Federal Reserve Bank of Minneapolis

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NARAYANA R. KOCHERLAKOTA
PRESIDENT

February 10, 2010

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Dear Mr. Feldman:

The Federal Deposit Insurance Corporation (FDIC) has requested comments on an Advance Notice of Proposed Rulemaking on "Incorporating Employee Compensation Into The Risk Assessment System." This letter transmits our comments (which do not necessarily reflect the views of others in the Federal Reserve System).

First, the FDIC should consider the compensation arrangements of depository institutions that hold insured deposits ("banks") in the setting of deposit insurance premiums. Specifically, in setting the premium, the FDIC should consider the additional costs that certain compensation arrangements could impose on the deposit insurer.

Second, when incorporating compensation arrangements into the deposit insurance premium, the FDIC should not consider equity-based compensation schemes—even when the equity comes in the form of restricted stock that vests over time, for example—as reducing risk to the deposit insurance fund. Instead, the FDIC premium should encourage compensation linked to "debt-like" instruments that better align bank employee incentives to those of the FDIC.

Third, the FDIC should also include supervisory assessments of compensation arrangements when incorporating the effect of compensation into the deposit insurance premium.

We elaborate on these three points in the rest of this comment.

<u>The FDIC should incorporate bank compensation practices into deposit insurance premiums.</u>
We strongly support the FDIC's effort to incorporate compensation arrangements into the deposit insurance premium and agree that the premiums should reflect the additional loss to the deposit insurance fund that such arrangements can yield. We take this position because the presence of the deposit insurance guarantee (and other implied governmental support for creditors) distorts the compensation arrangements that banks enter into with employees. As Christopher Phelan discusses in detail in "A Simple Model of Bank Employee Compensation," debt holders play a key role in a firm's setting of

optimal compensation.[1] Firms pay higher debt costs if they offer compensation arrangements that raise the probability that the debt holders suffer losses. Risk-varying price signals from debt holders encourage firms to offer compensation arrangements that induce employees to take on “good” projects while avoiding “bad” projects. Such compensation arrangements would include “incentive” compensation and would not rely on a base salary or bonus system unrelated to outcomes from the choice of good versus bad projects.

Insured depositors, however, do not bear the cost of increased risk-taking by the bank and therefore have no incentive to reflect compensation arrangements in the interest rates they charge for their funds. Instead, the FDIC absorbs the costs imposed by compensation arrangements that increase the probability that the bank defaults. As a result, the FDIC should reflect compensation arrangements in the prices (i.e., deposit insurance premiums) it charges banks. Not charging for the higher risk of default that a compensation arrangement may generate encourages too much risk-taking by banks and exposes taxpayers, whose credit stands behind the FDIC, to loss.

Implied government support for nominally uninsured bank depositors, other bank debt holders and other bank creditors can induce similar distortions to bank compensation arrangements and expose the government to losses otherwise born and priced by market participants. The government should also charge a “premium” to correct for the distortion to risk-taking, as manifested in certain compensation schemes, caused by implied support. To the degree the deposit insurance fund would bear the costs from this implied support, the FDIC should incorporate it into its deposit insurance premium.

<u>The FDIC deposit insurance premium should encourage bank compensation linked to debt, not equity.</u>
The FDIC’s proposal favors the granting of restricted, nondiscounted company stock that vests over a multiperiod term and is subject to a “clawback.” Banks that incorporate this form of compensation would not face an upward adjustment in their deposit insurance premium.

However, bank equity holders, assuming they hold a diversified portfolio of assets, reap the benefit of bank risk-taking beyond the risk-taking necessary to generate revenue that pays back debt holders. As such, equity holders have incentive to induce the bank to take on more risks than debt holders would prefer.

The FDIC is akin to a debt holder in the capital structure of the bank, given its insurance of certain deposits. As such, the proposal’s favorable treatment of equity-based compensation encourages more risk-taking than the FDIC should prefer. The FDIC has sought to limit that risk-taking by placing conditions on the form of equity provided to employees (e.g., clawbacks, multiperiod vesting). The FDIC proposal could also recognize that equity holders of small, closely held banks may not have diversified portfolios, which could dampen their incentive to take risk.

But the FDIC’s entire equity-based approach seems second best to more directly aligning employee risk tolerance and preferences with those of the FDIC. To achieve that alignment, the FDIC should encourage arrangements that pay bank employees with debt-like instruments (or which seek to mirror the payouts from debt).[2] For example, the FDIC could reduce or eliminate the “compensation surcharge” charged in a bank’s deposit insurance premium to the degree the bank provides debt-like payments to bank employees.

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[1] Christopher Phelan. 2009. “A Simple Model of Bank Employee Compensation.” Federal Reserve Bank of Minneapolis Working Paper 676. December. For a less technical discussion of the same issues, see Christopher Phelan and Douglas Clement. 2009. “Incentive Compensation in the Banking Industry: Insights from Economic Theory.” Federal Reserve Bank of Minneapolis Economic Policy Paper 09-1. December.

[2] Lucian Bebchuk of Harvard Law School makes a similar point in “Written Testimony Before the Committee on Financial Services, U.S. House of Representatives,” June 11, 2009.

The FDIC should incorporate supervisory assessments of compensation into the deposit insurance premium.

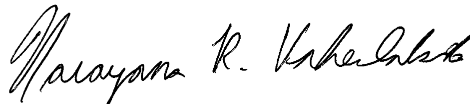
The FDIC must consider the cost and tractability of incorporating compensation arrangements into the deposit insurance premium. The administrative cost of incorporating the risk of bank compensation arrangements into the premium can exceed the benefits. The FDIC's proposed use of a simple, self-reporting mechanism to facilitate the incorporation of compensation arrangements in the premium would minimize administrative costs.

However, self-reporting implementation methods have important limitations. The analysis by Christopher Phelan already referenced suggests that optimal compensation arrangements may prove complex in implementation, as they take into account incentives to encourage investment in good projects while dissuading investment in bad projects. A few observable characteristics may not prove sufficient to identify the risk-inducing features of bank compensation plans. We recommend that the FDIC augment its use of self-reporting by banks with results from supervisory reviews of compensation practices.

Supervisory reviews will generate private and detailed information that will facilitate the FDIC's analysis of the degree to which a bank's incentive compensation scheme raises the probability of loss for the deposit insurance fund. For example, the Federal Reserve is currently in the process of reviewing incentive compensation practices at large, complex banking organizations. This review could potentially provide useful information to the FDIC in the setting of premiums.[3] Using supervisory assessments of compensation to help set premiums suggests that the FDIC limit the incorporation of compensation into premiums to the largest, most complex banks. Supervisors will have the most complete supervisory assessments for such banks. This suggests that the FDIC limit incorporation of compensation practices to these large, complex banks.

Thank you for consideration of these views.

Sincerely,



Narayana R. Kocherlakota
President

and

Ron Feldman
Senior Vice President

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[3] For a discussion of the review, see Daniel K. Tarullo. 2009. Incentive Compensation, Risk Management, and Safety and Soundness. Nov. 2.