



**Pearl Meyer**

**Bank**Director®

Bank Director Compensation & Talent Conference

Breakout IV—More Than Simply Moving the Incentive  
Goal Posts: Make Sure the Relationship Between Rigor  
and Opportunity is Right

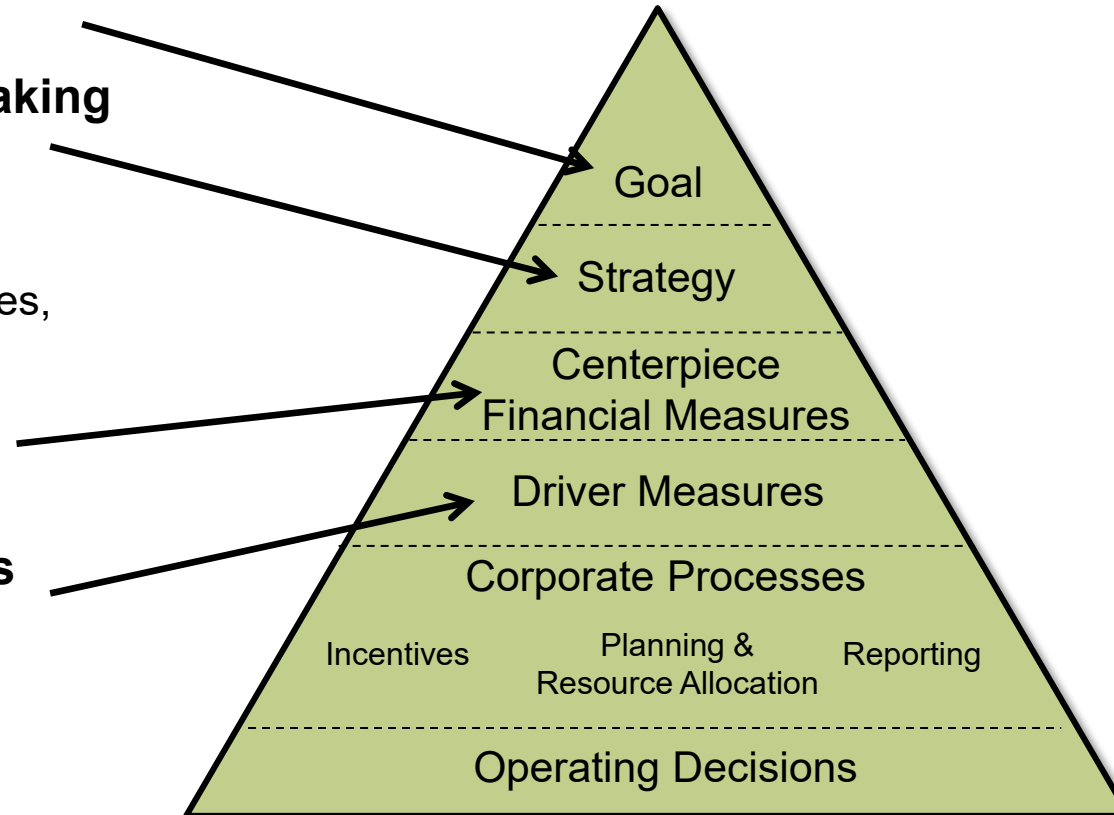
November 9, 2021

Dan Wetzel, Managing Director

Greg Swanson, Managing Director

# Performance measures are a critical link between stated business strategy and management execution

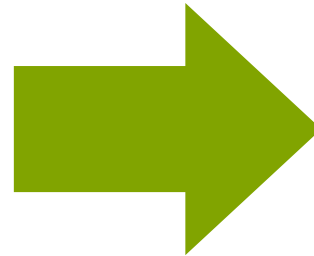
- **Maximize shareholder value**
- **Bank-specific path to value-creation taking into account**
  - Market economic, competitive position
  - Bank strengths, weaknesses, opportunities, and risks
- **Specific/relevant financial measures, balancing growth and returns**
- **Operational measures tied to business strategy**



- In general, for the average management team, a good rule of thumb is that:
  - Superior performance is achieved **10% - 20%** of the time
  - Target performance or better is achieved **50% - 60%** of the time
  - Threshold performance is achieved **80% - 90%** of the time
  
- Certainly, a superior management team may achieve high performance levels more often, but...
  - Does the company's stock price performance support such a belief?
  - Are you confident that the measures of performance really matter to shareholder value?

## Traditional Approach

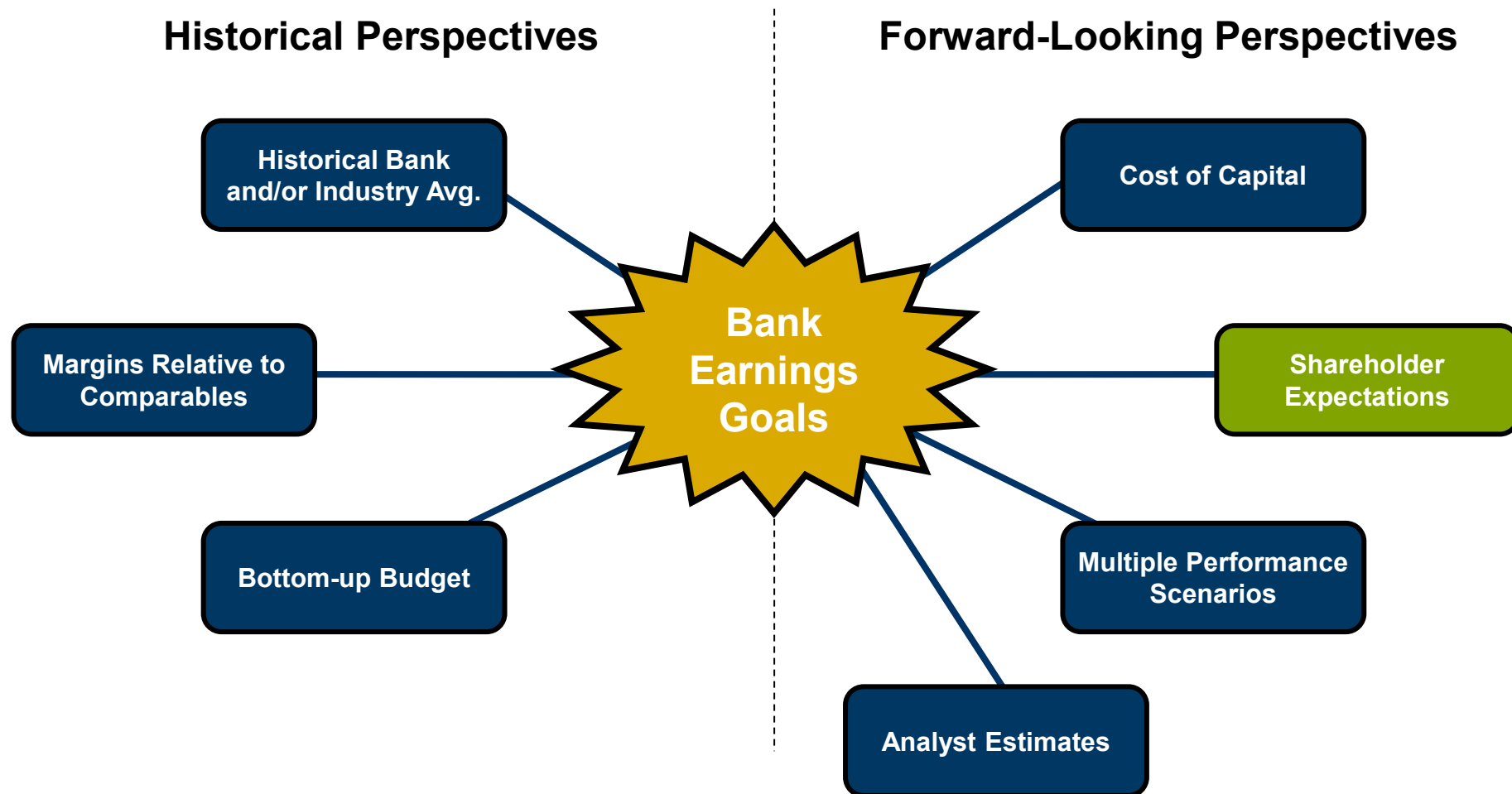
- **Budget-driven**
- **Target-focused**
- **Compensation committee involved at the end of the process**



