STATEMENT OF

MARC STECKEL

ASSOCIATE DIRECTOR
DIVISION OF INSURANCE AND RESEARCH
FEDERAL DEPOSIT INSURANCE CORPORATION

on

EXECUTIVE COMPENSATION OVERSIGHT AFTER THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010

before the

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Chairman Frank, Ranking Member Bachus, and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the FDIC's oversight of the executive compensation practices of insured depository institutions (IDIs).

Compensation programs are critical tools that contribute to the successful management of financial institutions. Properly run compensation programs can aid in the attraction and retention of qualified staff and the alignment of employee performance with organizational objectives. Federal banking regulators, many academics, and others agree that the incentive compensation practices of financial firms were a contributing factor to the excessive build-up of risk that precipitated the recent global financial crisis.

As the economic crisis continued to unfold, the federal banking agencies took steps to curb the potentially risky compensation practices that were proliferating at financial institutions. In November 2008, the federal banking agencies issued the interagency *Statement on Meeting the Needs of Creditworthy Borrowers*. In addition to addressing credit availability, this guidance emphasized the importance of properly structuring compensation. In early 2010, the FDIC joined the Federal Reserve Board (FRB) in its initial review of the compensation practices among large IDIs. In June, we also joined with the FRB, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision in issuing guidance on compensation practices.

During the past year the FDIC has explored whether, as the deposit insurer, there is specific action we could take to price for risky incentive compensation practices in deposit insurance assessments. The FDIC believes that the structure of employee incentive compensation programs can affect the overall risk profile of financial institutions, including IDIs. This, in turn, can affect the long-term performance of these institutions. Thus, the FDIC, as both a primary federal regulator and deposit insurer, is concerned with how certain incentive compensation programs can influence the risk-taking behavior of an IDI's employees.

Our testimony provides general background on studies of incentives and compensation practices. We discuss our supervision of those practices and the requirements outlined in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). Finally, we outline the FDIC's recent proposal to address certain incentive compensation practices through the risk-based assessment system.

Literature on Compensation that Influences Employee Risk-Taking

Our review of work by academics, consulting groups and others indicates that compensation structures influence incentives and can induce excessive and imprudent risk taking within financial organizations. FDIC staff also reviewed a selection of Material Loss Reviews issued by the Inspectors General for the FRB, the FDIC, and the Department of the Treasury, and found that a number of those reviews cited the compensation practices at the failed IDIs as a contributing factor in the institutions' failure.

The FDIC shares the view that incentive compensation practices influence the amount of risk undertaken by an institution and, in particular, that the composition of an executive's compensation will affect his or her willingness to engage a firm in risk-taking activity. Although not specific to the financial services industry, a 2005 study by Moody's Investors Service found that large unexplained bonus and option awards were predictive of default and large ratings downgrades in firms.[1]

With respect to IDIs, arguments by academics and others that these institutions are different from nonfinancial firms are well-known. Many believe that these differences influence the way economists and policymakers should think about corporate governance, executive compensation, and risk taking in banking.[2] In particular, IDIs are more highly leveraged than nonfinancial firms and because of deposit insurance, many IDI liability holders have weaker incentives to engage in risk-monitoring activities than holders of other types of debt.

Additionally, prior to the passage of the Dodd-Frank Act, arguments had been

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[1] Moody's Investors Service, Special Comment: CEO Compensation and Credit Risk (July 2005) (available at http://www.moodys.com/cust/content/content.ashx?source=StaticContent/Free%20pages/Credit%20Policy%20Research/documents/current/2003600000426617.pdf).

[2] See, for example, Macey, Jonathan R. and Maureen O'Hara. 2003. The Corporate Governance of Banks. *Economic Policy Revie,* Federal Reserve Bank of New York. April: 91-107. John, Kose, Anthony Saunders and Lemma W. Senbet. 2000. A Theory of Bank Regulation and Management Compensation. *The Review of Financial Studies* 13, no. 1: 95-125.

made that the likelihood the government would bail out large financial institutions lessened any incentive for uninsured depositors and other debt holders to monitor a large IDI's risk-taking activities (the "too-big-to-fail" problem). Such a possibility could also have made employees more willing to undertake excessive amounts of risk and for stockholders to allow excess risk to be taken. In a book published earlier this year, the Squam Lake Working Group on Financial Regulation (Squam Lake Group) noted that, "[b]ecause the owners and employees of financial firms do not bear the full cost of their failures, they have an incentive to take more risk than they otherwise would. This, in turn, increases the chance of bank failures, systemic risk, and taxpayer costs."[3]

The Squam Lake Group argued that a major goal of financial reform should be to force financial firms to bear the full cost of their actions. To this end, they suggested that regulators take steps to reduce employees' incentives to take excessive risk. Specifically, they recommended that systemically important financial firms should be required to hold back a significant share of each senior manager's annual compensation for a period of time. The authors also argued that such compensation should be for a fixed dollar amount—not stock or stock options. In this way, senior managers would become creditors of the firm and the deferred compensation they were owed would reduce any incentive they have to pursue risky strategies that might result in a government bailout. The Squam Lake Group argued that deferred compensation should be forfeited if the firm becomes bankrupt or receives extraordinary government assistance.

