PM&P | Pearl Meyer & Partners
Comprehensive Compensation®

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429-9990

February 18, 2010

Re: Financial Institution Letter 1-2010
Employee Compensation and Risk-Based Assessment System

Dear Mr. Feldman,

Pearl Meyer & Partners ("PM&P") is pleased to submit comments to the Federal Deposit Insurance Corporations (the "FDIC") with respect to its advance notice of proposed rulemaking concerning whether to incorporate employee compensation criteria into the risk assessment system, issued in its Financial Institution Letter dated January 14, 2010 (the "Proposal").

This letter is intended to provide feedback that represents our views, as well as those expressed by many of our banking clients, with respect to the Proposal. We also take into consideration the real implications and potential burdens that would be placed on many organizations by certain requirements under the Proposal.

By way of background, Pearl Meyer & Partners is one of the nation's leading independent compensation consulting firms, serving Board Compensation Committees as independent advisors and assisting companies in the creation and implementation of innovative, performance-oriented compensation programs to attract, retain, motivate and appropriately reward executives, employees and Board Directors. As independent advisors, we help Boards and Committees establish and maintain sound governance practices, particularly as this relates to executive and director pay decision-making. Since its founding in 1989, PM&P's compensation professionals have advised hundreds of organizations in virtually every industry, ranging from Fortune 500 companies to smaller private firms and not-for-profit organizations. In particular, we provide services to hundreds of community banks across the nation and, as their advisors, have a vested interest in ensuring sound compensation practices.

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570 Lexington Avenue, New York, NY 10022 TEL (212) 644-2300 FAX (212) 644-2320 www.pearlmeyer.com newyork@pearlmeyer.com

We appreciate the opportunity to comment and share our views. We note that PM&P is submitting this commentary on its own behalf and not on behalf of any specific client. Please contact us at (212) 407-9517 or (508) 630-1493 if you have any questions regarding our comments.

Sincerely,

Dave Swinford Susan C. O'Donnell

David N. Swinford
President and CEO
Pearl Meyer & Partners
david.swinford@pearlmeyer.com

Susan C. O'Donnell
Managing Director
Pearl Meyer & Partners
susan.odonnell@pearlmeyer.com

The Proposal

The Proposal seeks comment on how, and whether, the FDIC's risk-based deposit insurance assessment system applicable to all insured banks should be amended to account for risks imposed by employee compensation programs. The methodology that the FDIC is considering would lead to an established standard for employee compensation programs and includes a series of criteria that would allow the FDIC (and the insured depository institution) to determine whether that standard has been met. The Proposal contemplates a list of potential criteria that would create a "safe harbor" giving financial institutions greater certainty that their employee compensation programs will satisfy the FDIC's goals and that the insured depository institution will not be subject to an increased risk assessment.

The contemplated criteria that are outlined in the Proposal include the following:

- A significant portion of compensation for senior management and employees whose work presents significant risk to the institution and who receive a significant portion of compensation based on achieving performance goals should be made in the form of restricted, non-discounted company stock that would vest over a number of years.

- Company stock awards should vest over several years and should be subject to a "clawback" so that gains realized on payment of awards can be recouped in the event earlier risks lead to losses.

- A board committee comprised of independent directors, with input from independent compensation advisors, should administer the compensation program.

General Comments About Risk

At the outset, we point out that compensation plans by themselves – and the resulting executive compensation payouts – were not the primary cause of the collapse of the financial markets in 2008, although compensation plans clearly can contribute to excessive and/or unnecessary risk-taking. An incentive relating to a business activity, even a business activity that incurs substantial risk, may be appropriate if the existing business risk controls are robust or are supplemented to become robust. Robust risk-management systems will not allow risks to be undertaken that are excessive, regardless of the incentive pay arrangements in place.

Having said that, we believe that pushing organizations toward compensation programs with zero risk (i.e., 100% base salary and/or firm-wide profit-sharing programs) runs counter to the pay-for-performance linkage that investors and other stakeholders seek. Thus, some level of risk tied to performance is quite appropriate for compensation programs and, in a balanced program, encourages innovation, opportunity and growth.