## Today's Required Approach

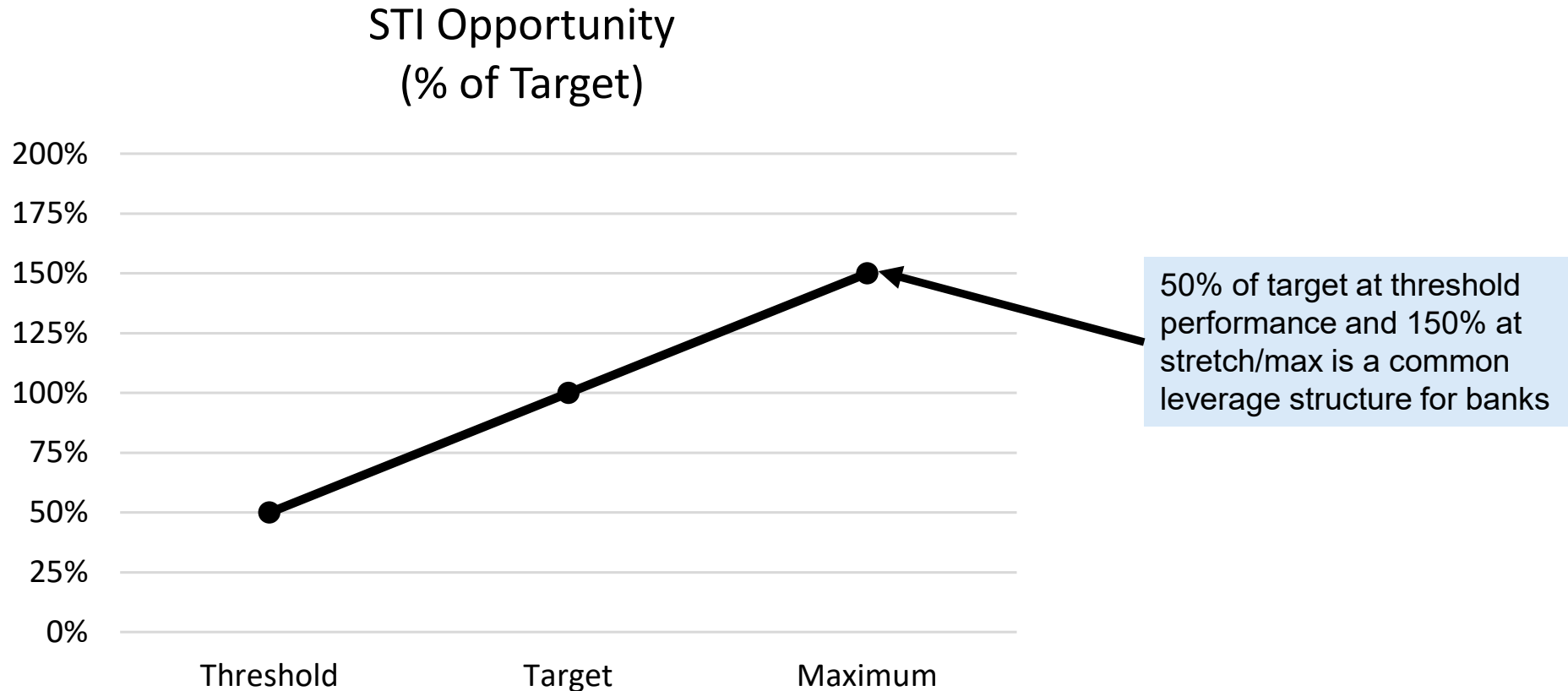
- **Multiple performance perspectives**
- **Multiple pay/performance scenarios considered**
- **Early, active involvement of the compensation committee**

