BANK COMPENSATION

by Steve Brown

Previously self-sufficient animals, like this bear on the left, were supportive of our growing welfare state. Politics aside, the economics of welfare means that the extension and increase in unemployment benefits, while kind, have the unintended consequence of providing a disincentive for those looking for work. Bankers, on the other hand, have almost the opposite problem.

Last Thursday, the Fed released its spate of guidance on compensation. For the largest TARP recipients, total compensation will be dramatically restructured. While we would love to expound on some the backward aspects of this proposal, today (and tomorrow) we wanted to focus on how the new Proposed Guidance on Sound Incentive Compensation Policies may affect community banks.

In short, the guidance, as it is currently proposed, requires a compensation review to be included in each Fed bank's focused regulatory exam. For 2010, compensation practices will need to be adjusted and documented to ensure employees are not incented to take on "excessive risk." What this means is subject to debate, but we will take a stab at it. However, before we get started, it is important to note that the guidance affecting community banks does not limit compensation in any way - it just asks that banks take into account a higher, and more balanced, risk component when deciding compensation.

This has a couple of practical ramifications: 1) Compensation plans that offer a material reward for things like loan volume will go away; and, 2) Plans that are closer aligned to firm-wide profits will be more common; and, 3) Plans that are risk-adjusted over a time horizon that is commensurate with the risk will most likely be the most suitable. The concept is that every material incentive plan within the bank must include a risk/reward balance. This is more than just coming up with a deferred bonus payout or providing a larger portion of pay in equity/options. Going forward, banks must quantitatively track both the most common risks like credit and the "long-tail" risks like legal, operations, compliance and reputational.

First, let's get some highlights of the Guidance on the table:

- Deferred payments are encouraged in comp plans to the extent that pay is being delayed to ascertain if risk has been mitigated or extinguished. In addition, "clawback language" (popular for executives under SOX) will be extended to many line employees.

- Banks should institute quantitative risk measures when adjusting compensation. Looking at risk-adjusted loan return is the classic example. This also may include taking into account the amount of capital-at-risk per business line.

- Scenario analysis should be used to access future income and risk volatility.

- Customized compensation packages are encouraged, as different employees may have varying sensitivity to risk.

- Equity-based compensation (stock, options, etc.) remais useful, particularly for senior executives.

- Golden parachutes and handshakes should be carefully reviewed (however plans that have a forfeiture of deferred income should an employee leave may weaken the effectiveness of the risk balancing and so should be taken into consideration).

- Internal controls (beefed up risk management in general) should be reviewed as it relates to compensation and firm performance.

- Communication by senior management should be increased to staff in order to better educate on risk/reward tradeoffs.

- A compensation program review should be conducted annually to ensure compliance. Banks should track their incentive awards and risk outcomes to determine effectiveness.

- The guidance places ultimate responsibility on the Board of Directors, as they should actively oversee plans to ensure sound compensation practices are being followed

It is our belief that this guidance will have one of the largest impacts on our industry of any new regulation for 2010. Unlike the bear, bankers will now have to be more sophisticated on how they go out and forage for profits. Tomorrow, we will further expand and talk about the strategic effects of this guidance.

BANK NEWS

Bank Closures (106 YTD)

On Friday, the FDIC closed: [1] Partners Bank ($66mm, FL) and sold it to Stonegate Bank ($375mm, FL). Stonegate will assume all deposits (no premium) and essentially all assets; [2] American United ($111mm, GA) and sold it to Ameris Bank ($2.3B, GA). Ameris will assume all deposits (1.02% premium) and 83% of assets. [3] Hillcrest Bank ($40mm, FL) and sold it to Stonegate Bank ($375mm, FL). Stonegate will assume all deposits (0.50% premium) and about 34% of assets. [4] Flagship National Bank ($190mm, FL) and sold it to First Federal Bank of Florida ($632mm, FL). First Federal will assume all deposits (no premium) and about 68% of assets. [5] Bank of Elmwood ($327mm, WI) and sold it to Tri City National Bank ($775mm, WI). Tri City will assume all deposits (no premium) and essentially all assets. [6] Riverview Community Bank ($108mm, MN) and sold it to Central Bank ($431mm, MN). Central will assume all deposits (no premium) and about 69% of assets. [7] First Dupage Bank ($279mm, IL) and sold it to First Midwest Bank ($7.7B, IL). Central will assume all deposits (0.75% premium), and about 89% of assets.