From: Mike Higgins [mailto:mhigginsjr@mhastakeholders.com]
Sent: Tuesday, January 26, 2010 1:58 PM
To: Comments
Subject: RIN #3064-AD56 Incorporating Employee Compensation Criteria...

Dear FDIC:

Our consulting firm has implemented compensation packages in banks for 22 years using a self-funding, cash-flow based, balanced scorecard approach (growth, profit, quality and productivity). We have published two books on the topic as well:

Library of Congress 89011920
Library of Congress 2001132984

I agree with the posted comments about oversight and control being in place prior to any compensation approach. **The best designed plans will fail with lack of oversight and control**.

When the Federal Reserve Board issued its guidance on compensation practices a few months ago, we prepared a response for our bank clients so they would be able to communicate how our "STAKEHOLDERS" methodology is designed to mitigate "incentive risk" within their bank in accordance with the guidelines (see attached PDF).

Four aspects of incentive risk that we have identified include:

Earnings Risk
Metric Risk
Business Literacy Risk
Distribution Risk

We also address mitigating incentive risk in compensating individual loan officers.

I offer this document up to you as a set of best practices and pitfalls to avoid that we have accumulated over the past 22 years serving the banking industry.

If you find the material in this document useful during your period of collecting comments, developing policy and assessing incentive risk within a member bank, then we have helped move the industry along in a the right direction.

Please contact me if you have any questions, comments or ideas.

Best Regards,

Mike

Mike Higgins, Jr.
Mike Higgins & Associates

How Stakeholders Supports Compliance

MHA

MIKE HIGGINS & ASSOCIATES, INC.

Managing and Mitigating Incentive Risk

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Introductory Comments…

- **A financial institution is a complex entity. With each action the organization takes, a number of offsetting reactions occur or risks propagate.**

- **Because of this, well intended, but simplistic reward programs can lead to a series of unintended and/or harmful consequences.**

- **The Stakeholders methodology is a very robust and wide-ranging approach to performance based compensation. The "balanced" approach to measuring and rewarding performance has been refined over the past 20 years, and will continue to adapt as the industry landscape changes.**

- ***It is imperative to review this <u>entire</u> document to fully absorb the breadth and depth of the methodology. There are a number of ways to mitigate "incentive risk" and once those are fully understood, the reader will be able to render an educated and well informed opinion of how well those risks are being managed within the organization.***

- ***We welcome calls or e-mails with questions regarding or clarifying the methodology. Our contact information is on the cover of this document.***

Contents…

Managing and Mitigating Incentive Risk

BACKGROUND

Background…

- In the fall of 2009, the Board of Governors of the Federal Reserve System established guidance criteria to help ensure that incentive compensation policies do not encourage excessive risk taking and are consistent with the safety and soundness of the organization (*"Proposed Guidance on Sound Incentive Compensation Policies"*).

- In accordance with these events, this document explains how the Stakeholders methodology works, how it is consistent with and how it supports the proposed guidance.

- In short, the methodology uses a comprehensive set of balanced metrics to precisely quantify how performance has affected earnings. The sum total of the earnings variances determines the size of the reward pool.

- The organization controls the actual distribution of the reward pool (cash, deferred compensation, stock, 401(k), etc.). The distribution approach should be in a manner that supports the guidance provided by the Board of Governors.

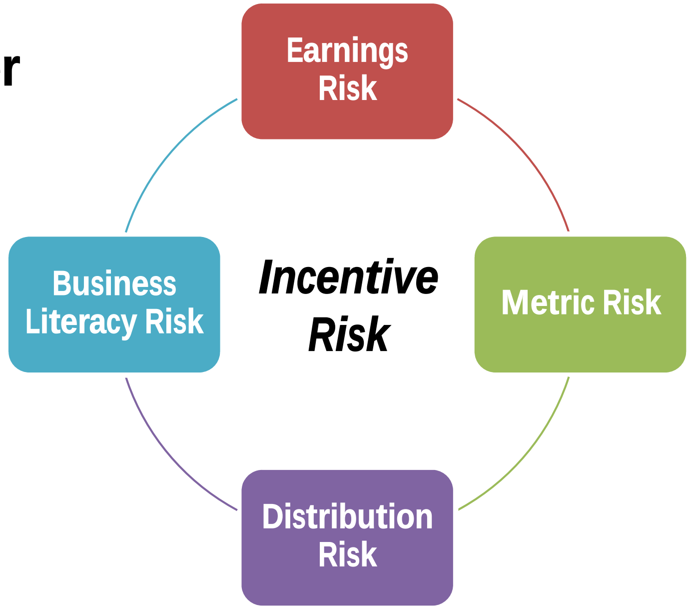
Key Aspects of Stakeholders Methodology…

- **Framework for performance based compensation**
- **Utilizes self-funding reward pool**
- **Uses Directors' Rationale to quantify and justify reward before year starts**
- **Communicates performance using balanced set of standard industry metrics**
- **Comprehensive results driven (not activity driven, not transaction driven, not singular product focused, not "net present value" derived)**
- **Proactive "what-if" analysis (explains what happens to earnings if performance, or lack thereof, is sustained for remainder of year).**
- **Fully transparent; utilizes data from general ledger (one version of the truth)**
- **Independent, third-party administration (no internal conflict of interest)**
- **Full "paper-trail audit" from setup to actual results (real-time back-testing)**

What is Incentive Risk???

- The term "incentive risk" in its broadest sense is the possibility (or probability) that rewarding for specific actions or outcomes today produce unintended and/or harmful consequences tomorrow.

- As with any reward plan, there are a number of elements of incentive risk that must be managed. The Stakeholders methodology directly addresses four aspects of incentive risk:
  - *Earnings Risk*
  - *Metric Risk*
  - *Distribution Risk*
  - *Business Literacy Risk*



- There are a number of additional incentive risks beyond these four areas and many are outside the scope of the methodology. The management team and board of directors should address such risks as outlined by the "Proposed Guidance on Sound Incentive Compensation Policies" issued by the Federal Reserve Board.

