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INCENTIVE COMPENSATION

Setting Goals to Incent High Performance

High-performing banks define and execute their strategic vision by clearly articulating what they want to achieve and how they will do it. The old adage, "what gets measured, gets done", is true when it comes to incentive plans. Companies that define specific measures and create accountability for achieving them are more likely to achieve the intended results. Tying meaningful incentives to those goals furthers the likelihood of achieving high performance.

Selecting the right metrics for an annual incentive plan is a critical first step that requires careful balance of a number of objectives. First, incentive plan metrics should tie to the strategic plan and business priorities specific to the bank. A highly acquisitive bank, an organic growth-focused bank and a turnaround bank will have different strategic priorities. Incentive measures should communicate and prioritize the specific results and behaviors desired. For example, is the focus on earnings, fee income, expense management, geographic expansion, technological innovation, customer acquisition/retention or cross-selling? Is the bank focused on organic growth or acquisitive growth?

Because no single metric can effectively reflect performance, most companies use multiple measures or a scorecard approach to communicate and focus participants on the most critical measures they believe will drive a bank's overall success.

It is also important to balance the types of measures (financial, operational, strategic and/or qualitative) and the scope of performance (bank, department and/or individual). Weighting the measures also helps focus priorities. While generally the highest weights are metrics that fund payouts, such as profitability, including additional metrics tied to strategic priorities can help incentivize long-term value creation. The result should be a focused and select group of performance measures (typically five or less) that will focus participants on driving the results and behaviors desired.

Once the metrics have been determined, the next challenge is to set the specific goals for each metric, which generally encompasses a range of acceptable performance, including a threshold goal for minimal performance, a target goal for expected performance and a stretch goal for maximum performance. Assessing the appropriateness of performance objectives can be challenging, particularly in uncertain environments.

The following are key questions to consider when evaluating and setting incentive goals.

- How do targets compare to the board-approved budget? Generally, target performance is tied to budget with a defined range to reflect threshold and stretch performance.
- Are incentive goals set to achieve the longer-term strategic plan?
- What is the range between threshold and stretch goals? Are threshold results worthy of payout, and do stretch goals represent outstanding performance?
- What key assumptions are built into target goals (loan growth, interest rates), and how would those change at the threshold and stretch levels?
- What is the probability of attaining the threshold, target and stretch performance goals? A general guideline is that threshold performance is attained approximately 80-90 percent of the time and stretch performance is attained 10-20 percent of the time.
- How does the payout range relate to the performance goals? Typically, threshold pays at 50 percent of target, and stretch pays at 150 percent of target, but the payout curve can vary to reflect desired results.
- How do the goals compare to historical results? Do they represent improvement over the prior year? When goals are outside of historical norms, is there an understanding of what is driving the difference?
- How do the goals compare to recent peer results? Does the bank's strategy drive differences in expected performance outcomes relative to peers?
- Will certain items (M&A expenses, impact of accounting changes) be excluded from the results?
- For publicly traded banks, are the goals aligned with expectations of analysts covering the stock and guidance provided to shareholders?

Goal setting in today's environment requires a strategic and disciplined approach. Selecting the right metrics, defining the goals and ensuring appropriate payouts requires due diligence and ongoing monitoring. The ultimate goal is to design incentive programs that motivate superior performance and reward high-performing employees. High-performing employees create high-performing companies.

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