THE FINANCIAL SERVICES ROUNDTABLE

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Via E-Mail

February 17, 2010

Mr. Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
Attn: Comments
550 17th Street, NW
Washington, DC 20429

Re: RIN # 3064-AD56: Advanced Notice of Proposed Rulemaking: Incorporating Employee Compensation Criteria into the Risk Assessment System.

Dear Mr. Feldman:

The Financial Services Roundtable[1] ("Roundtable") respectfully submits these comments in response to the Federal Deposit Insurance Corporation's ("FDIC") Advanced Notice of Proposed Rulemaking to Incorporate Employee Compensation Criteria into the Risk Assessment System (the "ANPR").[2] We have also enclosed an attachment enumerating the Roundtable's responses to each of the fifteen questions posed in the ANPR.

The Roundtable agrees with the FDIC that a depository institution's compensation policies and practices should align employees' interests with long-term institutional interests, but we oppose the ANPR's formulaic and prescriptive approach. We are concerned that the ANPR attempts to link compensation practices to premiums without providing any objective data showing a cause-and-effect between the compensation and risk of loss to the Deposit Insurance Fund ("DIF"). As such, **we oppose the adoption of an untested, one-sized fits all compensation model**. Our specific concerns with the model are

- ***The ANPR lacks quantifiable evidence that correlates compensation practices with the risk of failure.***
- ***The FDIC can use existing examination and supervisory methods to rate the alignment of employees' interest with the long-term interests of the institution and the DIF.***
- ***Compensation models and risk assessments should be individualized because "One-sized does not fit all."***
- ***The size of an institution does not necessarily determine the level of risk.***
- ***Successful reform requires coordination and consultation with other federal regulators.***
- ***The ANPR risks exceeding the FDIC's statutory authority***

[1] The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance and investment products and services to the American consumer. Roundtable member companies provide fuel for America's economic engine, accounting directly for $84.7 trillion in managed assets, $948 billion in revenue, and 2.3 million jobs.

[2] FDIC Advanced Notice of Proposed Rulemaking: Incorporating Employee Compensation Into the Risk Assessment System, RIN 3064-AD56, 77 Fed. Reg. 2823 (Jan. 19, 2010).

The ANPR Lacks Quantifiable Evidence that Correlates Compensation Practices with the Risk of Failure

The Roundtable agrees that firms should adopt prudent practices that address individual employee responsibility for understanding and managing risks involved in their actions and decisions, but we believe that the ANPR's narrow focus on compensation as a principle risk factor is misguided. The ANPR does not include any quantifiable or substantive data to support the ANPR's nexus between compensation practices and the risk of loss to the DIF. The ANPR's reliance on social commentary is not persuasive. Moreover, the Material Loss Reports cited in the ANPR contradict the ANPR's premise more than they support it: compensation was not a contributing factor in 65 percent of failures studied in 2009. Where compensation was a factor, nothing suggests that it was the only cause or even a dominating factor contributing to the failure of the institutions.

An overly narrow focus on compensation, instead of a firm's overall risk-management practices and controls, overlooks overall institutional risk-management controls. Aggregate risk management is the lynchpin of longevity. For example, appropriate risk-management policies like strong underwriting standards (like strong separation of underwriting from mortgage sales) are more likely to predict the health of a firm than broker compensation. Where primary regulators find institutional risk-management lacking, regulators can work with the institution to correct shortcomings. A myopic focus on compensation in lieu of a holistic evaluation of risk-management controls misses "the forest for the trees."

The FDIC should provide demonstrable data establishing that there is a cause-and-effect relationship between compensation practices and risk-taking behavior. The Roundtable opposes the ANPR because of a dearth of objective data correlating compensation with the risk a firm poses to the DIF. Even if such data were provided, it is inappropriate to adopt a "one-sized fits all" approach to compensation in an industry as diverse as the 8,000 plus insured depository institutions.

