HOW IS YOUR REWARD SYSTEM?

by Steve Brown

Given all the news in the press about AIG, Merrill Lynch and other firms that paid bonuses, we highlight compensation. As the credit tide goes out, one thing readily apparent is the fact that too many community banks paid incentives to loan officers based on volume, not risk. Even Fannie Mae, up until a couple of months ago, rewarded officers based on volume. While we have heard some unflattering comments by management about loan officers that booked what are now troubled loans, the blame lies squarely with whoever approved the compensation structure. Financial incentives drive behavior, either explicitly or implicitly. If a bank has a compensation plan based on volume, then the bank essentially "asked" lenders to book loans without regard to long-term performance. The sad part is that this boom-bust credit cycle has been repeated before, so this begs the questions - why aren't we learning and what can we do different? We point out ways to help.

After action reports ("AAR") - Military, law enforcement, NASA and a host of other organizations insist on AARs. Why did the bank book more non-performing loans than was expected and were the reserves correct? The upside of this downturn is that it presents an education of a lifetime. Figuring out what your institution did right and wrong during this downturn is vitally important to support a cycle of self-improvement. Make it a goal that every employee in the organization knows what mistakes were made and how to correct them. Banks need to be brutally honest with themselves about their success and failures to determined how processes and execution can be improved.

Pay for the performance you want - This point is now clear, paying for volume doesn't work. Paying for loans (or any other bank product) that you can measure profitability after adjusting for overhead cost and risk, works. Many banks that continue to perform in this downturn do so because loan officers have the incentive to create a portfolio of high risk/high return loans, as well as low risk/low return loans. Creating a deferred incentive component (tied to 3 to 5Y portfolio performance) also does wonders by aligning compensation with long-term results. Be sure not to count reserves in profit calculations, as reserves are capital and not a reduction to income. Additionally, staff that bring in deposits and fee income most likely create the most value for the organization, so compensation structure should reflect that. While pundits expound over the causes of the current financial mess, the answers are, in virtually every case, simple. People did what they were paid to do - make (bad) loans, take excessive risks, package and resell worthless paper, leverage the balance sheet, and so on. The public understands paying for performance, as long as it's the right performance. AIG, Merrill and others shouldn't have a problem defending a properly designed compensation structure. We are incensed that our economy lacks a corporate leader that will step up and defend the quality employee that produced quality long-term results. This current mob mentality against compensation will hurt the economy more in the long-run than it will help. Unless we get better at structuring a risk-adjusted compensation package, the current bad news will just get recycled in the future.

BANK NEWS

Better Capital Regulation

Amid ongoing stress in the financial markets, the FRB has delayed until 3/31/11 (2Y extension) the effective date of requirements that limit the aggregate amount of cumulative perpetual preferred stock, trust preferred securities and other restricted capital elements included in Tier 1 capital of bank holding companies ("BHCs"). The limits would have restricted capital elements includable in the Tier 1 of a BHC to 25% of the sum of core capital elements (including restricted core capital elements), net of goodwill less any associated deferred tax liability. In addition, on Oct. 22, 2008, the FRB issued an interim rule that allows BHCs to include new senior perpetual preferred securities issued to the Treasury in Tier 1 capital without limit.

TLGP

The FDIC extended TLGP through Oct 31 (covering maturities through 2012). 10 to 20bps will be charged to participating banks for insured deposits with fees increasing in 2Q in order to phase out the program. Revenues from TLGP will go to reduce the deposit insurance fund assessment.

Changes to SBA 504 Program

New stimulus package eliminates borrower (1.5%) and lender (0.5%) fees for SBA 504 loans. This fee elimination is expected through December 2009. Also, refinancing through 504 loans is now allowed (existing debt not to exceed 50% of new project financing).

Bank Marketing

Talk about customer segmentation! We aren't convinced that this is a profitable niche, but the 19% ROE from last year is quickly changing our minds. We give the folks at Bank of the Witchitas ($114mm, OK) huge credit for producing a marketing effort that exudes intelligence, courage and humor. Check out http://redneckbank.com/