Pearl Meyer

ADVISOR BLOG

Five Steps to Adapt Your Lender Incentives Scorecard for Maximum Results

AUTHOR

Laura Hay
Managing Director

Banks often have a love/hate relationship with their lending incentive programs. On one hand, the program should incent lenders to book loans and lots of them. But on the other hand, run-off, loan quality, and long-term business relationships also greatly matter. Because of all the competing priorities, a common plan design is to use a balanced scorecard (like the example below) that is measured and paid out on an annual basis.

Performance Measures	Incentive at Target	Weight	Performance Goals		
			Threshold	Target	Superior
Average Core Deposits	$X,XXX	30%	TBD	TBD	TBD
Average Loan Portfolio	$X,XXX	30%	TBD	TBD	TBD
Asset Quality & Portfolio Mgmt	$X,XXX	20%	TBD	TBD	TBD
Qualitative Assessment	$X,XXX	20%	TBD	TBD	TBD
Grand Total	**$XX,XXX**	**XX%**			

While there is nothing “wrong” with a scorecard plan design, there is always a nagging feeling that it doesn’t create the excitement or the line of sight that a more immediate payout could provide. The following is a hybrid approach that strives to harness a lender’s motivation and momentum while keeping a check on credit quality, deposit growth, and other portfolio management responsibilities.

October 2018

We suggest a five-step approach to adapt your incentive scorecard for maximum results:

1. Break out loan generation from the rest of the scorecard.
2. Get clear on what should be in and out of the annual scorecard.
3. Introduce performance-based equity or deferrals into the compensation structure.
4. Incorporate other risk mitigators.
5. Realize that not everything can be easily measured and allow for discretion.

Step 1: Break out loan generation from the rest of the scorecard

By breaking out loan generation and paying a quarterly incentive, lenders are incented to close loans throughout the year and are rewarded for production over goal. The line of sight between rewards and payment are more immediate, creating additional momentum.

For example, assume lenders must achieve 100% or greater on their cumulative year-to-date new loan production goal in order to receive a payment for the quarter. Further assume a lender has an $18 million annual goal and 10 basis points are paid per loan dollar funded. In Q1, the lender met the goal and received a payment. No incentive payment was made in Q2 because cumulative year-to-date new loan production was behind goal. The lender was over goal in Q3 and was paid $10,500 for Q2 and Q3 production ($15,000,000 – $4,500,000 = $10,500,000; $10,500,000 x .001 = $10,500). In Q4, the lender exceeds goal and continues to receive 10 basis points per loan dollar funded for a total of $20,000 in incentives rather than the $18,000 at goal.

Cumulative New Loans Funded	Q1	Q2	Q3	Q4	Total
Target New Loan Production	$4,500,000	$9,000,000	$13,500,000	$18,000,000	$18,000,000
Actual	$4,500,000	$7,500,000	$15,000,000	$20,000,000	$20,000,000
Grand Total	**$4,500**	**$0**	**$10,500**	**$5,000**	**$20,000**

Step 2: Get clear on what should be in and out of the annual scorecard

While it is tempting to want to include all the aspects in which a lender should be evaluated, incentive programs are meant to reward the critical outcomes that result in achieving annual business objectives. The more metrics, the more the bank dilutes its message on what is important for the lender to achieve. Dashboards or performance evaluations can be used for more refined feedback. For many banks, that means scorecards should reward keeping loans on the books and building deposits while maintaining credit quality, as noted in the first example.

Step 3: Introduce performance-based equity or deferrals into the compensation structure

The focus on loan production can cause some banks concern about short-term gain at the expense of long-term sustainability and rightfully so. After all, the financial crisis was a result of subpar credit standards. Consider introducing deferrals or long-term equity awards into the lender's compensation package that only vest if the quality of a commercial lenders' ongoing portfolio is acceptable. The lender will have a shared responsibility to stay on-top of credit situations.

