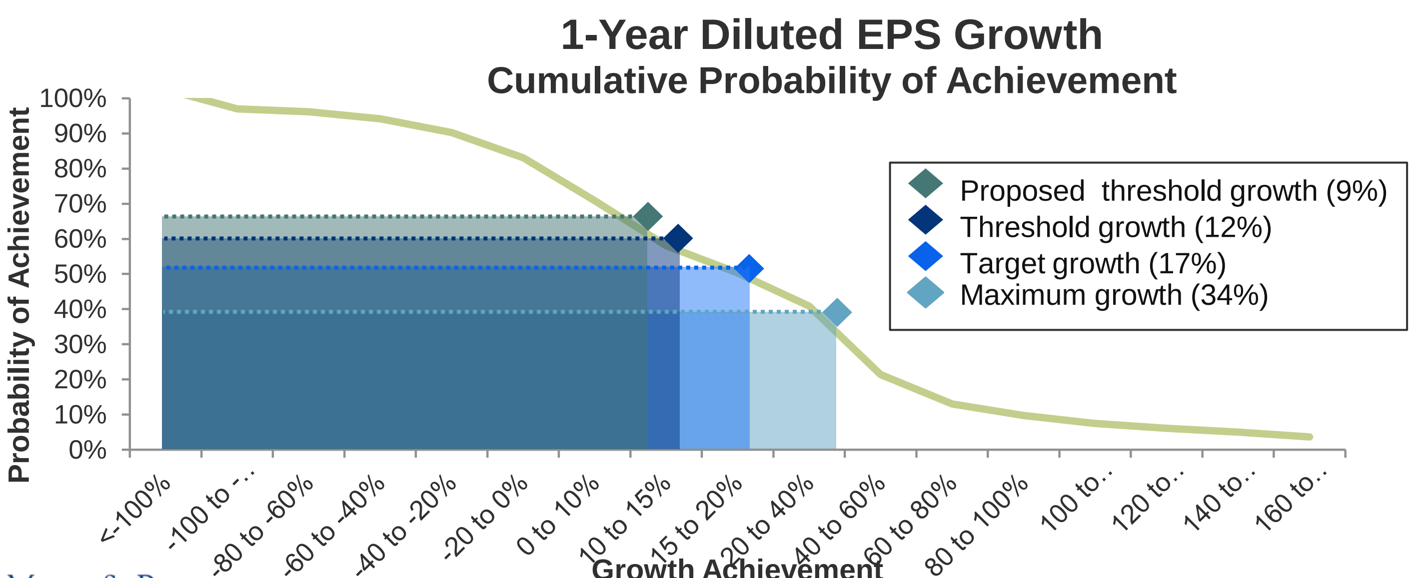
EPS Target Levels and Probabilities				
2012 Goals	**Proposed Threshold**	**Threshold**	**Target**	**Maximum**
Diluted EPS % Growth	9%	12%	17%	34%
Company A Historical Probability of Achievement	**80%**	**80%**	**20%**	**0%**



Measuring the Rigor of Performance Goals: External Perspective

- The chart below shows Company A's peers' cumulative probability of achieving various levels of 1-year diluted EPS growth
- Company A's threshold, target, and maximum level are within a narrow range of probable achievement for peers (39% - 67%)
  - Implies "probable achievement" spread is likely wider for most peers in both directions

