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TRENDS & ISSUES

What Behavior Does Your Incentive Plan Reward?

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Nearly all banks, regardless of size, view growth as a key driver of success. What differentiates Bank A from Bank B are the unique strategies they have formulated to achieve that growth. However, when it comes to compensation, regardless of business strategy, there's often just a single question asked: "How do my peers pay?"

While it is important to understand market norms regarding pay levels and practices, this information is most impactful when followed by additional questions including "What implications do those practices have for us?" and "How can we use compensation in a way that draws the right talent and ensures success?"

Assessing whether or not an executive compensation program is working requires going beyond market data and compliance to determine the program's degree of alignment with the bank's business and talent strategies. The following steps can help Compensation Committees think through this alignment with their program design.

Step 1: Define Path to Success

The ultimate goal of all banks is to create value for stakeholders over the long term. But in the interim, "success" can be defined as the effective execution of the bank's chosen strategy. For example, an acquisition strategy often seeks to create higher returns and shareholder value through market share and economies of scale. Examples of strategies include:

Strategy	Measure of Success
Acquisition	Higher returns through market share and economies of scale
Exit/Liquidity (e.g., Sale, IPO)	Maximize growth through capital infusion
Organic Growth	Stable and growing returns
Niche	Profitability through higher margin business

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Step 2: Consider Compensation Implications

Compensation Committees should consider whether the compensation structure is helping execute the strategy and deliver results. Let's stay with the example of an acquiring bank. When an acquisition is made, there can be significant noise in the financial statements along with one-time merger costs. If the annual incentive program is formulaic and heavily based on income-related metrics, it could very well discourage management from seeking acquisitions. Further, the plan may not be designed to reward key elements that can determine whether or not the benefits of the strategy are realized. For example, in the near term, it may be entirely appropriate to reward executives for bringing quality deals to the Board for consideration. Later, executives should be rewarded for ensuring merger integration is timely and efficient.

The following outlines common compensation design challenges and considerations:

Strategy	Challenges	Considerations
Acquisition	Financial results during the acquisition stage are highly variable	Does the annual plan include qualitative measurement to account for variability? Are there adjustments or exclusions for incentive calculations? Is there greater weight on equity compensation to reward long-term results?
Exit/Liquidity (e.g., Sale, IPO)	Short-term profitability and results related to franchise value are important	Does the annual plan focus on profitability and results related to franchise value (e.g., deposit and loan growth)? Is there greater weight on equity compensation to align interests? Are implications of the change-in-control agreement terms clear?
Organic Growth	Results are driven through increases in market share and cost reduction	Is the annual plan focused on profitability and moderate growth in key areas? Is wealth accumulation through equity, retirement benefits or both?
Niche	Results are driven through increases in market share and cost reduction	Is the annual plan appropriately customized for business lines? Is differentiation in compensation required to hire and retain specialized talent?

Step 3: Tailor the Program

Using our acquisition strategy example, a compensation program might be redesigned so equity encompasses a larger portion of incentive pay, taking pressure off immediate financial results and incenting deals that are accretive over time. The annual incentives could play a lesser role and continue to use profitability of the legacy lines of business, but would be complemented with measures that focus on deal flow and integration.

Step 4: Revisit and Refine

Compensation Committees should test the outcomes of the compensation program annually and refine as necessary:

- Did the program attract talent and retain our best people?
- Were pay and performance aligned?
- Did our results move us toward our strategic goal? If not, did the compensation program play an unintended role in not achieving objectives?
- Have milestones and objectives changed in a way that the program should be refined?

Moving beyond market practices to align compensation programs to a specific strategy can provide a competitive advantage when it comes to attracting and retaining your best people and driving business results. Being mindful of the alignment of strategy and the compensation programs that support those efforts ensures that the bank has the best probability for success.

About the Author

Laura Hay is a managing director at Pearl Meyer, where she leads the National Banking Industry Team. She has extensive experience advising financial institutions on compensation and compensation-related governance and regulatory matters. She advises both public and private financial services companies, including private equity and majority-shareholder owned institutions.

About Pearl Meyer

Pearl Meyer is the leading advisor to Boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, and Los Angeles.

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