The Clearing House

James D. Aramanda
Chief Executive Officer
Phone 212.613.0140
jim.aramanda@theclearinghouse.org

November 27, 2009

Board of Governors of the
Federal Reserve System
20th Street, N.W. and Constitution Avenue
Washington, DC 20551
Attention: Jennifer J. Johnson, Esq.
Secretary

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

Governors:

The Clearing House Association L.L.C. (the "Clearing House") appreciates the opportunity to comment on the Board of Governors of the Federal Reserve System's "Proposed Guidance on Sound Incentive Compensation Policies" (the "Proposal"). 74 Fed. Reg. 55,227 (Oct. 27, 2009). The Clearing House fully supports the Proposal's goal of avoiding incentive compensation arrangements that encourage undue risk taking. We believe that many of the key concepts in the Proposal are sound, and we support their adoption. We are, however, concerned by a number of other aspects of the Proposal, and we urge their modification.

I. Key Concepts

1. Relation of Incentive Compensation to Risk.

The Clearing House strongly agrees that incentive compensation arrangements should not encourage employees to take risks that endanger a bank's safety and soundness.

We further agree that the objective should be to avoid "excessive" risk, and not all risk. The banking function inherently involves elements of risk: credit risk of borrowers and counterparties, maturity risk as banks lend for longer periods than they borrow, and operational risk as they process transactions for companies and individuals around the globe. If banks were to attempt to build incentive-compensation arrangements—or any other risk-management systems designed to eliminate rather than control risk, banks could not perform their essential role in a modern economy.

Incentive compensation is, of course, only one of the myriad factors that affect the risk profile of a bank. In the final analysis, successful risk management depends on overall risk-management systems, and, importantly, on the quality of the bank's personnel. Accordingly, any evaluation of a bank's incentive compensation arrangements should take into account the strength of its risk-management processes, controls, and personnel. It is essential that a balance be struck in developing incentive compensation arrangements that do not inadvertently create inducements to take excessive risk while also avoiding compensation restrictions that will result in a reduction in the quality of personnel. We encourage the Federal Reserve to include an explicit statement to this effect in the final guidance.

The Proposal correctly notes that the incentive compensation arrangements for two individuals producing the same amount of revenues should be different if the individuals incur materially different risks in achieving those revenues. So, too, incentive-compensation arrangements may appropriately be different at two banks with the same basic risk profile if one bank has materially superior risk-management controls and systems.

2. Guidance Rather than Rules

The Proposal continuously stresses that it is designed to provide guidance rather than rules. We believe that it is essential to implement the Proposal in that spirit. Horizontal reviews can yield meaningful insights by gaining an industry-wide perspective, but they can also be misused to establish a patchwork of practices drawn from very different institutions and labeling them as "best practices." If, through the horizontal review or otherwise, the effect of the Proposal is to impose rules, the consequence will be less effective risk control. Banks will then have incentive-compensation arrangements that are not directed to their individual risk profiles but rather to an artificial amalgamation of rules that will often be inappropriate.

The need to recognize the risk characteristics of individual banks in assessing incentive compensation arrangements is about more than the issue of avoiding unnecessary restrictions on compensation arrangements that do not create undue risk. It is also about not promoting arrangements that are rule-compliant but may actually encourage undue risk in the particular circumstances of an individual institution.

3. "One Size Does Not Fit All"

We appreciate the Federal Reserve's recognition that "one size does not fit all" with respect to incentive compensation arrangements. As both the Federal Reserve and the Financial Stability Board recognize, a formulaic approach applicable to all firms would inevitably both exaggerate the incentives for some employees at some firms to incur undue risk and discourage some employees at some firms from taking reasonable and appropriate risks. Moreover, any specific practice at a given institution must be evaluated in the context of that institution's overall risk profile and risk-management process. Each institution not only has its own risk profile, but also its own business model and competitive position. Flexibility in applying the guidance would allow firms to attract the best talent to support these strengths and, therefore, the safety and soundness of the institution.

In this context, we trust that such references in the Proposal as a "common prudential function," "best practices," and "first mover" advantage are not translated by examiners into a call for de facto rules. We recommend that the final guidance explicitly provide that formulaic requirements or other rules would be counterproductive. Further, it would be helpful for the Federal Reserve to state explicitly that it is not developing industry-wide mandates for structure, results, programs, or plans.