Managing and Mitigating Incentive Risk

EARNINGS RISK

Earnings Risk…

- **Earnings risk occurs when the organization does not know the precise impact all levels and combinations of incentives will have upon earnings, rate of return (ROA/ROE) <u>and</u> capital adequacy.**

- **To address this concern, the Stakeholders methodology includes a "Directors' Rationale" that demonstrates the impact of the reward pool, at any level of performance, across all levels of participation (staff, management, executives) upon earnings, rate of return and capital adequacy, <u>before</u> the program year starts.**

- **The board of directors and/or compensation committee reviews this document and makes any necessary adjustments.**

- **At the discretion of the board, additional criteria (called "triggers") can be added that must be satisfied prior to distribution of any reward. For example…**
  - ***Reward distribution must not infringe upon the organization's capital policy.***
  - ***Asset quality must be deemed satisfactory by audit committee prior to distribution of reward.***

- **Once the Directors' Rationale is finalized, it serves as formal documentation of the plan parameters for the year.**

- **Actual results are "back-tested" against the Directors' Rationale on a monthly basis to validate that incentives are aligned with, and not exceeding, financial performance.**

Earnings Risk…

- **On the Directors' Rationale, a "Reward Pool Basis" that is used to fund the reward pool is established. The reward pool basis is one of the following:**

  – ***Net Revenue***
    - ***Net Interest Income + Non-Interest Income***
    - ***Non-Interest Expense and Net Charge Offs are not ignored, if applicable, they can still penalize the reward pool. A startup or rapidly expanding organization will focus on net revenue growth until they reach a size at which they can leverage operating expense. Specific areas of an organization may have no credit risk and fixed operating expense, in this case, net revenue as a reward basis would be most appropriate.***

  – ***Core Operating Income***
    - ***(Net Interest Income + Non-Interest Income – Non-Interest Expense)***
    - ***Net charge-offs are not ignored and can still penalize the reward pool, however, difficulty in accurately estimating potential losses in the upcoming year could lead to a windfall reward if losses are far less than expected (e.g., being under budget on an item that was "over-budgeted" to begin with).***

  – ***Cash Basis Income After Net Charge-Offs (Most Commonly Used)***
    - ***Net Interest Income + Non-Interest Income – Non-Interest Expense – Net Charge-Offs***
    - ***Loan loss provision (unrealized losses, not a cash flow) is replaced with realized losses (net charge-offs).***

  – ***Accrual Basis Income After Provision***
    - ***Net Interest Income + Non-Interest Income – Non-Interest Expense – Loan Loss Provision Expense***
    - ***Realized losses (net charge-offs) are replaced with unrealized losses (loan loss provision expense). See metric risk; reversal of unrealized losses produces "accounting" profit but no "cash" to fund reward.***

Earnings Risk…

- **On the Directors' Rationale, reward pool funding is direct and transparent.**

  – ***At budget, the organization funds reward based upon market and peer criteria.***

    - ***Organizations generally maintain "at market" levels of total compensation (base, reward and benefits) to <u>attract and retain qualified personnel</u>.***

    - ***Organization provides input with respect to market level of "incentive" across all levels of the organization (staff, management, executives). The precise amount of "at market" reward pool expense is computed.***

    - ***High performers use peer data to justify larger than market reward at budget (above average rate of return, better than average compensation efficiency, etc.)***

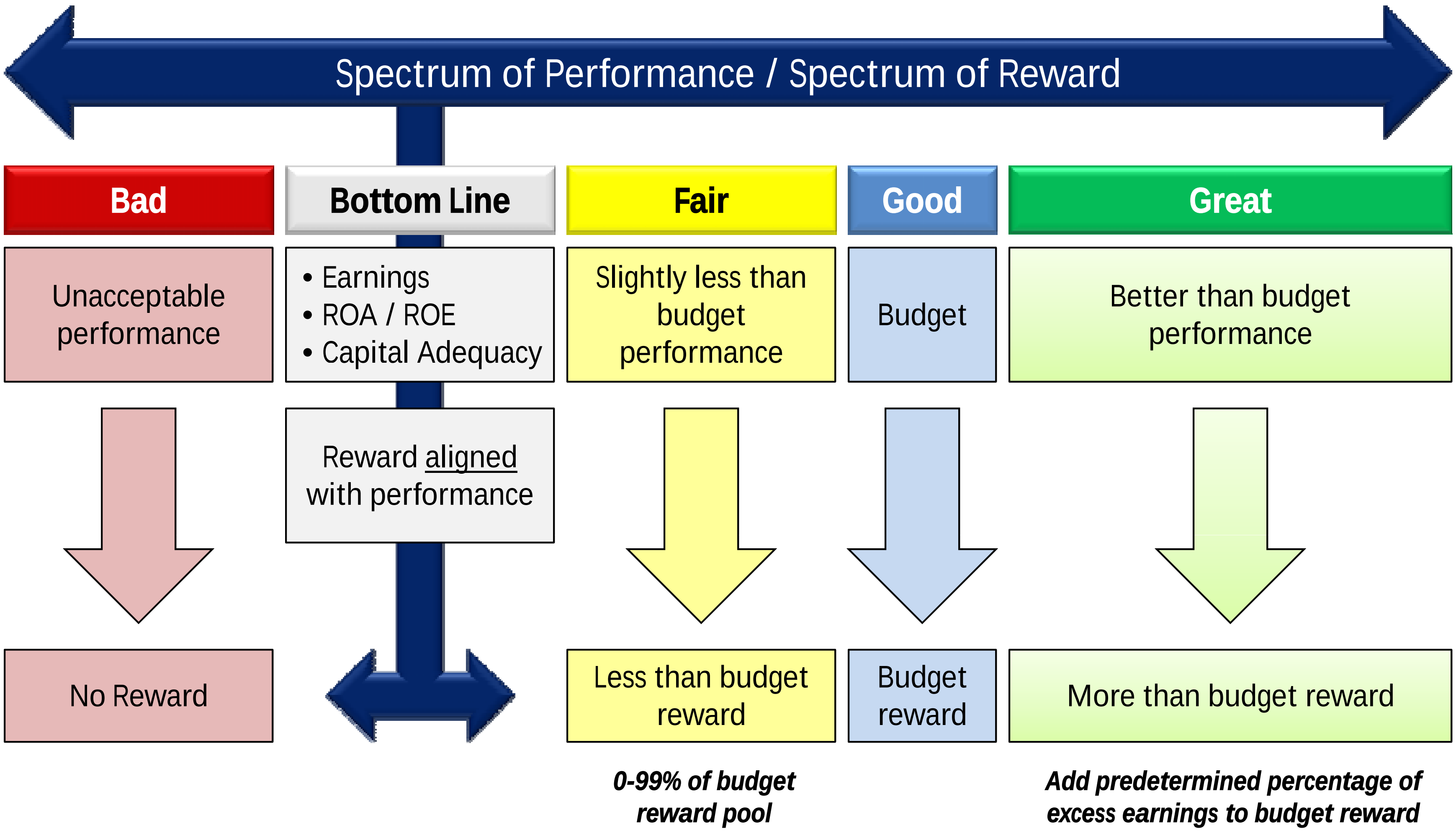
  – ***Below budget, organization decreases reward pool until a minimum level of earnings (baseline) is reached. There is no reward pool should performance fall below baseline.***

  – ***Beyond budget, a percentage of the reward pool basis, is added to the budget reward pool. Most organizations allocate 20-35% of the reward pool basis, in excess of budget, to the reward pool. The unallocated portion (65-80%) is either retained as capital and/or distributed as dividends.***

Earnings Risk…

- On the Directors' Rationale, the impact of the reward pool on the "bottom line" is computed.
  - *At all levels of performance (budget, below budget, beyond budget) the fully loaded impact of the reward pool across the organization (staff, management, executive) is displayed with respect to net income, rate of return (ROA/ROE) and capital adequacy.*
  - *With this information, the management team and board of directors has a basis to evaluate and justify the reward pool relative to "bottom line" results.*
  - *The Directors' Rationale can be revisited at any time during the year to "back-test" and "validate" the reward pool against actual performance.*
- On the two pages that follow, an illustration of the reward pool funding approach and an example Directors' Rationale are provided to demonstrate how the Stakeholders methodology attempts to minimize incentive risk by presenting the impact of the reward pool upon earnings.