# Goal-setting should incorporate multiple perspectives on performance expectations

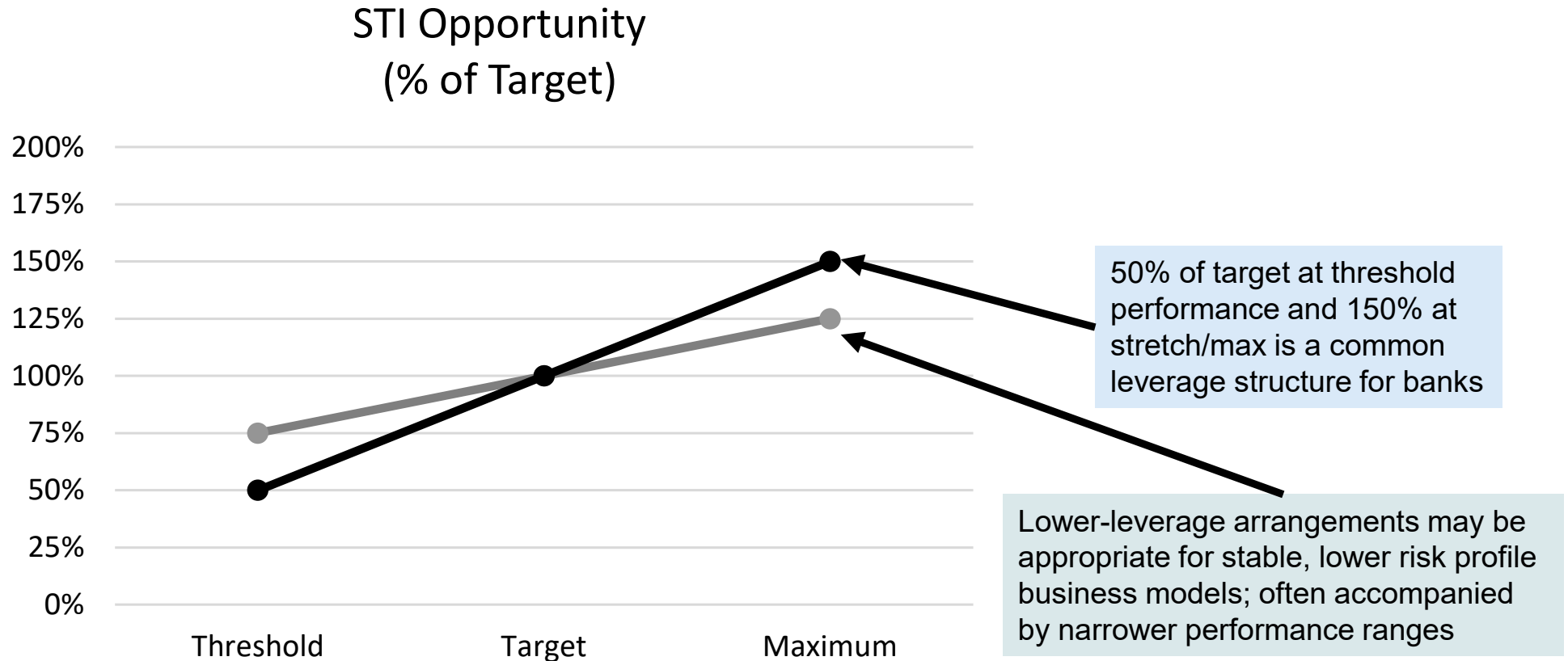


- The pursuit of alignment between executive pay and company performance is an ongoing endeavor
- Compensation committees can, and should, learn from the past and make appropriate adjustments
- Calibrating payout opportunities => the easier part of the equation
- Calibrating the rigor of performance goals => more complex and challenging

- The “leverage” of an incentive plan is a key design element => What happens to payout opportunities when performance is above or below target?
- The range of payout opportunities should reflect the philosophy and business model of the company (e.g., growth orientation, risk profile, leadership strategy)

