Don’t Play Russian Roulette With Your Succession Plan!

Presented by:
Kathy Smith
About Kathy Smith

As President, Kathy is a highly regarded expert in her field. She works with banks across the country to develop an understanding of current and long-term needs; provides an analysis of existing compensation and benefit practices and then prepares recommendations that address the impact on cash flows, earnings, shareholder value and other bank objectives to facilitate board approval. Kathy also collaborates with CPAs and attorneys to provide a coordinated financial strategy that includes benefit expense offset/bank-owned life insurance (BOLI) plans.

Kathy frequently presents seminars on nonqualified benefits, BOLI and succession planning for banks nationwide. She has presented these seminars through ICBA, ABA and various state banking trade associations. In addition, she has taught courses on financial planning for banking professionals at the Wisconsin Graduate School of Banking. Kathy graduated from Southern Methodist University in Dallas, Texas, with a bachelor’s degree in business administration.

A core group of professionals with more than 250 years’ combined experience assisting over 600 banks nationwide, BCC helps clients achieve their financial goals and enhance shareholder value.
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Is it plugged in, or isn’t it? There’s only one way to find out!
1. Introduction: Why Bother?

 ✓ Lesson Anxiety: While inevitable and not really “fun,” Death, Taxes, and Succession can all go more smoothly with planning.

 ✓ The Baby Boomer generation now at or approaching retirement age, as if Dodd-Frank wasn’t enough of an incentive to retire!

 ✓ Banks are not only losing CEOs, but entire teams of staff (This Is a Raid: Smaller Banks Get Taste for Poaching, American Banker, 03/09/12; How to Prevent Top Producers from Defecting, American Banker 06/04/13).
Why Bother?

✓ Regulators are asking for it. (*Tulsa National Bank Signs Pact with Federal Regulators*, Tulsa World, 04/12/12)

✓ Opens the bank to a takeover as the age of the selling CEO recently has been rising. (*Community Banks Are Falling Behind in Succession Planning*, American Banker, 03/26/13).

✓ Even Bank of America’s board was infamously caught flat-footed when Ken Lewis departed.
Manage Leadership Risks

- Where will your next C-level executives come from?
- Who will replace them if they:
  - Become disabled?
  - Prematurely pass away?
  - Leave the bank whether voluntarily or involuntarily?
  - How will other managers and employees handle the changes?
Manage Leadership Risks

- Should you hire an Executive Search Firm?
- What type of benefits are required for key management?
- What type of benefits are required for second tier management?
- What if your bank has a great opportunity to grow through mergers and acquisitions?
Competing for Talent

- It is not easy to find the “right candidate”
- Other banks are looking to fill similar positions
- Experienced talent is in demand
- Competitive market
Regulatory Scrutiny

- The regulators are talking about succession planning especially for the CEO
- They want banks to take a serious approach
- They want it in writing
The Bottom Line

✓ A board’s main job is to set the direction of the bank through the bank’s CEO that they hire and manage.

✓ Not having a succession plan and its tools for ensuring a competent CEO, puts the shareholders’ investment at risk.

✓ CEO shares the same responsibilities for succession planning of remaining key roles and positions throughout the bank
2. Levels and Types of Succession Plans
Levels and Types of Succession Planning

- Three levels of succession planning:
  - CEO/Management Succession
  - Board Succession
  - Ownership Succession

- Two common types of succession planning:
  - Emergency
  - Planned
CEO/Management Succession

- Regulators are concerned about the ability of banks to operate when an event occurs that impacts succession planning
- Regulators are asking boards how they are planning on succession
- Banks are looking at formalizing succession plans
- Management is “getting on board” with the concept of succession planning
- Involves Boards, CEO’s and Senior Management
Board Succession

- Board effectiveness more important than ever before
- Face the reality of regulatory oversight
- Build the board to compliment the strengths and preferences of the CEO
- Create competency matrix to identify critical knowledge and skill gaps
- Utilize CEO and management succession planning tools for board succession
Ownership Succession

- Regulators do not require Ownership Succession Planning
- Closely held community banks should still consider and implement Ownership Succession Planning
- Many tools are available to transfer stock from one generation to another
- More often we see mergers of community banks to continue the vision and commitment to remain a community bank
3. Real Scenario #1 - Unexpected
The CEO announced he is retiring in 6 months!
Now what do we do??????
Board scrambles with no plan in place
Steps Taken

