ICBA
INDEPENDENT COMMUNITY
BANKERS of AMERICA

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

Re: Incorporating Employee Compensation Criteria into the Risk Assessment System, RIN # 3064-AD56

Dear Mr. Feldman:

The Independent Community Bankers of America[1] (ICBA) welcomes the opportunity to comment on the advance notice of proposed rulemaking (ANPR) on how to incorporate employee compensation criteria into the FDIC's risk-based assessment system. Specifically, the FDIC is considering (1) how to adjust risk-based assessment rates to adequately compensate the Deposit Insurance Fund (DIF) for the risks inherent in certain compensation programs, (2) how to use the risk-based assessment rates to provide incentives for insured institutions and their holding companies and affiliates to adopt compensation programs that align employees' interests with those of the insured depository institution's other stakeholders, including the FDIC, and (3) how to provide incentives that promote the use of compensation programs that reward employees for focusing on risk management.

ICBA's Position

In our comment letter to the Federal Reserve concerning its proposed guidance on sound incentive compensation policies,[2] ICBA agreed with the Federal Reserve's premise that incentive compensation practices in the financial services industry were one of many

[1] The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever changing marketplace.

With nearly 5,000 members, representing more than 20,000 locations nationwide and employing nearly 300,000 Americans, ICBA members hold $1 trillion in assets, $800 billion in deposits, and $700 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

[2] See ICBA's Comment Letter dated November 25, 2009 to the Federal Reserve concerning the proposed guidance on sound incentive compensation policies.

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factors contributing to the financial crisis that began in 2007. Banking organizations, particularly some of the large financial institutions, too often rewarded employees for increasing the firm's short term revenue without adequate recognition of the risks the employees' activities posed for the firm. For instance, the way that certain large banking organizations paid their mortgage originators certainly exposed those financial institutions to a great deal of risk and contributed to the credit problems associated with subprime mortgage lending.

However, it is important to note that these risky compensation practices were confined to large banks. Few, if any, community banks had incentive compensation practices that had anything to do with the current crisis. Community banks were the common sense lenders during the crisis. Even though they did not contribute to the economic crisis, community banks, unfortunately, are suffering the effects of it from a shrinking asset base, heavier FDIC assessments, and a tough examination environment.

While we agree that risky compensation practices at some large banks contributed to the severe financial downturn that our economy is still experiencing, ICBA has serious concerns with the FDIC's attempt to address the problem by incorporating employee compensation criteria into the FDIC's risk-based assessment system. We believe the better way to address the problem of risky compensation practices in the industry is through a coordinated supervisory effort by the banking agencies directed at the large banks (i.e. those with over $100 billion in assets) and their holding companies and affiliates. The adverse effects of flawed compensation practices at these large institutions are more likely to have adverse effects on the broader financial system.

All of the banking agencies have the legal authority to prohibit, as an unsafe and unsound practice, any compensation arrangement that can lead to a material financial loss to an institution.[3] The banking agencies conduct safety and soundness examinations to ensure that a banking institution does not engage in any such practice. Examiners can evaluate bank compensation plans as part of the management component of the CAMELS ratings and this rating becomes part of an institution's composite rating. **ICBA therefore believes that the banking agencies have sufficient authority to prohibit risky compensation practices and that they should use their existing authority to focus their attention on the large, complex institutions that pose the greatest risk to the Deposit Insurance Fund and to our economic system.** As we stated in our comment letter to the Federal Reserve, community banks generally should be exempt from such supervisory review.

Furthermore, the evaluation of employee compensation programs should be left to the primary regulator of the institution since that agency is more familiar with the institution and its employee compensation practices. If the FDIC were to require an adjustment to the risk assessment rate of an institution because of its employee compensation programs, the agency would in effect be second guessing the evaluation of the primary regulator. Leaving the evaluation of employee compensation programs to the primary regulator appears to be the approach suggested by Congress in HR 4173. That legislation directs

[3] See Section 39(c) of the Federal Deposit Insurance Act, 12 U.S.C. 1831p-1(c).

the bank regulators to adopt jointly regulations which would prohibit incentive compensation plans that pose undue risks to the safety and soundness of an institution.

ICBA believes the FDIC should impose a systemic risk premium on those large, complex institutions that pose the greatest risks to the DIF that would be in addition to their regular base assessment. The amount of the systemic risk premium would be based on a number of factors such as the size of the institution and the risk it poses to the Fund, but could also incorporate the management component of the CAMELS rating of the institution as determined by the institution's primary regulator. That way, the systemic risk premium could provide incentives to those large institutions and their affiliates to adopt sound compensation programs.