Compensation Models and Risk Assessments Should be Individualized Because "One-Sized Does Not Fit All"

Even if we accept the ANPR's premise, the ANPR does not provide any evidence that the compensation criteria in the ANPR effectively mitigates unhealthy risk-taking. Furthermore, there is nothing to support that the ANPR is the *best* way to mitigate excessive risk-taking. Assessments should not be tied to compensation criteria unless the FDIC supplies objective and quantitative evidence demonstrating that the ANPR is the optimum compensation structure for the 8,000 plus insured depository institutions.

Given the diverse characteristics of insured institutions, it is unlikely that a one-sized fits all compensation model will supply optimum results for over 8,000 institutions. Insured institutions vary greatly in terms of liabilities, assets, lines of business, risk, and corporate governance structures. The most successful institutional risk management programs and controls are tailored to meet each firm's unique risk profile. While specific approaches outlined in the ANPR may be suitable for many institutions, they will not be workable for all.

The FDIC Can Use Existing Examination and Supervisory Methods to Rate the Alignment of Employees' Interest with the Long-Term Interests of the Institution and the DIF

The Roundtable believes that existing examination and supervisory models are better suited to achieve the ANPR's goals than a modification of the risk-based assessment regime that focuses solely on compensation policies and practices. Indeed, the "Management" component of the CAMELS rating system already addresses compensation. Creating a separate factor for compensation would effectively "double" count compensation practices in risk assessments.

To bring about needed improvements, the FDIC and other regulators can expeditiously develop comprehensive guidance and advisories concerning compensation. These can address both best practices and practices that potentially misalign employee and stakeholder interests. Both examiners and institutions would benefit from such guidance. The use of flexible guidance avoids a one-sized fits all approach and retains the flexibility regulators necessarily need when they compile a firms management score in CAMELS.

The use of existing examination and enforcement measures to address compensation policies are more likely to realize the ANPR's stated purpose of risk mitigation than assessment surcharges based on uniform criteria. Assessment charges may not be effective because an institution that does not wish to change compensation practices that the FDIC believes may promote excessive risk-taking can pay the higher assessment instead of changing its practices. Indeed, those institutions most wedded to practices that cause concern to the FDIC may be the least likely to make voluntary changes.

The Size of an Institution Does Not Determine the Level of Risk

The ANPR asked if only large firms should be subject to the ANPR's compensation criteria, but does not provide any data to justify the exclusion of small institutions from the ANPR's reach. A sized-based exclusion neglects the reality that the "size of the risk" does not depend on the size of the firm. Furthermore, while the FDIC's authorizing legislation, the Federal Deposit Insurance Act ("FDI Act"), allows the FDIC to "establish separate risk-based establish separate risk-based assessment systems for large and small members" of the DIF,[3] the FDI Act also forbids the FDIC from excluding large-firms from the lowest risk category "solely because of its size."[4] The lesson is that risk assessments must be based on the institution's overall risk profile, not the size of the institution.

Successful Reforms Require Coordination and Consultation with Other Federal Regulators

The Roundtable believes coordination and harmonization between federal regulators is essential to a safe and sound financial system. In light of the recent and forthcoming executive compensation regulations from the Securities and Exchange Commission[5] and the Federal

[3] *See* FDI Act, section 7(b)(1)(D), codified at 12 U.S.C. § 1817(b)(1)(D) (allowing separate systems for large and small members).
[4] *See* FDI Act, section 7(b)(2)(D), codified at 12 U.S.C. § 1817(b)(2)(D) (forbidding discrimination against large members).
[5] The Securities and Exchange Commission issued a final rule on shareholder "say on pay" on January 12, 2010. *See* 74 Fed. Reg. 2789 (mandating shareholder approval of executive compensation of TARP recipients).

Reserve Board,[6] we think it is crucial that the FDIC consult and coordinate with primary regulators on compensation and management risk in order to avoid the confusion and inefficiency caused by regulatory overlap.

