# BANK COMPENSATION - PART FOUR

by Steve Brown

Today we wrap up the last portion of our commentary series on starting the Fed's new Proposed Guidance on Sound Incentive Compensation Policies. This is where the rubber meets the road, as we get practical. While structure will vary depending on bank size, complexity and risk profile; we are going to take a stab at what procedures might look like on this subject at the average community bank.

After debating the nature of risk, policies and procedures (some of the subjects of our previous articles), it is time put a compensation structure into practice. Here are some general steps: Step 1 - Get the tools. A good risk-adjusted loan pricing model and a profitability model is almost mandatory if you are above $250mm in total asset size and you are serious about tracking risk-adjusted profitability. We have the models developed for community banks, so we know they are relatively inexpensive and readily available.

Step 2 - Determine the amount of residual risk in each position. The concern, when it comes to compensation, is what risk is left after a transaction is done that you may have eventually have to adjust compensation for. While handling wire transfers does have risk, after a transaction is complete, there is de minimus risk (so there is little need to hold back a portion of compensation). On the other side of the extreme is a relationship manager that generates a healthy amount of loans. For loans, most of the risk occurs over the length of maturity based on the outstanding balance. However, much of the risk depends on how the loan is managed and what happens to the general economy. As such, we argue it would be unfair to delay a majority of the compensation. While this is a controversial point, our suggestion is approximately 50% to 75% of the risk-adjusted value incentive should be recognized in the current period, with the rest held back to gauge performance over time. For deposit gathering the same is true. We suggest 50% to 75% of the incentive should be recognized once the client is brought in, because that was the hardest part. The remainder should be recognized on an ongoing basis depending on ongoing profitability.

Step 3 is to determine how much of the deferred incentive amount corresponds to what risk. Maybe 50% is credit, 30% is liquidity and the remaining 20% is a combination of operational, legal and reputational risk (notice the absence of interest rate risk from this calculation). When you go through this step, it is important to determine what portion the employee controls and what risks are managed elsewhere. Interest rate risk in most banks is likely managed by the CFO, so it would be unjust to penalize the relationship manager for interest rate sensitivity. However, for the CFO, a portion of their compensation should have a higher weighting for interest rate, regulatory risk and other potential negative events. In most cases, material risk will be spread in which case, go to Step 4.

Step 4 is to benchmark, adjust and track. This is the trickiest part of them all. A law firm relationship is brought in that includes $1mm in IOLTA accounts and a $600k loan of their owner occupied office. The expected risk adjusted return is 25%. However, of that 25%, most of the value 18 points is derived from the depository relationship. A good first step would be to recognize that most of the incentive is tied to deposit performance (that those balances remain over their expected life) and then adjust for loan performance. When it comes to loan performance, banks have to decide how much each officer should be responsible for related to general economic performance. Some banks feel nothing, others feel everything. Two ways banks may want to consider to handle ongoing credit risk is either set a 1 standard deviation band around the risk-adjusted expected return (and do not adjust compensation up or down if it falls within that band), or arrive at a benchmark to gauge relative performance (like a group of peers, GDP or index of economic data). If the loan has problems greater than general economic conditions, there should be less residual incentive earned. However, if the economy tanks, a bank may decide that the officer that brought in that 25% law firm deal, should be given their full incentive. Assuming the position encompasses a variety of risks, the easier way is to defer a portion of compensation based on overall risk-adjusted profitability. This takes into account all risks (credit, legal, etc.) and is probably the best way to handle it for line officers.

Four days isn't nearly enough to thoroughly discuss this topic, but we expect it will continue to weigh on the hearts and minds of bankers throughout the foreseeable future, so we will get another shot at it. Until then, if we can help your bank start thinking about complicated issues, please do not hesitate to contact us.

## BANK NEWS

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