Illustration of Reward Pool Funding…



Directors' Rationale Example...

Directors' Rationale Summary

Spectrum of Performance / Spectrum of Reward

		Bad	Bottom Line	Fair	Fair	Fair	Fair	Budget	Great	Great	Great	Great	Great	Great
			Reward Pool Basis											
A	If this happens...	< 6,754	Cash Basis Income After NCO	6,754	7,174	7,595	8,016	8,439	8,863	9,288	9,714	10,141	10,569	10,999
		< (1,685)	Budget Variance	(1,685)	(1,265)	(844)	(423)	+0	+424	+849	+1,275	+1,702	+2,130	+2,560
		< 80.0%	% Budget	80.0%	85.0%	90.0%	95.0%	100.0%	105.0%	110.1%	115.1%	120.2%	125.2%	130.3%
			Reward Pool											
B	Reward pool will be...	None	Reward Pool Funding	0.0% of Budget Reward	25.0% of Budget Reward	50.0% of Budget Reward	75.0% of Budget Reward	100% of Budget Reward	Budget + 25.0% of Variance	Budget + 25.0% of Variance	Budget + 25.0% of Variance	Budget + 25.0% of Variance	Budget + 25.0% of Variance	Budget + 25.0% of Variance
		No Reward	Reward Pool Expense	0	150	300	450	600	724	848	973	1,098	1,223	1,349
			Reward Distribution (% Salary)											
		No Reward	Tier 1 (Lowest) (1.00x)	0.00%	0.75%	1.50%	2.25%	3.00%	3.62%	4.24%	4.86%	5.49%	6.12%	6.74%
			Tier 2 (2.00x)	0.00%	1.50%	3.00%	4.50%	6.00%	7.24%	8.48%	9.73%	10.98%	12.23%	13.49%
			Tier 3 (3.00x)	0.00%	2.25%	4.50%	6.75%	9.00%	10.86%	12.72%	14.59%	16.47%	18.35%	20.23%
			Tier 4 (4.00x)	0.00%	3.00%	6.00%	9.00%	12.00%	14.48%	16.97%	19.46%	21.96%	24.46%	26.98%
			Tier 5 (5.00x)	0.00%	3.75%	7.50%	11.25%	15.00%	18.10%	21.21%	24.32%	27.45%	30.58%	33.72%
			Tier 6 (6.00x)	0.00%	4.50%	9.00%	13.50%	18.00%	21.72%	25.45%	29.19%	32.94%	36.70%	40.47%
			After Reward Pool Expense											
C	Bottom line will be...	< 6,786	**Net Income***	6,786	6,979	7,173	7,368	7,564	7,787	8,011	8,235	8,461	8,687	8,914
		< (778)	**Budget Variance**	(778)	(585)	(391)	(196)	+0	+223	+447	+671	+897	+1,123	+1,350
		< 89.7%	**% Budget**	89.7%	92.3%	94.8%	97.4%	100.0%	102.9%	105.9%	108.9%	111.9%	114.8%	117.9%
		< 1.31%	**Estimated Return on Assets**	1.31%	1.34%	1.36%	1.39%	1.41%	1.44%	1.47%	1.49%	1.52%	1.54%	1.57%
		< 13.85%	**Estimated Return on Equity**	13.8%	14.2%	14.6%	15.0%	15.4%	15.9%	16.3%	16.8%	17.3%	17.7%	18.2%
		< 10.82%	**Estimated Capital Ratio**	10.8%	10.7%	10.5%	10.4%	10.3%	10.1%	10.0%	9.8%	9.7%	9.6%	9.4%

**Extraordinary and/or non-operational items may be excluded at discretion of board.*

Managing and Mitigating Incentive Risk

METRIC RISK

Metric Risk…

- **Metric risk refers to the specific measure(s) that ultimately determine the incentive payout.**

- **Metrics should produce tangible, realized earnings (e.g., a cash inflow) to fund the incentive payment (a cash outflow).**

- **The following pitfalls <u>increase</u> metric risk and should be avoided:**

  – ***Incenting Activity. By definition, activities are not financial outcomes; therefore, rewarding for activity does not guarantee tangible benefit.***

  – ***Narrowly Focused Incentives (Single Product Sales/Transactions). In order to maximize the area being rewarded, sacrifices are made in other areas (e.g., increasing volume by sacrificing pricing, quality and expense control).***

  – ***Net Present Value Analysis (NPV) – Rewarding today, for what an "estimate" of earnings will be tomorrow.***

Metric Risk…

- **Stakeholders minimizes metric risk by using the following guidelines:**
  - ***The marginal contribution of each metric and its resulting impact on earnings, rate of return (ROA/ROE) and capital adequacy must be able to be <u>precisely quantified</u>. Metrics that fail this test are designated as "arbitrary" and the performance/reward tradeoff is quantified for reasonableness.***
  - ***Metrics must be robust and <u>counter-balancing</u>. Elements of growth, profit, asset quality and productivity provide a "check and balance" system to avoid the pitfall of being too narrowly focused and/or maximizing one area at the expense of another.***
  - ***Metrics should be consistent with the <u>industry business model</u>. This includes:***
    1. ***Maintaining Average Balance of Deposits***
    2. ***Maintaining Average Balance of Loans***
    3. ***Managing Net Interest Margin***
    4. ***Generating Non-Interest Income***
    5. ***Avoiding Credit Losses***
    6. ***Managing Non-Interest Expense***

Omitting <u>any</u> of these elements exposes the organization to <u>significant</u> metric risk; an offsetting reward pool trigger should be used to mitigate such risk.

