May 22, 2024

The Honorable Michael J. Hsu, Acting Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street, SW, Washington, DC 20219
Attn: Docket ID OCC-2011-0001, RIN 1557-AD39

The Honorable Martin J. Gruenberg, Chairman
The Honorable Travis Hill, Vice Chairman
The Honorable Jonathan McKernan, Director
Federal Deposit Insurance Corporation
550 17th Street, NW, Washington DC 20429
Attn: RIN 3064-AD86

The Honorable Sandra L. Thompson, Director
Federal Housing Finance Agency
400 7th Street, SW, Washington, DC 20219
Attn: RIN 2590-AA42

The Honorable Todd M. Harper, Chairman of the Board
National Credit Union Administration
1775 Duke Street, Alexandria, VA 22314
Attn: RIN 3133-AE48

The Honorable Jerome H. Powell, Chairman
The Honorable Philip N. Jefferson, Vice Chairman
The Honorable Michael S. Barr, Vice Chairman for Supervision
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW, Washington, DC 20551

The Honorable Gary Gensler, Chairman
The Honorable Hester M. Peirce, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
The Honorable Mark T. Uyeda, Commissioner
The Honorable Jaime Lizárraga, Commissioner
Securities and Exchange Commission
100 F Street, NE, Washington, DC 20549

Delivered electronically

Re: Comment on the Proposed Rulemaking "Incentive-Based Compensation Arrangements"

Honorable Ladies and Gentlemen:

Thank you for the opportunity to briefly comment on the proposed rulemaking "Incentive-Based Compensation Arrangements." I am currently a doctoral candidate in economics at George Mason University in Fairfax, Virginia. I previously served as the chief economist for the U.S. Congress Joint Economic Committee, the economist for the U.S. Senate Banking Committee, and have held staff roles in the Federal Reserve System. This comment reflects my expert views, which are my views alone. This comment does not represent the views of any affected party or special interest group.

As FDIC Vice Chairman Travis Hill notes, "this proposed rule would establish a highly prescriptive set of requirements for incentive-based compensation arrangements."[1] I urge you to carefully weigh the potential benefits of these requirements against their potential costs. An ill-tailored rule risks unintentionally dissuading economically-efficient activities by our financial institutions. Over time, less-efficient financial intermediation would make American families less prosperous.

I agree with Vice Chairman Hill's observation that "compensation agreements play a crucial role in the recruiting and retaining of qualified staff, and are the core of a well-functioning market economy."[2] The Vice Chairman correctly notes that the "highly subjective triggers for forfeitures and downward adjustments" and "the extraordinarily long lookback period" in this proposal would increase uncertainty about the value of employee compensation.[3] In turn, this greater uncertainty "would incentivize shifting a greater portion of compensation into base salary and out of incentive-based compensation."[4] Yet, why might this shifting reduce economic efficiency?

A longstanding literature in economics explains incentive-based compensation as a way for firms to dissuade shirking when individual labor productivity is costly to measure.[5] For risk-taking employees, shirking might include taking inappropriately low risk. A classic example is a CEO choosing personal 'empire building' over investments with higher risk-adjusted returns.[6] On this view, incentive-based compensation can better align employee incentives with the firm's goals.

Greater risk-taking is not a problem so long as its costs and benefits are internalized by the firm (i.e., shareholders and creditors of the firm ultimately bear the resulting gains or losses). In principle, a firm acting as if it is fully informed and profit maximizing will take the optimal level of risk (viz., the level of risk such that the marginal cost of risk equals the marginal benefit of risk). Of course, the notion of full-information profit-maximizing firms is an unrealistic but simple and

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[1] "Statement by Vice Chairman Travis Hill on Notice of Proposed Rulemaking on Incentive-based Compensation Arrangements," Federal Deposit Insurance Corporation, May 6, 2024, par. 3, https://www.fdic.gov/news/speeches/statement-vice-chairman-travis-hill-notice-proposed-rulemaking-incentive-based.

[2] "Statement by Vice Chairman Travis Hill," par. 1.

[3] "Statement by Vice Chairman Travis Hill," par 3.

[4] "Statement by Vice Chairman Travis Hill," par 3.

[5] See, e.g., Armen A. Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organization," *American Economic Review* 62, no. 5 (1972): 777-95.

[6] See, e.g., Michael C. Jensen and William H. Meckling, "Theory of the firm: Managerial behavior, agency costs and ownership structure," *Journal of Financial Economics* 3, no. 4 (1976): 305-60; Michael C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review* 76, no. 2 (1986) 237-75.

fruitful assumption.[7] In practice, firms might imperfectly adapt to changing circumstances by chance and limited foresight;[8] but presumably the same holds true for government agencies.[9]

Rather, as FDIC Chairman Gruenberg argues in support of the proposed rulemaking, the economic rationale is the claim that the costs of risk-taking are not fully internalized by financial institutions. Citing the 2008 Global Financial Crisis and the bank failures of Spring 2023, the Chairman writes, "When poor compensation practices involve the largest financial institutions, the negative impacts of inappropriate risk-taking can have broader consequences for the financial system."[10]

From this perspective, the government regulation of incentive-based compensation is akin to the regulation of any other negative externality (e.g., pollution). A firm that does not fully internalize the costs of its production would be incented to produce an inefficiently-high level of output. Assuming government could measure all the relevant costs and benefits of production, a carefully calibrated excise tax could enhance economic efficiency by aligning private cost with social cost.

However, working within this framework, note that the efficient level of a negative externality is not zero, and reducing a negative externality below its efficient level is efficiency diminishing. Moreover, other taxes on production already indirectly limit the level of the negative externality.[11] Taking this into account, appropriately tailoring the requirements would involve aligning the estimated level of risk-taking under the proposal with the estimated level of efficient risk-taking. Have the agencies undertaken such an analysis? If so, what were the methods, data, and results?

Finally, stepping back from this framework, we ought to recognize the sheer implausibility of any person acquiring all of the knowledge necessary to calculate the "economically efficient" level of risk-taking (or anything else). As F. A. Hayek famously observes, markets play the critical role of synthesizing this information through price signals.[12] Hayek's argument suggests that agencies should instead focus on internalizing the external costs of a financial institution's failure, while taking a principles-based approach to letting financial institutions choose their own riskiness.

I appreciate your thoughtful consideration of this comment, and the diligent work of your staff.

Sincerely,
Christopher M. Russo

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[7] Milton Friedman, "The Methodology of Positive Economics," in *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953), 3-43. See Friedman's discussion of the role of behavioral assumptions in economic theory.
[8] Armen A. Alchian, "Uncertainty, Evolution, and Economic Theory," *Journal of Political Economy* 58, no. 3 (1950): 211-21.
[9] Harold Demsetz, "Information and Efficiency: Another Viewpoint," *Journal of Law and Economics* 12, no. 1 (1969): 1-22. See Demsetz's warning against comparing an actual institution's imperfection against an ideal's perfection.
[10] "Statement by Martin J. Gruenberg Chairman, Federal Deposit Insurance Corporation Notice of Proposed Rulemaking on Incentive-Based Compensation Arrangements," Federal Deposit Insurance Corporation, May 6, 2024, par. 2, https://www.fdic.gov/news/speeches/statement-martin-j-gruenberg-chairman-federal-deposit-insurance-corporation-notice.
[11] John V. C. Nye, "The Pigou Problem," *Regulation* 31, no. 2 (2008): 32-37.
[12] Friedrich A. Hayek, "The Use of Knowledge in Society," *American Economic Review* 35, no. 4 (1945): 519-30.

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