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PAY FOR PERFORMANCE: INCENTIVE COMPENSATION AT LARGE FINANCIAL INSTITUTIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

EXAMINING INCENTIVE COMPENSATION AT LARGE FINANCIAL INSTITUTIONS

FEBRUARY 15, 2012

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PAY FOR PERFORMANCE: INCENTIVE COMPENSATION AT LARGE FINANCIAL INSTITUTIONS

WEDNESDAY, FEBRUARY 15, 2012

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION,
Washington, DC.

The Subcommittee met at 2:10 p.m., Room SD–538, Dirksen Senate Office Building, Hon. Sherrod Brown, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN SHERROD BROWN

Chairman BROWN. The Subcommittee will come to order. Thank you. At least three fourths of the witnesses, thank you for joining us. Mr. Jackson we think we might have made a mistake in notifying him of time. So, we think he will be here by 2:30 but we will proceed and my special thanks again to Senator Corker, the ranking Member, who has been terrific to work with.

I apologize at the outset. I will do the opening statement. Senator Corker will do his. We will start the questioning. I have a Federal judge nominee from Toledo, Ohio, that I need to introduce in the Judiciary. I will go down for half an hour and come back and Senator Reed will preside too and Senator Corker will be here through part of that.

So, thank you all for this. I will make a brief opening statement and then introduce Senator Corker and then introduce the witnesses.

In 1933 the Pecora Commission, as we know, investigating the causes of the 1929 stock market crash calls its first witness, Charles Mitchell, the CEO of what is now Citibank.

His testimony revealed he had paid himself and his top officers millions of dollars from the bank in interest-free loans. As a result of this testimony, Mr. Mitchell was disgraced.

We are here today to examine his successors in the role that what we think excessive and risky compensation packages played in causing the financial crisis.

During the 1970s, average compensation for a CEO was about 30 times the average pay of a production worker in his company. By 2007, CEO compensation had increased to nearly 300 times that of the average worker.

According to Thomas Philippon of NYU and Ariell Reshef of the University of Virginia, workers in the financial sector are paid a 40 percent wage premium above their counterparts in other industries.

In 2007, major Wall Street banks paid an estimated $137 billion in total compensation, roughly $33 billion in year-end bonuses alone. A significant portion of this compensation has come in the form of stock options that both encourage risk-taking and provide banks with special tax loopholes that Senator Levin and I have sought to close.

In part because of these payment schemes, the largest banks engaged in risky activities and took on leverage as high as 30 to 1 or 40 to 1.

Mr. Jackson, thank you for joining us and we are sorry if the mixup was ours on the times. So, sorry about that.

The evidence suggests that bank executives were not being paid based upon the merits of their work unless there is merit to creating the financial crisis that we have lived through.

The average total compensation for CEOs in some of the largest TARP recipients, the average compensation was approximately $21 million.

A study by Linus Wilson of the University of Louisiana at Lafayette shows that CEOs of banks that received emergency debt guarantees from FDIC were paid an average of $4¼ million more than CEOs of banks that did not receive FDIC support.

Is it any wonder that Federal Reserve Chairman Bernanke says that banks compensation practices led to misaligned incentives and excessive risk-taking contributing to bank losses and financial instability.

So, today we ask what, if anything, has changed in terms of Wall Street pay; what, if anything, can be done to rein in the excess and dangerous incentives. It is not so much just that, you know, you might argue they are overpaid. It is the incentives that this seems to bring that help bring our economy to the brink of collapse.

The Dodd-Frank Act provides a framework for reforming pay practices at Wall Street megabanks. Title IX of Dodd-Frank enacts important corporate governance reforms to address compensation practices including disclosure in, quote, say on pay.

Section 165 provides the Fed with authority to impose risk management standards or other prudential necessary for large complex financial companies.

It appears that significant tools exist for regulators to put an end to the "heads I win, tails the taxpayer loses" compensation packages. I look forward to hearing and our witnesses' comment on any and all of this as we analyze this.

And I will hand it over to Senator Corker.

Thank you, Bob.

STATEMENT OF SENATOR BOB CORKER

Senator CORKER. Thank you, Mr. Chairman, and I thank all of you for being here. I know we have looked at your testimony in advance and I am sorry. This is really unusual what is happening today.

But on the issue of compensation, I know that in Dodd-Frank we actually put in place a lot of provisions to deal with compensation at financial institutions. It is my understanding that that is being complied with and it is working.

I know personally on the claw back provisions I was very involved in ensuring that those kind of things took place so I am not sure exactly what the problem is now because it seems that we kind of dealt with that during the legislative process when we looked at some of the incentives that the Chairman is referring to.

But I hope in your comments that if you are considering something in addition to what has already been put forth that you will help us think through what we do with the auto industry which obviously received a whole lot of money that looks like it is never going to be paid back, the real estate industry that we subsidize hugely in this country, maybe realtor fees, appraiser fees. Maybe you can help us with some of the wind companies that receive huge subsidies from the Federal Government.

So, as you think about these issues, I hope it will not be only focused on the financial industry in the context of just the big reach that the Government has as it relates to providing certainly a lot of help to a lot of industries; and I say that obviously slightly rhetorically, if you get my point.

But I look forward to your testimony and I am glad to be here.

Chairman BROWN. Well, Senator, I get your point so that is good. Thank you, Bob.

Let me introduce the witnesses and we will begin the testimony and about halfway through I will step out and then come back and Senator Corker and Senator Reed will be here also.

Kurt Hyde is SIGTARP's Deputy Inspector General, Special Inspector General for Audit. He began his Government career as an audit manager for the GAO and later was detailed to the U.S. House of Representatives Commerce Committee's Subcommittee on Oversight Investigation, on which I sat, which was one of the most interesting subcommittees in the House, where he investigated property and casualty insurance company failures.

He also served as Deputy Assistant Inspector General for Audit at the Resolution Trust Corporation, charged with unwinding failed S and Ls.

Lucian Bebchuk is the William Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Financial and Director of the Program on Corporate Governance at Harvard Law school.

His research focuses on corporate governance, law, finance and the law and economics. He served as a consultant to the Treasury Department's Office of the Special Master on Executive Compensation.

Robert Jackson, Associate Professor at Law at Columbia where his research emphasizes empirical study of executive compensation and corporate governance matters. Before joining the faculty in 2010, Professor Jackson served as an advisor to senior officials at Treasury and the office of Special Master for TARP executive compensation.

Before that, he practiced in the executive comp department of Wachtell, Lipton, Rosen and Katz.

Michael Melbinger is a partner in the law firm of Winston and Strawn and global head of the firm's executive compensation and employee benefits practice. Mike practices exclusively in the area of executive compensation and employee benefit issues for corporations, partnerships, executives, boards of directors, and by fiduciaries.

He is also an Adjunct Professor of Law at Northwestern University School of Law and was commenting on Chicago weather today.

Thank you to all of you. And if you will begin Mr. Hyde, thank you very much for joining us.

STATEMENT OF KURT HYDE, DEPUTY SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM

Mr. HYDE. Thank you, Chairman Brown, Ranking Member Corker. I am honored to appear before you today on behalf of SIGTARP. The subject of financial sector pay packages is important and timely and I commend the Committee for examining it.

SIGTARP recently issued a report on employee compensation at seven companies whose TARP assistance stood out as exceptional. They were Bank of America, Citigroup, AIG, and the auto companies, General Motors, Chrysler, Chrysler Finance, and Ally Financial.

The legislation approving TARP contained important limits on compensation for TARP recipients. SIGTARP reported that after major TARP recipients paid billions in bonuses for 2008, the President announced a cap of $500,000 on cash salaries at TARP exceptional assistance companies. Congress set limitations on compensation for TARP recipients and Treasury created a special master charged with setting pay for TARP 25 employees at the seven companies.

After analyzing the special master's decisions, SIGTARP found that the special master could not effectively rein in excessive compensation at those companies because he was under the constraint that his most important goal was to get the companies to repay TARP.

Although generally the special master limited cash and made some reductions, the special master approved total compensation in the millions with 49 individuals receiving told compensation of more than $5 million from 2009 through 2011.

Former Special Master Kenneth Feinberg said that he was pressured by the companies and by Treasury to let the companies pay executives enough to keep the company's competitive.

The TARP companies proposed TARP high pay packages based on historical pay, failing to take into account the position that they had gotten themselves into that necessitated taxpayer bailout. Rather than view their compensation through the lens of partial Government ownership, they argued that the proposed pay packages when necessary to retain or attract employees.

AIG which, according to the Special Master Feinberg, constituted 80 percent of his headaches and actually proposed cash salary raises for the top 25 employees.

The special master set pay based on what he called prescriptions including that they should be at the 50th percentile for similarly situated employees and that cash salaries should generally not ex-

ceed $500,000, with any additional compensation paid in stock or long-term incentives.

SIGTARP found that the special master awarded cash salaries greater than $500,000 to 11 individuals in 2009 and 22 individuals in 2010 and 2011.

The special masters determinations are not likely to have a long-lasting impact at the companies. Bank of America and Citigroup exited TARP in part to escape OSM's compensation restrictions. Only AIG, GM, and Ally remained under those restrictions, and OSM will set 2012 pay for these coming up in April.

One conclusion of SIGTARP's review is that regulators should take on an active role in monitoring factors that could contribute to another crisis. Federal regulators have stated that executive compensation practices were a contributing factor to the financial practice because it encouraged excessive risk-taking.

Financial institutions should reform their compensation practices to restrain excessive risk-taking that could threaten the safety and soundness of the institution or that could have systemic consequences. However, for the seven companies reviewed by SIGTARP, in only a few rare instances did the companies take it upon themselves to limit pay.

Federal banking regulators are our monitoring compensation using a principals-based approach focusing on the limiting risk. In October 2011, the Federal Reserve reported progress by the largest institutions in reforming compensation but that significant progress remains.

In addition, the Dodd-Frank Act requires regulations on compensation. However, many of these regulations are not final and their effectiveness remains to be seen. The regulators strength and leadership in this area is critical.

Chairman Brown, Ranking Member Corker, and Members of the Committee, thank you again for this opportunity to appear before you and I will be pleased to respond to any questions.

Chairman BROWN. Thank you very much, Mr. Hyde.

Professor Bebchuk.

STATEMENT OF LUCIAN A. BEBCHUK, WILLIAM J. FRIEDMAN AND ALICIA TOWNSEND FRIEDMAN PROFESSOR OF LAW, ECONOMICS, AND FINANCE, HARVARD LAW SCHOOL

Mr. BEBCHUK. Chairman Brown, Ranking Member Corker, distinguished Members of the Subcommittee, I am honored to be testifying today on this important subject.

This is discussed in detail in my written testimony. There is a basis for concern that pay structures have contributed to the financial crisis. To help bring about desirable improvements and pay structures, regulators should strengthen the proposed rules that they issued last April in ways that I will presently discuss.

The focus of my comments will be on compensation of senior executives. This compensation is especially important because senior executives not only make key decisions but also influence the setting of incentive compensation for others in the firm.

One problem with past practices is that they have provided excessive incentives to focus on the short term. Executives were re-

warded for producing short-term gains even when doing so created an excessive risk of an implosion later on.

To illustrate, a study that I coauthored with colleagues documented that notwithstanding the 2008 meltdown of Bear Stearns and Lehman Brothers, the top five executives of these two firms took enough compensation off the table during 2000 through 2007 so that their bottom line for that period of 2000 through 2008 was decidedly positive and substantially so.

Going forward, regulators should ensure that equity-based compensation, the principal components of incentive compensation for senior executives will be tied to long-term results. Such regulations would serve both financial stability and the long-term interest of shareholders.

In my view, it is important for regulators to require firms to separate the times that options and restricted shares can be cashed from the time in which such shares and options vest. Firms should require executives to hold equity incentives for a fixed number of years after vesting. Firms should also adopt aggregate limitations that would restrict the fraction of the executive's portfolio of equity incentives that could be unloaded in any given year.

In addition, regulators should require financial firms to adopt robust limitations on hedging and derivatives transactions that senior executives could use to reduce the extent to which they would lose from a decline in the firm's stock price. Executives should not be able to use such transactions to undo the incentive consequences of the pay structure that was set for the executives.

Another feature and a separate feature of pay arrangements that has produced excessive risk taking incentives is the exclusive focus on shorter interest. Payoffs to financial executives have not attempted to internalize consequences that losses could impose on parties other than shareholders such as preferred shareholders, bondholders, depositors, or the Government as the guarantor of deposits. This gave executives incentives to pay insufficient attention to tailor risks and to the possibility of very large losses.

To address these problems, regulators should adopt rules that would induce firms to make the incentive compensation of senior executives depend significantly on long-term payoffs to the banks nonshareholder stakeholders and not only on the payoffs of shareholders.

To this end, firms could tie executive payoffs not only to stock price increases but also to increases in the value of other securities such as preferred shares and bonds.

In seeking to induce firms to go in this direction, regulators should recognize that the risk-taking incentives that are optimal from the shareholders' perspectives and that a shareholder regarding both would seek would likely be excessive from a social perspective.

Thank you. I look forward to your questions.

Chairman BROWN. Thank you.

Professor Jackson, welcome. Thank you.

STATEMENT OF ROBERT J. JACKSON, JR., ASSOCIATE PROFESSOR OF LAW, COLUMBIA LAW SCHOOL

Mr. JACKSON. Chairman Brown, Ranking Member Corker, and distinguished Members of the Subcommittee, thank you so much for the opportunity to testify today about incentive pay at America's largest financial institutions.

We have learned from hard experience, I think, that bankers' pay is a source of concern for all Americans, and so I welcome your invitation and am honored to be here today.

The financial crisis brought into sharp relief the dangers associated with bankers' incentives, and in 2010 Congress responded with the Dodd-Frank Wall Street Reform and Consumer Protection Act which included, as you mentioned today, several important new rules on executive pay.

Many of those rules, like the "say on pay" provisions that give shareholders a voice for the first time in setting executive compensation, have been the subject of quite considerable public debate.

But the most expansive pay-related provision in Dodd-Frank has received much less attention. That provision, Section 956, gives nine Federal agencies including the Federal Reserve, the FDIC, and the Securities Exchange Commission unprecedented authority to ensure that bonus practices at our largest banks never again endanger financial stability.

In Section 956, Congress and the Administration gave Federal regulators the broad powers they will need to ensure that bonuses do not again threaten the safety and soundness of America's financial system.

Now, last April the agencies proposed rules to implement these important provisions, and unfortunately the proposals fall a good deal short of the rigorous oversight of pay that Congress has authorized.

In this testimony, I am going to provide three reasons why the Subcommittee should not expect this to change bonus practices at America's largest banks, and I am going to give four suggestions for reform that would help ensure that bonus structures never again give bankers reason to preserve long-term value creation, to give bankers reason to pursue long-term value creation rather than short-term profits like those that led to the crisis.

First, although the rules require bankers to receive their bonuses over time so that more can be known about the risks they have taken before they get paid, these rules apply only to a few top executives. Yet, one of the few clear lessons from the crisis is that bankers who are not executives can cause a great deal of systemic damage.

None of the employees at the American International Group's Financial Products Division, the unit that contributed to the system's collapse, was an executive, for example, nor was the Citigroup trader who are more than 100 million in bonuses in the years running up to the crisis.

If those bankers were doing today exactly what they did before the crisis, the key rules under Section 956 would not apply to their bonuses.

Now, Congress and the Administration understood that these bankers' bonuses are important, and that is why the Treasury Department's rules on executive compensation and the Congress's rules on executive pay at TARP firms apply to well beyond the executive suite. But unfortunately the Section 956 rules do not and so bonuses remain unregulated for key risk-takers in our financial system.

So, my first recommendation is that these new rules on bankers' bonuses should apply to all risk-takers, not just executives. Now, that is not to say that executives' incentives are not important. They certainly are.

But the agency's rules for executives under 956 are no different than the ways that banks have paid executives for many years. Indeed, as I pointed out in my written testimony, the evidence on executive pay shows that large banks required executives to defer more pay between 2002 and 2006 than the rules would require today; and in many ways, the rules lag behind pay practices that banks are using right now to address incentives.

For example, the rules do not prohibit hedging, that is, the use of derivatives to undermine bankers' incentives. Many large U.S. banks have prohibited executives from hedging for years and the evidence shows that if they are allowed to do so, they will.

Perhaps the most prominent example of hedging involved CEO Hank Greenberg of AIG who hedged about $300 million worth of stock in 2005 and avoided millions of dollars in losses when the firm collapsed in 2008.

That is why the Office of the Special Master at Treasury has prohibited hedging at all the firms under its jurisdiction, but the rules under 956 do not stop executives from doing that.

So, my second suggestion would be that these rules should be changed to regulate executive pay in a way that does more than the current bank practices already do.

Finally, the last problem with these rules is that the way the rules are arranged, banks are entitled to make two key decisions that should not be left to the banks: first, picking out the individuals who take the risks that threaten the system, and the second, deciding how those bankers should be paid. Neither decision should be left to the banks.

As I point out in my written testimony, at the height of the crisis just six of America's largest banks had more than 1.3 million employees, 4,500 of whom received bonuses greater than $1 million in that year. It is hard to identify in that massive group exactly who was taking the risk that endangers our system.

But the regulators have left the decision to identify those individuals to the banks themselves and, more importantly, they have left the decision as to how those bankers should be paid to the boards of directors of banks.

The problem with that is that the boards of directors of banks owe their duties to the shareholders of the banks and, as Professor Bebchuk has pointed out, shareholders will want banks to take excessive risks from a social point of view.

The last problem with the proposed rules is that they do not require banks to disclose detailed information about bonus structures. The current rules only require a qualitative disclosure rather

than a quantitative disclosure. Because regulators need to know the numbers to understand bonus compensation at America's banks, I suggest the rules be changed to require quantitative detail on that subject.

Thank you, again, for the opportunity to testify today. I will be pleased to answer your questions.

Chairman BROWN. Thank you, Professor Jackson.

Mr. MELBINGER. Thank you.

