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Secretary,
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue NW
Washington D.C. 20551

RE: Proposed Guidance on Sound Incentive Compensation Policies
Docket No. OP-1374

Ms. Johnson:

The Missouri Bankers Association (MBA) appreciates the opportunity to comment on the Proposed Guidance on Sound Incentive Compensation Policies MBA copartners with the ABA and brings together Missouri banks and Savings and Loan Associations. MBA, following the lead of the ABA in this area works to find balance between "good profitability" and "excessive risk taking" to enhance Missouri's banking industry and strengthen Missouri's economy and communities. MBA's members – the majority of which are banks with less than $50 million in assets – represent over 30,000 employees and roughly 90% of commercial banking in Missouri. Guidance on sound incentive policies are important to insure that the bank's corporate culture sends the right message and protects the bank from excessive risk.

The MBA supports the principal goal of the guidance to ensure that incentive compensation arrangements at financial institutions do not encourage undue risk taking that could materially threaten the safety and soundness of the firm. As the Board recognizes, effective controls and risk management, coupled with strong corporate governance, including active oversight by the firm's board of directors, are a firm's best defense in ensuring that no individual or group of employees can create a material risk to the firm.

There are issues the MBA is concerned with both generally and specially. First, the FRB should strongly emphasize, through examiner guidance and training, that there is no single correct method of structuring an appropriate incentive compensation plan and that any FRB identified "best practices" may not be appropriate for a particular banking organization. Rather, it is up to each organization to determine how best to structure a balanced incentive compensation arrangement and to manage the risks, if any, associated with that arrangement.

Second, the FRB should make clear that not all incentive compensation arrangements need be subject to heightened scrutiny under the FRB's guidance. Rather, banking organizations should be able to determine which incentive compensation plans potentially pose risks to the safety and soundness of the organization and should be subject to the firm's risk management, control and corporate governance processes.

Third, implementing the FRB's guidance should not impair a banking organizations' ability to retain and attract talented employees or adversely affect the privacy rights of those employees. There are also comments on specific ways to manage incentives.

The proposed guidance appropriately places the determination of how best to structure incentive compensation arrangements for each banking organization squarely on the shoulders of bank management and its board of directors. Specifically, banking organizations are expected to evaluate their incentive compensation arrangements for executive and non-executive employees who, either individually or as part of a group, have the ability to expose the firm to material amounts of risk. Banking organizations are also expected to review their risk management, control and corporate governance processes related to these arrangements and address any deficiencies in these arrangements or processes that are inconsistent with safety and soundness.

DISCUSSION

The proposed guidance appropriately places the determination of how best to structure incentive compensation arrangements for each banking organization squarely on the shoulders of bank management and its board of directors. Specifically, banking organizations are expected to evaluate their incentive compensation arrangements for executive and non-executive employees who, either individually or as part of a group, have the ability to expose the firm to material amounts of risk. Banking organizations are also expected to review their risk management, control and corporate governance processes related to these arrangements and address any deficiencies in these arrangements or processes that are inconsistent with safety and soundness.

As the guidance notes, the prevalence and scope of incentive compensation arrangements will vary, generally with the scope and complexity of the organization's activities. Similarly, risk management and controls will vary across banking organizations according to the business model, risk tolerance, size and complexity of each firm.

No One-Size-Fits-All Approach

Consistent with this approach, the guidance does not mandate the use of a single formulaic approach to setting incentive compensation, partly in recognition that such singular approaches could provide certain employees with incentives to take on excessive risks. Moreover, while some banking organizations may find it helpful to defer a certain percentage of incentive compensation awarded to senior executives or to award a certain percentage of that deferred amount in the form of equity or equity-linked instruments, these approaches are just several of many measures that may be employed as part of balanced incentive compensation arrangements. As the guidance recognizes, other methods could include longer deferral periods and reducing the award rate as successive performance targets are met. Finally, by definition, a formulaic approach cannot embrace the diversity in terms of charter type, size, geography and business model of this nation's 7,000 plus banking institutions.

