SOMETHING MISSING

by Steve Brown

On this Good Friday, we wanted to touch on one of the largest hollow confections in banking Â–pay is tied to size. It is no surprise that according to recent compensation surveys, executives at larger independent banks receive larger salaries than their counterparts at smaller institutions. We understand that running a larger financial institution is more complex, but isn't a well run smaller institution more valuable than a mismanaged larger institution? Not statistically. For the industry as a whole (public and private), executive compensation is only loosely tied to performance. If 1.0 is perfectly correlated then executive compensation against ROE is closer to a 0.21. Size, however, is 0.43 correlated to compensation. In other words, size is more than twice as important as performance when it comes pay. It, of course, then follows that the current system rewards bank executives more for growing a bank than for performance. Is running a $1B dollar bank, 15% more complicated than running a $700mm one? We think not, but that is often the difference in compensation packages between the two. Arguably this is backwards. One of the problems lies in the fact that less than 75% of banks have executive compensation tied to performance and for those that do, less than 10% tie compensation to some risk measure. Logically, to maximize personal return under a compensation plan tied to ROE or ROA, a manager is motivated to take on the maximum risk allowed and hope for the best. Luckily banking is about as moral an industry as you can find, so most managers are very reluctant to add risk and will sacrifice personal return for the good of the organization. However, the question arises whether a bank's compensation structure provides an incentive to take on more risk in order to increase performance? The answer lies in trying to work in some measure of risk and return in your next compensation overhaul. Designing risk-adjusted compensation could be as easy as using a matrix of return versus non-performing loan performance, or as comprehensive as putting each business unit on a risk-adjusted return on capital basis that takes into account overhead and the cost of capital. Regardless of the method chosen, better aligning long-run shareholder return with management compensation is in the best interest of all parties. There are many managers out there that are not only returning 18% ROE numbers, but are doing so with low volatility of earnings. It is a shame that these managers are not being fairly rewarded, when compared to bank management at larger institutions that have had to rely on a string of acquisitions for performance numbers. Sometimes compensation structure is as hollow as a chocolate bunny.

BANK NEWS

Fed Switch

As of June 30th, 2009, the Fed will phase out their current computer system. Banks on Fedwire Funds, Fedwire Securities and FedACH will be moved to a new system by year-end 2008.

That's Funny

Advocacy groups called for a 6-month moratorium on selected subprime mortgage foreclosures in order to bring relief to troubled homeowners. The only thing more stupid than that proposal is the fact that Congress is actually looking into it.

Falling Apart

Coast Financial Holdings ($733mm, FL) has lost over half of its market value since January. The company is now being sued for alleged defrauding of investors by not informing them of troubles in the loan portfolio.

Hiring

According to USA Today and CareerBuilder.com, 33% of banks plan on hiring staff in 2Q. The survey also found that 31% of employers are having problems with retention, 33% are increasing compensation to better attract key employees and 15% are expanding benefits and 33% are moving to more flexible hours/workweek.

Competition

Wells Fargo is introducing a new credit card that offers a 1% rebate towards the principal of a pre existing Wells Fargo home mortgage.

Hug a Tree

In efforts to boost the use of electronic bill notification, Sovereign Bank (89.5B, PA) will plant a tree for every customer that opts for the electronic service. E-bills provide better organization, control and security on top of saving paper. This is another example how more banks are going "Green."