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2011 Compensation and Risk Management

June 2011

McLagan's 2011 Compensation and Risk Management Flash Survey focuses on current banking issues and initiatives related to the latest regulatory impacts on compensation.

The recent legislative environment has placed a great amount of focus on compensation practices, including the role of risk in incentive plans. Rules on incentive compensation practices at financial institutions covered under the Dodd-Frank Wall Street Reform and Consumer Protection Act are not yet final; however, banking regulatory agencies jointly issued the final guidance on Sound Incentive Compensation Policies (SICP) last June. SICP applies to all banking organizations.

Total participants – 52 organizations participated in our Compensation and Risk Management Flash Survey in May 2011. Public and private banks throughout the country were represented, with assets ranging from under \$500 million (11 banks) to over \$5 billion (8 banks), with a median asset size of \$1.2 billion.

SUMMARY OF RESULTS

Formal Risk Assessment: Overall, the prevalence of banks that conducted a formal compensation and risk management assessment has increased significantly since our last survey in the fall of 2009.

- Over half (57.6%) of the respondents indicated they had conducted a formal review, either internally or using outside experts, compared to 32.5% more than a year ago.
- Another 28.8% indicated they had at least discussed their compensation and risk management practices informally.
- This leaves 13.6% of responding firms that have not yet addressed how compensation practices and policies may impact risks to the bank.

Of the banks that conducted an assessment with outside experts, 40% plan to make changes, while 53% believe their programs already comply with good risk management practices. The ratios are swapped for banks conducting an internal assessment: 53% plan to make changes to strengthen their risk management practices and 40% believe they do not need to make changes.

Multiple Year Performance Goals

As expected, multiple year performance goals are not prevalent in the industry, given the complexity and continued economic uncertainty.

- Only 15% of banks indicated use of multiple year performance goals in their cash-based incentive plans
- Somewhat more prevalent in equity-based incentive plans: 38.5%
- Some banks are planning to adopt multiple year performance goals (18% in cash-based and 13% in equity-based)

Equity Incentive Plans

Equity is one way to tie compensation to longer term performance of the bank. While “full-value” shares (e.g., restricted stock) may pose less risk to an organization because award recipients experience a drop in value as well as an increase in value, survey respondents indicated that both full-value and appreciation shares (e.g., stock options) remain relevant in equity plans.

- Full-value shares are more prevalent (64% currently use) compared to appreciation shares (29% currently use)
- 11% of banks plan to begin using full value shares and only 3% plan to begin using appreciation shares
- A similar percentage, 12% and 13%, plan to increase use of full value and appreciation shares, respectively

Credit Quality Measures

Another way to maintain focus on longer term performance of the bank is by incorporating credit quality measures that mitigate risk associated with bad loans.

- Two-thirds (67%) of survey participants currently use credit quality measures
- Approximately one-third (31%) plan to increase the weighting in their incentive plans
- 29% of banks plan to begin using credit quality measures
- Past due status, loan loss, and loan risk ratings are all common quality measures