- Board appointed a search committee of 2 outside directors
- No internal candidates identified
- Search committee hired an executive recruiting firm and a bank compensation consulting firm, BCC
- Search committee interviewed and hired new CEO
- BCC met with search committee and new CEO to review compensation package
- CEO assisted in developing compensation plans for other key officers
Real Scenario #2 – Forewarned
Bank #2 – Trying to be Prepared

- CEO early 60’s
- Regulators asked CEO what his retirement plans were
- CEO decided he would work 5 more years and then retire completely from the bank and the board
- CEO announced his plans to the board and asked them to create a succession plan for his position
- Board unprepared for transition, questioned CEO’s commitment to the bank
Steps Taken

- Board called BCC to educate them on succession planning
- BCC supported the concept of succession planning
- Board finally came around and began planning
- Board has an internal candidate, the CFO
- Board will eventually hire a recruiting search firm to provide outside candidates
- Board and current CEO will interview and hire new CEO
- Board is implementing compensation plans for current CEO, CFO and CLO
- Board is designing a package for future CEO
4. How to Develop a Succession Plan
How to Develop a Succession Plan

- As Stephen Covey would say, “Begin with the end in mind”
- Determine the strategic plan of the bank
- Be able to communicate this plan to anyone who asks;
  - Regulators
  - Management
  - Potential candidates
Purpose of Succession Plan

✓ To intentionally seek and develop people to meet the needs of the bank, now and in the future.
Risks

✔ Process: in depth and involved; or weak or non-existent?
✔ Key Executive: is the CEO a “rainmaker” with large boots to fill? If so, it’s harder to replace without a definitive process.
✔ Board involvement: does the board review plans and get real exposure to internal candidates?
✔ Leadership Training: is there a formal program of training and informal mentoring with defined expectations for advancement?
✔ Company environment: do managers encourage betterment or just the status quo and silos?
✔ Is a retirement wave coming and how deep is the talent pipeline?
Twelve Step Process

1. Create Emergency CEO Succession Plan
2. Define Your Plan Goals
3. Determine Strategic Direction
4. Organizational Analysis
5. Determine Key Positions
6. Strategic Job Descriptions
7. Develop Planning Timeline
8. Assess Key Employees for Succession
9. Succession Readiness Analysis
10. Identify Potential Candidates
11. Protect Your Bank’s Investments
12. Communication and the Ongoing Process
Step One – Emergency CEO Succession Plan

✓ A plan that is implemented in the event the CEO suddenly departs whether temporarily or permanently
✓ Take the emotion out of the decision making
✓ Can be as simple as a one page document
✓ Decide on an interim successor and his/her key responsibilities
  ✓ Board member
  ✓ Key manager or
  ✓ Outside party
Emergency CEO Succession Plan

- Define internal/external communication plan
  - Employees
  - Stakeholders
  - Regulators
- Continually update job description and align with bank’s strategic plan
- Primary objective is for the board to approve a plan prior to an emergency situation
- Have CEO do the same for key reports
Step Two – Define Your Plan Goals

✓ Board Chairman and the CEO begin discussion on definition and components of Succession Planning
✓ Align process with Bank Strategic Plan
✓ Determine participants in the process
  ✓ Board
  ✓ Officers, current and future
  ✓ Consultants
✓ Internal development or outside recruitment
✓ Communication
Step Three – Determine Strategic Direction

- Growth
- Loans
- Deposits
- Branches
- Profitability
Step Four – Organizational Analysis

- Update/Create Organizational Chart
- Include details such as:
  - Performance Ratings
  - Qualifications
  - Retirement Analysis for next 10 years
  - Future Growth
- Competitive Analysis
- Purpose is to determine internal candidate pipeline and how it aligns with the bank’s strategic direction
Step Five – Determine Key Positions

- Target mission critical positions
- Clarify specific position skills and competencies needed to achieve current and future bank goals
- Don’t assume these are only “C-Level” positions
  - IT technical guru
  - Head of Mortgage Lending
Step Six – Strategic Job Descriptions

