



February 18, 2010

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

Re: Incorporating Employee Compensation Criteria Into the Risk Assessment System. 12 CFR Part 327 -
RIN 3064-AD56.

Dear Mr. Feldman,

Thank you for the opportunity to provide comments to the FDIC related to RIN 3064-AD56. I commend the FDIC for seeking to address this important issue of executive compensation. Attached are my specific comments. If you have any questions, please let me know.

With best regards,
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Re: Incorporating Employee Compensation Criteria Into the Risk Assessment System. 12 CFR Part 327 - **RIN 3064-AD56.**

My comments to the FDIC are based on my experience working in and with banks, on both compensation and risk matters. This includes my experience designing the first ever compensation program in a major US bank, which took into account economic risks and returns, aligning the compensation programs to encourage a long term focus and avoid excessive risk taking.

General Comments

I agree that an adjustment should be made to a bank's DIF funding to take into consideration the riskiness of their individual compensation program.

Compensation design impacts behavior, particularly in financial institutions. It is critically important that compensation metrics should not give mixed signals between (a) the basis for performance and (b) what is (and should be) valued as important in terms of behavior. The performance metrics and the compensation program should mirror that which the bank values in terms of behavior i.e. taking reasonable risk, not excessive risk, which adds value to the bank and its stakeholders.

Carrot and Stick: Three Tiers. My suggestion is that both a carrot and stick approach to this process be employed. Such an approach would be beneficial because it would encourage the very best of processes (in which case the bank could fund into the DIF at a preferred rate), a median level (for average or moderate practices) and it would discourage practices that don't meet a baseline set of standards (requiring a higher level of funding requirement to DIF to cover the increased risks associated with the bank's choice of approach).

The reason for suggesting a three tier approach is that it is impossible politically to *mandate* the very best approaches and practices; however, I believe rewarding banks for this choice would not only encourage the best processes in at least a few banks but be palatable from a policy design standpoint.

While I agree that adjustments to DIF funding should be made based on risk I do not agree with the bases as outlined on page 8.

Use of Stock. It is inadvisable to advocate the use of stock, even restricted stock, as the form of pay. (It was not that long ago that *almost everyone* was advocating stock options – and that proved to be a dangerous path too.)

Why is advocating the use of restricted stock inadvisable and problematic? There are multiple reasons.

One of the real problems in advocating the use of stock (even restricted stock) as a basis for pay is because of the nature of stock prices themselves. Stock prices may be robust for banks over long periods, as the last decade showed, although the underlying fundamentals of the banks may be weak -- and/or building hidden risks. The hidden risks or weaknesses in the bank may be masked for long periods, hidden from regulators -- and from investors, privy to even less information than effective regulators.

Not only is stock price a very *ineffective* monitor of developing risks but stock is problematic, whether restricted or not, because it focuses attention of the receivers of stock on the wrong metrics.

No matter what else is done to mitigate it, rewarding individuals with stock, restricted or otherwise, naturally focuses the receiver's attention on stock price. It is like saying "don't think of an elephant when I say the word elephant". Saying "don't think about stock price when I give you 'restricted' stock" has a similar effect.

Thus at best, restricted stock distracts managers' attention away from what they can control and toward stock price. At worse, it fixates managers on stock price.

Proper compensation design should discourage that which we wish to discourage and encourage what we wish to encourage.

Rather than stock price, the long term economic returns and risks (of the bank and its stakeholders) are what managers and employees should be asked (through the compensation program) to focus on. Long term economic returns and risks in the bank are aspects that employees and managers *can control* (let's hope they can't control/manage/manipulate long term stock price) – and those are the factors that will ultimately impact the DIF.

As I noted in an interview with the Corporate Finance Review on coping with the crisis (July/August 2009), "Simply because earnings statements are provided to investors doesn't mean earnings should be the gauge for strategies and budgets. And simply because investors are rewarded when stock prices rise doesn't mean managers should be. While the end is alignment, the means should not be identical." It is easy to slip into the false substitute of stock price, however, which has so often occurred. Although a handy measure, stock price even over a longer period is *not* an effective substitute. It is convenient – the street under the lamp post – but it is not where the keys will be found. For banks this is even more critical, as they need to also consider the value they have created for other stakeholders, beyond shareholders.

