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February 18, 2010

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

Attention: Comments

Re: Incorporating Employee Compensation Criteria into the Risk Assessment System: RIN 3064–AD56

Dear Mr. Feldman:

The Clearing House Association L.L.C. ("The Clearing House"[1]) appreciates the opportunity to comment on the advance notice of proposed rulemaking by the Federal Deposit Insurance Corporation (the "FDIC") regarding "Incorporating Employee Compensation Criteria into the Risk Assessment System" (the "ANPR").[2] The Clearing House believes that it is essential for depository institutions to establish well-calibrated compensation arrangements that can attract and retain the most capable employees, encourage performance, and control risk. We also acknowledge that an institution's compensation practices are an appropriate subject of regulatory review for safety and soundness.

We believe, however, that compensation practices should not be incorporated as an *independent* factor in the FDIC's risk-based assessment system (the "Assessment System"). Compensation practices—at both the depository institution and holding company levels—are already incorporated into the Assessment System as part of the management component of a depository institution's CAMELS ratings. If the FDIC believes that compensation practices need to be incorporated more formally into CAMELs ratings, this could be achieved through inter-agency guidance against which the management component would be evaluated. Such a CAMELs-based approach is even more compelling because compensation practices across a

1 The members of The Clearing House are: Bank of America, N.A.; The Bank of New York Mellon; Capital One, N.A.; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, N.A.; JPMorgan Chase Bank, N.A.; The Royal Bank of Scotland, N.V.; UBS AG; U.S. Bank, N.A.; and Wells Fargo Bank, N.A.

2 75 Fed. Reg. 2823 (Jan. 19, 2010).

wide range of institutions and employees are not susceptible to uniform, specific requirements or a binary ("meets" or "does-not-meet") test.

1. The Scope of the Risk-Assessment System.

Section 7(b) of the Federal Deposit Insurance Act (the "FDI Act") requires the FDIC to "establish a risk-based assessment system" for depository institutions that is based on the probability of loss to the depository insurance fund (the "DIF") from the failure of the depository institution, the likely amount of the loss, and the DIF's revenue needs. The probability of loss is to be determined by reference to categories and concentrations of assets and liabilities and "any other factors the [FDIC] determines are relevant."

Clearly, the range of factors the FDIC may consider is broad, but each factor must relate to a probability of a loss to the DIF. We respectfully submit that the ANPR does not demonstrate that the broad array of compensation practices it addresses presents such a probability of loss that a special assessment factor is appropriate. Although the ANPR does refer to compensation practices at some institutions as contributing to their failure, all these institutions appear to be quite small and almost all the cited situations involved a single practice—incentive payments to loan officers made solely on the basis of originations volume .[3]

Moreover, the ANPR by its terms appears to go beyond the FDIC's statutory authority to establish a risk-based assessment system that is based on probability of loss to the DIF. The ANPR is not limited to "compensat[ing] the DIF for the risks" involved, but "provides incentives for institutions to adopt compensation programs that align employees interests with the long-term interests of the firm and its shareholders" and "promote[s] the use of compensation programs that reward employees for internalizing the firm's focus on risk management [4]." The ANPR is explicitly designed to use the deposit insurance assessment system to provide incentives for institutions to meet "higher standards than those established by the supervisors" and to encourage institutions "to choose to exceed base supervisory standards [5.]"

With the greatest of respect, we believe that such objectives, however laudable they may be, cannot be legally adopted because they are not within the statutory structure established for DIF assessments. In our view, this conclusion is not altered by the "voluntary" nature of the incentive.[6]

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[3] S*ee*, Office of the Comptroller of the Currency Press Release 2010-3a (Jan. 12, 2010), available at http://www.occ.gov/ftp/release/2010-3a.pdf.

[4] 75 Fed. Reg. at 2824.

[5] *Id*.

[6] *Id*.

