AMERICANS FOR FINANCIAL REFORM
ACCOUNTABILITY ★ FAIRNESS ★ SECURITY

Americans for Financial Reform
1629 K St NW, 10th Floor, Washington, DC, 20006
202.466.1885

May 31, 2011

Via Email
Alfred M. Pollard
General Counsel
Attention Comments/RIN 2590-AA42
Federal Housing Finance Authority
Fourth Floor
1700 G Street, NW
Washington, DC 20552

Re: *Incentive-Based Compensation Arrangements, RIN 2590-AA42*

Dear Mr. Pollard:

American for Financial Reform ("AFR") appreciates this opportunity to comment on the Notice of Proposed Rulemaking on Incentive-Based Compensation Arrangements. AFR is a coalition of over 250 national, state, local groups who have come together to advocate for reform of the financial sector. Members of the AFR include consumer, civil rights, investor, retiree, labor, religious and business groups along with prominent economists and other experts.

AFR commends the Agencies for the approach of the Proposed Rule, which takes crucial steps to address the problem of short-term focus in financial sector compensation practices. Several aspects of the Proposed Rule, however, should be strengthened or clarified if the Proposed Rule is to fully address the incentives to take inappropriate risks embedded in current financial sector pay practices.

Summary

We strongly support the overall approach taken in the Proposed Rule, which provides for both closer regulatory scrutiny of incentive compensation arrangements and mandatory deferral of incentive-based compensation.

There is widespread consensus that flawed incentive compensation practices in the financial industry were a major contributing factor to the financial crisis.[1] As the non-partisan Financial Crisis Inquiry Commission stated in its conclusions on the causes of the crisis:

[1] Keller, Christopher and Michael Stocker, "Executive Compensation's Role in the Financial Crisis," The National Law Journal, November 18, 2008.

> "Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the downside limited. This was the case up and down the line—from the corporate boardroom to the mortgage broker on the street."

As Federal Reserve Chairman Ben Bernanke stated "[c]ompensation practices at some banking organizations have led to misaligned incentives and excessive risk-taking, contributing to bank losses and financial instability."[2]

Financial firms' reliance on compensation plans that rewarded executives and traders lavishly for short-term performance, without regard to risks over the medium and long term, led those employees to take excessive risks. The Proposed Rule properly takes a number of steps to address this situation. AFR particularly applauds the important step of instituting mandatory three-year deferral of one-half of incentive-based compensation with adjustment for long-term firm performance.

However, AFR recommends a number of steps to strengthen the Proposed Rule. Without these steps, it is doubtful whether the goal of eliminating inappropriate financial risk-taking due to excessive short-term compensation will be met. Some key steps include:

1) **Strengthen mandatory deferral:** The Rule requires systemically significant financial institutions to defer 50 percent of incentive-based compensation for three years. However, institutions may pay out the deferred compensation in equal pro rata annual shares over the deferral period. This means that only one-sixth of executives' pay could be at risk for the full three-year period. This does not create sufficient risk exposure. The rule should require at least a five-year deferral period, or else that more than 50 percent of pay be deferred.

2) **Require systemically important banks to ban executive hedging:** Permitting executives to hedge their pay packages to protect themselves against long-term risks involved with company performance would undermine the goals of this rule. Research clearly shows that executives who hedge their pay in this manner are betting on the weakness or failure of their own company.

3) **Strengthen institutional reporting requirement:** AFR is concerned that the basically narrative reporting requirement on incentive-based pay will not provide sufficient information to regulators to determine the sensitivity of incentive pay to long-term risks. We urge regulators to develop stronger quantitative metrics here. It may also be helpful to expand reporting coverage.

---

[2] Torres, Craig, "Bank Compensation Curbs Thrust Fed, Treasury into Boardrooms," Bloomberg, 10/23/09.

4) **Establish public reporting requirement**. Because this rule will be implemented and enforced through the confidential interactions between bank examiners, regulators, and regulated financial entities, the public will not have access to the information necessary to tell if the rule is actually improving incentives in the financial sector. AFR recommends that regulators issue an annual summary report providing the public with information quantifying the overall sensitivity of incentive pay to long-term risks at major financial institutions.

A number of other suggestions are also outlined below.

The Mandatory Deferral

We commend the Agencies for proposing a mandatory three-year deferral of 50% of incentive-based compensation of executive officers at larger covered financial institutions and for requiring that deferred amounts be adjusted for actual losses or similar performance measures of the covered financial institution during the deferral period.