STATEMENT OF MICHAEL S. MELBINGER, PARTNER, WINSTON & STRAWN, LLP

Mr. MELBINGER. Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, thank you for the opportunity to address the subject of compensation practices at financial institutions including, hopefully, the creation of appropriate pay-for-performance and building the right structure for incentive compensation.

As you know, my name is Mike Melbinger. I chair the employee benefits and executive compensation practice at the international law firm of Winston and Strawn. We represent companies and the boards of directors, and I have done that for 29 years.

I appeared today on behalf of the Financial Services Roundtable. The Roundtable is a national trade association that represents 100 of the Nation's largest financial service companies.

In my oral testimony today, I would like to highlight just the three key points on the topic of today's hearing that are elaborated upon in my written testimony.

The first and I think most important point that I want to make is that large financial institutions have embraced principles of safety and soundness and profoundly changed their compensation policies and practices since 2008.

Like everyone else, they learned important lessons from the financial crisis. Boards and management at these institutions have taken those lessons very seriously. They have taken the new rules very seriously and they are working very hard to comply with them and to improve their practices.

But they have also transformed their compensation practices and policies not just in response to lessons learned but also in response to the Dodd-Frank Act, the 2010 interagency guidance, the proposed interagency guidance under Dodd-Frank, and also I do not want to discount pressure from institutional investors and their advisers like to ISS, Glass Lewis, the large pension funds.

The second point I want to make is that financial institutions have made both directional and attitudinal changes in their compensation practices, dramatically in most cases.

In my testimony, my written testimony, I cite a survey of the Roundtable of its membership taken last year in which 100 percent of the institutions reported that since 2008 they have significantly revised their compensation practices.

Other findings of the survey which I think are borne out by nearly daily reports in the press over the last 12 months, are that overall levels of compensation in the industry are down. Annual bonuses have come down. Perquisites and benefits and contractual protections like golden parachutes, SERPs, things like that, are down. And these findings are similar to the Federal Reserve Board

study that was mandated by Dodd-Frank that was mentioned a minute ago.

The third and last point I would like to make is that financial institutions today have actually taken on the role of thought leaders in corporate America on issues such as pay-for-performance and mitigating the potential risks created by incentive compensation.

Now, in my experience nearly every public company in America has worked to improve its practices, compensation practices since 2008. But no other industry has had the focus and, frankly, the regulatory push that the financial industry has had in this director.

So, for decades aligning executive pay with company performance has been a very important objective of compensation committees and boards of directors of both financial institutions and public companies but it is not that easy.

I think that we all agree, however, that one effective way to align pay for performance is to design plans that avoid paying for short-term gains at the expense of true long-term performance; and in this area again, financial institutions are now leading the way. The world has changed for them dramatically.

For this, Congress and the regulators deserve substantial credit. For example, Section 165 of Dodd-Frank was alluded to earlier, requires large financial institutions to establish a separate board-level risk committee. All the financial institutions have done that, establish a board-level committee.

And risk oversight has become a major component of the role of boards and management, particularly in executive compensation. But in this area they are ahead of the curve, and it is like shareholder "say on pay", which was a financial institutions only provision that through Dodd-Frank has now spread to the rest of corporate America. I think that is where we are going with board-level risk committees, and that is why institutions are a bit out front.

With that, I will conclude. Again, I appreciate the opportunity to provide his statement to the Subcommittee for its consideration and would be happy to respond to any questions on compensation the Subcommittee Members may have.

Senator REED [presiding]. Thank you very much. Senator Brown has to go to Judiciary to introduce a nominee or a witness and I would like to recognize the Ranking Member for questions.

Senator CORKER. Thank you, Mr. Chairman. I appreciate it and I thank each of you for your testimony, and for what it is worth I think the emphasis that each of you have made on long-term success and compensation being based on longer-term versus short term results I just could not agree more with, and I thank you for that testimony.

And as I said in my opening comments, what we are hearing throughout the industry is that regulations that were passed during Dodd-Frank that so many of us were involved in and especially in this area supported, maybe not other provisions, it sounds like that in the industry it is working and that people are transforming the way they are looking at incentive pay.

Mr. Jackson, I know you were alluding to some of the rule-making and I know that that is different than maybe what the industry is actually doing itself and I think what you said was is that, you know, we passed these laws, you wish the regulators

would be a little more stringent in what they are putting out but that does not necessarily mean at this point, and we all know this can change. It does in cycles.

At this point are you seeing anything in the actual industry in itself that is different than what Mr. Melbinger just said?

Mr. JACKSON. I think it is too soon to tell. I think Mr. Melbinger's testimony, his written testimony in particular, points to a survey of the financial institutions that indicates that some attitudes are changing, and that is important. No doubt about it, and you are right, sir; the law that you passed absolutely enables the agencies to change compensation practices in the industry.

But I think my answer to you, Senator, would be that we should not leave it to the banks to do this, and there are two reasons why.

First, the shareholders of the banks have reason to take excessive risk because their failure is insured by the Government both as the insurer of deposits and as a source of bailout financing.

Second, we have evidence from just a few years ago that, if left to their own devices, the banks will engage in practices that turn out to involve substantial risk.

So, even though I am encouraged to learn that things may be changing in the industry, I think one lesson from the crisis is that we should not leave it to the banks to monitor themselves when it comes to compensation, and I am afraid that the current rules do just that, sir.

Senator CORKER. It is interesting. I think most people on this Committee would dispute the notion that you just mentioned about the bailout component. I think one of the things we tried to do is ensure that if an institution failed there was a resolution authority to actually take it out and I think that is in place; and while it is not in perfect, hopefully what you just said would not be the case.

I do not know if you want to speak, professor, regarding what was just said.

Mr. BEBCHUK. Sure. A couple of points. One is I agree what you just said, Senator, that the future about bailouts might be very different and importantly so.

However, we would all agree that financial institutions still have important possible externalities over the environment even with the reforms that have happened; and as long as there are systemic externalities, we have to be concerned that firms would not do what is optimal systemwide.

So, in the same way that we cannot count on firms to make the right choices with respect to capital levers so that we restrain their choices, we have to understand that compensation choices can create risks in the same way that capital lever choices do and, therefore, we need to monitor and regulate them.

Second, you are right, Senator, that some firms have been improving but looking at the landscape, we see many firms where some arrangement that Mr. Melbinger said are good and people generally will recognize them to be good, many firms still do not have.

So, many firms still do not have a prohibition on hedging by executives, and it is very hard to see any reason why this should be allowed.

Similarly, you said that everything should be tied to the long term. There is a very big variation and many firms that do not do it in a substantial way.

Senator CORKER. Listen. I know my time is up here in just a few seconds but I do thank you for your testimony.

I think we have to be careful. You know, populism is running pretty rampant right now, and that can really damage institutions. I know, you know, this is the political season and we talk a lot about the one and the 99 and all of those kind of things and people paying their fair share.

But I would just like to emphasize that people like you that are opinion leaders that come out and testify, and you have done a very good job today, that we can carry this so far that we actually damage these institutions, and the folks that actually have the ability to lever these institutions actually move out into unregulated areas where they are not compensated this way.

So, I would just ask that all of those who care about the safety of our financial system, I think some very good points have been made today, that is taken into account that populism can drive a lot of talent out that we want to see in the financial system.

And I would agree, Mr. Professor, that if we had a systemic crisis in this country, the resolution authority that has been put in place probably would not work and we would be trying to figure out what in the world we are going to do with our financial system.

So, I appreciate your comments and, Mr. Chairman, I thank you for leading me go first. I appreciate it.

Senator REED. Thank you so much, Senator Corker.

Thank you, gentlemen, for your excellent testimony and for your both written and oral testimony.

There is another aspect perhaps, Professor Jackson, following on your comments about why rulemaking is important. I think it dovetails on what Senator Corker also talked. It is the proverbial prisoners' dilemma, that is, at the height of this controversy we were asking financial executives why they were paying so much money, they would say, well, we just have to keep the talent. We are being driven, *et cetera.*

So, unless we have a comprehensive set of rules, there will always be that temptation to say we know this is a crazy compensation package but, you know, we have got to keep the person here.

Is that another factor that we have to consider?

Mr. JACKSON. Absolutely, Senator, I could not agree with you more. I think retention of these employees, particularly those who are overseeing systemically important decisions, is a very difficult challenge. It is one that the Office of the Special Master at Treasury faced and still faces, I think, and it is a very important challenge for these firms.

What I would say about that is that makes the issue of rulemaking all the more important, Senator, because the lawmakers have an opportunity to guide the industry with respect to these practices which would give us more sort of comprehensive solutions that would make it more difficult for employees to move their capital from one firm to the other.

I think we have to balance that consideration, as your question suggests, with the knowledge we all have that one size does not fit

all, and I am not at all opposed to flexibility, but what we see in the existing rules, I think, is so much flexibility that I cannot really imagine what practices would change directly in response to these rules.

As I pointed out in my written testimony, the current executives of banks were deferring more compensation in 2003 than they are required to defer under the current rule under 956. When I read the statute that you passed, Senator, it does not seem to me like that is what it requires.

Senator REED. Let me ask both Professor Bebchuk and Professor Jackson and if Mr. Melbinger wants to comment also too.

We are in an international economy and, again, another sort of looking back I will not say nostalgically looking back, is I can recall in the early 2000s where there was suggestions that, well, you know, if you do not let us do all of these things, pay these levels of compensation, more deregulation, we are all going to London. Now, I think the British have taken an even more aggressive posture toward regulation.

So, I think, Professor Bebchuk, Professor Jackson, you might have some insights on what Great Britain and other countries are doing which makes frankly our efforts seem rather tame.

Professor Bebchuk, do you have comments?

Mr. BEBCHUK. The Europeans go further than what we have done and I think it would be useful to, in this case, to look across the Atlantic and learn from their lessons.

One thing that I do want to stress is the fact that there is competition would be a reason for us to be careful not to reduce pay levels too much, but it is never a reason to pay people in an inefficient way, in a way that produces risk-taking incentives. That is never the case.

Senator REED. Professor Jackson.

Mr. JACKSON. I think there is no doubt at all that the British and the European Parliament has been more stringent than our regulators have been with respect to rules, and I want to point to a very specific way in which they are more stringent. That is what I think is most important.

As I mentioned in my testimony, with respect to executive compensation there has been change over time, and I think many of the changes that Mr. Melbinger refers to in his testimony have to do with top executives' pay.

For the folks who run these firms, they have had to disclose their pay for years. They are frequently the subject of public attention. I am not quite so concerned about their incentives.

What is critical is the few risk-takers under that level who make big decisions that can affect our systemic safety like, for example, the folks who worked at AIG Financial Products. No executives there but we learned the hard way how dangerous their decisions can be. Ditto for the Citigroup trader I mentioned in my testimony.

The Europeans have made absolutely clear that for those individuals their risk-taking and their incentives, their bonuses will be subject to the same stringent rules that apply to executives.

Our regulators have made a different decision. What they have said is that identifying who those people are and setting their pay is left to the banks; and in that way, among many others, I think

our regulations are much less likely to prevent incentives for excessive risk-taking than those overseas.

Senator REED. Mr. Melbinger, any comments on this line of questioning?

Mr. MELBINGER. Well, you are certainly correct that back in 2000 going to a foreign-owned bank was a very viable alternative in the competitive marketplace. Nowadays it is still a risk of folks going across the street to a competitive institution or an unregulated entity, but I think our differences of opinion are very slight.

We also agree that the Government should not be setting pay in a one-size-fits-all, but it should be focusing on improving practices. We are onboard with that.

Senator REED. Let me specifically raise the issue about hedging. As both Professor Jackson pointed out specifically is that I think most shareholders would be a little bit unnerved if they thought that someone was being hugely compensated with stock, their stock basically, was on the same time hedging it.

Is that something that explicitly should be addressed in the rules from your standpoint as it apparently is not being addressed?

Mr. MELBINGER. Well, there is a specific requirement in Dodd-Frank that institutions, well, all public companies disclose their hedging policies.

Senator REED. I am talking about individual executives, I think.

Mr. MELBINGER. You mean whether it should be prohibited? Well, I think actually even in Professor Jackson's, I do not mean to put words in your mouth, but he think he pointed out that most institutions already have put in place those kinds of policies.

Senator REED. Which can be removed too. I mean that goes to the whole point about if we are going to have sensible rules that apply to everyone not just the most scrupulous organizations but all organizations, then I would think this notion of hedging at least disclosing the fact that while you are being compensated in this stock of the company that you are working for and presumably doing everything you can to drive the value up, you are betting it might or at least taking into consideration it might go down.

Is that your point? Would you share that?

Mr. MELBINGER. Disclosure, yes.

Senator REED. Professor Jackson, disclosure, is that enough?

Mr. JACKSON. Well, I think disclosure is helpful, and I think Section 955 of Dodd-Frank, the section you mentioned earlier which requires disclosure, is helpful.

That applies to all public companies, and it is not clear to me why we would want shareholders to have to sift through this detailed disclosure and discover exactly whether executives are engaged in this kind of hedging.

Moreover, disclosure of a policy, which is what 955 requires, is not the same, as you suggested earlier, Senator, as requiring individuals to show us that they have hedged.

So, I do not think I would be satisfied actually with the disclosure requirement. I think it is clear that there is no sensible reason why shareholders or bank regulators, to be sure, would want bankers to be in a position to hedge their risk with respect to the stock of these companies.

Senator REED. Before I recognize Professor Bebchuk for his comments, I have the distinct impression from your last comment is that your opinion is that even regulators do not know who might be hedging against the stock of the company that they work for and are being compensated. Is that true?

Mr. JACKSON. Yes, sir. They have no way to know; and as I suggested in my testimony, one of the ways in which the rules are, I think, disappointing is the disclosure that the banks must provide to the regulators themselves.

So, in the provision 956, Congress has said clearly that the regulators can ask anything they want to know about incentives at large banks; and I would think that the existence of hedging would be one of the things they want to know on an individual case-by-case, banker-by-banker basis.

But instead, all the disclosure rules require is a written description, an essay about pay practices at the company; and so, in this way I think the disclosure rules fail to give regulators the type of information you are describing.

Senator REED. Professor Bebchuk please.

Mr. BEBCHUK. Yes, I agree with you, Senator, that we should not just stop at disclosure policies but just have as part of the agency's regulation a general requirement that firms do not allow hedging because, even though usually we like to say one size does not fit all, this is one of the rare instances in which there is really no good reason; and I do not know of anyone who has come up with a reason, why any company should allow a kind of general freedom for executives to hedge in an engaging derivative transactions because what those transactions do, they simply undo whatever the firm is setting in place.

So, the firm is spending money to create some incentives and then the executive has the freedom to undo in a way that the company might not be fully aware of what those incentives are trying to accomplish.

So, there is very little reason to allow this to happen.

Senator REED. Thank you.

Mr. Hyde, you have had a lot of experience at the SIGTARP in terms of a lot of these issues. Can you give us your impression in terms of where we are with the regulations?

And I share, I think, the sense of urgency, at least I have heard on some members of the panel that these regulations have to be strengthened, adopted quickly. Would that be your position?

Mr. HYDE. Right. We do think that. You know, I think the devil is in the details and I think it is important that the regulations do come out, that they are evaluated as to how they are performing.

One of the things there is that there may be, you may have an intended objective with that regulation; but actually when they are put in place, they are not getting that intended consequence.

I just want to add a few things to this last discussion on hedging.

Senator REED. Yes.

Mr. HYDE. I personally do not believe that hedging, I mean, that disclosure is enough. I do think that if you look at AIG and AIGFP, it was the executives in AIGFP or the employees within AIGFP that caused a substantial problem for AIG. It was not the executives that would be reporting under disclosure of hedging.

So, we have got to get further down into the bowels of the corporation in order to assess what the risks are within that corporation and whether there are employees that are going to be putting that institution at risk.

Senator REED. Very good. There is another issue that comes up in the context of these proposed regulations and that is that some people have suggested in comments at least that I am aware of that the calculation of the senior executive pay vis-a-vis the median pay is too complicated, *et cetera;* and I wonder if you have any opinions with respect to whether that is too complicated or whether, your comment.

Mr. HYDE. Right. We did not look at that. I mean, I know that has just come out there; and again, I go back to what is the intent there and are you meeting that intended purpose of it; and I think we have got to, it is important for the Government to look at that; but we did not look at that here in these companies.

Senator REED. Professor Bebchuk, Professor Jackson, do you have any comments on sort of the technical aspects of this? Is it too complicated?

Mr. JACKSON. I think you are referring, Senator, to Section 953(b) of the Dodd-Frank Act, which requires disclosure of the ratio between the amount of the CEO's compensation and the median employee of a large public company. I know there has been a great deal of debate about the cost of implementing such a rule.

My intuition and my sense from talking to folks in the industry is that those costs are very real and that they raise serious implementation problems for the statute.

My own sense is that they could be overcome, but what will be required is that the SEC have some flexibility about the way that the rule should be implemented.

So, for example, some commentors have proposed that perhaps the company could be sampled to figure out the approximate median compensation rather than the exact median compensation. Or perhaps, some elements of pay could be included or excluded from the calculation to make the calculation more manageable.

I think if the SEC engages in a careful cost-benefit analysis that limits the work the firms have to do, the rule could provide valuable information. They could comply with the letter of the law but still make it manageable for firms to do this without spending too much on it.

Senator REED. Anyone else, Professor Bebchuk, Mr. Melbinger?

Mr. BEBCHUK. I think this is one area where regulators should definitely accommodate the industry. It is one of the issues on which the precision is not going, I mean, there are some things that would make this reporting limited in its precision anyway; and therefore, I would support making an effort to kind of require making this calculation in a way that would economize as much as possible on cost implementation.

Senator REED. Anyone else in this disregard? Mr. Melbinger.

Mr. MELBINGER. I agree.

Senator REED. Thank you. Let me raise a final topic. I am anticipating Senator Brown's arrival momentarily. I know he has questions.

But we recently saw, and this is a related point because there is at least a possibility that whatever regulation is proposed it will be challenged in court.

And most recently the Circuit Court of Appeals in Washington, DC, rejected the SEC rule with respect to proxy access for investors to nominate a director based on sort of an interesting logic.

