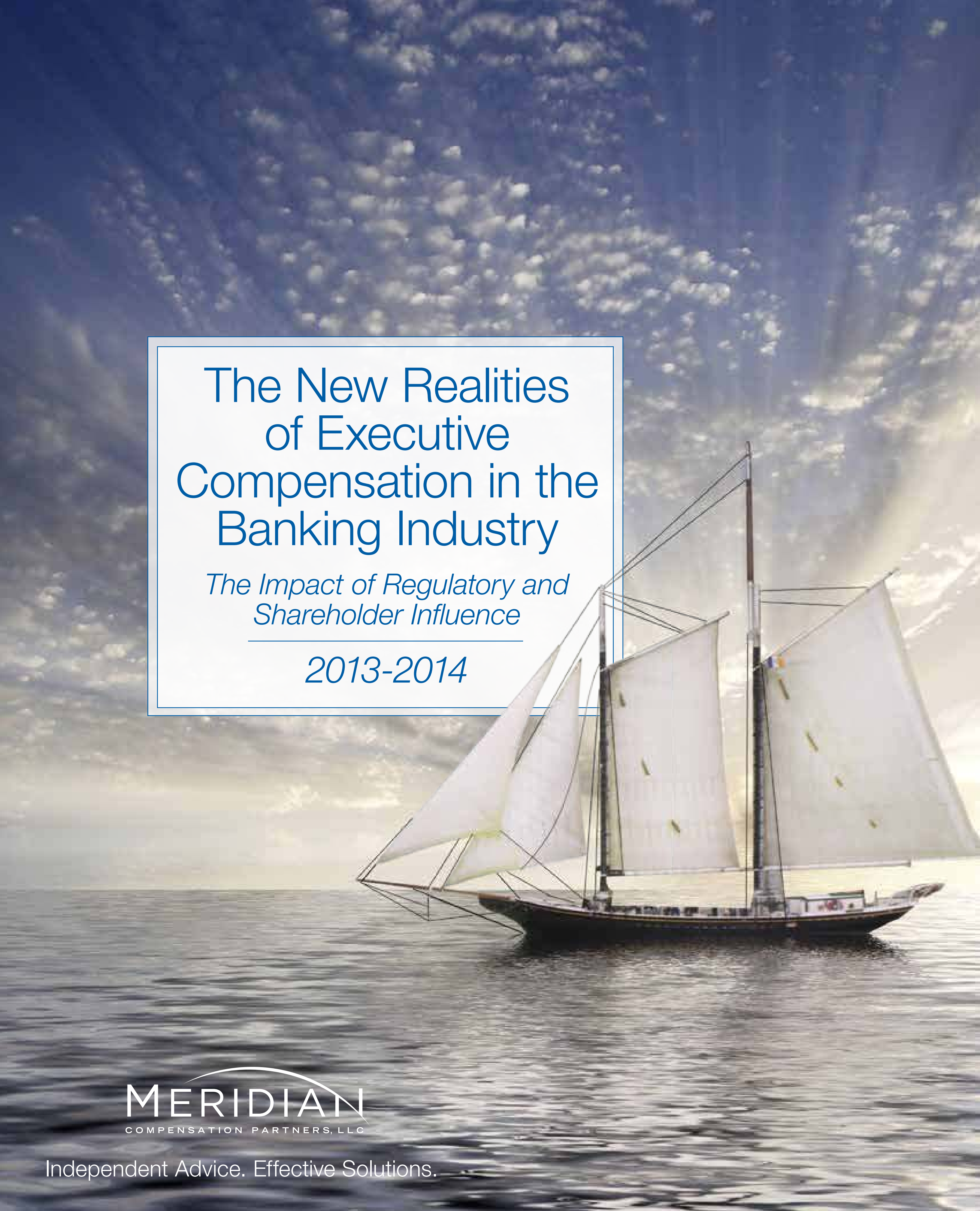

The New Realities of Executive Compensation in the Banking Industry

The Impact of Regulatory and Shareholder Influence

2013-2014

MERIDIAN
COMPENSATION PARTNERS, LLC

Independent Advice. Effective Solutions.

About Meridian

Meridian Compensation Partners, LLC is an independent executive compensation consulting firm providing trusted counsel to Boards and Management at hundreds of companies. We consult on executive and Board compensation and governance. Our many consultants throughout the U.S. and in Canada have decades of experience in pay solutions that are responsive to shareholders, reflect good governance principles and align pay with performance. Our partners average 25 years of executive compensation experience and collectively serve over 450 clients. Over three-quarters of our engagements are at the Board level.

Our Banking/Financial Services Team

Meridian is dedicated to serving the banking/financial services industry. We have team members across our offices who "live and breathe" the issues facing the banking industry, and we have built our reputation through long-term relationships and high-quality advice. We understand the diversity of banking business models; evolving regulations; and how to align each client's unique strategy, culture and philosophies into customized pay programs that best meet their needs. Our work spans banks of all sizes, ranging from denovo to the largest financial service organizations.

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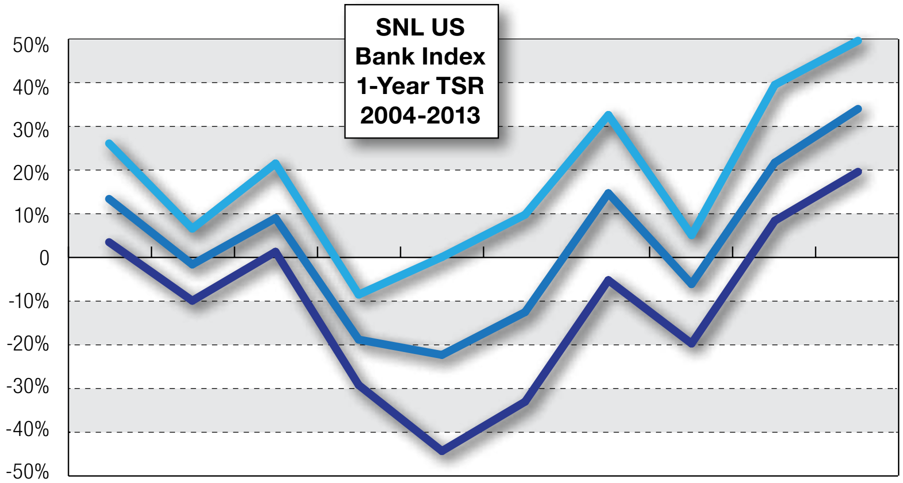
Introduction

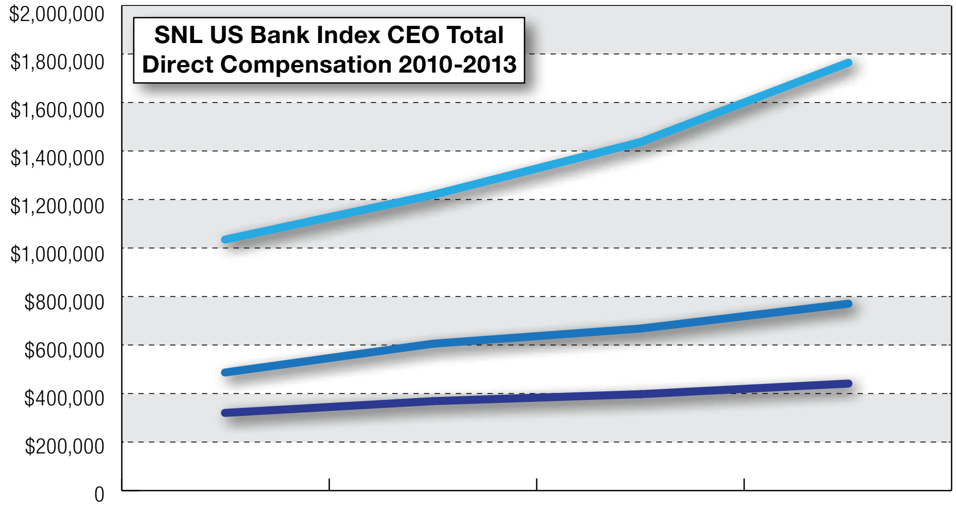
Banks today are pulled in multiple directions. Shareholders and advisory firms like ISS and Glass Lewis seek strong alignment between executive pay and performance, while bank regulators prefer less leveraged, lower-risk pay programs. In the extreme, each suggests different pay program designs. Shareholders and the Securities and Exchange Commission expect clear disclosure of pay and performance alignment often through more formulaic/quantitative approaches, while bank regulators are more accepting of discretion, provided it is applied within a consistent framework. Shareholders favor pay that adjusts in line with performance, with upside and downside opportunities, providing variation in payouts, while regulators view too much upside and stretch goals as potentially creating excessive risk.

