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Succession Planning: Retaining and Compensating the Next Generation

independent BANKERS ASSOCIATION™ of New York State, Inc.

CFO/SR Management Conference

Shrinking Talent Pool

- **Succession becoming a critical issue**
- TALENT RISK
  - Shortage of qualified executives
  - Only 13% of CEO's are under age 50…40% are 60+
- Demise of Management Training Programs
- Competition for Rising Stars

Liburnium Research, C-Suite Turnover

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Where are they going?

- Competing banks
- Other industries with less regulations
- Anywhere – Banking is no longer “Respectable”
- Retirement

Liburnium Research, C-Suite Turnover

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M & A Impact

M&A activity continues….

- Prediction – 4,000 banks in the next "few years"
- More Talent will EXIT the industry…WHY?
  - **Banking Career is RISKY**

Liburnium Research, C-Suite Turnover

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M&A Landscape

What's driving all this M&A activity?

- **Fatigue**: bankers and directors are tired…
- Regulatory Burden: increased compliance = smaller profits
- Competition: limited number of loans = compressed margins
- Shareholders: want out…
- Distressed Banks: no other choice

So…let's sell and take our $ and go to the beach…RIGHT?

Excess Parachute Payment

Year	Executive 1	Executive 2
5-Year Average (280G Base Amount)	$ 684,169	$ 521,869
280G Threshold (3x less $1))	**$ 2,052,507**	**$ 1,565,605**
Parachute Payment	**$ 5,182,190**	**$ 3,083,811**
Excess over 280G Limit	**$ 3,129,683**	**$ 1,518,206**
Gross-Up for Excise Tax @20%	**$ 1,124,505**	**$ 640,486**
Total Parachute Payment	**$ 6,306,695**	**$ 3,724,297**
Corporate Tax @40.0%	**$ 2,249,010**	**$ 1,280,971**

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M&A Landscape

If we sell – Low multiple and IRS…

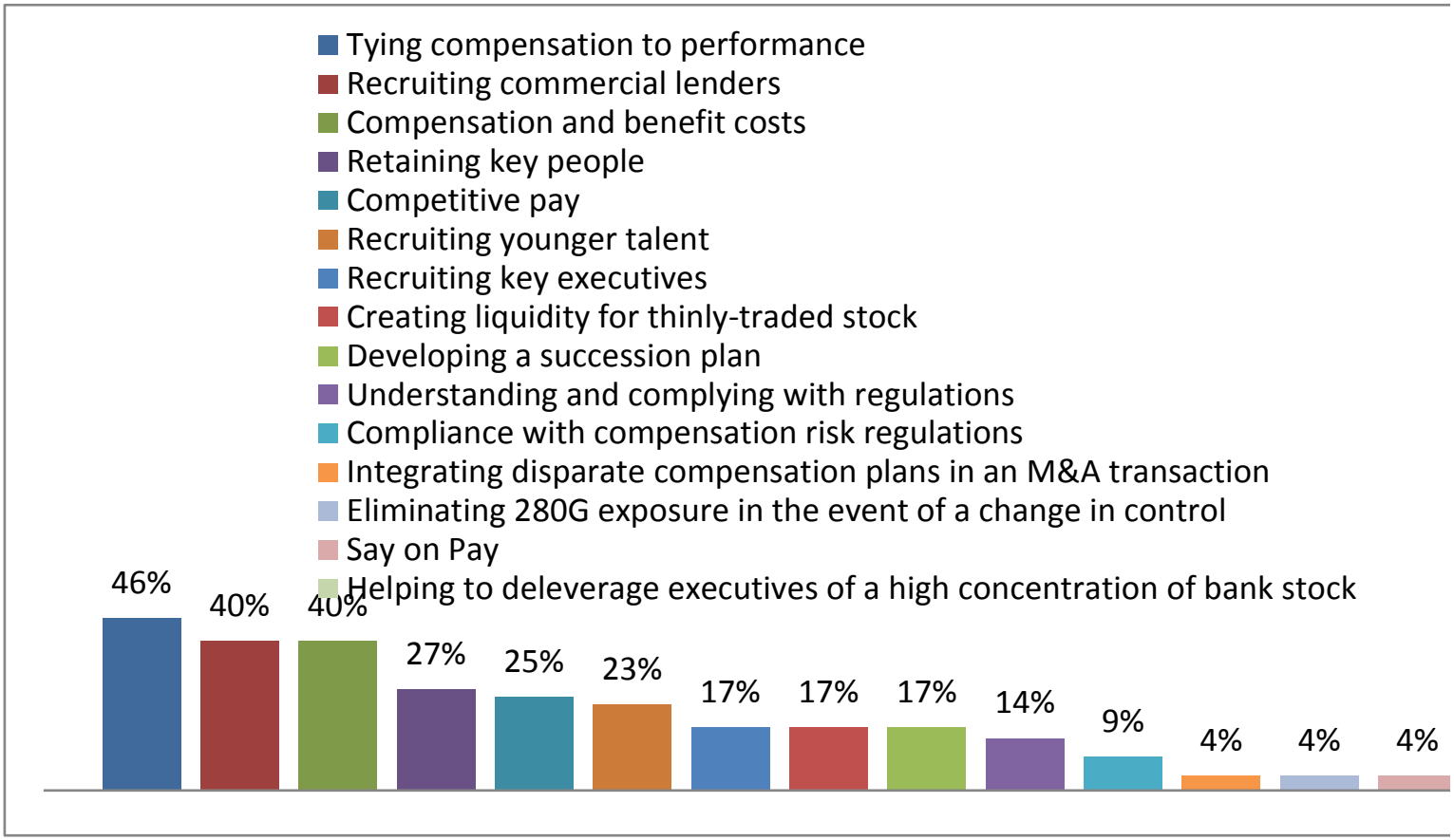
If we DON’T sell…succession planning, attracting and retaining talent critical to success…

HOW DO WE SUCEED IN THE BATTLE FOR GOOD PEOPLE?