A mandatory deferral would create a longer-term focus for executives. Raghuram Rajan, a professor at the Chicago Graduate School of Business, found that incentive deferral provides increased returns to the firm over the traditional bonus model.[3] Mandatory deferral would also bring U.S. financial institutions into line with evolving global practice. Here we note that deferring incentive compensation has gained significant support internationally. In September 2009, the G-20 endorsed the Principles for Sound Compensation Practices, which recommend that a substantial portion of variable compensation be deferred to be distributed in portions over a period of not fewer than three years and subject to adjustment based on performance.[4] France now requires that at least 50 percent of bankers' bonuses be deferred for three years.[5] Similarly, the U.K.'s Financial Services Authority (FSA) adopted a remuneration code providing that two-thirds of senior employees' bonuses must be deferred to be distributed in portions and subject to adjustment over three years.[6]

AFR strongly supports the general idea of a deferral requirement such the one outlined in the Proposed Rule. However, the specific deferral requirement in the rule would not create sufficient risk sensitivity. According to the Proposed Rule, the 50 percent of compensation that is deferred can be paid out in equal pro rata shares over the three-year deferral period. This implies that only one-sixth of executive pay could be at risk for the full three-year period. We believe this level of deferral is inadequate to seriously affect incentives.

This is particularly true given that financial sector compensation can very substantially exceed compensation in other sectors of the economy, in part because of the implicit government backing available to systemically significant institutions. For example, the Council of

[3] Rajan, Raghuram, "Bankers' pay is deeply flawed," The Financial Times, January 8, 2008.
[4] "FSB Principles for Sound Compensation Practices," Financial Stability Board, 9/25/09.
[5] "Ca Fait Malus: France Gets Tough on Bankers' Pay," The Economist, 8/27/09.
[6] "FSA Introduces New Remuneration Code in the UK," Morgan Lewis, 8/14/09.

Institutional Investors has found that during the 2003-2007 period, just prior to the most disastrous financial collapse since the Great Depression, median total compensation for Wall Street CEOs was two and half times higher than median total compensation for CEOs at Fortune 50 companies in the rest of the economy.[7] Thus, a deferral of the full one-half of executive pay would still leave executives with earnings that are higher than Fortune 50 CEOs in other economic sectors. Clearly, deferring just one-sixth of pay for the full three years would have only a small impact on long-term risk incentives.

Given this, AFR believes that the length of the deferral period and/or the amount of pay deferred should be increased. An alternative would be to eliminate the ability to make pro rata payments over the three-year period, and require the entire deferred pay amount to be held for the full three years. If the ability to make pro rata payments is kept, and the 50 percent deferral requirement is not substantially increased, then the minimum three year deferral period should be lengthened to at least five years.

In addition, AFR believes that using a single deferral period for all executive officers of larger financial institutions may not be ideal. The purpose of the deferral is to align employees' incentives with the risk they undertake. It seems unlikely that the risks undertaken by all executive officers at a financial institution (or, more accurately, undertaken under executive officers' supervision) can be fully assessed within a three-year period.

Hedging Transactions

The Agencies ask for comment on whether covered financial institutions' policies and procedures should be required to include limits on personal hedging strategies. We believe that allowing hedging subverts the measures prescribed in the Proposed Rule, which are intended to align compensation with risk.

Academic research clearly shows that insider hedging of compensation forecasts earnings restatements, poor stock performance, and other adverse events.[8] Executives who hedge are in effect betting on adverse outcomes for their own company. A well managed financial institution should not permit this practice.

The Agencies should therefore include in the final rule a provision requiring banks to prohibit hedging by executive officers and other employees who have the ability to expose financial institutions to substantial losses. Banning insider hedging is particularly important for large and systemically significant financial institutions, where there is the greatest public interest in preventing inappropriate risk-taking.

---

[7] Hodgson, Paul et. al., Wall Street Pay: Size, Structure, and Significance for Shareholders, The Corporate Library, November, 2010.

[8] Bettis, J. Carr, Bizjak , John M. and Kalpathy, Swaminathan L., Why Do Insiders Hedge Their Ownership? An Empirical Examination (May 25, 2011). Available at SSRN: http://ssrn.com/abstract=1364810

Institutional Reporting Requirement

The Proposed Rule would require larger covered financial institutions to submit annual reports to their regulator disclosing the structure of its incentive-based compensation arrangements, including descriptions of policies and procedures, material changes to compensation arrangements since the last annual report and the "specific reasons why the covered financial institution believes the structure of its incentive-based compensation plan does not encourage appropriate risks by the covered financial institution . . . ."

In AFR's view, narrative disclosures like those set forth in the Proposed Rule are of limited utility in evaluating the level of risk created by compensation arrangements. Experience with the narrative Compensation Discussion and Analysis section of the proxy statement, which requires some disclosures that are similar to those contained in the Proposed Rule, shows that such descriptions tend to be heavily lawyered and convey little meaningful information.

