FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 327

RIN [number]

Incorporating Employee Compensation Criteria Into The Risk Assessment System

AGENCY: Federal Deposit Insurance Corporation (FDIC).

ACTION: Advance notice of proposed rulemaking (ANPR).

SUMMARY: The FDIC is seeking comment on ways that the FDIC's risk-based deposit insurance assessment system (risk-based assessment system) could be changed to account for the risks posed by certain employee compensation programs. Section 7 of the Federal Deposit Insurance Act (FDI Act, 12 U.S.C. § 1817) sets forth the risk-based assessment authorities underlying the FDIC's deposit insurance system, and the parameters of the FDIC's rules are set forth at 12 C.F.R. Part 327.

Section 7 of the FDI Act requires the FDIC to establish a risk-based assessment system that incorporates statutory and other factors determined to be relevant in assessing the probability that the Deposit Insurance Fund (DIF) will incur a loss from the failure of an insured depository institution. In accordance with this mandate, the FDIC is exploring whether and, if so, how to incorporate employee compensation criteria into the risk-based assessment system. The FDIC does not seek to limit the amount which employees are compensated, but rather is concerned with adjusting risk-based deposit insurance assessment rates (risk-based assessment rates) to adequately compensate the DIF for the risks inherent in the design of certain compensation programs. By doing this, the FDIC seeks to provide incentives for institutions to adopt compensation programs that align employees' interests with the long-term interests of the firm and its stakeholders,

including the FDIC. Such incentives would also seek to promote the use of compensation programs that reward employees for internalizing the firm's focus on risk management.

This initiative is intended to be a complementary effort to the supervisory standards being developed both domestically and internationally to address the risks posed by poorly designed compensation programs. While supervisory standards are set to define the minimum standards that all institutions must meet, the FDIC seeks to use the deposit insurance assessment system to provide incentives for institutions to meet higher standards, should they choose to do so. Using the deposit insurance assessment system in this way does not mandate institutions to adopt higher standards, but instead would broaden and improve the regulatory approach to addressing compensation issues by providing institutions with an incentive to choose to exceed base supervisory standards. The FDIC seeks comment on all aspects of this ANPR.

DATES: Comments must be submitted on or before **[INSERT DATE 30 DAYS AFTER FEDERAL REGISTER PUBLICATION]**.

ADDRESSES: You may submit comments on the advance notice of proposed rulemaking by any of the following methods:

- Agency Web Site: http://www.FDIC.gov/regulations/laws/federal/propose.html. Follow the instructions for submitting comments on the Agency Web Site.

- E-mail: Comments@FDIC.gov. Include RIN #________ on the subject line of the message.

- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments, Federal

Deposit Insurance Corporation, 550 17th Street, N.W., Washington, DC 20429.

• Hand Delivery: Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

Instructions: All comments received will be posted generally without change to http://www.fdic.gov/regulations/laws/federal/propose.html, including any personal information provided.

FOR FURTHER INFORMATION CONTACT: Marc Steckel, Associate Director, (202) 898-3618, Rose Kushmeider, Acting Section Chief, (202) 898-3861, Daniel Lonergan, Counsel, (202) 898-6971, or Sheikha Kapoor, Senior Attorney, (202) 898-3960.

SUPPLEMENTARY INFORMATION:

I. Background

In the wake of the global financial crisis that began in 2007, public, academic, and government attention has been directed toward the compensation practices of financial institutions—especially the largest, most complex, financial organizations—with particular focus on whether compensation practices contributed to the excessive build-up of risk that precipitated the crisis. A review of work by academics, consulting groups and others indicates a broad consensus that some compensation structures misalign incentives and induce imprudent risk taking within financial organizations.[1] Some poorly designed

[1] See for example, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008." Bebchuk, Lucian A., Alma Cohen, and Holger Spamann Yale Journal on Regulation, Forthcoming.; "Does Stock Option-Based Executive Compensation Induce Risk-Taking? An Analysis of the Bank Industry." Chen, Carl R.; Steiner, Thomas L.; Whyte, Ann Marie. Journal of Banking and Finance, March 2006, v. 30, iss.3, pp.915-945; "The 2007-2009 Financial Crisis and Executive Compensation: Analysis and a Proposal for a Novel Structure" by Alon Raviv and Yoram Landskroner (*NYU Working Paper No.* June 2009. *FIN-09-03); "Corporate Governance of Banks" by Jonahthan R. Macey and Maureen O'Hara*

compensation structures reward employees based on short-term results without full consideration of the longer-term risks to the firm. In so doing, they fail to align individual incentives with those of the firm's other stakeholders, including shareholders and the FDIC.

Excessive and imprudent risk taking remains a contributing factor in financial institution failures and losses to the DIF, and to some extent these losses can be attributed to the incentives provided by poorly designed compensation programs. Section 7 of the FDI Act requires the FDIC to account for these risks to the DIF when setting risk-based assessment rates. This ANPR seeks comment on a variety of issues that will be considered in this effort.

