



How Should You Determine Executive Bonuses?



human resources leadership employees

Summary: Finding the right amount to award your executives for bonuses can be a challenge. Compensation committees that use discretion in determining incentive payouts risk receiving criticism from investors and proxy advisory firms, whose policies tend to prefer formulaic incentive plans. However, discretion is an important feature of many banks' annual incentive plans that, if used appropriately, can enhance the relationship between executive and CFI.

Last July, the Pittsburgh Pirates baseball team set the record for the highest signing bonus ever paid to a major league baseball player. The [\\$9.2MM bonus was offered to Paul Skenes](#), a 21-year-old, right-handed pitcher who posted an impressive 1.69 earned run average across 122 innings, among achieving many other eye-catching stats this past season.

Although a seven-digit bonus isn't feasible for any but the largest corporations and institutions, companies do want to reward top executives for hitting the mark and driving success. Like other workers, executives at community financial institutions (CFI) appreciate knowing the metrics by which they'll be judged when it comes to determining their incentivized compensation. In general, that's what they get: a set of metrics that are clearly tied to business performance and that executives can directly impact, based on how effectively they do their jobs. When they move the needle on these metrics in positive directions, their incentive pay goes up.

That model is called a formulaic incentive plan. It contrasts with [discretionary incentive plans](#), which let the employer award or withhold payment entirely at its own discretion, with neither amount nor timing known to employees ahead of time. The amount you pay your babysitter is formulaic: a certain amount per hour, multiplied by the number of hours. An extra \$20 for the babysitter because the kids were especially energetic is discretionary. It recognizes exceptional performance.

Most companies emphasize formulaic incentive plans.

Not surprisingly, formulaic incentive plans are popular throughout the business world. According to an annual survey done by the compensation consultant firm Pearl Meyer & Partners, 42% of companies didn't anticipate using discretionary incentives for executives' long- or short-term goals for pay cycles ending in 2023. Those that did think they might use discretionary incentives for executives said that potential triggers included unanticipated transactions, extraordinary changes in interest rates, and restructuring charges. Just 5% anticipated possible discretion around challenges caused by the COVID-19 pandemic, a substantial drop from 14% last year. Virtually no respondents thought they might use negative discretionary incentives, and many said that it was simply too soon to tell about positive discretionary incentives.

Discretionary incentives can enhance relationships.

Although mostly formulaic incentive plans are probably the right choice for most financial institutions, there's also an argument to be made for a bit of positive, discretionary incentive pay. Discretionary incentives give CFIs flexibility to make compensation decisions that reflect overall performance while also taking surprises into account, rewarding not just a goal achieved, but how an executive achieved that goal. Perhaps executives overachieve their objectives or meet CFI goals despite unanticipated difficulties beyond their control.

Acknowledging this and providing the executive recognition of the extra lengths they may have gone to for the CFI’s success can breed goodwill and encourage similar efforts in the future.

Even discretion needs structure.

Even discretionary incentives, however, should happen inside a structure, one that offers executives, board members, and shareholders consistency, fairness, and transparency. That might mean some of the following solutions would help:

- A weighted portion of the bonus — maybe 15% to 25% — is discretionary.
- Incentive funding goes up or down by 15% to 20% based on a review of quantitative and qualitative performance criteria.
- The CFI modifies individual bonuses based on how each executive did relative to individual performance goals.
- The compensation committee chooses an overall bonus adjustment based on the year’s unplanned events.

By being clear about the ways that it will use discretion in awarding bonuses, a CFI can stay consistent and build trust while also rewarding the ways that executives go above and beyond in their professional efforts.

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ECONOMY & RATES

Rates As Of: 01/03/2024 06:40AM (GMT-0800)			
Treasury	Yields	MTD Chg	YTD Chg
3M	5.46	0.06	0.06
6M	5.24	-0.02	-0.02
1Y	4.81	0.05	0.05
2Y	4.36	0.11	0.11
5Y	3.97	0.12	0.12
10Y	3.99	0.11	0.11
30Y	4.13	0.10	0.10
FF Market	FF Disc	IORR	
5.33	5.50	5.40	
SOFR	Prime	OBER	
5.40	8.50	5.32	

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