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February 17, 2010

Robert E. Feldman  
Executive Secretary  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, NW  
Washington, DC 20429

Re: Incorporating Employee Compensation Criteria into the Risk Assessment System, RIN # 3064-AD56, 75 Federal Register 2823 (January 19, 2010).

Dear Mr. Feldman:

The American Bankers Association<sup>1</sup> (ABA) appreciates the opportunity to offer comments on the advance notice of proposed rulemaking (ANPR) issued by the Federal Deposit Insurance Corporation (FDIC) exploring ways the FDIC's risk-based deposit insurance assessment system (risk-based assessment system) could be changed with regard to banks' employee compensation programs. With this approach, the FDIC is considering incorporating into the risk-based premium structure for the deposit insurance fund (DIF) assessment factors relating to employee compensation programs and to provide incentives for institutions to adopt certain compensation programs that the FDIC favors, such as practices that in the view of the FDIC align employees' interests with the long-term interests of the firm and its stakeholders.<sup>2</sup> The proposed incentives would also seek to promote the use of compensation programs that reward employees for focusing on risk management.

The ABA is on record in support of clear, effective and targeted regulatory guidance that is intended to ensure that incentive compensation arrangements at financial institutions do not encourage undue risk taking that could materially

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<sup>1</sup> The ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members—the majority of which are banks with less than \$125 million in assets—represent over 95 percent of the industry's \$13.3 trillion in assets and employ over 2 million men and women.

<sup>2</sup> The FDIC repeatedly suggests that the FDIC is a stakeholder in insured depositories, akin to shareholders. We take issue with this characterization as the FDIC is never an owner of the corporation but rather an insurer of deposits and, on occasion and when properly appointed, a conservator or receiver of the corporation.

threaten the safety and soundness of an institution.<sup>3</sup> For the reasons discussed below, we are, however, strongly opposed to the FDIC's proposal.

Supervisory attention to inappropriate compensation programs should take an important place, along with attention to other inappropriate practices, as part of a well-structured safety and soundness supervisory program, as that is where any such inappropriate practices can most quickly and effectively be addressed. The DIF premium proposal is ill-advised and would set a terrible precedent by allowing the FDIC to substitute its judgment for that of the functional regulator that has more familiarity and understanding of the banking institution's business model, risk tolerance and compensation practices and has more nimble tools to deal with supervisory issues.

Furthermore, the proposal is also out of step with ongoing regulatory policy reviews, both by domestic and international authorities, of compensation practices at financial institutions. The FDIC and the industry itself would be much better served if the functional regulators were to adopt a coordinated approach to address those compensation arrangements that pose significant safety and soundness concerns. We also believe that the FDIC has offered insufficient empirical evidence to support the proposal. The whole concept of a risk-based premium structure is to relate premiums to risk of loss to the DIF. The supporting fact case linking compensation practices to DIF losses in an identifiable and predictable way has not been established. Finally, the proposal, by suggesting "a one-size-fits all" approach, fails to recognize the diversity in terms of charter type, size, geography and business model of this nation's 7,000 plus banking institutions. As such, it is unworkable and would impose substantial burdens on the nation's banking system.

## DISCUSSION

### The Proposal Inappropriately Substitutes the Judgment of the FDIC for that of the Functional Regulators.

The FDIC suggests that this initiative is intended to be a complementary effort to the supervisory standards being developed both domestically and internationally to address risks posed by poorly designed compensation programs. The ABA would submit that the FDIC's proposal would effectively and inappropriately substitute the judgment of the FDIC for that of the primary banking supervisor and would unilaterally set unproven standards for banking industry compensation practices.

All the federal banking regulators prohibit, as an unsafe and unsound practice, compensation arrangements that could lead to material financial loss to an institution<sup>4</sup> and conduct on-site examinations and inspections to ensure that a bank

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<sup>3</sup> See Letter from Sarah A. Miller, American Bankers Association, to Jennifer J. Johnson, Board of Governors of the Federal Reserve System regarding Proposed Guidance on Sound Incentive Compensation Policies, dated November 25, 2009.

