January 12, 2010

TO: The Board of Directors

FROM: Arthur J. Murton
Director
Division of Insurance and Research

SUBJECT: Advance Notice of Proposed Rulemaking on Employee Compensation

INTRODUCTION

In the wake of the global financial crisis that began in 2007, private, academic, and government attention has focused on the compensation practices of financial institutions—especially the largest, most complex, financial organizations—and whether these practices contributed to the excessive risk taking underlying the crisis. Studies almost universally find that poorly designed employee compensation programs provide incentives to take risks that can significantly and adversely affect a firm beyond the period when the compensation is earned or awarded. As set forth in Section 7 of the Federal Deposit Insurance Act, the FDIC is required to establish a risk-based assessment system for depository institutions that incorporates all factors the FDIC determines are relevant to assessing the probability that the Deposit Insurance Fund (DIF) will incur a loss with respect to an institution. In accordance with this mandate, the FDIC is exploring whether the design of employee compensation programs should be considered as a factor in the risk-based pricing system. Staff has produced an Advance Notice of Proposed Rulemaking (“ANPR”) that explores options to reduce risk presented by employee compensation programs involving insured institutions.

RECOMMENDATION

Staff recommends that the Board authorize publication of the attached ANPR that explores how to incorporate employee compensation criteria into the FDIC’s risk-based assessment system to compensate the DIF adequately for the risks inherent in certain compensation programs. In doing so, the FDIC seeks to provide incentives for institutions to adopt compensation programs that align employees’ interests with those of the firm’s stakeholders, including the FDIC, and that reward employees for internalizing the focus on risk management.

Concur:______________
Michael Bradfield
General Counsel
SUMMARY OF THE ANPR

In weighing how best to incorporate compensation criteria into the FDIC’s risk-based assessment system, the FDIC’s will consider:

- How to adjust risk-based assessment rates to adequately compensate the DIF for the risks inherent in certain compensation programs.

- How to use the 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.

- How to provide incentives that promote the use of compensation programs that reward employees for focusing on risk management.

In assessing institutions for the risk posed by certain compensation systems, the FDIC seeks to develop criteria that are straightforward and that would not require institutions to provide more than a minimal amount of additional data. The criteria should allow the FDIC to readily determine whether an institution has a well-designed compensation system (that is, “meets” the criteria) or a system that is not well-designed (“does not meet” the criteria). The FDIC does not seek to impose a specific level of compensation that institutions may pay to their employees, but is solely concerned with whether a compensation system aligns employee performance with the long-term interests of the firm and its stakeholders, including the FDIC. 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 ANPR poses questions on all aspects of employee compensation programs, including, for discussion purposes, a proposed compensation model that provides that:

1. A significant portion of the compensation for employees whose business activities can present significant risk to the institution be paid in restricted, non-discounted company stock.

2. Significant awards of company stock only become vested over a multi-year period, subject to a look-back mechanism (e.g., clawback) to account for the outcome of risks assumed in earlier periods.
3. The employee compensation program be administered by a committee of the Board composed of independent directors with input from independent compensation professionals.

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