Payment Deferrals

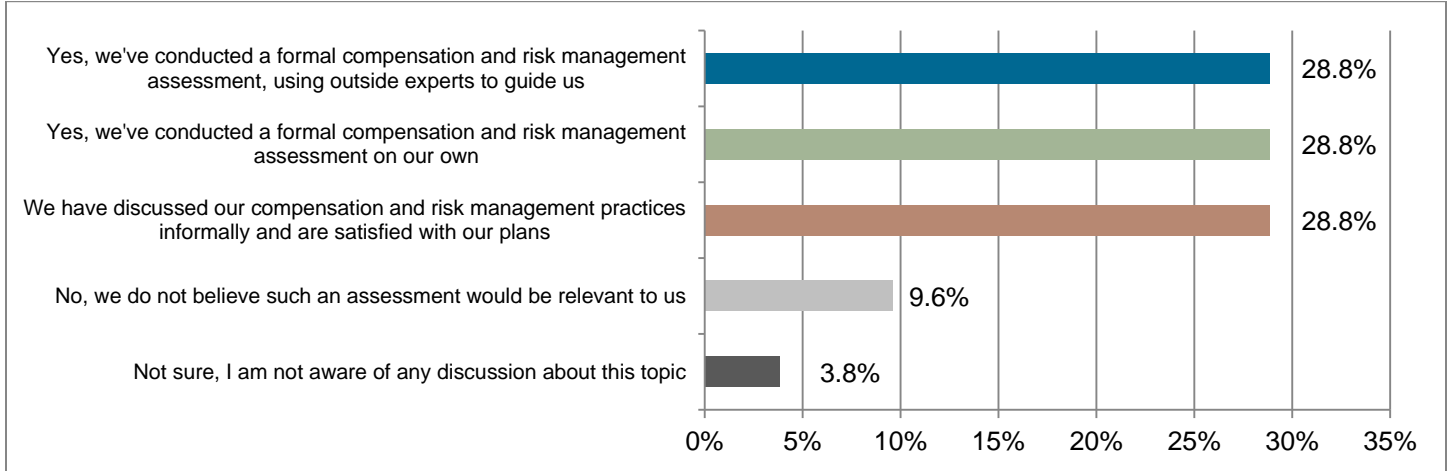
Mandatory deferrals of incentive payments are yet another way to balance short-term and long-term risk, typically for senior management and lending personnel.

- Only 19% of respondents are currently utilizing payment deferrals, but
- Another 15% plan to start.

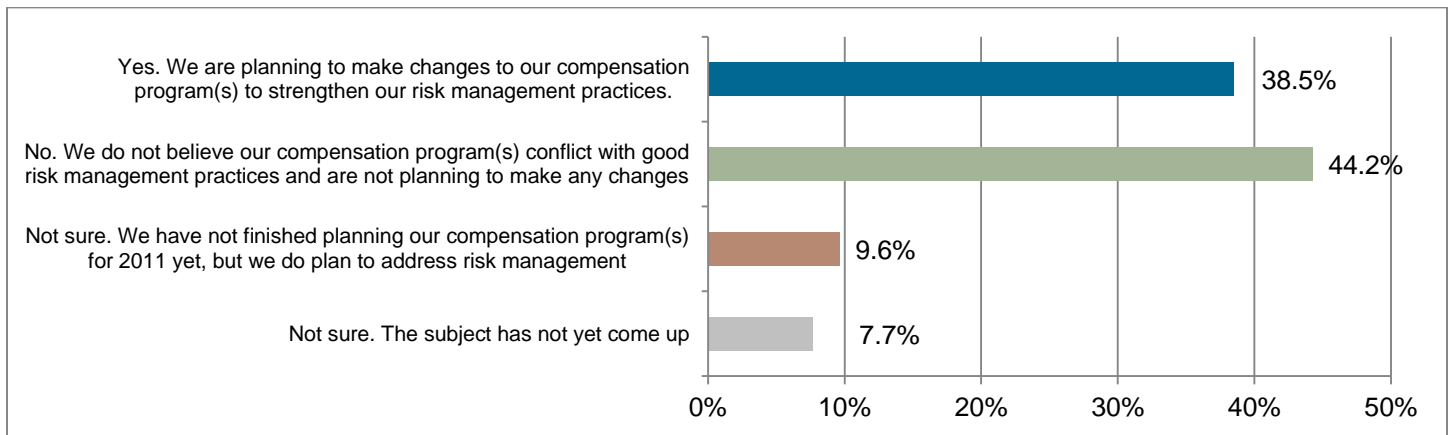
The Dodd-Frank Wall Street Consumer Reform and Consumer Protection Act will largely apply to banks with assets greater than \$1 billion. Not surprisingly, deferral prevalence is higher at those banks (29%), even though final rules are not yet published.

SURVEY RESULTS

Responses to the question “Has your bank conducted a formal risk assessment focusing on compensation practices and policies and how they impact risks to the bank?”



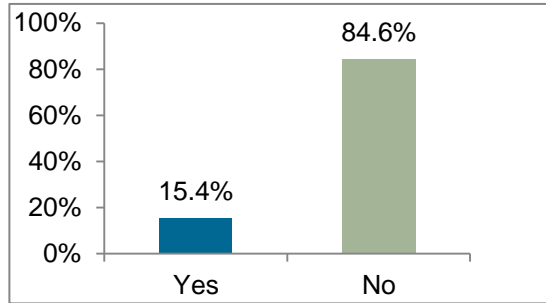
Responses to the question “In light of SICP guidance, is your bank planning to make any changes to your compensation plans to reduce the likelihood of motivating risky behavior?”



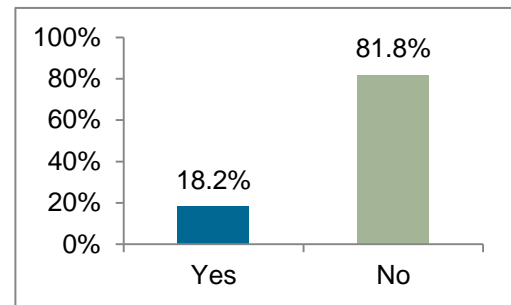
Multiple Year Performance Goals

A sole focus on short-term results may not lead to long-term shareholder value creation. Incentive plans that incorporate multi-year performance goals maintain this long-term focus and help prevent employees from pursuing unsustainable strategies.

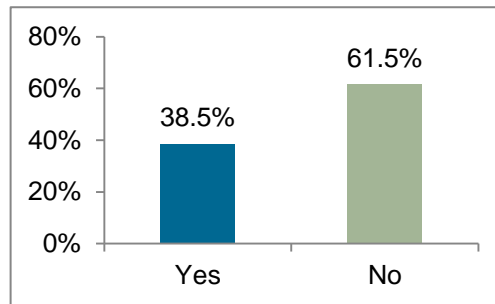
Do you currently use multiple year performance goals in your cash-based incentive plans?



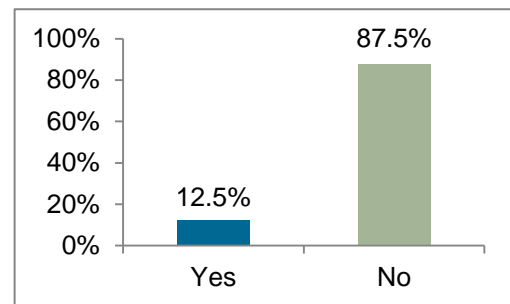
If "No" to the question above, are you planning to adopt multiple year performance goals in your cash-based incentive plans?



Do you currently use multiple year performance goals in your equity-based incentive plans?



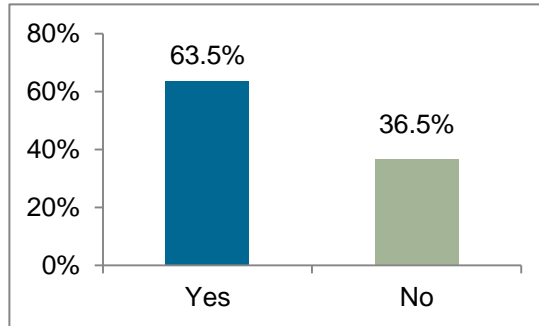
If "No" to the question above, are you planning to adopt multiple year performance goals in your equity-based incentive plans?



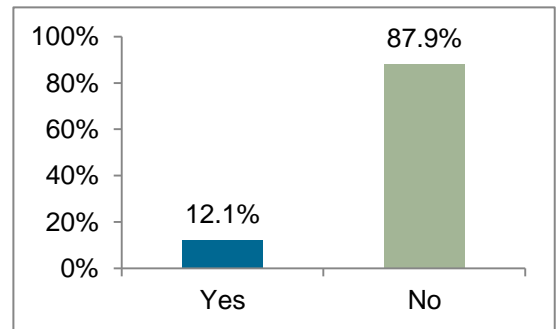
Equity Incentive Plans

“Full-value” stock awards (e.g., restricted shares or phantom stock) pose less risk to an organization because as share prices go down, award recipients experience a correlating drop in value. “Appreciation-based” equity awards (e.g. options or stock appreciation rights) present more risk to an organization because award recipients only forgo gains without experiencing actual loss.