✓ Think outside the box when writing descriptions
✓ Determine objectives and challenges of the strategic plan that impact the executive’s core responsibilities
✓ Specific capabilities
✓ Required experience
✓ Management style
✓ Track record
Strategic Job Descriptions

✓ Job descriptions should include:
  ✓ Job Title
  ✓ Reports to:
  ✓ Job Summary
  ✓ Time Responsibilities
  ✓ Leadership: direct and indirect reports
  ✓ Internal and External Contacts and their purpose
  ✓ Minimum requirements
  ✓ Expectations
Step Seven – Develop Planning Timeline

- Specific dates and times for completion
- Map out a calendar to set deadlines
  - Week 1, Week 2, etc.
- Determine roles and accountability with the timeline
  - Board
  - Management
  - Executive Search Firm
  - Consultants
- Create an Emergency CEO Succession Plan before tackling the larger comprehensive succession plan
- Be realistic; this can take several months
Step Eight – Assess Key Employees for Succession

- Board and CEO first determine potential CEO successors
- CEO may involve board with the next one or two layers of internal prospects to feed into a pool of potential CEOs or other mission critical positions
- Utilize an employee assessment tool or an outside firm
  - 360 degree evaluations, leadership grid, etc.
  - Fact-based, not personality-based assessments
- Commit to develop leaders and any gaps in necessary skills and competencies
- If necessary, recruit to fill the pipeline
Step Nine - Succession Readiness Analysis

- Prime – Person proven to be ready to step in the role
- Temporary – “Hold down the fort”
  - person with key skills but not all skills needed for role; (may or may not be a successor)
  - Could be a hired gun from outside
- Desired – Not quite ready for “Prime Time”
  - Being developed for leadership role
- Future – High performer with specific skill and/or competency gaps (needs more experience)
- Trainee – Potential high performer
  - Young gun that shows promise
Succession Readiness Analysis

- **CEO**
  - Prime: John
  - Temporary: ?
  - Desired: Paul
  - Future: ?
  - Trainee: Sarah

- **COO**
  - Prime: Bob
  - Temporary: ?
  - Desired: Roger
  - Future: Jim
  - Trainee: ?

- **CLO**
  - Prime: ?
  - Temporary: Sue
  - Desired: ?
  - Future: Chris
  - Trainee: ?

- **CFO**
  - Prime: ?
  - Temporary: Mark
  - Desired: ?
  - Future: ?
  - Trainee: Tim

- **CCO**
  - Prime: ?
  - Temporary: ?
  - Desired: Mary
  - Future: Don
  - Trainee: ?
Step Ten – Identify Potential Candidates

- Ideal situation is the current CEO working with the board to identify his/her potential successors
  - Ensures continuity with staff
  - Ensures continuity with external relationships
  - Promotes an effective environment operationally
- Some banks hire an executive search firm
  - Especially when there are no internal candidates
  - Even if there are internal candidates
Step Eleven – Protect Your Bank’s Investments

- Your bank’s biggest investments are the **right people**
- Succession planning needs to include proper incentive and retention tools
- Tools can be used to fill vacancies and retain key people identified in your *Succession Readiness Analysis*
- Tools can also incentivize job advancement within the bank when offered at higher levels
- Planned CEO succession can go more smoothly with proper compensation packages for recruiting and retiring
Compensation Trends

- More emphasis on incentive compensation to retain and reward key personnel
- More bonus deferrals in light of the Fed guidance
- Stock Options and Restricted Stock are certainly still viable
- Increased interest in Phantom Stock Plans and Stock Appreciation Rights Plans
- Clawback provisions implemented with incentive plans
- Longer term incentive plans
Compensation Plans & Objectives

- EQUITY PLANS
- LONG-TERM WEALTH ACCUMULATION
- SHORT-TERM DEFERRED INCENTIVES
- ANNUAL CASH INCENTIVES
- STANDARD BENEFITS

BENEFIT EXPENSE OFFSET/BOLI
Annual Cash Incentive Plan (ACIP)

**Plan Highlights**

- Determine plan participants
- Create scorecards to measure performance
  - Bank wide
  - Branch wide
  - Department wide
  - Individual
- Design affordable plan
Deferred Cash Incentive Plan (DCIP)

Plan Highlights

♦ Employees selected by bank
♦ Deferral period at bank’s discretion
♦ Bonus compensation often percentage of salary
♦ Performance targets with scorecards or discretionary
♦ Interest set by bank
♦ Benefit forfeited upon early termination
Long-Term Wealth Accumulation

Plan Highlights

- Employees selected by bank
- Supplemental retirement income
- Formula driven
- Offsets caps on qualified plans
- Vesting schedules ("golden handcuffs")
- Plan provision at bank’s discretion
- Covered by ERISA Top-Hat rules
## Salary Continuation Plan (SCP)

### Summary of Benefits

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<th>Name</th>
<th>Current Age</th>
<th>Retirement Age</th>
<th>Current Salary</th>
<th>Inflation Rate</th>
<th>Projected Final Salary</th>
<th>Benefit Percent</th>
<th>Benefit Payments</th>
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## Salary Continuation Plan Accounting Detail

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Equity Plans

Plan Options

♦ Restricted Stock
  • Real Equity – actual stock certificates

♦ Stock Options
  • ISO – Incentive/Statutory Options
  • NSO – Nonqualified/Non-statutory Options

♦ Stock Appreciation Rights (SAR) – Future appreciation

♦ Performance Stock Units (PSU) – Current & future stock appreciation
  • Synthetic equity – no stock certificates
  • More generous & costly
Phantom Stock (PS) plans provide both current grant value and future appreciation to the participant.

Stock Appreciation Right (SAR) plans provide only future appreciation to the participant.

*PS plans are more generous and more costly than SAR plans.*
Stock Appreciation Rights

- Bank grants employee a stock appreciation right (SAR)
- SAR has an initial value
- SAR is a right to a cash payment equal to the increase in FMV above the initial value over time
- Employee usually does not receive dividends on SAR

**Example**
1. 1,000 SARs granted to employee
2. Initial value $10.00
3. Bank pays $2.50 per share cash dividend on stock
4. FMV as exercise $60.00
5. Employee receives $50,000 cash payment at exercise
# Stock Appreciation Rights Accounting Detail

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Plan Highlights

- BOLI is an asset on the balance sheet
- BOLI is used to offset employee benefit expenses
  - Medical Benefit Costs
  - Qualified Retirement Benefit Costs
  - Nonqualified Benefit Costs
- BOLI is utilized in over 54% of all banks in the U.S.
- Monthly earnings are not taxable
- **Valuable tool for offsetting costs for Succession Planning Compensation Packages**
## Benefit Expense Offset/BOLI

### Tax Results of Alternative Assets vs BOLI

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<td><strong>Net Earnings Impact</strong></td>
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<th></th>
<th>Alternative Asset Income 2.00%</th>
<th>First Year BOLI Income 3.29%</th>
<th><strong>Gain/Loss Due to BOLI</strong> First Year</th>
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## Income Statement with Employee Benefit Expenses

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Step Twelve – Communication and the Ongoing Process

- Communication to stakeholders in obtaining “buy-in” is key to a successful succession plan.
- Good people start to look outside when there is a lack of communication and rewards.
- The ongoing process involves regular reviews and updating of plans ensuring you have the “right people in the right seats on the bus” (author Jim Collins).
- Train and develop future leaders to ensure a full pipeline.
- Banks can utilize your local and national association resources such as conferences and workshops.
Communication and the Ongoing Process

✓ Consider generational differences in attitudes and expectations of entitlement when long-range planning of succession candidates
✓ Effective CEO’s, working with the board, can channel these Gen Y future managers
✓ Utilization of incentive compensation with technology that allows work outside the normal work environment and greater creativity
✓ Bank culture, work-life balance, advancement opportunities
Communication and the Ongoing Process

- Successful transition of new CEO or key employee
- Board should develop a written plan communicating the board’s expectations for the first 12 months
- CEO should create the same type of plan for subordinates
- Quarterly reviews to ensure everything is on track
5. Key Takeaways
Key Takeaways

- Start discussion of a succession plan with board
- Set a firm timeline
- Identify key components that align with bank strategy
- Develop succession plan & continually update
- Communicate succession plan with key management
- Utilize incentive and retention packages to protect management development plans and expenses
- Boards and CEOs need to work closely, but boards have the fiduciary responsibility to ensure capable successors for the CEO and other key bank roles
Questions?

THANK YOU!

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