

BankDirector

**Breakout 4:**  
**What Compensation  
Committees Need to  
Know to Design  
Effective Incentive  
Plans in the Current  
Economic Environment**

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#BBTF23

# What Compensation Committees Need to Know to Design Effective Incentive Plans in the Current Economic Environment

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# Session Description

*In this session, we cover the strategies effective compensation committees employ to ensure incentive plans support the bank's strategic objectives and culture, are competitive in the current talent environment and create alignment between executives and shareholder value. We also discuss the committee's role in annual and long-term incentive plan design, best practices for assessing performance and ongoing monitoring of incentive plans.*

# Agenda

- Essential Inputs into Incentive Plan Design
- Strategies to Ensure Effective Incentive Plan Design
- Annual and Long-term Incentive Plan Design
- Strategies for Monitoring the Effectiveness of Incentive Plans
- Compensation Committee's Role in Incentive Plan Design
- Market Data for Reference

# Essential Inputs into Incentive Plan Design

Designing an effective incentive plan requires consideration of various inputs to ensure alignment with the bank's goals, drives the right behavior, and attracts, retains and motivates key talent. Key inputs include:

- Business and strategic objectives
- Company culture
- Alignment with stakeholders
- Understanding the competitive market
- Risk management
- Legal and regulatory compliance

It is essential to involve relevant stakeholders, including senior management, human resources, risk management, and legal teams, in the design of an effective incentive plan

# Strategies to Ensure Effective Incentive Plan Design

Key strategies to create an incentive plan that effectively motivates employees, drives desired behaviors, and contributes to the bank's success include:

- Clear alignment with business goals
- Communication and transparency
- Balanced metrics
- Performance differentiation
- Attainable targets
- Annual review
- Risk consideration

# Annual Incentive Plan Design

## Types of Annual Incentive Plans

### Goal Attainment

- Formulaic
- Utilizes weighted financial metrics measured on a quantitative basis
- Set threshold, target, and maximum performance goals
- Determine payout as a percentage of target

### Discretionary

- Holistic performance evaluation at year-end based on quantitative and qualitative criteria to determine a payout
- No fixed formula, giving the Compensation Committee flexibility in considering various outcomes to determine the payout

### Hybrid

- Formulaic plan with discretionary component
- Balances flexibility and objectivity by incorporating quantitative and qualitative criteria to determine a payout

# Annual Incentive Plan Design

## Metric Selection

- Metrics should balance various priorities for the bank; common metrics include:

### Growth

- Pre-provision net revenue growth
- Deposit growth
- Loan growth
- Earnings per share / income growth

### Profitability/ Returns

- Efficiency ratio
- Return on equity
- Return on assets
- Margin

### Credit/ Asset Quality

- Net charge-off ratio
- Non-performing assets / loans ratio
- Capital ratios

### Strategic

- Customer experience
- Diversity, equity & inclusion
- Merger integration
- Investments in technology



# Annual Incentive Plan Design

## Absolute vs. Relative Measurement

- Absolute measurement most common in annual plans across industries, including banks
- Relative measurement helpful if market conditions change during year
- Some banks with goal attainment plans use relative measurement
- Banks with discretionary or hybrid plans often consider relative performance as part of the holistic performance evaluation

# Annual Incentive Plan Design

## Sample Goal Attainment Plan

Metric	Weight	Performance Goals			Actual Result	Payout as % of Target
		Threshold	Target	Maximum		
Net Income (\$mm)	50%	\$24.0	\$30.0	\$36.0	\$34.0	167%
Efficiency Ratio	20%	65.0%	60.0%	55.0%	58.0%	140%
Deposit Growth (\$mm)	15%	\$64.0	\$80.0	\$96.0	\$88.0	150%
Loan Growth (\$mm)	15%	\$80.0	\$100.0	\$120.0	\$110.0	150%

<b>Payout as % of Target</b>	<b>50%</b>	<b>100%</b>	<b>200%</b>	<b>156%</b>
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Example Bonus Payout:

<b>Salary</b>	x	<b>Target Bonus % of Salary</b>	x	<b>Payout % of Target</b>	=	<b>Actual Bonus Payout</b>
\$500,000		50%		156%		\$390,833

# Annual Incentive Plan Design

## Sample Discretionary Plan

- Consider performance across various categories:

