Daniel Rodda is a partner at Meridian Compensation Partners.

Laura Hay is lead consultant at Meridian Compensation Partners.

COMPENSATION

Incentive Plans That Withstand Uncertainty

Bank compensation committees have operated in an environment of significant uncertainty and volatility for nearly three years.

Directors are now looking for a number of tools to ensure their banks' incentive plans better withstand current and future volatility. Here are five approaches to improving incentive plan flexibility and resilience.

Widen Performance Ranges

A common approach is to establish a wider range of results that qualify for an incentive payout, which acknowledges the potential variability in results. This often is coupled with a reduction in the incentive value at threshold-level performance, and either setting aggressive goals at maximum or capping payments.

For example, a plan historically may have used a performance range of 90% to 110% of the expected or target goal, with payouts ranging from 50% of the target payout for results at the bottom of the range to 150% at the top. Under this scenario, a committee could adjust the thresholds to 80% of expected performance and stretch to 115%, with payouts ranging 25% to 150% of the executive's incentive target.

Conduct "What If?" Analyses

As part of the goal-setting process, management should run a series of analyses that examine the impact of volatile influencers. such as changes in interest rates or allowance increases as a result of the current expected credit loss model. If the outcomes result in meaningful volatility in incentive outcomes, consider:

- Setting performance levels as a range of outcomes rather than a single number.
- Using conditional adjustments that limit the impact of economic variables such as interest rates.
- Removing the impact of reserve builds or releases under CECL while including actual charge-offs.
- Using peer comparisons for highly variable metrics.

Weighting Non-Financial Metrics

New challenges often require a shifting of priorities and adjustments in strategy. Banks can design incentive plan structures that support the execution of key priorities through non-financial metrics. These may include strategic objectives and milestones, environmental, social and governance (ESG) goals, and stakeholder goals such as net promoter scores and employee engagement.

While financial results generally should remain the primary driver of incentive payouts, incorporating non-financial goals in the plan can direct managements' focus toward key strategic priorities and promote long-term thinking.

Public companies should be thorough in disclosing the rationale and rigor behind these non-financial components to avoid proxy advisor and shareholder criticism.

Operationalize Discretion

Compensation committees should have the authority to use discretion. This ensures they can consider financial results and internal and external factors. "Operationalizing" discretion provides greater certainty to both directors and executives. Boards should:

- Develop a guideline document that outlines the situations and framework in which adjustments will be made.
- Require a proposal from management that discusses the impact of the adjustment on short- and/or long-term awards, including illustrations.
- Discuss potential adjustments with management at the time business decisions are made, not at the time of payout.
- Keep a record of past adjustments and the rationale behind the action.
- Use these guidelines consistently, potentially resulting in both positive and negative adjustments to the incentive payments.

Equity Program Perception, Value

The real and perceived value of equity awards can be vastly different based on equity type and vesting terms.

- Consider scope of influence. Equity vehicles with the most risk, such as performance-contingent stock awards, typically are only used for the first two or three layers of management.
- Determine needs for retention and share ownership. Most programs include a portion of time-based restricted stock or units, often with more junior employees receiving only time-based awards.
- Resist overreacting to short-term changes in the stock price.

There is always uncertainty involved in structuring incentive plans and establishing goals. Incorporating these concepts into your bank's incentive programs helps mitigate the challenges that volatility creates, and forms a structure that appropriately motivates and drives plan participants while ensuring payouts remain aligned with performance.

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