Metric Risk…

- **Guidelines to minimize metric risk (continued):**

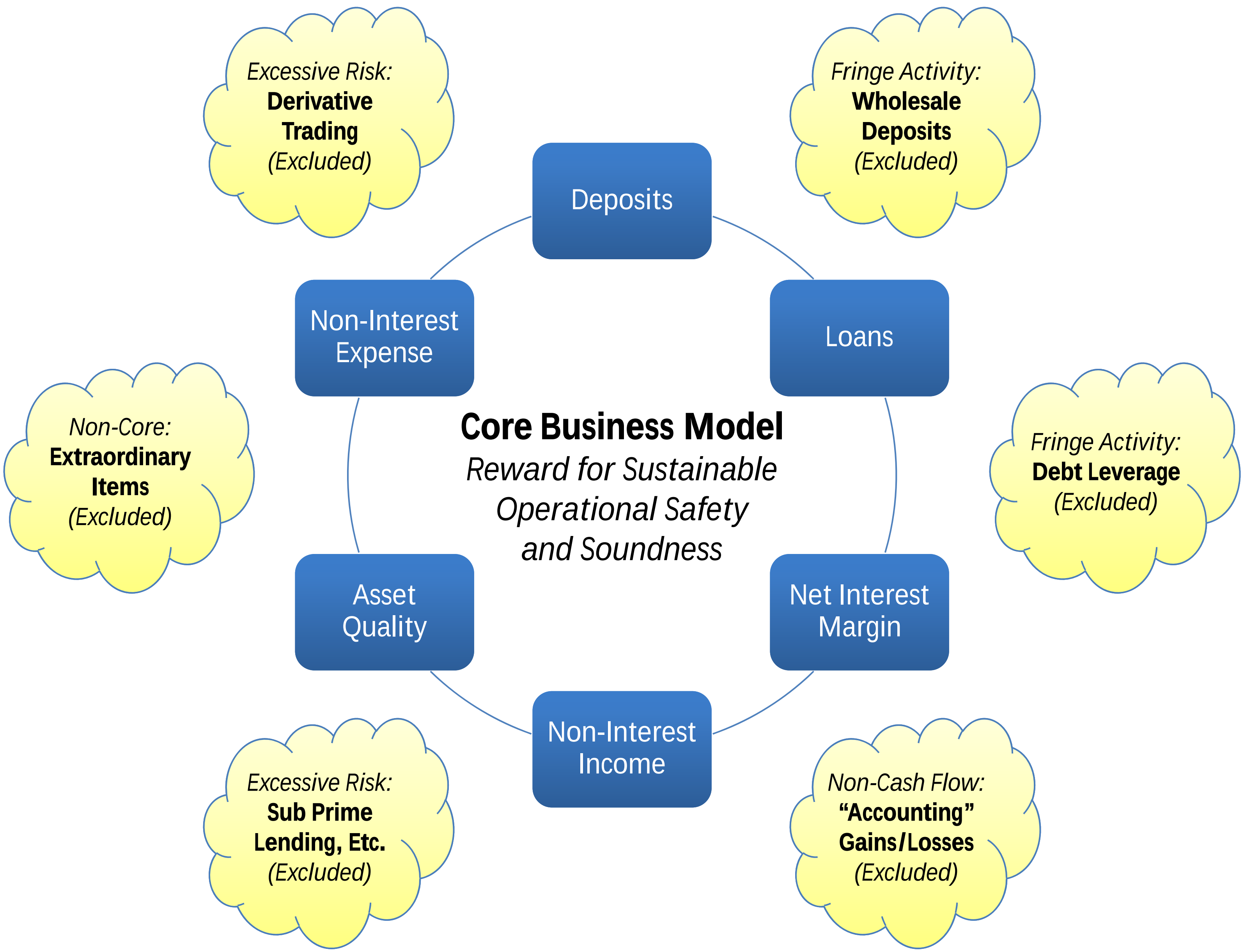
  - ***Metrics, or elements of metrics, that relate to "fringe" functions of the business model should be avoided or excluded.*** *For example, leveraging the balance sheet by increasing borrowings to fund high yield or risky investments. Changes in non-earning assets balance and other liabilities balance are other examples.*

  - ***Metrics, or elements of metrics, that do not produce a tangible, realized cash flow should be avoided or excluded.*** *For example, non-cash flow producing accounting adjustments that produce an earnings "windfall" should be excluded.*

  - ***Extraordinary items should be avoided or excluded.*** *Extraordinary income and expense are not a part of "core" operations and could lead to an incentive windfall or penalty irrespective of the underlying and ongoing safety, soundness and fundamental business practices of the organization.*

  - ***Elements of core operating metrics that are deemed too risky or undesirable may be excluded to avoid incenting for the wrong behaviors.*** *For example, high yield loans, excessive duration loans, excessively large loans, unguaranteed portion of SBA loans, high rate wholesale deposits, etc.*

Metric Risk (Illustration)…



Metric Risk…

- **Once the set of metrics are agreed upon, they are placed onto a one page "scorecard" that provides for monitoring of performance each month.**

- **At the top of the scorecard is the reward pool relative to budget (Variance to Budget Earnings).**

- **Below the reward pool section, the metrics, called Key Performance Indicators (KPIs) are displayed. KPIs represent the elements of the core business model; they explain how earning are created.**

- **KPIs can be weighted to communicate priority and alignment with strategic priorities. KPI weights are symbolic and do not determine the actual reward payout (earnings determine the payout).**

- **Because the marginal contribution of each KPI is known (via the budget) *performance variances* to budget can be precisely quantified and displayed as *earnings variances*.**

- **Favorable earnings variances increase the budget reward; unfavorable earnings variances penalize the reward pool.**

- **The sum of the individual KPI earnings variances determines the total reward.**

- **An example "total organization" scorecard is presented on the next page.**

Example of "Total Organization" Scorecard...

Balanced Scorecard Show All | In Use | Show Results | KPI Weights **Scorecard Setup**

What...

< 65% Budget	65% of Budget	70% of Budget	75% of Budget	Bottom Line		80% of Budget	85% of Budget	90% of Budget	95% of Budget	Budget Hurdle	105% of Budget	110% of Budget	115% of Budget	120% of Budget	125% of Budget	130% of Budget	> 130% Budget
	(2,970)	(2,546)	(2,121)	Variance to Budget Earnings (000s)........	+0	(1,685)	(1,265)	(844)	(423)	+0	+424	+849	+1,275	+1,702	+2,130	+2,560	
				Reward Pool (% Salary)........	3.0%	0.0%	0.8%	1.5%	2.3%	3.0%	3.6%	4.2%	4.9%	5.5%	6.1%	6.7%	
				Reward Pool (Weeks of Pay)........	1.6	0.0	0.4	0.8	1.2	1.6	1.9	2.2	2.5	2.9	3.2	3.5	

Why...

KPI Earnings Variance (000s)	Key Performance Indicator (KPI)	KPI Wgt	Budget	Budget Variance	Earnings Variance	KPI Earnings Variance (000s)	Earn Var Vs. May
	Average Daily Balance						
	Gross Loans (000s)	10%	380,000	0	-		↑ 6.6
	Demand Deposits (000s)	15%	67,989	0	-		↓ 12.5
	Savings Deposits (000s)	15%	182,179	0	-		↑ 64.2
	CDs & IRAs (000s)	5%	215,225	0	-		↓ 2.4
	Interest Rates						
	Net Interest Margin (%)	15%	3.75%	0.00%	-		↓ 82.4
	Non-Interest Income						
	Non-Interest Income (000s)	10%	7,344	0	-		↑ 352.0
	Asset Quality						
	Past Dues (%)	5%	0.87%	0.00%	-		n/a
	Net Charge-Offs (000s)	15%	325	0	-		↓ 35.0
	Operating Expense						
	Non-Interest Expense (000s)	10%	17,172	0	-		↓ 300.0
	Sum of Weights:	100%	Total Variance:		-		↓ 9.5

Total earnings variance drives reward pool (from Directors' Rationale).

