FDIC SEEKS COMMENTS ON INCORPORATING EMPLOYEE COMPENSATION CRITERIA INTO ITS DEPOSIT INSURANCE ASSESSMENT SYSTEM

On January 19, 2010, the Federal Deposit Insurance Corporation (FDIC) published in the Federal Register, 75 Fed. Reg. 11, an advance notice of proposed rulemaking (ANPR) seeking comments on how to modify the FDIC's risk-based deposit insurance assessment system to adequately compensate the Deposit Insurance Fund (DIF) for risks inherent in the design of certain compensation programs. Comments on the ANPR are due by February 18, 2010.

Through the proposed rulemaking, the FDIC sets forth a proposed framework for incorporating compensation plans into its deposit insurance assessment model. While not proposing specific rules at this point, the ANPR set forth a possible structure for considering the issue. Such a structure, according to the ANPR, would not seek to impose a ceiling on employee compensation, but rather provide incentives for institutions to adopt compensation programs that align employees' interests with those of the institution's stakeholders, including the FDIC. The FDIC stated in the preamble to the ANPR that the initiative is intended to complement both domestic and international efforts to develop supervisory standards to address the risks posed by poorly designed compensation programs. Recent domestic and international efforts include the Federal Reserve's Proposed Guidance on Sound Incentive Compensation Policies (Federal Reserve's proposed guidance) (issued on November 2, 2009),[1] the Financial Stability Board's Principals for Sound Compensation Practices (issued on September 25, 2009), and the Interagency Statement on Meeting the Needs of Creditworthy Borrowers (Interagency Statement) (issued on November 12, 2008). The ANPR states that while other supervisory standards may define minimum standards that all institutions must meet, the FDIC has indicated that its proposal aims to provide incentives to institutions to exceed such minimum standards.

The ANPR was approved by the Board of Directors of the FDIC (FDIC Board) over the objections of two FDIC Board members—Comptroller John C. Dugan of the Office of the Comptroller of the Currency (OCC) and Director John E. Bowman of the Office of Thrift Supervision (OTS). Comptroller Dugan and

1 The Federal Reserve's proposed guidance is discussed in Arnold & Porter's advisory *available at* http://www.arnoldporter.com/resources/documents/Advisory_Federal_Reserve_Proposes_Incentive_Compensation_Guidance_for_Banks_110509.pdf.

Brussels
+32 (0)2 290 7800

Denver
+1 303.863.1000

London
+44 (0)20 7786 6100

Los Angeles
+1 213.243.4000

New York
+1 212.715.1000

Northern Virginia
+1 703.720.7000

San Francisco
+1 415.356.3000

Washington, DC
+1 202.942.5000

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Director Bowman both criticized the ANPR for being premature and lacking a sufficient legal basis. They also noted that there are already multiple regulations and supervisory guidance related to the issue of employee compensation, including the federal banking agencies' general authority to supervise institutions for safety and soundness under Section 8(b) of the Federal Deposit Insurance Act (FDIA), the Interagency Statement, the Federal Reserve's proposed guidance, and the Interagency Guidelines Establishing Standards for Safety and Soundness that prohibits excessive compensation. In addition, they both noted that Congress is currently considering statutory language on the issue of employee compensation as part of the Wall Street Reform and Consumer Protection Act that was passed by the House of Representatives in December 2009.

I. LEGAL FRAMEWORK AND BASIS FOR ANPR

Section 7 of the Federal Deposit Insurance Act (FDIA) requires the FDIC to base an institution's deposit insurance assessment rate on the probability that the DIF will incur a loss with respect to that institution.[2] In setting risk-based assessments, the FDIC Board is required to consider certain enumerated risk factors, the estimated operating expenses of the DIF, the estimated resolution expenses and income of the DIF, the projected effects of the payment of assessments on the capital and earnings of institutions, and any other factors the FDIC Board determines to be appropriate.

The federal bank regulators also are required to conduct Material Loss Reviews to determine the factors that contributed to the losses resulting from any institution's failure. Seventeen out of the forty-nine Material Loss Reviews conducted by the FDIC in 2009 cited employee compensation practices as a contributing factor for the loss. In addition, based upon the work of academics, consulting groups, and others, the ANPR states that there is a broad consensus that some compensation structures misalign incentives and induce imprudent risk taking within institutions. As a result, the ANPR states that the FDIC believes that the risks presented by certain employee compensation programs are an appropriate factor for the FDIC Board to consider when setting risk-based assessments.

II. PROPOSED COMPENSATION MODEL

The ANPR sets forth a proposed compensation model that would meet the FDIC's stated goal of reducing the risk created by an employee compensation program. The ANPR suggests that institutions that are able to attest that their compensation structures include the elements of the proposed model might receive lower deposit insurance assessments than those that do not. Alternatively, the ANPR suggests that the FDIC could raise the deposit insurance assessments of those institutions that cannot attest that their compensation programs include the elements of the model. The proposed model set forth in the ANPR includes the following elements:

(1) A significant portion of the 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 paid in restricted, non-discounted company stock. Such employees would include at a minimum the institution's senior management. Restricted, non-discounted company stock would mean stock that becomes available to the employee at intervals over a period of years.

(2) Significant awards of company stock only become vested over a multi-year period, subject to a look-back mechanism (e.g., clawback) to account for the outcome of risks assumed in earlier periods.

(3) The employee compensation program is administered by a committee of the board of an institution composed of independent directors with input from independent compensation professionals.

2 *See* 12 U.S.C. § 1817(b)(1)(C).

III. REQUESTS FOR COMMENTS

The FDIC has requested comments on all aspects of its proposal, but also asked specific questions concerning it. The questions, which address such basic areas as how to define compensation and whether deposit insurance assessment models should include a consideration of compensation structures, indicate that the FDIC has not finished creating its proposal, but rather it is still gathering facts.

Arnold & Porter LLP is available to respond to questions raised by the ANPR or to provide any assistance in drafting comments. We also can assist you in determining how the proposed changes may affect your business and in ensuring that your business is compliance when the FDIC issues a final rule on the topic. For further information, please contact your Arnold & Porter attorney or:

Beth S. DeSimone
+1 202.942.5445
Beth.DeSimone@aporter.com

Edward E. Bintz
+1 202.942.5045
Edward.Bintz@aporter.com

Jeremy W. Hochberg
+1 202.942.5523
Jeremy.Hochberg@aporter.com

Douglas S. Pelley
+1 202.942.5423
Douglas.Pelley@aporter.com