So, I wonder if you have looked at the case, Professor Jackson, if you have a view, or Professor Bebchuk, not only about that but also what the agencies have to do now in order to be sure that their well thought out regulations are upheld.

Mr. JACKSON. I think I would make three points about that, Senator. First, I have read the opinion and what the DC Circuit has said, very clearly I think, is that the SEC is responsible for assessing the cost and benefits of any new rules including those that you have instructed them to enact in the Dodd-Frank bill.

And I think as far as it goes, that is unobjectionable, of course. I mean, there is a relevant statute that requires the SEC to take account of costs and benefits.

The question is the level of precision with respect to which the court should demand the SEC to undertake that analysis, and there is some debate about that. The DC Circuit opinion describes it.

But the first thing I would say is I would expect over time the courts to recognize the necessary imprecision of the study of costs and benefits and to accommodate the SEC's best efforts to undertake that work.

So, I think, first, the SEC should not expect every opinion to look like that proxy access opinion that you were referring to earlier.

Second, I think in order to engage in the kind of very precise cost-benefit analysis that the DC Circuit has described, the SEC needs people who can do it; and for that they need budget, sir. They need to hire substantial staff so that they can engage in the work that they have been asked to do by the DC Circuit; and my intuition about reading the opinion is that this kind of work would be very difficult.

It is the kind of empirical work I do in my own research and it is challenging; and I think the SEC will need additional resources to do it.

The third thing I would say is that to the extent the SEC has an opportunity to promulgate a rule on a temporary basis and observe its costs and benefits and use that as a way to answer the DC Circuit and its concerns about costs and benefits, it should explore that.

Scholars have been saying for some time actually that a rule could be issued temporarily to see what happens in the markets in response to costs and benefits, and the SEC can use that information in its work.

It has not yet done that and I can understand why. But I think the proxy access opinion should give the SEC a moment to think hard about whether that is a strategy they should pursue.

Senator REED. Professor Bebchuk, do you have any comments? I know you have probably looked at this also.

Mr. BEBCHUK. Yes. I hope that the court's going forward will recognize that this is an area of the law where some predictions are

just impossible to make with precision, and this would not be an issue that can be solved by diligence and good faith effort because as financial economists we know that if you have an arrangement that is new, has not happened, your ability to predict with precision its future consequences is just going to be limited.

So, had we demanded this, we would not have had probably the rules on insider trading because before we had those rules, it would have been very difficult to access with precision all the costs and benefits.

So, I think this is an area where we want regulators to do the best job they can, but in the end we will have to count on them making some policy judgments that are not going to be able to rely with perfectly precise predictions.

Senator REED. Thank you, very much.

The Chairman has returned.

Chairman BROWN [presiding]. Thank you, Senator Reed, and I appreciate the patience of all of you and, Mr. Melbinger, I am sorry, I did not hear you orally but I have certainly looked that your testimony. I am sorry for the rudeness of walking out.

The prospective Federal judge has now been introduced. I know not a big thing but a big thing for our State. So, thank you.

I have a series of questions and I will obviously go beyond the 5 minutes but I wanted to ask you about several things.

The title of this hearing is pay-for-performance. It seems clear that Government support and, as we have had in other testimony in August, Professor Ed Kane suggested that regulators should track the level of Government support subsidies that Wall Street receives. We know that larger banks' access to capital is less expensive than a community bank in Coldwater or Mansfield, Ohio.

So, as I was saying, that the hearing title is pay-for-performance. It is clear that Government support both prevents trillion dollar institutions from failing in many ways and gives them funding advantages that, say, the large six bank whose assets range from 800 billion to 2.2 trillion they have funding advantages that unfairly boost their performance based on advantages they have especially access to cost of capital.

My question is this. I will start with Mr. Hyde, if you want to answer. Is the level of Government support, either explicit or implicit, something that regulators should consider when evaluating the appropriateness of executive pay packages?

Mr. HYDE. Well, I think absolutely. I think it is important to do that. The Government put in quite a bit of money, I mean a huge amount of money into a lot of these institutions; and so, rightly so they should be looking at the executive compensation that they are getting. They should be thinking about all the different types of support that they are getting and whether that is going to help and how much, how much they really need.

So, I think it is important. I want to add that it was not just the top institution certainly that we are giving explicit support but it was a number of institutions that were in fact getting it, and I just think it is an important topic to look at.

Chairman BROWN. Professor Bebchuk, would you comment on not just direct Government subsidies they got through TARP but advantages they get on the capital markets as a result of their size

and our unwillingness in this body, it seems to me, to do something about the sheer size of these institutions?

Mr. BEBCHUK. I completely agree, and in some things I stressed in my written testimony and in some academic writings.

The way I would think about this is that when we talk about pay for performance, in many cases outside the financial sector it is clear what performances. It is performance for the shareholders.

In the case of financial institutions, it is important not only how executive decisions affect the bottom line for the shareholders but also for others that contribute capital, and that the debt holder is the preferred shareholder and it is also the Government as the guarantor, either explicit or implicit, of deposits.

So, that is an important element of performance and that is why it is important to count executive performance not just by looking at the narrow metric of shareholder payoffs but the kind of broader metric of looking at the effect on those other stakeholders.

And in my testimony I kind of provided ways in which this can be done.

Chairman BROWN. Professor Jackson, your comments on sort of either approach to that question about Government direct or less direct subsidy and its effect on what you believe the regulators' response should be.

Mr. JACKSON. So, I absolutely agree with both Mr. Hyde and Professor Bebchuk that these benefits that the firms obtain that you have described should be included in the way regulators think about compensation packages, and I would offer another thought for your consideration on this point, Senator.

One thing that stock compensation tends to do, particularly stock options, is it rewards rising tides. So, as markets generally increase, the rise of stock prices generally result in very substantial payments to executives, and that is particularly true with respect to stock options because they are very leveraged bets on the increase in the value of the company.

To the extent that we are concerned that the financial industry as a whole is benefiting from the kind of subsidy you have been describing, one way to address that problem might be to only pay executives for relative increases in the value of their stock as opposed to, say, their competitors' stock, and to punish them for decreases in the value of their stock as opposed to their competitors' stock, because this would be a practical way to get at the issue that you are describing.

Unfortunately, stock-based compensation at public firms, to my knowledge, generally does not do this. One reason is a provision of the tax code that makes it administratively difficult, but another reason is that the culture of stock compensation over the years has just developed in a way to reward rising tides. And I think to the extent that we want to get serious about taking account of the subsidy that the industry is benefiting from, we might want to think about this kind of relative analysis of how firms are performing when we decide how to reward executives, rather than just rewarding them for stock prices rising more generally.

Chairman BROWN. Thank you, Professor.

Mr. Melbinger, any comments?

Mr. MELBINGER. I am a compensation guy. So, the access to capital is a little out of my wheelhouse, but I think I can say the financial institutions accept the additional level of scrutiny to which and regulation to which they are subjected because of their financial role in the system.

We are not arguing against Dodd-Frank. Quite the contrary, I think Dodd-Frank pushed institutions to make these critical changes to their compensation programs.

Chairman BROWN. Mr. Melbinger, if I could just follow up a little bit on that.

When you are looking at compensation questions for executives at particularly the largest banks that do have that cost of capital advantage, if I could term it that, and you compare that to others, their chances of success are a bit higher because they have that access to less expensive capital.

Is that a consideration that you should make in your recommendations to those boards on executive compensation that their chance, as you could argue these big banks are too big to fail, these executives in some sense are in a better position to succeed than an executive that might not have this sort of indirect subsidy on less expensive capital.

Mr. MELBINGER. I think the way that institutions address that is to compare their performance relative to their peers and, when they set pay levels, to compare pay levels relative to their peers.

Chairman BROWN. And their peers are a very small number of banks in this case.

Mr. MELBINGER. At the very highest levels, yes.

Chairman BROWN. Thank you for that.

Let me take a different approach. I mentioned in my opening statement that the financial sector workers are paid higher than their counterparts in other industries.

A Bloomberg editorial, certainly no left-leaning publication, argued erasing that compensation gap that did not exist 30 years ago would cut the typical banks' operating expenses by almost 20 percent.

That is just about enough to raise the capital ratio from 5 to 10 percent without increasing lending rates, without impairing shareholder profits.

Give me your thoughts about the tension between excessive bonus pools and equity funding, if you will, and how you see that fitting together, any of you.

Mr. HYDE. I think there does need to be a hard look at the amount of bonus payment and how that bonus payment is. I think in our audit what we found that the executives were coming to the table in 2009, for example, were coming to the table requesting excessive pay; and they were also requesting AIG, for example, it was requesting, for some group of employees requesting 550 percent increases in pay. For other groups of employees, 120 percent increase.

One of the things that they wanted was to have stock that was immediately sellable and so it was not going to be tied to a long-term performance.

So, I think it is important to have the compensation, have that looked at and have it tied to long-term performance which would I think in turn equate to return of investment.

Chairman BROWN. Mr. Melbinger, do you agree that what Nobel prize-winning economist Joseph Stiglitz pointed out that excessive bonus pools do, in fact, and this again may not be quite in your wheelhouse and certainly deflect if it is, but that excessive bonus pools can drain from a bank's equity base?

Mr. MELBINGER. That is something I guess I have read in the press but I have never seen any studies or really frankly read that study.

Chairman BROWN. Good.

Professor, would you like to answer that?

Mr. BEBCHUK. Sure. I mean, basically you can think about the aggregate pie that comes in the financial firm, and in the end it is going to be divided between the employees and the shareholders.

So, to the extent that the employees and the executives especially are taking a larger slice of it, there is less that is going to be left for the shareholders.

Chairman BROWN. Would you argue then that excessive compensation actually can threaten the safety and soundness of financial institutions?

Mr. BEBCHUK. I think that what financial economies are most concerned about is that the size of the financial sector is in terms of its slice of total earnings and in terms of the talent that it attracts might create some distortions.

Most financial economies would not be for regulating pay levels but they have been watching the trends over time in terms of the slice of the financial sector occupies within the economy, and then also the slice of it that goes to financial executives.

The concern is that it distorts the allocation of talent and that it leads to too much taking of rents.

Chairman BROWN. Does excessive compensation then mean that there is less money to lend for those institutions in a significant enough sense to measure?

Mr. BEBCHUK. I do not think people have tried to measure it, but I am sure there is going to be left less to those that provide the capital. Yes.

Chairman BROWN. Professor Jackson, your comments on any of this?

Mr. JACKSON. I think you have raised a very important point, Senator. I will tell you why.

Around the time of the financial crisis, it became clear that many of the largest firms, right at the end of 2008, paid out very, very large cash bonus compensation at a time when they were so short on cash that, as you know, the Federal Government had to provide TARP funding to keep them liquid.

So, I think it is very clear actually that, under certain circumstances, this cash that goes out the door for compensation can make the capital base of the institution much less stable; and I want to say that that is why so many of us who are thinking about this issue are so insistent that firms should give out stock that is locked up that individuals cannot sell over time, because this gives the firm a base of patient capital that the firm can lend, as you

point out, or can just use to ride out these difficult times that these financial institutions often face.

And I guess one thing that is troubling about the new rules that we have is that they do not require this kind of holding mechanism that would require cash to be held in the firm and keep it solvent over time.

One thing to remember when you think about financial institutions in this country is that for a very long time they were partnerships, and partnerships, like a big firm that has locked up equity, has patient capital—and these financial institutions are not partnerships anymore.

For that reason, this kind of cash going out the door in a large public company can create exactly the kind of situation your question raises.

So, I think it is a very important issue.

Chairman BROWN. Let me ask another question of all four of you.

John Reed, the former Citigroup CEO, testified before the full Banking Committee in support of the Volcker rule. He cited in his words, quote, a dominant business philosophy focusing on shareholder value as a contributing factor to the crisis.

What we have seen in the last 30 years in this country a very different and evolving and changing manufacturing sector and financial services sector.

Thirty years ago finance was roughly one sixth of our economy, of our GDP, a little less than that I believe; and manufacturing was 26, 27, 28 percent of our GDP 30 years or so ago.

Today that has pretty much flipped, that the manufacturing is only about 10 percent of our GDP. Financial services is a much higher percent, more than double that.

Finance, you were using the word partnership and you could have used that is different sense too. Finance was more of a partner to local businesses and its purposes was not financial services as much as lubricating the rest of the economy, as you know.

So, as Wall Street shifted its focus from activities that allowed institutions to grow with its customers, that trading were firms sometimes bet, as you know, against their own clients. Today financial services, it could be argued, is a bit of an end in itself rather than a means of supporting growth in other sectors.

So, my question to all four of you is: Should factors such as the growth of the broader economy or the success of an institution's clients factor into the measurement of appropriate compensation?

Is that one of the places that regulators and analysts of executive compensation and people like Mr. Melbinger should consider as they discuss compensation levels?

Do you want to start this one, Mr. Bebchuk?

Mr. BEBCHUK. I think that, you know, it is part of what I recommended in my writings, in my testimony. I would like to see the payoffs to which executives are tied broadened to include other contributors of capital and the risk of the firm.

I would not go further than that and look at the effect of the bank on the economy. That will be both difficult to measure and I am not sure that conceptually it is the right thing.

But I think it is clear to me that it is important to broaden the objective to include at least the effects on all of those that con-

tribute capital to the firm which includes, and in this way to take more fully into account the effects of the choices of the executives on the risk of the firm.

Chairman BROWN. Other comments on that?

Mr. JACKSON. I think your question raises two separate points that are worth discussing. First, as Professor Bebchuk points out, the idea that we want to incorporate the performance of the bank's clients and the performance of those to which it is lending money into performance measures I think is quite clear and uncontroversial for the reason that Mr. Bebchuk has given.

And what I think the industry has been learning over time, and I wonder whether Mr. Melbinger would agree, is that these kinds of performance measures are something about which you can learn, that you can sort of figure out over time exactly how to measure these kinds of things.

I think the industry has been working hard to understand the types of performance measures they are using and I think those practices have improved over time, although, as I said at the outset of my testimony, not because of the rules the regulators have issued but instead because of the initiative of the industry.

The second point I think I would make is that the measurement of these things can actually be quite challenging; and so it is difficult to understand, for example, the contribution that a bank is making to the communities in which it lends.

It is difficult to understand exactly each lending decision the bank has made. It is difficult to translate those decisions into the performance of the senior folks whose incentives we are often focused on in these discussions.

I think one thing the regulators should be doing is to help banks study that question. So for example, to the extent that you care about how a bank is lending in the local economy or how its auditors are performing, you might find that out by getting data about exactly who is making lending decisions, how they are being paid, and what the relationship is between those two things.

And that is why it is so important that the rules under the Dodd-Frank Act require better disclosures than are in the proposed rules, because all of that kind of information—who does the lending, who makes the decision, and how do they get paid—all of that stuff is obscured in the disclosure that the regulators would require, because those disclosures only require generalized essays about pay-for-performance.

Chairman BROWN. Thank you. Do you want to add something, Mr. Melbinger?

Mr. MELBINGER. Yes. Well, in my experience, compensation committees are always interested in best practices and open to new ideas. So, this is certainly not something that I would reject out of hand at all. I too would have concerns about measurement of it; but, again, new ideas are always welcome at the comp committee.

Chairman BROWN. Thank you.

Let me do one more question and then thank you again for joining us.

Professor Jackson, you mentioned partnership structure. Talk to me, and this question is aimed at you but any of you who would like to weigh in on this.

Are there ways we can re-create any of the incentives that were associated with the partnership structure perhaps by putting more of executive's wealth at risk would be one way of doing it, I assume. Give me any thoughts you have on how we could sort of recreate that situation where, which would probably be safer for the financial markets.

Mr. JACKSON. It is very challenging, of course, because the deal we make when we have partnerships become public companies is that, in exchange for being able to raise capital, we allow the separation of who owns the firm and who is running it, and that is just a fundamental compromise that we strike when we allow companies to be public companies.

And the growth of our financial institutions has significantly aided the growth of our economy. So, it is hard to say it is a bad thing that the firms are no longer partnerships.

But the question that you are asking is how do we get back to those incentives, and I think the answer is that we can or we can at least get close.

I think the way to do it would be to require the people who run these firms, as you say, to put wealth at risk; and the way I would suggest doing that is by having them be paid in stock that is then locked up for a significant period of time.

And let me say that many of the members of Mr. Melbinger's organization actually already do this. The Office of the Special Master at the Treasury Department has required that those firms do it. It is not that it is impossible. It is just that it is challenging.

And if you do it, as I mentioned earlier, you will have the kind of capital that the employees are keeping in the firm just like a partnership.

Let me add one more thought about something I would not suggest that we do, a proposal that I have heard a little bit about which would be to suggest that the people that run these firms should be held personally liable for the liabilities of the firms, that we should break through the liability shield that is created by the corporate form.

I think that is a bad idea. And the reason I do is, first of all, we have another solution that is less intrusive, that is more intuitive, and that is more likely to align incentives in a way that a partnership would. But much more importantly, although we want to manage the risk that banks take, we do not want to make the people who run them so risk averse that they do not lend into our economy, especially at a time like this where communities need active financial institutions.

So what I would say is there is a way to do it and it is just to pay them in stock that is locked up over time; and that makes it puzzling, really, that the rules that have been issued under Section 956 do not have a requirement along those lines, and I would not go further to the more extreme proposals I have just described.

Chairman BROWN. Thank you.

Anybody else want to comment on those ideas, Professor Bebchuk?

Mr. BEBCHUK. The recommendations that I made with respect to the limitations on unwinding of equity incentives and that I would

like to see incorporated into the final rules of the regulators would go exactly in the direction that you suggested, Senator Brown.

So, under what I think is a desirable state of affairs there is a clear separation between vesting and when you can sell your stock. So, vesting would mean that you have earned the stock. It belongs to you, and, therefore, it cannot be taken from you but that does not mean that the terms of the security are ones that allow you to sell it right away. The security can belong to you but you might be able to sell it only over a long period of time.