The ANPR May Exceed the FDIC's Statutory Authority

The need for coordination increases when the complex corporate structures of certain institutions are considered. The ANPR asks whether the compensation criteria should apply to non-bank affiliates and persons employed by the parent company of the insured institution. Applying the ANPR to non-bank affiliates and parent companies exceeds the statutory intent of the FDI Act. The FDI Act limits the FDIC's rule making authority to insured depository institutions. In contrast, Congress granted the Federal Reserve Board the authority to regulate affiliates and holding companies.[7] The Federal Reserve Board already mitigates risk posed by non-bank affiliates, holding companies and foreign banks.[8]

The Roundtable also questions the FDIC's statutory authority to collect the requisite information needed to evaluate compliance with the ANPR. The FDI Act expressly limits the FDIC's ability to compel the submission of new information to the FDIC.[9] We are also concerned that the FDIC's unilateral action on compensation usurps the supervisory discretion of primary regulators in favor of a "voluntary" standard. We are not convinced that the ANPR is a "voluntary" measure to raise minimum standards when the ANPR disregards the opinions of supervisory regulatory agencies. Firms that fail to comply with the ANPR will be reflexively penalized with higher assessment rates, with no consideration of the primary regulator's opinion on the safety and soundness of the institution's practices.

The lack of consultation with primary federal regulators is contrary to the statutory language governing risk-based premium system. The FDI Act requires the FDIC to consult with other federal regulators when the FDIC is determining "the risk of loss to the Deposit Insurance Fund" posed by an insured depository institution.[10] A lack of coordination with primary regulators could hamper the FDIC's ability to collect the requisite information needed to evaluate compliance with the ANPR because the Congress explicitly limited the FDIC's ability to request additional information from institutions.[11]

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[6] Federal Reserve Board Docket OP-1374 Proposed Guidance on Sound Compensation Policies. 74 Fed. Reg. 55227 (Oct. 27, 2009).

[7] *See* Federal Reserve Act (FRA) (12 U.S.C. 221 *et seq.*); the Bank Holding Company Act of 1956 (BHC Act) (12 U.S.C. 1841 *et seq.*); and the International Banking Act of 1978 (IBA) (12 U.S.C. 3101 *et seq.*).

[8] *See e.g.*, Regulation W, 12 C.F.R. 223 *et. seq.* (regulating transactions between member banks and affiliates); Regulation K, 12 C.F.R. 211 *et. seq.* (regulating international banking operations).

[9] *See* FDI Act, section 7(b)(1)(E)(iii), codified at 12 U.S.C. § 1817(b)(1)(E)(iii) (stating "[n]o provision of this paragraph shall be construed as providing any new authority for the Corporation to require submission of information by insured depository institutions to the Corporation.

[10] 12 U.S.C. 1817(b)(1)(E)(i)(I) states: "In general, Except as provided in subclause (II), *in assessing the risk of loss to the Deposit Insurance Fund with respect to any insured depository institution, the Corporation shall consult with the appropriate Federal banking agency of such institution*" (emphasis added). Subclause II allows the FDIC to consult with other regulators on an aggregate basis when assessing the risk of loss posed by well-managed and well capitalized institutions. 1817(b)(1)(E)(i)(II).

[11] *See supra* note 7.

Alternative Suggestions on Limiting Risk to the DIF

The Roundtable believes the risk-based assessment program could be improved by improving existing examination and enforcement methods. First, the FDIC could develop risk-based premiums for all institutions, not just Category I institutions. Secondly, the FDIC can incorporate quantifiable, forward looking factors into the FDIC risk-based formula.

1) Risk-Based Premiums for All Categories

As of June 30, 2009, firms in the highest risk group, Category IV paid the same premium rate, except for adjustments attributable to secured and unsecured debt and brokered deposits, regardless of their individual risk profile. The same was true for the 362 banks in Category III and 1,014 banks in Category II. However, a separate premium rate was calculated for each of the 6,706 banks in Category I, the banks deemed the least likely to fail. The same thoroughness should apply to all insured institutions, especially when a firm is considered to pose a heightened level of risk to the DIF. Individually rating *all* institutions, particularly firms determined to be at risk, will mitigate the DIF's exposure to risk.

