Designing Incentive Plans for Executives

How To Drive Your Bank’s Success with Pay for Performance Plans

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Using Pay for Performance Plans to Drive Your Bank’s Success

Incentive plans are intended to help your financial institution achieve specific performance goals by driving certain behaviors of individuals. This is accomplished through compensating an individual for performance that impacts the success of the financial institution and increases shareholder value. There are several important considerations when designing an incentive plan.

Incentive plans should:

- Be in line with your financial institution’s strategic plan.
- Have a balance between both long-term and short term goals.
- Maintain strong safety and compliance by not encouraging excessive risk.
- Be designed to meet the needs of the institution.

This white paper examines these considerations and the decisions to make when creating an incentive compensation plan for your institution’s executives.

Understanding Your Performance Goals

Setting the appropriate performance targets of an institution is one of the most important steps in designing an incentive plan. Goal setting for annual incentive plans should consider both internal and external factors. If your incentive plans aren’t properly aligned with your institution’s goals, your executives’ attention and focus will not be aligned either. It is important for executives and directors to remain conscious of the current market conditions and set realistic goals for the firm. Setting unrealistic goals will decrease the focus and mitigate the positive effects performance-based plans can achieve.

Look at the Correct Key Performance Indicators (KPIs)

Relative total shareholder return (TSR) is the most common metric used as a performance indicator in long term incentive plans. However, generating shareholder value should be a result of the strategy and not the basis for the strategy itself. Incorporating TSR as a metric should be done with constraint. A major shortfall of TSR is that
fluctuations in the market unrelated to executive performance can result in bumps in incentive compensation. Long term incentive objectives should primarily be metrics that are measures influenced by the performance of the executives (unlike increases in bank stocks, which may not be).

Common key performance indicators other than TSR include:

- Return on equity (ROE)
- Return on assets (ROA)
- Net income
- Earnings per share (EPS)
- Asset quality
- Net loan growth
- Net charge offs
- Non-interest growth
- Non-interest income as a percent of total revenue
- Acquisitions
- Outside audit downgrades

This list only scratches the surface; there are dozens of KPIs that can be beneficial to use. When considering longer term incentives, the primary factors should be net income growth, asset growth, non-interest income growth, and book value growth.

Remember, incentive plans are set in place to drive specific behaviors toward achieving desired performance. Ensure that the KPIs you choose are aligned with accomplishing the strategic vision of the institution. As an example, a strategic goal may be to expand your IT infrastructure or build a new branch. While these may be long term goals that aid your organization’s growth and create shareholder value, they will not be directly connected to earnings in the short term. As such, earnings expectations in the short term may need adjustments to account for the additional expenses.

Setting Criteria for Incentive Plans

The compensation committee should determine the criteria for the CEO. It is a best practice for the committee to review the goals of the other non-executive officers; the final decision is typically the responsibility of the CEO. The senior executives may then set the incentive criteria for the remainder of the bank. Here are some key points to consider when setting criteria for your incentive plans.

"Limit the number of criteria for incentive plans to 4 or fewer, and ensure that no one criteria represents less than 20% weighting."
Keep Your Incentive Plans Simple

Incentive plans are often built with significant complexity that takes too many different KPIs, thresholds, and tiers into account. As a rule, keep your incentive plans simple. This will also make it easy to determine whether a plan is reasonable.

- Limit the number of criteria to ensure that there is a dedicated focus for each objective.
- More than 4 criteria, or any one criteria representing less than 20% weighting, creates a diluted incentive structure.
- Configure plans so they are simple to administer.
- Plans should be easily communicable to executives.

Use the Minimum Acceptable Return Approach (MAR)

Incentive plans should be designed to offer executives compensation for performance above the expected. Shareholders become concerned when incentives are being paid to executives and they are not realizing a return on their own investment in the institution. Shareholders want a balance; otherwise, they may look to invest their money somewhere else. The minimum acceptable return (MAR) approach is an incentive model that requires minimum performance before the incentive is paid. Using the MAR approach guarantees that shareholders are paid first.

How do you set your MAR?

You could determine MAR based on what makes sense for your bank internally. However, your internal budget should also be tested against the external market and what your peer banks are returning to their shareholders. There may be a disconnect between your budget and market value. MAR can also be determined by normalizing earnings per share. Look at banks of your asset size, perform a relative analysis, and ask: What would be a reasonable return on assets/equity that is also competitive in the market?

Incorporate a Threshold

Private Banks: Incentive plans for private institutions can incorporate a CAMELS threshold. The bank must be in good standing with regulators and maintain a minimum CAMELS rating (2 is recommended). If this threshold is not met, there should be no incentive. The board retains discretion in this matter.

Public Banks: Public institutions should consider a compliance threshold other than CAMELS. An internal or external audit can be used to determine a “compliance rating,” and incentive payments would be tied to that rating.

Consider the Level of Responsibility Per Position

The level of responsibility a position has should directly correlate with the amount of incentive received. Criteria should be limited to what an individual can specifically influence.
Striking the Right Balance with Awards: Cash vs. Equity

Equity compensation is frequently used as a long-term incentive for executives, but there needs to be a balance between cash and equity, as well as the type of equity used. Over the past few years, the regulators’ preference has been restricted stock over stock options. This is primarily due to executives’ potential risk-taking to drive up the stock price in order to maximize the value of their options. To help the board manage risk, the compensation committee or board should conduct an annual risk assessment to ensure no excessive “risky” behaviors are incented.

Multiple compensation vehicles should be considered alongside long term incentive plans, such as nonqualified deferred compensation (NQDC) plans and retirement plans. Having a mix of different compensation vehicles is ideal for risk management, driving value to the shareholders, and retaining or recruiting key talent. You can learn more about challenges related to equity and how to restructure and improve your equity compensation practices in the whitepaper The True Cost of Equity: The Hidden Cost and Dangerous Compensation Levels.

The Right Incentive Plans Will Help You Achieve the Right Success

The accomplishments and expectations set forth in an incentive plan should be realistic. Realize that other components of compensation (outside of an incentive plan) will also incentivize employees to enhance the long-term franchise value of the financial institution and result in higher profitability over time. Remember, annual incentives are meant to encourage specific behaviors, but this does not always directly coincide with earnings in the short-term. Make sure you’re always looking ahead to the future and thinking long-term while ensuring that it is clear how these incentives tie to your goals. A compensation consultant can assist in creating an incentive compensation plan that results in the best performance.

“Having a mix of different compensation vehicles is ideal for risk management, driving value to the shareholder, and retaining or recruiting key talent.”
About Compensation Advisors

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To talk to an expert about creating the right incentives for your executives, or any aspect of compensation, contact Compensation Advisors today.

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