<sup>4</sup> Section 39(c) of the Federal Deposit Insurance Act, 12 USC 1831p-1(c), requires all the federal banking agencies to establish standards prohibiting as an unsafe and unsound practice any

does not engage in any such practices. Bank compensation plans are evaluated and weighted in the management component of the CAMELS ratings and are factored into the composite rating as well. The FDIC already factors those ratings into its risk-based assessment system which begins with a bank's CAMELS rating. The new FDIC proposal raises the suggestion that it would be appropriate to supplant the primary supervisor's judgment regarding the safety and soundness of compensation plans and place an additional weight on those plans that do not meet criteria specified by the FDIC. The primary supervisors of a bank will be most familiar with the entities they regulate and their compensation practices. The FDIC should not be able to dismiss or override the primary supervisor's determinations other than as already provided for under specific and extraordinary circumstances. In addition, by singling out compensation plans for an extra adjustment or charge, the proposal sets a dangerous precedent of the FDIC unilaterally determining to double count certain practices or arrangements for purposes of the FDIC's risk-based assessment system.

Significantly, the proposal fails to recognize the compensation guidance that is currently under development both internationally and domestically.<sup>5</sup> Last fall, the Board of Governors of the Federal Reserve Board (FRB) issued proposed guidance regarding incentive compensation plans at bank holding companies and state member banks.<sup>6</sup> The FRB is currently reviewing compensation practices, in light of that guidance, at these firms. The guidance is designed to help ensure that incentive compensation policies at banking organizations are consistent with the safety and soundness of the organization and do not encourage excessive risk-taking. In addition, banking organizations are also expected to review their risk management, control and corporate governance processes related to these arrangements and address any deficiencies that are inconsistent with safety and soundness. The FRB recognized that the implementation of the guidance should be appropriate in light of the scope and complexity of the banking organization's activities as well as the prevalence and scope of its incentive compensation arrangements.<sup>7</sup> In recognition of the fact that these arrangements are not susceptible to simple solutions, the FRB is

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compensatory arrangement that would provide any executive officer, employee, director, or principal shareholder of the institution with excessive compensation, fees or benefits and any compensatory arrangement that could lead to material financial loss to an institution. Section 39(c) also requires that the agencies establish standards that specify when compensation is excessive. See e.g., 12 CFR Part 30 (OCC).

<sup>5</sup> See e.g., Principles for Sound Compensation Practices adopted by the Financial Stability Board (FSB) in April 2009; FSB Implementation Standards (September 2009); Securities and Exchange Commission, *Proxy Disclosure Enhancements*, Rel. No. 33-9089, 74 Fed. Reg. 68334 (December 23, 2009).

<sup>6</sup> The FRB and the functional regulators, e.g., the SEC for broker-dealer and investment advisory firms, are the regulators more appropriately charged with addressing non-bank compensation plans, not the FDIC as suggested in the ANPR.

<sup>7</sup> Unlike the instant proposal with its "one-size-fits all" criteria, the FRB guidance properly anticipates allowing compensation best practices to evolve over time.

expending significant resources through the establishment of multidisciplinary resource teams for supervisory staff and plans to issue a report at year-end on trends and developments in incentive compensation arrangements.<sup>8</sup> Given the great deal of regulatory attention that is being paid to compensation arrangements, we would submit that it is inappropriate for the FDIC to impose additional, possibly conflicting, requirements on banks and bank compensation structures. Rather, the FDIC, the other federal banking agencies, and the banks themselves would be better served if the banking agencies were to adopt joint and coordinated supervisory standards that address incentive compensation arrangements. This is the approach suggested by the House of Representatives when it approved HR 4173.<sup>9</sup>

Further, it is our understanding that the other functional regulators follow supervisory standards similar to the FRB's guidance in conducting their own safety and soundness reviews of bank compensation practices. Our understanding, as well as the fact that the FRB recognizes that its guidance is to be scaled depending on the scope and complexity of the organization and its compensation practices, forms the basis for our recommendation that the FRB's proposed guidance should serve as the basis for any such interagency effort.