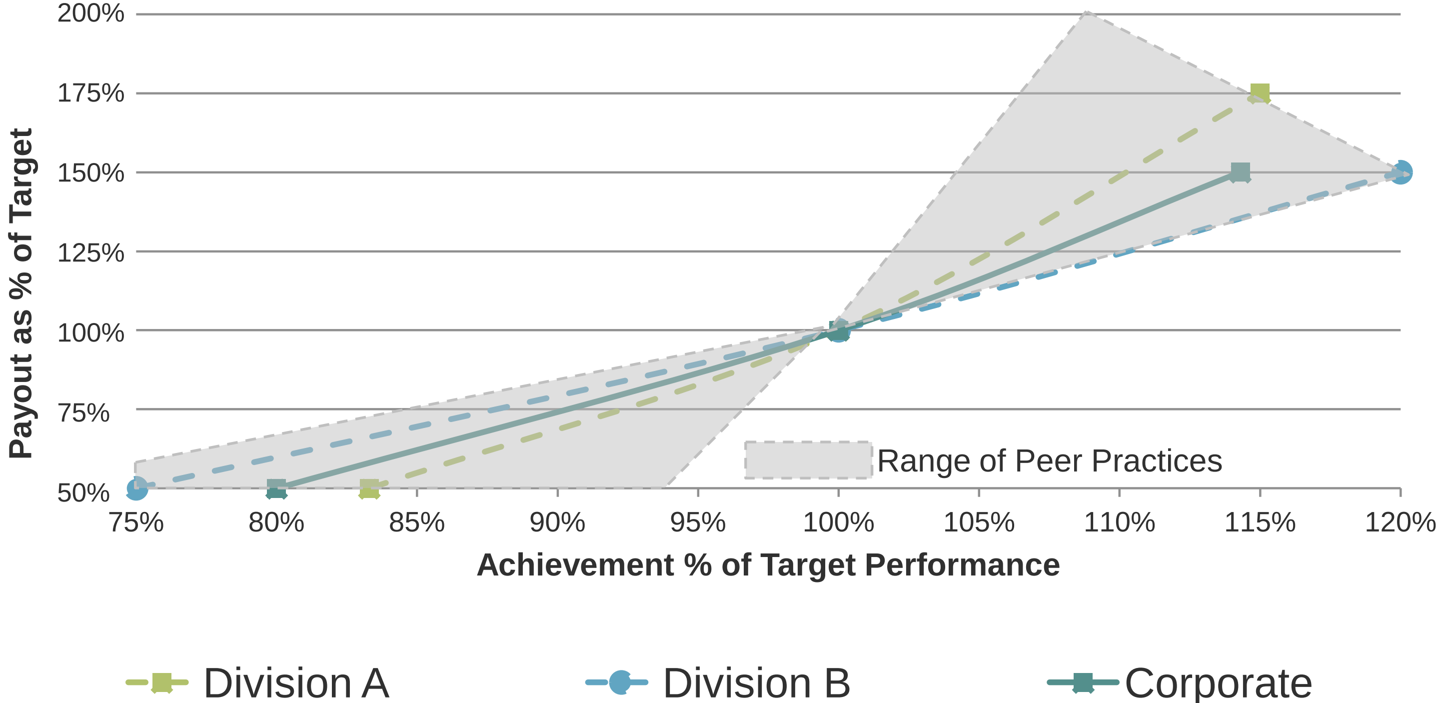
EPS Target Levels and Probabilities				
2012 Goals	**Proposed Threshold**	**Threshold**	**Target**	**Maximum**
Diluted EPS % Growth	9%	12%	17%	34%
Peer Probability of Achievement (n = 360)	**67%**	**60%**	**52%**	**39%**
Company A Historical Probability	**80%**	**80%**	**20%**	**0%**



The Board feels confident about our "target" performance and payout levels, but less certain about how payout levels should respond to performance below or above target …

Determining the "Right" Amount of Leverage

- Banks are re-examining and modifying incentive metrics and payout slopes to help find the proper balance between pay for performance and prudent risk management
- Regulators have expressed displeasure with excessive upside leverage in incentive arrangements
- A company's compensation philosophy should provide parameters for the desired amount of overall leverage within the incentive arrangements
- Responsiveness of payouts to performance often varies based on the specific measure and/or participant group



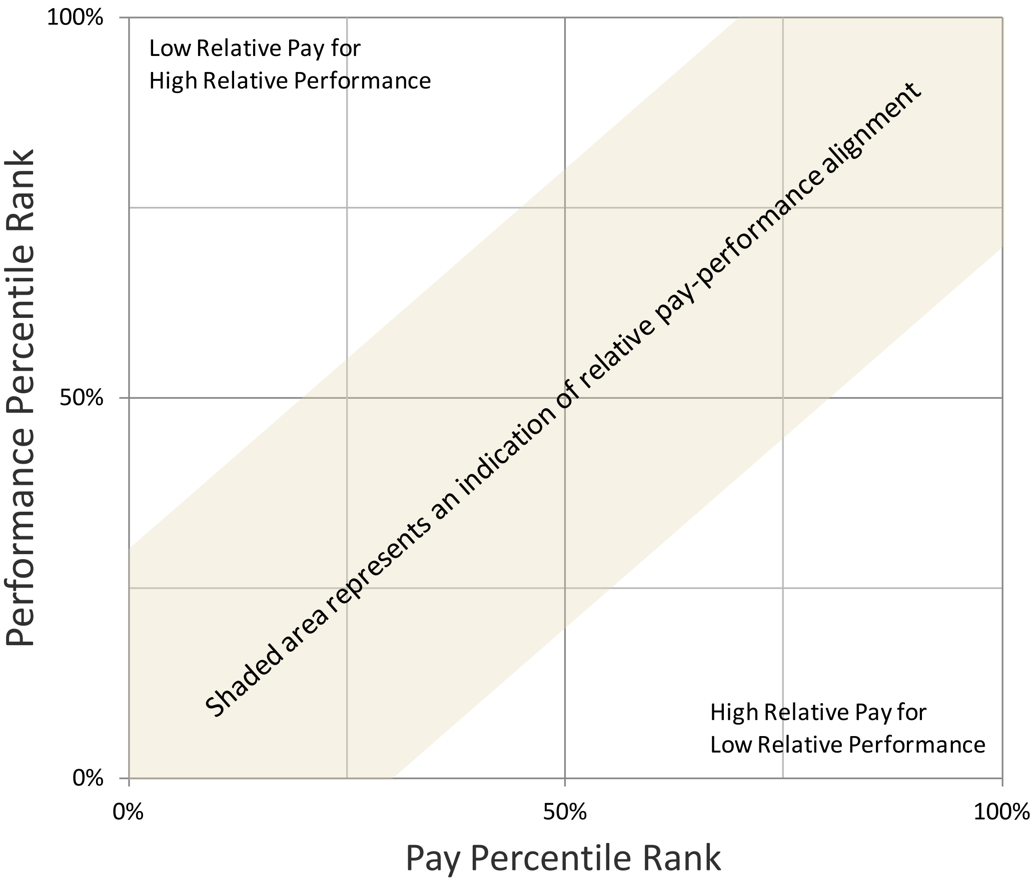
Evaluating Relative Pay-Performance Alignment

Our Board desires a better understanding of our relative pay-performance alignment compared to peer banks … how can we do that?

Measuring Relative Pay-Performance Alignment

Quantification of Relative Pay-Performance Alignment Requires:

- Identification of relevant comparator companies
- Definitions of “Pay” and “Performance”
- Time period(s) over which relative comparisons are evaluated



Measuring Relative Pay-Performance Alignment
Larger Community and Regional Banks

- Larger community banks and regional financial institutions have robust data available for measuring pay-performance alignment for their executives
- Proxy filings from companies that are not considered smaller reporting companies (< $75 million float) are required to provide detailed compensation information for all components of pay for their top 5 executives
- Using the publicly available compensation and financial performance data for these companies, detailed relative comparisons of pay and performance can be readily made for the CEO or any group of executives
  - Requires agreement on the time period(s), definitions of pay and performance, and some number crunching
- Shareholder advisory firms (e.g. ISS) perform such an analysis when determining their proxy voting recommendations on items related to compensation

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Our bank is too small to compare ourselves to public banks … is there another way we can assess relative pay-performance alignment?

Measuring Relative Pay-Performance Alignment
Smaller Community Banks

- Without the granular compensation information for peer executives (like what's available to larger banks), performing a relative pay-performance analysis for a specific executive or group of executives is not possible

- A smaller bank Board may find it helpful, however, to gain an understanding of how pay and performance compares to peer banks at the company-wide level, using data that is publicly available for every financial institution through regulatory filings
  - "Pay" could be defined as total company payroll
  - "Performance" could be defined as one of many measures available through call reports

- While not specific to the CEO or executive team, such an approach can provide a big-picture perspective for a smaller bank's pay-performance alignment and directional movement in that regard

Measuring Relative Pay-Performance Alignment
Sample Approach for a Smaller Bank – "ABC Bank"

Defined Items	Definitions	Comments
Comparator Companies	• All commercial banks with assets one-half to twice the size of ABC Bank	The goal would be to keep the size of comparators close enough to be relevant to ABC Bank, but the range broad enough to include a meaningful number of data points.
Pay	• Two pay ratios are evaluated, each with a numerator of reported company-wide compensation and benefits expense • Denominators are: 1) Reported total revenue (sum of net interest income and non-interest income) 2) Reported net income before tax (NIBT)	Defining pay as a ratio of revenue or NIBT helps to normalize the relative pay concept for banks of different structure and/or size. It gets to the macro-level question … "How much of our [revenue or profits] are we sharing with employees, relative to others?"
Performance	• Reported return on average equity	Total shareholder return (for public companies) or return on average assets might also be considered as potential definitions of performance.
Time Period(s)	• Fiscal years 2009 – 2012, each evaluated separately	Evaluating relative alignment over a number of years provides important long-term context

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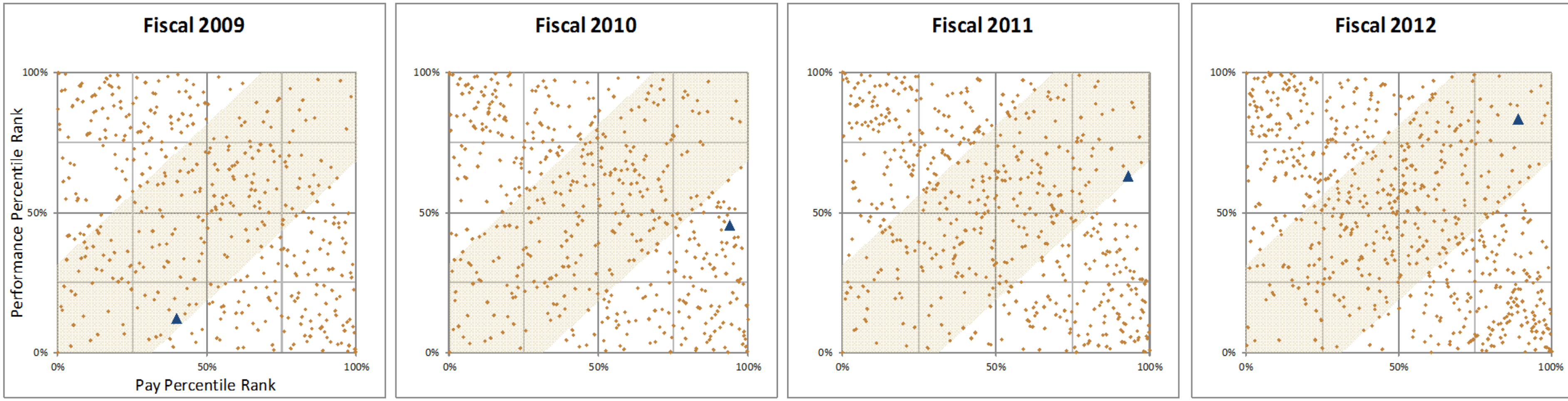
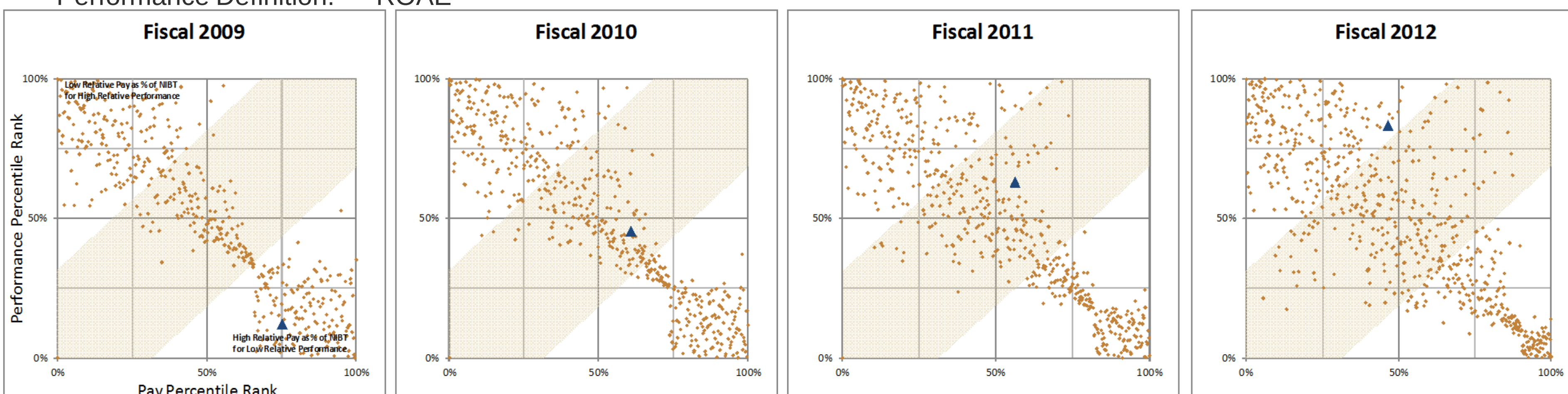
Measuring Relative Pay-Performance Alignment
Sample Approach for a Smaller Bank

Pay Definition: Total Comp & Benefits as % of Revenue
Performance Definition: ROAE

▲ = ABC Bank



Pay Definition: Total Comp & Benefits as % of Net Income Before Tax
Performance Definition: ROAE



A Few Compensation Considerations Related to Mergers & Acquisitions

Consolidation Continues

- The trend toward fewer, larger banks continues its march
- Drivers may include compliance costs, increased capital requirements, regulatory actions, margin pressures, technology demands, lack of apparent successor, etc.
- FDIC insured institutions by asset size:

	1992	2011	2013	% Change 1992 - 2013
< $100 Million	9,455	2,416	2,057	-78%
$100 - $250 Million	2,615	2,394	2,207	-16%
$250 - $1 Billion	1,322	1,892	1,884	43%
$1 - $10 Billion	522	556	565	8%
> $10 Billion	52	71	108	108%
Total	13,966	7,329	6,821	-51%

Source: FDIC Statistics on Banking

Buy-Side vs. Sell-Side Compensation Implications

Buy-Side

- How fast should our compensation structure grow into our larger size?
- How do we retain the key people we want from the acquired bank?
- How do we integrate M&A into our incentive plans?
  - Deal-related costs, discontinuity in balance sheet growth, etc.
  - Acquisition/success bonuses?
  - What metrics will accommodate an acquisitive strategy?

Sell-Side

- In anticipation of a near-term sale, the focus is on retention & protection of key employees while maximizing the value of the company
- What compensation vehicle(s) will be most effective/appropriate?
  - Change in control agreements?
  - LTI awards?
  - Stay bonuses?
  - What's the right balance?

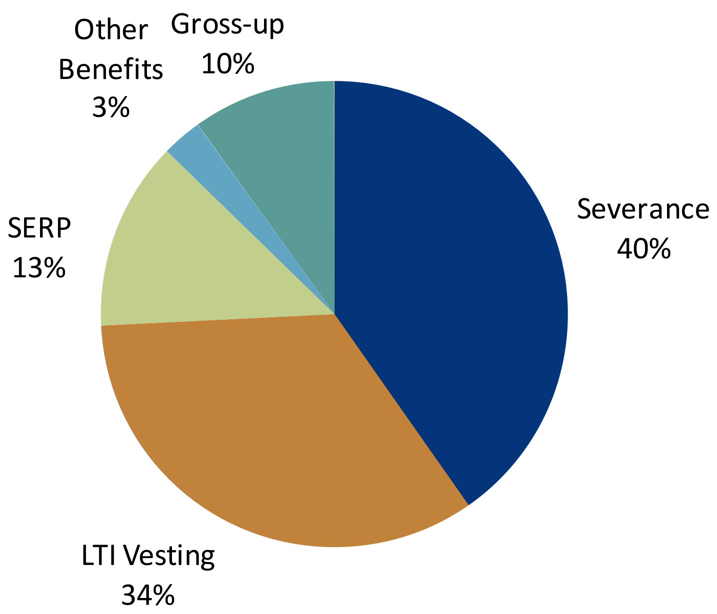
Payments Associated with a CIC

Typical "parachute" payments upon termination following CIC include

- Cash severance as a multiple of salary (and possibly annual incentive)
- Continuation of welfare benefits for a period of time
- Acceleration of vesting on outstanding equity (LTI) awards
- Enhancements under supplemental executive retirement plan (SERP)

CIC payments in actual deals (2012 – 2013)

- Bank transactions in 2012 & 2013 with deal value under $1 billion
- Average CIC payment mix based on 12 bank CEOs that were expected to be terminated following CIC



IRC Section 280G and Related Surprises

- Punitive tax penalties accompany CIC payments in excess of a defined safe harbor
- "Excess parachute payments" result in a 20% excise tax to the employee and non-deductible compensation for the employer
- The largest compensation-related surprises at the time of a deal are related to this section of the tax code and the company's handling of 280G within its agreements with employees (e.g. employment/severance/CIC agreements, equity plans and related award agreements, SERPs, etc.)
- Lack of careful attention and planning in this area can result in:
  - Significant reduction in the intended benefits to a terminated executive
  - Excises taxes that unreasonably punish the employee
  - Egregious payouts, well beyond what was intended, possibly having a material impact on the deal price (or worst case, a "poison pill" effect)
- Planning in advance can make all the difference
  - Careful handling of safe harbor treatment can reduce the chance of unpleasant surprises
  - Purposeful adjustments ahead of time may allow for a reduction in potential parachute payments without sacrificing the intended benefits
  - To be effective, most adjustments to CIC agreements/provisions must be made more than one year prior to a CIC

Final Thoughts

Pay-for-performance, or performance-for-pay??

About PM&P's Banking Practice

PM&P serves hundreds of bank clients annually through a national team of consultants exclusively dedicated to serving the banking industry. These consultants work closely with a wide range of banking organizations, from de novo banks, mutuals and credit unions to super regional and international financial institutions. Our services include compensation and governance advisory services to Compensation Committees and Boards, the development of executive and employee compensation programs tailored to the business needs of each client, and the administration of compensation surveys for bank executives, employees, and Board of Directors (including PM&P's National Banking Compensation Survey). The firm maintains offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, San Francisco, San Jose, Los Angeles, and London. For more information on our bank consulting services visit www.pearlmeyer.com/banking.

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