In this connection, we note that the guidance contemplates that through the special horizontal review of incentive compensation practices at large complex banking organizations (LCBOs), as well as through the risk-focused examination process for all other banking organizations, the FRB will be able to identify emerging "best practices" in connection with incentive compensation arrangements. While MBA agrees that the future development and refinement of effective and balanced incentive compensation arrangements is to be encouraged, we are concerned that the FRB's efforts to identify "best practices," through the use of multidisciplinary resource teams for supervisory staff and its planned 2011 report on trends and developments in incentive compensation arrangements, could have the unintended effect of dictating one-size-fits-all incentive compensation arrangements for banking organizations. To avoid this result, we strongly encourage the FRB, through examiner guidance and training, to educate its supervisory staff that the responsibility for structuring balanced incentive compensation arrangements appropriate for each particular banking organization rests not with the regulators but with bank management and its board of directors.

Minimizing Undue Burdens

The guidance recognizes that designing and implementing compensation arrangements that properly incent employees to pursue the organization's long-term well being and that do not encourage excessive risk-taking is a complex task that requires the commitment of extensive resources. As an example, many public banking organizations have historically focused much of their scrutiny on their top five senior executive incentive compensation plans. Under the guidance, this scrutiny will now be expanded to cover:

- All senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;
- Individual employees whose activities may expose the firm to material amounts of risk (e.g., traders); and
- Groups of employees who, in the aggregate, may expose the firm to material amounts of risk (e.g., loan officers).

While it is appropriate to focus beyond the incentive compensation structures of the top five senior executive officers, regulatory examination and supervision should, nevertheless, be narrowly focused on the incentive compensation plans of those employees or groups of employees that truly can affect the safety and soundness of the firm. In this vein, the guidance appropriately recognizes that certain job families pose little risk to the safety and soundness of the banking organization and, thus, are outside of the guidance. We strongly believe that risk management and control processes are the heart of safety and soundness, and, accordingly, the FRB should explicitly acknowledge in the guidance that banks can consider the effectives of these processes in determining which employees are "covered" by the guidance.

Similarly, banking organizations should also be able to demonstrate through their processes and controls that certain types of incentive compensation plans do not pose sufficient risk to the safety and soundness of the institution to come within the guidance's coverage. For example, referral programs that reward employees, small sums of money for sending a customer to an investment counselor pose little risk to the institution, especially as the referring employee has no control over whether the customer purchases an investment product. Employees, such as these, are less likely to engage in excessive risk taking when their incentive compensation is a small portion of their overall compensation. Profit sharing plans should also be excluded from the guidance's coverage as they, too, pose little, if any, incentives for excessive risk taking.

Retaining Talented Staff

The MBA strongly endorses the fact that the proposed guidance is consistent with the Principles for Sound Compensation Practices adopted by the Financial Stability Board (FSB) in April 2009, as well as the Implementation Standards for those principles issued by the FSB in September 2009. As the guidance recognizes, incentive compensation arrangements serve several important and worthy objectives, including helping to attract and to retain skilled staff and promoting better firm and employee performance. Given the global nature of financial services, coordination, as appropriate, with international and other domestic supervisors on compensation issues is central to the banking industry's continued ability to retain and attract talented employees.

In this connection, we understand the need for the regulators to have access to confidential information concerning incentive compensation awards made. We are, however, concerned that, the guidance's focus on increased disclosures could have the unintended consequences of undermining the banking organization's ability to retain and attract talent, as well as violating individuals' privacy. For example, the guidance emphasizes the need for banking organizations to provide sufficient information concerning its incentive compensation arrangements and related risk management, control and governance processes in order to allow shareholders to monitor and take action where appropriate. The FRB has stated its intention to work with the Securities and Exchange Commission to improve public banking organization incentive compensation disclosures in ways that promote safety and soundness of the firms. The FRB has also suggested that its regulatory reporting forms may be amended to require certain information about incentive compensation awards and payments.