Category	Criteria
“What” we achieved	<ul style="list-style-type: none"><li>▪ Assess unadjusted financial performance vs. plan across multiple metrics</li><li>▪ Consider impact of potential adjustments (e.g., M&amp;A)</li></ul>
“How” we achieved it	<ul style="list-style-type: none"><li>▪ Review additional metrics (e.g., asset and credit quality, risk outcomes)</li></ul>
Performance vs. peers	<ul style="list-style-type: none"><li>▪ Consider how bank performed vs. peers on key metrics</li></ul>
Effective management	<ul style="list-style-type: none"><li>▪ Consider how the management team adapted to challenges during year</li><li>▪ Consider from employee, customer, and community perspective</li></ul>
Customer experience	<ul style="list-style-type: none"><li>▪ Assess customer satisfaction scores vs. previous years</li></ul>
Strategic Initiatives	<ul style="list-style-type: none"><li>▪ Assess progress vs. strategic initiatives (e.g., digital transformation)</li></ul>
Human Capital	<ul style="list-style-type: none"><li>▪ Assess progress on diversity, equity and inclusion goals</li></ul>

# Long-term Incentive Plan Design Vehicles

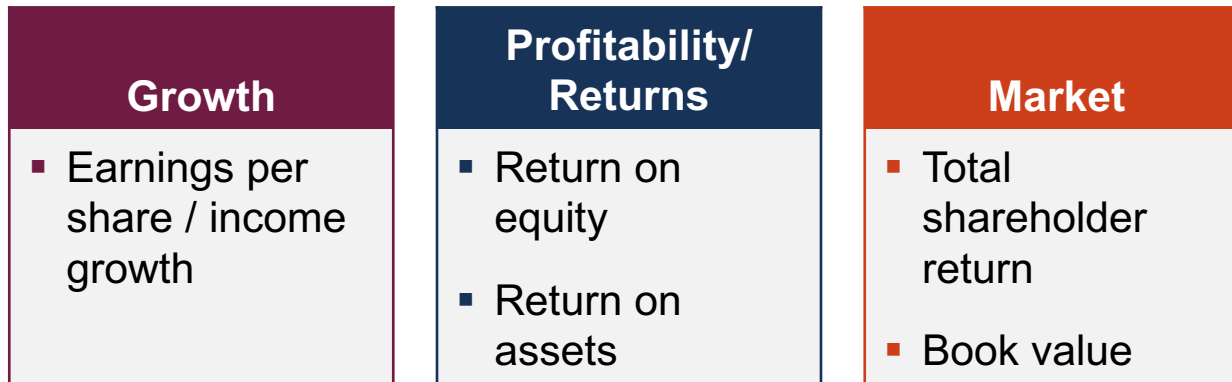
- Different long-term incentive vehicles are appropriate in different situations; some banks use a “portfolio approach” with multiple vehicles

Vehicle	Most Common Use	Design Considerations
Time-based Restricted Stock / Units	<ul style="list-style-type: none"> <li>▪ Public banks</li> </ul>	<ul style="list-style-type: none"> <li>▪ Vesting period (e.g., 3 years)</li> <li>▪ Vesting type (e.g., ratable, cliff)</li> </ul>
Performance Plan	<ul style="list-style-type: none"> <li>▪ Public banks use performance equity</li> <li>▪ Private banks use performance cash</li> </ul>	<ul style="list-style-type: none"> <li>▪ Cash vs. equity</li> <li>▪ Performance period (e.g., 3 years)</li> <li>▪ Performance metrics</li> <li>▪ Absolute vs. relative measurement</li> </ul>
Stock Options / Stock Appreciation Rights	<ul style="list-style-type: none"> <li>▪ Private banks</li> <li>▪ As part of a portfolio of vehicles for public banks</li> </ul>	<ul style="list-style-type: none"> <li>▪ Vesting period and type</li> <li>▪ Term</li> </ul>

# Long-term Incentive Plan Design

## Metric Selection

- Most common long-term metric is return on equity (or return on tangible common equity)
- Total shareholder return and earnings per share/net income are also common, typically combined with return on equity



# Long-term Incentive Plan Design

## Absolute vs. Relative Measurement

- Most banks use relative measurement in long-term performance plans
- Some banks use a combination of relative and absolute measurement

### Absolute

- Creates alignment with business plan
- Credible multi-year goals
- Changes in market conditions (e.g., interest rates, credit environment) impact credibility of goals
- Common for book value; some use for return metrics and income growth