KPIs, which are de-facto earnings drivers, explain <u>why</u> variance exists (and to what magnitude).

Symbolic weights communicate strategic priority.

<u>Overall Reward Pool Trigger(s):</u>
> Net income after reward must meet or exceed $6,785,850.
> Reward pool cannot infringe upon captial policy.
> Extraordinary items may be excluded from net income trigger.

<u>Individual Trigger(s):</u>
> Employed with satisfactory review.

<u>Scorecard Legend:</u>
- (green) Performance causing earnings to be more than budget; funding <u>larger</u> than budget reward pool.
- (yellow) Performance causing earnings to be slightly behind budget; funding <u>smaller</u> than budget reward pool.
- (red) Performance causing earnings to be significantly behind budget; <u>penalizing</u> reward pool.

<u>Reward Pool Summary:</u>

Metric Risk…

- **The performance of each metric relative to budget is reported monthly.**

- **The impact of the budget variance is precisely quantified as to its impact upon earnings.**

  – ***Metrics whose performance is leading to a favorable earnings variance are highlighted in GREEN.***

  – ***Metrics whose performance is leading to a slight unfavorable earnings variance are highlighted in YELLOW.***

  – ***Metrics whose performance is leading to a significant unfavorable earnings variance are highlighted in RED.***

- **The sum total of the earnings variances determines the size of the reward pool. It is the "tension" of the metrics upon each other that demonstrates the balance necessary operate a complex organization in a safe, sound and fundamentally solid manner.**

- **An example scorecard with year to date results is included on the next page.**

YTD Results on "Total Organization" Scorecard...

Balanced Scorecard Show All In Use ☑ Show **June 2009**

What...

< 65% Budget	65% of Budget	70% of Budget	75% of Budget	Bottom Line		80% of Budget	85% of Budget	90% of Budget	95% of Budget	Budget Hurdle	105% of Budget	110% of Budget	115% of
	(2,970)	(2,546)	(2,121)	Variance to Budget Earnings (000s)	(395)	(1,685)	(1,265)	(844)	(395)	+0	+424	+849	
				Reward Pool (% Salary)	2.3%	0.0%	0.8%	1.5%	2.3%	3.0%	3.6%		
				Reward Pool (Weeks of Pay)	1.2	0.0	0.4	0.8	1.2	1.8	1.9	2.2	

Why...

KPI Earnings Variance (000s)	Key Performance Indicator (KPI)	KPI Wgt	YTD Results	Budget Variance	Earnings Variance	KPI Earnings Variance (000s)	Earn Var Vs. May
	Average Daily Balance						
	Gross Loans (000s)	10%	380,933	+933	12	12	⇧ 6.6
	Demand Deposits (000s)	15%	65,515	(1,478)	(24)	(24)	⇩ 12.5
	Savings Deposits (000s)	15%	193,880	+14,370	182	182	⇧ 64.2
	CDs & IRAs (000s)	5%	207,226	(4,846)	(13)	(13)	⇩ 2.4
	Interest Rates						
(312)	Net Interest Margin (%)	15%	3.74%	-0.13%	(312)		⇩ 82.4
	Non-Interest Income						
	Non-Interest Income (000s)	10%	3,793	+121	121	121	⇧ 352.0
	Asset Quality						
	Past Dues (%)	5%	0.61%	-0.26%	21	21	n/a
	Net Charge-Offs (000s)	15%	161	(1)	1	1	⇩ 35.0
	Operating Expense						
(383)	Non-Interest Expense (000s)	10%	8,969	+383	(383)		⇩ 300.0
	Sum of Weights:	100%	Total Variance:		(395)	(395)	⇩ 9.5

Overall Reward Pool Trigger(s):
> Net income after reward must meet or exceed
> Reward pool cannot infringe upon cap
> Extraordinary items may be excluded

Individual Trigger(s):
> Employed with satisfactory review.

Scorecard Legend:
Performance causing earnings to be more than bu
Performance causing earnings to be slightly be
Performance causing earnings to be significan

Reward Pool Summary:

YTD results and budget variance.

Earnings variance as a result of budget variance.

Sum total of earnings variances.

Overall performance is slightly behind budget; so is reward.

Managing and Mitigating Incentive Risk

BUSINESS LITERACY RISK

Business Literacy Risk…

- **Business literacy risk refers to the extent to which the organization's employees understand its industry business model and what action (or inaction) is taken to address budget variances.**

- **An organization that does not understand its business model and how to influence it is a far greater risk than one that does.**

- **It is imperative that the organization know where performance variances exist, why they exist, what will happen if they are not remedied and what corrective action to take.**

- **The example scorecard on the next page highlights the questions that should be asked with respect to budget variances.**

The Obvious Questions...

Balanced Scorecard Show All | In Use | ☑ Show Results | ☑ KPI Weights **June 2009**

Why...

Bottom Line		80% of Budget	85% of Budget	90% of Budget	95% of Budget	Budget Hurdle	105% of Budget	110% of Budget	115% of Budget	120% of Budget	125% of Budget	130% of Budget	> 130% Budget
...ariance to Budget Earnings (000s)	(395)	(1,685)	(1,265)	(844)	(395)	+0	+424	+849	+1,275	+1,702	+2,130	+2,560	
...eward Pool (% Salary)	2.3%	0.0%	0.8%	1.5%	2.3%	3.0%	3.6%	4.2%	4.9%	5.5%	6.1%	6.7%	
...ward Pool (Weeks of Pay)	1.2	0.0	0.4	0.8	1.2	1.6	1.9	2.2	2.5	2.9	3.2	3.5	

Key Performance Indicator (KPI)	KPI Wgt	YTD Results	Budget Variance	Earnings Variance	KPI Earnings Variance (000s)	Earn Var Vs. May
Average Daily Balance						
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Interest Rates						
Net Interest Margin (%)	15%	3.74%	-0.13%	(312)	(312)	↓ 82.4
Non-Interest Income						
Non-Interest Income (000s)	10%				121	↑ 352.0
Asset Quality						
Past Dues (%)	5%				21	n/a
Net Charge-Offs (000s)					1	↓ 35.0
Operating Expense						
Non-Interest Expense (000s)					(383)	↓ 300.0
Sum of Weights:	100%				(395)	

How do we prevent further deterioration? (RED)

How can we eliminate these variances? (YELLOW)

How are we going to sustain favorable variances? (GREEN)

Overall Reward Pool Trigger(s):

> Net income after reward must meet or exceed $6,785,850.
> Reward pool cannot infringe upon captial policy.
> Extraordinary items may be excluded from net income trigger.

Individual Trigger(s):

> Employed with satisfactory review.

