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The FDIC should adopt a bonus-to-salary ratio risk metric.
The FDIC should adopt the metric of bonus-to-salary ratio, as proposed in Question 12. When
this ratio becomes too high, a bank is less able to manage its risks, and so the FDIC should
charge companies a higher assessment.
One of the fundamental challenges an employer faces in introducing a bonus-based compensation system is that it creates incentives for an employee to take-on more risk than is
prudent for the company as a whole. Both an employee and her company have the same incentives to make money under a bonus compensation system—making more money benefits
both. However, because an employee cannot lose money in a given year—at worst she might
receive $0 or the minimum wage—she does not have the same incentive to manage the magnitude of losses in her projects that the company would want. Her salary will be $0 whether
she loses $10,000, $100,000 or even bankrupts the company. Because an employee is not hurt by
bad investment decisions to the same extent as her employer, the bonus creates an incentive for
her to take on more risk than would be optimal for the bank. Thus the higher a performance
bonus an employee can earn, the more an employee’s optimal investment or loan-making strategy will diverge from her bank’s, and the greater the inherent risk.
The same problem occurs when the FDIC insures a bank. Because the bank’s shareholders are
protected from loss by deposit insurance, they will want to take-on greater risk to potentially
garner higher returns than they would if the bank were uninsured. By charging higher insurance
premiums when a bank engages in riskier behavior, the FDIC would make taking on risk more
costly and counterbalance the bank’s incentive to make riskier investments. (See Douglas Clement, Incentive Compensation in the Banking Industry: Insights from Economic Theory,
2009).
But only if data demonstrates that a high bonus-to-salary ratio correlates to higher risk in practice.

However, while the ratio of bonus-to-salary is a good indicator of risk in theory, the FDIC should
use empirical data to determine whether this is in fact an indicator of the risk that a bank will fail.
The FDI Act requires the FDIC to assess each bank based on that bank's probably of incurring a
loss and the size of any loss that the Deposit Insurance Fund will cover. 12 U.S.C. § 1817(b)(1)(C). While the FDIC cites its Material Loss Reports as demonstrating the problems
inherent in certain types of compensation packages, the FDIC has not demonstrated that compensation packages provided to loan officers and executives at failed banks are any different
than at those banks that are still solvent. In fact, among those Material Loss Reports that cite
employee compensation as a contributing factor, the problem in all but three instances is that
loan officers or executives were compensated based on the quantity of loans they created, but not
the quality. The problem cited could just as easily be a symptom that bonuses were tied to the
wrong metric—origination statistics as opposed to a stable, high-performing loan portfolio—than
that the bonus structure itself was problemmatic. Unless the FDIC can demonstrate in that bonus
structures lead to riskier banks than salaried compensation, the FDIC encouraging one form of
compensation over another through its assessments does not make sense and is outside the
FDIC's statutory authority.