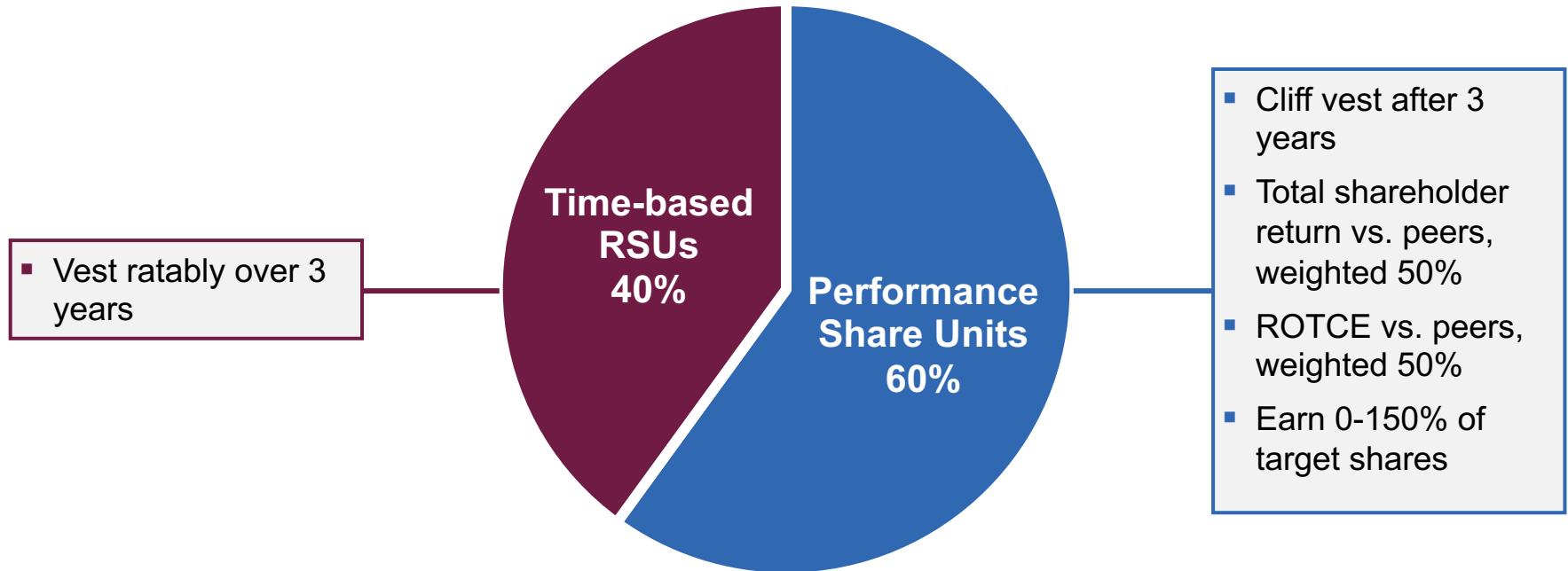
### Relative

- Mitigates impact of changes in market conditions on incentive plan
- Comparator group selection (peer group vs. index)
- Common for total shareholder return, return metrics; some banks use for income growth

# Long-term Incentive Plan Design

## Sample Public Company Design

- Public bank with two equity-based long-term incentive vehicles



# Long-term Incentive Plan Design Vehicles for Private Companies

- Prevalence of long-term incentive plans at private companies is increasing. Common vehicles include:

Long-Term Incentive	Vehicle
Real Equity	<ul style="list-style-type: none"><li>▪ Restricted stock awards/units</li><li>▪ Performance share units</li><li>▪ Stock options</li><li>▪ Profits interests (for LLCs)</li></ul>
Phantom Equity	<ul style="list-style-type: none"><li>▪ Phantom stock</li><li>▪ Stock appreciation right</li></ul>
Long-Term Cash	<ul style="list-style-type: none"><li>▪ LT cash plan (multi-year bonus)</li><li>▪ Dollar-denominated performance unit</li></ul>



# Long-term Incentive Plan Design

## Sample Private Company Design

- Private bank long-term incentives typically limited to most senior executives
- Most use one long-term vehicle, though some may use portfolio approach