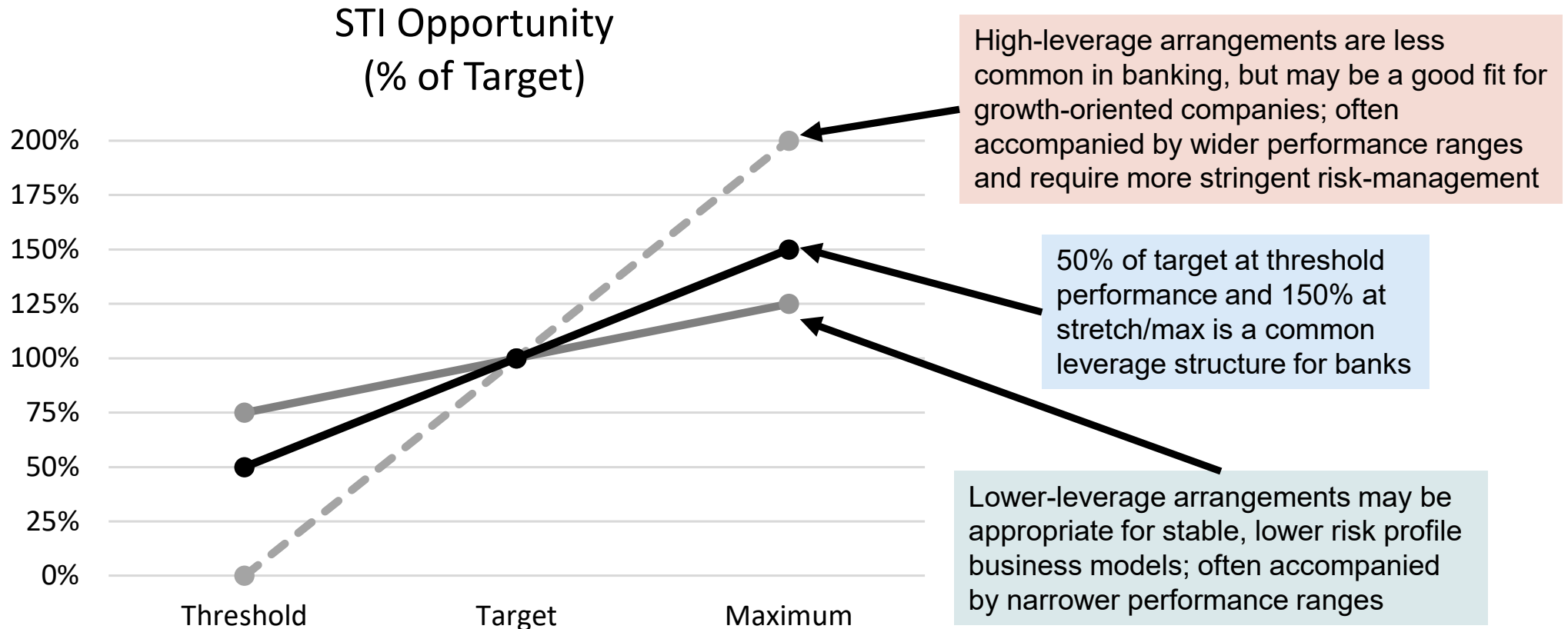


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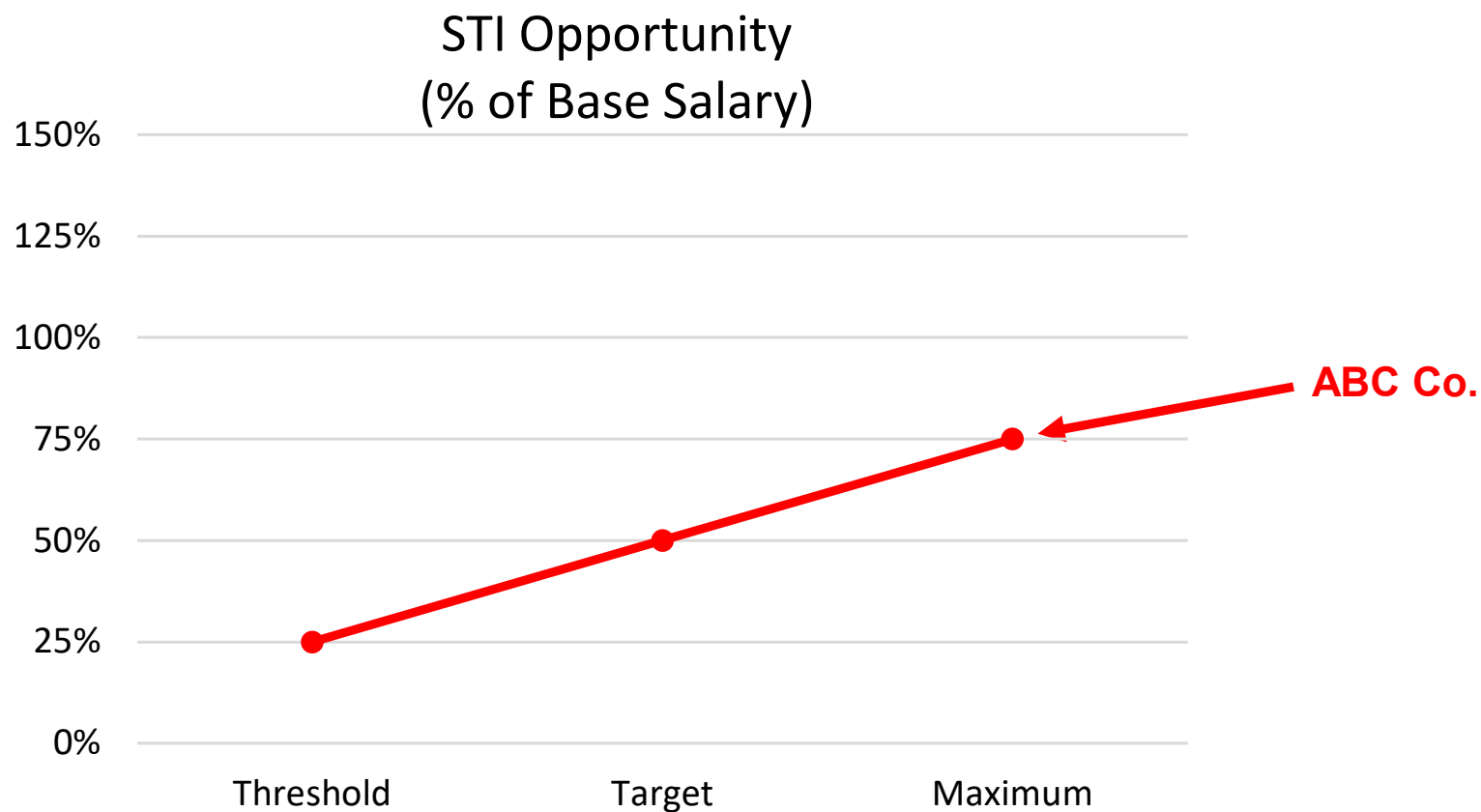




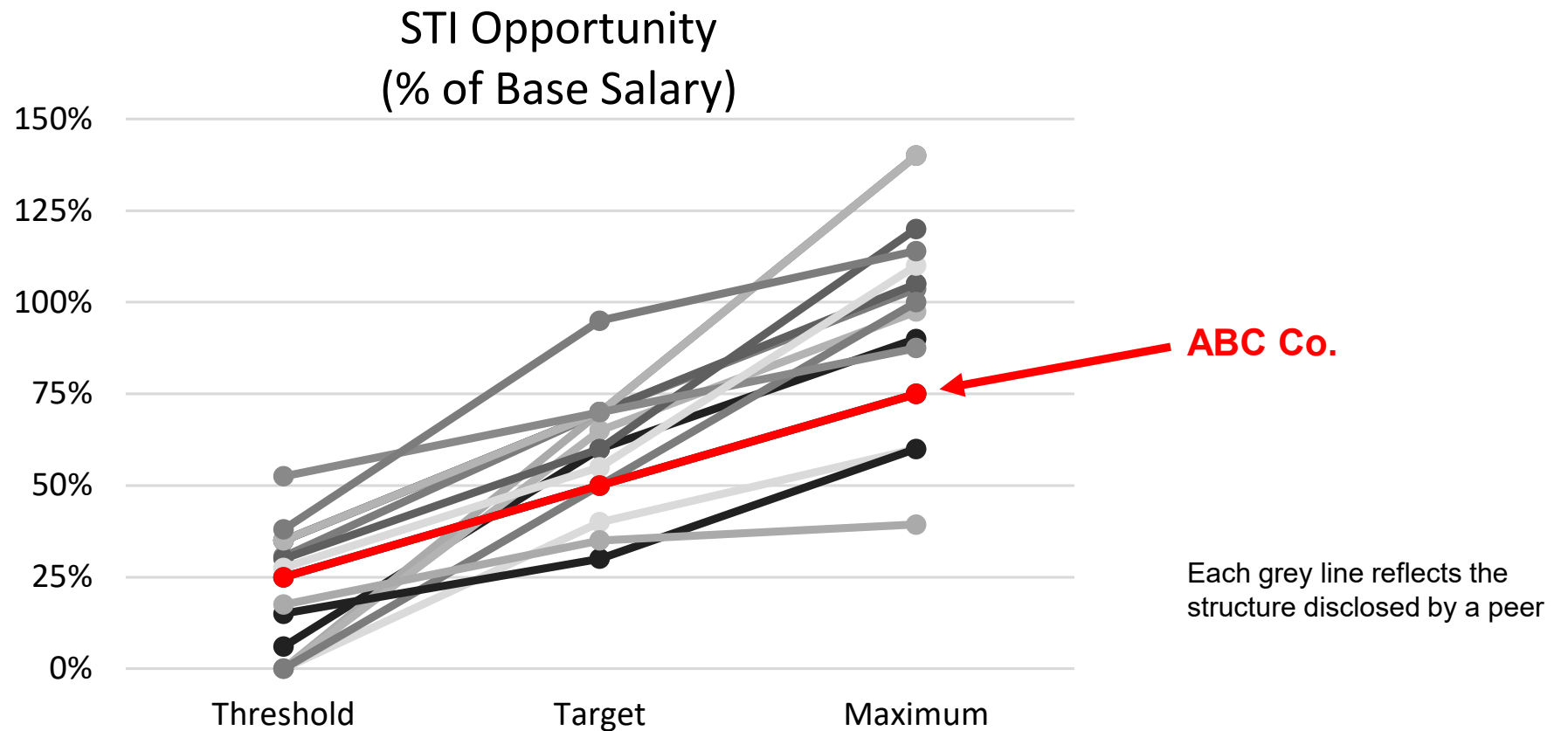
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Goal calibration can take several forms, but the building blocks are consistent.

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| 6. Analyze/interpret the results  |   |
| 7. Use the findings to either validate your confidence in the proposed goal structure or inform appropriate adjustments prior to finalizing the structure | <i>Time the analysis so that it can inform the coming year’s incentive structure; can be conducted concurrent with the budget approval process</i>    |

As part of your analysis and interpretation of the data, there are three key examinations to undertake:

### **1. How challenging is your budget?**

- Incentive plan goals are commonly tied directly to the board-approved budget for the year, with budgeted performance resulting in “target” payout opportunity.
- Your directional performance trend in recent years (and possibly analyst estimates for the coming year) may give an indication whether your budget is too aggressive or too soft to warrant target-level payouts and motivate the desired behaviors.

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### **2. What if your incentive plan goals were imposed on your peers?**

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### **3. Do we have the right performance-payout leverage relationships for each goal?**

- A goal calibration analysis will shed light on the likeliness of achieving the proposed threshold, target and stretch performance requirements, and may indicate the need for adjustments to achieve the desired performance-pay relationship.