Market Considerations

(2016 survey sponsored by Compensation Advisors)

1. What are your top three compensation challenges for 2016?
   Respondents were asked to select three.



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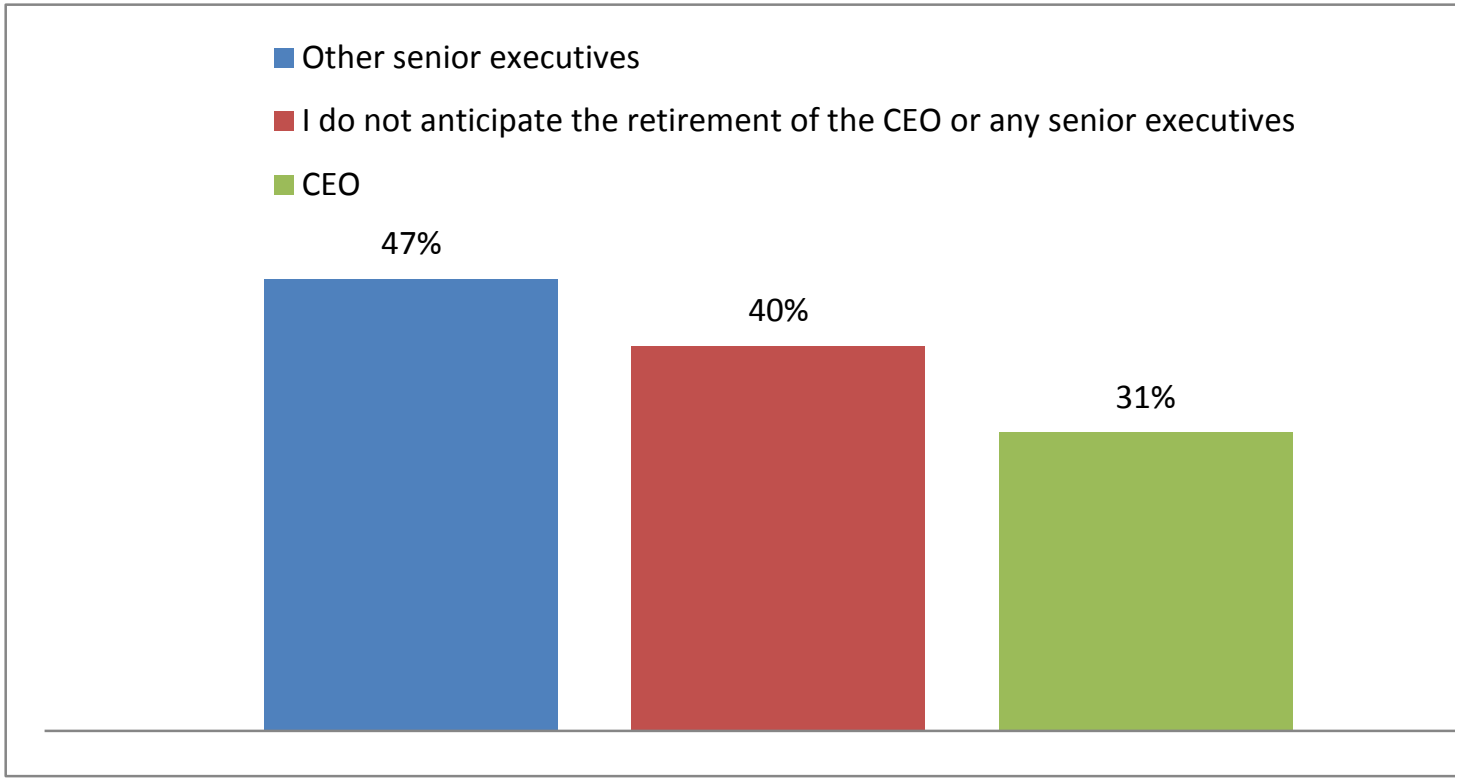
Survey Data

1. Do you expect individuals in any of the following positions within your institution to retire within the next five years?
   Respondents were asked to select all that apply.



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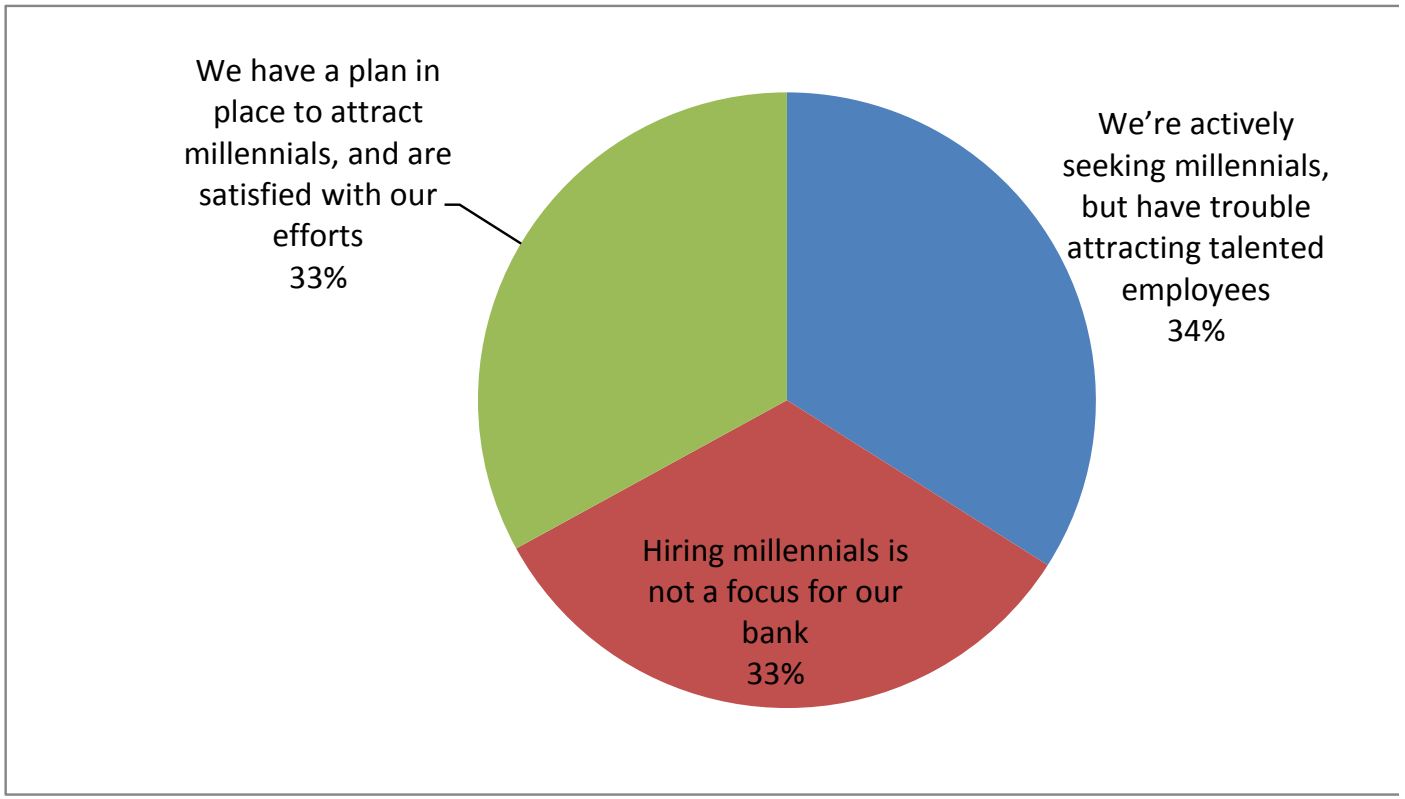
Survey Data