II. Specific Comments.

1. Role of Incentive Compensation Arrangements

We strongly agree with the Federal Reserve that incentive compensation arrangements are an essential element of a modern financial institution's total compensation arrangements (along with fixed salary and retirement and other benefits).

Incentive compensation is encouraged by legislative enactment, such as the tax laws, and, more importantly, mandated by basic principles of sound corporate governance and regulatory policy. As the Proposal notes, "incentive compensation arrangements often seek to serve several important and worthy objectives." Id. at 55,231 and n.2. If compensation is not tied to some appreciable extent to performance, excellence, and commitment will go unrewarded and ultimately will be discouraged. Financial institutions will have difficulty attracting and retaining the most capable individuals, and their employees will have reduced incentive to perform well. The potential that poor performance will be compensated on equal terms with strong performance will ultimately lead to a compensation system that reduces safety and soundness and the quality of service provided to customers.

In these circumstances, it is essential that the principles guiding incentive compensation not discourage all incentive compensation or even reduce its general role. The problem is not incentive compensation as a concept but its use in an imprudent manner. We submit that, although almost all large, complex banking organizations utilize incentive compensation programs, at only a relatively small number can excessive risk be attributed to these programs.

2. Penalties

The Clearing House is concerned by the suggestion that the Federal Reserve would utilize the full panoply of its supervisory powers lower examination ratings, restrictions on acquisitions, and enforcement actions against banks that fail to comply with regulatory guidance and expectations regarding incentive compensation arrangements. We agree that those actions are appropriate when reserved for those institutions that have been given fair warning about the practices in question and failed to make appropriate modifications.

It must be remembered, however, that we are dealing with often novel and constantly changing practices. "Effective and balanced incentive compensation programs are likely to evolve significantly in the coming years." Id. at 55,232. There will need to be a trial period for both the institutions and their supervisors. The correlation between a particular program and risk is often not obvious, and a reliable conclusion will require time and experience to emerge. For this reason, we recommend that the first round of examinations after the implementation of the final guidance should be aimed at discovery and discussion in other words at identifying the practices implemented by the examined institutions, reviewing their effectiveness and relationship to risk-taking, and discussing the relevant issues with the institution. We believe this would allow the Federal Reserve to become appropriately expert in prevalent compensation practices before taking supervisory actions.

3. Special Focus on LCBOs

The Proposal provides directly for the special horizontal review of 28 large complex banking organizations ("LCBOs") and can be read to suggest that the LCBOs will be subject to both more stringent scrutiny and more stringent restrictions on an on-going basis.

We recognize that imprudent compensation practices, or other unsound practices, at a large institution have the potential to pose greater risk to the system than unsound practices at a smaller institution. It is essential, however, to distinguish this truism from the inaccurate assertion that size itself puts an individual institution at greater risk. As the Proposal indicates, an incentive-compensation system can encourage excessive risk taking even if it applies to a small bank focusing on a single loan product. Likewise, a broader suite of products and services does not equate to greater risk to the institution. Indeed, business or product diversification can reduce an institution's risk profile. Moreover, size can permit a greater commitment of resources to risk management in absolute terms and enable the development of greater and more specialized expertise in control functions.

It is, therefore, essential that the Proposal not result in undue restrictions on incentive-compensation practices at institutions just because they are large or complex. The issue should be analyzed in terms of risk, not size. We simply submit that the Proposal not be enforced differently at large institutions solely because of their larger size.

4. International and Interagency Coordination

The Federal Reserve, as well as the Financial Stability Board, stresses the need for supervisory action because the so-called "first mover" problem discourages initiatives at individual institutions. We submit that a similar issue will arise if any individual country imposes compensation requirements that are inconsistent with the compensation practices in other major financial centers. The banks in such a country will be placed at a significant competitive disadvantage. They will have difficulty in retaining or attracting the best performers those who will ultimately be able to assure the bank's safety and soundness. The same is largely true with respect to interagency cooperation within the U.S. regulatory system.