As the FRB is aware, recent public disclosures concerning certain firms' bonus payouts have caused those affected employees to be subject to unwarranted scrutiny and, in some cases, to fear for their personal safety. Even information disclosed at a summary level can be easily traceable to individual employees. We would encourage the FRB to tread carefully in this area and be mindful the impact these disclosures could have on banking organizations' ability to attract talent. In addition, information obtained through the examination process should be treated with the appropriate level of confidentiality that it deserves. For all these reasons, MBA does not support further public or regulatory reporting of incentive compensation arrangements, even if provided at a summary level.

Concerns that this Guidance May Misdirect Some Banking Organizations

I. Community banks were not and are not the principle cause of the financial troubles the American economy has been subjected to in the last 2 years. While enormous amounts of TARP funds went to Wall Street and the very largest financial institutions, layers of cost and new guidance have been imposed on community banks.

The proposed guidance issued by the Board defining banking organizations, include for the purpose of this proposal "U.S. bank holding companies, state member banks, Edge and Agreement Corporations and [certain U.S. operations of foreign banks]". However once the Federal Reserve has promulgated guidance, it seems inevitable that the FDIC, OCC and OTS will follow with a similar version.

While the concern we hear from banks about new guidance of incentive compensation is great, the Federal Reserve at the end of its proposed guidance indicates that for $5 billion holding companies and less, it will continue to follow advice provided in SR Letter 02-1, see *Federal Register* Vol. 74, No. 206, page 55238, from January 9, 2002, footnote 21. This suggests the focus of this guidance is on large complex banking organizations (LCBO). It would be far simpler to cut out community bankers that are flooded with new guidance and guidelines; these bankers could check off one area that has not apparently changed. With all the new guidance, there is a very different "moral hazard" that systemic risk will be ignored and community banks may surrender to consolidation, merger, or other means to realize value for their bank and end community banking. Economies of scale do count, particularly with the requirements for new software to address many of the regulatory and/or guidance challenges.

For details, one only needs to look at the increased regulatory and cost pressures on community banks, including prepaid FDIC assessments, pressures on earnings from new regulation of convenience overdrafts to low interest rates on loans, disintermediation and/or reduction in interest spreads between loans and deposits or other sources of funding. These issues contribute to a misplaced focus since without a profitable bank, no bonuses are possible. However incentive bonuses for real estate loans, the bread and butter of many community banks, could be subject to the same assessments as a LCBO.

II. The Board's proposal has been broken up into three parts: 1. Balanced Risk-Taking Incentives, 2. Compatibility with Effective Controls and Risk Management, and 3. Strong Corporate Governance.

1. Balanced Risk-Taking Incentives Reviewing the large complex banking organizations (LCBO), the Federal Reserve has proposed four categories of solutions to meet the Balanced Risk-Taking mentioned above and include a)"Risk Adjustments of Awards",

b)"Deferral of Payments", c)"Longer Performance Periods" and d)"Reduced Sensitivity to Short-Term Performance". These are reviewed below:

a) Risk adjustment of awards takes into account on a judgmental basis the relative risk that an employee's activities pose to the bank. b) through d) stretch out the earning of incentives so that "the award is delayed perhaps [even beyond the performance period] and adjusted for actual losses… that became clear only during the deferral period". Longer employee reward incentive performance periods aid the process and reduce the risk to the bank and this is coupled with "reduced sensitivity to Short-Term performance". This micro managing of a private business brings up all kinds of questions.

- Will not disbursing loan incentive fees over time inhibit bank's ability to attract and retain its most talented employees?
- When an employee leaves the bank, how does the bank treat the incentive compensation it holds?
- How is the employee compensation protected with new management? Will some type of trust hold the employee's earnings tax free?
- If the incentive based pay is withheld for three or four years, will former employees be subjected to "haircuts" [because of losses that result to the loan or other project but not necessarily due to the employees fault]?

