Federal Deposit Insurance Corporations
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RE: Incorporating Executive Compensation Criteria Into The Risk Assessment System.
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Regarding the FDIC's proposal to tie Deposit Insurance Fund (DIF) assessments to the "riskiness" of a bank's compensation program, let me start by saying that I agree that the size of DIF assessments should reflect the perceived risk in the firm.

I believe that certain incentive compensation practices can be, and likely have been, a contributing factor in the failure or near failure of financial firms, and higher levels of risk in firms that have not failed. I have witnessed how such practices have prompted bank officers and their managers to accept unnecessarily high levels of risk in order to "get the deal done."

To some of the questions raised in the Advanced Notice of Proposed Rulemaking (ANPR), I believe compensation programs should apply to all levels and not be limited to just executive or senior management. While these organizational levels are responsible for managing the level of risk in the firm, risk does not just suddenly appear at these levels. Risk is introduced to the firm at the transaction level, the level at which the loan, commitment or investment is made. So, the rules should apply to all those individuals that share responsibility for the risk. I also believe the rules should be applied to all firms, not just the largest ones. Although small firms, individually, represent limited risk to the DIF, as the FDIC has experienced over the last couple of years, a large number of small failures mount up to seriously diminish the DIF.

As for the method of payment: cash or restricted stock. I believe restricted stock carries risks for the employees that are not appropriate to impose on an individual employee. As an example, look back at what happened at Enron. Many employees had the vast majority of their retirement in Enron stock. When Enron cratered, so did the retirement plans of many of its employees. Effectively requiring employees to put the bulk of what is likely their retirement funds in one stock carries, among other things, a "concentration risk" that regulators criticize in the banks they supervise. In addition, the stocks of many smaller banks are either not publically traded or they are rather thinly traded, limiting the marketability and liquidity of investments in those stocks. In my opinion, the reality is that cash bonuses are not problematic by their nature. The problem is in how the amounts of the bonuses are determined, not in the form of payment.

As to the goals stated in the ANPR, I agree with and applaud the FDIC's goals of trying to provide incentives for financial institutions to develop compensation plans that: align employees interests to the interests of their firm, shareholders and FDIC; and reward employees for focusing on risk management.

I addressed this very issue in a 1993 article I wrote in the "American Banker." I was very concerned with how banks were managing risk. Specifically, I believed that the common practice of awarding bonuses and granting promotions based on the amount of loans booked, interest and fee income generated was inconsistent with the strategic goals of the bank because there was no accountability for the risks assumed in booking those loans. In response to this, I recommended a way to address these issues. The article presented an outline, a framework for more effectively managing risk. It focused on the commercial loan portfolio primarily because that was the area of the bank about which I was most knowledgeable, but it is also applicable to other loan and investment portfolios, and asset categories. My goal was to fully incorporate the management of risk in decision making. Rather than duplicate the article here, or parts of it, I am attaching a copy to review.

I believe this solution meets the goals established by the FDIC in the ANPR: align employees' interests with the interests of the firm, shareholders and FDIC; focus employees on risk management. This would also support other, secondary, objectives. It would not require the collection of any additional data as all the data needed is already being collected by firms. It would be something regulators, including but not limited to the FDIC, could examine and determine whether or not the firm's management and/or board of directors were complying with the established system.

Having said this, although I believe very strongly that the framework I proposed should be promoted by regulators and implemented by financial firms, trying to directly or indirectly manage compensation is the wrong focus. I do agree that certain methods of compensation tend to lead to higher levels of risk in firms, but it is very important to understand that those methods do not *necessarily* result in higher risk. There may be a positive correlation, perhaps even a fairly strong correlation, but I doubt that it is a perfect one. The types of compensation programs that are of concern are, at best, only a proxy for greater risk. In my opinion, heavy reliance on proxies is, in part, what got us where we are today: many firms that failed or got into trouble used some type of model to tell them what the risk was. They plugged numbers into the models and believed, apparently without question, what the model said.

Going back to what I said earlier, risk is introduced to the firm at the level of the transaction. It is based on what people in the firm do, or don't do, that determines the amount of risk a firm has. The risk in any one loan, for instance, is determined as much by how it is underwritten and how it is documented, as it is to the financial condition of the borrower at the time of the loan. Financial conditions of borrowers change over time, but the loan's structure and documentation typically don't change unless there's a default. At that point it is too late to effectively manage risk.

