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15 April 2011

- 12 CFR Parts 741 and 751
- RIN 3133-AD88
- Incentive-based Compensation Arrangements

Dear Sir.

Thank you for giving us the opportunity to comment on your proposed rule: Incentive-based Compensation Arrangements.

The OCC, Board, FDIC, OTS, NCUA, SEC, and FHFA (the Agencies) are proposing rules to implement section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposed rule would require the specific reporting of incentive-based compensation arrangements by a covered financial institution and prohibit any incentive-based compensation arrangements at a covered financial institution that provide excessive compensation or that could expose the institution to inappropriate risks that could lead to material financial loss. I will make some general comments on compensation policy and incentive-based compensation, and also discuss some more detailed points.

Transparency, communication and governance

It is absolutely necessary that institutions are required to have in place clear and transparent compensation policies. These should be communicated and disclosed to all stakeholders, including investors and shareholders, regulators and internally within the institutions. It is also necessary to have strong, independent governance structures and processes to ensure that the institutions' compensation policies are appropriate and are being followed. Some arguments in favour and against these principles are as follows:

In favour

- Oversight of compensation practices in institutions has been sorely lacking. It is appropriate that more regulatory oversight be brought to bear here.
- We hold executive management accountable for the performance of institutions, but not for the proper functioning and control of compensation policies and practices.

Against

- To make rules on compensation, which are required in institutions anyway, it to take the view implicitly that regulators have more expertise in managing institutions than the institutions' management themselves do. One also mistakenly assumes that institutions will adopt sound compensation policies and practices only if required to do so by regulators.
- The very existence of such rules will increase the frequency of regulatory action against institutions, which implies that existing supervisory management and shareholders are incapable, or unwilling, to supervise the institutions themselves. This itself undermines the integrity and confidence in supervisory management and shareholder actions.

After considering and weighing these arguments I would have to say that I support the principles. Importantly, it does not matter whether an institution is already complying with such principles; it is more critical that they are seen to be complying. I do not believe that this would be an onerous procedure, or be costly to implement. Either institutions are already implementing the principles – which is good, or they are not – in which case they should.

Risk adjustments

It is clearly appropriate that incentive-based compensation should take account of the risks being taken on by personnel. If personnel meet performance targets by taking on excess risk, then this endangers the institution, and effectively rewards luck, which is unacceptable. I would recommend that the risk adjustment to incentive-based compensation should be done through a cost of capital type adjustment, for example by linking performance to a risk adjusted measure such as economic value added or RORAC.

Deferral of incentive-based compensation

Incentive-based compensation should be paid out in instalments over a minimum period of 3-5 years after award. The important compensation principle to uphold here is that personnel receive a salary for doing their job, and should only receive bonuses for outperformance, and one can only reasonably measure outperformance over a medium-term period. It is also important that personnel who have outperformed actually receive their bonuses, i.e. that bonuses represent earnings, and the deferral of payment is exactly that. This would mitigate the need for such things as "golden handshake" and "golden parachute" payments. The only mitigation that should be required here is that an institution should apply an ex post risk or performance adjustment mechanism (malus or clawback clause) to incentive-based compensation for losses incurred by the institution after the date on which the incentive-based

compensation was awarded. Such adjustment mechanism should always apply in the case of fraud or misleading information.

Proportionality and link to performance

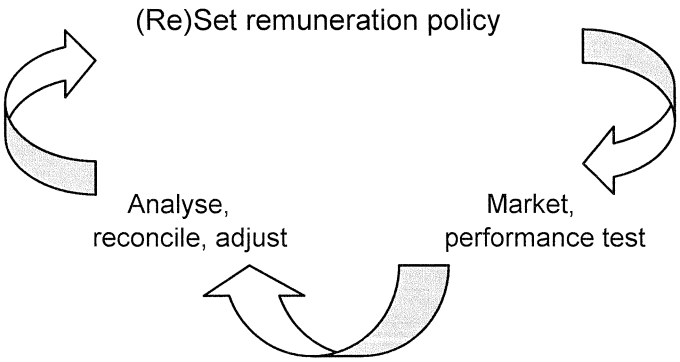
There should be a clear link between the variables used to measure risk, determine risk adjustments and performance, and the seniority of and influence that employees have on said risk and performance. Ideally, all incentive-based compensation should relate to areas within the control and responsibility of employees. Additionally, incentive-based compensation should not have a floor, i.e. it could be zero.

As a principle, all incentive-based compensation should be based on achieved performance in some way. Guaranteed incentive-based compensation is a contradiction in terms, and should be prohibited.

Reconciling against targets and expectations

Institutions should be able to reconcile how final outcomes compare to initially expected outcomes by means of a movement analysis. For example: initially expected outcomes, plus or minus any changes in Compensation policy, plus or minus any experience adjustments, plus or minus any variances due to ad hoc or discretionary features should equal final outcomes.

Institutions should also monitor and control the expectations and outcomes of their compensation policy by using a control cycle technique as follows:



Unintended consequences

Unfortunately your proposed incentive-based compensation arrangements (and more so with my proposals) will probably lead to a greater weighting towards fixed components of compensation, i.e. salary, and a consequent reduction in incentive-based components. This

may have the adverse effect of making the compensation system more rigid, and even less flexible than before.

Proposed arrangements

I support the principles-based approach that you have taken with these proposals. In particular I support §751.4 Required reports to regulators and §751.5 Prohibitions. I would only recommend that you add a new section to (a)(2) under Prohibitions, which would refer to the actual performance of the covered person compared to the set initial targets. I believe that you can only meaningfully assess "excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person" in relation to the risk adjusted performance of the covered person.

Summary

In summary, I welcome and support your proposed rule. I agree with the principles-based approach that you have taken in this arena. I would only specifically recommend that you explicitly allow for a covered person's actual performance as one of the factors that should determine whether the covered person's compensation would be deemed excessive.

Yours sincerely

Chris Barnard