1. How would you describe your bank's efforts to recruit millennial employees (ages 18-34) to your bank?



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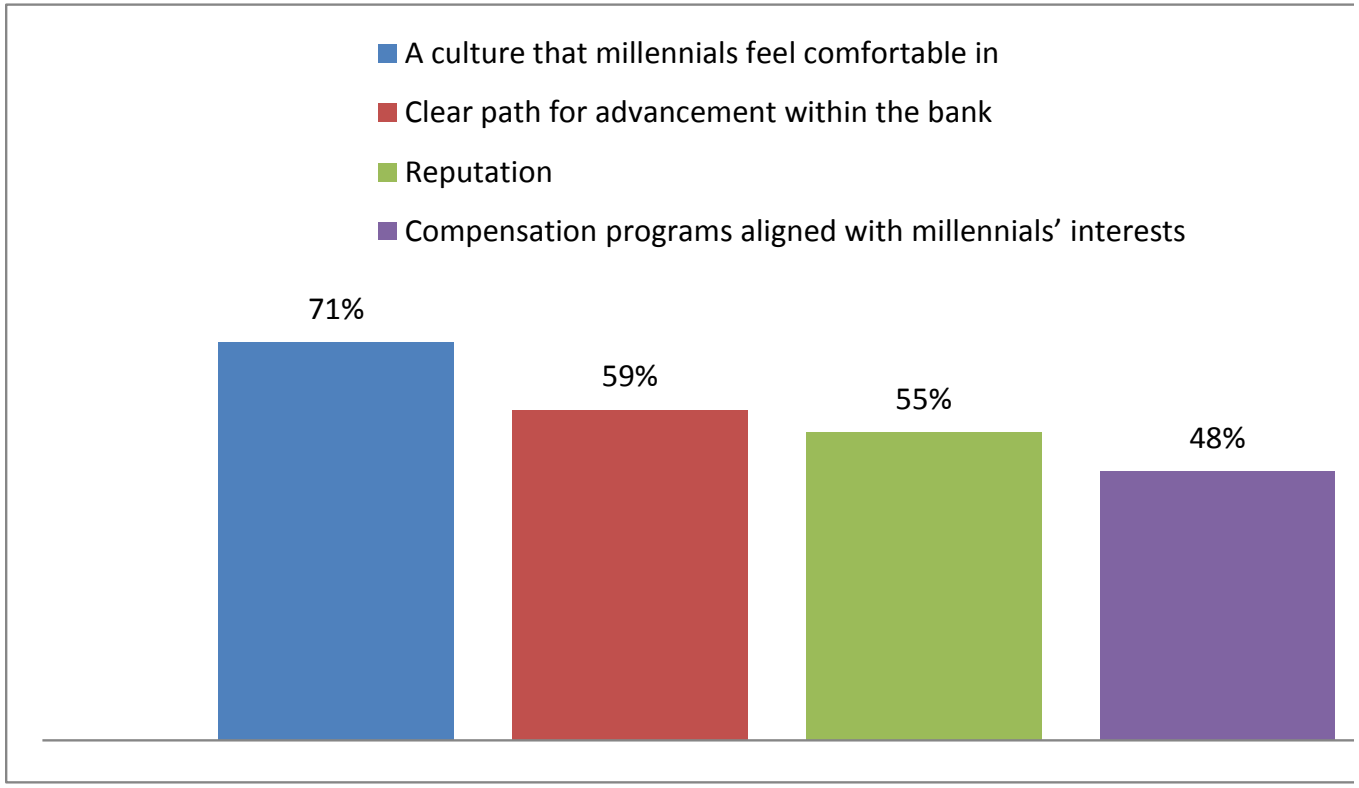
Survey Data

1. Which of the following do you believe contribute to the success of your bank's efforts to attract millennials?
   *Respondents were asked to select all that apply. Question was only asked of respondents who indicate that bank leadership is satisfied with its efforts to attract millennial employees. **Indicates a base count of less than 10 within a category.*