We are particularly concerned by the extension of the Assessment System to affiliates of depository institutions. The relationship between compensation practices of affiliates (including the holding company) of a depository institution and risk to the DIF is unclear. As stated above, the authorized risk-based assessment system is a system "for depository institutions," and is not for the entire holding company structure. Moreover, the ANPR's proposed assessment of compensation practices at bank affiliates would represent a sharp departure from long-standing practice. All the factors in the FDIC's current assessment regulations, including the CAMELS rating, pertain to the depository institution itself. We submit that the potential impact of its affiliates on the health of the depository institution itself is best dealt with by other safeguards such as restrictions on affiliate transactions, dividend restrictions, and the oversight of bank holding companies and their nonbank subsidiaries by the Board of Governors of the Federal Reserve System (the "Federal Reserve") (including with respect to compensation practices, as discussed below).

2. Potential Conflict with Other Requirements.

It is not our objective to diminish the FDIC's crucial role in maintaining the safety and soundness of depository institutions, and we certainly recognize the FDIC's special mission of protecting the solvency of the DIF. Nonetheless, it is our belief that the FDIC should continue to rely on the primary regulator of the depository institution for its assessment of the numerous safety and soundness factors, including those at the parent level, that are incorporated into CAMELS ratings.

In this regard, we note that the Federal Reserve's recently proposed compensation guidance would generally cover the same elements of compensation addressed by the ANPR. We are concerned that depository institutions would be faced with inconsistencies between the FDIC's assessment rules and the Federal Reserve guidance. The federal banking agencies may wish to consider joint guidance in this important area.

3. Double Counting of the Compensation Factor.

As discussed above, The Clearing House agrees that certain compensation practices can create undue risk at a depository institution. As we also noted, however, the compensation practices of an institution and its parent are examined by its primary regulator and an assessment of those practices is already incorporated into the primary regulator's CAMELS rating for the depository institution. Accordingly, there is seemingly no more reason for the FDIC to create a special assessment factor for compensation practices than it is for it to incorporate any other component of the CAMELS rating, for example, liquidity or asset quality.

The following example illustrates how a separate compensation assessment factor would result in double counting that factor and thereby exaggerating its consequences. Assume that an institution is a borderline 2 on management. If the tipping point in favor of a 2 is the primary regulator's conclusion that the institution has sound compensation practices, and the FDIC agrees, the positive impact of the institution's compensation would be counted twice and result in an unduly low risk assessment. Conversely, if the tipping point in favor of a downgrade to a 3 is the primary regulator's conclusion that the institutions has unsound compensation practices, and the FDIC agrees, the negative impact of those practices would again be counted twice and result in an unduly high risk assessment.

4. The Difficulty of Implementing the ANPR's Core Requirements.

The core of the ANPR is a certification requirement. A depository institution must certify, among other things, that its employees whose business activities "can" present "significant" risk to the institution, and who receive a "portion" of this compensation "according to formulas" have received a "significant" portion of their compensation in the form of "restricted stock." The stock would be restricted if it becomes available to the employees "at intervals over a period of years." In addition, stock compensation that is deemed a "significant" award would be subject to a "look-back mechanism (clawback)." This certification would be "subject to verification."[7]

In view of the inherent subjectivity and uncertainty in these tests, it would be difficult for a depository institution to make such a certification with any degree of confidence. The institution would be exposed to an ex post facto determination that would involve a substantial increase in its future FDIC assessments, as well as a charge (and conceivably even penalties) in respect of prior assessment payments.

As discussed below, the alternative of attempting to define these tests with specificity is at least equally flawed. A single set of specific, quantifiable standards cannot be applied to a wide variety of employees (e.g. traders, mortgage loan officers, commercial lenders, private bankers) at all different types and sizes of banks.

5. The Use of Specific Compensation Criteria.

As discussed above, The Clearing House believes that it is inappropriate for compensation criteria to be used as an independent factor when determining an institution's assessment rate. Should a form of the ANPR nevertheless be adopted, The Clearing House believes that any adjustment to an institution's assessment rate should be based on an overall failure to comply with principles of compensation rather than adherence to specific

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[7] 75 Fed. Reg. at 2825

compensation arrangements. As the ANPR acknowledges, "identifying the risks posed is easier than identifying the most appropriate solution to remedy them."[8]

We appreciate that the ANPR does not attempt to impose a ceiling on the absolute level of compensation. Nonetheless, other hard-and-fast criteria or tests would also appear undesirable. Thus, for example, The Clearing House would agree that equity grants with delayed vesting are an important component of incentive compensation in many cases. We believe, however, that it would be inappropriate for any regulator to attempt to specify for all—or any class of—employees at all institutions what portion of compensation should be paid in stock, what the vesting period for deferred compensation should be, or what the proportion of an employee's salary to bonus should be.