2. <u>Compatibility with Effective Controls and Risk Management</u> Summarizing the subcategories here from the proposed guidance for comment, banking organizations should have appropriate controls…for achieving balanced compensation. These controls should include "risk management personnel… for designing incentive compensation and assessing their effectiveness in restraining excessive risk taking." Compensation (and apparently authority) of risk management personnel should be such that they believe in their function and have the adequate tools to perform it. The bank has the overall responsibility for monitoring its incentive compensation arrangements and making adjustments to reflect risk.

- This may be necessary to re-school some banks in risk management, or, is this just another level of upper management bureaucracy that slows down an efficient well organized bank and is bypassed by the risky bank?
- Where were the bank regulators? In the *New York Times* Business Section for November 19, 2009, the chief bank examiner for the OCC is quoted as follows: "Hindsight is a wonderful thing" said Timothy W. Long … "At the height of economic boom, to take an aggressive supervisory approach and tell people to stop lending is hard to do."
- The same article quotes "Federal Officials" as discussing hard limits, not just soft guidelines on the portion of the bank balance sheet that can be made up of commercial real estate loans. Is this proposal on hard limits a new "straightjacket" for all banks that will retard economic recovery?

- Does this mean as the United States is emerging from the "great recession" banks need a narrow mandatory requirement to limit commercial real estate loans?

3. Strong Corporate Governance. There are a number of generalized statements proposed in this category, though the breath and depth of reorganization may so tax the banks or bank holding boards and the bank directors responsible, that the current boards resign and are replaced with lower quality board members with the time but far less expertise. Currently for LCBO, the giants in industry and the academic world serve as directors on the bank; who will replace them?

Only some categories are addressed here: b) The Board should regularly review the design and function of incentive arrangements on an annual or more frequent basis. d) A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.

Under the second category of incentive review (b), this guidance calls for a "backward-looking basis" to determine whether the bank incentive compensation arrangements may be promoting excessive risk taking.

- With so much at stake, could a bank board's "backward-looking basis" drawing lessons from the past on incentive compensation, turn into a *scape goating* exercise, where the "golden high productive bankers" now become object lessons in what not to do, despite changes in the analysis? The productive bankers then suffer unfair ostracisms creating perhaps ex-employees, or a more conservative corporate culture.
- The board is directed to stay abreast of current changes in incentive compensation with the warning that each bank is potentially different and incentive compensation for one banking group may not be prudent for another banking group.
- For example commercial real estate market is all about real estate…but each parcel and building is unique. In realtors training there is the cry of "location, location, location". How much risk and customization is needed to balance "downtown redevelopment" with its own risk, with suburban and ex-urban development each with their own risk? Each step including the power of eminent domain (condemnation by public authority of private property for a quasi public/private purpose) and the risk based incentive connected with each building or raw ground is based on banker judgment and experience…that may from hindsight go bad.

Under the forth category above (d), A banking organizations disclosure practices should support safe and sound incentive compensation arrangements.

- Banking organizations disclosure practices should provide an appropriate amount of information concerning incentive compensation to stockholders and take action to restrain the potential for such arrangements and processes. How much transparency is enough? For public corporations, if the stockholders and public filings with the SEC are consulted, there is significant transparency. Requesting more may allow anyone in the industry through shareholder ownership, potential access to what the bank may consider “trade secrets” or other secret methods that insure a bank’s success.

- There is some bright light in this guidance; a positive footnote 18 on page 55237 indicates that small regional and community banks with less complex lending may not find it necessary to retain and use outside experts for effective overview.

CONCLUSION

In conclusion, the MBA appreciates the opportunity to offer comments on the FRB’s incentive compensation guidance. The FRB should make clear that the guidance does not embrace a one-size-fits all model of compensation structures; that any “best practices” developed are suggestions at best; that only those job families and incentive compensation plans that pose risks to the safety and soundness of an organization should be subject to rigorous risk management, controls and corporate governance processes; that care should be taken so that implementing the guidance does not impair a banking organization’s ability to retain and attract talented employees; and finally the MBA is concerned that the pendulum of regulation may swing to far towards micromanaging a banking organization.

Sincerely

(Signed)

Max Cook
President