Goal calibration is not a perfect science ... consider the following:

- ✓ Remove “noise” in the data when possible – incentive goals are normally based on projected organic results for the coming year; consider evaluating historical data on a “core” basis
  - For example – if your incentive plan goal is GAAP ROAA, consider using Core ROAA data to remove the nonrecurring items associated with M&A activity

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- ✓ Some incentive plan metrics may not be directly comparable across companies; consider using “proxy” metrics in these situations
  - Example – if your incentive plan metric is Net Income, consider using Core ROAA or Core ROAE (or both) as a more comparable indication of the implied rigor of the proposed goals

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- ✓ Exercise business judgment (common sense) when evaluating the data
  - A goal calibration exercise is meant to provide valuable context for decision-making purposes ... it should not be expected to make the decisions for you



The rest of the session will be focused on examples of approaches to goal calibration:

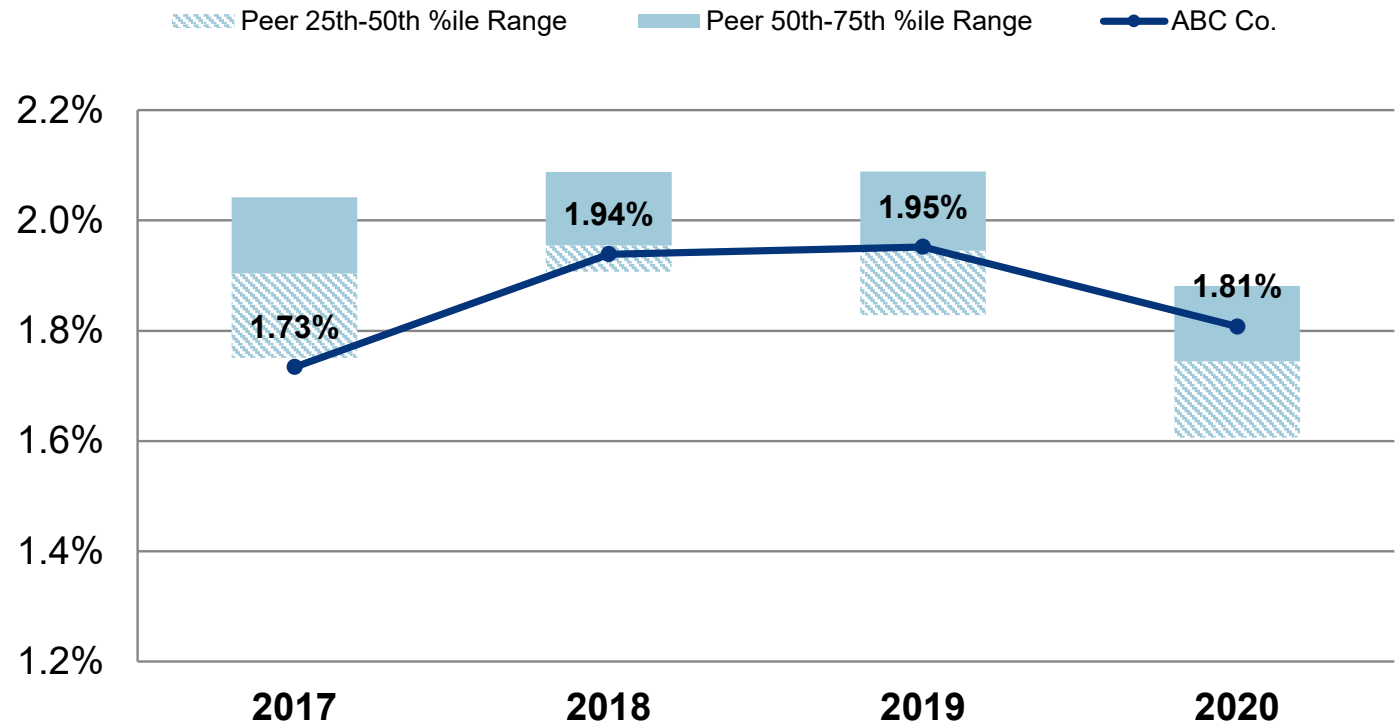
- Application to a variety of performance metrics – operating returns, growth, efficiency
- Illustration of alternative approaches – historical trends-based, probability-based

# Example #1: Operating return goal; trends-based approach

## Evaluating management's proposed goals in a volatile environment

- Reviewing recent performance history of your company and relevant peers can provide helpful context for market trends and your relative performance on a specific incentive plan metric
- In this illustration, recent performance for the company and the peers more broadly has been trending downward, but relative performance has shown improvement (from median to between median and 75<sup>th</sup> percentile)