Likewise, we are concerned by the ANPR's binary approach of "meets" or "does not meet." We think that an evaluation of an institution's compensation arrangements is much more complex than a pass-fail test.

An approach by which the FDIC adjusts assessment rates based on the presence of a uniform set of compensation elements would inevitably exaggerate the risk of certain incentive programs for some employees at some institutions to risk and discourage some employees at some institutions from taking reasonable and appropriate risks. Any specific practice at a given institution must be evaluated in the context of that institution's overall risk profile and risk-management process. For example, the suggestion (provided in the Request for Comments section of the ANPR) that compensation might be tied to a specific variable relating to the institution's health or performance would fail to take into account important differences across institutions and special circumstances at individual institutions.

The question of how to structure employee compensation is a matter of on-going discussion in both the regulatory and legislative communities. This does not provide an excuse for institutions to delay adopting well-considered compensation programs that manage risk as effectively as possible, but it would be unfortunate if the FDIC were to preempt the discussion by tying the assessment rate to the presence of specific compensation features. The compensation practices at issue are often novel and constantly changing, and the relationship between a particular compensation program and risk is often not obvious, much less uniform. Given this, we submit that the FDIC should not crystallize a particular approach to compensation in the risk assessment system that discourages institutions from continuing to work to adjust their compensation methods and adapt them to the changing economic environment.[9]

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8 *Id.*

9 The Clearing House also notes the Securities and Exchange Commission's proposals in this area with respect to public companies. Proxy statements of public companies must now include a narrative discussing any material impact the company's executive compensation practices have on the company, and further rules have been proposed that would provide shareholders with a "say-on-pay". Though not a substitute for supervision by the banking agencies, greater disclosure to and involvement by shareholders may lead to further evolutions in compensation programs.

6. Specific Request for Comments.

We offer the following responses to certain of the ANPR's specific Request for Comments.

(a) *The Role of the Board of Directors.* The Clearing House recognizes the important role that the board of directors must play in overseeing an institution's incentive compensation arrangements, but we do not believe that the board's performance in this role can evaluated in a way that can be meaningfully factored into an assessment rate. Boards of directors of depository institutions and their holding companies are already subject to basic principles of corporate governance, shareholder election, and regulation and supervision by the primary regulator. We do not believe that it would be productive for the FDIC to add additional standards for boards.

(b) *Large Institutions.* We strongly oppose any adjustment that applies only to large banks—either directly by applying size criteria or indirectly by covering only activities in which large banks engage. In the cases cited by the ANPR where compensation issues have been identified as a contributing factor to DIF losses, the banks have been small in size and the activities in question were lending.

(c) *Various Questions.* We think that a number of the questions raised in the Request for Comments illustrate why specific criteria and a binary test are inappropriate for inclusion in the Assessment System. For example, certain "executives" have little capacity to create risk and the definition of "employees who are in a position to place the institution at significant risk" will vary from institution to institution. Similarly, the appropriate "mix of current compensation and deferred compensation" would differ among institutions, even for employees with similar titles and responsibilities, and it would change from time to time. Finally, a definition of bonuses as "greatly disproportionate to regular salary" could encourage a disconnect between performance and compensation and would fail to take into account historical or other relevant antecedents.

7. Conclusion.

The Clearing House agrees that institutions must continually evaluate and, as necessary, revise their compensation practices in order to encourage employee productivity without creating undue risk and that the banking agencies need to supervise this effort. The Clearing House believes, however, that attempting to achieve this by incorporating compliance with uniform, specific compensation standards into the FDIC's risk-based assessment system is unnecessary and inappropriate. Though general principles may apply across the board, institutions tailor their compensation programs to the particular characteristics of their business and employees, and they likewise should be subject to supervision on such a case-by-case basis.

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We hope these comments have been helpful. If you have any questions about any matter discussed in this letter, please contact Joseph R. Alexander, Senior Vice President and Senior Counsel, at 212-612-9234 or joe.alexander@theclearinghouse.org.

Very truly yours,