If you look at many of the reports of what went wrong at individual firms there is a very telling common thread: breakdown in risk management within firms. Lawrence McDonald's account of what happened at Lehman Brothers in his book A Colossal Failure of Common Sense is a perfect example. Mr. McDonald says that Madelyn Antoncic, Lehman's highly regarded managing director of risk management, was expressing concerns regarding the levels of risk at Lehman. During one meeting she was reportedly told to "shut up" by the chairman. Executive management began to specifically exclude her from meetings, asking her to leave the room and ultimately demoted her. Recent testimony given to the Financial Crisis Inquiry Commission tells similar, albeit less detailed stories. Michael May, managing director and financial services analyst at Calyon Securities stated, among other things (concentrations of assets, higher yield/higher risk loans, inadequate reserves for losses), that "The system lashed out against those whose job it is to report on the financial health of companies and the industry." Lloyd Blankfein, chairman and CEO of Goldman Sachs, is quoted as saying "Too many financial institutions and investors simply outsourced their risk management." Risk management was "outsourced" by relying on models and, especially, other firms' models. Their own risk management staffs, as at Lehman, were ignored and perhaps excluded. In my opinion, herein lies the real problem: because risk is determined by what people do in individual firms, the solution to excessive risk also rests with what happens in individual firms. Models, even proprietary ones, may be good at estimating risk, at least in theory, in individual transactions at the moment of the transaction given what is known at that moment, but they are not very good at accurately assessing risk in individual transactions over time. I believe that many firms have ignored, possibly decimated or even eliminated their risk management functions.

This is a structural problem within firms that I alluded to in my article. This deficiency must be repaired in order to effectively address risk in individual firms and the industry as a whole. Regulators need to ensure that risk management functions exist, that they have the authority and true independence to do what needs to be done, and that risk management represents a very viable career path for qualified professionals. If these structural issues are not resolved the FDIC and other regulators will be relegated to chasing problems and implementing other proxy measures that have limited effect on protecting the system.

Respectfully,

Kelly B. Buechler

COMMENT / *By Kelly B. Buechler*

To Manage Risks Better, Budget Them

Critics say that Congress and the regulators are attempting to "micromanage" the industry. That is true, but the trend in recent legislation and regulation is in response to the perception that banks have done poorly at identifying and managing risk.

Regardless of whether we agree with all the new rules, we all must play by them. Risk management will determine Bank Insurance Fund premiums, what products and services a bank can provide, and in which markets it can provide them. Risk management will determine which banks are competitive and perhaps which will survive.

While existing internal and external risk measurement systems are very important, they do have weaknesses.

One is in the objective internal systems used to identify and measure risk. These systems typically do so after the fact, and they do not account for the direct and indirect costs of excessive risk.

Pinning Down the Costs

The costs may be difficult to isolate, as in the cost of management time to monitor problem assets or to respond to regulatory criticism. They may not be cash expenses, as with loan-loss provisions. Regardless, they do affect the bottom line and capital position of the bank.

Most banks monitor loan growth, interest and fee income, and other expenses resulting from lending activities at the department level.

Credit risk and the costs of risk are tracked at a different level, even though they also result from lending activities. This separation has served only to frustrate effective risk management.

As with any such situation, weaknesses can be turned around and become advantages. The solution to overcoming these weaknesses is twofold:

- First, develop or enhance the internal risk assessment system.

Managers should be accountable for the risks they make the bank assume.

- Second, integrate existing reporting systems to account for the costs of risk.

Risk-Based Budgeting

One way to achieve this is to integrate the system of monitoring the costs of risk into existing budget systems, for risk-based budgeting.

Historically, budgeting has been an important management tool through which to communicate and measure progress toward strategic objectives.

The problem is that the managers focus on the income statement, reporting the highest possible income by generating high loan volumes with the lowest possible expenses (primarily salaries and interest).

In the past this was acceptable because loan losses were not particularly high. When they did occur, inflation helped to cover these mistakes and loan volumes could make up for minimal losses.

The environment has changed, but managers continue to be preoccupied with putting loans on the books. Because they are not held accountable for the costs of the risk they assume, asset quality suffers.

Assigning Accountability

Risk-based budgeting is the allocation of defined costs of risk to the managers most responsible – those whose departments originated the loans. In this way the costs of risk resulting from lending are given the same level of attention as has historically been given to interest and fee income.

To define a risk-based budgeting program, management first must determine what costs should be allocated, how they will be measured, and on what basis they will be allocated.

Perhaps the most obvious costs to allocate are reserves for loan losses. The bank's existing reserve allocation methods can serve as a guide for measuring costs.

