ICM in the banking industry: A Best Practices Approach

Banking Industry Overview

Today's banking industry is characterized by innovation, intense competition, and an uncertain regulatory environment. The 2008 financial crisis rocked markets in North America and throughout the world, raising concerns about excessive risk-taking in financial institutions. In the aftermath, both regulators and the industry itself have been focused on risk mitigation and ensuring that compensation incentives are appropriate to maintaining stable growth that protects consumer assets.

COMPETITION

The banking industry is increasingly competitive with new products, new players, and new rules about **foreign participation** in the domestic marketplace.

Today, the traditional banks compete with other financial service companies, including trust companies, life insurance companies, credit unions and an array of government-run financial or mortgage agencies. The broad range of providers and products gives consumers greater choice for meeting their financial needs.

Competition has also intensified as rule changes have increasingly permitted foreign banks to compete in the domestic marketplace.

In the United States, federal and state banking laws allow Foreign Banking Organizations (FBOs) – those foreign companies that operate a US-based bank or operate a branch of a foreign bank in the United States -- to establish a variety of different businesses within the US marketplace. Data published by the US Federal Reserve showed that, as of December 2012, FBOs from 55 different countries were operating businesses in 18 different banking categories within the United States.[1] The different business lines included standard chartered banks, investment banks and trust companies, among other categories. Together these businesses constitute a serious competitive rival to US domestic banks.

Similarly, the Canadian banking sector includes banks from China, the United States, India, Korea, the United Kingdom, Japan, the Netherlands and France that compete directly with domestic banks. Canada's rule changes have also allowed different types of organizations to offer banking services, and the Canadian banking sector now includes:

- Banks owned by commercial companies such as department stores, hardware stores and grocery chains;

1. http://www.federalreserve.gov/releases/iba/201212/default.htm

- A bank owned by an insurance company;
- Virtual banks offering customers traditional banking services in addition to retirement savings products, mortgages and lines of credit. [C1]

INNOVATION AND TECHNOLOGY

Financial institutions have led the development of technology solutions such as online and mobile services, payment and clearing technologies, privacy and information security. Innovation in the banking sector has seen the development of numerous business solutions that have been adopted by companies and industries beyond the financial world.

UNCERTAIN REGULATORY ENVIRONMENT

As the industry evolves and grows more complex, government regulators are introducing and revising rules to keep the marketplace stable and responsive to consumer needs. In the post-crisis environment, regulatory changes have a real impact on each company's profitability. In the US, for example, implementing the Dodd-Frank Act increases the regulatory burden by requiring banks to add compliance personnel and processes, while limiting the revenue that banks can generate through certain business activities. Increased regulation will impact the business environment both in North America and globally.

ENHANCING STABILITY

In the aftermath of the financial crisis, the North American banking industry is emerging as a healthier, more resilient sector. Risk has been mitigated as a result of industry improvements and stringent systemic oversight.

Recent data from the Federal Deposit Insurance Corporation (FDIC) shows that US banks are holding nearly $1.6 trillion in capital, the highest levels in history[1]. At the same time, insurance firms' capital and surplus are at all-time highs, and insurance companies have been making record payments to individuals.

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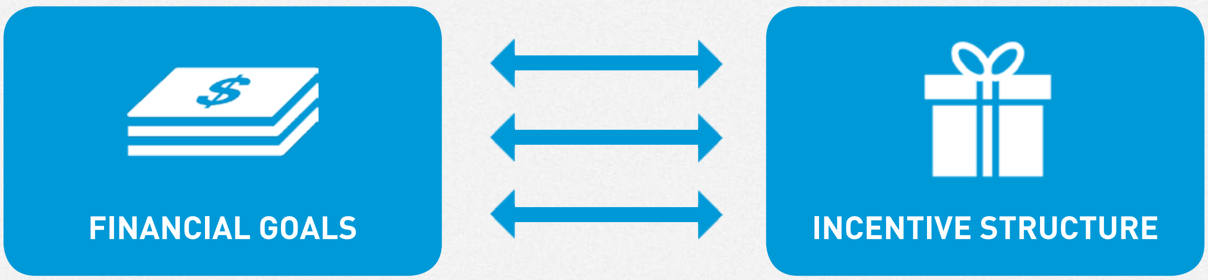
1. Regulatory changes under the Dodd-Frank Act require backs to maintain higher levels of capital to prevent losses to customer assets.