To effectively carry out the purpose of the Proposed Rule, the Agencies need to be able to monitor the risk created by compensation arrangements on an institution-by-institution basis and across regulated institutions; in both cases, the Agencies also need to be able to track trends over time. To do so, the Agencies need specific quantitative data from covered financial institutions, in a uniform format to allow data aggregation and analysis, about specific compensation arrangements. We suggest that the Agencies should receive data on median stock option grants, stock awards and stock/option holdings to allow the Agencies to calculate measures of the sensitivity of pay to risk and performance at covered institutions. AFR recommends that the Agencies develop one or more standard quantitative metrics of the sensitivity of pay to long-term performance and require that large covered institutions report this metric.

Data on the median amount of compensation paid under short-term incentive plans, as well as the median amount of compensation subject to deferral, would also be useful.

Finally, the data should cover a group of employees beyond executive officers in order to provide a full picture of compensation arrangements at an institution. We recognize that even larger financial institutions have widely varying numbers of employees, making it difficult to select a single number of employees for all covered institutions. Accordingly, we suggest that structural data be required about a specified percentage of employees. One possibility is to focus on the most highly compensated employees at a financial firm (outside of executive officers) or those who receive the largest amounts under short-term incentive plans.

AFR Recommends Addition of Public Reporting Requirement

This rule will be implemented and enforced through the confidential interactions between bank examiners, regulators, and regulated financial entities. Because of this, the public will not have access to the information needed to determine if the rule is actually improving incentives in the financial sector. Given the central significance of this issue to financial reform, AFR believes that this is not appropriate.

We recommend that regulators issue an annual summary report providing the public with information on the overall sensitivity of incentive pay to long-term risks at major financial institutions. Such a report need not reveal institution-level data, but could aggregate quantitative data on the sensitivity of pay to long-term performance to give a picture of the extent to which executives at major financial institutions faced the proper incentives. The report could also track trends over time.

Definition of Excessive Compensation

The Proposed Rule would prohibit incentive-based compensation arrangements that encourage covered persons to expose the institution to inappropriate risks by providing excessive compensation. The Proposed Rule would define "excessive compensation" as compensation that is "unreasonable or disproportionate" in relation to the services being performed by a covered person. Under the Proposed Rule, the Agencies may consider a list of enumerated factors in determining whether compensation is excessive and may also consider any unlisted factor they determine to be relevant.

The factors listed in the Proposed Rule are unobjectionable. We believe, however, the financial institution's financial performance is a factor that should be added. Compensation is excessive when it's disconnected from the performance of the institution. An institution's financial condition (one of the factors set forth in the Proposed Rule) may be sufficiently healthy to allow it to pay compensation, but that compensation may be excessive because the institution's financial performance has been subpar. Performance should be evaluated at least in part by reference to an appropriate peer group because any determination of excessiveness should take into account the performance of a financial institution relative to its peers.

The Proposed Rule identifies compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the institution's operations and assets, as a factor in the excessiveness analysis. We believe that additional guidance should be provided on what constitutes a "comparable" institution. There is ample evidence that Companies choose highly paid peers to justify high CEO compensation.[9] The Agencies' familiarity with firms within their jurisdiction gives them a solid basis for defining comparable institutions.

Special Review and Approval Requirement for Other Designated Individuals

[9] Faulkender, Michael W. and Yang, Jun, "Inside the Black Box: The Role and Composition of Compensation Peer Groups," (May 1, 2010). "Compensation Peer Groups at Companies with High Pay," IRRC Institute, June, 2010.

The Proposed Rule would mandate that the board of a covered financial institution identify those covered persons other than executive officers who have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance. The board or a committee of the board would be required to approve those individuals' compensation and maintain documentation of approval.

We urge the rule to cover a larger group than just executive officers, especially at larger covered financial institutions. As the financial crisis showed, compensation practices throughout an institution can incent non-executive employees to take imprudent risks that can significantly and adversely affect the institution.

Accordingly, we urge the Agencies to provide some non-exclusive bright-line standards to guide this inquiry. One possibility is to focus on the most highly compensated employees at a financial firm (outside of executive officers) or those who receive the largest amounts under short-term incentive plans. Our calculations indicate that, based on data from the 2008 Cuomo Report on financial firm bonuses, the median TARP financial firm recipient paid bonuses of $1 million or more to approximately .2% of its employees in 2008. Thus, a bright-line or modified bright-line rule based on the dollar amount of incentive compensation could pull in many more employees than simply executive officers.

* * * *

We appreciate the opportunity to comment on the proposed rule. If you have any questions, please contact Marcus Stanley, AFR's policy director, at marcus@ourfinancialsecurity.org or (202) 466-3672.

Sincerely,

Americans for Financial Reform

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AARP
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Affairs Bureau/Dollars & Sense
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions

- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now

- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

Partial list of State and Local Signers

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network

- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO

- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG