TRAUMA IN BANK COMPENSATION

by Steve Brown

NBC debuted their new series Trauma last night about a group of paramedics in San Francisco. We had to watch, but were disappointed. Hollywood made these EMS professionals out as a bunch of sex-loving, non-patient caring, unprofessional cowboys with God-complexes. The reality is nothing could be farther from the truth.

In like fashion, the public has a view devoid of reality when it comes to bank compensation. Since we talk to dozens of bankers of all types both on Main St. and Wall St., we can tell you that it is rare that we run into anyone that actually thought they were making money now and leaving their company with all the risk. The reality is that most senior managers believed that they had most of the risk either covered or at least understood. In their defense, risk management has only really been around as a discipline since the 80's and we are still in the nascent stages. While all the risk was not covered in retrospect, all the compensation controls in the world won't stop this from happening in the future. Unmitigated risk happens in all walks of life, regardless of compensation. This being the case, limiting compensation and making it detached from performance is going to lead to nowhere we want to go as an industry.

Compensation took a huge step forward in the 90's when it shifted towards stock options and grants. This better aligned long-term performance with long-term compensation. Now, there is a move afoot to limit that practice. In addition, many in Congress are calling for overall limits in compensation. Basic economics will tell you that if you limit the price of a resource, that resource will move elsewhere to its highest and best use. This is never truer than when it comes to people. Limit bank compensation and the best and brightest in the industry will move to consulting, insurance, finance companies or other areas where they can seek a just reward for the value they bring to an organization. If regulators and politicians want to change compensation here is what they should do:

1) Don't compensate for taking on systemic risk. The reality is the banking industry really doesn't want to stop rewards for taking on non-systemic risk. We want banks out there exploring new products, niches and credit opportunities. We ran into trouble when we became overly leveraged, too big to fail and too concentrated as an industry. While these aspects of banking should be regulated and separate from the compensation argument; if politicians did want to combine them, then make it clear what is the "bad risk" that can bring down the industry and what is a "good risk" that can revolutionize finance.

2) Increase incentives for risk management. In particular, reward for the building of revenue streams with non-correlative risk. We ran into trouble when we took on risks that were closely tied to real estate. Managers should be incented to seek out cash flow generating businesses that offset one another in a negative shock and are limited as to concentration.

3) Reward on a variety of metrics. Tying compensation to a metric like net interest margin will often result in employees trying to exploit or "game" that factor. As an industry, we compensated on loan volume and we got loan volume. Let's compensate for what we want; which is really a variety of EPS growth, risk-adjusted return on equity, customer satisfaction and regulator compliance. By

establishing a scorecard of metrics, employees will find it much more difficult to game the compensation system.

The last thing the industry wants to do is to limit compensation at a time when we are under tremendous stress and change. We need more brainpower and hard work than ever. The taxpayer and government should want this as well. Limiting bank compensation will turn performance into a disaster similar to a bad T.V. series.

BANK NEWS

DIF

To replenish the DIF, the FDIC is expected to order banks pay 2010-2012 insurance premiums in advance, totaling about $36B to 54B, according to WSJ.

BHC Change

The FRB has proposed a change to the Bank Holding Co. reporting form FR Y-9C that would split out further detail on unused commitments; loans; OTTI on debt securities and brokered deposits. The comment deadline is Nov. 24.

Banking Update

The latest data shows bank lending to small businesses is down $113B from just before the crisis (the first contraction since 1993); unused small business credit lines have been cut by 25% and 79% of small businesses say credit card limits have been tightened dramatically (note that 82% of such customers say credit cards are an essential funding source).

Mobile Banking

Wells Fargo has announced an option that will allow its customers to transfer up to $1k daily in money to each other through its mobile banking service. The product targets parents with children in college, small businesses and those who have a need to transfer money.