And it is also important and that again would push us closer to this partnership award is that we have clear restrictions that say whatever is your portfolio of equity incentives you cannot sell in any given year more than 10 percent or some other fraction.

The reason is that there are many executives that are ones that stayed sometime in the firm. They might be in a situation in which most of their portfolio is one that is completely free to unload at any point in time and that gives them the wrong frame of mind. It does not make them feel like a partner. It makes them feel like someone who can exit at any time based on the short-term price. And, therefore, if we have aggregate limitations on unwinding, it would make them more like partners.

The last point I would make about this is that if you look at Goldman Sachs which is the firm that people often think about when they think about the partnership model, if you look at the proxy statement you see that they actually have very substantial limitations on unwinding that are much better than those that many of the peers right now have.

They require their executives to retain a very large percentage of all the equity that is given to them. My hope is that the regulators would push other companies to go in that direction as well.

Chairman BROWN. Thank you. Mr. Hyde.

Mr. HYDE. Yes. I would agree with both Professor Jackson and Professor Bebchuk. I think it is important to do that. I think hearing the delinking of their vesting requirements and how when it is actually being, when they are actually selling it I think that is important.

I also think shifting away from cash compensation or some sort of heavy, short-term compensation to one that is more long-term compensation, these are the things that I believe the special master was trying to do at Treasury and with these seven exceptionally assisted institutions.

Chairman BROWN. Thank you.

Thank you all for joining us today. Your comments were very, very helpful. Thank you for that.

Some Committee Members may have comments or questions that they want to direct at you in the next 5 days. We will keep the record open for 7 days. So if you would respond to them if they have questions and we may follow up too. If you have any remarks that you want to add, you certainly can do that and be in touch with Committee staff. So, thank you again for joining us.

The Subcommittee for Financial Institutions is adjourned. Thanks.

[Whereupon, at 3:24 p.m., the hearing adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF KURT HYDE

DEPUTY SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM

FEBRUARY 15, 2012

Chairman Brown, Ranking Member Corker, and Members of the Committee, I am honored to appear before you today to discuss compensation practices at the largest financial institutions.

The Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) is charged with conducting, supervising, and coordinating audits and investigations of the purchase, management, and sale of assets under the Troubled Asset Relief Program (TARP). SIGTARP's mission is to promote economic stability through transparency, robust enforcement, and coordinated oversight. In fulfilling its mission, SIGTARP protects the interests of those who funded TARP programs—American taxpayers.

This Committee is committed to examining an important and timely issue, the historical structure of financial sector pay practices, the role that these practices played in the financial crisis, and ongoing efforts to reform financial sector pay packages. As part of its mission of transparency, SIGTARP has shed light on the details of some of the largest institutions' pay practices and the Government's decision making in this area, including determinations made by the Office of the Special Master for Executive Compensation (OSM) on pay for companies that had received funds under TARP programs designated as "exceptional assistance." For example, we released an audit report detailing the efforts by Federal banking regulators and Treasury to get the largest banks out of TARP. In that audit we highlighted that Bank of America Corporation (Bank of America) and Citigroup, Inc. (Citigroup) exited TARP's exceptional assistance program known as the Targeted Investment Program, citing a desire to be outside of the jurisdiction of OSM.[1] In that audit, SIGTARP reported that Citigroup's CEO told SIGTARP that the desire to escape management compensation restrictions was a factor in motivating Citigroup's desire to exit TARP. The report also states that Sheila Bair, then-Chairman of the Federal Deposit Insurance Corporation (FDIC), worried that Citigroup's request to terminate its asset guarantee, another form of exceptional assistance it received under TARP, was "all about compensation." As noted in the audit, two of Bank of America's former executives told SIGTARP that executive compensation was an important factor in the firm's decision to repay TARP. One of the executives told SIGTARP that executive compensation was a major factor behind the firm's repayment decision and that the company did everything possible to get out from under the executive compensation rules. Former Special Master Kenneth R. Feinberg testified before the Congressional Oversight Panel (COP) that one of the things he learned as Special Master was the desire of these companies to get out from under Government regulation. Specifically he was referring to Citigroup and Bank of America wanting to get out from under TARP and OSM's restrictions.

Last month, SIGTARP published a report, "The Special Master's Determinations for Executive Compensation of Companies Receiving Exceptional Assistance Under TARP," which examined executive compensation determinations made by OSM for the Top 25 employees at seven companies receiving exceptional assistance under TARP.[2] SIGTARP reviewed the process designed by OSM to set pay packages and OSM's decisions on compensation for the Top 25 employees at the seven companies. Under this evaluation, SIGTARP assessed the criteria used by OSM to evaluate and make determinations on each company's executive compensation and whether OSM consistently applied criteria to all seven companies.

SIGTARP's Review of Executive Compensation Determinations Made By the Office of the Special Master for TARP Compensation

When Congress created TARP in 2008, it included some limits on compensation for employees at companies that received TARP assistance. After several major TARP recipients paid employees billions of dollars in bonuses for 2008, the President, the U.S. Department of the Treasury (Treasury), and Congress expressed frustration. The President announced the capping at $500,000 of annual salaries at companies that had received "exceptional assistance" under TARP, with any further compensation to be paid in stock that could not be cashed in until the company paid

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[1] SIGTARP, "Exiting TARP: Repayments by the Largest Financial Institutions", issued September 29, 2011, *http://www.sigtarp.gov/reports/audit/2011/Exiting_TARP_Repayments_by_the_Largest_Financial_Institutions.pdf.*

[2] SIGTARP, "The Special Master's Determinations for Executive Compensation of Companies Receiving Exceptional Assistance Under TARP," issued January 23, 2012, *www.sigtarp.gov/reports/audit/2012/SIGTARP_ExecComp_Audit.pdf.*

back TARP. After the President's announcement, Congress passed legislation under which Treasury created OSM. Kenneth R. Feinberg served as the Special Master and was succeeded by Patricia Geoghegan, who is the Acting Special Master.

The seven companies that received assistance that was "exceptional"—because of the amount and the nature of their bailouts—stood out from the more than 700 financial institutions in the Capital Purchase Program. Those seven companies were American International Group, Inc. (AIG), Bank of America, Citigroup, Chrysler Financial Services Americas LLC (Chrysler Financial), Chrysler Holding LLC (Chrysler), General Motors Corporation (GM), and Ally Financial Inc. (Ally), formerly GMAC, Inc. The Special Master's authority was narrowly limited to setting pay for the Top 25 most highly paid employees at these companies, and approving compensation structures, rather than individual pay, for the next 75 most highly compensated employees. The Special Master was required to determine whether compensation structures and payments were inconsistent with the TARP legislation or were otherwise contrary to the public interest by using his discretion to apply six principles developed by Treasury: (1) avoiding incentives to take risks; (2) keeping the company competitive and retaining and recruiting employees who would contribute to the company's success and its ability to repay TARP; (3) allocating compensation between salary and incentives; (4) basing pay on performance metrics; (5) setting compensation consistent with similar peers at similarly situated companies; and (6) setting compensation that reflects an employee's contribution to the company's value. Special Master Feinberg told SIGTARP that these criteria are inherently inconsistent because of conflicting goals and company-specific circumstances. He explained that the criteria are intended for institutions to remain competitive and to promote employee retention but do not allow for compensation structures similar to those of some market participants because they are deemed to be excessive and not performance based over the long term. On October 21, 2010, Feinberg testified before COP that the clear direction given to him was that the most important goal was to get these seven companies to repay TARP.

SIGTARP found that the Special Master could not effectively rein in excessive compensation at the seven companies because he was under the constraint that his most important goal was to get the companies to repay TARP. Although generally he limited cash compensation and made some reductions in pay, the Special Master still approved total compensation packages in the millions. Given OSM's overriding goal, the seven companies had significant leverage over OSM by proposing and negotiating for excessive pay packages based on historical pay, warning Special Master Feinberg that if he did not provide competitive pay packages, top officials would leave and go elsewhere.

Special Master Feinberg said that the companies pressured him to let the companies pay executives enough to keep them from quitting, and that Treasury officials pressured him to let the companies pay executives enough to keep the companies competitive and on track to repay TARP funds. Feinberg testified to the House Committee on Financial Services, "The tension between reining in excessive compensation and allowing necessary compensation is, of course, a very real difficulty that I have faced and continue to face in making individual compensation determinations." Feinberg told SIGTARP that every day he was pressured to soften his stance and that Government officials reminded him that the companies had large obligations to repay the taxpayers.

In proposing high pay packages based on historical pay prior to their bailout, the TARP companies failed to take into account the exceptional situation they had gotten themselves into that necessitated taxpayer bailout. On October 28, 2010, Feinberg testified to the U.S. House of Representatives Committee on Oversight and Government Reform that for 2009 pay, six of the seven companies' compensation proposal submissions would result in payments contrary to the public interest, and should, therefore, be rejected.[3] Special Master Feinberg testified that the companies requested excessive cash salaries and bonuses; stock compensation that could be immediately or quickly redeemed; "perks" such as private airplane transportation, country club dues, and golf outings; excessive levels of severance and retirement benefits; and compensation that did not take into account future cash awards already scheduled to be paid based on contracts that existed prior to current compensation regulations.

Rather than view their compensation through the lens of partial Government ownership, the companies argued that their proposed pay packages were necessary to retain or attract employees who were crucial to the company. For example, in 2009, AIG proposed cash raises for several of its Top 25 employees and the ability to sell stock salary immediately. Ally officials pushed for high pay, despite knowing

[3] The seventh company was Chrysler Financial.

that Feinberg was concerned that a majority of the company's Top 25 employees were part of the problem that resulted in the need for a bailout. Ally CEO Michael Carpenter told SIGTARP, "We had an individual who was making $1.5 million total compensation with $1 million in cash. Cutting this person's salary to $500,000 cash resulted in the person being cash poor. . . . This individual is in their early 40s, with two kids in private school, who is now considered cash poor. We were concerned that these people would not meet their monthly expenses due to the reduction in cash." In a few rare instances, the companies took it upon themselves to limit pay. In 2010, Ally's board told the new CEO that he would be paid stock but no cash. Citigroup's CEO told Congress that he would take only $1 in cash salary.

Special Master Feinberg testified to Congress that he determined a new compensation regime be implemented for the seven companies that received exceptional assistance under TARP. The regime he envisioned was a replacement of guaranteed compensation with performance-based compensation designed to tie the individual executive's financial opportunities to the long-term overall financial success of each company. He told Congress that he hoped that his individual compensation determinations would be used, in whole or in part, by other companies in modifying their own compensation practices. He testified that he believed that his determinations were a useful model to guide others.

Under conflicting principles and pressures, despite reducing some pay, the Special Master approved multimillion-dollar compensation packages for many of the Top 25 employees, but tried to shift them away from large cash salaries and toward stock. OSM approved pay packages worth $5 million or more over the 2009 to 2011 period for 49 individuals. OSM set pay using what Feinberg called "prescriptions" that he developed, including that total compensation would be set at the 50th percentile for similarly situated employees, and that cash salaries should not exceed $500,000, except for good cause, with any additional compensation in the form of stock salary or long-term restricted stock.[4] In testimony to the House Committee on Oversight and Government Reform, the Special Master said that he used stock salary to encourage senior executives to remain at the companies to maximize their benefit from the profitability of the company. To tie individual compensation to long-term company success, OSM used long-term restricted stock contingent on the employee achieving specific performance criteria. The Special Master said that each company's independent compensation committee had to have an active role in both the design of incentives and the review and measurement of performance metrics. Although OSM developed general prescriptions, OSM did not have any established criteria at the beginning of the process for applying those prescriptions.

Some companies pushed back on OSM by claiming that their compensation should be higher than the 50th percentile. The companies' beliefs may relate to what has been called the "Lake Wobegon Effect," named after radio host Garrison Keillor's fictional hometown where "all the children are above average." Companies also proposed that their employees be paid cash salaries higher than $500,000, claiming that the employees were crucial. For 10 employees in 2009, and 22 employees in 2010 and 2011, GM, Chrysler Financial, Ally, and AIG convinced OSM to approve cash salaries greater than $500,000. With the exception of Bank of America's retiring CEO, the Special Master approved cash salaries in excess of $500,000 for the CEO of each company who asked for a higher salary, and approved millions of dollars in CEO stock compensation.

AIG's proposed compensation for its Top 25 employees did not reflect the unprecedented nature of AIG's taxpayer-funded bailout and the fact that taxpayers owned a majority of AIG. The proposed AIG compensation was excessive. In 2009, AIG wanted cash salary raises ranging from 20 percent to 129 percent for one group of employees and from 84 percent to 550 percent for another group. AIG proposed high cash salaries, even though some of these employees would also be paid significant retention payments. Feinberg told SIGTARP that AIG was against stock salary and wanted to pay employees in cash. Feinberg told SIGTARP that in his 2009 discussions with AIG, AIG believed that its common stock was essentially worthless. Feinberg testified before COP that AIG common stock "wasn't worth enough to appropriately compensate top officials." Feinberg told SIGTARP that he was pressured by other senior Treasury officials and was told to be careful, that AIG owed a fortune, and that Treasury did not want it to go belly up. Treasury told him that paying salaries and grandfathered awards in stock rather than cash would jeopardize AIG. Feinberg said that Treasury officials felt those amounts were relatively small compared to the Government's exposure in AIG. However, Feinberg said that no one trumped his decisions.

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[4] The economic stimulus legislation did not contain a $500,000 cash salary limitation, nor did the Treasury rules.

In 2009, OSM approved total compensation of cash and stock of more than $1 million each for five AIG employees, including a $10.5 million pay package for AIG's new CEO that included a $3 million cash salary. OSM approved compensation ranging from $4.3 million to $7.1 million each for four AIG employees who that year were also scheduled to receive cash retention awards of up to $2.4 million. OSM was tough on employees of AIG Financial Products (AIGFP), the unit whose losses contributed to the need for Government intervention. For five AIGFP employees who were scheduled to receive retention awards of up to approximately $4.7 million, OSM froze their salaries at 2007 levels and gave them no stock. In 2010, OSM also cut AIG's proposed salaries, but compared to 2009, approved much larger compensation packages for AIG's Top 25 employees, despite the fact that 18 of these employees were scheduled to receive significant retention awards and other payments. In 2010, OSM approved 21 of AIG's 22 employees to receive between $1 million and $7.6 million, with 17 of those pay packages exceeding $3 million. OSM approved cash salaries of more than $500,000 for five employees, and cash salaries ranging from $442,874 to $500,000 for 12 employees. OSM approved all but three of AIG's Top 25 employees to receive stock salary ranging from $1.3 million to $5.1 million each. OSM generally approved these same pay packages for 2011 for AIG, which included the CEO's same compensation as in earlier years, compensation packages of $8 million each for two employees, compensation packages of $7 million each for two employees, and compensation packages of $5 million to $6.3 million each for seven employees.

OSM's pay determinations are not likely to have a long lasting impact at the seven TARP exceptional assistance companies or other companies. Chrysler, Citigroup, and Ally executives said they would not fully follow the Special Master's determination framework after they exited TARP. OSM's decisions had little effect on Citigroup and Bank of America, which exited TARP, in part to escape OSM compensation restrictions. Once out of TARP, salaries and bonuses climbed. Today, only AIG, GM, and Ally remain subject to OSM's review. CEOs at AIG and GM told SIGTARP that they would not maintain OSM's practices once their company exits TARP. OSM has had little ability to influence compensation practices at other companies outside of the seven. Feinberg told SIGTARP that the long-term impact will likely come from regulators.

The Role of Executive Compensation in the Financial Crisis

In the years preceding the financial crisis, employee compensation at large financial institutions increased significantly. The Financial Crisis Inquiry Commission (FCIC) reports that pretax profit for the five largest investment banks doubled between 2003 and 2006 (from $20 billion to $43 billion), and total employee compensation at these investment banks increased from $34 billion to $61 billion. According to the FCIC, in 2007 Wall Street paid workers in New York approximately $33 billion in year-end bonuses alone, and total compensation for the major U.S. banks and securities firms was estimated at approximately $137 billion. [5]

Federal regulators have stated that compensation structures and practices at the largest financial institutions contributed to the financial crisis. Chairman of the Board of Governors of the Federal Reserve System (Federal Reserve) Ben S. Bernanke stated that compensation structures "led to misaligned incentives and excessive risk taking, contributing to bank losses and financial instability." [6] Treasury Secretary Timothy F. Geithner testified before COP that executive compensation played a "material role" in causing the financial crisis because it encouraged excessive risk taking. [7] At the January 2010 FDIC Board meeting, then-FDIC Chairman Sheila Bair stated that "there is such an overwhelming amount of evidence" that compensation practices at the largest financial institutions were "clearly a contributor to the crisis and to the losses that we are suffering." [8] In addition, in its October 2011 report on incentive compensation practices, the Federal Reserve stated that "risk-taking incentives provided by incentive compensation arrangements in the financial services industry were a contributing factor to the financial crisis that

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[5] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report,* Jan. 2011 (online at fcic.law.stanford.edu).

[6] Board of Governors of the Federal Reserve System, press release (Oct. 22, 2009) (online at *www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm*).

[7] Congressional Oversight Panel, Testimony of Timothy F. Geithner, Secretary, U.S. Department of the Treasury, *Transcript: COP Hearing with Treasury Secretary Timothy Geithner* (Dec. 16, 2010) (online at cybercemetery.unt.edu/archive/cop/20110402013346/http://cop.senate.gov/documents/transcript-121610-geithner.pdf).