[3] Squam Lake Working Group on Financial Regulation, 2010, Regulation of Executive Compensation in Financial Services. Council on Foreign Relations. Working Paper at 2.

A number of empirical studies have analyzed the relationship between executive compensation, risk taking, and the performance of IDIs. Most of these studies, however, have focused solely on the compensation of the chief executive officer (CEO). Earlier studies tend to find a more tenuous relationship between CEO compensation and firm performance. One early study found little evidence to support the claim that the structure of an IDI's CEO compensation provides incentives for risk taking.[4] Other studies attributed the strengthening of the relationship between CEO compensation and bank performance to the deregulation that occurred in the industry during the 1990s.[5] More recent studies, however, have found relationships between compensation and IDI performance and have also linked the use of option-based compensation to greater risk taking.[6]

A recent working paper by DeYoung, Peng and Yan investigates how the terms of CEO contracts at large commercial banks influenced or were influenced by the risk

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[4] See: Houston, Joel F. and Christoper James. 1995. CEO Compensation and Bank Risk: Is Compensation in Banking Structured to Promote Risk Taking? *Journal of Monetary Economics* 36: 405-431.

[5] See: Crawford, Anthony J., John R. Ezzell and James A. Miles. 1995. Bank CEO Pay-Performance Relations and the Effects of Deregulation. *The Journal of Business* 68, no. 2: 231-256. Hubbard, R. Glenn and Darius Palia. 1995. Exeuctive Pay and Performance: Evidence from the U.S. Banking Industry. *Journal of Financial Economics* 39: 105-130. Fields, L. Page and Donald R. Fraser. 1999. On the Compensation Implications of Commercial Bank Entry into Investment Banking. *Journal of Banking & Finance* 23: 1261-1276.

[6] Harjoto, Maretno A. and Donald J. Mullineaux. 2003. CEO Compensation and the Transformation of Banking. *The Journal of Financial Research* 26, no. 3: 351-354. John, Kose and Yiming Qian. 2003. Incentive Features in CEO Compensation in the Banking Industry. *Economic Policy Review* Federal Reserve Bank of New York. April: 109-121. Adams, Renee and Hamid Mehran. 2003. Is Corporate Governance Different for Bank Holding Companies? *Economic Policy Review* April: 123-142. Also see, Chen, Carl R., Thomas L. Steiner and Ann Marie Whyte. 2006. Does Stock Option-Based Executive Compensation Induce Risk-Taking? An Analysis of the Banking Industry. *Journal of Banking & Finance* 30: 916-945. DeYoung, Robert, Emma Y. Peng and Meng Yan. 2010. Executive Compensation and Business Policy Choices at U.S. Commercial Banks. The Federal Reserve Bank of Kansas City Research Working Papers RWP 10-02.

profiles of these firms. Using data from 1994 to 2006, the paper finds strong evidence that CEOs took on more risk in response to the risk-taking incentives of their compensation contracts. The paper also found that the sensitivity of CEO wealth to changes in the volatility of their IDI's stock returns increased dramatically during the period. CEOs with higher sensitivity to stock market volatility took on greater credit and market risks at their IDIs.

Although most compensation studies have focused on the relationship between compensation and the performance of CEOs or top-level executives, some literature examines compensation for lower-level employees and whether such compensation also contributed to excessive risk taking in the most recent financial crisis. In a 2009 paper, Aggarwal and Wang examine data on the compensation of small business loan officers from a major commercial bank. They find that switching compensation practices to incorporate incentive-based compensation for these loan officers resulted in riskier underwriting and poorer performance than a control group that received fixed compensation.[7]

The FDIC as Safety-and-Soundness Regulator

Section 39 of the Federal Deposit Insurance Act

After the economic downturn in the late 1980s, Congress took action to prescribe certain safety-and-soundness standards for financial institutions and revised Section 39 of

[7] Agarwal, Sumit and Faye H. Wang. 2009. Perverse Incentives at the Banks? Evidence from a Natural Experiment. Federal Reserve Bank of Chicago Working Paper 2009-08.

the Federal Deposit Insurance Act (FDI Act).[8] As revised, Section 39 requires each appropriate federal banking agency for all IDIs to, among other things, prescribe standards to prohibit, as an unsafe-and-unsound practice, employment contracts, compensation or benefit agreements, perquisites, stock option plans, post employment benefits, and other compensatory arrangements that would provide employees with "excessive compensation, fees, or benefits" or that "could lead to material financial loss to the institution."

