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VIEWPOINT

Guilt by Association on Main Street

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In a banking world of toxic assets, the environment has gone toxic, too. Not the air we breathe, but the air of distrust of all things financial. With the latest allegations about **Goldman Sachs** and others, it seems the public is ready to believe that everyone in a bank must be a crook.

I, for one, do not believe it.

Let's separate the Wall Street traders from the Main Street bankers — something the press and Congress seem reluctant to do. There is no question that trading requires different skills than lending money on Main Street. The rules governing traders probably should be tightened. But those rule changes do not work on Main Street.

Perhaps some of the sparring over the past few months has given us an opportunity to correct our guilt-by-association image as Main Street bankers. And, for the majority of honest, hardworking, client-focused bankers, there are some actions the compensation committee can take to create a less toxic environment.

First, let's debunk the notion that outlandish compensation systems are the root cause of the unwarranted risk-taking that tanked the industry. Most bankers, particularly at banks with assets below $25 billion, have never met a synthetic CDO, much less sold one. But they have met bad real estate loans, and they are struggling to get them worked out. We've got to get the public to acknowledge that lending money involves managing risk — not eliminating it. Don't punish the whole banking system with draconian compensation rules to correct the unethical excesses of purveyors of esoteric instruments.

Compensation committees need to reexamine the measurements that underpin their executives' rewards. They must reevaluate the goals by which the executives earn their annual bonus, and be clear on what constitutes success and what constitutes failure to achieve. Input from the chief risk officer can help clarify the differences between setting a volume goal (e.g., produce more loans) versus an efficient use of capital goal (e.g., risk-adjusted return on assets or equity). The first allows payout without regard to credit quality; the second assures that credit costs figure into the calculation — reserves go up, ROA goes down, we get paid a smaller bonus.

For most of us, this is Banking 101. But when was the last time your compensation committee examined its compensation philosophy statement in the proxy? Next, the compensation committee needs to embrace two concepts that their executives may resist: multiyear payouts and clawbacks.

If the clawback language correctly focuses on the intentional misrepresentation of financial facts (aka fraud) as the reason to withhold or recoup bonus payments, there should be no resistance.

Multiyear payouts may be more problematic, particularly in the first year when total cash compensation probably goes down. There is common sense to the notion that multiyear loans may sour and be less valuable, even toxic, in the future. Should the top executives really get paid on loans that damage the bank? Surely there is a compromise that encourages appropriate risk-taking when setting credit parameters — even if we can't accurately predict credit environments two and five years out. Again, the chief risk officer is the compensation committee's best friend in trying to set appropriate parameters.

It appears likely these concepts will be incorporated somehow in future regulations. Midsize and smaller banks are better served by demonstrating efforts to make wise choices before they are forced to comply with rules better suited to larger banks.

Finally, let's incorporate the concept of a reputational-risk officer into our governance thinking. While the actions of top executives should always be within policy, sometimes these executives make dumb decisions. Someone needs to be empowered to call them on it. Keep the executive physicals, but lose the country club memberships. Don't charge the $1,000 bottle of wine to the bank, no matter how important the client.

Perhaps the chief risk officer and the chief human resources officer can double-team the reputational-risk element. But the board should want to know that the senior team is embracing good sense, and is not caught up in its own self-importance.

In these toxic times, let's retain our sense of balance. Don't let the outrageous behavior of a small number of our colleagues taint the good names and hard work of the rest of us.

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