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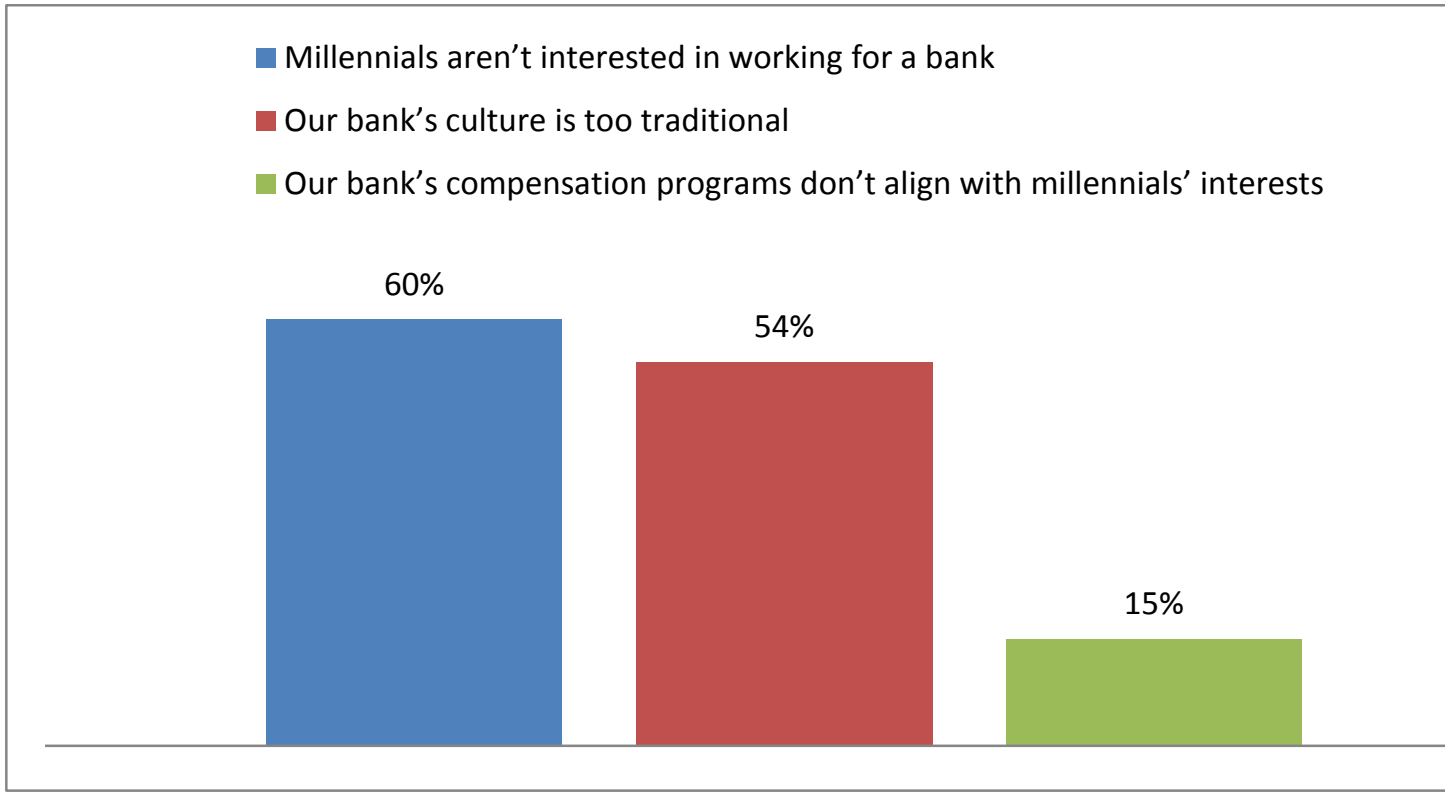
2016 Survey Data

1. Why do you believe your bank struggles to attract talented millennials?
   Respondents were asked to select all that apply. Question was only asked of respondents who indicate that the bank has trouble attracting millennial employees.
   ***Indicates a base count of less than 10 within a category.*



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Making Sense of the Survey…

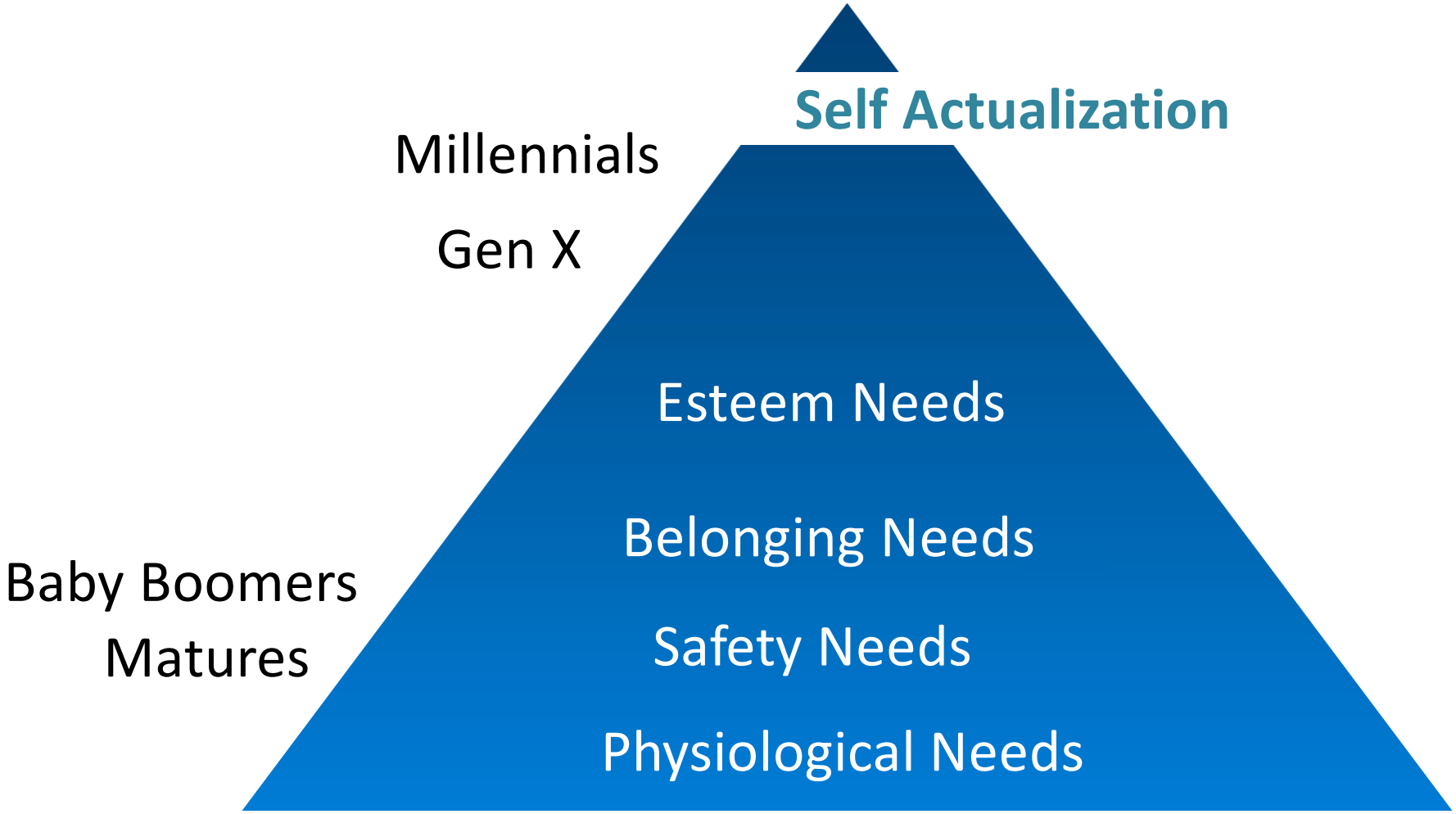
- Paying for Performance – **GET WHAT YOU PAY FOR**
- Retention – **KEEP THE KEY PERFORMERS**
- Costs – **BEST BANG FOR THE BUCK**

How do we know WHAT works?