### Core Pretax Pre-Provision ROAA ABC Co. vs Peers

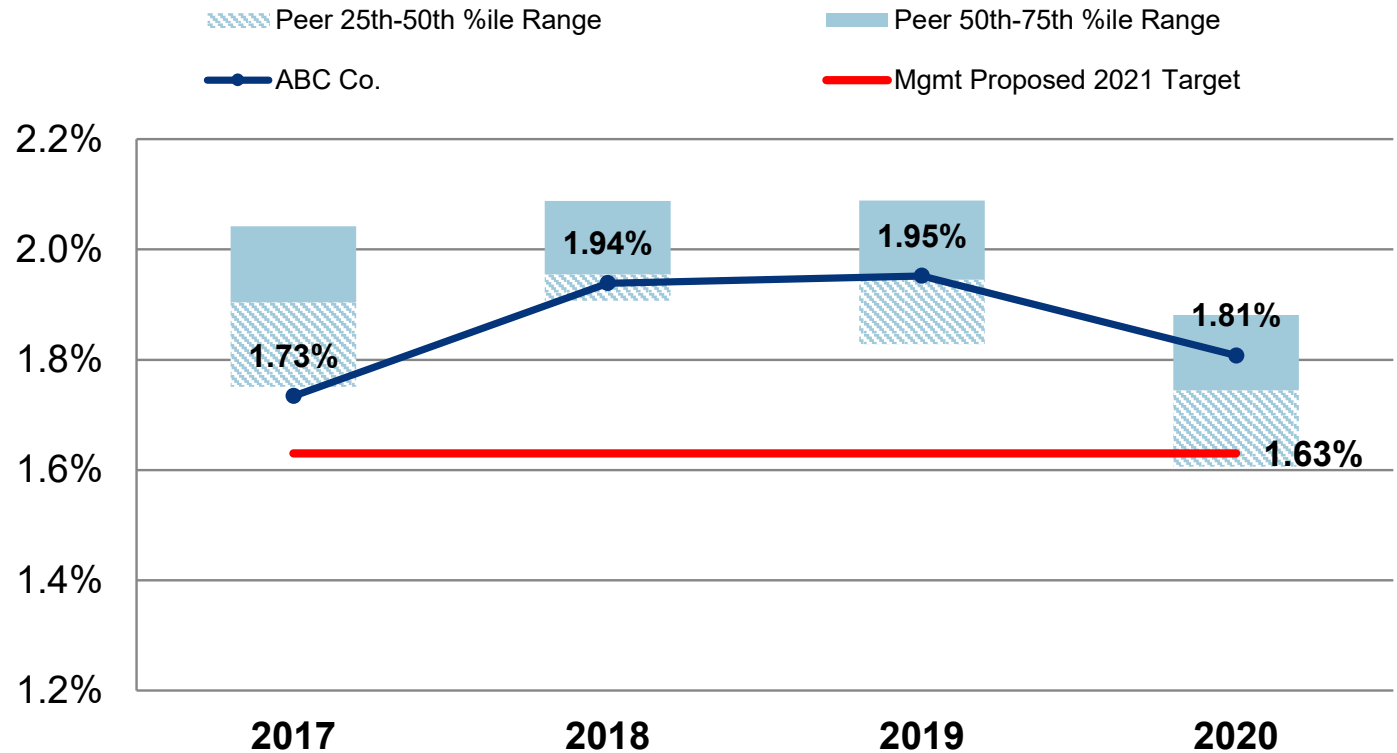


# Example #1: Operating return goal; trends-based approach

## Evaluating management's proposed goals in a volatile environment

- The target performance goal proposed by management (equal to the board-approved budget) is significantly lower than historical performance of the company and its peers
- Without additional context, this could raise concern by the compensation committee that insufficient rigor is being represented by the proposed requirement for target payout on this metric

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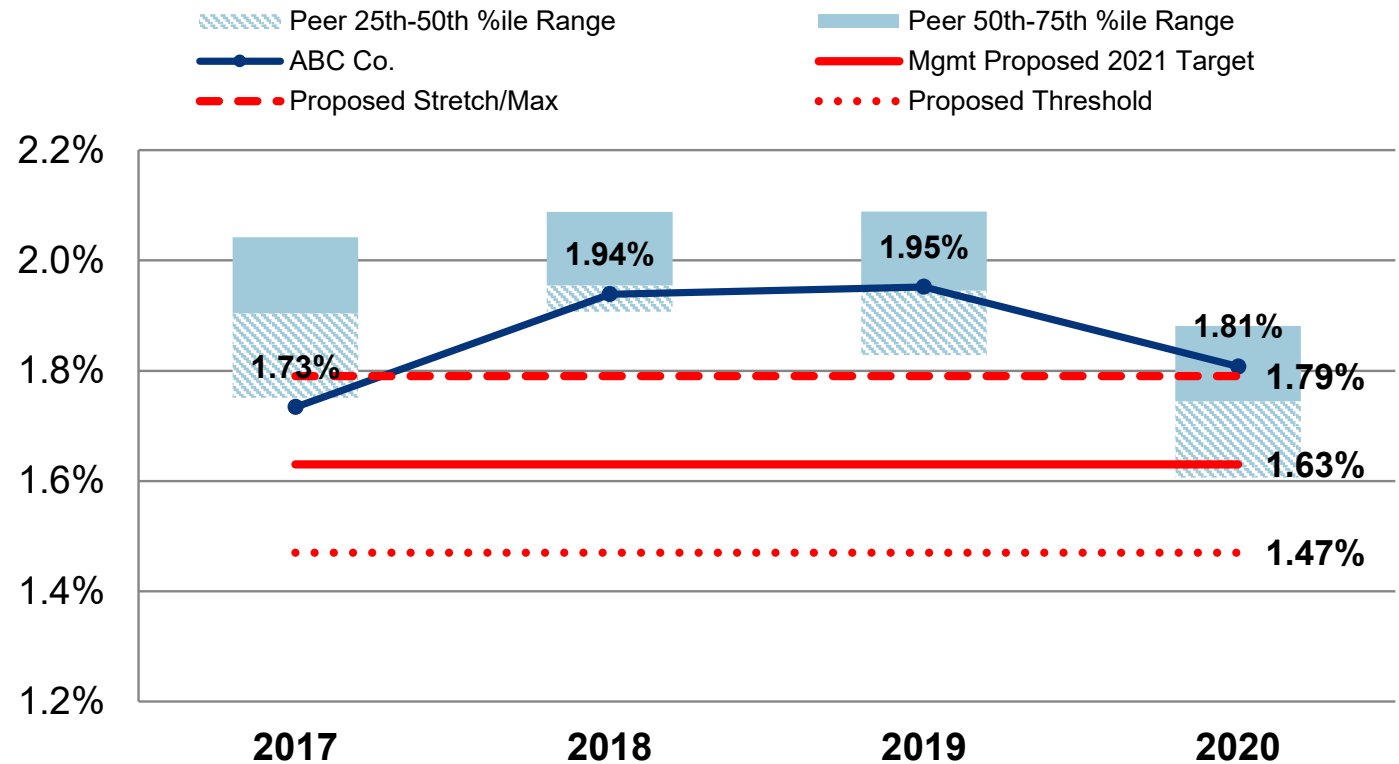


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- Proposed performance requirements for threshold and maximum payout could raise similar concerns
- Performance on this metric each of the last four years would have resulted payout well above target, and at maximum each of the last three years