The establishment of separate, risk-sensitive premiums for all insured institutions would improve the overall rigor of the FDIC's evaluation and assessment. The fact that the safest institutions are evaluated separately while the riskiest banks are evaluated in the aggregate is the antithesis of the Congressional instructions in the legislation authorizing the risk-based premium system. Section 1817(b)(1)(E)(ii)(II) permits aggregate risk assessments of well-managed and well-capitalized institutions but section 1817(b)(1)(E)(ii)(I) contains mandatory language instructing that all but the best capitalized and well managed firms be subject to *individual* assessments determine the risk of loss each firm poses to the DIF. Separate premium rates for institutions in the riskiest categories will increase revenue for the DIF and could discourage institutions from undertaking high-risk activities in the hopes of high return.

2. Incorporate objective, forward-looking factors into the risk-based assessment

If the FDIC wants to expand the factors included in the risk-based premium system, we suggest that the FDIC attempt to incorporate quantifiable, forward-looking factors into the FDIC's risk-based formula, such as rapid asset growth and excessive credit-risk exposure to asset bubbles. The ANPR attempts to predict future performance through subjective compensation criteria, but the use of an alternative metric to predict future performance, such as rapid asset growth, is more likely to yield objective data that can be used to develop rational and objective assessment standards that are capable of showing cause-and-effect. The Roundtable opposes the incorporation of any new factors into the risk-based assessment until the FDIC can provide raw data and analysis substantiating a cause-and-effect relationship between the factor and the predicted outcome.

The Roundtable appreciates the opportunity to comment on the ANPR. As noted above, we **oppose** adoption of the proposal for the specific reasons noted in the foregoing paragraphs. In addition, please find an addendum attached with the Roundtable's responses to the fifteen questions posed in the ANPR

Sincerely,

Richard M. Whiting

Richard Whiting
Executive Director

Enclosure

Attachment A

1) *Should an adjustment be made to the risk-based assessment rate an institution would otherwise be charged if the institution could/could not attest (subject to verification) that it had a compensation system that included the following elements?*

a. *Significant portion of compensation for employees whose business activities can present significant risk to the institution and who also receive a portion of their compensation according to formulas based on meeting performance goals would be comprised of restricted non-discounted company stock...employees affected would include the institution's senior management, among others. Restricted, non-discounted stock would be stock that becomes available at intervals over a period of a year...the stock would initially be awarded at the closing price in effect on the day of the award.*
b. *Significant awards would only become vested over a multi-year period and would be subject to a look-back mechanism...to account for risks assumed in earlier periods.*
c. *The compensation program would be administered by a committee of the Board comprised of independent directors with input from independent compensation professionals.*

The Roundtable opposes formulaic, industry-wide mandates on compensation issues. It is imprudent to impose an identical compensation model for all institutions regardless of size, corporate structure, assets, liabilities or risk. Furthermore, such a narrow focus on compensation ignores the reality that an institution's overall risk mitigation programs and controls that ultimately determine whether the institution is sustainable. If the risk management system is in need of improvement, regulators can assist an institution's development of improved policies.

Any rules designed to address the risk of loss to the DIF should consider overall risk management strategies. Given the breadth and complexity of the industry, any guidance should be as flexible as prudently possible to allow firms to craft a solution that fits best with their institution's profile.

2) *Should the FDIC's risk-based assessment reward firms whose compensation programs present lower risk or penalize institutions with programs that present higher risks?*

While the Roundtable supports the use of strong risk-mitigation programs and controls, we do not believe that compensation should be an independent factor in FDIC premium assessments. Such a narrow focus on compensation as an indicator of long-term stability ignores the larger picture of an institution's over-all risk-management procedures that, if properly installed and implemented, would prevent a compensation practice from directly causing a loss. For example, much has been said about mortgage broker compensation causing a material impact on an institution. However, this view ignores the fact the primary control over mortgage portfolio risks are (1) an institution's credit policies and (2) the separation of underwriting from sales; not the compensation of mortgage lenders.