The past six to eight years have been challenging, as banks have responded to the financial crisis, depressed stock/shareholder returns, poor asset quality and margin pressures. As the charts to the right illustrate, total shareholder return in the past two years was the highest in the past decade, and CEO pay moved upward during the past two years. As industry performance continues to improve, banks will be challenged to develop compensation programs and make pay decisions that appropriately reward executive performance while addressing the increasing expectations of shareholders and regulators.

The remainder of this paper explores emerging trends related to executive compensation in the banking industry. It outlines perspectives from regulators and the impact they are having on pay programs. It also provides guidance on how to measure and ensure alignment between pay and performance to address shareholder goals. The two perspectives (regulators' and shareholders') are not always aligned, which is creating significant challenge in bank boardrooms across the United States and globally.



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
75th %ile	26.1%	6.6%	21.5%	-8.5%	0.1%	9.8%	32.6%	5.1%	39.5%	49.6%
Median	13.4%	-1.6%	9.0%	-18.8%	-22.3%	-12.5%	14.7%	-6.1%	21.7%	34.0%
25th %ile	3.5%	-9.9%	1.3%	-29.2%	-44.3%	-33.0%	-5.2%	-19.7%	8.4%	19.6%



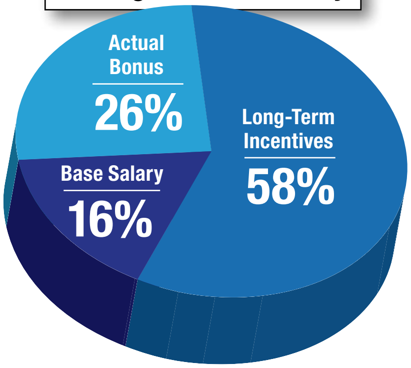
	2010	2011	2012	2013
75th %ile	$1,034,552	$1,218,867	$1,436,749	$1,764,234
Median	$486,665	$605,262	$667,929	$770,344
25th %ile	$320,253	$368,585	$397,445	$441,120

Throughout our paper we present data from Meridian's review of 2014 proxies for U.S. banks with assets between $10 billion and $400 billion. This perspective was selected as representative of the group of banks already on the front line of regulator and shareholder scrutiny. Trends faced by these banks provide an indication of the emerging themes and changes likely to cascade down to the broader banking industry. It is important to realize that bank compensation has and will continue to evolve. Regulators will continue to push their agenda, and we still await final regulations from the Dodd Frank Act of 2011 (e.g., clawbacks, hedging/pledging, pay for performance, CEO pay ratio, incentive risk management). Meanwhile, shareholders will continue to demand variability in pay that aligns with performance results.

Monitoring Risk — The Bank Regulator Perspective

Meridian's review of 2014 proxies confirmed that the Federal Reserve Bank's feedback to the largest banks is trickling down to smaller banks. Incentive plans in particular have been under the most scrutiny. The biggest area of change was in long-term incentive pay practices, which constitute the largest component of compensation for CEOs (58% of total pay).

