



July 2, 2010

Mr. Robert E. Feldman
Executive Secretary
FDIC
550 17th Street, NW
Washington DC 20429

Re: Risk Assessment System 12 CFR Part 327 - **RIN 3064-AD57**

Dear Mr. Feldman,

Thank you for the opportunity to provide comments to the FDIC related to RIN 3064-AD57. I commend the FDIC for seeking to enhance risk based assessments. Attached are my specific comments. If you have any questions, please let me know.

With best regards,
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Re: Risk Assessment System. 12 CFR Part 327 - **RIN 3064-AD57**.

My comments to the FDIC are based on my experience working in and with banks, on both governance and risk matters.

- **Worthwhile if enacted with Care.** I agree that it makes sense to revise the assessment system to better capture risk. Because it is likely that institutions will focus on whatever measures or issues are addressed in the final rule, they need to be chosen with care. They also need to be broad enough to ensure lack of gamesmanship, which have the opposite of the intended impact – wasting bank resources to meet a formula that has been devised rather than focus on the business of managing risks.
- **Governance.** I notice that there is no mention of governance of the bank (or its board of directors) in this risk assessment proposal. I think that is an oversight. (I have been told by someone who is purchasing failed banks that in every instance there was a governance issue.) I think the issue of governance transcends the particular products that might cause the next crisis. Therefore, to address the commentary from others regarding your proposal and its potential focus on the past, governance would be an excellent addition to your review. This goes beyond risk management processes or the board's role in risk oversight although those should be included. It really goes to whether or not there are effective mechanisms for stopping a rolling snowball – from the board level all the way through the organization. Are whistle blowing practices working as they should? Please see http://money.cnn.com/2010/06/22/news/companies/bp_horizon_macondo_whistleblower.fort_une/index.htm As Michael Griffin points out, there are always those who know what the issues are. The question is whether they speak and someone listens – and acts.

If you would like to discuss specific measures in this area and governance more broadly which could be incorporated, please let me know.

- **Reach out further.** Per the proposal, “The FDIC also anticipates that any final rule issued pursuant to this notice of proposed rulemaking would be followed by discussions with the industry on ways to improve the system adopted, as well as coordination with other regulators.”

I attended an event last year in DC sponsored by the National Academy of Public Administration on the science of making regulations. In that session, an issue discussed was the accepted wisdom in some quarters that regulators have to be close to the industry to understand it. I don't think that's true. While there is value in what industry has to say, there are people who understand the industry that are outside it – that have other experiences with the industry that can provide very valuable insights – like suppliers, customers, independent advisors, academics, or people who have left the industry but keep their fingers on the pulse – it is a mistake, I believe, for regulators default to the industry (almost every time), mainly a mistake of

imagination and it is part of why the systems of checks and balances fails. (BP, here again, springs to mind in the context of Minerals Management.) It also contributes to the lack of faith of individuals in the democratic process.

Therefore if you are going to reach out, and I think you should, you need to **reach out to outsiders** as well to assist you as discussed here, to provide balance and to be sure there is enough independent input to the process. The benefit of outsiders is discussed here. http://money.cnn.com/2010/06/22/news/companies/bp_horizon_macondo_whistleblower.fort_une/index.htm I don't think other regulators is sufficient.

In this regard, this study is relevant also: In 1995, the USDA conducted a lengthy study of food safety inspectors and its inspection processes, which it memorialized in a 600 page study. One of the issues they set out to address were the informal pressures of allegiance that occurred when inspectors were imbedded in the meat or poultry plant they were inspecting. An industry analysis of the reforms which industry could expect stated (<http://www.haccpalliance.org/sub/news/AAMPReport.pdf>): "Rather than having an individual inspector, plants could deal with an inspection team formed at what is now the circuit supervisor level. Problems with plants would be correlated at team meetings and inspection plans outlined. It could involve several, or all, team members descending on a deviating plant. Inspectors would be rotated to avoid linkage with the plant and the circuit supervisor could serve as the team "coach."...At the same time, inspectors will be told where they inspect is **not my plant** and operators will be advised that the person handling [Food Safety Inspection Services] FSIS functions is **not my inspector**. A new identity relationship of arm's length relationships is in the cards."

- **Changing risk profile.** One of the articulated goals for the process is for it to reflect an institution's changing risk profile. I don't disagree with that. If that is the case, **the weights in your calculations should be reflective of shifts in the business.**
- **Accountability.** According to the proposal, "The FDIC proposes that it have the flexibility to update the minimum and maximum cutoff values and weights used in each scorecard annually, without notice-and comment rulemaking." I think that's a reasonable request as the comment process is cumbersome. For accountability reasons, however, this information should be **openly shared with the public** in an accessible place on the website, including why the changes are being made. In addition, one of FDIC's metrics that are supplied to Congress should include how well the system has worked and the trends in improvements overtime in the ability of the system to predict future or building risks.
- **Changing risk profile.** One of the articulated goals for the process is for it to reflect an institution's changing risk profile. I don't disagree with that. If that is the case, **the weights in your calculations should be reflective of shifts in the business.**

- **The Measurements.** It is very difficult to second-guess the measurements without access to the regression data and a better understanding of whether or not the basis for them makes sense. Other commenters have addressed short time periods for data which are relevant. I also think that the comments related to FDIC's expert judgment-based risk ranking as a measure of validity of the models are worthwhile. In step with expert judgment-based ranking, I will provide you with some intuitions and thoughts. Regarding areas that should be stressed further in the measurement of risk: 1- - risks related to derivatives (the word derivatives is only mentioned once in the whole proposal) 2- trading/investments – should be emphasized further – the conference bill allows some risky investments 3 – risks related to off- balance sheet (the words off-balance sheet are only mentioned once in the whole proposal). Specifically, issues like Repo 105 should be addressed. 4- management and operational risk issues. Also I think more Var measures are needed than the short term 10 day Var. I think you should be looking at multiple Vars with longer time frames and greater than 99% confidence levels.