Scorecard Legend:

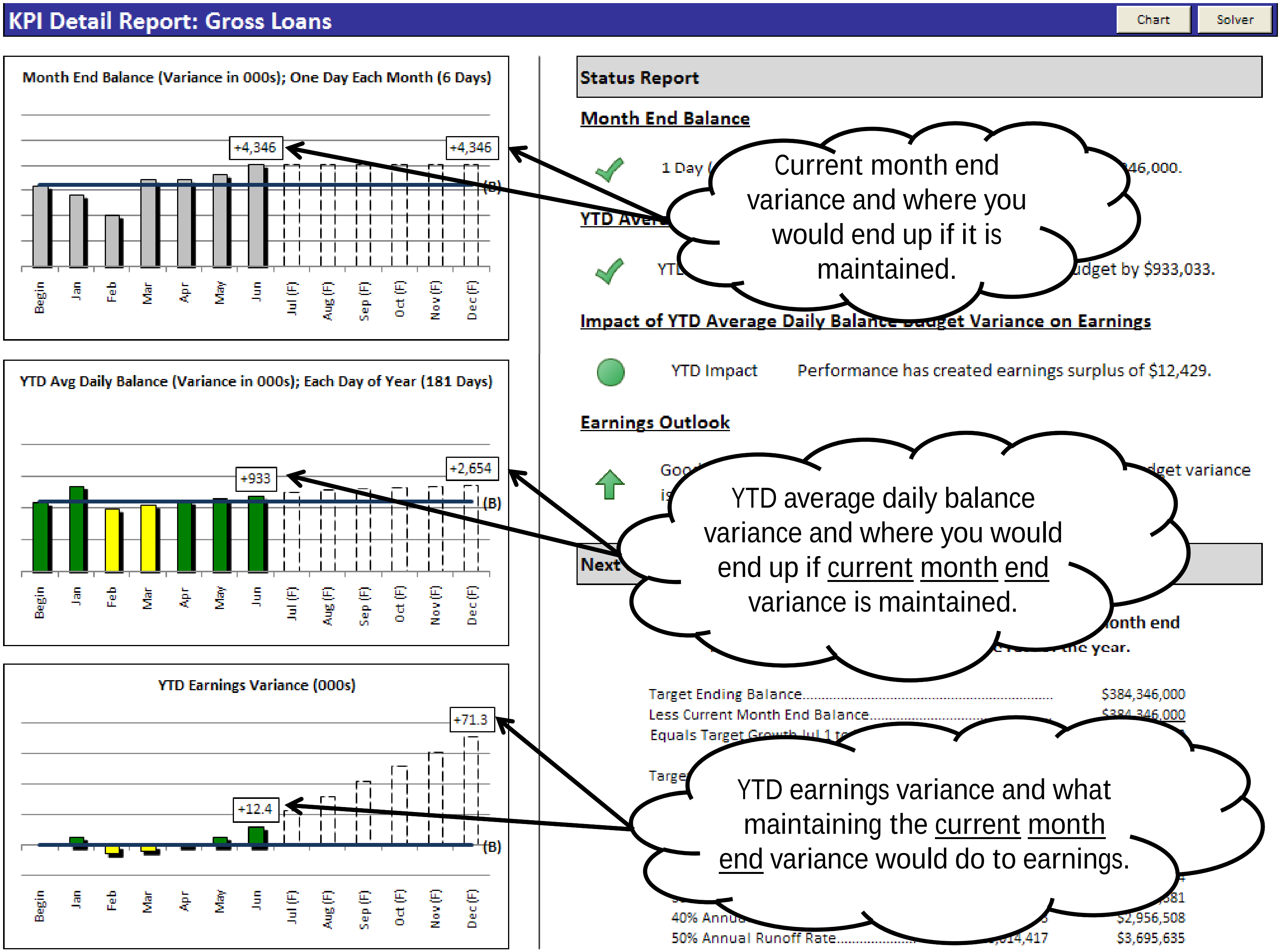
- Performance causing earnings to be more tha...
- Performance causing earnings to be slightly...
- Performance causing earnings to be significa...

Reward Pool Summary:

