Pearl Meyer

TRENDS
& ISSUES

Do You Have the Right Incentive Goals?

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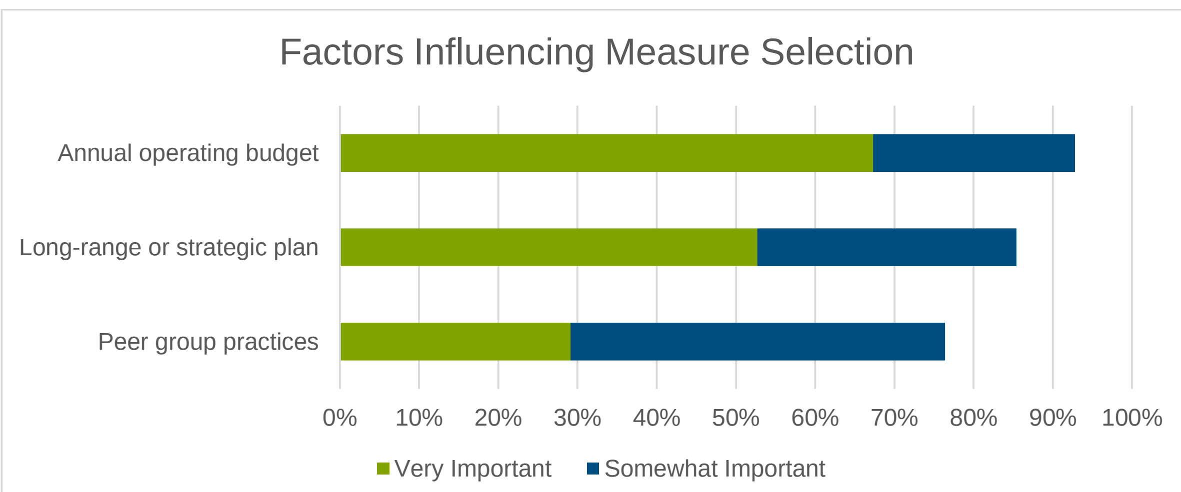
The first quarter of every fiscal year finds Compensation Committees and management teams wrestling with setting performance goals for the coming year's incentive arrangements. What does that process look like for your institution? If your company hasn't conducted a ground-up assessment of the goal setting process in recent years, consider taking a fresh look at your approach this year.

How does your institution select the performance measures?

In Pearl Meyer's recent survey, "Looking Ahead to Executive Pay Practices in 2016 – Banking Edition", respondents indicated the following three factors as having the greatest influence on performance measure selection:



We would argue that the "long-range or strategic plan" should carry substantially more influence in the selection of performance measures than the other two factors–doing so also takes substantially more effort and intentionality. In contrast to plucking some high profile measures from the approved budget, copying what peers are doing, or appeasing

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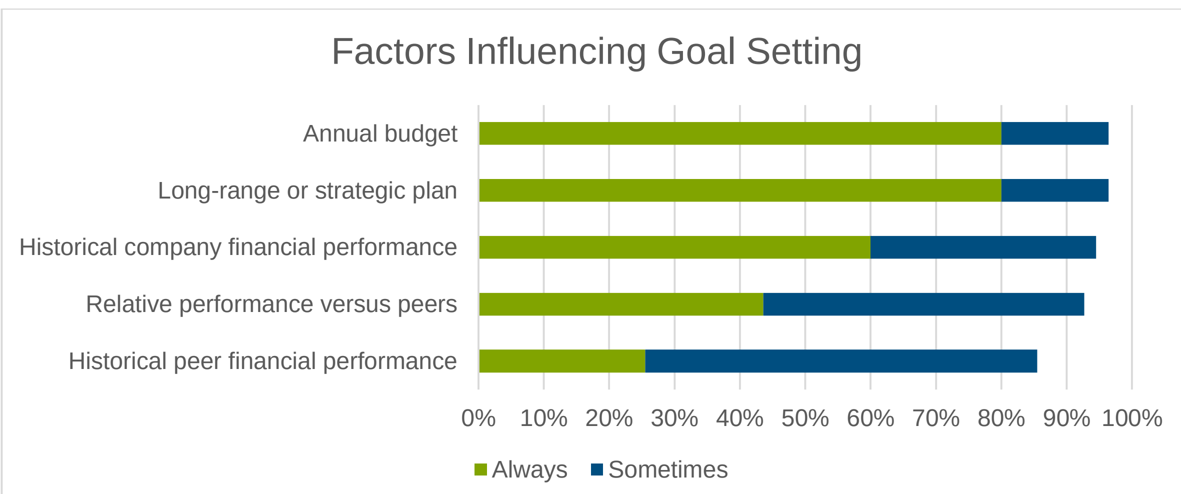
institutional investors or their advisors, selecting measures that effectively support the long-range or strategic plan requires a multi-step line of thinking that starts with the end goal in mind (long-term growth in enterprise value) and drills down to very specific actions that need to occur now in order to achieve the end goal.

Some practical steps in the process include the following:

- Outline the company's business objectives and strategy and the drivers of long-term value creation. Then select short- and long-term incentive performance measures that directly tie to the achievement of milestones toward these goals.
- Identify and focus on the centerpiece financial metrics that will signal success within your company, your industry and the global economic environment.
- Incorporate both "lag" metrics (that reward achievement) and "lead" metrics (that spur desired new actions and behaviors).

Once the measures are selected, how does your institution set performance expectations?

Respondents to our survey identified the following five factors as having the greatest influence on their performance goal setting process:



For performance measures that can tie directly back to the annual budget, the budget is a very common way to establish "target" performance expectations. This can be effective and appropriate, so long as there is high confidence among the Board and management team that the annual budget represents the proper amount of rigor deserving of target incentive payouts. But the budget is not terribly helpful at setting performance expectations appropriate for "threshold" or "stretch/maximum" payouts. This is where observations regarding historical performance, both for your institution and your peers, can be extremely helpful.

Evaluating actual performance against the selected measures over the last several years (preferably five or more) can provide excellent information about the likelihood of achieving specific performance outcomes and can help you to be confident that the appropriate rigor is represented at all payout opportunity levels (i.e., threshold, target and maximum). A rule of thumb for the rigor of performance expectations is as follows:

- Threshold performance/payout should be achievable about 80 percent of the time
- Target achievable 50 percent to 60 percent of the time
- Stretch/Maximum achievable only 10 percent to 20 percent of the time

Observing historical performance is an excellent way to calibrate the performance expectations with the respective payout opportunities and to understand directional trending on specific measures.

Most of the attention and speculation by investor groups surrounds the potential for insufficient rigor in the performance expectations, relative to the payout opportunities. This is a valid concern. It's also a valid concern when performance expectations are unreasonably high, relative to payout opportunities, because that could discourage employees or potentially encourage them to expose the bank to excessive risks in pursuit of otherwise unattainable levels of performance. A little effort and historical data can go a long way toward addressing both concerns.

Selecting incentive performance measures and establishing the performance expectations are not routine, one-meeting-per-year exercises. If conducted in a thoughtful, intentional manner, your incentive plan design in the first quarter of 2016 can truly support your business strategy and drive behaviors that lead to growth in the value of your company. Make 2016 the year that you challenge—and improve—your incentive goal-setting process.

About the Author

Greg Swanson is a Managing Director with Pearl Meyer's San Francisco office 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.

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, Los Angeles, and San Francisco.

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