[8] Meeting of the Board of the Federal Deposit Insurance Corporation (Jan. 12, 2010).

began in 2007."[9] Financial institutions have also identified compensation practices as a contributing cause of the financial crisis. In a 2009 survey conducted on behalf of the Institute of International Finance, of the 37 large banking organizations engaged in wholesale banking activities that responded, 36 agreed that compensation practices were a factor underlying the financial crisis.[10]

One area of particular concern are incentive compensation structures for non-senior employees who can expose the firm to substantial risk that do not align the employees' interests with those of the institution. According to the Federal Reserve's October 2011 report, incentive compensation practices may pose safety and soundness risks if not properly structured. The Federal Reserve report stated that before the crisis, most large firms whose compensation practices were reviewed by the Federal Reserve focused only on risk-based incentives for a small number of senior highly paid employees, and no firm systemically identified the relevant employees who could influence risk.[11] The Federal Reserve reported in October 2011 that many of the large financial institutions have since determined that they have "thousands or tens of thousands" of employees, who individually or as a group, are able to take or influence material risks, including mortgage originators, commercial lending officers, or traders.[12]

Efforts To Reform Executive Compensation

The onus is on the financial institutions to take efforts to reform their own executive compensation practices in a manner that restrains excessive risk taking that could threaten the safety and soundness of the institution. This is particularly true for companies designated as systemically important financial institutions (SIFIs). These companies have a responsibility to reduce risk taking that could trigger systemic consequences. As Federal Reserve Board Governor Daniel K. Tarullo has noted, incentive compensation arrangements should not provide employees with incentives to engage in risk taking that are beyond the institution's capacity to effectively identify and manage. "The amounts of incentive pay flowing to employees should reflect the risks and potential losses—as well as gains—associated with their activities. Employees are less likely to take imprudent risks if their incentive payments are reduced or eliminated for activities that end up imposing significant losses on the firm."[13]

In its report of decision making by OSM, SIGTARP concluded that one lesson of this financial crisis is that regulators should take an active role in monitoring and regulating factors that could contribute to another financial crisis. In June 2010, one month prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Federal banking regulators issued interagency guidance "to ensure that incentive compensation arrangements at financial organizations take into account risk and are consistent with safe and sound practices."[14] This guidance followed the regulators' in-depth analysis of incentive compensation practices at 25 large banking organizations, in which the Federal Reserve found deficiencies.

The June 2010 interagency guidance does not mandate or prohibit any specific form of compensation, but is instead principle-based to allow for differences in the size and complexity of banking organizations.[15] The interagency guidance recog-

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[9] Board of Governors of the Federal Reserve System, *Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations* (Oct. 5, 2011) (online at *www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf*).

[10] The Institute of International Finance, Inc. (2009), *Compensation in Financial Services: Industry Progress and the Agenda for Change.*

[11] Board of Governors of the Federal Reserve System, *Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations* (Oct. 5, 2011) (online at *www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf*).

[12] Board of Governors of the Federal Reserve System, *Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations* (Oct. 5, 2011) (online at *www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf*).

[13] Governor Daniel K. Tarullo, "Incentive Compensation, Risk Management, and Safety and Soundness", at the University of Maryland's Robert H. Smith School of Business Roundtable: Executive Compensation: Practices and Reforms, Washington, DC, Nov. 2, 2009, online at *www.federalreserve.gov/newsevents/speech/tarullo20091102a.htm.*

[14] Guidance on Sound Incentive Compensation, Final Guidance, *Federal Register* 75:122 (25 June 2010): p. 6395 (online at *www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm*) (accessed Feb. 10, 2012).

[15] The principles include that incentive compensation arrangements should: (1) provide employees incentives that appropriately balance risk and reward; (2) be compatible with effective controls and risk management; and (3) be supported by strong corporate governance, including

nizes that while incentive compensation serves important goals, including attracting and retaining skilled staff, "these goals do not override the requirement for banking organizations to have incentive compensation systems that are consistent with safe and sound operations and that do not encourage imprudent risk-taking."[16] The first principle in the guidance is that incentive compensation arrangements should balance risks and rewards so that pay takes into account risks and losses of employees' activities, including credit, market, liquidity, operational, legal, compliance, and reputational risks. In the guidance, the Federal banking regulators outlined four nonexclusive methods to make compensation more sensitive to risk:

- adjusting performance awards to reflect the risks of employee activities;
- deferring payments of awards and adjusting actual payments to reflect risk outcomes using risk information that becomes available at different points in time;
- using longer periods for measuring the performance on which awards are based; and
- reducing the sensitivity of performance measures to short-term revenues or profits.

Each method has advantages and disadvantages. For example, according to the guidance, compensation packages for senior executives at large institutions "are likely to be better balanced if they involve deferral of a substantial portion of the executive's incentive compensation over a multiyear period with payment made in the form of stock" with the amount ultimately received dependent on the performance of the organization. "Deferral, however, may not be effective in constraining the incentives of employees who may have the ability to expose the organization to long-term risks, as these risks may not be realized during a reasonable deferral period."[17] Another principle contained in the guidance is that compensation structures should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors. In October 2011, the Federal Reserve reported that the 25 large banking organizations have made significant progress toward enhancing their incentive compensation arrangements, however, "every firm needs to do more." The Federal Reserve stated that most firms still have significant work to do to achieve full conformance with the interagency guidance.

In addition to this guidance, the Dodd-Frank Act enacted July 21, 2010, requires regulations on executive compensation at financial institutions that may force companies to change their compensation practices. The Dodd-Frank Act enhances disclosure and reporting requirements and prohibits certain incentive-based payment arrangements that regulators determine encourage inappropriate risks by covered financial institutions.[18] The Dodd-Frank Act's provisions on executive compensation are to be implemented in new regulations by several Federal regulators, and some of those regulators have already implemented or proposed rules.[19] The Dodd-Frank Act requires that the new Federal regulations require certain financial institutions to disclose the structures of all incentive-based compensation sufficient to determine whether the compensation structure provides an executive officer, employee, director, or principle shareholder with excessive compensation, fees, or benefits, or could lead to material financial loss.[20] Federal regulators are also required to develop reg-

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active and effective oversight by the organization's board of directors. Guidance on Sound Incentive Compensation, Final Guidance, *Federal Register* 75:122 (25 June 2010): p. 6395 (online at *www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm*) (accessed Feb. 10, 2012).

[16] Guidance on Sound Incentive Compensation, Final Guidance, *Federal Register* 75:122 (25 June 2010): p. 6395 (online at *www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm*) (accessed Feb. 10, 2012).

[17] Guidance on Sound Incentive Compensation, Final Guidance, *Federal Register* 75:122 (25 June 2010): p. 6395 (online at *www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm*) (accessed Feb. 10, 2012).

[18] As to CEO pay, the Dodd-Frank Act requires public companies to disclose in public filings: (1) the median total annual compensation of all employees other than the CEO; (2) the annual total compensation of the CEO or equivalent position; and (3) the ratio between the median compensation of all employees and the CEO's total compensation.

[19] The regulators required to promulgate regulations under the Dodd-Frank Act include: the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the FDIC, the National Credit Union Administration (NCUA), the Securities and Exchange Commission (SEC), and the Federal Housing Finance Agency (FHFA).

[20] Covered financial institutions include: Depository institutions or depository institution holding companies, broker-dealers, credit unions, investment advisors, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and other financial institutions that the appropriate Federal regulators, jointly, by rule, determine should be treated as covered.

Continued

ulations that prohibit any type of incentive-based payment arrangement that the regulators determine encourages inappropriate risk. On April 14, 2011, Federal regulators published their joint proposal to ban "excessive" incentive-based compensation that may promote risky behavior or lead to material financial loss at financial institutions, but the rule is not final.[21] In addition, the SEC adopted regulations that give shareholders a say-on-pay advisory vote on executive compensation and "golden parachute" compensation arrangements. The Dodd-Frank Act also requires regulations for institutions designated as SIFIs. For example, the Federal Reserve recently proposed restricting executive pay and bonuses if a SIFI fails certain capital, liquidity, or stress test thresholds.[22] It is too early to tell whether the Dodd-Frank Act will ultimately be successful in reforming financial sector pay packages because all of the regulations required under the Dodd-Frank Act are not final and their effectiveness remains to be seen. The regulators' strength and leadership in the area of executive compensation are critical.

Finally, the public continues to have a paramount interest in appropriate compensation structures and pay at companies in which Treasury has a significant ownership interest from a TARP investment. Only AIG, GM, and Ally remain as TARP exceptional assistance companies under OSM's oversight, and OSM will release its 2012 compensation package determinations for the Top 25 executives at these three companies in April. Taxpayers are looking to OSM and the regulators to protect them and to help reinforce the stability of the largest firms and the financial system.

Chairman Brown, Ranking Member Corker, and Members of the Committee, thank you again for this opportunity to appear before you, and I would be pleased to respond to any questions that you may have.

PREPARED STATEMENT OF LUCIAN A. BEBCHUK

WILLIAM J. FRIEDMAN AND ALICIA TOWNSEND FRIEDMAN PROFESSOR OF LAW, ECONOMICS, AND FINANCE, HARVARD LAW SCHOOL

FEBRUARY 15, 2012

Chairman Brown, Ranking Member Corker, and distinguished Members of the Subcommittee, I would like to thank you very much for inviting me to testify today. Adequate design of compensation practices at large financial institutions is important for financial stability, and I am honored to have been invited to testify on this subject.

Below I discuss the role that compensation practices played in the financial crisis and how they should generally be designed going forward. I describe two distinct sources of risk-taking incentives: first, executives' excessive focus on short-term results; and, second, their excessive focus on results for shareholders, which corresponds to a lack of incentives for executives to consider outcomes for other contributors of capital. I discuss how pay arrangements should be designed to address each of these problems. The issues I discuss are ones on which I have done a significant amount of academic writing, and my testimony draws on my writing.[1]

My focus throughout is on how senior executives of financial firms should be compensated. Regulators now rightly devote attention to the compensation of all employees of financial institutions who take or influence risk and not just senior executives. However, the pay arrangements of senior executives deserve special attention because such executives have substantial influence both on key risk choices of their

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However, the requirements do not apply to covered financial institutions with assets of less than $1 billion.

[21] The regulators include OCC, Federal Reserve, FDIC, NCUA, SEC, and FHFA. Available at *www.occ.gov/news-issuances/federal-register/76fr21170.pdf.*

[22] Board of Governors of the Federal Reserve System, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies,* 12 C.F.R. Part 252 (Dec. 20, 2011) (online at *www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf*).

[1] My testimony draws on Lucian Bebchuk, Alma Cohen and Holger Spamann, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008", *Yale Journal on Regulation* 27 (2010): 257–282, available at *http://ssrn.com/abstract=1513522;* Lucian Bebchuk and Jesse Fried, "Paying for Long-Term Performance", *University of Pennsylvania Law Review* 58 (2010): 1915–1960, available at *http://ssrn.com/abstract=1535355;* Lucian Bebchuk and Holger Spamann, "Regulating Bankers' Pay", *Georgetown Law Journal* 98 (2) (2010): 247–287, available at *http://ssrn.com/abstract=1410072;* and Lucian Bebchuk, "How to Fix Bankers' Pay", *Daedalus* 139 (2010): 52–60, available at *http://ssrn.com/abstract=1673250.*

Also, the views expressed herein are solely my own and should not be attributed to Harvard Law School or any other institution with which I am affiliated. My affiliation is noted for identification purposes only.

firm and on the setting of compensation arrangements for other employees in their firm.

Problem I: Short-Term Focus

Standard pay arrangements have incentivized and rewarded short-term results. Jesse Fried and I warned about this problem and its consequences in our book *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, published 7 years ago.[2] Under the standard design of pay arrangements, executives have been able to cash out large amounts of compensation based on short-term results. This feature of pay arrangements has provided executives with incentives to seek short-term gains even when doing so creates excessive risk of a later implosion.

In our study "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman Brothers 2000–2008",[3] Alma Cohen, Holger Spamann, and I illustrate the problem through a case study of compensation at Bear Stearns and Lehman Brothers. We document that, notwithstanding the 2008 meltdown of the firms, the bottom lines for the period 2000–2008 were positive and substantial for the firms' top five executives. These top executives regularly unloaded shares and options, and thus were able to cash out a lot of their equity before the stock price of their firm plummeted.

The top executives' payoffs were further increased by large bonus compensation during 2000–2007; while the earnings providing the basis for these bonuses evaporated in 2008, the firms' pay arrangements did not contain any "claw back" provisions that would have enabled recouping the bonuses that had already been paid. Altogether, while the long-term shareholders in these firms were largely decimated, the executives' performance-based compensation kept them in decidedly positive territory. Indeed, combining the figures from equity sales and bonuses, we find that, during 2000 to 2008, the top five executives at Bear Stearns and Lehman pocketed about $1.4 billion and $1 billion, respectively, or roughly $250 million per executive.

The divergence between how the top executives and their companies' shareholders fared raises a serious concern that the aggressive risk-taking at Bear Stearns and Lehman (and other financial firms with similar pay arrangements) could have been the product of flawed incentives. The concern is not that the top executives expected their aggressive risk-taking to lead to certain failure for their firms, but that the executives' pay arrangements—in particular, their ability to claim large amounts of compensation based on short-term results—induced them to accept excessive levels of risk.

Such incentives were not unique to these two firms: a subsequent study by Sanjai Bhagat and Brian Bolton finds a similar pattern—precrisis cashing out of large amounts of compensation by the CEO that exceeded losses suffered by the CEO from stock price declines during the crisis—for other large financial firms that had to be bailed out during the financial crisis.[4] There is also empirical evidence indicating that risk-taking was associated with the extent to which the CEO's compensation was sensitive to the volatility of the company's stock returns,[5] as well as with the sensitivity of the CEO's compensation to short-term earnings per share.[6]

Solving Problem I: Paying for Long-Term Performance

To address the problem of short-term focus, financial firms should reform compensation structures to ensure tighter alignment between executive payoffs and long-term results. Senior executives should not be able to collect and retain large amounts of bonus compensation when the performance on which the bonuses are based is subsequently sharply reversed. Similarly, equity incentives should be sub-

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[2] Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, MA: Harvard University Press, 2004).

[3] Bebchuk, Cohen, and Spamann, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008", *supra* n. 1.

[4] Sanjai Bhagat and Brian Bolton, "Bank Executive Compensation and Capital Requirements Reform", Working paper (2011), available at *http://ssrn.com/abstract=1781318.*

[5] *See,* Marc Chesney, Jacob Stromberg, and Alexander Wagner, "Risk-Taking Incentives and Losses in the Financial Crisis", Swiss Finance Institute Research Paper No. 10-18 (2010), available at *http://ssrn.com/abstract=1595343;* Robert DeYoung, Emma Peng, and Meng Yan, "Executive Compensation and Business Policy Choices at U.S. Commercial Banks", *Journal of Financial and Quantitative Analysis,* forthcoming, available at *http://ssrn.com/abstract=1544490;* Amar Gande and Swaminathan Kalpathy, "CEO Compensation at Financial Firms", SMU Working Paper (2011), available at *http://ssrn.com/abstract=1865870;* and Felix Suntheim, "Managerial Compensation in the Financial Service Industry", Working paper (2011), available at *http://ssrn.com/abstract=1592163.*

[6] Sugato Bhattacharyya and Amiyatosh Purnanandam, "Risk-Taking By Banks: What Did We Know and When Did We Know It?", Working paper (2011), available at *http://ssrn.com/abstract=1619472.*

ject to substantial limitations aimed at preventing executives from placing excessive weight on their firm's short-term stock price. Had such compensation structures been in place at Bear Stearns and Lehman, their top executives would not have been able to derive such large amounts of performance-based compensation for managing these firms in the years leading up to their collapse.

Equity-based compensation is the primary component of modern pay packages. In a recent article, Jesse Fried and I, building on the approach we put forward in *Pay Without Performance,* proposed a detailed blueprint for preventing equity-based compensation from producing an excessive focus on short-term results.[7]

First, the time that options and restricted shares can be cashed should be separated from the time in which they vest. As soon as an executive has completed an additional year at the firm, the options or shares promised as compensation for that year's work should vest; it should belong to the executive even if he or she immediately leaves the firm. The executive, however, should not be free to cash out these vested equity incentives; rather, he or she should be permitted to do so only after a substantial passage of time.

Second, unwinding should be subject to a combination of grant-based and aggregate restrictions. Grant-based limitations would require executives to hold equity incentives awarded as part of a given grant for a fixed number of years after vesting. For example, an executive receiving an equity award could be prevented from unwinding any awarded equity incentives for 2 years after vesting, with each subsequent year freeing another 20 percent of the awarded incentives to be unloaded.

These grant-based limitations, however, are not sufficient to ensure adequate long-term focus. With only grant-based restrictions in place, longtime executives might amass large amounts of equity incentives that they could immediately unload, which could induce them to pay excessive attention to short-term prices. Therefore, grant-based limitations should be supplemented with aggregate limitations restricting the fraction of an executive's otherwise unloadable equity incentives that could be sold in any given year. To illustrate, executives could be precluded from unloading, in any given year, more than 10 percent of their total portfolio of otherwise unloadable incentives. By construction, such limitations would ensure that executives would not place substantial weight on short-term stock prices.

Firms should not make limitations on unwinding a function of events under the control of executives. Some reformers have urged using, and some firms have been using, "hold-till-retirement" requirements that allow executives to cash out shares and options only upon retirement from the firm. Such requirements, however, provide executives with a counterproductive incentive to leave the firm in order to cash out their portfolio of options and shares and diversify their risks. Perversely, the incentive to leave will be strongest for executives who have served successfully for a long time and whose accumulated options and shares are especially valuable. Similar distortions arise under any arrangement tying the freedom to cash out to an event that is at least partly under an executive's control.

Third, firms should generally adopt robust limitations on executives' use of hedging and derivative transactions, a practice that can weaken the connection between executive payoffs and long-term results. An executive who buys a "put" option to sell his or her shares at the current price is "insured" against declines in the stock price below current levels, which undermines incentives and the effectiveness of limitations on unwinding. Therefore, whether or not they are motivated by the use of inside information, executives should be precluded from engaging in any hedging or derivative transactions that would reduce or limit the extent to which declines in the company's stock price would lower executive payoffs. In 2009, following the antihedging approach that Jesse Fried and I advocated in our book, the Special Master for TARP Executive Compensation Kenneth Feinberg (whom I served as an adviser) required companies subject to his jurisdiction to adopt such an antihedging requirement.[8] This approach should be followed by financial firms in general. Whatever equity-plan design is chosen by a given bank's board, executives should not be allowed to unilaterally use hedging and derivative transactions that undo the incentive consequences of this design.