Understand the Generational Aspect

• Matures	> 69
• Boomers	51 to 69
• Gen X	35 to 50
• Millennials (GenY)	15 to 34
• iGen	< 15

Understand the Generational Aspect



Generational Insights August, 2014

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Understand the Generational Aspect - Boomers

- "Me" Generation
- Strong Work ethic
- Optimistic, Driven, Team-Oriented
  - "If you need me, I'm there."
  - "And I expect you'll do the same for me."
- Technology & Innovation require "learning process". "Have we gone too far?"
- Respect Authority, Structure and Tradition

The Six Living Generations in America – Dr. Jill Novak

Understand the Generational Aspect - Gen X

- Most cynical, pessimistic, unhappy, and unfriendly generation we've ever seen.
- "Latch Key Kids"
- Very Individualistic, Entrepreneurial
- Immediate gratification, deeply in debt
- Averages 7 career changes in their life
- Stalk products / services.
- Idea of "sharing" = watching videos together
- "Misunderstood", wary of authority

Generational Insights August, 2014

Understand the Generational Aspect - Millennials

- “Echo” Boomers
- Optimistic, focused, respect authority.
- Work in teams, schedule EVERYTHING, world is 24/7. Fast, immediate processing.
- Their parent’s "friends“. Told they are “SPECIAL” and expect world to treat them that way. Need to be stroked…often
- Not adults or adolescents –Adultolescent
- Do not live to work, prefer “relaxed”

Understand the Generational Aspect - Millennials

Life, liberty, and ~~the~~ ~~pursuit of~~ happiness.

Generational Insights August, 2014

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Creating Tomorrow's Leaders

- Today's Millennials at age 27 are equivalent to Boomers at age 21
- Many of the tactics used to engage and retain the Millennials early in their careers are Band-Aides to keep them "happy" in their workplace until they move through "adultolescence".

Creating Tomorrow's Leaders – Process

- Mentors for career development.
- In a development plan show the first six month in weekly increments. Outline the first year.
- Highlight areas of autonomy and leadership training opportunities.
- Words to use: Develop. Plan. Train. Grow. Explore. Fulfill. Expand.

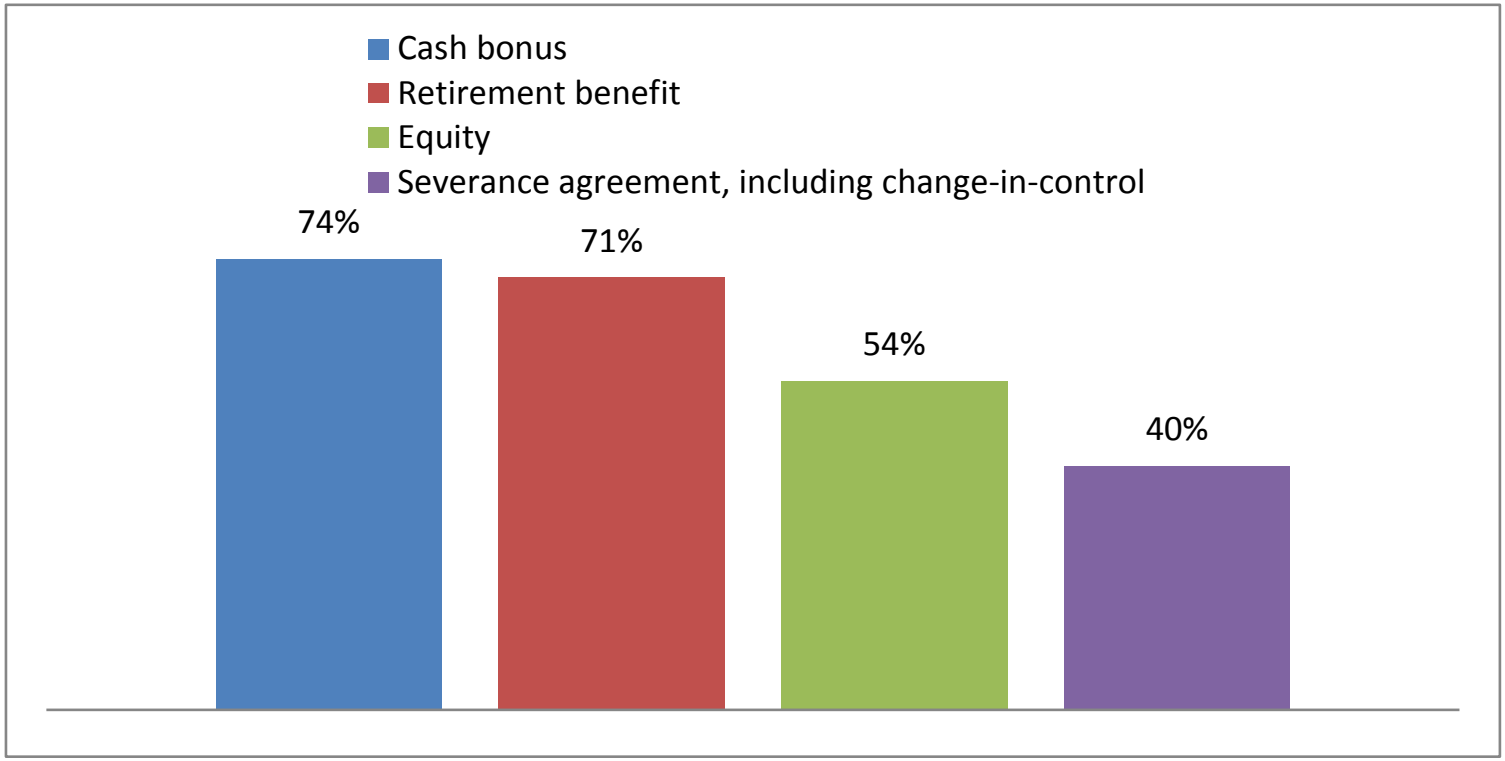
Creating Tomorrow's Leaders

The greatest predictor of turnover is the age of the candidate.

- Younger - require lots of time, attention, and can be emotionally taxing but cost less.
- Older - more expensive but tend to be better (old school) team players and stick around longer.

2016 Survey Data

1. Excluding a salary, what areas of compensation do you feel are highly valued by executives?
   Respondents were asked to select all that apply. Only outside directors and chairmen were asked to respond.



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What Do Employees "Value"

34 & Under	35 – 49	50-64	65+
Base Pay	Base Pay	Base Pay	Base Pay
Career Opportunties	Retirement Plan	Retirement Plan	Retirement Plan
Retirement Plan	Low Health Care Costs	Low Health Care Costs	Type of Work
Low Health Care Costs	Bonus/ Incentive	Bonus/ Incentive	Bonus/ Incentive
Bonus/ Incentive	Paid Time Off	Paid Time Off	Low Health Care Costs
Flexible Schedule	Flexible Schedule	Type of Work	Working for a Respectable Organization

Mercer 2015 Survey

Happy But Leaving

Mercer's research finds that nearly **two in five** US employees (37%) are seriously considering leaving their organization at the present time.

45%

of US workers who are **VERY** satisfied with their organizations are seriously considering leaving

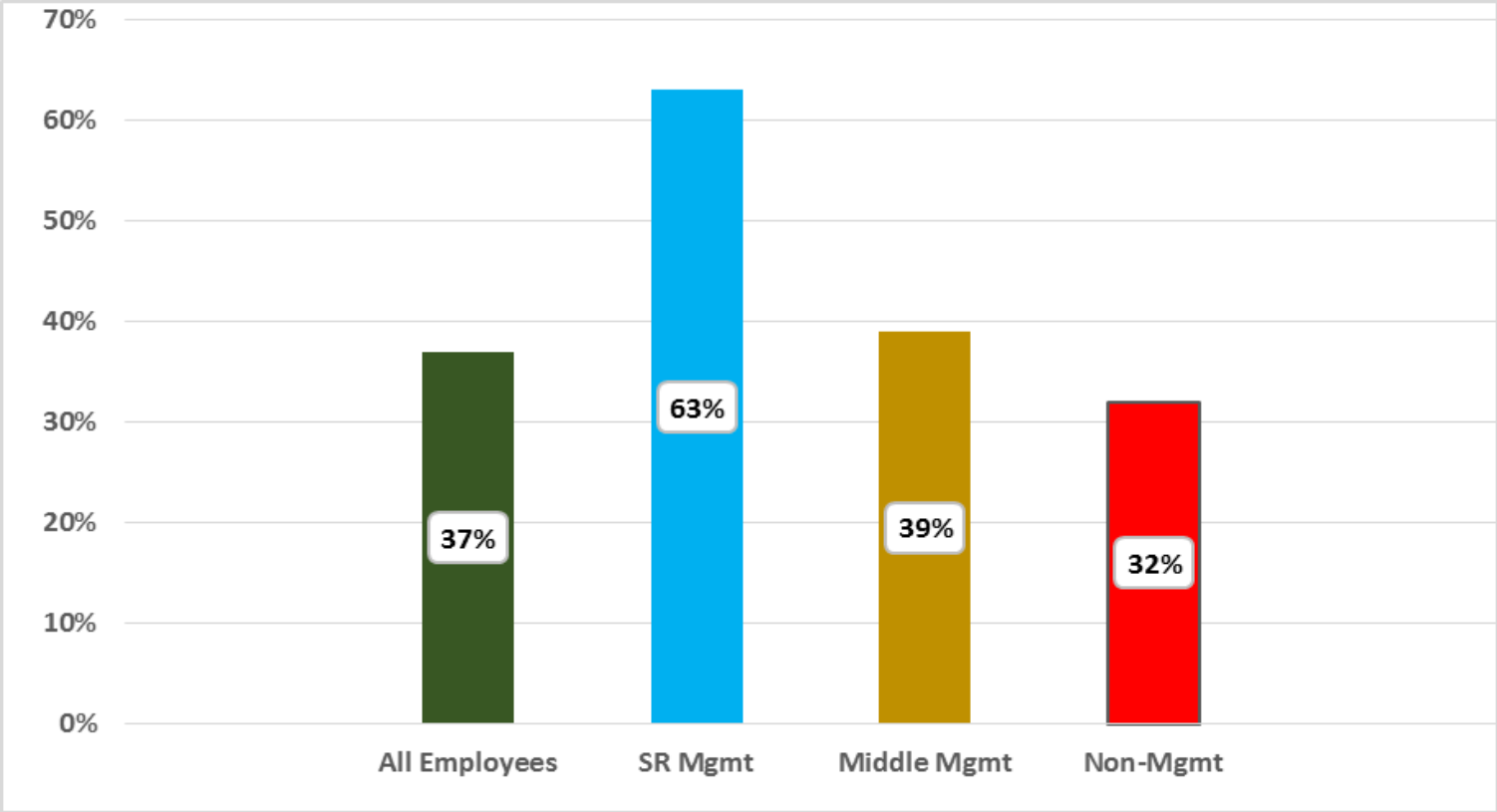
42%

of US workers who are **VERY** satisfied with their jobs are seriously considering leaving

Mercer 2015 Survey

Most at Risk

Senior Managers are almost **TWICE** as likely as non-management employees to be seriously considering leaving their organization at the present time