There is another negative result of using stock (and stock price) that is worthy of discussion. Suggesting the use of stock or stock price as a substitute for long term economic returns vis a vis risks does not encourage the deep thinking which should take place related to the economics (risks and returns) produced by the bank for itself and its stakeholders. And that thinking and analysis is something I believe the FDIC should strongly encourage, not eschew by providing an "easy out".

Finally, as hinted above, the interests and risk appetites of customers of banks and shareholders are different. Shareholders may be willing to take on more risk because of diversification than customers, particularly depositors, are. Therefore, they may bid up a risky stock because the upside is good and they are hedged elsewhere. Customers, however, in banks, need to be made whole, dollar for dollar.

Multi-year period for awards. This is an excellent feature. I have implemented compensation programs with this feature and they work well. I would say again, that the metrics, as the Federal Reserve has noted in its guidance, do matter. The question must be continually asked and answered: *what are the incentives (directly or indirectly) asking staff and management to focus on?*

I would also make a distinction as I did in a NY Times letter between clawbacks and the use of a bonus banking mechanism. A bonus banking mechanism is much more effective and a better motivator than clawbacks. Under this mechanism, portions of payouts are reserved and placed in a bonus bank. Amounts awarded are not fully paid at one time, but paid over time. If individuals are seen to have been over paid, those amounts are deducted from the bonus bank. There is no need under such a mechanism, under normal circumstances, therefore, to ask for a payment back from the employee (“clawback”) which can be de-motivating and difficult to accomplish. Payments into the bonus bank should remain restricted based on future results even after the manager leaves. Clawbacks, strictly speaking, should be in place and used then only when that is the sole recourse i.e. in unusual circumstances only, for example, fraud uncovered years later.

Board involvement and input. I advise boards of directors. Regarding independence, the FDIC should consider “superindependence” ala the SEC proposal in the Bank of America case, requiring that committee members be prohibited from accepting other compensation from the bank.

Independence should not be the only consideration. True independence is difficult to fully measure. Of significant importance in addition to independence, the FDIC should also consider the competence of those board members. A competency review should address specifically whether or not the independent directors can clearly articulate the relationship between compensation and risk and how the compensation program serves to mitigate (or doesn’t) the various risks in the bank. Do they understand the risks of the bank? Do they understand how the incentives focus the attention of managers and employees? The articulation by the independent directors could be provided in a written response to questions and verified during closer reviews of the banks’ activities. (See also my response to question 3 below.)

I do not know whether it is intended as such but I do not believe as stated that compensation consultants, even “independent” ones, should be a required feature of compensation programs. (“The compensation program should be administered by ...with input from independent compensation professionals.”) In many instances, compensation consultants do more harm than good (emphasizing

pay level benchmarking rather than the basis for pay) and to the detriment of all relieve the board of the hard work of carefully thinking through these matters for themselves. I think the use of consultants should be optional.

Regarding your specific questions:

1. See full discussion above.
2. Yes, see above.
3. A questionnaire that addresses process and competency could be effective. Sufficient meeting time, adequacy of the materials reviewed, clear explanation for the basis of pay, and ability of the committee to articulate the potential risks in its pay practices should all be considered. I would be happy to provide additional detailed suggestions.
4. Not as a substitute, no, though certain benchmarks might be useful to the FDIC as early warning mechanisms for risk. I would be happy to provide additional detailed suggestions.
5. All.
6. I would recommend soliciting bank directors as to what amount would cause them to consider changes.
7. Should apply to any entity which has an insured deposit affiliate.
8. Should have similar requirements.
9. All employees.
10. Not sure of the intent of this question, given the number of unknowns.
11. Dependent on the business mix of the entity and the time horizons of risks and returns.
12. These practices should be classified as third tier practices, warranting additional DIF contribution.
13. No, this should be dependent on the business mix of the entity the individual works for and the time horizons of risks and returns.
14. See 11 and 13 above.
15. My book, *Economic Value Management: Applications and Techniques* in the Wiley Finance Series, describes these approaches more fully. I would be happy to discuss these in depth.