### Example 1: Long-term Cash

- Cliff vests after 3 years
- Pays between 0% and 200% of target value based on performance
- Two metrics: Absolute net income growth (weighted 50%) and relative ROE (weighted 50%)
- Settled in cash upon vesting

### Example 2: Stock Appreciation Right

- Vests ratably over 3 years
- Exercisable between vest and the 5<sup>th</sup> anniversary of grant
- Settled in cash upon exercise
- Exercise price = fair market value on grant date based on 3<sup>rd</sup> party valuation

# Strategies for Monitoring the Effectiveness of Incentive Plans

Monitoring the effectiveness of an incentive plan is critical to ensure they are achieving their intended goals and driving the right behavior. Key strategies include:

- Review rigor of performance goals
- Evaluate alignment of performance metrics and strategic objectives
- Conduct pay vs. performance assessment
- Review payout historical payout distribution relative to market norms
- Assess if the incentive plan is contributing to an appropriate level of risk-taking
- Calculate sharing ratios
- Assess competitiveness of design relative to market

# Compensation Committee's Role in Incentive Plan Design

The Compensation Committee plays a critical role in the design, oversight, and governance of incentive plans. Key responsibilities for incentive plan design include:

- Plan design and review relative to:
  - Alignment with overall business strategy, goals, and risk tolerance
  - Market competitiveness
  - Participant understanding
- Metric and performance evaluation
- Performance assessment and adjustments
- Approval of the final design and payout



# Market Data for Reference

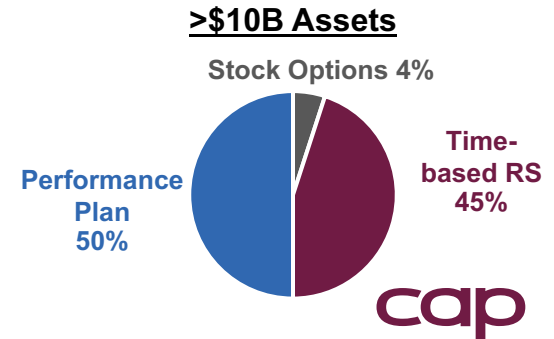
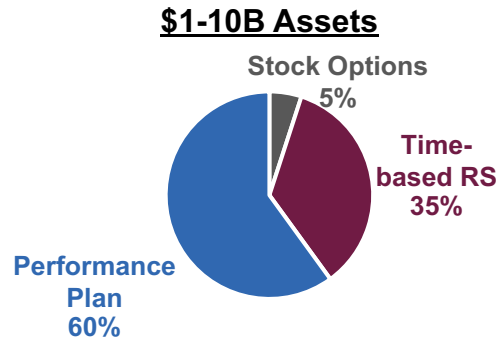
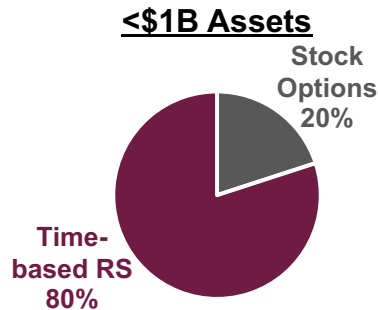
# Annual Incentive Plan Design Metrics

- Top 5 metrics by asset size:

	<\$1B	\$1-10B	>\$10B
1	Net Income / EPS	Net Income / EPS	Net Income / EPS
2	Return on Assets	Efficiency Ratio	Asset Quality
3	Deposit and Loan Growth	Return on Assets	Efficiency Ratio
4	Return on Equity	Deposit and Loan Growth	Return on Assets
5	Asset Quality	Asset Quality	Return on Equity

# Long-term Incentive Plan Design Vehicles and Mix

- **Time-based restricted stock / units:** Common among banks of all sizes
- **Performance-based stock / units:** Common among banks with assets >\$1B; not common among banks with <\$1B in assets
- **Stock options:** limited use among banks with assets >\$1B; more common among smaller banks and private banks
- Average mix by asset size:



# Long-term Incentive Plan Design Metrics

- Top 4 metrics by asset size:

	<\$1B	\$1-10B	>\$10B
1	Insufficient Data	Total Shareholder Return	Total Shareholder Return
2	Insufficient Data	Return on Equity	Return on Equity
3	Insufficient Data	Return on Assets	Return on Assets
4	Insufficient Data	Net Income / EPS	Net Income / EPS

# Creative Solutions from a Dedicated Team



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