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

Dear Mr. Feldman,

I write to commend the FDIC's proposal to consider compensation structures as one factor in setting deposit insurance rates (Incorporating Executive Compensation Criteria into the Risk Assessment System, RIN # 3064-AD56).

Insurance rates (in any industry) should reflect the risks posed and be designed to reduce the insurer's exposure to risks—the well-known moral hazard problem. (Indeed, it was in the context of insurance that moral hazard was first studied.) This is the fundamental principle of insurance. I have written extensively on the implications of this principle. (While I emphasize the importance of this principle to ensure *efficiency* and the *solvency* of the insurance fund, there are also matters of *equity*: those who undertake excessive risk should not be subsidized by those who act more prudently.)

The one thing that economists agree upon is that incentives matter. Indeed, one of the main justifications put forward by the banks themselves for their compensation structures is that it affects behavior. But a closer look at the standard executive compensation schemes makes clear that they encourage both risk taking and short-sighted behavior—increasing the kinds of risks to which FDIC is exposed.

The most recent episode provides ample evidence of this kind of excessive risk taking. In 2005, Moody's linked executive compensation and credit downgrades, finding default rates of similar companies dramatically higher when executive compensation packages were especially lucrative.

There is a broad consensus among economists that compensation schemes should be designed to discourage short-sighted behavior and excessive risk taking on the part of insured depository institution. Even the Business Roundtable has put forward a series of "best practices" for compensation that acknowledge the risks of poorly designed compensation practices and recommends gearing these compensation structures to the longer-term benefit of firms and their investors.

It would be a mistake for the FDIC to wait until others have dealt with the matter.

Indeed, such a delay makes no economic sense: if other regulators impose parallel constraints, it would help ensure the effective and complete implementation; if they fail to adequately address the issues, the FDIC would remain at risk. The risks of inadequately constraining distortionary executive compensation schemes which induce excessive risk taking and short-sighted behavior far outweigh the risks of any significant costs being imposed by duplicative actions.

Sincerely,

Joseph E. Stiglitz
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