# American Federation of Labor and Congress of Industrial Organizations

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February 18, 2010

*Sent via Electronic and U.S. Mail*

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 Seventeenth Street, NW
Washington, DC 20429

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

Dear Mr. Feldman:

The American Federation of Labor and Congress of Industrial Organizations ("the AFL-CIO") welcomes this opportunity to comment on the proposed rule RIN #3064–AD56 on incorporating employee compensation criteria into the risk assessment system.

The AFL-CIO is the country's largest labor federation, representing 11.5 million members who participate in benefit plans with more than $4 trillion in assets. Union-sponsored pension plans own around $450 billion in assets, and union members also participate directly in the capital markets through 401(k) retirement plans and Individual Retirement Accounts.

Many AFL-CIO members have lost their homes, their jobs and their retirement savings because of the recent financial crisis. At the same time, many financial institutions have tightened lending standards for consumers and refused to modify home mortgages. It is, therefore, deeply disturbing that these financial institutions which were bailed out by taxpayers have reverted to business as usual executive compensation practices that could once again encourage short-sighted behavior and threaten the very existence of these companies.

We are, therefore, heartened that FDIC Chairman Sheila Bair and the Board of Directors have proposed tackling the moral hazard inherent in deposit insurance—that institutions with a government-backed safety net are more likely to take excessive risks. We believe it is imperative that the Deposit Insurance Fund ("DIF") is not jeopardized by institutions whose compensation programs are misaligned with the long-term interests of the firm, investors, and society at large. This is particularly important because misaligned compensation programs "have been cited as a contributory factor in 35 percent of the reports prepared in 2009 investigating the causes of insured depository institution failures and the associated losses to the DIF."[1]

When banks fail, it is not just the FDIC that loses money, but investors and taxpayers as well. The AFL-CIO has long been concerned that asymmetric pay practices such as stock option compensation encourage executives to take large risks without any downside. We concur with the FDIC's approach to giving banks incentives to voluntarily adopt compensation policies and programs that could result in lower risk-assessment rates. The FDIC's proposal is consistent with and dovetails the guidance proposed by the Federal Reserve Board last October on sound incentive compensation policies.

However, we encourage the FDIC to broaden the scope of compensation policies that it considers are consistent with the safety and soundness of the organization beyond those stated in the proposal:

First, as the AFL-CIO recommended to the Federal Reserve Board last fall, we believe that financial regulators must be able to easily assess, using a standardized measure, whether compensation—both at the senior executive level and company-wide—is linked to short-term gains or long-term value creation. We encourage the FDIC, in tandem with the Federal Reserve, to take the lead in developing such a standardized measure, akin to the "duration" of a bond, to measure the sensitivity of compensation packages for both senior executives and line officers to time and risk against that of their industry-wide peers.[2]

Second, the oversight of risk and its relationship to company-wide pay practices must be an integral part of the oversight functions of a bank's board of directors. The board's oversight of risk should begin with assessing the appropriateness of the company's strategy and the risk that is inherent in that strategy. This includes understanding and agreeing on the amount of risk the organization is willing to accept or retain—"its risk appetite."[3]

Third, all financial institutions must implement the best practices for incentive compensation, as articulated in the Aspen Institute's 2009 report "Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management," the Special Report on Regulatory Reform issued by the Congressional Oversight Panel in January 2009, and by Professors Lucian Bebchuk and Jesse Fried of the Harvard Law School, Nell Minow, co-

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[1] FDIC proposed rule, Federal Register/Vol. 75, No. 11/Tuesday, January 19, 2010.
[2] AFL-CIO comment letter to the Federal Reserve Board on Proposed Guidance on Sound Incentive Compensation Policies (Docket OP-1374), November 25, 2009.
[3] "Risk Governance: Balancing Risk and Reward," *Report of the NACD Blue Ribbon Commission,* Oct. 2009.

founder of The Corporate Library, as well as other corporate governance experts, and supported by the AFL-CIO. These include:

- The bulk of total pay for senior executives must be variable, incentive, performance-vested equity awards that are deferred for at least five years after they are earned.
- Companies should consider tying pay to the value of a basket of securities beyond common stock, especially at poor performing companies with very low stock prices, where equity does not provide much of an incentive. Moreover, it could also be useful to tie the executive's payoff to changes in a measure—possibly based on the price of credit default swaps reflecting the probability of default—that reflect changes in the expected cost to the government from the prospect of having to bail out the bank in the future.[4]
- Incentive awards must be subjected to "claw backs," that ensure a downside if the performance metrics are not met or if the performance turns out to be illusory.
- Incentive compensation should be based on more than one performance metric.
- Different incentive awards should measure different kinds of performance.
- Bonuses should not be guaranteed as they can create a perverse incentive to take excessive risks as they eliminate some of the downside risk, but leave the bonus compensation sensitive to performance on the upside.[5]
- Severance should be limited to what is received by other employees generally.
- Annual Say on Pay. All financial institutions, not just those that received taxpayer assistance, must allow shareholders to cast a non-binding vote on the CEO pay, as well as the compensation policies for senior executives discussed in the company's annual proxy statement.

Fourth, financial companies must be held to the highest level of good corporate governance practices. Key among these good governance practices that the AFL-CIO supports are:

- An Independent Chair. The chairman of the board should be a non-executive who holds no position at the bank or bank holding company. It is not acceptable for the CEO of a bank or bank holding company to also be the chairman of the board.
- Majority Voting. Directors must be elected by a majority of votes, and those who fail to receive the majority of the votes must step down.

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[4] Testimony of Lucian A. Bebchuk, Friedman Professor of Law, Economics and Finance, Harvard Law School, before the House Financial Services Committee on Compensation Structure and Systemic Risk, June 11, 2009.
[5] "Bonus Guarantees Can Fuel Risky Moves," *The Wall Street Journal* op-ed by Lucian Bebchuk, Friedman Professor of Law, Economics and Finance, Harvard Law School, Aug. 27, 2009.

- Equal Access to the Proxy: Shareholders should be permitted to nominate candidates for election to the board of directors on company proxy statements.

If you need any additional information, please contact me at 202-637-5379.

Sincerely,

D. F. Pedrotty

Daniel F. Pedrotty
Director
Office of Investment

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