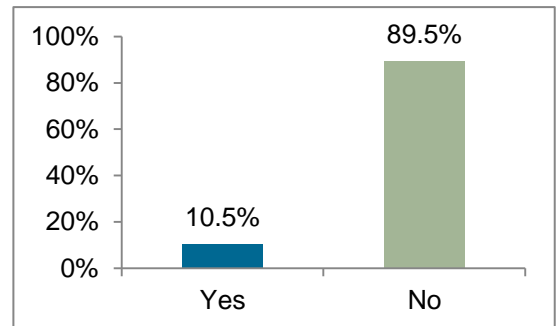
Are you currently using full value shares (e.g. restricted stock or phantom stock) in your equity plan?



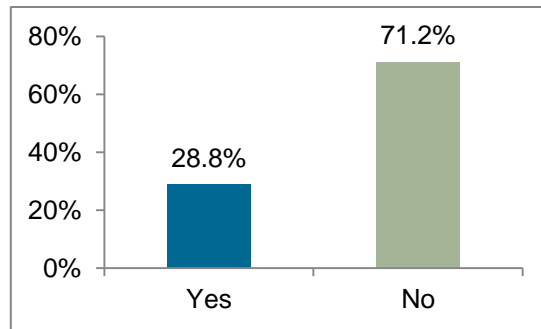
If “Yes” to the question above, are you planning to **increase** your use of full value shares in your equity plan in 2011?



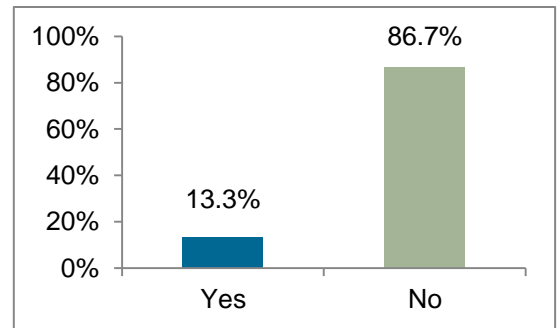
If “No” to the question above, are you planning to **begin** using full value shares in your equity plan in 2011?



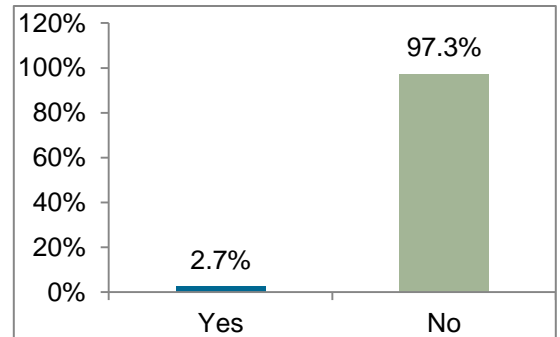
Are you currently using appreciation shares (stock options or stock appreciation rights) in your equity plan in 2011?



If "Yes" to the question above, are you planning to **increase** your use of appreciation shares in your equity plan in 2011?



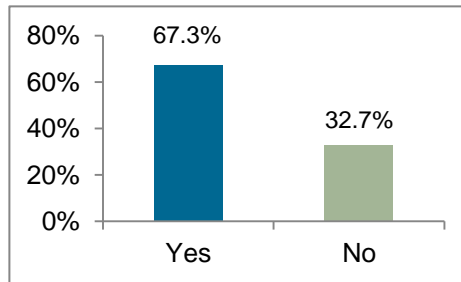
If "No" to the question above, are you planning to **begin** using appreciation shares in your equity plan in 2011?



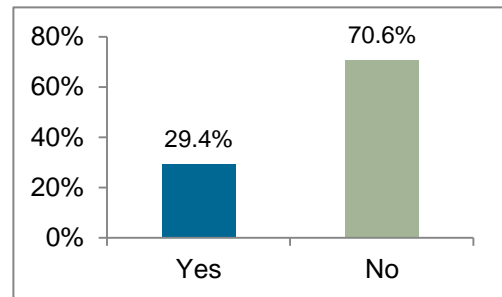
Credit Quality Measures

Incentive plans should be designed to limit short-term payments for transactions with long-term time horizons. Loans inherently affect the bank on a long-term basis and the quality of these loans have a significant impact on the profitability of the bank. Incentive plans that appropriately incorporate credit quality measures reduce the potential risks associated with bad credit.

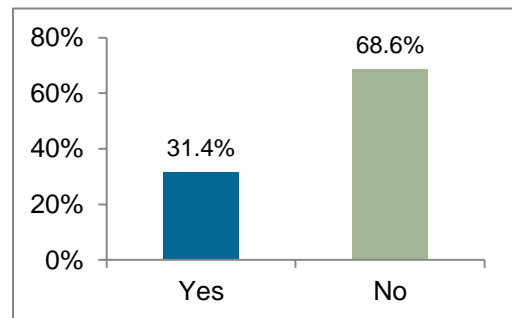
Do you currently use credit quality measures in your incentive plan?



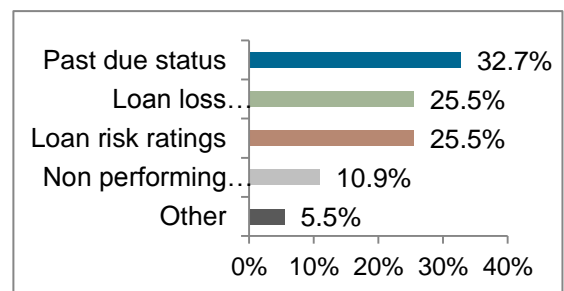
If "No" to the question above, are you planning to **begin** using credit quality measures in your incentive plans?



If "Yes" to the question above, are you planning to **increase** the weighting of credit quality measures in your incentive plans?



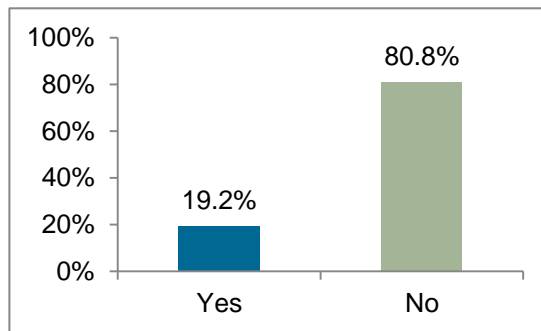
If "Yes" to either question above, report measures you are planning to adopt or increase.



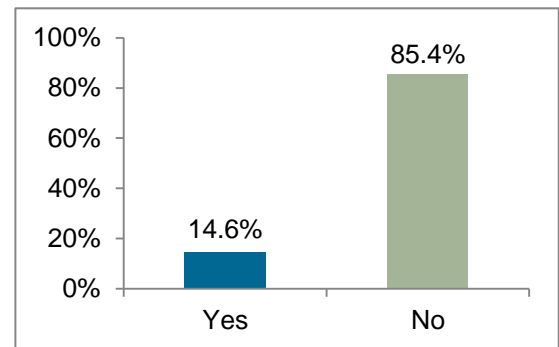
Payment Deferrals

One method to mitigate short-term risk is to defer payments beyond the end of the performance period. The deferral concept is addressed in the SICP, and more recently, in the proposed rules under Section 936 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (published in the Federal Register on April 14, 2011, with the comment period ended May 31, 2011). For larger institutions (e.g., banks with assets over \$50 billion) the proposed Rules call for a mandatory deferral of 50% of incentive compensation over a three year period for the population of executive officers.

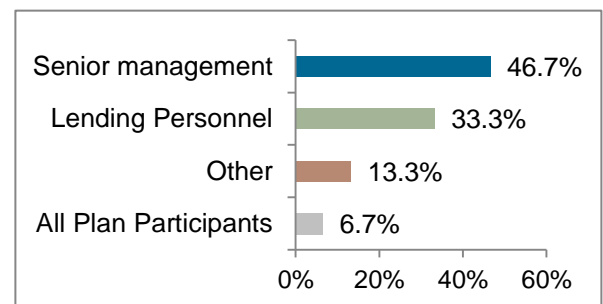
Do you currently utilize payment deferrals?



If "No" to the question above, are you planning to start using payment deferrals in incentive plans?



If "Yes" to the question above, which employee groups currently participate in incentive plans with mandatory payment deferral requirements?



Contacting McLagan

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