**Core Pretax Pre-Provision ROAA**  
ABC Co. vs Peers

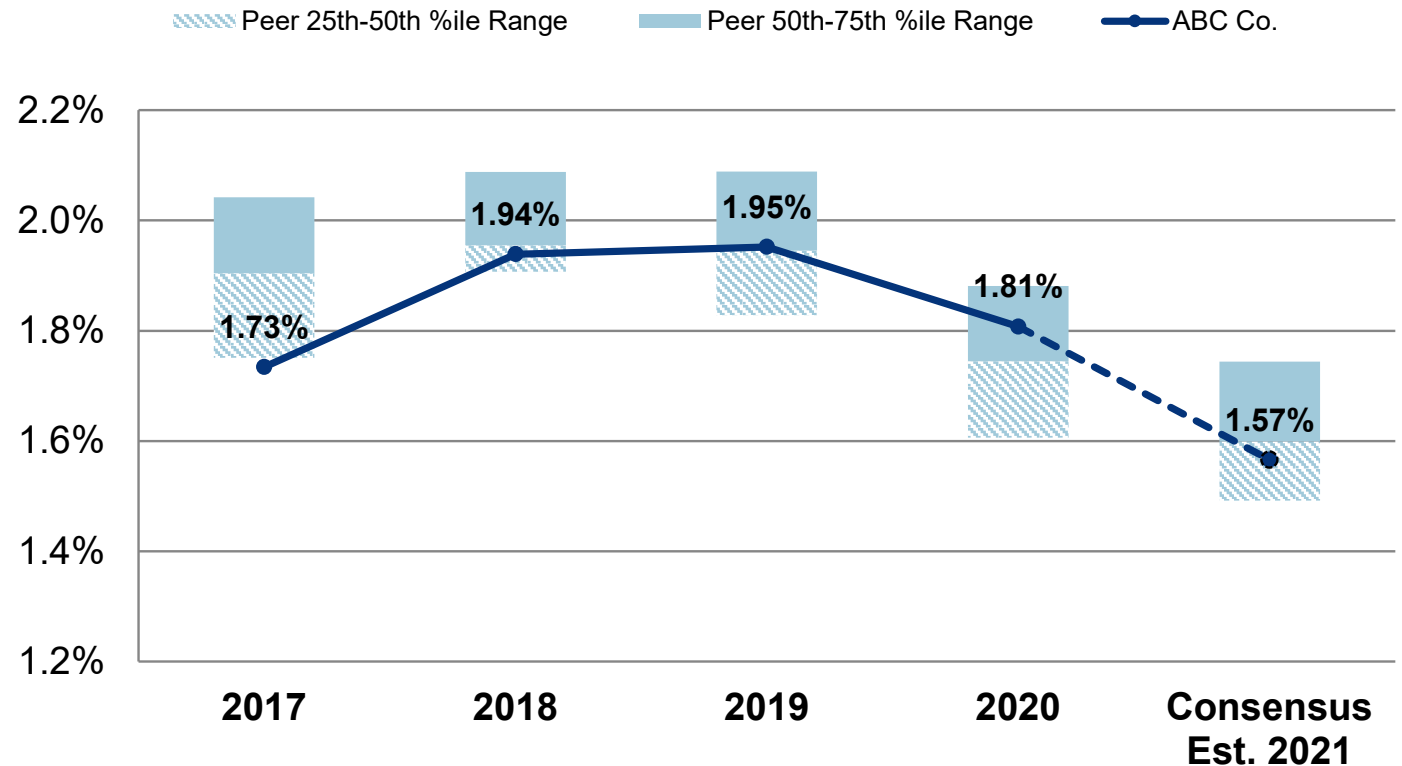


# Example #1: Operating return goal; trends-based approach

## Evaluating management's proposed goals in a volatile environment

- In a volatile environment, it may be helpful to gather consensus analyst estimates for your company and the peers to see directional market expectations
- Note: We don't generally recommend using analyst estimates to set performance goals, but they can be helpful context in certain situations

### Core Pretax Pre-Provision ROAA ABC Co. vs Peers

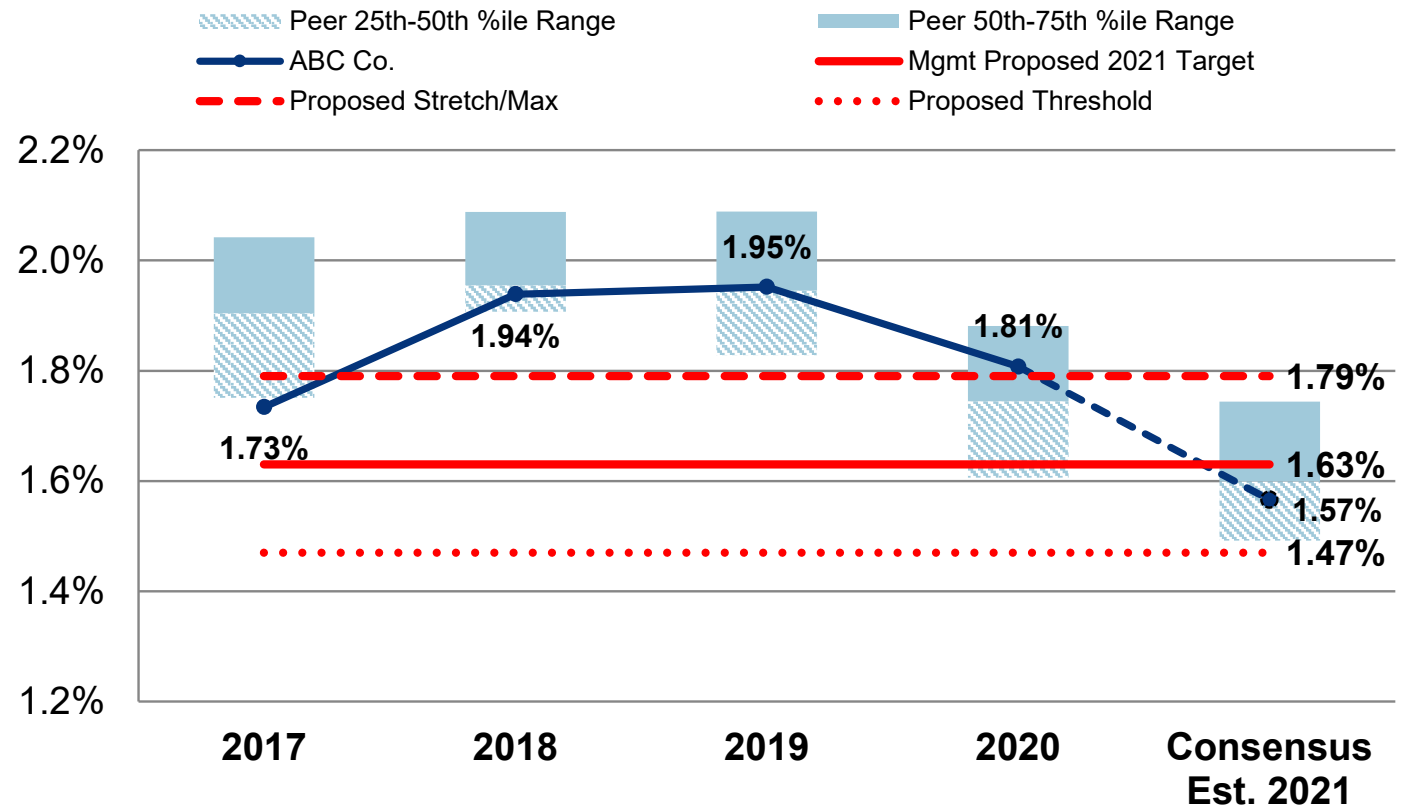


# Example #1: Operating return goal; trends-based approach

## Evaluating management's proposed goals in a volatile environment

- Mapping the goal structure against both historical data and analyst projections can help provide the context needed by the compensation committee to evaluate the rigor of the proposed goals