Step 4: Incorporate risk mitigators

After the executive incentive plans, the most requested plans that regulators want to review are lending plans. Make sure that the plan includes "risk mitigators" such as clawbacks and non-payment for ethics violations. This language ensures that amounts received due to errors, omissions, or fraud are paid back. If Step 3 is implemented, repayment will be easier because unvested value is waiting to be realized and can be forfeited in those situations. Clawbacks also may be paid out of future compensation.

In addition to plan language, sound underwriting principles and approval processes are the primary way to mitigate risk. Create a good credit culture where both lenders and credit work collaboratively for the best outcomes.

Step 5: Realize that not everything can be easily measured and allow for discretion

Like all sales positions, there are a number of subjective factors that may make a calculated payment seem stingy or rich depending on the circumstances. Did the lender take over a less than stellar portfolio from a departing employee? Is the lender always asking for an exception? Does the lender make the numbers but is not a team player? Did the lender provide referrals that strengthened the business relationship with a strategic customer?

Instead of incorporating the myriad behaviors and outcomes that make one lender better than another, consider having a portion of the incentive be discretionary or qualitative so that the bank can right-size payments and reinforce valued behaviors and qualities.

Putting it all together:

Assume a lender has a $144,000 base salary and is targeted to have a 25% incentive opportunity. Progress on the annual loan production goal is paid quarterly and a scorecard of portfolio management and credit quality metrics is paid out annually. At the end of the year, the lender was between threshold and target-level performance on the annual scorecard and exceeded the loan production goal for a total payment of $36,200.

Incentive Opportunity		
Base Salary	$144,000	
Target Scorecard Incentive	$18,000	12.50%
Targeted New Loan Production Incentive	$18,000	12.50%
Total Incentives	**$36,000**	**25.00%**

Actual Incentive Paid		
Base Salary	$144,000	
Actual Scorecard Incentive	$13,500	9.4%
Actual New Loan Production Incentive	$20,000	13.9%
Total Incentives	**$33,500**	**23.3%**

A. Scorecard incentive

Performance Measures	Incentive at Target	Weight	Performance Goals			Actual Performance	Payout
			Threshold	Target	Superior		
Average Loan Portfolio	$7,200	40%	TBD	TBD	TBD	Above Maximum	$7200 x 150% = $10,800
Asset Quality & Portfolio Mgt.	$7,200	40%	TBD	TBD	TBD	Below Threshold	$7,200 x 0% = $0
Qualitative Assessment	$3,600	20%	TBD	TBD	TBD	Between Threshold & Target	$3600 x 75% = $2,700
Grand Total	**$18,000**	**100%**					**$13,500**

B. New loan productive incentive

Assume an annual loan production goal of $18 million and that the basis point incentive pays 10 basis points (.001) for each dollar of new loan production.

Cumulative New Loans Funded	Q1	Q2	Q3	Q4	Total
Target New Loan Production	$4,500,000	$9,000,000	$13,500,000	$18,000,000	$18,000,000
Actual	$4,500,000	$7,500,000	$15,000,000	$20,000,000	$20,000,000
Grand Total	**$4,500**	**$0**	**$10,500**	**$5,000**	**$20,000**

This proposed approach is different than the norm and it takes courage to lead the pack rather than follow. With a shortage of lending talent, daring to be different might be exactly what your bank needs to stand out and attract and retain the right talent.

About the Author

Laura Hay is a managing director at Pearl Meyer, where she leads the National Banking Industry Team. She has extensive experience advising financial institutions on compensation and compensation-related governance and regulatory matters. She advises both public and private financial services companies, including private equity and majority-shareholder owned institutions.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, and Los Angeles.

Pearl Meyer

NEW YORK
461 Fifth Avenue, 19th Floor
New York, NY 10017
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA
One Alliance Center
3500 Lenox Road, NE, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON
93 Worcester Street, Suite 100
Wellesley, MA 02481
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE
3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO
151 N. Franklin Street, Suite 450
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LONDON
Collegiate House
9 St. Thomas Street
London SE1 9RY
+44 (0)20 3384 6711
london@pearlmeyer.com

LOS ANGELES
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

For more information on Pearl Meyer, visit us at www.pearlmeyer.com or contact us at (212) 644-2300.