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November 27, 2009

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Docket No. OP-1374

Dear Ms. Johnson,
Thank you for the opportunity to provide comments to the Board related to Docket No. OP-1374, Proposed Guidance on Sound Incentive Compensation Policies.

I commend the Board for its efforts.

Attached are my specific comments which I would be happy to expand on at a later time.

If you have any questions, please let me know.

With best regards,
Eleanor Bloxham
CEO, The Value Alliance and Corporate Governance Alliance
614-571-7020
ebloxham@thevaluealliance.com

Here below are specific comments on the Board's Proposed Guidance on Sound Incentive Compensation Policies based on my experience in this arena, including implementing the first risk based performance measurement and compensation plan in a major US financial institution in the late 1990s.

**The Guidance is Not New**
What you propose in this guidance is not new.

The plans which I designed in the late 90s included both deferrals of payment and the use of risk adjusted measures (as well as other features which your guidance does not address but which I will discuss below).

The work was a result of leading approximately two years of skunks works operations to figure out what worked and what didn't in a complex banking environment. The incentives were developed to address the work of executives as well as those taking risks in relationship to customers and others. So that aspect of your proposed guidance is not new either.

What resulted from the work was a true accountability system, which I in part describe in my book *Economic Value Management: Applications and Techniques* (a book which is part of the Wiley Finance Series).

In the late 1990s the NY Fed knew of my work and in 2000 I traveled to meet with the Chicago Fed to discuss my work and why it was important. Bankers also knew of my work from the many risk and other conferences I spoke at and chaired and my meetings with them one on one. There was (mild) interest but little/no action. (More recently, in the wake of the crisis, I have been interviewed about this work and its application now.)

I give you this background by way of introduction in the hopes that you will read my comments as a practitioner and teacher in this area with care, and also that you understand that I agree with you that this is one of those subjects that requires supervisory attention and action in order to create better practices.

**Compensation Design Makes a Difference**
I also agree with your comment that compensation mechanisms played a role (and I would argue a significant one) in the financial crisis. What is paid for is deemed important as money is a tangible representation of what is valued. As I have said many times it is a public statement about what is important.

In my experience, bonuses are an effective way to channel behavior. Channeling behavior appropriately is exactly the solution to preventing another crisis; therefore, your initiatives in this area are very important. From my experience, I know that it is possible to construct a bonus program that appropriately channels behavior by paying for long term upside while penalizing risky behavior.

**Risk Based Performance Metrics are Key**
The first requirement to constructing any effective compensation program is that every business should understand and be able to quantify its core earnings and the risk it is taking on to generate those earnings. With financial institutions this is imperative. I disagree with any notion suggested or implied

in the guidance or elsewhere that some businesses in major financial institutions are too complex to fully understand the risks of and quantify.

I would suggest (strongly) that as a matter of fact banks should not engage in businesses in which they are unwilling or unable to quantify the risk. (I fully understand that some have not but they should at this juncture be willing to begin to quantify and improve their risk quantification to include their entire portfolio.)

If a bank does not understand (and is unwilling to attempt to understand) the complex risks and returns of a business, then for the sake of its customers, shareholders, other stakeholders, and the economies of the world, that bank should not be in that business.

The benefits of a discipline of quantification, even of rough measures are immediate. Such a process helps an institution immediately weed out overly risky businesses which can not contribute to the bottom line over the long term. At the same time (something not mentioned in your guidance but critically important as well), it puts complex and different business lines on similar apples to apples bases. This makes it possible for the bonus structure in a diverse institution to fairly pay executives and relationship managers in different business lines, focused more on rewards versus risks in those businesses, than historical norms for pay. This focus, of course, creates greater alignment with shareholders and other stakeholders.

Now it may be that a novice will ask: what if the initial risk quantification process is wrong and I am paying based on that? Deferrals which you mentioned in the guidance -- and other mechanisms (such as the use of relative changes in performance versus absolute measure --- which you have not mentioned in the guidance) -- can accommodate these issues without adverse consequences. These techniques are useful and it is far better to use these techniques than throw out the baby with the bath water and not use a risk based metric.

To wit, Countrywide was ahead of many financial institutions in recognizing risk in their incentive structures. Taking it into account is not enough, however. Humans, and particularly bankers, are mesmerized by numbers. As your guidance suggests, metrics are key. Risk needs to be more than considered, it needs to be part of the basis for pay. The plans need to not only take into account risk, they need to measure it.

**Bottom line**: The guidance should encourage risk based performance measures for *all* lines of business not just the easy to quantify. It can be done -- and given the disaster we've experienced from "not doing", regulators should encourage all to fully embrace this approach.

**Earnings Manipulation is a Risk and Properly Measuring Return is Key**
As supervisors of banking institutions, you know better than most that in financial services, in particular, many of the numbers in reported accounting are subject to a number of management assumptions which may not have a strong relationship to the core values being generated. As supervisors you also know that in banking earnings manipulation is easy to do. Over the years, some banks have run into trouble related to their calculation of loss reserves and how they may calculate those to create an effect. Valuations of non-liquid instruments create similar risks.

The issue is important for multiple reasons. From a macro perspective, when earnings are distorted markets have a more difficult time doing their job of self-correction. Markets did not provide effective warnings in advance of this most recent crisis – or of the many others that have led to bailouts over the last 40 years. (I spoke at the FDIC in the early part of the decade on the importance of market mechanisms in bank regulation. More recently, I wrote an article published by the National Investor Relations Institute on the failures of financial analysis and market mechanisms as exemplified in bailouts over the last 40 years.)

Earnings manipulation is thus detrimental in a broad, macro sense. More than that, however, it is detrimental internally to the company as well. As I noted earlier, humans, and particularly bankers, are mesmerized by numbers. If a number exists, it has a certain power, whether it means what it is assumed to mean or not.