CT. Need to lead with US equivalent

Incentive Compensation Management (ICM)

One of the keys to success in this competitive and innovative industry is achieving *alignment* between a company's compensation incentive structure and its overall financial goals. Incentive Compensation Management (ICM) – a process for driving individual performance in accordance with overall strategy – is a key factor in a bank's long-term profitability.



"**ALIGNMENT**" MUST BE THE TOP PRIORITY

Focusing on alignment is especially important in the banking industry where companies have a range of products and business units, and customers routinely interact with a variety of company representatives. A typical customer, for example, will commonly interact with retail banking representatives, investment advisors, mortgage specialists, insurance agents or other staff. Each of these interactions is an opportunity to enhance the customer relationship through additional product sales, referrals or bundling. However, organizing this process across the network of customer-facing staff has the potential to create inefficiencies and throw off the alignment strategy.

Successful banks companies need an enterprise-wide ICM system to ensure that employee incentives drive desired behaviour and improve bottom-line results. Front-line representatives who understand they will be compensated by referring a customer to a particular product or division will take initiative to make the referral. When the customer takes the next step, the employee's scorecard will record the referral and the ICM system will reflect that upward trend of compensation plan driving the company's goals.

Properly designed and executed, an ICM process can drive a virtual cycle of company growth.

Regulatory Requirements Drive Business Practices

Following the 2008 financial meltdown, the banking industry came under pressure to follow risk-appropriate compensation practices that will not jeopardize a company's financial standing. Today, certain ICM practices are being driven by the introduction of government rules on compensation management.

US REGULATION

In the US market there are two specific regulatory policies that are driving regulatory compliance on compensation practices. First, the US Federal Reserve has issued *Guidelines on Incentive Compensation* calling on companies to adopt incentive compensation programs that are risk-appropriate and supported by strong corporate governance. Second, the Dodd-Frank legislation – the *Wall Street Reform & Consumer Protection Act* – also requires incentive compensation practices that are not excessive and do not promote behavior that will put their organizations at risk.

In order to understand and comply with the far-reaching regulations of the Act, agencies and financial institutions have hired more full time employees.
Over the past two years, the Federal Reserve alone has hired over 900 new employees. For smaller and mid-sized banks, hiring additional staff can be costly, and could reduce the ability to provide loans, securitizations, and other services.

In August 2012, Standard & Poor's reported that the Dodd-Frank Act could reduce pretax earnings for eight of the largest banks by between $22 billion and $34 billion each year.

INTERNATIONAL AGREEMENTS

Regulatory oversight of the US banking industry is also reflected in international governance practices. The Basel Accords – commonly referred to as the series of Basel I, Basel II and Basel III – commit the signatory countries to adopting a prescriptive set of banking regulations to ensure minimum capital requirements, proper supervision and market discipline. Basel discussions accelerated after the 2008 financial meltdown as the international agreements urged regulators in various countries to adopt Basel's risk mitigation policies.

Firms Still Rely on Inadequate Solutions

The banking sector is a key driver of technological innovation, although it is not unusual to find individual banks using outdated, homemade or disparate solutions.

