

January 13, 2010

## FDIC Proposal on Compensation Programs

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### FDIC Authorizes Publication of Advance Notice of Proposed Rulemaking on Employee Compensation at Banking Organizations

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#### SUMMARY

At the January 12, 2010 meeting, the Board of Directors of the Federal Deposit Insurance Corporation ("FDIC") authorized publication of an Advance Notice of Proposed Rulemaking on Employee Compensation (the "ANPR") by a vote of 3 to 2 (with Comptroller Dugan and OTS Director Bowman dissenting). The ANPR 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.

Citing a "broad consensus that some compensation structures misalign incentives and induce imprudent risk taking within financial organizations", the FDIC is considering establishing criteria to determine whether a financial institution's employee compensation programs provide incentives for employees to take excessive risks. The FDIC is concerned that such risk-taking increases the institution's risk of failure and thereby could lead to increased losses to the Deposit Insurance Fund. The ANPR proposal could apply not only to compensation at the insured depository, but also at its parent and nonbank affiliates. Under the approach outlined in the ANPR, whether a financial institution's compensation program either "meets" or "does not meet" the criteria would be used to adjust the institution's risk-based assessment rate, thereby acting as an incentive for institutions that meet the criteria and a disincentive for those that do not. According to the ANPR, the criteria that the FDIC is considering are not aimed at limiting the amount that insured depository institutions can pay their employees, but rather are intended to compensate the Deposit Insurance Fund for risks associated with certain compensation programs.

The FDIC requests comments on the ANPR within 30 days after publication in the Federal Register.

## BACKGROUND

Section 7 of the Federal Deposit Insurance Act ("FDIA") requires the FDIC to establish a risk-based system to assess the probability that the Deposit Insurance Fund will incur losses from the failure of insured depository institutions. The ANPR cites a number of articles by academics, consultants and others for the "broad consensus that some compensation structures misalign incentives and induce imprudent risk taking". It concludes that excessive and imprudent risks, including, "to some extent", incentives provided by poorly-designed compensation programs, were contributing factors to financial institution failures and increased losses to the Deposit Insurance Fund. Utilizing the authority under Section 7 of the FDIA, the FDIC is considering whether, and how, risks associated with employee compensation programs should be incorporated into its existing risk-based assessment system to compensate the Deposit Insurance Fund for potential risk associated with employee compensation programs that reward employees based on short-term results without considering whether those short-term results create longer-term risks to the firm and its stakeholders, including shareholders and the FDIC.

The ANPR joins a number of other recent legislative and regulatory agency efforts focused on risk management by financial institutions and the risks associated with compensation programs, including: efforts by Congress to implement regulatory reform, such as under H.R. 4173, sponsored by Representative Barney Frank, which passed the House of Representatives in December; the Federal Reserve Board's recent principles-based proposal on incentive compensation policies for banking organizations, described in our Memorandum of October 25, 2009; and final disclosure rules adopted by the SEC in December requiring expanded disclosure of compensation and corporate governance matters, described in our Memorandum of December 18, 2009 (both memoranda are located on our website at <http://www.sullcrom.com/publications>).

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## METHODOLOGY

### Purpose

The FDIC's purpose in establishing a methodology to assess the risk of employee compensation programs is to "focus on whether an employee compensation system is likely to be successful in aligning employee performance with the long-term interests of the firm and its stakeholders, including the FDIC".

The FDIC's stated goals under the ANPR include:

- Adjusting the FDIC's risk-based assessment rates to compensate the Deposit Insurance Fund for risks presented by certain compensation programs;
- Using the FDIC's risk-based assessment rates to provide incentives for insured depository institutions to adopt compensation programs to align employees' interests with those of the insured depository institution's other stakeholders, including the FDIC; and

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- Promoting the use of compensation programs that reward employees for focusing on risk management.

According to the ANPR, the purpose of the initiative is not to impose a cap or ceiling in the level of compensation that institutions may pay to their employees. Instead, the ANPR states that the FDIC's initiative is intended to "complement" other supervisory initiatives (such as the Federal Reserve Board's principles-based proposal related to incentive compensation) related to compensation programs. Nonetheless, the ANPR pointedly notes that supervisory standards are set to define "minimum standards" and the FDIC would use the assessment system to "provide incentives for institutions to meet higher standards".

### Establishing Standard and Criteria

The methodology that the FDIC is considering would lead to an established standard for employee compensation programs and would include a series of criteria that would allow the FDIC (and the insured depository institution) to determine whether that standard has been met. The ANPR seems to contemplate that the list of potential criteria would create a "safe harbor", so that financial institutions will have 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 ANPR may 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.

### Consequences of Meeting or Not Meeting Standard

The ANPR leaves open for comment what the consequences of meeting or not meeting the established standard would be. As described in the ANPR, the FDIC could determine to levy a reduced risk-based assessment on an institution that meets the foregoing criteria or an increased risk-based assessment on an institution that does not, based on the relative risk that the employment programs represent to the Deposit Insurance Fund.

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## REQUEST FOR COMMENTS

The ANPR requests comments on all aspects of the proposal, including, but not limited to:

- Whether, and how, to incorporate employee compensation criteria into the FDIC's risk-based assessment system?

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- Should the risk-based assessment system reward firms whose compensation programs present lower risk or penalize institutions with programs that present higher risks?
- How should the FDIC measure and assess whether a board of directors is effectively overseeing the design and implementation of the institution's compensation program?
- Whether an adjustment should be made to the risk-based assessment rate of an institution that could or could not attest that its compensation program included the contemplated approach described above?
- Should the effort to price the risk posed to the Deposit Insurance Fund by compensation programs be directed only towards larger institutions; institutions that engage in certain types of activities (such as trading); or should it include all insured depository institutions?
- How large (how many basis points) would an adjustment to the risk-based assessment rate of an institution need to be for the FDIC to have an effective influence on compensation practices?
- Whether, as an alternative to the contemplated approach described above, the FDIC should consider using quantifiable measures of compensation that relate to the institution's health or performance?
- How should the risk-based assessment system be adjusted if an employee is paid by both the insured depository institution and its holding company and affiliates?
- Which employees should be subject to the compensation criteria and how should those employees be identified?
- How should compensation be defined?
- Should an adjustment to the risk-based assessment system be made where certain bonus compensation practices are followed, such as guaranteed bonuses, bonuses "greatly disproportionate" to base salary and lump sum bonuses not subject to clawback?
- What would be a reasonable period of deferral for payment of variable or bonus compensation?
- What vesting period would be appropriate for restricted stock awarded as described in the contemplated approach described above?

Comments on the proposal are due within 30 days after publication of the ANPR in the Federal Register.

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## IV. CONCLUSION

As evidenced by the FDIC's adoption of this ANPR, issues related to employee compensation and efforts to quantify and control risks related to various types of compensation arrangements continue to evolve and will continue to be a topic of significant discussion in 2010.

One issue highlighted by the ANPR is how difficult it may be for financial institutions to satisfy the different, and often inconsistent, compensation initiatives being proposed by both legislative and administrative bodies. As mentioned above, the ANPR refers to higher standards than the supervisory standards. The proposed compensation model under the ANPR contemplates significant portions of compensation to be paid in restricted, non-discounted company stock, while other initiatives (such as the Federal Reserve Board's proposal) encourage financial institutions to weight compensation more heavily in salary.

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