In addition to equity compensation, bonus plans should also be designed to encourage long-term focus. Bonuses should commonly be based not on 1-year results

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[7] Bebchuk and Fried, "Paying for Long-Term Performance", *supra* note 1.

[8] *See,* testimony of Kenneth R. Feinberg, the Special Master for TARP Executive Compensation, before the House Financial Services Committee, February 25, 2010, *http://www.treasury.gov/press-center/press-releases/Pages/tg565.aspx.* Feinberg reports that one of the principles used in evaluating pay at subject firms was that "employees should be prohibited from engaging in any hedging, derivative or other transactions that undermine the long-term performance incentives created by a company's compensation structures."

but on results over a longer period. Furthermore, bonuses should not be cashed right away; instead, the funds should be placed in a company account for several years and adjusted downward if the company subsequently learns that the bonus is no longer justified. The need for such a downward adjustment is not limited to firms in which financial results are restated. Even if results for a given year were booked consistent with accounting conventions, executives should not be rewarded for profits that are quickly reversed. Rewarding executives for short-term results distorts their incentives and should be avoided by well-designed compensation arrangements.

Problem II: Excessive Focus on Shareholder Interests

Thus far, I have focused on the insulation of executives from long-term losses to shareholders—the problem that has received the most attention following the recent crisis. However, as Holger Spamann and have highlighted in our research,[9] there is another type of distortion that should be recognized: payoffs to financial executives have been shielded from the consequences that losses could impose on parties other than shareholders. This source of distortion is distinct from the "short-termism" problem discussed above and would remain even if executives' payoffs were fully aligned with those of long-term shareholders.

Equity-based awards, coupled with the capital structure of banks, tie executives' compensation to a highly levered bet on the value of banks' assets. While bank executives expect to share in any gains that might flow to common shareholders, they do not expect to bear (in the event losses exceed the common shareholders' capital) any part of losses borne by preferred shareholders, bondholders, depositors, or the Government as a guarantor of deposits. This state of affairs leads executives to pay insufficient attention to the possibility of large losses sustained beyond the shareholders' equity; it thus incentivizes excessive risk-taking.

Insulation of executives from losses to parties other than shareholders can be expected to produce at least two types of risk-taking distortions. First, it encourages executives to make investments and take on obligations that can contribute to "tail" scenarios, in which the bank suffers losses exceeding the shareholders' capital. Second, it creates reluctance to raise capital and fosters excessive willingness to run the bank with a capital level that provides inadequate cushion for bondholders and depositors.

The above analysis is consistent with empirical evidence indicating that risk-taking was positively correlated with CEOs' equity-based compensation;[10] that risk-taking was negatively correlated with inside debt holdings by bank CEOs;[11] and that banks whose CEOs had larger equity holdings performed worse during the crisis.[12]

Solving Problem II: Linking Executive Pay to the Payoffs of Nonshareholder Stakeholders

How should pay arrangements be designed to address the above problem? To the extent that executive pay is tied to the value of specified securities, such pay could be tied to a broader basket of securities, not merely common shares. Thus, rather than tying executive pay to a specified percentage of the value of the common shares of the bank holding company, compensation could be tied to a specified percentage of the aggregate value of the common shares, the preferred shares, and all the outstanding bonds issued by either the bank holding company or the bank. Because such a compensation structure would expose executives to a broader fraction of the negative consequences of risks taken, it would encourage greater prudence in evaluating risky choices.

One could broaden further the set of positions to which executive payoffs are tied by using the value of credit default swaps. Because the value of credit default swaps is associated with increases in the risk posed by the bank's operations, adjusting executives' long-term payoffs by an amount dependent on changes in the value of credit default swaps would provide executives an incentive to take into account the effects of their risk choices on nonshareholder stakeholders.

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[9] Bebchuk and Spamann, "Regulating Bankers' Pay", *supra* n. 1.

[10] Sudhakar Balachandran, Bruce Kogut, and Hitesh Harnal, "The Probability of Default, Excessive Risk, and Executive Compensation: A Study of Financial Services Firms from 1995 to 2008", Columbia Business School Research Paper (2010), available at *http://ssrn.com/abstract=1914542.*

[11] Frederick Tung and Xue Wang, "Bank CEOs, Inside Debt Compensation, and the Global Financial Crisis", Boston Univ. School of Law Working Paper No. 11-49 (2011), available at *http://ssrn.com/abstract=1570161.*

[12] Rűdiger Fahlenbrach and René Stulz, "Bank CEO Incentives and the Credit Crisis", *Journal of Financial Economics* 99 (2011): 11–26, available at *http://ssrn.com/abstract=1439859.*

Similarly, in firms in which executives receive bonus compensation tied to specified accounting measures, bonuses could be linked instead to broader metrics. For example, the bonus compensation of some bank executives has been dependent on accounting measures that are of interest primarily to common shareholders, such as return on equity or earning per common share. Such plans could be redesigned to be based on more expansive measures, such as earnings before any payments made to bondholders. Alternatively or in addition, bonuses could be paid not in cash but rather in the form of a subordinated debt obligation of the bank payable in several years.

Ensuring that executives perfectly internalize the expected losses their choices would impose on contributors of capital other than shareholders is far from straightforward. But doing so imperfectly would likely be better than not doing so at all. Requiring financial executives to expand their focus beyond consequences for shareholders would significantly improve their risk-taking incentives.

The Role of Regulations

Outside the financial sector, the Government should not intervene in the substantive terms of pay arrangements. In the case of banks, however, financial regulators should monitor and impose meaningful regulations on financial firms' compensation structures. Such pay regulation is justified by the same moral hazard reasons that underlie the long-standing system of prudential regulation of banks.

When a bank takes risks, shareholders can expect to capture the full upside, but part of the downside may be borne by the Government as guarantor of deposits. Because bank failure imposes costs on the Government and the economy that shareholders do not internalize, shareholders' interests may be served by greater risk-taking than is in the interest of the Government and the economy. This moral hazard problem provides a basis for the extensive body of regulations that restrict the choices of financial firms with respect to investments, lending, and capital reserves.

Aligning the interests of executives with those of shareholders, which some governance reforms seek to do, could eliminate risk-taking that is excessive even from the shareholders' perspective. But it cannot be expected to get rid of incentives for risk-taking that are excessive from a social standpoint but not from the shareholders' perspective.

Shareholders' interest in greater risk-taking implies that they stand to benefit when bank executives take excessive risks. Given the complexities of modern finance and the limited information and resources of regulators, the traditional regulation of banks' actions and activities is necessarily imperfect. Regulators are often one step behind banks' executives. Thus, executives with incentives to focus on shareholder interests can use their informational advantages and whatever discretion traditional regulations leave them to take excessive risks.

Because shareholders' interests favor incentives for risk-taking that are socially excessive, substantive regulation of the terms of pay arrangements—that is, limiting the use of structures that reward risky behavior—can advance the goals of banking regulation. Regulators should focus on the structure of compensation—not the amount—with the aim of discouraging excessive risk-taking. By doing so, regulators would induce bank executives to work for, not against, the goals of banking regulation.

The regulation of bankers' pay could well supplement and reinforce the traditional direct regulation of banks' activities. Indeed, if pay arrangements are designed to discourage excessive risk-taking, direct regulation need not be as stringent as would otherwise be necessary. Conversely, as long as banks' executive pay arrangements are unconstrained, regulators should be stricter in their monitoring and direct regulation of banks' activities. At a minimum, when assessing the risks posed by any given bank, regulators should take into account the incentives generated by the bank's pay arrangements. When the design of compensation encourages risk-taking, regulators should monitor the bank more closely and should consider raising its capital requirements.

Before concluding, it is worthwhile to respond to objections that have been raised against a meaningful governmental role in this area. First, regulation of pay structures may be opposed on grounds that it is the shareholders' money and the Government does not have a legitimate interest in telling bank shareholders how to spend their money. The Government, however, does have a legitimate interest in the compensation structures of private financial firms. Given the Government's interest in the safety and soundness of the banking system, intervention here is no less legitimate than the Government's established involvement in limiting banks' investment and lending decisions.

Second, opponents of meaningful regulation have argued that one size does not fit all and that regulators are at an informational disadvantage vis-a-vis decision

makers within each firm. But the knowledge required of regulators to effectively limit compensation structures that incentivize risk-taking would be no more demanding than that which is requisite to regulators' direct intervention in investment, lending, and capital decisions. Furthermore, setting pay arrangements should not be left to the unconstrained choices of informed players inside banks; while such players might be best informed, they do not have incentives to take into account the interests of bondholders, depositors, and the Government.

Proposed Regulations

The case for meaningful regulation of pay structures in large financial firms is strong. Although regulators issued proposed rules for incentive-based compensation arrangements in April 2011, they have not thus far adopted final rules. Furthermore, and importantly, the proposed regulations should be tightened to ensure that firms take the steps discussed above as necessary to eliminate excessive risk-taking incentives.

The proposed regulations should be revised to include robust and meaningful rules requiring large financial firms to subject all equity compensation of senior executives not only to vesting schedules but also to grant-based limitations on unwinding for a substantial period after equity incentives are vested, as well as to aggregate limitations on unwinding. The proposed regulations should also be revised to require large financial firms to prohibit their senior executives from engaging in any hedging or derivative transactions that would reduce or limit the extent to which declines in the company's stock price would lower executive payoffs. Adopting the rules discussed in this paragraph would serve both financial stability and the long-term interests of shareholders.

In addition, the proposed regulations should be revised to include rules that would induce firms to make the variable compensation of senior executives significantly depend on long-term payoffs to the bank's nonshareholder stakeholders and not only on the payoffs of shareholders. In designing such rules, regulators should recognize that securing risk-taking incentives that are optimal from shareholders' perspective would be insufficient to eliminate risk-taking incentives that are excessive from a social perspective.

Conclusion

To reduce the likelihood of future financial crises, it is important to pay close attention to the incentives provided to financial firms' senior executives. The structure of pay should induce executives to focus on long-term rather than short-term results, as well as to take into account the consequences of their decisions for all those contributing to the bank's capital (rather than only for shareholders). Because of the importance of providing such incentives for financial stability, ensuring that financial firms design pay arrangements to provide such incentives should be regarded as a regulatory priority.

PREPARED STATEMENT OF ROBERT J. JACKSON, JR.

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FEBRUARY 15, 2012

Thank you, Chairman Brown and Ranking Member Corker, for the opportunity to testify before you about incentive compensation at America's largest financial institutions. Hard experience has taught us that bankers' pay can be a source of concern for all Americans, so I welcome your invitation and look forward to participating in this hearing. As a researcher at Columbia Law School who writes on, among other matters, bankers' incentives, I am pleased to have the opportunity to testify on this important issue. [1]

The financial crisis of 2008 brought the potential dangers associated with bankers' incentives into sharp relief. In 2010, Congress responded with the Dodd-Frank Wall Street Reform and Consumer Protection Act, which included several important new rules that now govern executive pay at large public companies. For example, one provision proposed by the Administration and included in Dodd-Frank now requires

[1] My institutional affiliation is given for identification purposes only. Further, from 2009 to 2010 I served at the Department of the Treasury as an advisor to senior officials on executive compensation and in the Office of the Special Master for TARP Executive Compensation. The views set forth here are solely my own and should not be attributed to the Treasury. This testimony expands upon comments I submitted to Federal regulators in May 2011, see Robert J. Jackson, Jr., Ltr. to the Board of Governors of the Federal Reserve System, available at *http://www.law.columbia.edu/null/download?&exclusive=filemgr.download&file__id=6035*.

large public companies to give shareholders a vote on executive pay. Boards of directors initially resisted federally mandated "say-on-pay" votes, arguing that they might compromise the board's long-standing freedom to use its business judgment in setting executive pay. While it is too soon to know how say-on-pay will affect executive compensation in the long run, preliminary study of results from the first year of votes suggests that say-on-pay has facilitated important dialogue between directors and shareholders on pay while leaving the ultimate decision to the sound judgment of the board. [2]

Say-on-pay has been the subject of considerable political debate and media scrutiny. But Dodd-Frank's broadest compensated-related provision has received much less attention. That provision, Section 956, gives nine Federal agencies, including the Federal Reserve, the Federal Deposit Insurance Corporation and the Securities and Exchange Commission, extraordinarily expansive authority to ensure that bonus practices at our largest banks never again endanger financial stability. Section 956 gives the agencies two key powers in regulating banker bonuses. First, the agencies must "prohibit any" bonus arrangement that gives bankers excessive pay or could lead to material financial loss. Second, the agencies must require banks to disclose "the structures of all" bonus arrangements to regulators so that those who oversee our financial institutions can identify incentive structures that could lead bankers to take excessive risks. [3] In Section 956, Congress and the Administration gave Federal regulators the expansive powers they will need to ensure that bonus practices do not threaten the safety and soundness of America's financial system. The agencies jointly issued proposed rules under Section 956 last April, and these rules are scheduled to be finalized later this year. [4]

Unfortunately, the agencies' proposals fall far short of the rigorous oversight of banker pay that Congress authorized in Section 956. In this testimony, I will provide three reasons why Congress should not expect these rules to change bonus practices at America's largest banks, and describe three principles for reform that would help ensure that incentive structures give bankers reason to pursue long-term value rather than the illusory, short-term profits that led to the crisis.

First, the rules focus their attention on the few top executives who lead America's banks. But bank executives' incentives have for many years been the subject of extensive disclosure rules and media scrutiny. That is not to say that top executives' incentives are unimportant. But for two reasons the rules governing bankers' incentives should apply beyond this limited group. First, one of the clearest lessons of the crisis was that bankers outside the executive suite can cause a great deal of systemic damage. None of the employees at American International Group's Financial Products division, the unit that contributed to the system's collapse in September 2008, was an executive. If that division were still operating today, the agencies' most stringent rules under Section 956 would not apply to bonuses paid to its employees. Second, because executives' incentives have long been scrutinized by investors and the public, rules governing their bonuses may be redundant to existing practices. Indeed, as I explain below, the agencies' most rigorous rule under Section 956 is redundant to pay practices that were in place at many large banks years before the crisis. Accordingly, I argue that rules governing bankers' bonuses should not be limited to the group of executives, and regulation of executives' incentives should go beyond long-standing industry pay practices.

Second, the rules provide little hope that regulators will actually oversee or address the incentives of employees, like those who worked at AIG Financial Products, who make decisions with critical consequences for the safety and soundness of our financial system. The rules require only that banks identify these employees using a vague standard—and then have the bank's own board of directors approve the employees' pay. For two reasons, we should not expect these rules to address bonus structures that encourage bankers to take excessive risk. First, because there is no clear standard for identifying these employees, there is little hope that the rule will apply to all of the risk takers whose decisions might threaten systemic stability. In

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[2] *See, e.g.,* "Council of Institutional Investors, Say on Pay: Identifying Investor Concerns", (Sept. 2011), at 20 (concluding, following empirical study of the shareholder votes cast during the 2011 proxy season, that "[i]nvestors by and large agree that they do not want to dictate executive pay arrangements").

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §956(a-b), 124 Stat. 1376, 1905 (2010) (emphases added).

[4] Office of the Comptroller of the Currency *et al.,* Incentive-Based Compensation Arrangements, 76 *Fed. Reg.* 21,170 (April 14, 2011). Although the agencies initially expressed hope that the rules would be finalized in the first 6 months of 2012, they recently signaled that final rules will not be issued until the second half of this year, *see,* "SEC, Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act—Upcoming Activity", available at *http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml#07-12-12.*

2008 alone, just six of our largest banks collectively had more than 1.3 million employees, more than 4,500 of whom received bonuses of more than $1 million each. A vague standard applied by the banks themselves is hardly likely to lead to the identification of the few employees in that large group whose incentives warrant special attention. Second, even if banks do identify the appropriate group of employees, the rule is unlikely to eliminate bonuses for those employees that encourage them to pursue short-term profits at the expense of systemic stability. Because directors, as a matter of law, owe their allegiance to shareholders rather than to financial stability, there is no reason to think that requiring the board to approve bonuses will eliminate incentives for excessive risk taking. Thus, regulators should provide clear rules for identifying significant risk takers at large banks and require bonus structures for these risk takers to be reviewed by regulators rather than the boards of directors of the banks themselves.

Third, while there can and should be debate about how regulation should influence bonus practices, there is no question that regulators need detailed information about those practices to do their work under Section 956. Congress and the Administration understood as much; that is why the broadest language in Section 956 is reserved for the requirement that banks disclose detailed information about incentives to regulators. But the agencies' proposal requires only that banks provide qualitative, general descriptions of their policies on pay. These reports will be redundant to disclosure long required by securities rules. And, more importantly, because they will consist of qualitative reports rather than clear, quantitative data, they have very little chance of giving regulators the information they need to identify bonus practices that could lead bankers to take the kinds of excessive risks that contributed to the financial crisis. Instead, I argue, the agencies should require banks to provide meaningful quantitative disclosure of bankers' incentives rather than the duplicative qualitative reporting that the agencies have proposed.

Despite the sweeping authority Congress granted Federal regulators in Section 956, the agencies' proposal likely leaves bonuses completely unregulated for many significant risk takers at our largest banks. Below I explain why—and what might be done about it.

I. Regulation of Executives' Incentives

Consistent with Section 956's command that regulators prohibit incentive-pay arrangements that encourage bankers to take inappropriate risks, the agencies' proposal requires that, at large financial institutions, at least 50 percent of each executive's incentive pay be deferred for at least 3 years. Many have debated whether a 50 percent deferral requirement is likely to give bankers optimal risk-taking incentives. I agree with the agencies that deferrals can be useful in structuring incentives—because, as the agencies have explained, deferral "allows a period of time for risks not previously discerned" "to ultimately materialize," and for bankers' pay to be adjusted for those risks. But for two reasons, the agencies' decision to apply this rule only to executives means that the deferral requirement will have little effect on bankers' incentives.