DISPARATE SYSTEMS

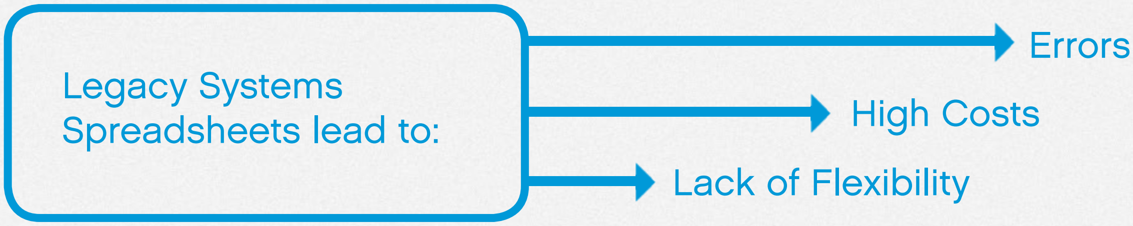
A disparity of systems often results from acquisition; banks acquire companies or divisions and those organizations continue using their historical systems. At the same time, disparate systems may emerge within a single company, developed within the "siloed" culture of different business units as each division builds its own system rather than following an overall and integrated strategy. Regardless of the cause, disparate systems generally suffer from:

- An inability to make timely changes;
- Excessive costs to maintain; and
- A lack of proper governance.

These practices lead to inefficiencies, missed opportunities for data tracking, learning and identifying growth opportunities.

INADEQUATE SOLUTIONS

Many companies rely on systems that are not well suited to achieving alignment. Some organizations continue using spreadsheets even though that approach lacks features that current practices demand. Spreadsheets can be:



Furthermore, multi-year compensation plans are complicated, and spreadsheet-based systems tend to spawn additional pages and create confusing, disorganized layers of data. Spreadsheets also lack embedded auditing, logging or reporting capabilities.

As a financial company grows and the industry evolves, each company should adopt an overall solution that aligns with its business strategy.

Management Best Practices for Incentive Compensation Management (ICM)

To design and implement an ICM system that achieves alignment, drives desired behavior and improves the bottom-line, companies should embrace best practice standards.

Learn and adapt.

The market is changing quickly, so a company's compensation-incentive structure must be flexible and ready to adapt. Building on their understanding of the performance, managers should keep the plan competitive and adjust it accordingly to ensure the incentives align with the top-level goals.

Communicate the plan.

A key part of alignment is getting the team on-board and making sure people understand the plan and the bank's overall business priorities. Senior managers should distribute clear, meaningful plans that have a visible connection between compensation opportunities and executive goals.

Enlist a strong senior-level champion.

Employees take their cue from the top, and a visible commitment from senior management will go a long way to making sure employees understand the system and commit to following the practices.

Strive for flexibility.

The ICM strategy must support all aspects of the bank's sales staff and their compensation plans, including:

- Commercial
- Small Business
- Mortgage Lending
- Product Referral
- Call Centers Scorecards
- Retail
- Wealth Management
- Insurance
- Annual Bonuses

The solution must be cross-functional, flexible and scalable to incorporate the incentive structure of the organization's range of divisions and business functions.

Measure and track performance.

Finally, the management team must track performance to get a clear picture of incentive compensation costs versus goals achieved. It is a key part of learning and adapting – management must use measurements to inform the strategy and continuously revise the plan as necessary. A company should set its compensation plan as a two-year goal and make sure it understands the impact that incentives are having on the bottom line.

Conclusions

Incentive Compensation Management (ICM) is a key factor in a bank's long-term profitability. Successful banks companies need an enterprise-wide ICM system to ensure that employee incentives drive desired behaviour and improve bottom-line results. Companies should follow these best practices:

- **MAKE ALIGNMENT THE PRIORITY**
  Companies must strive to achieve alignment between a company's compensation incentive structure and its overall financial goals.

- **ADOPT A FLEXIBLE, SCALABLE ICM SOLUTION**
  Companies should adopt a cross-functional solution that incorporates the incentive structure of the organization's range of divisions and business functions.

- **LEARN AND ADAPT**
  Companies must be ready to adapt to a fast-changing marketplace to keep the plan competitive and ensure incentives align with the top-level goals.

- **MEASURE AND TRACK PERFORMANCE**
  Companies must inform their continuous learning and adapting by continuously measuring their ICM performance.

For more information on how Intangent can help to align your ICM practices with your business goals, contact us today.

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