While there is general agreement that certain compensation programs misalign incentives and increase risk, the proposals to address these problems differ. In sum, identifying the risks posed is easier than identifying the most appropriate solution to address them. Recommendations include mandated stock purchases, performance look-back periods, and bonus clawbacks. Other recommendations focus on the benefits of improving the effectiveness of compensation committees, or on the benefits of shareholders' "say-on-pay."

Legal Framework

Section 7 of the Federal Deposit Insurance Act (FDI Act, 12 U.S.C. § 1817) sets forth the risk-based assessment authorities underlying the FDIC's deposit insurance

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(Economic Policy Review, Vol. 9, No. l, April 2003); and "The Changing Corporate Governance Environment: Implications for the Banking Industry." Craig, Valentine. *FDIC Banking Review* 16, no. 4:121-135. In addition, the Federal banking agencies addressed compensation in the Interagency Statement on Meeting the Needs of Creditworthy Borrowers (Nov. 12, 2008). Specifically, this interagency statement notes that poorly designed compensation policies at insured institutions can "create perverse incentives" that may jeopardize the institution's health.

system. It requires that a depository institution's deposit insurance assessment be based on the probability that the DIF will incur a loss with respect to that institution, the likely amount of the loss, and the revenue needs of the DIF. 12 U.S.C. § 1817(b)(1)(C). Employee compensation programs have been cited as a contributing factor in 35 percent of the reports prepared in 2009 investigating the causes of insured depository institution failures and the associated losses to the DIF.

The FDIC's Board of Directors is required to set risk-based assessments for insured depository institutions in such amounts as it determines to be necessary or appropriate. 12 U.S.C. § 1817(b)(2)(A). The Board of Directors must, in setting risk-based assessments, consider the estimated operating expenses of the DIF, the estimated case resolution expenses and income of the DIF, the projected effects of the payment of assessments on the capital and earnings of insured depository institutions, the risk factors listed at 12 U.S.C. § 1817(b)(1)(C), and any other factors the Board determines to be appropriate. 12 U.S.C. § 1817(b)(2)(B). The FDIC believes the risks presented by certain employee compensation programs are an appropriate factor for the Board to consider when setting risk-based assessments.

In some cases, an institution's risk profile can be affected by holding company and affiliate activities. For example, employees of a parent holding company may be responsible for making decisions or taking actions that will have a material effect on the insured depository institution. In this scenario, the control of significant risks affecting the insured depository institution resides outside the institution, but in the event of failure, the costs associated with the risk will be borne by the DIF. In another example, an employee may have dual responsibilities—to the insured depository institution and to the parent holding company or affiliate—and thus be partly compensated under a contract with a parent company or affiliate. The FDIC is seeking comment on how these types of risks should be accounted for when setting an institution's risk-based assessment.

The Board of Directors may establish separate risk-based assessment systems for large and small members of the DIF. 12 U.S.C. § 1817(b)(1)(D). However, no insured depository institution may be barred from the lowest-risk category solely because of size. 12 U.S.C. § 1817(b)(2)(D). Any changes made to the risk-based assessment system would be subject to this constraint.

The FDIC views the contemplated changes to the risk-based assessment system as separate from and complementary to recent supervisory initiatives to address compensation issues. Unlike supervisory standards, which set a floor below which the insured depository institution cannot operate, the contemplated standards used for determining risk-based assessment rates would be voluntary. The risk-based assessment system is therefore designed to provide incentives for institutions to adopt standards that exceed supervisory minimum standards. The existing risk-based assessment system provides a variety of incentives for institutions to achieve lower risk-based assessment rates by exceeding supervisory minimum standards. The FDIC views the contemplated approach as consistent with the existing approach whereby the deposit insurance system is used to provide incentives for risk management practices that exceed supervisory minimum standards, while stopping short of mandating higher standards.

II. Methodology

Certain compensation programs can increase losses to the DIF as they provide incentives for employees of an institution to engage in excessive risk taking which can ultimately increase the institution's risk of failure. In 2009 there were 49 Material Loss Reviews completed that addressed the factors contributing the losses resulting from financial institution failures - 17 of these reports (35 percent) cited employee compensation practices as a contributing factor. Therefore, the FDIC is seeking to identify criteria upon which to base adjustments to the risk-based assessment system in order to correctly price and assess the risks presented by certain compensation programs. These criteria would be organized to provide either a "meets" or "does not meet" metric, which would then be used to adjust an institution's risk-based assessment rate.

Description of the FDIC's Goals

The FDIC's goals include:

- Adjusting the FDIC's risk-based assessment rates to adequately compensate the DIF for the risks presented by certain compensation programs.
- Using the FDIC's risk-based assessment rates to provide incentives for insured institutions and their holding companies and affiliates to adopt compensation programs that align employees' interests with those of the insured depository institution's other stakeholders, including the FDIC.
- Promoting the use of compensation programs that reward employees for focusing on risk management.