Mercer 2015 Survey

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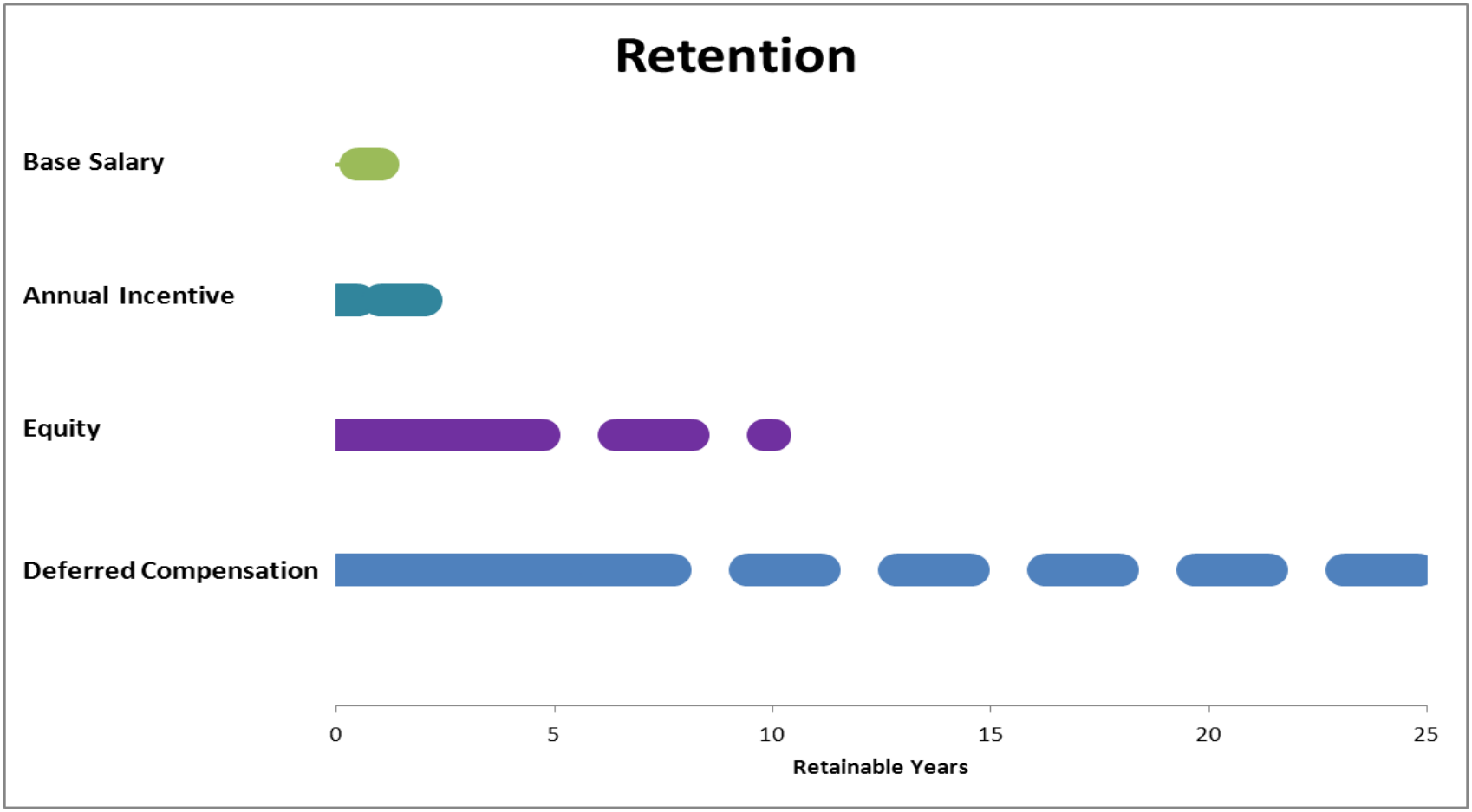
Retention for SUCCESS(ion)



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Equity & Benefits

Three Primary Types

Equity

- Incentive Stock Option (ISO)
- Nonqualified Stock Options (NSO)
- Restricted Stock Awards
- Performance Adjusted Restricted Stock (PARS)

Synthetic Equity

- Stock Appreciation Rights (SARS)
- Restricted Stock Units (RSU)
- Full Value Rights

Nonqualified Plans

- Voluntary Deferral Plan
- Supplemental Executive Retirement Plan (SERP)
- LINQS+

Equity (Dilutive)

Options

- Share price must appreciate to have value
- Dilutive to shareholders
- Participant must buy shares
- Appreciation taxable as Capital Gain (ISO) or Ordinary Income (NSO)
- Expensed over vesting period

Restricted Stock

- "Gift" to Participant
- Taxed as Ordinary Income upon vesting
- FMV expensed over vesting period
- IRC 83b election available
- Less dilutive to shareholders

Performance Adjusted Restricted Stock (PARS)

- Restricted Stock Awards
- Vesting tied to performance
- Vested shares increase or decrease based on actual performance
- Less dilutive to shareholders, but more upside to participants

Synthetic Equity (Non-dilutive)

Also known as "Shadow Stock" or "Phantom Stock"

Stock Appreciation Rights (SARS)

- Similar to Options
- Expense equal to value upon vesting
- Value of appreciation received upon vesting
- Paid in Cash

Restricted Stock Units (RSU's)

- "Units" are awarded at time of grant
- At vesting, units are converted to cash (or equity)
- Flexibility to settle award with both cash and equity

Full Value Rights

- Similar to restricted stock
- Granted a number of 'shares' at award
- Cash payment is settled upon vesting

Non-Equity LTI Plan Designs

Performance Based Long Term Incentive Plan Illustration

Assumptions: 25% award as a percent of salary, 4% annual salary increase, crediting rate equal to ROE (7%), 3 year cliff vesting schedule and retirement at age 65 (alternative to the illustrations, a lump sum of the account balance could be distributed upon retirement)

Year	Age	Salary	Bank Contribution	Crediting Rate (ROE)	Earnings Credited	Deferred Payment Award	Account Balance
1	55	100,000	25,000	7%	-	-	25,000
2	56	104,000	26,000	7%	1,750	-	52,750
3	57	108,160	27,040	7%	3,693	-	83,483
4	58	112,486	28,122	7%	5,844	30,626	86,822
5	59	116,986	29,246	7%	6,078	31,851	90,295
6	60	121,665	30,416	7%	6,321	33,125	93,906
7	61	126,532	31,633	7%	6,573	34,450	97,663
8	62	131,593	32,898	7%	6,836	35,828	101,569
9	63	136,857	34,214	7%	7,110	37,261	105,632
10	64	142,331	35,583	7%	7,394	38,752	109,857
11	65	-	-	7%	7,690	40,302	77,245
12	66	-	-	7%	5,407	41,914	40,739
13	67	-	-	7%	2,852	43,590	-
			300,153		67,547	367,700	

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What, When, Why and Who

- **WHAT:** type of Equity depends on "Liquidity" and Company Structure:
  - **True Equity** (Options, Restricted Shares) – Actively traded on a public exchange, large demand for stock
  - **Synthetic Equity** (SARS, Phantom, RSU, LTIP) – Not actively traded, little demand for stock, family owned, Sub S

MUST award ENOUGH VALUE to influence behavior!!!!

