November 27, 2009

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

Re: Proposed Guidance on Sound Incentive Compensation Policies (Docket #OP-1374)

Dear Ms. Johnson:

The American Association of Bank Directors is pleased to provide comments on the proposed guidance issued by the Board of Governors of the Federal Reserve System ("Board") concerning incentive compensation policies at banking organizations. AABD, a nonprofit trade association, represents the interests of bank and savings institution directors throughout the United States.

AABD feels compelled to be politically incorrect in questioning the wisdom of and need for the proposed guidance. The proposed guidance does not set forth adequately or with specificity the need for the proposed guidance (its primary source of showing that a problem exists appears to be a survey conducted of 37 huge multinational financial institutions engaged in wholesale activities, a fraction of the 8,000 plus banks in the U.S., most of them with no international or wholesale operations). It also never successfully explains how incentive compensation arrangements have caused risk management system failures. In addition, while the proposed guidance pays great heed to the findings and recommendations of the Financial Stability Forum's Principles for Sound Compensation Practices, it ignores a central premise of that report that effectively removes the vast majority of U.S. banks from its purview.

Here are our specific comments:

- The proposed guidance does not provide any concrete and detailed examples of how incentive compensation arrangements caused banks to engage in unsafe or unsound banking practices. Our view is that where banks engaged in unsafe or unsound banking practices, it was largely a failure of risk management systems, not incentive pay arrangements, that permitted banks to engage in such practices; in other instances, the risks assumed by certain banks were not foreseeable based on what was known or could have been known at the time the risks were assumed. Robust risk-management systems will not allow risks to be undertaken that are excessive regardless of the incentive pay arrangements that might be in place. That should be the focus of the Board, and not on business judgments of boards of directors on how to attract, retain and motivate qualified personnel.

- In testimony on June 11 of this year before the House Committee on Financial Services, Scott G. Alvarez, General Counsel, pointed out that adjusting incentive compensation targets and amounts to account for risk requires an institution to have reasonably accurate indicators of all risks relevant to the business line or activity being rewarded. "However, the quality of the risk indicators is uneven across activities and types of risk…Developing and implementing an appropriately risk-sensitive compensation system across the full range of a large firm's businesses will be a highly complicated and difficult task." In our view, this supports the recommendation that the Board first focus on what went wrong with the risk management systems in major banks.
- The proposed guidance correctly points out that risk management personnel should not be compensated predominately based on the financial performance of the business units that they review. Assuring the integrity of the risk management function, including encouraging banks to invest sufficient resources in hiring qualified risk management professionals, is a legitimate focus for the Board and the other banking agencies.
- None of the proposed guidance's references to the Financial Stability Forum Principles for Sound Compensation Practices mention that the report was applicable only to "major financial firms", not the community and the smaller regional banks that predominate in the U.S.
- Page 5 of the report states that "…supervisory strategy has focused on risk control systems. A few decades ago this was a workable approach for most financial institutions. Most risk was in the traditional loan book and most firms were able to control front-line incentives towards excessive risk by having strong and separate credit underwriting and monitoring departments. In recent years, however, risk has become more multidimensional and complex and the array of means of taking risk has grown large…" For the most part, the main risk facing community and smaller regional banks in the U.S remains in the traditional lending function. Risk in those banks is normally controlled through a robust independent credit underwriting and loan review function. Community and smaller regional banks learned long ago that rewarding loan officers based solely on volume and revenue was not a wise practice.
- Yet the proposed guidance forces all banks, regardless of size, to expend time and money to discover whether any of their incentive compensation arrangements violate the guidance or represent unsafe or unsound practices. The fact that the proposed guidance states that community and regional banks won't be required to have as formalized a review as large institutions does not really minimize the need for community and regional banks to conduct a thorough and, in cases where they decide to retain outside counsel or executive compensation consultants, expensive review.

- Although the proposed guidance asserts that one size does not fit all, it then proceeds to express an intention to identify "best practices" over time. The risk is that its "best practices" will become mandates for all banks subject to Fed supervision and bank holding companies.
- We question the Fed's capacity to oversee and make enforcement judgments over incentive compensation arrangements. The proposed guidance points to a multi-disciplinary approach and mentions banking supervision, economists, risk management, finance, law, accounting "and other areas as appropriate." Executive compensation experts are not listed.
- As Jonathan Macey, a Yale Law School professor recently pointed out in an October 25, 2009 opinion piece in the Wall Street Journal ("Washington's Plans May Result in Even Higher Executive Pay"), "History teaches that the most profound consequences of new compensation regulation will be unintended. It also teaches that as bad as private ordering may have worked in getting executive compensation right, the results of central planning have been even worse."
- One unintended consequence of the guidance may be that banks will return to a time when compensation was based almost entirely on salary. But that approach was discredited long ago as ineffectual in motivating officers and employees.

Guidance is often a misnomer in bank regulation. If, as the proposed guidance points out, it helps support enforcement actions against Fed-regulated banks and bank holding companies, it is much more than that. Absent a demonstration by the Board that incentive compensation arrangements have undermined in institutions of all sizes sound risk management systems, thereby causing unsafe or unsound banking practices, we recommend that the Board withdraw the proposed guidance and not issue a final guidance.

Sincerely,

David Baris
Executive Director
AABD