#### The Board Has Failed to Offer Sufficient Evidence to Justify its Proposal

Section 7 of the Federal Deposit Insurance Act (FDIA) requires that a depository institution's deposit insurance assessment be based on the probability that the DIF will incur a loss with respect to that institution, the likely amount of the loss, and the revenue needs of the DIF. The proposal broadly asserts that the design of certain employee compensation programs poses risks to the DIF and that compensation is, therefore, an appropriate factor for the Board to consider when setting risk-based assessments. In support, the Board cites as evidence that, in 2009, 17 of 49 Material Loss Reviews completed noted that employee compensation practices were a contributing factor to the institution's failure. The analysis does not attempt to develop a stronger causal relationship than that nor attempt to estimate how compensation practices led to costs to the DIF.

The ABA would submit that this is insufficient justification to support adding employee compensation plans as a risk factor when setting risk-based assessments. The proposal fails to recognize that the primary causes of these failures were poor asset quality and lack of liquidity; incentive compensation plans were at most a contributing factor to failure of the firm, and one where the contribution to DIF losses has not be demonstrated. Further, the proposal does not recognize that employee compensation practices were not a contributing factor for 65% of the

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<sup>8</sup> We do not agree with the FDIC that the bank supervisory guidance issued to date establishes only minimum standards or floors.

<sup>9</sup> HR 4173 directs the bank regulators to adopt jointly regulations requiring banks to make incentive compensation disclosures to their primary banking regulators and prohibiting those incentive compensation plans that pose undue risks to the safety and soundness of an institution. See Section 2004.

failures reviewed. The MLRs alone simply do not provide sufficient empirical evidence to support elevating a contributing factor at a minority of the institutions reviewed to a risk factor to the DIF warranting an additional assessment.

### The Proposal is Both Unworkable and Burdensome.

As envisioned by the FDIC, institutions would be required to attest to whether their compensation programs satisfied certain criteria, which could include the following:

- A significant portion of compensation paid to certain employees whose business activities present significant risk to the institution should be paid in restricted, non-discounted company stock;
- These awards should vest over a multi-year period and should be subject to claw back; and
- The compensation program should be administered by an independent Board committee that has access to independent compensation consultants.

Risk-based assessment rates could be adjusted up or down depending on whether the firms could attest that their compensation programs meet these standards and, thus, present a decreased risk of loss to the DIF.

The FDIC's formulaic "one-size-fits-all" approach is unworkable. It fails to recognize, for example, that mutual banks are, by definition, non-stock entities and would not be able to comply with this requirement. Nor does it recognize that some state banking commissioners have taken the position that state chartered banks are not permitted to issue restricted stock<sup>10</sup> or that Subchapter S corporations can only issue one class of stock to no more than 100 shareholders.<sup>11</sup> Employee stock awards also could tip privately held banks over the 500 shareholder threshold requirement of the federal securities laws,<sup>12</sup> requiring the bank to register and to file public company periodic reports with the SEC, as well as to incur significant costs associated with being a public company. Further, the approach excludes cash payout plans, even if deferred payment is an element of such plans.

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<sup>10</sup> See, e.g., North Carolina Office of the Commissioner of Banks interpreting N.C. Gen. Stat. Section 53-6.

<sup>11</sup> S corporations are corporations that elect to pass corporate income, losses, deductions and credit through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. In order to qualify for S corporation status, the corporation must satisfy several requirements including limits on the number of shareholders.

<sup>12</sup> See Section 12(g) of the Securities Exchange Act, 15 USC 78l(g), which requires companies with \$10 million in assets and 500 shareholders to register with the SEC. As almost all banks have \$10 million or more in assets, the 500 shareholder threshold is the only real measure of whether a bank is a public company.