We do not believe that risk, or mitigation of risk, can be defined by a single formula or set of safe harbor rules as it relates to compensation. Nor do we think that achievement of the three goals in the Proposal should wield such a significant influence on risk-based assessment rates.

We believe that the approach used by the Federal Reserve Board's Proposed Guidance on Sound Incentive Compensation Policies (the Federal Reserve Proposal) is a more appropriate assessment of risk-related compensation programs. It is principles-based, and recognizes that the goal is balance, rather than a rigid set of requirements.

The FDIC should likewise consider a flexible and balanced compensation review in determining whether or not assessment rates should be adjusted. Balance includes an individually tailored and appropriate mix of performance measures that include: (i) company and individual performance; (ii) financial and qualitative goals; (iii) short- and long-term performance horizons; (iv) absolute and relative (to peer company) perspectives; and (v) formulaic and discretionary considerations. Such a program is more likely to mitigate excessive risk taking and ensure pay-for-performance alignment.

Conflict with Other Risk-Related Authority

The Proposal is just one of a series of risk-related rules promulgated by different authorities in the past two years. These include:

- The passage of the *Emergency Economic Stabilization Act of 2008* and the *American Recovery and Reinvestment Act of 2009*, which contain a complex set of rules and regulations applicable to risk and compensation for TARP companies (many of which are insured depository institutions that would be subject to the Proposal);

- The SEC's adoption of amended rules in December 2009, requiring publicly traded companies to assess risk in their compensation plans, as well as report their findings in proxy statements in certain situations; and

- The Federal Reserve Proposal, released only a few months ago.

We believe that it poses extreme difficulty to financial institutions to satisfy the different, and often inconsistent, compensation initiatives being proposed by both legislative and administrative bodies. For example, while the FDIC Proposal is supportive of compensation that is paid in restricted, non-discounted company stock, other initiatives seem to encourage financial institutions to weight compensation more heavily in salary. Thus, we believe yet another set of initiatives would place an undue burden on institutions already trying to navigate through other risk-based rules and initiatives.

One-Size-Fits-All Formulaic Approaches are Inappropriate

Compensation programs are best when matched to corporate strategies. The balance among compensation forms and between short-and long-term incentives marks a sound and balanced plan. Evaluation of the effectiveness of compensation programs, as well as the risk inherent in such programs, is very complex and intended to be holistic in nature. The guidelines prescribed do not cover the breadth of possible compensation programs and elements, nor are they sufficient reason to implement new premium assessments.

A one-size-fits-all approach is a poor construct for any compensation program. In order to promote the long-term success (as well as the safety and soundness) of institutions, compensation programs should always be specifically tailored to the organization's goals, as well as the individual filling the role. No two organizations or executives are the same. Trying to homogenize compensation across or among organizations will jeopardize attraction, motivation and retention of talent, as well as impede organizational growth and innovation.

In short, the black and white criteria used in the Proposal are not adequate or broad enough. While the Proposal's goals appear to be voluntary, it is probable that most banks will attempt to follow them to reduce assessment rates, thereby making them, *de facto,* required. This regime could result in the unintended consequence of driving away performance pay if institutions prefer not to pay in long-term restricted stock. In addition, it may put banks at a competitive disadvantage for executive talent by limiting the forms of compensation programs available.

Undue Hardship on Small and Regional Banks

The FDIC seeks comment on whether the effort to price the risk posed by DIF by certain compensation plans should be directed only toward larger institutions or those that engage in certain activities, such as trading. We firmly believe that if the Proposal is adopted, is should be amended to exclude small and regional banks.