In assessing institutions for the risks posed by certain compensation programs, the FDIC seeks to develop criteria that are straightforward and require little additional data to be collected. The criteria should allow the FDIC to determine whether an institution has adopted a compensation system that either meets a defined standard or does not. The FDIC does not seek to impose a ceiling on the level of compensation that institutions may pay their employees. Rather, the criteria should focus on whether an employee compensation system is likely to be successful in aligning employee performance with the long-term interests of the firm and its stakeholders, including the FDIC. In this manner any adjustment to the risk-based assessment system should complement supervisory initiatives to ensure that institutions have compensation policies that do not encourage excessive risk taking and that are consistent with the safety and soundness of the organization.

Compensation programs that meet the FDIC’s goals may include the following features:

1. A significant portion of compensation for employees whose business activities can present significant risk to the institution and who also receive a portion of their compensation according to formulas based on meeting performance goals should be comprised of restricted, non-discounted company stock. Such employees would include the institution’s senior management, among others. Restricted, non-discounted company stock would be stock that becomes available to the employee at intervals over a period of years. Additionally, the stock would initially be awarded at the closing price in effect on the day of the award.
2. Significant awards of company stock should only become vested over a multi-year period and should be subject to a look-back mechanism (e.g., clawback) designed to account for the outcome of risks assumed in earlier periods.
3. The compensation program should be administered by a committee of the Board composed of independent directors with input from independent compensation professionals.

Under the approach contemplated above, the FDIC could conclude that firms that are able to attest that their compensation programs include each of the features listed above present a decreased risk to the DIF, and therefore would face a lower risk-based assessment rate than those firms that could not make such attestation. Alternatively, the FDIC could conclude that firms that cannot attest that their compensation programs include each of these features present an increased risk to the DIF, and therefore would face a higher risk-based assessment rate than those firms that do make such attestation.

III. Request for Comments

The FDIC requests comment on all aspects of the proposal to incorporate employee compensation criteria into the FDIC's risk-based assessment system, including comments on the FDIC's stated goals and the features of compensation programs that meet such goals. In particular, the FDIC invites comment on the following:

1. Should an adjustment be made to the risk-based assessment rate an institution would otherwise be charged if the institution could/could not attest (subject to verification) that it had a compensation system that included the following elements?

    a. A significant portion of compensation for employees whose business activities can present significant risk to the institution and who also receive a portion of their compensation according to formulas based on meeting performance goals would be comprised of restricted, non-discounted company stock. The employees affected would include the institution's senior management, among others. Restricted, non-discounted company stock would be stock that becomes available to the employee at intervals over a period of years. Additionally, the stock would initially be awarded at the closing price in effect on the day of the award.

b. Significant awards of company stock would only become vested over a multi-year period and would be subject to a look-back mechanism (e.g., clawback) designed to account for the outcome of risks assumed in earlier periods.

c. The compensation program would be administered by a committee of the Board composed of independent directors with input from independent compensation professionals.

2. Should the FDIC's risk-based assessment system reward firms whose compensation programs present lower risk or penalize institutions with programs that present higher risks?

3. How should the FDIC measure and assess whether an institution's board of directors is effectively overseeing the design and implementation of the institution's compensation program?

4. As an alternative to the FDIC's contemplated approach (see q. 1), should the FDIC consider the use of quantifiable measures of compensation—such as ratios of compensation to some specified variable—that relate to the institution's health or performance? If so, what measure(s) and what variables would be appropriate?

5. Should the effort to price the risk posed to the DIF by certain compensation plans be directed only toward larger institutions; institutions that engage only in certain types of activities, such as trading; or should it include all insured depository institutions?

6. How large (that is, how many basis points) would an adjustment to the initial risk-based assessment rate of an institution need to be in order for the FDIC to have an effective influence on compensation practices?
7. Should the criteria used to adjust the FDIC's risk-based assessment rates apply only to the compensation systems of insured depository institutions? Under what circumstances should the criteria also consider the compensation programs of holding companies and affiliates?
8. How should the FDIC's risk-based assessment system be adjusted when an employee is paid by both the insured depository institution and its related holding company or affiliate?
9. Which employees should be subject to the compensation criteria that would be used to adjust the FDIC's risk-based assessment rates? For example, should the compensation criteria be applicable only to executives and those employees who are in a position to place the institution at significant risk? If the criteria should only be applied to certain employees, how would one identify these employees?
10. How should compensation be defined?
11. What mix of current compensation and deferred compensation would best align the interests of employees with the long-term risk of the firm?
12. Employee compensation programs commonly provide for bonus compensation. Should an adjustment be made to risk-based assessment rates if certain bonus compensation practices are followed, such as: awarding guaranteed bonuses; granting bonuses that are greatly disproportionate to regular salary; or paying bonuses all-at-once, which does not allow for deferral or any later modification?

13. For the purpose of aligning an employee's interests with those of the institution, what would be a reasonable period for deferral of the payment of variable or bonus compensation? Is the appropriate deferral period a function of the amount of the award or of the employee's position within the institution (that is, large bonus awards or awards for more senior employees would be subject to greater deferral)?
14. What would be a reasonable vesting period for deferred compensation?
15. Are there other types of employee compensation arrangements that would have a greater potential to align the incentives of employees with those of the firm's other stakeholders, including the FDIC?

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Dated at Washington, DC, this __th day of January, 2010.

By order of the Board of Directors.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.