



Pearl Meyer & Partners
Comprehensive Compensation®

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Compensation Strategies to Keep Your Highest Performers

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Today's Challenges

How do we attract and retain executives/employees during these unprecedented and challenging times?

How can our compensation programs achieve these goals AND meet emerging best practice?

■ The Community Bank Environment

Amidst unprecedented financial, economic and business turmoil ...

- Financial crisis and global economic recession
- Government intervention – A Compensation Czar?!?!?!?
- Bank regulators (increased supervision/focus)
- Bank failures
- FDIC assessment
- Net Interest Margin
- Earnings pressures
- Credit risk
- Housing slump
- Plunging stock prices

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

- Community banks painted with same brush as the “troubled” Wall Street Banks
- TARP vs Non TARP banks
- Intense scrutiny of executive compensation 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 executive 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 trend toward increased base salaries if strict limitations remain; 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**

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

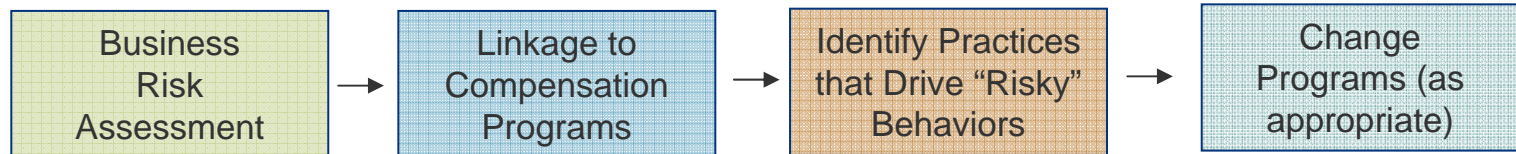
■ Current Best Practice

- **Align executive and employee rewards with bank's strategic goals/objectives**
 - Focus on critical performance achievements/results/measures
 - Balance annual business plan/budget with long-term strategy
- **Define and communicate your compensation philosophy**
 - Your “value proposition” to employees; shareholders; candidates
 - Your “road map” for plan design
 - Critical element of public disclosure
- **Ensure pay-for-performance alignment – even with limited \$\$s**
 - Know what you are looking for (how you define high performance – bank and individual)
 - Clarify and define performance expectations for executives and employees (results and behaviors)
 - Know your ABC's and HIPOs
 - Prioritize your limited resources on As and HIPOs
 - Provide multiple “rewards” for As and HIPOs; no rewards for C's
 - » Cash, non cash, recognition, development/training
 - Test and assess the pay-performance relationship

Emerging Best Practice

Understand and manage/mitigate risk in incentive plans

- Required of TARP participants
- Government/Regulators/SEC suggesting all banks/companies perform
 - » Likely impact on ALL incentives plans not just executive (e.g. lenders)
- Responsibility: Senior Risk Officer, Compensation Committee + others
- Process:



- 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?

■ Emerging Best Practice

- **Ensure 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
- **Strategies/practices**
 - Review and reshuffle “mix” of total compensation
 - » Include both short and long-term incentives
 - » Ensure significant portion of compensation is based on long-term, sustained performance
 - Reward periods should match timeframe for determining when decision/action was successful
 - Consider “holdbacks”
 - » Retain a portion of earned bonus or equity and subject to future risk if the performance is not sustained in future years.
 - Institute ownership/holding requirements
 - Claw backs

■ Pay-for-Performance – The Holy Grail

■ 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

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

■ 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

■ Pay-for-Performance – The Holy Grail

- **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*)
- **Pay-Performance Reality**
 - The reality: 1-2 years in 10, incentives won’t pay out
 - Don’t lose track of original intent
 - » Annual plans reward annual results; long-term plans reward results over multiple years
 - If you don’t have a long-term incentive plan, it puts too much pressure 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



THANK YOU!

QUESTIONS?

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