

Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

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Enterprise-Wide Risk Assessment Key to Understanding Compensation Risk

When regulators ask you to justify the risk embedded in your compensation plans, they're asking you to put that risk in context, whether you realize it or not. Without understanding your firm's total risk and the place your compensation and incentive plans play within it, you won't understand the risk in those plans, let alone be able to justify them to regulators, experts say. An enterprise-wide risk monitoring program may be the only way to vet that risk and prove to examiners – as well as investors and the board – that a given bank's incentive plans fit within and forward the banks strategic plans.

As recently proposed Dodd-Frank rules on incentive-based compensation suggest, the regulators and the federal government haven't lost interest in compensation and the role it can play in triggering firm-killing risk. Under the new rules, firms over \$1 billion in assets will have to convince examiners that their incentive-based compensation plans don't bring "excessive" risk to the bank (see "Dodd-Frank Incentive Rules to Rely on Nebulous Standards," *Bank Safety & Soundness Advisor*, February 28, 2011).

Banks that don't understand their aggregate risk profile will be hard pressed to make this case to examiners, says Dan Borge, a director and risk consultant with LECG in New York, N.Y.

"You really do need ERM in a practical sense [if you want to understand compensation]," he says. "Otherwise, how do you know how much risk you're taking? If you haven't made a serious attempt to at least look at most of the business units, products and locations and then come to grips with an aggregate position [of total risk], then you have no credible position – you can't say you're not taking excessive risk."

Regulators likely won't expect banks to have bullet-proof justifications for compensation risk at your next exam, but they will want to see that you are taking steps to better understand that risk, Borge adds.

"In the regulator's mind, excessive risk is defined at the institutional level," he says. "If you can't show them that you're coming to grips with this, you'll have an unpleasant experience."

Some regulators are already pressing banks on the risk embedded in their compensation, says Marcus Faust, an ERM consultant and SVP at RP Financial, Arlington, VA. Regulators have been particularly keen on questioning banks holding TARP, he says. "They're telling banks that they need to look at the compensation risk to the entity. They view it as a way to protect TARP repayment."

Examiners aren't exempting smaller firms from compensation risk discussions, either, Faust adds. "[Regulators] certainly are looking at compensation in smaller firms, particularly those in troubled condition and those [holding] TARP," he says.

What examiners want to know is that banks are balancing incentives, he says. That they're not encouraging short term results over long term value creation, whether intentionally or not.

Compensation risk shouldn't matter only to regulators, Borge adds. Your shareholders and board should also want to know that the bank has deployed its resources efficiently and that it isn't inadvertently funneling unnecessary or hidden risk into the firm.

Compensation Risk and ERM

Vetting compensation risk should come relatively early in the ERM process, says Smiechewicz, chief

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Publisher:

Aaron Steinberg
800-929-4824 ext 2471
asteinberg@banksoundness.com

Group Publisher:

Hugh Kennedy
800-929-4824 ext 2213
hkennedy@banksoundness.com

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ADDRESS:

Bank Safety & Soundness Advisor
Two Washingtonian Center
9737 Washingtonian Blvd., Ste. 100
Gaithersburg, MD 20878-7364

ERM

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audit executive with First Niagara Bank, (\$21 billion), Lockport, N.Y. Ideally, the chief risk officer and even the chief audit officer should look into it as soon as the bank has completed its enterprise-wide risk assessment. Once risk officers do turn their attention to compensation, it's critical that they understand just what, exactly, the banks incentives have and will create.

"When you incent someone to do something, they'll do it," he says. "Banks need to be careful that they're not incenting employees to take on too much risk. Incentive structures can, and often do, incent employees to take on more risk than the bank's plan desires. In this case, you get what you pay for, but that isn't what you've planned for."

Once you've been through an enterprise-wide risk assessment, you can start to investigate compensation as a function of risk. There are many ways a bank can do this, suggests Borge. Here's one: compare business units based on revenue and capital-at-risk.

In a simple example, if two business units and see that they both brought in \$100 million in revenue in a given year, yet one of the two was twice as risky as the other, you may want to revamp compensation in that second unit.

"Obviously, you'd question the performance and the compensation in the higher risk unit," Borge says. "They're taking on more risk to make the same revenue and that might suggest that they're not very good at their jobs or that they don't realize the risk that they're taking."

Here's another method: Zero in on the outcomes. Banks that want to know if their incentives match up with their bank-wide risk appetite and strategic goals can simply look at what they produce from the incentives they have in place, says Smiechewicz. "Look at the assets that the business units are bringing in, juxtapose that with the types of deals they're doing and then juxtapose that with the revenue stream they're bringing in," he says. "Then compare it all to the strategic plan and see how they align."

Some mismatches won't be hard to spot, he adds. A bank may think it's pursuing a relatively conservative strategy, but then the bank starts to spot complex, hybrid instruments on the balance sheet. "The reason they're there is because individuals in the bank have been incented to take that risk," he says. "The numbers tell a story. I'm a firm believer in this."

This kind of comparison can only follow from an ERM analysis, Borge adds. A basic assumption in ERM is that once you complete the analysis you've created a standard measure for risk. This allows you to compare different products or businesses to other products or businesses based on their risk profiles. "[In this way, ERM] gives you the presumption of a level playing field."

Regulators will expect regular reviews of compensation plans. This happens to be a best practice, too, notes Pat Cole, a compensation consultant in the Grand Rapids, Mich. office of Crowe Horwath. "The annual review of the plan documentation is very important,"

he says. "Banks need to make sure that their strategic plan priorities are represented in the compensation document."

One reason why some banks desperately need this kind of planning: They have too many compensation plans and can't track them all. A CFO of a larger bank recently asked Cole to come in and review his bank's multiple compensation plans. The executive couldn't even tell Cole how many the bank had. As it turned out, the bank carried 55 separate compensation plans. "This is a best practice," Cole adds. "Banks need to know how many plans they have and put oversight for those plans under a single committee."

A lot of banks aren't very far along on this process. According to Crowe Horwath's 2010 Financial Institutions Compensation Survey only around one half of banks track and approve compensation plans. Out of 340 respondents, 52.1% said that its board did, in fact, review and approve incentive compensa-

tion plans.

Compensation risk troubles don't end once you've calibrated your compensation to your risk appetite. Here are a few problems you could run into, long after your risk assessment is complete.

1. Compensation risk in acquisitions. A bank may have the right risk culture and an incentive plan that fits within that culture, but it could still run into trouble after a merger. Banks shouldn't underestimate the cost and the effort involved in transferring its risk appetite to new acquisitions, says Bart Kimmel, an ERM consultant and director in the Los Angeles office of Crowe Horwath.

"Some clients have done a stellar job with the growth of an organization and they've done great due diligence when they start to acquire other banks, but sometimes they'll end up collecting incentive plans that haven't been fully reviewed," he says. "That bank might also [inherit] new employees that have a different appreciation

for the level of risk that's acceptable. You can encounter a completely different risk profile in an acquisition."

Banks that are involved in the merger market need to take a "much broader view of what risk management means," when it has to deal with a new business unit or bank subsidiary operating under a different risk philosophy.

2. The lasting impression of a high-risk culture. If a bank or a business division within a bank has a history of setting aggressive incentive targets, it may continue to set too aggressive targets after a bank has long since set risk limits, says Cole. A bank's incentive culture can have a lasting influence on risk and incentives, he says. Make sure that your bank's incentives really do fit within the bank's stated risk appetite.

A central, enterprise-wide risk function can help banks avoid this pitfall, adds Kimmel. ■