Average CEO Mix of Pay

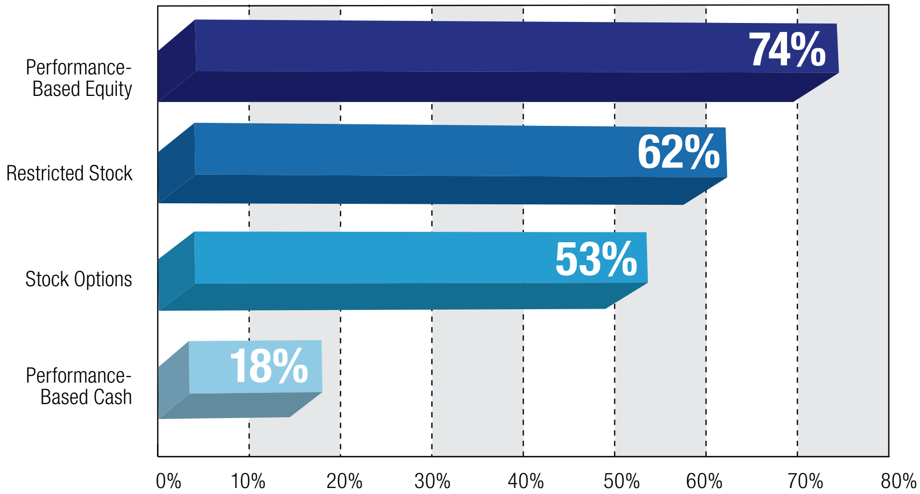


The Mix of Long-term Incentives is Changing

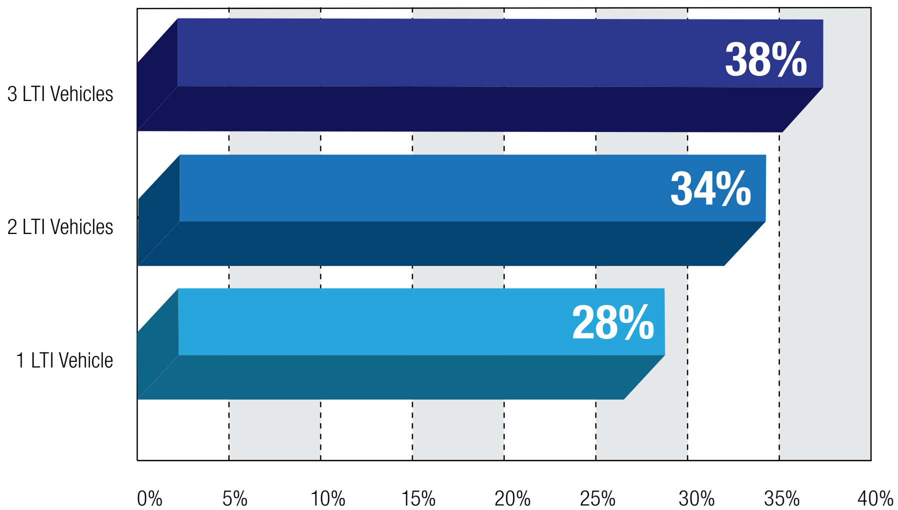
- Stock option grant values decreased 30%. While still a component of bank compensation in more than half the banks in our study (53% prevalence), the value attributed to stock options has been declining each year in response to regulators' concern that options can motivate excessive risk-taking. Shareholder advisory firm ISS has also influenced the decline in options, as it does not consider this instrument to be performance-based, a claim most companies and shareholders do not support. The impact: Many banks have either reduced the focus and/or amount of long-term incentives awarded as stock options.
- Performance-based stock (e.g., performance shares) increased and now represents the most prevalent equity/long-term incentive instrument, with 74% of banks including it in their compensation program. This component has become very popular since shareholders and advisory firms like ISS want to see a significant portion of long-term pay based on performance. However, it can be challenging to design these awards in a manner that satisfies both shareholders and regulators while serving as an effective incentive for executives.
- Time-vested restricted stock still remains a component in many long-term incentive programs because it aligns executives with shareholders, has strong retention value and creates "skin in the game" or ownership. However, it is often criticized by shareholders as "pay for pulse" since there is not a direct link to performance for awards to be earned.

Because the different award vehicles serve separate purposes, and have unique strengths and weaknesses, most banks incorporate multiple award vehicles into their long-term plans.

Overall Prevalence of LTI Vehicles



Overall Number of LTI Vehicles



Other Changes to Incentive Plan Design

In addition to influencing the mix of equity vehicles, bank regulators have also put pressure on other incentive plan design features:

- **Reduced Upside Leverage:** A typical practice in banking and general industry has been to vary performance share awards from 50% of target to 150–200% of target depending on actual performance against metrics like TSR, EPS, ROE and ROA over a defined performance period (typically three years). While this design is intended to support desired pay-performance alignment, bank regulators have pushed back on the practice of providing upside leverage to reward performance. Consequently, the larger banks have reduced the maximum awards to 125–150% of target. We are also beginning to see signs of pressure on upside leverage in annual incentive plans.
- **Reduced Use of Relative Metrics.** For longer-term performance periods, banks have tended to utilize relative performance against a peer or industry comparator group as a means of assessing performance. Shareholders invest based on such basis, and one objective of long-term plans it is to align executives with shareholders. Furthermore, volatile economic conditions in the banking industry can create challenges with setting long-term absolute goals. On the other hand, regulators fear that the overuse of relative metrics leads to risk-taking and "chasing" of peer performance. As a result, we are seeing an increased use of absolute measures in long-term plans, with nearly half (46%) of banks in our study using a combination of absolute and relative performance. Over one-third (37%) still use only relative measures, and 17% use only absolute measures.
- **Increased Prevalence of Forfeiture Provisions.** While clawbacks have emerged as common practice despite the lack of final Dodd Frank rules, these policies will be challenging to enforce. It is easier to adjust pay before the award is made or vested, rather than after pay has been doled out. About 30% of banks, including the largest banks that have faced the most regulatory scrutiny, have forfeiture provisions on long-term incentives prior to vesting. Such provisions allow for potential reduction of outstanding cash and equity grants in instances of negative earnings, poor returns and/or "bad risk behavior" (i.e., significant negative individual actions such as a violation of risk policies).

Monitoring Pay and Performance Alignment — The Shareholder Perspective

While all banks need to respond to regulator feedback, ensuring an appropriate link between pay and performance also is a critical objective. For public banks, shareholders expect pay and performance to be aligned and can vote "Against" a company's pay practices as part of the "Say on Pay" vote if they perceive a disconnect. Each year, several banks "fail" Say on Pay, generating unwanted press and attention on their pay practices. It is imperative that compensation committees regularly evaluate the alignment and effectiveness of their pay programs. However, it is not a straightforward exercise.

Assessing the Relationship Between Pay and Performance

Assessing pay and performance alignment is influenced by several factors, including: 1) stakeholder perspective (shareholder vs. regulator vs. executive); 2) time horizon considered (short term vs. long term); 3) performance measure(s) considered (earnings growth, returns, capital levels, shareholder return); and 4) the perspective of pay considered (granted vs. realized/earned). Understanding these different perspectives can help banks to assess the relationship under different scenarios.

One consideration often debated is how to define "pay." Proxy disclosure requirements tend to be the de facto representation of pay but not necessarily the most accurate. The table below outlines four primary pay definitions, each representing different "views."

As noted in the table, granted pay is useful for evaluating the annual pay decisions

	How Pay Is Included			Ideal Use	Challenges
	Salary	Annual Bonus	Long-Term Incentives		
Target Pay	Annual rate	Target award	Target grant	Assess competitiveness of pay opportunities relative to market	Less directly linked to performance
Granted Pay	Amount paid	Amount earned	Grant-date value	Compare to annual performance	Grant-date value of LTI may vary substantially from ultimate value received
Realized Pay	Amount paid	Amount earned	Value realized from stock vesting and option exercises	Understand value actually received by executives	Will reflect realization of awards granted before the beginning of the performance period and can be impacted by executive's tenure
Realizable Pay	Amount paid	Amount earned	Current value of long-term incentives granted during the period	Compare to long-term performance	It can be challenging to value open long-term performance cycles, and the ultimate value of equity awards will be impacted by stock price changes

made by a committee (i.e., base salary, incentive/bonus paid and equity granted). It represents information reported in the proxy tables of public companies, so it can be easily benchmarked. While this is an important perspective to consider, compensation committees should consider additional perspectives.

Ultimately, executive pay programs should create long-term alignment between pay and performance relative to peer banks. Realizable pay should be compared to performance results over multiple years (typically three to five years). For publicly traded banks, total shareholder return is the most important performance comparison, but it also is useful to include financial performance measures (e.g., earnings growth, revenue growth, ROE, ROA).