For this reason, we urge the Federal Reserve to consult and coordinate closely with the banking supervisors in other major countries. Although we recognize that no two countries will have identical regulatory schemes for incentive compensation, every effort should be made to coordinate both the substance and timing of incentive compensation regulation.

We also urge the Federal Reserve to consult and coordinate with the other U.S. banking regulators. This coordination will potentially give the Federal Reserve deeper insight into the risk-management practices at institutions directly supervised by these other regulators as well as avoiding, or at least minimizing, conflicting expectations from multiple regulators.

5. Formulaic Limits

For the reasons discussed above, The Clearing House strongly opposes formulaic limits. The example provided in the Proposal illustrates the deficiencies in any formula that would be applied to multiple banks or multiple employees. Id. at 55,234, n.14.

As the Proposal itself recognizes, different types of risk occur over multiple time horizons. The risks in a short-term trading portfolio or liquidity-management function may be realized over a short period of time while the risks in a loan portfolio, longer-term trading portfolio, or equity-investment portfolio are only recognized over a longer (perhaps much longer) period. A given level of deferral may be excessive for the first category and insufficient for the second, although it is also possible that performance measures for each category could be risk-adjusted such that compensation decisions could result in similar deferral levels for both.

Likewise, a requirement that a minimum percentage of compensation be paid in equity can produce the outsized compensation packages that have generated so much recent controversy.

This is not to argue against the basic approaches of deferral and usage of equity, both of which we believe represent important components in developing an incentive compensation program. Our position is, instead, that the appropriate degree of reliance on each should be determined by each firm within an overall firm-determined framework for compensation and risk governance, which may include the results of the firm, segments of the firm, and the individual responsibilities of the relevant employees.

6. Golden Parachutes and Golden Handshakes

The Proposal strongly suggests that "golden parachutes" and "golden handshakes" should be eliminated. We submit that these arrangements have only a tangential tie to the incurrence of excessive risk and that a total bar would be counterproductive to the Proposal's overall goals.

The Federal Reserve is apparently concerned that the change-in-control feature of golden parachutes encourages excessive risk. As we understand the Federal Reserve's position, even if deferral would otherwise protect against an employee's incurrence of excessive risk, the employee will be "bailed out" by a change in control. We submit, however, that the prospects for a change in control are so speculative that a golden-parachute arrangement would encourage few, if any, employees to take excessive risk. Employees would not assume that, even if the risk results in losses and thereby loss of compensation, there will be sufficient offsetting benefit from a change in control parachute. We also note that golden-parachute arrangements for "troubled banks" are already tightly regulated under existing regulatory programs.

More broadly, separation arrangements provide an important retention tool, encouraging employee continuity and affording incentives for appropriate transition when employees depart. These arrangements can effectively work as a form of deferred pay that guards directly against the risk of abrupt employee departure in a way that other pay structures may not. We submit that such arrangements should not be prohibited on the basis of a few, well-publicized excesses, but instead evaluated as part of a comprehensive compensation structure.

Likewise, a bar on golden handshakes seems unduly restrictive because, again, these arrangements seem too speculative to encourage undue risk. The apparent Federal Reserve concern is that deferred compensation (and other arrangements) will not act as a sufficient check if the employee believes he or she can "earn" that compensation at another employer through the "replacement" element of a golden handshake. For this scenario to arise, a large number of factors must come together: the employee must be seeking a new job before the deferral period ends; the employee would not be entitled to the deferral income if he or she stays because of yet-to-be-realized losses; the employee is able to find a new job; and the employee is able to secure an equivalent golden handshake. We believe that this series of predicate events makes it unlikely that the potential of a golden handshake plays a material role in incentivizing excess risk.

7. Background Assumptions in the Proposal

We recognize that, in some cases, "banking organizations too often rewarded employees for increasing the firm's short-term revenues or profit without adequate recognition of the [related] risks . . . ." 74 Fed. Reg. at 55,228. At the same time, however, we believe that such conduct was far from universal. Moreover, we believe that at a number of companies robust overall risk-management was sufficient to prevent the risk in incentive-compensation arrangements from being realized.

Our point, once again, is that all institutions should not necessarily be treated the same even if they have similar incentive-compensation arrangements. If they have different businesses or different risk-management controls, the outcome will be different.