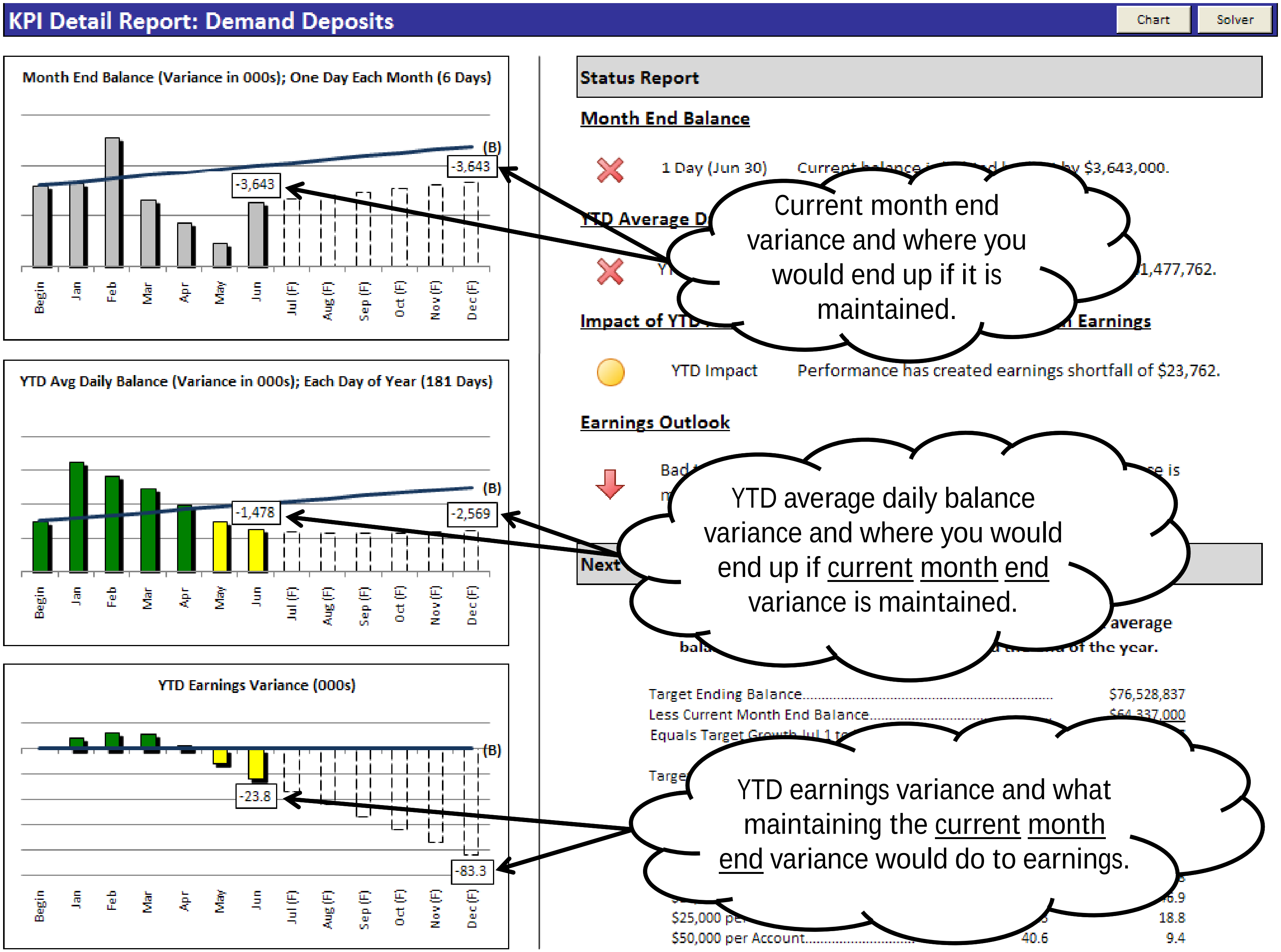
Business Literacy Risk…

- **More than an incentive program, Stakeholders is an approach to managing performance. For each financial metric on the scorecard, a detailed report is produced that includes the following:**
  - ***Performance to date versus budget and how has that impacted earnings.***
  - ***Where performance for the year would end up if the current budget variance is maintained and how that would impact annual earnings (e.g., forward looking analysis; would earnings variance get bigger or smaller and to what magnitude).***
  - ***A suggested course of action based upon the current budget variance:***
    - ***If ahead, an action plan is automatically created to sustain the favorable variance.***
    - ***If slightly behind, an action plan is automatically created to eliminate the variance.***
    - ***If way behind, an action plan is automatically created to reduce the variance.***
  - ***A business literacy lesson that shows how the metric affects earnings***
  - ***Source data from the general ledger for validation.***

KPI Detail Report Example (Ahead of Budget)...



KPI Detail Report Example (Behind Budget)...



Managing and Mitigating Incentive Risk

DISTRIBUTION RISK

Distribution Risk…

- **Distribution risk refers to the timing and format in which the incentive is paid and the impact that has upon behavior. More specifically…**
  - ***Monthly, quarterly, semi-annual or annual distribution of incentive(s)***
  - ***Multi-year distribution or vesting period prior to distribution***
  - ***Cash payment, stock, stock options, 401(k) contribution, etc.***

- **Distribution risk is outside the scope of the Stakeholders methodology; however, it is well documented that the methodology is designed to promote the <u>long</u> <u>term</u> viability of the organization[1].**

- **Our opinion is that semi-annual and annual distributions for staff and managers coupled with multi-year (and at-risk) distributions for officers and executives best reinforces long term viability. Resistance to being a "first mover" in the market place with respect to multi-year, at-risk distributions has inhibited acceptance of such practices.**

(1) Performance Compensation for Stakeholders: 14 Prerequisites for Success © 2002, 198 Pages, Library of Congress 2001132984

Distribution Risk…

- **Regardless of differences in opinions with respect to the format and timing of distribution, organizations should engage in practices that allow them to attract and retain qualified personnel. Failing to do so puts the organization at general business risk.**

- **The Stakeholders methodology will precisely compute the amount of earnings created to fund any distribution <u>method</u> (e.g., cash, stock, stock options, deferred, etc.) and any distribution <u>horizon</u> (e.g., quarterly, semi-annual, annual and multi-year); it is up to the organization to determine what best fits their requirements.**

- **The distribution approach should be in a manner that supports the guidance provided the Federal Reserve Board of Governors.**

Managing and Mitigating Incentive Risk

INDIVIDUAL OFFICER SCORECARD

Individual Scorecards…

- When applicable, individual performance compensation scorecards can be created within the organization. "Individuals" are generally employees who manage multiple customer relationships or a specific line of business:
  - *Loan Officer, Business Banker, Business Development Officer, etc.*
  - *Trust, Investments, Insurance, etc.*

- There are other "implied" individual scorecards as well. For example:
  - *The "individual" scorecard for the CEO is the total organization scorecard.*
  - *The "individual" scorecard for the branch manager is their branch scorecard.*
  - *Etc.*

- The same principles that apply to the total organization scorecard apply to the individual (and any other scorecard) as well:
  - *Directors' Rationale (e.g., mitigation of earnings risk)*
  - *Balanced set of comprehensive metrics (e.g., mitigation of metric risk)*
  - *Detailed reporting (e.g., mitigation of business literacy risk)*
  - *Organization is responsible for mitigating distribution risk*

Individual "Loan Officer" Scorecards…

- **The largest risk resides with what is traditionally referred to as the "Loan Officer" scorecard. In the pages that follow, we will provide specific examples of how the loan officer scorecard works.**

- **First and foremost, the loan officer scorecard is bottom line driven. Each officer is set up just like a bank with its own balance sheet and income statement. Because of this, the methodology avoids metric risk associated with:**
  - ***Rewarding only for originations***
  - ***Rewarding only for fee income production***
  - ***Rewarding based upon a net present value (NPV) basis***
  - ***Ignoring counter-balancing metrics (pricing, asset quality and expense control)***

- **Second, the methodology is "transaction lifetime" driven. The officer is responsible for the loan over the entire life of the loan.**

- **Third, the methodology is "portfolio" focused. Officers are rewarded to manage and maintain relationships and not for maximizing the number of transactions in a given year.**
  - ***Officers with large profitable portfolios are an efficient use of resources and extremely valuable to the organization and its shareholders. Accordingly these officers are rewarded to sustain their portfolio (rather than being incented to ignore the portfolio and only focus on new business).***
  - ***Officers with small or moderate sized portfolios represent a less efficient use of resources. They need to focus on a balance of portfolio maintenance and portfolio growth.***

Individual "Loan Officer" Scorecards…

- **Fourth, the methodology includes a <u>capital</u> <u>charge</u>. The capital charge shows up on the individual income statement to discourage activity that would pose elevated levels of risk to the organization. The greater the risk, the greater the capital charge (and the smaller the reward).**

- **Fifth, the methodology effectively back-tests the organization's loan pricing model. The methodology can be custom tailored to match the exact parameters used in the loan pricing model. Here is how the process works…**

  – ***During negotiation, various parameters of the anticipated relationship are entered into the loan pricing model (e.g., <u>unrealized</u> income):***
    - ***Loan Balance, Term, Amortization, Rate and Rate Type (Fixed/Variable)***
    - ***Anticipated Fees (as applicable)***
    - ***Anticipated Deposits (e.g., compensating balances, etc. as applicable)***
    - ***Anticipated Use of Credit Line (as applicable)***
    - ***Etc.***

  – ***Each month, the methodology captures the <u>realized</u> balance, rate and fee income information for each relationship the officer has. The realized income on the entire portfolio can then be compared with the expected income from the loan pricing model.***

  – ***Because the methodology only rewards for <u>realized</u> income, the risk associated with rewarding for expected income from a loan pricing model is eliminated entirely.***

Individual “Loan Officer” Scorecards…

- **The balanced set of metrics on a loan officer scorecard typically include:**
  - ***Loan Average Daily Balance***
  - ***Deposit Average Daily Balance (if measurable)***
  - ***Net Interest Margin (a counter-balance to loan volume)***
  - ***Leading Indicator(s) of Asset Quality (a shorter term counter-balance to sacrificing quality in return for volume or ignoring required account maintenance). Commonly used metrics include (but are not limited to)…***
    - ***Accuracy of Loan Grading***
    - ***Technical/Documentation Exceptions***
    - ***Watch List Loans***
    - ***Past Dues***
    - ***Non-Accruals***
    - ***Etc.***
  - ***Net Charge-Offs (a counter-balance to sacrificing quality in return for volume).***
- **As with the total organization scorecard, items that are too risky or undesirable may be excluded (sub prime loans, excessive duration loans, excessively large loans, etc.)**
- **An example of a loan officer scorecard is included on the next page.**

Example of Individual "Loan Officer" Scorecard...

