BANK COMPENSATION - PART THREE

by Steve Brown

When it comes to figuring out the new Proposed Guidance on Sound Incentive Compensation Policies, bankers should start with their core risk - credit. Of all the risks, credit composes between 45% and 90% of the bank's operations depending on the structure. As such, for a new compensation plan to work, it must work with both lenders and underwriters.

Traditionally, many banks have approached this problem in a self-defeating way. Oftentimes a bank will compensate loan officers on volume, without regard to credit risk or with only a short-term holdback. Meanwhile, underwriting is compensated for loan safety, without much regard to profitability. This sets up an inherent conflict that usually serves to frustrate all as credit tends to be too cautious and sales, too cavalier. By moving to a risk-adjusted methodology that all sides agree with both credit and sales become aligned. Credit realizes that risk can be lowered by obtaining better pricing and structuring, while sales is now motivated to either increase pricing or bring down risk. The result is usually a better risk-adjusted loan profile that should motivate shareholders.

The other major correction when employing risk-adjusted compensation is the paradigm shift in thinking about risk. Risk is nothing more than a negative unexpected outcome - delete the possibility of the outcome and you remove the risk. If it is cold outside and you put on a jacket, the cold no longer becomes a risk. Risk is agnostic and without intention. That is to say there is no "good" or "bad" risk to take - all risk is the same. The difference between risk is only a matter of degree. A dollar of credit risk is the same as a dollar of interest rate risk which is the same as a dollar of operational risk. When it comes to risk management, the goal is to mitigate the risk to the extent possible and then make sure you have a return that compensates for that risk. Underwriting defaulted home loans is no better or no worse than purchasing Treasuries. If you understand the risk and price appropriately, then both assets are equal. As proof, consider that the riskiest loan for shareholders that a community bank could historically make is a loan on an apartment building. This is not because the probability of default is high or the loss given default is excessive, only that banks have historically underpriced this risk. As such, multifamily, followed by single family have been the largest net detractors of ROE over the last 5Ys.

The last major piece of employing risk-adjusted compensation is the recognition of relationship value. Despite how many banks operate, it is the customer relationship, not credit that is usually a core competency. As such, not including the value of the relationship in risk-adjusted compensation is equally self-defeating. Taking into account deposits, fees and expenses is helpful for managing any business line so extending the value tracking to cover the relationship makes immense sense.

Once banks have the basic concepts together, a compensation plan can be designed to reward a portion of the compensation at the time of relationship origination and a portion over time as the relationship grows. In conjunction with origination, the manager of the relationship and credit portfolio should be benchmarked at the time of origination and then have a compensation adjustment for any increase or decrease in the profitability of the account over time. Thus, the credit and customer portfolio manager get rewarded for maintaining risk-adjusted profitability or improving it. Conversely, should credit or profitability deteriorate, both portfolio managers will be affected in addition to a portion of the compensation of the originating officer or department.

Tomorrow, we will get more practical and give some real life examples of how banks may institute the Fed's new guidance to increase both performance and compensation.

BANK NEWS

M&A

Union Savings Bank ($1.89B, CT) has entered a deal to purchase First Litchfield Financial Corp., holding company of The First National Bank of Litchfield ($550mm, CT) for an estimated $35mm.

SBA

The administration is considering increasing credit availability on loans, contracting and other programs available to 71 different categories of businesses. 66% would be in retail industries and the rest in food and other services and accommodation.

Rescue Your Rival

The Treasury and a member of the House are proposing a bill requiring financial companies larger than $10B in assets to cover the costs of a collapsed competitor through new penalties and fee regulations, according to WSJ.

TBTF

The House Financial Services Committee released its Treasury approved draft bill that addresses systemic risk of large banks. The bill would create a Resolution Fund from assessments from banks with $10B in assets or greater. In addition, the Fed will have the authority to compel any large financial holding company to divest or cease certain, risky activities that pose a threat. The bill also creates a regulatory team that would monitor those banks that could pose a systemic risk and mandate heightened oversight.