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The Federal Deposit Insurance Corporation would be keeping with its responsibilities to taxpayers if it imposed higher reserve requirements on banks that provide substantial bonuses or other incentives to executives based on short-term performance. Economic theory predicts that these banks will take greater risks in their lending decisions.

While there is not enough evidence at this point to convincingly establish that banks that base a substantial portion of executive compensation do face a higher risk of failure, this is the result predicted by theory. It is worth noting that Moody's has found a relationship between outsize executive compensation packages and credit downgrades [http://www.moodys.com/cust/content/content.ashx?source=StaticContent/Free%20pages/Credit%20Policy%20Research/documents/current/2003600000426617.pdf]. While this does not provide direct evidence as to whether compensation packages based on short-term performance will lead banks to take greater risks, it does show evidence that excessive executive compensation can lead to poor performance.

In the absence of compelling evidence in either direction, it would seem the safer decision by the FDIC is to follow the prediction of theory rather than assume this prediction to be wrong and not take the structure of compensation packages into account in determining reserve requirements. If the FDIC does not take the prediction of theory into account, and the theory is correct, then it means that it will effectively be forcing more cautious banks to subsidize the risk-taking of the less cautious banks. This is not sound regulatory policy.

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