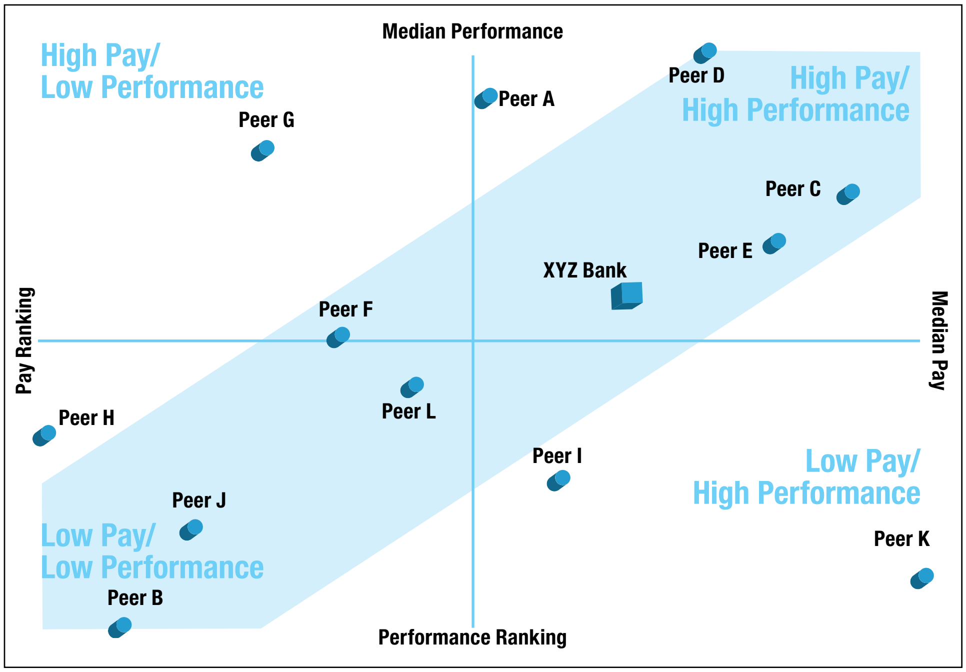
The graph below provides an illustration of a pay-for-performance assessment. The horizontal axis plots a bank's performance relative to its peers, while the vertical axis is based on the realizable pay ranking. The shaded area represents the zone where pay and performance are reasonably aligned relative to peers. In this example, XYZ bank shows alignment with both performance and compensation above median.

Addressing Pay-for-Performance Disconnects

Evaluating whether pay and performance are aligned is inherently a retrospective exercise. However, if a disconnect is found, it is important to make adjustments to the pay programs to create future pay outcomes more in line with performance. Compensation committees that believe pay and performance have not been aligned should ask the following questions:

- ✓ Are target pay opportunities aligned with market?
- ✓ Do incentive plans measure the right performance metrics?
- ✓ Do the metrics work together to balance short- and long-term performance?
- ✓ Are performance targets set appropriately?
- ✓ Do incentive plans have the right leverage, in terms of how payouts are calibrated for performance above and below target?
- ✓ Are incentives based on an appropriate balance of formulaic results and discretion, as well as absolute and relative performance assessments?
- ✓ Has risk mitigation been appropriately incorporated into incentive plans?

Comparison of CEO Pay and Performance Rankings Relative to Peers



Assessing these questions will help compensation committees determine what changes need to be made to ensure better alignment of pay and performance going forward.

Balancing Multiple Constituencies

Banks today are challenged to design compensation programs and make pay decisions while attempting to please stakeholders with very different needs. Many fear homogenization of pay programs and limited ability to be creative or make decisions in the best interest of the company. If pressures continue in the extreme, that is possible. However, we encourage banks to be proactive and take a holistic view of their compensation philosophy and programs to ensure they are balanced, support the business strategy, align pay and performance and appropriately mitigate risk. The following guidelines can help:

- **Strategic Alignment.** Incentives are intended to motivate and reward specific performance achievements, which should reflect each bank's unique strategy and goals. Performance measures should communicate to shareholders, executives and other stakeholders what is important to drive the success of the bank, both short and long term (i.e., performance measures and levels of performance).
- **Pay mix:** Executive compensation must be appropriately balanced among fixed salary, short-term and annual cash incentives, and deferred long-term compensation (e.g., equity grants or long-term cash). While annual cash bonuses remain a critical component of pay programs, they must be balanced by meaningful compensation tied to the bank's long-term performance. Banks greater than $50B are required to grant at least 50% of incentive compensation as long-term awards.
- **Balance of performance perspectives.** No one measure effectively reflects performance. Annual incentive measures should align with your bank's annual business plan while long-term incentive measures should reflect sustained value creation and shareholder returns. Banks

should understand the total incentive opportunity (short and long term) that is allocated to different performance perspectives (e.g., profitability, growth, shareholder return, individual performance) to ensure it reflects desired results.

- **Balance discretion with formula.** The Securities Exchange Commission and shareholders like to understand the performance goals and resulting incentive payouts to assess pay-performance alignment. However, regulators prefer a structured process of discretion, particularly with respect to risk considerations. The use of overly formulaic incentive plans can create excessive risk if banks and committees do not assess *how* results are achieved. Discretion can be a valuable tool for incorporating risk mitigation into incentive payouts, as the committee can assess whether results were achieved in a manner consistent with the bank's risk tolerances and expectations. However, discretion should be structured so that both management and the committee understand how performance will be assessed and how discretion will be applied.
- **Incorporate risk adjustments.** Ensure incentives incorporate risk mitigating strategies. This can be done through quantitative or qualitative adjustments to payouts as well as formal forfeiture provisions that provide for reduced payouts of outstanding incentives to further ensure that pay outcomes are linked to appropriate risk-conscious performance.

In Summary: Strategies for Success

Faced with differing perspectives and continued evolution of compensation best practices, bank compensation committees need to stay diligent in their oversight responsibilities. Compensation decisions will continue to require a balancing act among regulators, shareholders and bank strategies and philosophies; but the ultimate goal should be to make sound business judgments. Best-practice program designs and processes should:

- Align and drive your bank's unique strategic business goals
- Reflect your bank's desired compensation philosophy and guiding principles
- Define compensation through a balanced perspective that includes:
  - Fixed and variable/performance-based pay (What portion should be in base salary/benefits vs. annual and long-term incentive?)
  - Multiple performance measures (What metrics should be rewarded, short and long term?)
  - Short- and long-term performance (How much weight should be focused on short-term vs. long-term performance)
  - Cash and equity-based compensation (What proportion of incentives should be in cash vs. equity?)
  - Bank, team and individual performance (How much focus should be placed on bank, division/team and individual performance?)
  - Formula and discretion (Where should discretion exist, and how should it be defined/evaluated?)
  - Absolute and relative performance (Where is it appropriate to set specific goals vs. compare performance to peers/industry index?)
- Include appropriate risk mitigating features relevant to the participants to ensure payouts reflect the time horizon of risk (e.g., clawback policies, forfeiture provisions, deferrals of payout)
- Reinforce stock alignment with shareholders through stock ownership policies and holding requirements

While effective compensation design is critical, assessing the results of the programs and pay-performance relationship is even more critical — and also more challenging. Compensation committees today need to regularly monitor and assess their pay actions to ensure the results are appropriately aligned with objectives. Best-practice analyses include but are not limited to:

- Tally sheets of executive's total compensation (including cash and equity compensation as well as benefits and perquisites) to ensure understanding of the sum of the components of pay
- Pro forma illustration of the range of potential compensation that might be paid under various performance scenarios (short and long term); payouts under extreme performance scenarios should never be a surprise
- Realized and realizable pay analyses to illustrate the impact of performance on actual payout
- Regular updates on potential payouts under the annual and long-term incentive plans
- Comparison of CEO and executive performance and pay relative to peer group
- Current stock ownership and progress toward ownership guidelines
- Value of retention compensation components, such as unvested stock grants, deferred compensation, supplemental retirement benefit(s) to ensure executives have appropriate "hooks"
- Severance payouts under various termination scenarios, such as change in control or termination without cause; consider individual payouts as well as total cost of benefits.
- Internal pay relationships (e.g., CEO pay compared to next highest paid, named executive officers and median employee). Note: Dodd Frank Act CEO Pay Ratio to be finalized by the SEC.

In addition, compensation committees should ensure they receive regular updates relating to:

- Executive performance (feedback from CEO; board feedback on CEO)
- Progress toward business goals and potential incentive award payouts
- Regulatory, legislative, ISS trends updates
- Shareholder engagement and feedback on compensation programs, policies and practices
- Compensation disclosure and analysis
- Risk assessment of incentive plans for covered employees and an understanding of risk-mitigating features

Keeping informed and understanding compensation from multiple perspectives can help compensation committees ensure that the pay program is meeting desired objectives and aligning with key stakeholders.

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