Regulatory Guidelines

Banking circulars 201 and 201 Revised from the Office of the Comptroller of the Currency, provide guidelines for national banks on what areas or characteristics of risk they should consider in defining total reserves, and they identify a number of risk factors.

Some of these factors, such as concentrations and lending policies, do not lend themselves to risk-based budgeting allocations, as discussed below. Other factors, such as delinquencies, credit and collateral exceptions, and stale collateral appraisals, are appropriate for budget allocations because they imply above-average risk.

Allocations should reflect the estimated direct and indirect costs of excessive risk based on objective information. An allocation based on delinquencies or collateral exceptions is straightforward: A loan is either past due or it is not.

Trickier Situations

Allocating reserves is a little trickier. For one, who is to say that a certain loss exposure exists or, given a migration-driven reserve based on historical losses, whether a particular loan is substandard as opposed to "other assets especially mentioned," or OAEM.

Credit policy provides a solution to this problem. First, policy should give some guidance on what constitutes a certain risk grade. Second, the risk assessment staff must have the technical skills and objectivity to provide reasonably accurate assessments.

Allocations should be made on a clearly defined basis and be attributable to specific depart-

See **COMMENT** *next page*

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COMMENT/*By Kelly B. Buechler*

Put Costs of Risk into Managers' Budgets

Continued from *page* 4

ments. This implies the ability to track loans according to their originating department, at least until the loan is renewed or restructured by another department – workouts, for example.

Disregard Type of Loan

Allocations should probably not be made based on the type of loan, for instance energy or real estate. Although Banking Circular 201 identifies "concentrations of credit or collateral" as a risk factor to be addressed, these concentrations are not a good basis for allocations because the initial decision to lend to these industries was a strategic decision.

Allocations of reserves in any one budget period should be based on incremental changes in reserves. Downgrading a loan to substandard from OAEM should not result in a budget allocation for a substandard reserve, but rather the difference between OAEM and substandard.

Allocations should also provide for reductions in reserves that result from lower reserve allocation percentages, reduced loss exposure, or an improvement in the risk grade. These "negative" amounts would offset other risk allocations and reduce the total budget allocation.

A Negative Expense

Management will need to decide if a "negative" allocation is permissible. Essentially being treated as a negative expense, this would increase the department's net contribution.

Management must also determine if any reserve normally established on the "pass," or healthy, portfolio is to be deducted from the allocations on the criticized portfolio.

For example, if a reserve allocation of 5% is applied to OAEM loans and 1% is applied on the pass portfolio, will the budget allocation for a loan rated OAEM be 5% or 4%? I believe the allocation should be 4% because the 1% allocation on the pass portfolio is essentially a cost of doing business that cannot be attributed to the assumption of excessive risk by any one lending department manager.

Finally, management must determine whether to include chargeoffs and recoveries. If chargeoffs are to be included, only the amount charged off in excess of existing reserves, if any, should be allocated to the department budget.

The most obvious costs to allocate are reserves for loan losses.

If the existing reserves are greater than the amount charged off, the excess reserve should be allocated as a negative risk allocation, as described above. With respect to recoveries, a question arises as to who is responsible for the recovery. One solution is to credit any recovery back to the originating loan department.

Benefits of the Policy

If designed carefully and implemented properly, management should expect benefits for effective credit risk management. If managers' performance continues to be their departments' bottom line contribution, their accountability for risk and credit quality will balance their historic focus on loan volume.

A few problem credits will not seriously hurt the bottom line contribution, but will draw attention to the department's activities.

If there are enough problem loans to substantially reduce a department's contribution, it will serve as a warning that there may be a more serious underlying problem: poor underwriting and/or loan management.

Risk-based budgeting will promote more thorough due diligence and lead to better credit structure and documentation. Managers will still have the flexibility to accept risk, but they will be prompted to structure loans to mitigate risk and perhaps price them to better compensate the bank for the risk assumed.

An Engaged Management

Risk-based budgeting will promote more active management of the portfolio, thus minimizing delinquencies and problems. And it will promote early detection of potential problems and credit deterioration before the loans reach a point where the most likely result is a loss.

Addressing risk more thoroughly in underwriting and loan management at the department level will reduce ultimate loan losses and the need for provisions and reserves.

With mark-to-market valuation, risk-based budgeting might help support the use of lower discount rates and reduce the amount by which loans would be written down. In either case, it will serve to improve earnings and capital. □