In response to this mandate, the FDIC, along with the other federal banking regulators, issued *Interagency Guidelines Establishing Standards for Safety and Soundness*.[9] Among other things, these guidelines provide that "excessive compensation" and "compensation that could lead to a material financial loss to an insured institution" are prohibited as unsafe-and-unsound practices. The guidelines provide that compensation shall be considered "excessive" when amounts paid to the employee are unreasonable or disproportionate to the services actually performed, considering specified factors outlined within the guidelines.

[8] 12 U.S.C. § 1831p-1 was added by the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. 102-242, 105 Stat. 2236, and subsequently amended by the Housing and Community Development Act of 1992, Pub. L. 102-550, 106 Stat. 3895 (1992) and the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. 103-325, 108 Stat. 2160 (1994).

[9] 12 C.F.R. Part 364 Appendix A.

The FDIC and the other federal banking agencies also have the authority to restrict compensation when institutions' capital levels fall below certain thresholds under Section 38 of the FDI Act (Prompt Corrective Action).[10]

Golden Parachutes

In addition to the safety-and-soundness standards, Congress created restrictions on golden parachute payments through title XXV ("Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990") of the Crime Control Act of 1990.[11] Importantly, these restrictions apply to institutions that are in a "troubled" condition. The purpose of restricting golden parachute payments was to prevent officers and directors of IDIs, or their holding companies, from voting generous compensation for themselves at the expense of their troubled financial institutions.

The statute does not restrict golden parachute payments directly; rather, it authorizes the FDIC to "prohibit or limit, by regulation or order, any golden parachute payment or indemnification payment" and lists a number of factors for the FDIC to consider in restricting golden parachute payments to institution-affiliated parties ("IAPs").[12]

[10] 12 U.S.C. § 1831o.

[11] Pub. L. No. 101-647, 2523, 104 Stat. 4789, 4867 (codified at 12 U.S.C. § 1828).

[12] 12 U.S.C. §1828(k)(1)-(2).

The FDIC's regulations address both entering into agreements to make golden parachute payments, as well as actually making such payments, when an institution is in a troubled condition. The regulations permit limited exceptions by application. As more banks are falling into the "troubled condition" category, thereby triggering the golden parachute restrictions, the FDIC is preparing new guidance on the regulation of golden parachutes. The guidance to the industry will highlight the golden parachute rules and clarify the application process for exceptions and the factors considered in the review of those applications. This proposed guidance will ensure that applications made on behalf of senior management of a troubled institution will continue to be subject to heightened scrutiny that will include an evaluation of the individual's performance as well as his or her influence and involvement over major corporate initiatives and policy decisions, especially any actions that may have facilitated high-risk banking strategies.

Recent FDIC Supervisory Actions

As noted above, as part of their response to the financial crisis, the federal banking agencies moved to strengthen regulation of compensation at financial institutions. In November 2008, the federal banking agencies issued the interagency *Statement on Meeting the Needs of Creditworthy Borrowers*. In addition to addressing credit availability, this guidance emphasized the importance of properly structuring compensation. The Statement warned that poorly designed management compensation policies can create perverse incentives that can ultimately jeopardize the health of a banking organization. In addition, such policies are to be supported by independent risk management and control functions.

The FDIC then began working with the FRB on compensation issues in early 2010 by participating in the FRB's horizontal review of incentive compensation practices at large banks. The interim results of these reviews revealed common incentive compensation weaknesses in the following areas: identifying covered employees, balancing risk and reward, designing and monitoring incentive compensation programs, assessing the compatibility of incentive compensation with risk management and control functions, and implementing effective corporate governance.

In June 2010, the FDIC joined with other federal banking agencies in issuing interagency *Guidance on Sound Incentive Compensation Policies*.[13] The guidance identifies three key principles. Compensation arrangements should:

- Provide employees with incentives that appropriately balance risk and reward;
- Be compatible with effective controls and risk-management; and
- Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

As a follow-up to the interagency guidance, the FDIC is developing enhanced examination procedures to use in evaluating incentive compensation at our institutions during each safety and soundness examination and in connection with processing relevant institution applications. In the coming months, the FDIC and the other federal banking agencies will contribute to an FRB report on trends and developments in compensation.

[13] 75 FR 36395 (June 25, 2010)

The Dodd-Frank Act

The Dodd-Frank Act requires the federal banking agencies to prescribe joint regulations or guidelines to enhance reporting of incentive compensation structures and to prohibit certain compensation arrangements. Specifically, the act mandates that incentive-based compensation should be prohibited when it encourages inappropriate risks by providing employees with compensation that is "excessive" or "could lead to material financial loss." The FDIC has begun discussions with other financial regulators to implement the requirements of the Dodd-Frank Act. Implementation of these requirements will further strengthen the FDIC's and other federal banking regulators' authority over, and supervision of, compensation practices at IDIs and affiliated entities.

