Financial Services Management

Compensation-Related FDIC Premiums

Personnel	Legal Action Item

Cite

FDIC

Advance Notice of Proposed Rulemaking

Incorporating Employee Compensation Criteria Into The Risk Assessments

Recommended Distribution

Personnel, Legal, Government Relations

Website

http://www.fdic.gov/regulations/laws/federal/2010/10proposeAD56.pdf

Overview

The FDIC has issued an advance notice of proposed rulemaking (ANPR) outlining ways that compensation practices could be reflected in the risk assessments that determine deposit-insurance premiums. While seeking views on a number of ways to do so, the ANPR includes a lengthy defense of the FDIC's need to intervene and the legal rationale on which it could do so. This includes a discussion of authority the FDIC believes would authorize it for the first time to impose premiums based on holding-company and/or affiliate activities, as well as adjust premiums solely based on the size of a bank or its parent.

Impact

The FDIC's action of course comes at a time of growing debate over financial-industry compensation issues. House-passed reform legislation addresses this issue[1] although still tougher proposals may be in the works. President Obama has highlighted bonuses in his recent proposals to impose a new fee on large institutions[2] and to limit big-bank activities and size.[3] Regulators have advanced less far-reaching measures, with the FRB recently issuing a proposal to ensure compensation incentives align with risk-management ones[4] and pending SEC initiatives in this area.[5] FDIC Chairman Bair does not, however, think these sufficiently stringent nor does she plan to await final action on legislation or the Administration plan before proceeding with the proposal detailed below.

The ANPR states that, while supervisory standards are set to define the minimum standards that all institutions must meet, the FDIC should use the deposit-insurance assessment system to provide incentives for higher, voluntary standards. The FDIC argues that this is an appropriate use of the risk-based premium (RBP) system. However, critics – including Comptroller Dugan and OTS Director Bowman -- have countered that there is little consensus on which compensation structures pose risk and, even if some practices are clearly problematic, ways to measure and price for them in RBPs are wholly uncertain.

Rebutting these assertions, the ANPR states that the FDIC does not seek to limit the amount which employees are compensated, but rather is concerned with adjusting RBPs 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 employee 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.

Among its most contentious proposals, the ANPR would not only link insured-depository RBPs to compensation, but also charge higher premiums based on holding-company or affiliate practice. The FDIC bases this on the view that its statutory authority obliges it to assess any practice that poses a risk to the DIF, which includes those at holding companies and/or affiliates. This is, however, the first time the FDIC has sought to do so. The principle of

[1] See Client Report **COMPENSATION20**, *Financial Services Management*, August 10, 2009.
[2] See Client Report **CRISISFEE**, January 14, 2010.
[3] See Client Report **PROPTRADE**, January 21, 2010.
[4] See Client Report **COMPENSATION22**, *Financial Services Management*, January 6, 2010.
[5] See Client Report **COMPENSATION24**, *Financial Services Management*, January 6, 2010.

RBP assessments on non-insured depositories would, if sustained, have broad impact were the FDIC to extend to it a wide array of non-bank activities (e.g., proprietary trading) to which the FDIC now objects. Comment is solicited on this issue.

Another issue on which comment is sought is whether only large banks and/or those engaged in certain activities should be subject to higher RBPs related to compensation. The FDIC notes in the ANPR that it may charge higher premiums based on size as long as size alone is not the sole criterion on which higher rates are based. Large banks have long objected to any size-based assessment scheme, but smaller institutions and some at the FDIC think higher premiums are warranted by the larger risk to the DIF posed by major insured depositories.

What's Next

The ANPR was adopted at a contentious meeting on January 12[6] and published in the *Federal Register* on January 19. Comments are due by February 18.

Analysis

The ANPR includes a description of the FDIC's views on its legal authority to link RBPs to compensation, citing an array of studies concluding that certain compensation practices pose prudential risk (although the ANPR also notes differences of opinion on precisely which compensation practices are problematic). In 2009, about one-third of the material-loss reviews on failed banks linked loss to compensation practice.

A. Compensation Practices

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

- 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

6 See Client Report **COMPENSATION25**, January 12, 2010.

on meeting performance goals should be comprised of restricted, non-discounted company stock. Such employees would include the institution's senior management. 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.

- 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.

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

Firms that meet all three criteria would be charged lower RBPs.

B. Request for Comment

In addition to seeking views on the FDIC's goals with this ANPR and the compensation features noted above, views are solicited on:

- whether higher premiums should be charged for non-compliant firms or if lower RBPs would provide incentives for best-practice firms;
- ways to measure board compliance with the requirement for effective compensation management;
- use of quantifiable compensation measures (e.g., ratios to some specified measure) and, if so, which ones;
- whether only large banks should be subject to RBPs related to compensation and/or only those that engage in certain activities (e.g., trading);
- how large the RBP adjustment related to compensation should be;
- coverage of holding companies and/or affiliates;
- which employees' compensation should be evaluated;
- compensation definition;
- the best mix of current and deferred compensation; and
- adjustments for certain bonus practices.