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What Community Bank Compensation Committees are Asking About Incentive Plans

Autumn is around the corner and that means a busy season for compensation committees. They need to both review performance under the current year's incentive plans and finalize the plans for the coming year. In the era of pay-for-performance, committees are feeling more pressure to ensure that the right metrics are incorporated into the incentive plan framework, to set performance goals with an appropriate level of rigor, and to assess the plan's response to performance.

We have noted three questions frequently asked by compensation committees during the incentive planning process:

Our committee is wrestling with whether we have selected the right performance metrics for maximum effectiveness. What should we consider?

One of the first things to consider is whether the performance metrics within your incentive programs make sense in light of the bank's current business strategy. If a new strategic plan has been developed recently, do the current incentive metrics support the new strategy?

How do your performance metrics work together as part of long- and short-term incentive plans to drive sustainable results? Choosing metrics that support the business strategy while also reflecting a balance of growth measures (e.g., loan/asset/deposit growth), earnings/returns (e.g., return on assets, return on equity, earnings per share, and total shareholder return), and quality/operational efficiency (e.g., non-performing assets, efficiency ratio) will help create a balanced incentive strategy. In times when higher growth outcomes could come with lower earnings and/or operational efficiency, it is important to achieve a balance among metrics in order to optimize shareholder returns.

We tend to set our incentive plan goals based on our budgets/forecasts. How can the committee evaluate the level of rigor represented by the goals?

Goal-setting is one of the most challenging aspects of incentive plan design. It is common practice by many banks to use only the annual budget when setting target performance goals. However, committees are sometimes wary of this approach and can be concerned that management might manipulate the budget given that it is linked to the incentive plan. As a rule of thumb, the probability of achieving the threshold (minimum level of performance which must be achieved in order to earn an award), target, and stretch goals (the target and maximum level of performance above which no additional award is earned) should be 70–80 percent, 50–60 percent, and 10–20 percent, respectively.

There are two ways to help measure probability:

- The internal perspective examines the bank's own historical performance. For example, you could look at the bank's performance during the past five to eight years. How often in any given year did the bank achieve your current proposed goals? If the analysis indicates that the historical probability of achievement for the proposed target goal is 80 percent, then maybe the goal has been set too low and should instead be the threshold goal.
- The external perspective examines the historical performance of peer institutions in order to determine their cumulative probability of achieving the proposed performance goals compared to the internal perspective. For example, the bank's historical probability of achievement is 80 percent likelihood at threshold and five percent at the stretch goal. However, the peers' historical probability of achievement is 60 percent at threshold and 40 percent at stretch. Since the bank's spread is wider than peers, you may need to raise the threshold and lower the stretch goals.

Besides evaluating peer historical performance, committees can consider investor expectations by examining analyst estimates for various performance metrics and how they relate to the proposed goals. However, there is the potential for some circularity in this analysis given that analyst estimates often take into consideration management input regarding the bank's expected performance.

How can we determine the right level of payouts in our incentive programs?

Many banks are re-examining and modifying incentive metrics and payout slopes to help find the proper balance between pay-for-performance and prudent risk management. Incentive payouts typically range from 50 percent of the target incentive payment at threshold to 125 or 150 percent of the target payment at maximum. An exception to this approach is with revenue-generating employees such as loan officers, who might get payouts up to 200 percent of target if they reach their stretch goals.

To validate, committees can examine peer practices in terms of the range of payouts. This might require analysis on a metric-by-metric basis. For example, net income may range from +/- 20 percent of target between threshold and stretch goals, but the range for the efficiency ratio will likely be narrower given it is a percentage metric.

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