3) *How should the FDIC measure and assess whether an institution's Board of Directors is effectively overseeing the design and implementation of the institution's compensation program?*

The Roundtable cautions the FDIC not to adopt rules that institute "one-sized fits all" policies regarding the compensation committees. It is important that firms retain the flexibility to staff a compensation committee according to the firms needs. The Federal Reserve guidelines attempt to preserve flexibility by allowing boards to consist "predominately" of independent directors.

We think it would be imprudent to impose a flat prohibition on inside directors serving on the compensation committee. The presence of a management director on the committee allows the management director to provide insight on the firm's compensation philosophy and the history and nature of the institution's workforce.

4) *As an alternative to the FDIC's contemplated approach, should the FDIC consider the use of quantifiable measures of compensation – such as ratios of compensation to some specified variable – that relate to the institution's health or performance? If so, what measure(s) and what variables would be appropriate?*

As we noted above, the application of a one-sized fits all prescription for compensation and adoption of universal measurements ignores the diversity of insured institutions. A universal quantitative approach would be premised on the basis that all institutions are comparable along the same measurements, and necessarily ignores the differences in size, activities, risk profiles, and the risk-management of each institution. No measures should be adopted until the FDIC can demonstrate that the measures are capable of establishing a cause-and-effect linkage between compensation and the risk of loss to the DIF.

5) *Should the effort to price the risk posed to the DIF by certain compensation plans be directed only toward larger institutions; institutions that engage only in certain types of activities, such as trading; or should it apply to all insured depository institutions?*

Any effort to price risk posed by the DIF to certain compensation plans must be directed at all institutions, because the risk of failure is not limited to large institutions. Risk-taking behavior varies widely across the industry, and the size of the risk is not dependent on the size of the bank. Moreover, section 7(b) of the FDI Act prohibits the FDIC from applying higher premiums based of the *size* of the institution. We are concerned the ANPR promotes levying larger assessments on institutions because of their size and not their risk profile.

The "predictive" use of compensation criteria is further eroded by the fact that different institutions have different lines of businesses, but the presence or absence of a specific line of business does not necessarily correlate with the risk of failure. The ANPR did not provide any data or analysis showing that specific lines of business or compensation practices increase the risk of institutional failure.

Until the FDIC can release raw data that correlating risk and business activities, no specific lines of businesses should be targeted for higher assessments. A firm's overall risk-management and controls determine whether a business activity poses a threat to the firm. If a firm's risk-management system is deficient, primary federal regulators can work with firms to correct the risk-management system. Building a meaningful risk management system will yield more benefits than imposing a generic prescription on a diverse population.

6) *How large (in basis points) would an adjustment to the initial risk-based assessment of an institution need to be in order for the FDIC to have an effective influence on compensation practices?*

Uniform basis point adjustments will not be effective because of the different sizes, risk profiles, corporate structure and goals of an institution. A basis point adjustment that would be burdensome on one institution may be shrugged off by another. A compensation-linked assessment is also unlikely to deter firms from adopting unsound compensation policies because firms that are strongly attached to their current practices are likely to pay the increased assessment and leave their compensation structure intact.

7) *Should the criteria used to adjust the FDIC risk-based assessments rates apply only to the compensation systems of insured depository institutions? Under what circumstances should the criteria also consider the compensation programs of holding companies and affiliates?*

FDIC regulations should apply only to insured depository institutions. The FDIC's legislative authority restricts the FDIC's reach to insured depository institutions.[15] As such, we believe that Federal Reserve Board is better positioned to regulate and collect information on risk-management and compensation from a wider range of firms. Because of this, we believe it is premature to proceed with the ANPR without considering the final guidelines issued by the Federal Reserve Board.

8) *How should the FDIC's risk-based assessment system be adjusted when an employee is paid by both the insured depository institution and its related holding company or affiliate?*

This question highlights the difficulty of attempting to apply FDIC regulations to institutions governed primarily by other federal regulators. Any regulations issued by the FDIC should be limited to insured depository institutions.

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[15] The legislative authority for risk-based assessments also raises the question of whether the FDIC is empowered to request additional information regarding compensation practices from insured depositories. *See* 12 USC § 1817(b)(1)(E)(ii) (noting that nothing in the section gives the FDIC the authority to request additional information from insured institutions).