First, one of the few clear lessons from the financial crisis is that employees outside the group of executives frequently make decisions that affect systemic stability. None of the employees at American International Group's Financial Products division was an executive; nor was the Citigroup banker who earned more than $100 million in annual bonuses trading energy futures in the years leading up to the crisis.[5] Congress and the Administration understood well that, even though they are not executives, these employees' incentives demand scrutiny. That is why both Congress's rules and the Treasury Department's oversight for bonuses at recipients of financial assistance under the Troubled Asset Relief Program apply beyond the group of executives,[6] and that is why the language of Section 956 itself specifies

[5] *See,* American International Group, Inc., Form 10-K (filed Feb. 2, 2008), at 15 (listing AIG's executives, including its general counsel and chief human resources officer—but excluding employees at Financial Products). *Compare,* Michael Sinconolfi and Ann Davis, "Citi in $100 Million Pay Clash", *Wall St. J.* (July 25, 2009), at A1 (describing the trader, who was an employee of Citigroup's energy-trading unit, Phibro) with Citigroup, Inc., Form 10-K (filed Feb. 22, 2008), at 129, 201 (listing Citigroup's executives, including its general counsel and vice chairmen but excluding this trader—even though Phibro earned $843 million in trading revenues in 2007 alone).

[6] Congress placed limits on bonuses for employees of TARP recipients that applied, for most large banks, to the senior executive officers and 25 most highly paid employees of each firm, *see,* American Recovery and Reinvestment Act, Pub. L. No, 111-5 §7001, 123 Stat. 115 (2009). For seven significant recipients of TARP assistance, the Treasury Department went even further, requiring review by the Special Master for TARP Executive Compensation of compensation

Continued

that it applies not only to payments to any "executive" but also to any other "employee." That is also why international standards on banker pay require that mandatory-deferral rules apply to employees outside the executive suite.[7] But the agencies' deferral rules under Section 956 apply only to executives, excluding many employees whose decisions can have important systemic implications.

Second, because bank executives' pay has long been subject to disclosure and public scrutiny, the proposed deferral rule is redundant to long-standing pay practices at America's largest banks. Figure 1 below describes the percentage of executives' incentive pay that was deferred at six of America's largest banks in the years leading up to the financial crisis:

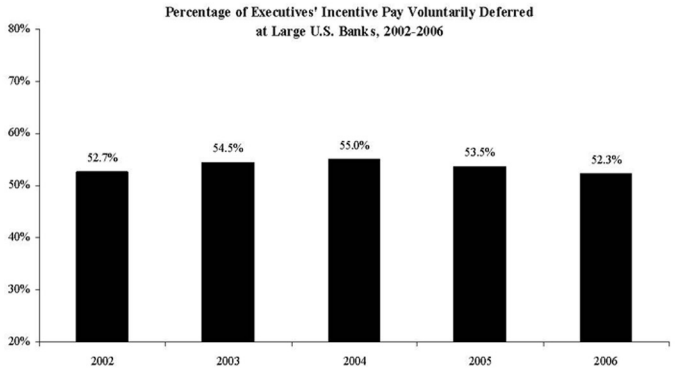


Figure I: Deferral Practices for Executive Incentives at Large Banks Before the Financial Crisis[8]

As Figure 1 shows, the largest U.S. banks deferred more than 50 percent of their executives' incentive pay for years prior to the financial crisis. Moreover, in the years immediately following the crisis, the banks voluntarily agreed to defer even larger proportions of executives' incentives even before Congress enacted Section 956.[9] Because the proposed rules are redundant to long-standing industry practices

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structures for both executives and the 100 most highly paid employees, Department of the Treasury, TARP Standards for Compensation and Corporate Governance, 74 *Fed. Reg.* 28,394 (2009).

[7] For example, standards on banker pay adopted by the Financial Stability Board state clearly that incentive pay should be deferred for "senior executives *as well as other employees whose actions have a material impact on the risk exposure of the firm*." *Financial Stability Board, Principles for Sound Compensation Practices: Implementation Standards* 3, Basel, Switzerland (Sept. 2009) (emphasis added). Similarly, deferral rules recently adopted by the European Parliament expressly apply "at least" to "senior management, risk takers, . . . and any employee whose [pay] takes them into the same [pay] bracket as senior managers and risk takers." *European Parliament*, Directive 2010/76/EU (Dec. 14, 2010) at Par. 3.

[8] The data reflected in Figure 1 include incentive payments disclosed for the top five executives at Bank of America, Citigroup, Goldman Sachs, J.P. Morgan Chase, Morgan Stanley, and Wells Fargo, in each case drawn from the ExecuComp dataset. *See,* "Compustat Executive Compensation Dataset, Wharton Research Data Services", available at *http://wrds-web.wharton.upenn.edu/wrds/index.cfm* (last accessed February 11, 2012). Figure 1 assumes that payments under long-term incentive programs and in the form of options or stock are "deferred" for purposes of the agencies' proposal, because a standard term of those programs is that amounts paid vest over several years on a pro rata basis. Compare Morgan Stanley, Schedule 14A (filed February 24, 2006), at 22 (noting that stock awards granted to executives vested 50 percent on the third anniversary of the grant date and 50 percent on the fourth anniversary of the grant date) with Office of the Comptroller of the Currency *et al., supra* n. 4, at 21,194 (explaining that the agencies' proposal under Section 956 requires deferrals "over a period of no less than 3 years, with the release of deferred amounts to occur no faster than on a *pro rata* basis").

[9] *See, e.g.,* "Goldman Sachs Grp., Goldman Sachs Compensation Practices", 12 (March 2010) (noting that all of Goldman's executives, as well as other officials who are members of the firm's Management Committee, received 100 percent of their incentive pay in stock that was not transferable for 5 years pursuant to policies voluntarily adopted months before the passage of Dodd-Frank).

on executive pay, we should not expect that the agencies' proposed rules will meaningfully change bankers' incentives. [10]

The agencies' most stringent rules on incentives do not apply to bankers who take significant risk—and are redundant with respect to the few executives to whom they do apply. To the extent that Congress and the agencies seek to ensure that bonus structures do not give bankers incentives to pursue excessive risk, rules governing bankers' bonuses should not be limited to the group of executives, and regulation of executives' bonuses should go beyond long-standing industry practices on executive pay. [11]

II. Regulating the Incentives of Significant Risk Takers

As I have noted, the agencies' proposed deferral requirement applies only to executives. With respect to all other employees, including significant risk takers, the proposal requires only that the board of directors of the bank identify employees who "individually have the ability" to cause losses "that are substantial in relation to the institution's size"; for these employees, the board must approve their incentive pay as "appropriately balanced." This approach is unlikely to allow regulators or banks to identify the employees whose incentives deserve special scrutiny. More importantly, even if those employees are identified, it is doubtful that the proposal will ensure that their incentives are consistent with systemic stability.

At a large financial institution, thousands of risk takers are spread throughout the firm. Although it is difficult to know how many of these employees take systemically important risk, pay levels may serve as a helpful means of identifying those who bear substantial organizational responsibility. Table I below describes the number of employees at six large U.S. banks—and the number of bankers who received bonuses of more than $1 million—in 2008:

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[10] In addition to the deferral requirement, the agencies' proposal also requires that, during the deferral period, incentives paid to executives be subject to a claw back, or "look-back" provision, that would require incentives to be "adjusted downward to reflect actual losses." Office of the Comptroller of the Currency *et al., supra* n. 4, at 21,198. This requirement, too, is redundant to existing executive pay practices at large U.S. banks. *See, e.g.,* "Goldman Sachs Grp.", *supra* n. 9, at 12 (describing the adoption of such a claw back); "Morgan Stanley", Schedule 14A (filed April 14, 2010), at 18 (same).

[11] Indeed, in many respects the agencies' proposal lags prevailing industry practices on executive pay. For example, the proposal would not prohibit executives from hedging—that is, from using derivatives and similar instruments to undermine the incentives created by stock compensation. "Office of the Comptroller of the Currency *et al.*", *supra* n. 4, at 21,183 (requesting comment on whether hedging should be prohibited). Many large U.S. banks have prohibited executives from hedging for years, *see, e.g.,* "Goldman Sachs Grp.", Schedule 14A (filed March 7, 2008) at 21 ("Our [executives] are prohibited from hedging . . . their equity-based awards."), and academics long ago provided evidence that hedging is used to undermine the incentives provided by stock-based pay, *see,* J. Carr Bettis *et al.*, "Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders", 36 *J. Fin. and Quant. Analysis* 345, 346 (2001) (finding that executives "use [hedging transactions] to cover a significant proportion of their holdings of the firm's stock"). Hank Greenberg, the CEO of AIG, provided perhaps the most prominent example, hedging approximately $300 million worth of AIG stock in 2005 and avoiding $280 million in losses when the firm collapsed in 2008. *Id.* at 347. The Office of the Special Master for TARP Executive Compensation has prohibited hedging for all of the employees at all of the firms subject to its jurisdiction. Kenneth R. Feinberg, U.S. Dept. of the Treasury, Ltr. to Bob Benmoche (Oct. 22, 2009), at 3.

Financial Institution	Total Number of Employees	Employees Receiving Incentive Pay of More than $1 Million
Bank of America	243,000	263
Citigroup	322,800	1,102
Goldman Sachs	30,067	1,407
J.P. Morgan Chase	224,961	1,826
Morgan Stanley	28,475	55
Wells Fargo	281,000	89
Totals	**1,130,303**	**4,742**

Table I. Bankers Receiving Incentive Pay of More Than $1 Million in 2008[12]

At the height of the crisis these six firms alone had more than 1.1 million employees, more than 4,500 of whom received bonuses of more than $1 million in 2008—a year in which performance suffered considerably. Identifying the key risk takers among a group of this size and scope requires a careful assessment of the relationship between employees' activities and the firm's exposures against a clear set of rules. One might expect, for example, that the agencies would require that the group of significant risk takers include the employees who, according to the regulators' risk models, are responsible for the firm's most significant exposures. Instead, however, the agencies' proposal provides only a vague standard under which the banks themselves are responsible for identifying these critical employees. This approach is likely to lead either to an overinclusive group, with too little attention given to each risk taker's incentives, or an underinclusive analysis that excludes significant risk takers from regulators' reach.

More importantly, even if the group of significant risk takers is properly identified, incentives for these employees to take excessive risk will likely remain in place. That is because the agencies' proposal requires only that the board of directors of the bank itself approve the compensation of significant risk takers. The problem with this approach is that, as a matter of law, the board owes its duties strictly to the shareholders of the bank. And it is now well-accepted that shareholders in large banks prefer that the bank take excessive risk. That is because shareholders capture the full upside from such risk taking, while some of the downside of bank failures is borne by the Government, both as an insurer of deposits and as a provider of bailout financing. [13] Thus, even if the board of directors identifies employees with incentives to take excessive risk, their legal obligations will not necessarily lead them to eliminate those incentives. Considerations regarding the socially appropriate level of risk taking are not within the purview, or expertise, of banks' boards of directors. Those considerations are more appropriately addressed by bank regulators, which is why Section 956 requires those regulators to "prohibit all" bonus structures that could someday lead to material losses—even if those structures are in the short-term interests of shareholders.

The proposed rules under Section 956 would permit large banks to identify their most significant risk takers under a vague standard. Once these risk takers are identified, the proposal requires only that the bankers' bonuses be approved by the bank's own board of directors—whose duties are to shareholders, not systemic stability. This approach is unlikely to provide needed scrutiny for the incentives of all of the risk takers whose decisions have implications for the safety and soundness of our financial system—and, even if it does, that scrutiny will be applied by directors with no duty to pursue systemic stability rather than short-term profits. To the extent that Congress and banking regulators want to ensure that the incentive

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[12] *See,* Andrew M. Cuomo, "No Rhyme or Reason: The 'Heads I Win, Tails You Lose' Bank Bonus Culture", available at *http://www.oag.state.ny.us/media_center/2009/july/pdfs/Bonus%20Report%20Final%207.30.09.pdf.*

[13] *See, generally,* Lucian A. Bebchuk and Holger Spamann, "Regulating Bankers' Pay", 98 *Geo. L.J.* 247, 284–85 (2010).

structures of significant risk takers are subject to meaningful oversight, clear, uniform rules for identifying significant risk takers are needed—and bonus structures for these risk takers should be reviewed by banking regulators rather than the banks' own boards of directors.

III. Providing Meaningful Quantitative Disclosure of Bankers' Incentives

Section 956 requires "enhanced disclosure and reporting of compensation" at financial institutions, including disclosure on the "structures of all incentive-based compensation arrangements." This broad language empowers, and indeed directs, regulators to obtain detailed information from large banks about their employees' incentives. The agencies' proposal would require that each financial institution provide a "clear narrative description" of its incentive-pay arrangements; a "succinct description of [the bank's] policies and procedures" on incentive pay; and "specific reasons why the [bank] believes the structure of its [incentive pay] does not encourage inappropriate risks." For two reasons, these disclosures are inadequate to carry out both the purpose of Section 956 and the agencies' policy mandate.

First, most large banks are public companies subject to securities rules that have long required qualitative disclosure of exactly the kind required by the proposal.[14] In Section 956, Congress gave the agencies sweeping authority to obtain "enhanced disclosure and reporting" on bankers' incentives. Congress's purpose is hardly met by requiring banks to provide duplicative reports identical to those that banks already must provide under securities law.

Second, and more importantly, qualitative reports are unlikely to give regulators the information they need to supervise banker incentives. Importantly, the securities rules that require qualitative discussion of pay policies are accompanied by clear, quantitative tables describing the amount and structure of the compensation to be paid.[15] Unlike those rules, the agencies' proposal requires only generalized essays that will be difficult to compare either to each other or to prevailing best practices.[16] It is hard to see how regulators will be able to use these reports to identify bonus practices at large banks that could threaten financial stability.

Indeed, qualitative descriptions, in the absence of quantitative data, may well give regulators misleading information about bankers' incentives. Suppose, for example, that a large bank qualitatively describes its pay practices as requiring that its employees' bonuses be paid in stock. Regulators might well conclude that these bankers have strong incentives to increase the value of the firm because the bankers will suffer personal losses if the bank's stock price falls. But this assumes that the bankers have not "unloaded" their shares—that is, sold a sufficient number of shares to eliminate the incentives created by the stock-based bonus. Empirical study has shown that unloading is common at the largest U.S. banks—both for executives and

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[14] *See, e.g.,* 17 C.F.R. §229.402(b)(2)(i) (requiring a qualitative description of the company's "policies for allocating between long-term and currently paid out compensation"); *see also id.,* §229.402(e)(1)(i-iv) (requiring a "narrative description" of incentive pay). The proposal's language on this reporting requirement is nearly identical to the language that has governed securities-law disclosure requirements since 2006. Financial institutions and their counsel have generally concluded that the agencies' proposal allows them to use identical reports to comply with identical language in the agencies' proposal under Section 956 and long-standing securities rules. This might explain why comments from the Financial Services Roundtable and Chamber of Commerce, among others, although critical of some aspects of the agencies' proposal, offered only "applau[se]" in response to the "streamlined" nature of the reporting rules. Letter from Center on Executive Compensation et al. to Elizabeth M. Murphy, Sec'y, SEC (May 25, 2011), at 10.

[15] 17 C.F.R. §229.402(c).

[16] Recently the Federal Reserve, upon the conclusion of its "horizontal review" of bonus practices at 25 large banks, indicated that its staff "intends to implement" disclosure requirements on banker pay recently promulgated by the Basel Committee. "Board of Governors of the Federal Reserve System, Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations" (Oct. 2011), at 3, at *http://www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf* (citing "Bank of International Settlements, Pillar 3 Disclosure Requirements on Remuneration Issued by the Basel Committee", at *http://www.bis.org/publ/bcbs197.pdf* (July 2011)). The Basel standards appear to require disclosure of some quantitative information on bonus structures, *see,* "Bank of International Settlements", *supra,* at 4. Those standards were promulgated in July 2011, however, and the agencies have not yet indicated that U.S. banks are required to provide that information to their regulators. Thus, it remains to be seen whether banks will be required to disclose meaningful quantitative information on their bonus practices under Section 956. Moreover, even the Basel standards would not provide regulators with all of the information they need to have a full picture of bankers' incentives. *See, infra,* n. 18.

for other significant risk takers.[17] Without quantitative detail on unloading, qualitative disclosures will give regulators no way to distinguish between a banker whose pay is actually tied to the long-term future of her firm—and the banker who has unloaded, taking advantage of short-term increases in value before the systemic consequences of her risk taking can be known.[18]

In sum, the reporting provisions of the agencies' proposal will give regulators no new information on bonus compensation at America's largest banks. As proposed, the rules will leave regulators unable to identify which bankers have incentives to take excessive risk. These rules are inconsistent with the sweeping authority that Congress provided in Section 956 and the agencies' objective of ensuring that incentive-pay practices do not threaten the safety and soundness of these institutions. Rather than the duplicative qualitative reports required by the agencies' proposal, the rules under Section 956 should require large banks to provide the agencies with clear quantitative data on the structure of incentive compensation for all employees who take significant risk.

Conclusion

Bankers' incentives remain a significant concern for all Americans who rely upon the safety and soundness of our financial system. In Section 956, Congress and the Administration provided Federal regulators with the sweeping authority they will need to ensure that bankers do not have incentives to pursue short-term gains that could compromise systemic stability. The agencies' proposed rules on banker incentives are, however, inadequate to the regulators' critical task. Further diligence from Congress, from the Administration and from the regulators themselves is needed to make certain that the agencies use this new authority to ensure that banker incentives are aligned with all Americans' interest in a safe and secure financial system.

Thank you once again for the opportunity to testify about this important issue. This statement concludes my formal testimony; I will of course be pleased to answer any questions you or your staff may have.

PREPARED STATEMENT OF MICHAEL S. MELBINGER

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FEBRUARY 15, 2012

Chairman Brown, Ranking Member Corker, and Members of the Subcommittee: thank you for the opportunity to address the subject of "Pay for Performance: Incentive Compensation at Large Financial Institutions." My name is Mike Melbinger and I Chair the Employee Benefits and Executive Compensation practice group at the law firm of Winston & Strawn LLP. I am also an Adjunct Professor of Law at Northwestern University School of Law, and I write extensively on the topic of executive compensation. I have practiced exclusively in the area of executive compensation for 29 years.