This is a long way round of saying earnings manipulation while not addressed in the guidance should be. Earnings manipulation was an important issue we addressed in our skunks works in the late 90s and I have documented the issues that should be addressed in my book.

As supervisors, you should know them well.

Risk based metrics include a measure of risk and return.

The words in the guidance regarding the integrity of the processes (measuring risk etc.) are key and appropriately you assign that role to the board. The guidance, however, does not address the fact that in measuring return, it is critically important to consider (1) the potential earnings manipulation and (2) issues related to accounting and how it is reported which may in fact create adverse motivations.

In my opinion, to not address this fundamental issue is to create a lot of work for banks without the true benefit.

Returns need to be measured not just over longer time periods, they need to be reflective of the core values being generated by the employees. Pay should be tied to what employees can create, rather than what it is possible to "manufacture". Returns that are not sustainable should be addressed not just in the design of the plan but also in the metrics themselves.

**Bottom line:** The issue of earnings manipulation and the appropriateness of (an ever changing due to accounting changes) accounting earnings number should be addressed in the guidance. Banks should be encouraged to address measurement of risk and also appropriate measurement of reward in calculating the risk based metric.

**The Risk of Conflicting Measures**

JP Morgan has led some of the pack in that it has had some compensation linked to a risk based measure for nearly a decade. But the program (and my understanding, the measure) has not effectively addressed earnings manipulation as a risk and the appropriateness of earnings as a measure. To wit, their plans as disclosed use both earnings and risk based measures.

The Value Alliance. 6834 Willoughby Ct. Westerville, OH 43082 USA www.thevaluealliance.com
Eleanor Bloxham. 614-571-7020. ebloxham@thevaluealliance.com

While the guidance does not address this issue, it is critically important that supervisors in their oversight encourage institutions to not develop programs that use conflicting measures i.e. both risk based measures and earnings measures. To do so, can create confusion and severely limits the ability of any improvement from the risk based measurement.

**Other Measurement Risks**

Another issue not addressed in the guidance is the issue of the form of the metric. Bankers (I was one so I can say this from close-up experience) love ratios. But a risk based metric in ratio form can create adverse motivations (as I documented in my book). (Dan Borge who first developed RAROC and with whom I've subsequently written articles on risk topics agrees on this.)

One important impact (which I demonstrate in my book) can be its impact on the amount of safe credit a bank may be willing to extend. As supervisors and monitors of the economic system, you should be aware of these issues.

In the late 90s, in implementing compensation, we eschewed using a percentage measure because of its adverse impact on behavior, and I have discussed this issue in many forums in the US and abroad.

**Bottom line**: The guidance does not discuss this issue but given the prevalence of "RAROC" and the love of ratios by bankers and the adverse consequences that could develop with respect to the availability of credit and other services if this is not addressed, the guidance should address this important issue.

**Disclosure**

As noted earlier, disclosure and transparency are critical elements to improving market efficiency (as is effective financial analysis) in preventing major disruptions in the financial system.

I believe the guidance should address the importance of strong disclosure related to risk based compensation.

Here are my comments to the SEC on this important matter which I incorporate here by this reference to the website publication.
http://www.sec.gov/comments/s7-13-09/s71309-107.pdf

**Bottom line:** Sound compensation structures can be supported by the markets via strong disclosure. The guidance should support that and include that as another pillar in strengthening bank safety and soundness.

**The Form of Pay**

Equity (and options, etc) has been shown time and time again to be a form of pay associated with adverse risk taking. See reference to Floyd Norris' article in http://www.sec.gov/comments/s7-13-09/s71309-107.pdf and the Lehman example. I believe before this form of pay is recommended by a regulator as the guidance does, it should be further researched.

Here, again the metric is key and the implied metric of equity awards -- short or long term -- is *increase in stock price*. That metric, however, does not promote safety and soundness. Even if the time horizon is changed, the mesmerizing effect of the implied metric , I believe, lives on in the minds of those who receive it.

I believe it is false to assume that creating alignment with/on behalf of the shareholder need include the requirement that employees hold equity. That aside, particularly given the broader issues of safety and soundness, which this guidance seeks to address, this may be especially imprudent.

**Bottom line**: I do not think that the Federal Reserve has enough information to reputably recommend equity as a form of compensation due to the adverse motivations it can (and often does) create.

**"Best Practice" or the Best Practices**
There is one area of the guidance that hit a hot button with me.

In speeches and in the Corporate Governance Alliance Digest of December 29
http://www.thevaluealliance.com/PDF/CGADigest122908.pdf
which was then picked up by Catherine Finamore in an article in the Journal of Compliance and Ethics and in a recent full length interview for the Corporate Finance Review on *Coping with Change: Corporate Governance in a Time of Crisis* i.e. over and over again, I have been attempting to sound the alarm on the idea of what is often called "best practice".

Too frequently, as in the case of the most recent crisis, what is called "best practice" i.e. the best practices that we can now find as examples, is confused with the idea of being the best practice. As I said in the interview with Corporate Finance Review, "Companies should always be asking not 'what is the best practice I can find' but 'what is the best possible practice'?" Similarly, while it may be instructive for the Federal Reserve Board to gather information on what is being done, given the failures of the past, it should not be assumed that this will lead to a set of "best practices" worthy of promulgation and adoption.

**Bottom line**: It is critically important that the Federal Reserve continually strive to understand what a best practice might be, with input from current practices as only one small part of that equation.

Thank you for the opportunity to comment. I have kept my comments brief but would be happy to expand on these comments at a later time. Please feel free to post my comments as I will also post them on my website as well.

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