The FDIC as Deposit Insurer

The FDIC is also concerned about the incentive compensation practices of IDIs because of our unique role as deposit insurer. Among other things, the Federal Deposit Insurance Reform Act of 2005 gave the FDIC, through its rulemaking authority, the opportunity to better price deposit insurance for risk.[14] Poorly designed incentive compensation practices at IDIs can motivate employees to engage in imprudent and excessively risky activities on behalf of the institution that can ultimately pose potential risk and cost to the DIF. The FDIC is examining whether and, if so, how the risk-based

[14] Section 2109(a)(5) of the Federal Deposit Insurance Reform Act of 2005. Section 7(b) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)).

deposit insurance assessment system should price for such risks.

As a first step, the FDIC Board of Directors voted to issue an Advance Notice of Proposed Rulemaking (ANPR) in January of this year to explore what action it could take as deposit insurer that would complement the supervisory guidance and standards being developed domestically and internationally.[15] Supervision, by its nature, focuses on defining the minimum standards that all institutions must meet in order to continue operation. The FDIC, as deposit insurer, is also concerned with how differences in risks among institutions can contribute to their likelihood of failure. With this in mind, the FDIC sought comment on whether, in conjunction with the supervisory guidance and standards being developed, it should price the risk posed by poorly designed incentive compensation practices directly into the deposit insurance assessment system.

In issuing the ANPR, the FDIC made clear that it did not seek to limit the amount of employee compensation or to limit its concern only to executives of the IDI. Rather, our concern was whether IDI incentive compensation programs are structured so that employees have incentives that are aligned with the long-term interests of the IDI and that such programs reward employees for focusing on risk management. The ANPR included a preliminary model of how the FDIC might assess the potential risk to the DIF posed by an IDI's incentive compensation program.

The comments we received fell into two groups, those that stated the FDIC should

[15] 75 FR 2823 (Jan. 19, 2010)

pursue rulemaking and those that stated the FDIC should allow time for supervisory efforts to be finalized. A number of the comments addressed the specific questions in the ANPR and provided valuable suggestions regarding specific aspects of the proposal. Staff reviewed these comments and is undertaking a more in-depth study of how best to protect the DIF from the risk posed by poorly designed incentive compensation practices. As a part of this undertaking, staff is also studying whether risk-based premiums should be used to provide incentives for IDIs to design incentive compensation programs that go beyond supervisory standards.

Moving Forward

Our research on incentive compensation finds, as did the recent interagency guidance, that there are improvements to incentive compensation practices that IDIs can take that could motivate their employees and better hold them accountable for the long-term risk that their activities pose to the IDI.

First, Boards of Directors and senior managers of IDIs should take primary responsibility for ensuring that the IDI's incentive compensation programs effectively align employees' motivations with the long-term interests of the IDI. This could be accomplished, for example, by adopting corporate governance structures that would include a separate compensation committee of the board of directors (this structure may be adjusted to accommodate the realities of staffing boards of directors in smaller institutions). At least annually, this committee would review and approve the compensation program(s) for senior executives and other highly compensated employees of the IDI.

Second, IDIs should require that portions of incentive compensation above certain levels be deferred at least for senior executives and designated employees who have the ability to directly influence the amount and type of risk undertaken by the institution. Such compensation, however, could be extended to other employees as appropriate. Additionally, the receipt of deferred compensation must be conditioned on the long-term results of the original justification of the award ("look-back"). Academics, international bodies, and compensation experts recognize that the full, immediate payment of an incentive compensation award may cause an employee to disregard the longer-term consequences of his or her activities that form the basis of the award. To focus employee behavior on longer-term consequences, deferred compensation must be coupled with an effective look-back mechanism that permits the institution to reduce or rescind the compensation if the original justification for the award proves to be invalid.

Whether these practices are implemented as a result of our collaboration with other regulators or by incorporating the risk posed by incentive compensation practices into our risk-based premium system, or a combination of actions, the FDIC believes their implementation is important for controlling risk to the DIF.

Conclusion

The FDIC recognizes that a broad range of compensation practices exist among IDIs. We understand (as many of the commenters to our ANPR noted) the importance of avoiding a "one-size-fits-all" approach when discussing how an IDI could improve its incentive compensation practices. FDIC staff will continue to work with our fellow regulators and continue to seek ways to bring our unique perspective and capacity as deposit insurer to bear on this important issue. IDIs that are significant users of incentive compensation programs need to ensure that their employees are motivated to consider not just the potential for short-term benefit from the risks they undertake on behalf of the IDI, but also to realize the longer-term consequences that undertaking those risks may pose.

Again, thank you for the opportunity to testify. I look forward to your questions.