The Proposal also suggests that more restrictions on incentive-compensation arrangements are necessary at banks than at other companies because bank shareholders may be willing to tolerate a degree of risk that is inconsistent with safety and soundness due to the "protections offered by the federal safety net." Id. We respectfully disagree. Recent experiences demonstrate that the federal safety net does not prevent shareholders from being wiped out or virtually so. An analysis of the identity of investors in LCBOs and their price-book and price-earnings ratios does not suggest an undue risk appetite.

Again, we agree with the "first mover" analysis provided in the Proposal, and, as discussed above, believe that it should be extended internationally.

8. Three Principles

The Clearing House agrees with and supports the three principles that are the foundation of the Proposal. We are particularly supportive of the explicit connections between incentive-compensation arrangements and overall risk controls and management. We submit that our recommendations in this letter would enhance the ability of banks to meet these principles. We further recommend that the Federal Reserve's examiners be instructed that the goal of the examination process is to ensure implementation of these principles and not to prescribe a specific set of rules.

9. Consistency with Current Practice

Our member banks report that they believe that their current incentive and compensation arrangements are generally consistent with the three basic principles. See id. at 55,229. We note, however, that this is an evolving area and that regulatory expectations have not been fully developed, let alone articulated. Accordingly, the Federal Reserve should provide sufficient lead time for banks to conform to those expectations.

We are not aware of material legal, regulatory, or other impediments to the prompt implementation of incentive-compensation arrangements that are consistent with the Proposal.

10. Exempted Plans

We believe that firm-wide profit-sharing plans should generally be considered as exempt from the guidance. See id.

11. Exempted Employees

In order to minimize burden and to focus on true risk creation, we support the conclusion that there should be exemptions for certain broad classes of employees who do not, or whose compensation arrangements do not, create material risk. We recommend that the final Proposal explicitly authorize individual banks to create such exemptions and outline additional examples. In addition to tellers and bookkeepers, potential examples could include administrative assistants, employees whose tasks are to process but not originate transactions, and employees whose target incentive compensation does not exceed one-third of total compensation.

12. Foreign Banking Organizations

Our concerns about international coordination are heightened by the application of the Proposal to the management of a foreign organization's entire U.S. operations. Id. at n.3. It is essential, as the Proposal recognizes, that such assessments be compatible with the home country's overall operations. Id. at 55,232. Moreover, we urge that, when reviewing management oversight of the incentive compensation of such an organization, the Federal Reserve look to the local management rather than to the foreign board of directors. This is the method suggested in the introductory section of the Proposal. Id. at 55,229, n.3. The Proposal itself, however, could be read to suggest that the Federal Reserve will look to the governance exercised directly by the foreign board of directors. Id. at 55,232, n.7. We believe that the latter approach is neither the most effective way for the Federal Reserve to supervise these arrangements nor the way that a foreign organization is most likely to structure the governance of its U.S. operations. Accordingly, the concept in footnote 7 on page 55,232 should be expanded to include a statement to the effect that oversight by regional management of the policies and practices applicable to incentive-compensation arrangements within the foreign bank's U.S. operations will be deemed appropriate if consistent with the foreign bank's overall compensation-management structure. It would not be appropriate to suggest that a foreign bank's directors should be expected to be directly involved in the oversight of specific compliance of the bank's U.S. operations with U.S. policies.

13. Joint Ventures and Minority Interests

An issue that is not dealt with directly in the Proposal is its application to joint ventures and minority interests, as well as merchant banking investments. Application of this guidance to all entities deemed "controlled" by a banking organization under a standard "control" analysis could create considerable havoc for existing investments and preclude future ones.

We recommend that the Proposal not apply in such circumstances unless both (i) the bank owns a majority of the voting shares or otherwise has actual managerial control over the other company and (ii) the other company represents 5% or more of the banking organization's revenues.

14. Role of Directors

The Clearing House recognizes the important role that the board of directors must fulfill in overseeing a bank's incentive compensation arrangements. We recommend, however, that the final version of the Proposal make clear that it is not designed to impose a new or higher standard on the board with respect to incentive-compensation arrangements than with respect to its other responsibilities. We are particularly concerned that the use of adverbs to describe the board's duties, e.g., "closely monitor" and "actively oversee," and the frequent use of "ensure," can be read to impose a special standard.