**Core Pretax Pre-Provision ROAA**  
ABC Co. vs Peers

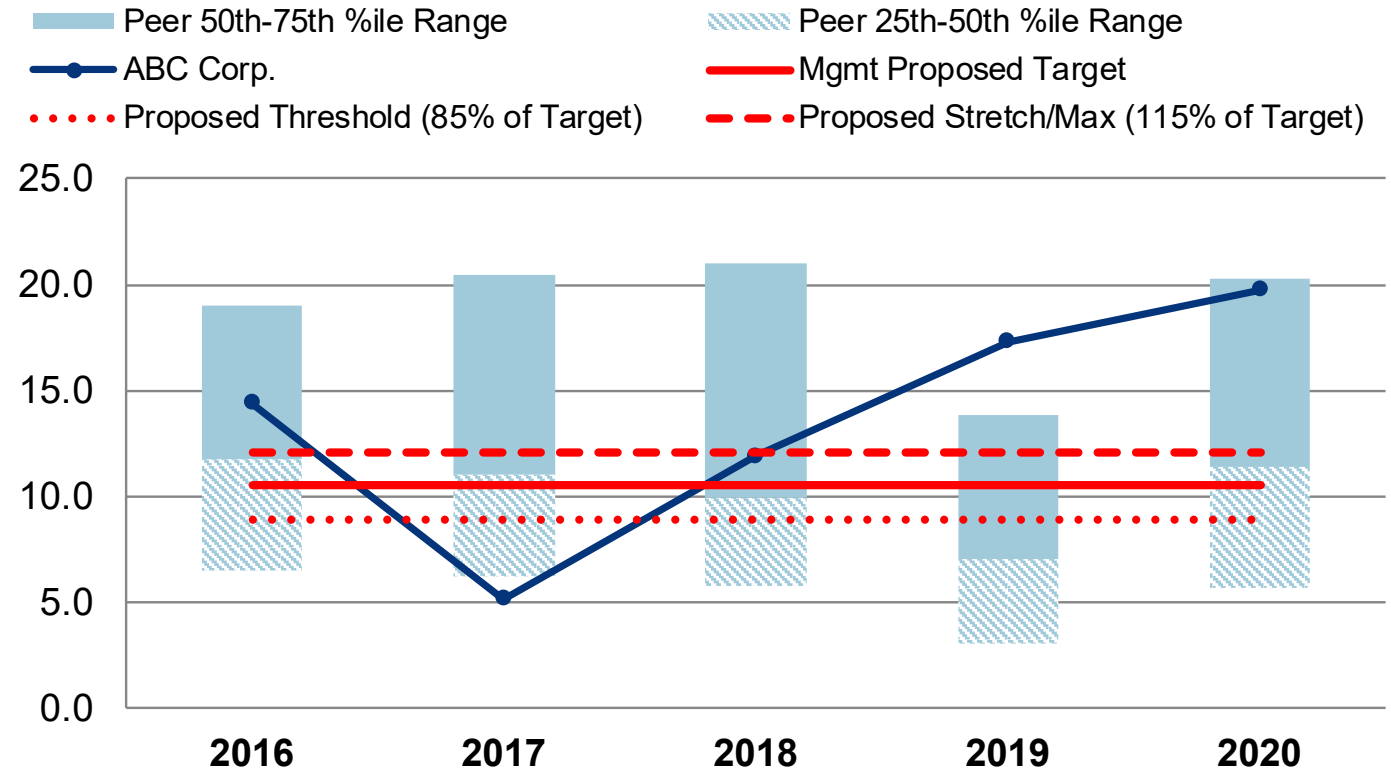


## Example #2: Growth goal; trends-based approach

### Evidence that a wider performance range is appropriate

- The range on either side of target for threshold and stretch/maximum performance should be tailored to the specific metric
- Year-over-year growth metrics can tend to be much more volatile than other metrics
- While +/- 15% of target may be an appropriate range for some metrics, the example here illustrates that both ABC Corp's and peer historical YoY loan growth results indicate that a much wider range would be more appropriate
- Note: The proposed target for year-over-year growth appears reasonable, but ABC Corp. didn't fall within the threshold – stretch/max range in any of the last 5 years (i.e. would have resulted in either zero or maximum payout in all years)

### Growth in Gross Loans HFI (%)

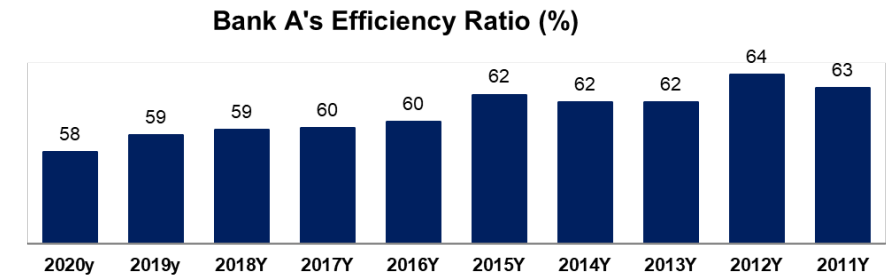
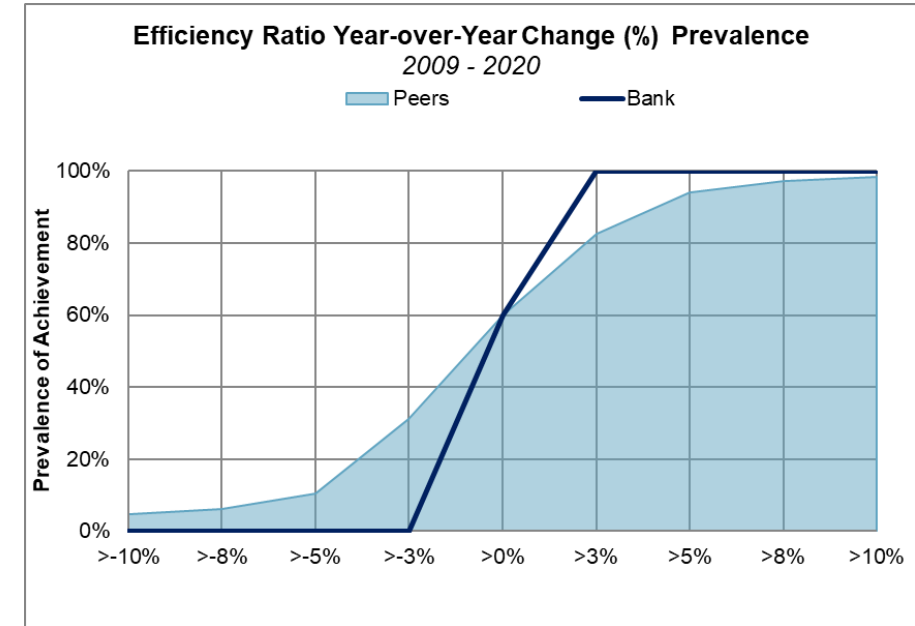


# Example #3: Efficiency ratio goal; probability-based approach Applying the 80/20 Rule

- Bank A traditionally utilized wide range for efficiency goal changes (e.g. +/-10%)
- Comparison of historic practice indicates +/- 0.3% was typical outcome
- Comparison to peer practice also indicated +/- 2% range based on 80/20 rule
- Indicates performance range unlikely to pay out at minimum or maximum

| Efficiency Ratio  |           |        |         |
|---|-----------|--------|---------|
|   | Threshold | Target | Maximum |
| Historical Probability of Achievement                         |           |        |         |
| Bank '21 Goals  | 64%       | 59%    | 53%     |
| Bank  | 100%      | 10%    | 0%      |
| Peers   | 65%       | 41%    | 23%     |
| Historical Probability of Achievement (Year-over-Year Change) |           |        |         |
| Bank '21 Goals vs. 20   | 6.77%     | 0.92%  | -4.93%  |
| Bank  | 100%      | 80%    | 0%      |
| Peers   | 96%       | 68%    | 10%     |
| Efficiency Ratio (Year-over-Year Change)                      |           |        |         |
| Bank '21 Goals vs. 20   | 7%        | 1%     | (5%)    |
| Bank Historic   | 1%        | (0%)   | (2%)    |
| Peers   | 2%        | (1%)   | (4%)    |

Less requiring than predicted  
More requiring than predicted





# QUESTIONS