ICBA Has Operational Concerns with the Proposal

The FDIC concedes that there are difficulties with any approach to incorporating employee compensation criteria into the FDIC's risk-based assessment system. However, the FDIC solicits comment on one particular approach that involves issuing restricted stock to employees. Specifically, the FDIC would require that each bank attest to following features regarding their compensation plans:

(1) A significant portion of compensation for employees whose business activities can present significant risk to the institution and who also receive a portion of their compensation according to formulas based on meeting performance goals should be comprised of restricted, non-discounted company stock.
(2) Significant awards of company stock should only become vested over a multi-year period and should be subject to a look-back mechanism (e.g., clawback) to account for the outcome of risks assumed in earlier periods.
(3) The compensation program should be administered by a committee of the board composed of independent directors with input from independent compensation professionals.

The FDIC would then adjust assessment rates up or down depending on whether a bank could attest that its compensation plans met these standards.

While this approach might work for large, publicly held institutions, ICBA believes it would be unworkable for many community banks. Many family-owned or management-owned community banks, for instance, have restrictions in their charter that prevent them from issuing additional stock except to certain existing stockholders. Furthermore, even if these charter amendments could be amended, many of these banks would be unwilling to dilute their controlling interest in the bank and issue restricted stock to their employees.

Community banks that are mutual institutions also would have problems with this requirement since they are unable, except through a holding company, to issue restricted stock. Furthermore, banks that are Subchapter S institutions would have difficulty issuing restricted stock since they can only issue one class of stock and are limited under IRS rules to 100 shareholders. Many banks that are close to the 500 shareholder limit under the Securities Exchange Act of 1934 would be reluctant to issue restricted stock to their employees for fear they would have to register with the SEC under that law if they crossed that threshold.

While establishing separate compensation committees may be good corporate governance for large financial institutions, for community banks, it is costly and difficult with few benefits for management or shareholders. Family-owned community banks located in smaller towns and communities, for instance, would find it very challenging to establish separate compensation committees made up of outside directors who are both independent from management and competent on compensation issues.

Furthermore, it would also be costly and difficult for community bank boards to seek input from compensation consultants. While compensation consultants can be very helpful with regard to establishing executive salaries and compensation plans, their expertise and experience is often limited with regard to managing the business risks of the bank and how those risks could be increased under certain compensation arrangements. In most cases, bank boards can do just as good a job at evaluating the business risks of compensation arrangements. We also fear that even if the FDIC only suggested in its rules that compensation consultants be used, that examiners in the field would interpret this as a "best practice" and that banks would be pressured to use such consultants if they wanted to receive better treatment under the risk-based assessment system.

ICBA urges the FDIC not to use quantifiable measures of compensation-such as ratios of compensation to some specified variable—that relate to the institution's health or performance. These limits would not necessarily promote the long-term safety and soundness of banking organizations and would severely limit the ability of community banks to fashion appropriate compensation packages for senior executives. Similarly, any proposed rules on employee compensation should not presume that golden parachute arrangements are too risky for a banking organization. Many community banks find golden parachute arrangements very useful for retaining their senior executives, and such arrangements pose few, if any, material risks to the safety and soundness of the organization.

Conclusion

While we agree that risky compensation practices at some large banks contributed to the current economic downturn, ICBA has serious concerns with the FDIC's attempt to address the problem by incorporating employee compensation criteria into the FDIC's risk-based assessment system. We believe the better way to address the problem of risky compensation practices in the industry is through a coordinated supervisory effort by the banking agencies directed at the large banks and their holding companies and affiliates. Community banks generally should be exempt from such supervisory review. ICBA supports a systemic risk premium in addition to a base premium to compensate for the increased risk that large, systemically dangerous, financial institutions and their affiliates pose to the DIF and this premium could reflect the degree to which these institutions have risky compensation practices as determined by their primary regulators.

While encouraging banks through the risk-based assessment system to issue restricted stock to their executives and other employees may be a workable approach for large publicly held institutions, this approach would not be workable for many community banks. Many family-owned and management-owned community banks have restrictions in their charter that would prevent such issuances and, in many instances, would have concerns about diluting the interests of their controlling shareholders. Also, Subchapter S and mutual institutions for the most part would be unable to comply with the requirement.

While establishing separate compensation committees may be good corporate governance for large financial institutions, for community banks, it is costly and difficult. Family-owned community banks located in smaller towns and communities would find it very challenging to establish separate compensation committees made up of outside directors who are both independent from management and competent on compensation issues. Furthermore, it would also be costly and difficult for community bank boards to seek input from compensation consultants. In most cases, bank boards can do just as good a job at evaluating the business risks of compensation arrangements. We also urge the FDIC not to adopt, as part of their rules, quantifiable measures of compensation that relate to an institution's health or performance since that might severely limit the ability of community banks to fashion appropriate compensation packages for senior executives.

ICBA appreciates the opportunity to comment on the FDIC's advance notice of proposed rulemaking on how to incorporate employee compensation criteria into the FDIC's risk-based assessment system. If you have any questions or need additional information, please do not hesitate to contact me at my email address (Chris.Cole@icba.org) or at 202-659-8111.

Sincerely,

/s/ Christopher Cole

Christopher Cole
Senior Vice President and Senior Regulatory Counsel