Balanced Scorecard | Show All | In Use | ☐ Show Results | ☑ KPI Weights | **Scorecard Setup**

What...

< 65% Budget	65% of Budget	70% of Budget	75% of Budget	Bottom Line		80% of Budget	85% of Budget	90% of Budget	95% of Budget	Budget Hurdle	105% of Budget	110% of Budget	115% of Budget	120% of Budget	125% of Budget	131% of Budget	> 131% Budget
	(400)	(343)	(285)	Variance to Budget Excess Return (000s)............................	+0	(226)	(169)	(113)	(56)	+0	+57	+114	+172	+230	+288	+347	
				Reward Pool (% Salary)..	15.0%	0.0%	2.5%	5.0%	10.0%	15.0%	20.7%	26.4%	32.2%	38.0%	43.8%	49.7%	
				Reward Pool (Weeks of Pay)...	7.8	0.0	1.3	2.6	5.2	7.8	10.7	13.7	16.7	19.7	22.8	25.8	

Why...

KPI Earnings Variance (000s)	Key Performance Indicator (KPI)	KPI Wgt	Budget	Budget Variance	Earnings Variance	KPI Earnings Variance (000s)
	<u>Average Daily Balance</u>					
	Portfolio Loans (000s)	25%	36,591	0	-	
	Portfolio Deposits (000s)	10%	6,165	0	-	
	<u>Interest Rates</u>					
	Portfolio Spread (%)	20%	3.12%	0.00%	-	
	<u>Non-Interest Income</u>					
	Non-Interest Income (000s)	10%	90	0	-	
	<u>Asset Quality</u>					
	Technical Exceptions (%)	5%	10.00%	0.00%	-	
	Watch List (%)	5%	5.00%	0.00%	-	
	Past Dues (%)	10%	2.00%	0.00%	-	
	Net Charge-Offs (000s)	15%	-	0	-	
	Sum of Weights:	100%	Total Variance:		-	

Excess return drives reward pool
(net income minus cost of capital)

KPIs, which are de-facto earnings
drivers, explain <u>why</u> variance
exists (and to what magnitude).

Individual "Loan Officer" Scorecards…

- The greatest risk on the loan officer scorecard is credit risk, followed by interest rate risk and "excessive reward" risk.

- Asset quality is the counter-balance to help mitigate credit risk. Regardless of the counter-balancing metrics, strong internal policies with respect to underwriting need to be in place and <u>enforced</u>.

- ALCO policies must also be in place and enforced to mitigate interest rate risk. On the loan officer scorecard, spread will deteriorate (and reward will be penalized) if interest rate risk is realized.

- Excessive reward risk occurs when an individual has a very large portion of their total annual compensation based upon incentives.

  – *For example, annual incentives in excess of 35-50%, when the benefit to the organization of performance is realized over a period of years. Excessive risk (e.g., detrimental behaviors) could be taken to sustain such high levels of incentive compensation each year.*

  – *When appropriate, adjustments to base compensation should be made to transition high amounts of annual incentive compensation to base pay.*

  – *Excessive reward risk does not apply to a "fully/highly commissioned" individual who generates realized fee income in the same year they are incented.*

Individual "Loan Officer" Scorecards…

- Lastly, the incentive risk with the loan officer scorecard is not as large as one might initially think. Consider the following example…

  – ***Maintain an Average Loan Balance of $1,000,000***
  Reward = [Avg Bal X (Loan Yield – Loan Funding) – Cost of Capital] X Allocation to Reward
  Reward = [$1,000,000 X (5.50% - 2.50%) – ($1,000,000 X 10% X 15%)] X 25%
  Reward = $3,750 (for every year balance is maintained)

  – ***Incur Loan Net Charge-Off of $1,000,000***
  Penalty = Net Charge-Off X Allocation to Reward
  Penalty = $1,000,000 X 25%
  Penalty = $250,000

  – *Comparison = $3,750 annual reward Vs. $250,000 potential penalty over transaction lifetime*

- The individual scorecard is designed to reward for maintaining and growing a portfolio of profitable relationships (just like the organization's overall business model).

Managing and Mitigating Incentive Risk

CLOSING COMMENTS

In conclusion…

- **The Stakeholders methodology and its focus upon promoting the long term viability of financial institutions is well documented:**

  Beyond Survival: How Financial Institutions Can Thrive in the 1990s © 1990, 332 Pages
  Library of Congress 89011920

  Performance Compensation for Stakeholders: 14 Prerequisites for Success © 2002, 198 Pages
  Library of Congress 2001132984

- **The Stakeholders methodology is a performance management system first, and a compensation <u>opportunity</u> second (performance drives reward).**

- **The methodology unto itself is not a guarantee of success (no program can make such a claim). However, the methodology places a simultaneous emphasis on growth <u>and</u> profit <u>and</u> quality <u>and</u> productivity. It is the balance of these four factors that determines how successful the organization will be in the long term.**

In conclusion…

- **Relative to the industry business model, the Stakeholders methodology rewards the most for the items that are the <u>most</u> profitable, <u>least</u> risky and require the <u>smallest</u> amount of capital.**

- **In rank order, here is how the most commonly used metrics compare against each other on a dollar of budget variance versus reward paid basis:**

Rank	*Metric*	*Budget Variance and Pretax Marginal Contribution*	*Impact on Earnings/Reward*
T1.	*Non Interest Income Generation*	*$1.00 Variance = $1.00 Contribution*	*Highest Impact; Largest Reward*
T1.	*Non-Interest Expense Savings*	*$1.00 Variance = $1.00 Contribution*	
T1.	*Credit Loss Avoidance*	*$1.00 Variance = $1.00 Contribution*	
4.	*Interest-Free Deposit Balance*	*$1.00 Variance = ± $0.0250 Contribution*	
5.	*Loan Balance*	*$1.00 Variance = ± $0.0225 Contribution*	
6.	*Interest Bearing Deposit Balance*	*$1.00 Variance = ± $0.0100 Contribution*	
7.	*Time Deposit Balance*	*$1.00 Variance = ± $0.0025 Contribution*	*Lowest Impact; Smallest Reward*