Compelling banks to compensate employees through restricted stock awards fails to recognize the many other unintended consequences of this proposal, including the dilutive effect such awards will have on current owners of the company and thus affecting the cost and availability of bank equity capital. Bank boards of directors and senior management take seriously their responsibilities to current shareholders when considering whether or not to issue additional shares of company stock. In addition, many banks may not be authorized, under their articles of incorporation, to issue further stock and would have to seek shareholder approval to amend their charters in order to meet these requirements. Because of the dilutive effect issuance of further stock could have on their holdings, it is conceivable that current bank shareholders would not approve such an amendment.

Banks that for legal reasons are unable to comply with the FDIC's then-current view of appropriate compensation program criteria will be required to pay higher risk based assessment premiums than those banks that can make the appropriate attestations. It is highly unlikely that the public will be able to discern the difference between these banks that are constrained legally from complying with the proposal and those institutions that truly do pose a risk to the DIF.

The FDIC's proposal is also extremely burdensome. Many banks do not have the necessary infrastructure to manage grant dates, pricing information, appropriate vesting period, tax reporting and any claw back requirements associated with implementing a restricted stock award program.<sup>13</sup> Bank management should not be forced to weigh whether the increased cost of risk based premiums justifies incurring further costs to hire outside vendors to manage such a program.

Moreover, many community banks will be required to assist employees with the sale of their vested shares. As the FDIC is well aware, large sell or buy orders can have a significant impact on the price of the stock at banks whose stock is thinly traded, e.g., average daily volume of trading is less than 1000 shares. Banks that award restricted stock to employees as required under the FDIC proposal may be forced to put in place an orderly and measured process for those employees desiring to sell their vested stocks, e.g., weekly sales of blocks of 100 shares, in order not to cause precipitous drops in the price of the bank's stock.

Other criteria suggested by the FDIC as warranting more favorable risk-based premium assessments are also problematic. The responsibility for structuring balanced incentive compensation arrangements appropriate for each particular banking organization rests with bank management and its board of directors, and it should be up to the board and management to determine whether the establishment of an independent compensation committee and the hiring of compensation consultants are warranted. Many community banks, especially those that are family owned, would have difficulty drawing from their local communities' individuals that

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<sup>13</sup> In suggesting that the proposal's requirements may be more burdensome to some subset of banks, we do not in any way wish to suggest that it may be appropriate for the FDIC's proposal to be limited to large banks or those that engage in only certain types of activities, such as trading.

both meet rigid definitions of “independence” and are sufficiently knowledgeable about compensation and bank risk management and control processes.

Moreover, there is no reason to believe that the input of compensation consultants would be any more helpful than advice developed by a banking organization’s board of directors exercising its best business judgment. Compensation consultants are extremely expensive and more usually provide advice regarding executive salaries, bonuses, and severance and change-in-control practices. Presently, the expertise of most compensation consultants is not in the area of assisting compensation committees in identifying and managing business risks and how those risks may be increased under various employee compensation arrangements. Bank board members generally share a deep and intimate knowledge of the organization, its risk appetite, and its risk management and controls and, in most cases, are better suited to serve the compensation structures of the institution. Requiring bank boards to hire compensation consultants in order to receive more favorable treatment under the risk-based assessment system is, we would submit, an inappropriate waste of bank resources.

Finally, the FDIC’s criteria are unduly vague. The FDIC has not made any attempt to define the term “significant” as used in the criteria or, otherwise, offered any guidance as to how an institution should measure or determine when business activities present a significant risk to the institution.<sup>14</sup>

## CONCLUSION

In conclusion, the ABA is strongly opposed to the FDIC’s proposal to incorporate employee compensation criteria into the risk assessment system. The proposal inappropriately rejects any notion of comity among the primary supervisors, is inconsistent with broader regulatory consideration of compensation issues, and is unsupported by empirical evidence. Finally, the proposal is both unworkable and burdensome. A far better approach would be for the banking regulators to develop joint supervisory standards that ensure that incentive compensation arrangements at financial institutions do not encourage undue risk taking that could materially threaten the safety and soundness of those organizations.

Sincerely yours,



Sarah A. Miller  
Senior Vice President

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<sup>14</sup> The criteria apply to “[a] *significant* portion of compensation for employees whose business activities can present *significant* risk to the institution....” (emphasis added)