9) *Which employees should be subject to compensation criteria? How should these employees be identified?*

We are concerned that the ANPR can be interpreted to apply to certain staff, due to the nature of their position, without consideration of the employee's actual involvement in activities that actually increase the amount of risk incurred by the institution. Any determination of risk exposure should include a careful consideration of an employee's actual duties and not end at the employee's title.

10) *How should compensation be defined?*

If the FDIC moves forward with this proposal, any definition of compensation must be considered carefully. At this crucial time in the economy, it is important to strike a balance between prudent regulation and a firm's ability to recruit and retain top-talent to manage complex institutions as well as compete internationally.

11) *What mix of current compensation and deferred compensation would best align the interests of employees with the long-term risk of the firm?*

The Roundtable emphatically believes that it is imprudent to design or prescribe a compensation model as the "best" for a firm without accounting for the firm's overall risk-management and controls installed and the characteristics of the individual institution. Even simple factors like geography could impact whether a particular compensation model is the very best practice for a particular institution. What works in Boston may be impractical for the Midwest, and *vice versa.*

12) *Should an adjustment be made to risk assessment rates if certain bonus compensation practices are followed such as: awarding guaranteed bonuses; granting bonuses that are greatly disproportionate to regular salary; or paying bonuses all-at-once, which does not allow for deferral or later modification?*

Management should retain the ability to make individual decisions regarding incentive compensation based on relevant market and geographical factors in order to attract and retain talented employees without being penalized by a higher assessment.

13) *For the purposes of aligning an employee's interests with those of the institution, what would be a reasonable period for deferral of the payment of variable or bonus compensation? Is the appropriate deferral period a function of the amount of the award or of the employee's position within the institution?*

The Roundtable is supportive of vesting periods in general, but the use or length of any deferral period should be firm-specific.

Additionally, we are concerned about the clawback provision. Clawbacks present thorny issues involving employment and tax law, and practicality issues. For example, how does a firm recoup compensation from employees that have since left the firm? How long would an employee be liable for recoupment after his or her departure from the firm?

Because of the complex considerations involved when an institution adopts look-back measures, the use of clawbacks should be left to the individual discretion of the institution.

14) *What would be a reasonable vesting period for deferred compensation?*

It is not practical to impose a uniform vesting period on all institutions. For example, the liquidity (or illiquidity) of the company's stock may be important when determining whether a vesting period is appropriate and if so, to determine is the optimum length of the vesting period.

15) *Are there other types of compensation arrangements that would have a greater potential to align the incentives of employees with those of the firm's other stakeholders, including the FDIC?*

We encourage the FDIC to consider that there may be a variety of compensation arrangements that align the incentives of employees with other stakeholders, and the viability of an identical compensation model depends on the characteristics of the institution implementing the arrangement.

One suggestion for the FDIC would be to establish firm-by-firm, risk sensitive premiums for all institutions, not just institutions in Category I. As of June 30, 2009, firms in the highest risk group, Category IV paid the same premium rate, except for adjustments attributable to secured and unsecured debt and brokered deposits, regardless of their individual risk profile. The same was true for the 362 banks in Category III and 1,014 banks in Category II. However, a separate premium rate was calculated for each of the 6,706 banks in Category I, the banks deemed the least likely to fail.

The fact that the safest institutions are evaluated separately while the riskiest banks are evaluated in the aggregate is the antithesis of the Congressional instructions in the legislation authorizing the risk-based premium system. Section 1817(b)(1)(E)(ii)(II) permits aggregate risk assessments of well-managed and well-capitalized institutions but section 1817(b)(1)(E)(ii)(I) contains mandatory language instructing that all but the best capitalized and well managed be firms be subject to *individual* assessments determine the risk of loss each firm poses to the DIF.

Separate premium rates for institutions in the riskiest categories would increase revenue for the DIF and could discourage institutions from undertaking high-risk activities in the hopes of high return.