Few, if any, community banks had incentive compensation practices that are significant enough or designed in ways that motivate risk taking. The benefits to be gained from imposing this "safe harbor" approach on smaller organizations are limited. Many organizations of this size have a limited population participating in incentive compensation programs, and among those that participate, the incentives typically cover a minor portion of total compensation (i.e., less than 50% of total compensation). This is hardly the paradigm that would rise to the level of incentivizing employees to take risks contemplated by the FDIC. It is also in stark contrast to the Wall Street banks that provide 95% of total pay in the form of incentives with, in some cases, total compensation in exponential multiples of their base salaries. We fear that the unintended consequences of this scheme will be abandonment of any incentive compensation programs whatsoever, and perhaps higher salaries and fixed compensation to make up for the difference. Again, this outcome undermines the concept of pay-for-performance.

We believe that the compensation programs of the following organizations should influence the institution's insurance premiums:

- Banking organizations that have less than $1 billion in assets. These organizations do not typically fit the profile of having incentive compensation programs that promote unnecessary risk at the expense of the institution.

- Banking organizations that have programs whereby incentive compensation comprises no more than 25% of the employee's (or employee group's) total compensation. It is unlikely that incentives of this proportion will drive the type of risky behavior that jeopardizes an entire institution because they are not material.

We are not suggesting that the above organizations should be exempt from reviewing their incentive programs for undue risk. However, we believe that essentially prescribing the compensation program for these companies is simply not necessary.

Exclusive Focus on Stock is Inappropriate and Limiting (Goal #1)

Many plans are not stock-based and don't encourage excessive risk-taking. In fact, many institutions covered by the Proposal (e.g., mutual and private banks) are not even stock banks and wouldn't have the capacity to provide a significant portion of compensation in stock. Many Subchapter S banks are very restricted when it comes to granting stock. Moreover, required payments in the form of stock for the family-owned or closely held corporation are problematic; while such compensation may be acceptable for the CEO or other majority owner, it may not be an appropriate approach for the organization as a whole. It would result in forced dilution and essentially new ownership.

The FDIC can effectively promote a long-term focus through other vehicles, such as a long-term cash program. It should not force the issuance of stock. Many smaller banks already provide limited incentives that effectively mitigate any excessive risk-taking. The Proposal could exert pressure on these smaller banks to implement incentives they might otherwise not utilize and at additional cost, which may put them at a competitive disadvantage.

We have already seen the problematic results of requiring a significant amount of total compensation to be paid in the form of stock. Many TARP recipients were required to pay out large portions of compensation in the form of "salary stock." One of the many issues encountered by these institutions was a shortage of shares available under shareholder-approved plans, as well as increased dilution to other shareholders.

Moreover, we believe that the assumption that restricted stock held over a long period induces executives to be more risk-averse is flawed. In many cases, stock ownership may in fact incentivize grantees to take greater risks in order to realize or exceed the net present value of what they would have received today. Executives at Bear Stearns and Lehman Brothers, for example, lost substantial amounts of money in the stock that they held over the long-term. Such losses were at least in part attributable to executive failure to recognize and balance risks in an appropriate manner.

Incentive payments paid in cash are not problematic by their nature – the problem is how the amounts are determined and the amount paid, not in the form of payment.

<u>The Clawback Feature (Goal #2)</u>

Goal Number 2 of the Proposal states that "*Company stock awards should vest over several years and should be subject to a "clawback" so that gains realized on payment of awards can be recouped in the event earlier risks lead to losses.*" However, this goal lacks specificity as to: (i) whether it relates to time-based and/or performance-based stock; (2) how far the look-back mechanism should reach; and (iii) whether events such as retirement, death, disability and/or sale of stock should be a factor in determining if the stock is subject to recoupment. While we acknowledge that clawbacks are certainly becoming "best practice," we point out that they are after-the-fact protection. Moreover, their enforceability is not guaranteed. For these reasons, it may be inappropriate to base rates on the existence of a clawback feature.

<u>Independent Committee and Advisors (Goal #3)</u>

While we maintain that rates set by the FDIC should not be contingent on a rigid set of goals specified in the Proposal, we agree that members of the Committee should be independent to the extent feasible. While management can and should have input into the process, ultimate decisions regarding compensation are more objectively made by outside directors, as is currently required by the NYSE and NASDAQ. We also believe that should this Committee (or management, as the case may be) lack sufficient experience about compensation-related matters, it should have access to outside independent consultants.