What, When, Who and Why

- **WHEN:**
  - Long term horizon – retain 3 to 10 years
  - Short term horizon – 6 month project (CIC)

- **NEVER** until employee VALUES Equity

- **WHO:** Executives, Directors and Employees who contribute significantly to current **AND** Future Success

- **WHY: Equity or Long term Incentives (LTI) are intended to REWARD and RETAIN**

What to do with Previous Equity Awards

If Bank stock is THINLY traded, consider a VALUE – FOR – VALUE Exchange

- "Swap" existing UNVESTED or UNEXERCISED AWARDS
- Provide Executive with Cash Settled Award
  - Less Dilutive
  - Does Not impact share price
  - No impact on Income Statement

Benefits (NQDC)

Voluntary Deferral

- Participant contributes earnings (Elective NQDC)
- 100% vested in contributions
- Taxable upon payout
- Individual election to participate

SERP

- Paid by Bank (Non Elective NQDC)
- Payments begin upon retirement
- Lump sum or periodic (Typically - 15 years)
- Taxable when received

LINQS+

- Similar to SERP
- Payments paid until Death (Lifetime)
- Less Expensive than SERP
- Payments made by third party
- Creditor Risk eliminated in certain designs

Non-Equity LTI Plan Designs

Supplemental Executive Retirement Plans - Two Types of SERP designs (Traditional and LINQS+)

Typical Traditional SERP

- Period certain payment (industry standard is 15 years)
- Percentage of final pay as a retirement benefit (expense is NOT fixed in this design)
- Benefit is typically hedged with BOLI to provide beneficiaries a benefit in the event of premature death

LINQS+ Design

- LIFETIME payment stream
- Retirement benefit is fixed from day 1 (expense is fixed)
- Benefit is FIXED and Guaranteed – NOT contingent upon any investment performance
- Benefit is typically hedged with BOLI to provide beneficiaries a benefit in the event of premature death

Comparing a Typical SERP Benefit to a LINQS+ Lifetime Benefit

Executive	Age 2013	Benefit Start Age	Annual Benefit	SERP Expense (15 years)	LINQS+ Expense (LIFETIME)	LINQS+ Savings	Percentage Reduction in Cost
CEO	49	65	150,000	2,250,000	1,408,694	841,306	37%
COO	59	68	120,000	1,800,000	1,329,640	470,360	26%
CFO	51	65	75,000	1,125,000	722,178	402,822	36%
CLO	41	65	100,000	1,500,000	545,104	954,896	64%
Total			**445,000**	**6,675,000**	**4,005,616**	**2,669,384**	**40%**

LINQS+
Lifetime Income NonQualified Solution

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What, When, Why and Who

WHAT: type of Benefit depends on Strategic Plan, budget and needs of participants

- **SERP** (Non-Qualified Retirement Benefit) – Intended to supplement existing retirement benefits. Paid ONLY upon retirement for 10years, 15 years or lifetime
- **DIP** (Deferred Incentive Plan) – Based on individual needs for cash **WHILE employed**, i.e., tuition, parental long term care, etc.
- **Voluntary Deferral** (Directors typically) – Income tax play

What, When, Who and Why

WHEN: Hiring Key executives
Retain Successors, high performers
Profitable

NEVER If not valued by participant

WHO: Key employees critical to future success
Limited to top 10% of Highly Compensated

WHY: RETENTION of Key Personnel ONLY

Consequences

BENEFITS ARE EXPENSIVE

- Cost must be expensed over remaining term of employment. Older executives incur greater annual cost…
- Potential for negative perception by shareholders – must be positioned correctly.
- Inclusion of too many execs, immediate taxation (Top Hat)
- Must consider future events, such as CIC (280G)

If the bank has as SERP or is considering…

- LINQS+ may be a good solution for you… **Less expensive, can't outlive benefit. Better Retention**

Proposed SEC Pay for Performance Disclosures: Dodd Frank Strikes Again…

- On April 29, 2015, based on Section 953(a) of the Dodd-Frank Act, the SEC released its proposed "pay versus performance" disclosure rule.
- The 137-page proposal, if adopted, will require ***U.S. public companies*** to use a new table in their proxy statements that will disclose information on executive compensation and include a related discussion (smaller company exemptions apply).
- The table must present data, for the most recently completed five fiscal years (there is a phase in period beginning with 3 years, followed by 4 years and then five years), covering:
  - the relationship between the executive compensation of the company's named executive officers (NEOs) and its total shareholder return (TSR); and
  - the relationship between the company's TSR and that of a peer group that the company chooses.

Questions?

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Executive & director compensation review
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Annual incentive plans
Risk assessment of incentive plans
Internal pay equity

Change in control agreements
Non-compete agreements
Employment agreements
Stock option expensing
Review of possible excess parachute payments (280G) and related excise tax

Deferred incentive plans
Deferred compensation plans
Qualified & nonqualified plans
BOLI review
Supplemental executive retirement plans
Salary continuation plans

Deferred compensation compliance (409A)
CD & A preparation
Compensation philosophy
Compensation Committee Charter
Succession planning
Regulatory compliance

and LINQS+

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Flynt Gallagher heads Meyer-Chatfield Compensation Advisors, Inc. in its mission of assisting clients in attracting, motivating and retaining personnel critical to achieving success. Mr. Gallagher brings considerable experience and expertise to his role of providing MCCA's clients with comprehensive and effective support. He combines extensive knowledge of accounting and income tax matters related to community banks with years of experience within the financial services industry.

Mr. Gallagher has a strong history of assisting financial institutions. His career began in the field of Public Accounting and continued for ten years while moving into manager and ultimately partner positions with a Regional firm before accepting the Tax Manager positions with Florida National Bank and its successor First Union National Bank. In this capacity, he the reviewed and developed compensation plans focused on retaining current and future wealth for executives of both large banks and community banks. Mr. Gallagher also worked with key clients of these banks on compensation, wealth management, income tax and related IRS issues. Subsequently, Mr. Gallagher established his own consulting firm and began offering these services to the banking community for the past twenty years.