We also accept that the board or the compensation committee of the board should directly approve the incentive-compensation arrangements for "senior executives." It would be helpful, however, if the final Proposal provided more guidance on the definition of "senior executives" for this purpose, perhaps by incorporating other regulatory definitions of "executive officers." A logical choice for public companies would be the set of officers deemed executive officers for purposes of annual reports filed on Form 10-K.

We disagree with the suggestions that "one or more of the board of directors should have a level of expertise and experience in risk-management and compensation practices in the financial services industry . . . ." Id. at 55,237 (emphasis added). We believe that very few individuals possess both sets of skills. These two invaluable skill sets can, however, be held by two different members of the compensation committee or full board.

More generally, we are concerned by the Federal Reserve's apparent view that the boards of banks should be populated with individuals with highly specific skills, whether risk management, compensation, or substantial banking expertise. A broad range of experience and skills is critical to a well-functioning board, and a board or committee can determine in what circumstances it may choose to seek more specialized expert assistance of whatever nature. Moreover, the supply of individuals with substantial banking expertise is limited. If such an individual is currently employed by another bank, there are regulatory (Regulation L) and conflicts issues. Recruiting retired individuals can be inconsistent with a bank's director age-limit requirements. Moreover, retired bankers often may have equity holdings in their former employers that may give rise to conflict concerns. The Clearing House is supportive of utilizing banking expertise on the board, but the limitations in obtaining that expertise, and the value of other experience, should be recognized.

15. Disclosure

We are concerned that the Proposal's discussion of disclosure will have two unintended adverse consequences. First, as recent experience has demonstrated, disclosure about individuals' compensation levels beyond that mandated by the Securities and Exchange Commission can create a severe intrusion into personal privacy and subject the employee and his or her family to abuse and even safety concerns without any compensating benefit for safety or soundness or for disclosures relevant to shareholders. Second, we believe that there should be only one public disclosure regime, as agreed to by the Federal Reserve and the Securities and

Exchange Commission. Two separate and different sets of disclosures will create more confusion than transparency and threaten to impeach one another. We note in this regard the SEC's proposed rules requiring disclosure of the relationship between risk management and compensation.

We believe strongly that information beyond that required by the Securities and Exchange Commission should be considered confidential supervisory information and kept confidential by the Federal Reserve.

16. Shareholders' Role

The role of shareholders in participating in the compensation process is the subject of substantial debate. The Proposal adds to the debate by suggesting— incorrectly we believe— that shareholders of a large bank may encourage (or, at least, not discourage) undue risk because of the federal safety net. We respectfully submit that such issues as "say on pay" should be decided in the broader context of corporate governance. Accordingly, we recommend removal of language, such as "shareholders . . . where appropriate, take actions . . . ", that suggests that the form and scope of shareholder participation should be decided as a bank regulatory issue. Id. at 55,237.

17. Timing

Our member banks' incentive-compensation arrangements will be determined early next year. It is essential that the final guidance be applied only prospectively and not be the basis for criticism of these arrangements. As suggested earlier, we believe that the first examinations after the implementation of the Proposal should be focused on discovery and discussion.

18. Information Collection

The Proposal outlines what appears to be a very significant collection of information in connection with the horizontal review. Although little detail is given as to the breadth of the information to be collected, we believe that it is likely to be a burdensome exercise for the affected banks. Although the Proposal estimates that the burden will only be 40 hours, per institution per year, we believe that this will be a much more significant undertaking.

III. Conclusion

The Clearing House recognizes that the recent financial crisis requires the Federal Reserve to review areas previously left predominantly for management and the board. We further believe that, for the most part, the Proposal represents a balanced and effective approach. Our most serious concern is that these guidelines not become "one size fits all" rules, culled from "best practices" at institutions with widely diverse business and risk-management controls, that will both impede the ability of banks to attract and retain the most qualified individuals and fail to deal with the actual risks at individual institutions.

* * *

If you have any questions or if the members of The Clearing House can assist you in any way, please contact Joseph R. Alexander, Senior Vice President and Senior Counsel, at (212) 612-9234.

Very truly yours,

G D Aranda