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Via Electronic Submission
Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Docket No. R-1374
Proposed Guidance on Sound Incentive Compensation Policies

Dear Ms. Johnson:

The following comments are submitted on behalf of the Independent Bankers Association of Texas ("IBAT"). IBAT is a trade association representing approximately 500 community banks domiciled in Texas.

The purpose of this comment letter is to address the Board of Governors of the Federal Reserve System's (the "Board") "Proposed Guidance on Sound Incentive Compensation Policies (the "Guidance"). The Board has requested comment on all elements of the Guidance as well as comment on any undue burden or unintended consequence the Guidance would place on regional and community banking organizations.

First, we suggest that the principles contained in the Guidance are not necessary. Banks are already subject to a strong and robust system of financial regulation. Although the Board's concerns about excessive compensation are warranted given events that have occurred over the past year, these concerns can already be addressed under the existing regulatory framework. For example, existing interagency guidance already prohibits "compensation that constitutes an unsafe and unsound banking practice," and regulators can impose enforcement action for such a practice. *See* 12 C.F.R. Part 364, Appendix A. Bank regulators already have the necessary tools to work with banks to craft incentive compensation structures that reinforce the goals of safety and soundness and that do not encourage excessive risk taking. Furthermore, an unnecessary additional regulation now would primarily affect community banks—institutions that were not the original source of problems in the area of excessive or inappropriate compensation. Strong bank management teams should be encouraged, and regulators should use existing tools to deal appropriately with weaker ones.

Second, formulaic limits should not be adopted. Bank compensation programs cannot be and should not be "one size fits all." While all banking organizations face some of the same issues, each organization's product line, customer base, size, and complexity vary, sometimes drastically, from organization to organization and market to market. Key employee compensation is an important tool that can be used to attract talented management, which in turn allows a bank to build its strength. It can take decades to produce a solid banker who is qualified to manage a bank during difficult economic times. This important tool should not be interfered with. It is counterproductive to prohibit reasonable compensation of bank managers and of significant revenue producers when these are the people who can see our banks through these difficult economic times.

Third, the Guidance is vague. Better defined principles would reduce compliance costs by providing clarity as to expectations. We suggest that the Guidance should clearly and directly address certain incentive compensation practices that appear to have actually had an adverse effect on banks' safety and soundness. Specifically, incentive compensation that is tied to the interest rate obtained on a particular loan or group of loans would appear to give lenders a personal economic motive for obtaining the highest rate possible regardless of the credit characteristics of the borrower. The least sophisticated borrowers would likely not be in a position to negotiate or even be aware that they could negotiate the rate. Thus, the result could also be viewed as a predatory lending practice. A better constructed incentive program would tie bonuses to achieving the bank's strategic goals for loan volume in accordance with the bank's lending policies and pricing matrices. Achieving targets should also be dependent on the quality, not just the quantity, of the loans booked, for example, to avoid the bank having unsafe loans added to its portfolio.

Another area where problems have been seen is where income is dependent on the sale of credit insurance products. This is currently appropriately regulated for national banks by 12 C.F.R. Part 2. In Texas, the same rules are applied to state chartered banks. Specific guidance addressing items such as the above would provide clarity as to the practices to avoid and those to consider appropriate.

Fourth, the Guidance places an increased burden on community and regional banking organizations and their respective boards of directors and committees. The board of directors and compensation committee will be faced with the task of evaluating the banking organization's current compensation structure as applicable to all employees. The board of directors and compensation committee traditionally are only involved in this process for top level employees. However, with the expansion to all employees under the Guidance, this evaluation and the process of performing an associated risk analysis will take a significant amount of time, cause increased legal exposure, and increase recruiting challenges, all of which translate to additional costs. The Guidance significantly expands board of director and compensation committee duties, and community and regional banking organizations cannot afford to compensate directors and committee members for this additional time constraint. Community and regional banks are already struggling to keep up with the influx of new regulations promulgated during the past year and the associated costs of compliance.

Fifth, as part of the Board's new supervisory initiatives, it will review the incentive compensation arrangements at community and regional banking organizations as part of the regular, risk-focused supervisory process. It is unclear what examiners will be looking for in terms of policies and procedures at regional and community banks. The lack of concrete requirements in the Guidance can lead to subjectivity on the part of the examiner. This subjectivity and lack of clarity will lead to increased costs, regulatory uncertainty, and potentially unfair treatment.

Banks need to know what the rules are so they can follow them, rely on them, and trust that examiners will apply the same standards to all organizations.

Finally, there are incentive compensation plans that provide for distributions in a manner that are not materially linked to the performance of specific employees or groups of employees that should be exempted from the Guidance. Examples of such plans include plans qualified under § 401 of the Internal Revenue Code like profit sharing plans, 401(k) plans, defined benefit plans, and money purchase plans. These plans generally cover all employees of a banking organization, and are governed by diversification requirements and prohibited transaction rules under the Employee Retirement Income Security Act and the Internal Revenue Code that restrict the investment of assets. The amount of contributions to such plans is limited by the Internal Revenue Code and determined by the board of directors of a banking organization. Investment decisions are made by the Trustee of the plan. For all of these reasons, such plans are unlikely to affect the risk-taking incentive of all or a significant number of employees.

In conclusion, IBAT appreciates the flexibility offered in the Guidance, but as discussed, the Guidance is not necessary. Rather, existing laws and regulations should be enforced. The lack of clarity in the Guidance leads to regulatory uncertainty. Regulatory uncertainty leads to increased costs for regional and community banks that must turn to outside counsel for compliance advice. Also of concern is the potential overreaction by conservative community bankers, leading to constriction in creative compensation plans. An unintended consequence could well be reduced capacity to compete with larger institutions for talent. Finally, without specific guidance as to examiner expectations, regional and community banks may be subject to unfair or inconsistent examiner treatment.

Thank you for this opportunity to comment.

Respectfully,

Karen M. Neeley
General Counsel

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