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Incentive Plan Goal Calibration Analysis Should Be a Standing Agenda Item

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You've carefully selected the metrics that will be used to measure the management team's performance and then benchmarked incentive payout opportunities against a relevant peer group of companies. But sometimes there are important lingering questions among compensation committee members. How do we know the performance requirements are truly appropriate to warrant the potential payouts? Are we setting up an inadvertent windfall—or setting management up to fail?

These are important considerations and there are quantifiable ways to get to the answers—information that helps the compensation committee feel confident they have gone beyond the process to create the plan and addressed *why* the goals and targets are set as they are.

Undergoing an annual performance goal calibration assessment is the critical step that can help address these concerns and ensure your executive incentive compensation plans have the appropriate balance of rigor and opportunity to drive results.

The building blocks of a goal calibration assessment

Goal calibration can take several forms, but the building blocks are consistent.

1. Define a relevant peer group of comparator companies.
2. Determine an appropriate measurement time period.
3. Gather historical performance data for the peers using your specific incentive metrics.
4. Map your historical performance against the peers for each metric.
5. Lay the proposed goal structure for the year in question on top of the historical data.
6. Analyze/interpret the results.
7. Use the findings to either validate your confidence in the proposed goal structure or inform appropriate adjustments prior to finalizing the incentive plan structure for the year.

As part of your analysis and interpretation of the data, there are three key examinations to undertake.

1. How challenging is your budget?

To the extent metrics are objective financial performance measures (e.g., ROAA, efficiency ratio, balance sheet growth), incentive plan goals are commonly tied directly to the board-approved budget for the year, with budgeted performance resulting in "target" payout opportunity. Your directional performance trend in recent years (and possibly analyst estimates for the coming year) may give an indication whether your budget is too aggressive or too soft to warrant target-level payouts and motivate the desired behaviors.

2. What if your incentive plan goals were imposed on your peers?

A goal calibration analysis can provide a market-based sniff test as to the rigor of not only the proposed target performance requirements, but also the proposed performance requirements for threshold and stretch (or maximum) payout. If your incentive goal structure was imposed on the employees of your peers would they be demoralized, see it as a walk in the park, or find it to be a reasonable, but challenging structure? By mapping your proposed goal structure onto the peer performance results over the last four or five years, the compensation committee and management team can gain a collective understanding of the prospective rigor of the goal structure relative to peer incentive goal structures, as well as an indication of the perception of the goal-setting rigor by your institutional investors and their advisors when reviewing your proxy disclosures.

3. How can you know your performance-payout leverage relationships are appropriate?

You may become confident in the performance required for target-level payouts, but what performance should warrant a maximum payout? And below what level of performance should no payout be earned? As a rule of thumb, incentive structures are most effective if there is a perceived 70 to 80 percent likelihood of achieving threshold payout, 50 to 60 percent likelihood of achieving target, and only a 10 to 20 percent likelihood (i.e., a rare occurrence) of achieving maximum payout for performance against a given metric. A goal calibration analysis will shed light on the likeliness of achieving the proposed threshold, target and stretch performance requirements, and may indicate the need for adjustments to achieve the desired performance-pay relationship.

Make sure a goal calibration analysis is on your compensation committee's calendar for the coming year and increase the level of confidence in your goal setting process.

About the Author

Greg Swanson is a managing director at Pearl Meyer and a member of the firm's national banking practice. He has more than 20 years' experience consulting with public and private companies on all aspects of executive and board compensation, including governance, education, compliance, communication, philosophy, design, implementation, monitoring, modeling, benchmarking, succession planning, employment agreements, and more. The majority of his work in recent years has been focused on executive and director compensation issues affecting community and regional banks. Greg is a frequent speaker at banking association conferences and is a regular author on board and executive pay topics.

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