I appear today on behalf of The Financial Services Roundtable (the "Roundtable"). The Roundtable is a national trade association that represents 100 of the Nation's largest integrated financial services companies. Member companies of the Roundtable provide banking, insurance and investment products and services to millions of American consumers.

I will provide observations about the current state of management members' and boards of directors' approaches to compensation plans and the significant improvements made since 2008. I will then review the range of recent laws and regulations that impose new requirements in the areas of executive compensation and corporate governance, and how they have affected compensation policies for better. Finally, I

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[17] *See, e.g.,* Lucian Bebchuk *et al.,* "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000—2008", 27 *Yale J. On Reg.* 257 (2010) (documenting unloading prior to the collapse at Bear Stearns and Lehman Brothers); Robert J. Jackson, Jr., "Stock Unloading and Banker Incentives", 112 *Colum. L. Rev.* (forthcoming 2012) (documenting unloading by the partners of Goldman Sachs).

[18] More generally, the financial-economics literature on managerial incentives has shown that equity ownership in the firm provides a far stronger pay-performance link than standard incentive payments like cash bonuses. *See, e.g.,* Michael C. Jensen and Kevin J. Murphy, "Performance Pay and Top-Management Incentives", 98 *J. Pol. Econ.* 225, 226 (1990). More recent research has suggested that substantial equity stakes may lead bankers to pursue levels of risk taking that is socially excessive. *See, e.g.,* Bebchuk and Spamann, *supra* n. 13, at 284. All agree, however, that bankers' equity ownership in their firms is a critical determinant of their incentives. Yet under the agencies' proposal and the Basel standards, Federal regulators would have no quantitative data from America's largest banks about the equity ownership of their employees—even those who take systemically significant risk.

will provide my thoughts on whether the enforcement and monitoring of the laws in place will be sufficient or whether additional laws and regulations are needed in this area.

Observations on the Evolution of Compensation Policies Since 2008

First, I would like to offer my observations as to financial industry compensation trends and describe how financial institutions have transformed their compensation practices in response to the financial crisis, the Dodd-Frank Act, board oversight requirements, and other recent regulations.

All of the members of the Roundtable and, indeed, other of my clients which are not in the financial services industry, have been working very hard to design and implement best practices and compensation programs that reflect appropriate incentives to motivate employees to achieve defined corporate objectives.

Large financial institutions have embraced principles of safety and soundness and profoundly changed their executive compensation practices. Today, financial institutions have become the thought leaders in corporate America on issues such as pay for performance and mitigating the potential risks created by incentive compensation programs.

Aligning executive pay with company performance has been an objective of the boards of directors and compensation committees of financial institutions and other public companies for decades. However, the economic crisis—beginning with 2008 and continuing to today—surprised even the most experienced leaders of business with how close to the brink that our economy and businesses came. From that experience came difficult but not easily forgotten lessons—particularly for those who were convinced that "that could never happen." Many companies have responded, even those that are not in the financial services industry, by adopting a more balanced and comprehensive view of compensation philosophies with a view to align employees compensation to a more conservative risk profile and to align corporate goals with investor priorities.

In addition, since 2008 Board Compensation Committees have sharpened their focus on pay for performance as part of good corporate governance. While no silver bullet exists to align executive pay to company performance perfectly, significant efforts are being made. However, several challenges exist in aligning long-term compensation plan components to performance priorities. For example, during highly volatile economic times, multiyear priorities may change dramatically and indeed, external changes may heighten rather than mitigate risks in compensation plans. Management and Board Compensation Committees must be vigilant to recognize these changes and have plans that can be appropriately changed. One effective way to align pay for performance is to design plans to avoid paying for short-term gains at the expense of true long-term performance. In the financial institutions area, various forms of risk mitigation are applied to incentive compensation policies, and have become a significant component of pay for performance.

For example, Section 165 of the Dodd-Frank Act, would require large financial institutions designated as systemically important to establish a separate Board-level "Risk Committee" consisting of independent directors, with at least one risk expert on it.[1] Most large bank holding companies have established separate risk committees of the board. Risk management and oversight have become a major component of the work of financial institution Boards and Compensation Committees. In much the same way that Say on Pay proxy proposals moved from being a financial institution only issue to one that effects most public companies, nonfinancial companies have established separate board level risk committees.

Roundtable Survey

Financial institutions have led the way in designing plans with reduced risks attributable to incentive compensation, greater transparency, better correlation between pay and performance, and just plain lower compensation. One hundred percent (100 percent) of surveyed Roundtable companies reported that they had significantly reformed their executive compensation practices since 2008, according to a 2011 Financial Services Roundtable membership survey. In part, the Survey found:

- Overall levels of compensation were down for the last few years.
- Annual bonuses have come down.
- The benefits, perquisites, and other contractual protections contained in the employment agreements of the senior executives—things like golden parachutes

[1] Dodd-Frank Act Section 165, "Enhanced Supervision and Prudential Standards for Nonbank Financial Companies Supervised by the Board of Governors and Certain Bank Holding Companies."

and supplemental executive retirement plans—have been reduced significantly since 2008.

Roundtable member companies reported many other executive compensation reforms they had undertaken over the last 3 years, all without legislative or regulatory mandates, including:

1. Instituting maximum payout caps (87 percent of companies)
2. Having claw back provisions in place (83 percent of companies)
3. Improving risk management (77 percent of companies)
4. Introducing new performance metrics (69 percent of companies)
5. Restricting stock awards (52 percent of companies)
6. Instituting new performance reviews (45 percent of companies)
7. Creating stock holding requirements (41 percent of companies)
8. Developing new bonus formulas (38 percent of companies)
9. Increasing base salary and linked performance to stock (31 percent of companies)

Federal Reserve Board Report

In October 2011, the Board of Governors of the Federal Reserve (the "Federal Reserve") released its report "Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations," as mandated by the Dodd-Frank Act. The Horizontal Review was a supervisory initiative, under the Federal Reserve's Proposed Guidance on Sound Incentive Compensation Policies (the "Proposed Guidance"),[2] to perform a multidisciplinary, horizontal review of incentive compensation practices at 25 large, complex banking organizations (LCBOs).[3]

The Federal Reserve observed that "every firm in the review has made progress during the review in developing practices and procedures that will internalize the principles of the interagency guidance into management systems at each firm."

> With the oversight of the Federal Reserve and other banking agencies, the firms in the horizontal review have implemented new practices to make employees' incentive compensation sensitive to risk.

In its 2011 Report, the Federal Reserve concluded that:

1. The largest banks are already at or above Dodd-Frank proposed guidelines for executive compensation (to defer 50 percent for 3 years);
2. Senior executives have more than 60 percent of their incentive compensation deferred on average;
3. Some of the most senior executives have more than 80 percent deferred;
4. Deferral periods generally range from 3 to 5 years, with 3 years the most common.

Finally, for last year's proxy season, and again this year, most financial institutions, and other public companies generally, directly address pay for performance in their proxy statements. Institutions and other corporations generally took this step to address the need to seek shareholder approval of the executives' pay packages—shareholder say on pay. The financial industry directly took on this issue in both the Compensation Discussion and Analysis CD&A section of the proxy—usually with an executive summary—and in a supporting statement for the shareholder say on pay resolution. Last year financial institutions and other public companies provided investors with heightened transparency through detailed charts showing companies' performance compared to executive pay, and as well as better explanations in the text of proxy statements.

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[2] Proposed Guidance on Sound Incentive Compensation Policies, 74 Fed. Reg. 55227 (Oct. 27, 2009).

[3] The financial institutions in the Incentive Compensation Horizontal Review were Ally Financial Inc.; American Express Company; Bank of America Corporation; The Bank of New York Mellon Corporation; Capital One Financial Corporation; Citigroup Inc.; Discover Financial Services; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; Northern Trust Corporation; The PNC Financial Services Group, Inc.; State Street Corporation; SunTrust Banks, Inc.; U.S. Bancorp; and Wells Fargo & Company; and the U.S. operations of Barclays plc, BNP Paribas, Credit Suisse Group AG, Deutsche Bank AG, HSBC Holdings plc, Royal Bank of Canada, The Royal Bank of Scotland Group plc, Societe Generale, and UBS AG.

Recent Laws and Regulations Imposing New Requirements on Executive Compensation and Corporate Governance

Dramatic changes in financial institutions' compensation programs since 2008 have occurred. To begin with, financial institutions dramatically changed their executive compensation programs in reaction to lessons learned from the financial crisis. Other changes were prompted by the various laws passed by Congress and regulations promulgated by the financial regulatory agencies. However, financial institutions not only have complied with new regulatory strictures; institutions have actively embraced the role as thought leaders nationwide in how to balance risk with reward, implement appropriate compensation claw backs, compensation holdbacks, and other needed changes.

These new attitudes can be seen in the way that the industry responded to significant changes required under the Troubled Asset Relief Program (TARP), the 2010 Interagency Guidance, the Horizontal Review process, and the Dodd-Frank Act.

TARP

In October 2008, President Bush signed into law the Emergency Economic Stabilization Act (EESA),[4] creating the Troubled Assets Relief Program (TARP). In February 2009, President Obama signed into law the American Recovery and Reinvestment Act (ARRA),[5] which included amendments to the executive compensation provisions of EESA. Section 111 of EESA, as amended by ARRA,[6] imposed a variety of new limitations and restrictions on the executive compensation plans and arrangements of any entity that received financial assistance under TARP. These restrictions and standards applied throughout the period during which any obligation arising from financial assistance provided under TARP remained outstanding (the "TARP obligation period").

SEC Reporting Rules

The influence of the executive compensation provisions affecting financial institutions receiving TARP funds were further extended on December 15, 2009, when the U.S. Securities and Exchange Commission (SEC) issued a new Final Rule on executive compensation disclosure and corporate governance that imposes risk assessment requirements similar to those under TARP to all publicly traded companies, beginning in 2010.[7] The SEC's Final Rule requires all public companies to assess their compensation policies and practices to determine if they are reasonably likely to have a material adverse effect on the institution.

Horizontal Review

In late 2009, the Federal Reserve initiated a multidisciplinary, horizontal review of incentive compensation practices at 25 LCBOs, to foster implementation of improved practices.[8] The Horizontal Review was a supervisory initiative, under the Federal Reserve Board's 2009 Proposed Guidance on Sound Incentive Compensation Policies,[9] which preceded the Interagency Guidance described below. The Horizontal Review was designed to assess:

- the potential for incentive compensation arrangements or practices to encourage imprudent risk-taking;
- the actions an institution has taken or proposes to take to correct deficiencies in its incentive compensation practices; and
- the adequacy of the organization's compensation-related risk-management, control, and corporate governance processes.

One goal of the horizontal review was to assist the Federal Reserve's understanding of incentive compensation practices across financial institutions and cat-

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[4] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).
[5] American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).
[6] 12 U.S.C. §5221 (2010).
[7] Proxy Disclosure Enhancements, 74 *Fed. Reg.* 68334 (Dec. 23, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249 and 274).
[8] The financial institutions in the Incentive Compensation Horizontal Review were Ally Financial Inc.; American Express Company; Bank of America Corporation; The Bank of New York Mellon Corporation; Capital One Financial Corporation; Citigroup Inc.; Discover Financial Services; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; Northern Trust Corporation; The PNC Financial Services Group, Inc.; State Street Corporation; SunTrust Banks, Inc.; U.S. Bancorp; and Wells Fargo & Company; and the U.S. operations of Barclays plc, BNP Paribas, Credit Suisse Group AG, Deutsche Bank AG, HSBC Holdings plc, Royal Bank of Canada, The Royal Bank of Scotland Group plc, Societe Generale, and UBS AG.
[9] "Proposed Guidance on Sound Incentive Compensation Policies", 74 *Fed. Reg.* 55227 (Oct. 27, 2009).

egories of employees within institutions. The second, more important goal was to guide each financial institution in implementing the interagency guidance on sound incentive compensation policies.

In four key areas of the Horizontal Review, the Federal Reserve concluded that:

- *Effective Incentive Compensation Plan Design.* All firms in the horizontal review have implemented new practices to balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks. The most widely used methods for doing so are risk adjustment of awards and deferral of payments.
- *Progress in Identifying Key Employees.* At most large banking organizations, thousands or tens of thousands of employees have a hand in risk taking. Yet, before the crisis, the conventional wisdom at most firms was that risk-based incentives were important only for a small number of senior or highly paid employees and no firm systematically identified the relevant employees who could, either individually or as a group, influence risk. All firms in the horizontal review have made progress in identifying the employees for whom incentive compensation arrangements may, if not properly structured, pose a threat to the organization's safety and soundness. All firms in the horizontal review now recognize the importance of establishing sound incentive compensation programs that do not encourage imprudent risk taking for those who can individually affect the risk profile of the firm.
- *Changing Risk-Management Processes and Controls*. Because firms did not consider risk in the design of incentive compensation arrangements before the crisis, firms rarely involved risk management and control personnel when considering and carrying out incentive compensation arrangements. All firms in the horizontal review have changed risk-management processes and internal controls to reinforce and support the development and maintenance of balanced incentive compensation arrangements. Risk-management and control personnel are engaged in the design and operation of incentive compensation arrangements of other employees to ensure that risk is properly considered.
- *Progress in Altering Corporate Governance Frameworks.* At the outset of the horizontal review, the boards of directors of most firms had begun to consider the relationship between incentive compensation and risk, though many were focused exclusively on the incentive compensation of their firm's most senior executives. Since then, all firms in the horizontal review have made progress in altering their corporate governance frameworks to be attentive to risk-taking incentives created by the incentive compensation process for employees throughout the firm. The role of boards of directors in incentive compensation has expanded, as has the amount of risk information provided to boards related to incentive compensation.

2010 Interagency Guidance

In June 2010, the Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System, (Federal Reserve); Federal Deposit Insurance Corporation (FDIC); and Office of Thrift Supervision, Treasury (OTS) issued Guidance on Sound Incentive Compensation Policies in final form (the "2010 Interagency Guidance").

The 2010 Interagency Guidance describes four methods that are "often used to make compensation more sensitive to risk": (i) risk adjustment of awards; (ii) deferral of payment; (iii) longer performance periods; and (iv) reduced sensitivity to short-term performance. (In February 2011, new interagency rules were proposed, as described below. These new rules, when finalized, may make the 2010 Interagency Guidance obsolete.)

The Dodd-Frank Act

In July 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act[10] (the "Dodd-Frank Act"). The Dodd-Frank Act technically became effective on July 21, 2010. However, many of the provisions relating to executive compensation are not self-executing, in that they require the SEC to modify its requirements for maintaining an effective registration under the Securities Exchange Act of 1934 (the "Exchange Act") and/or require the national securities exchanges to modify their listing standards.

The Dodd-Frank Act included between 10 and 13 separate provisions directly or indirectly effecting executive compensation, depending on how you count, including two applicable to financial institutions only.

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[10] Pub. L. 111-203, H.R. 4173

1. Dodd-Frank Act Section 951, added a new Section 14A to the Exchange Act, entitled "Shareholder Approval of Executive Compensation", which provides that, not less frequently than once every 3 years, a company's annual proxy statement must include a separate resolution, subject to nonbinding shareholder vote, to approve the compensation of executives, as disclosed in the company's Compensation Discussion and Analysis (CD&A), the compensation tables, and any related material. Dodd-Frank Act Section 951 also requires that, not less frequently than once every 6 years, the proxy statement must include a separate resolution subject to a nonbinding shareholder vote to determine whether future votes on the resolutions required under the preceding paragraph will occur every 1, 2, or 3 years.
2. Dodd-Frank Act Section 951 added a new Section 14A to the Exchange Act, "Shareholder Approval of 'Golden Parachute' Compensation", which requires in any proxy solicitation material for a meeting of shareholders at which the shareholders are asked to approve an acquisition or merger, the party soliciting the proxy must disclose any agreements or understandings that the party soliciting the proxy has with any named executive officers of company concerning any type of compensation that relates to the transaction and the aggregate total of all such compensation that may be paid or become payable to or on behalf of such executive officer.
3. Dodd-Frank Act Section 952 added a new Section 10C(a) to the Exchange Act, "Independence of Compensation Committees", which requires the SEC to promulgate rules that direct the NYSE, NASDAQ, and other national securities exchanges and associations to prohibit the listing of any equity security of a company that does not have an independent compensation committee.
4. Dodd-Frank Act Section 952 added a new Section 10C(b) to the Exchange Act, "Independence of Compensation Consultants and Other Compensation Committee Advisers", which provides that the compensation committee, in its sole discretion, may obtain the advice of independent legal counsel, compensation consultants, and other advisers. If it does, the committee may only select a compensation consultant, legal counsel or other adviser after taking into consideration factors identified by the SEC.
5. Dodd-Frank Act Section 954, "Recovery of Erroneously Awarded Compensation Policy", added new Section 10D to the Exchange Act, which requires the SEC to direct the national securities exchanges to prohibit the listing of any security of an issuer that does not develop and implement a claw back policy.
6. Dodd-Frank Act Section 955, "Disclosure of Hedging by Employees and Directors", added a new subsection 14(j) to the Exchange Act, which requires the SEC to require companies to disclose in their annual proxy statement whether the company permits any employee or director to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities (1) granted to the employee or director by the company as part of the compensation; or (2) held, directly or indirectly, by the employee or director.
7. Dodd-Frank Act Section 953(a), "Disclosure of Pay Versus Performance", added a new 14(i) to the Exchange Act, which requires each public company to disclose in its annual proxy statement "information that shows the relationship between executive compensation actually paid and the financial performance of the issuer."
8. Dodd-Frank Act Section 972, "Corporate Governance", added a new Section 14B to the Exchange Act, which requires the SEC to issue rules that requires the company to disclose in its annual proxy statement the reasons why it has chosen the same or different persons to serve as chairman of the board of directors and chief executive officer (or in equivalent positions) of the company.
9. Dodd-Frank Act Section 953(b), "Executive Compensation Disclosures", requires the SEC to amend the proxy statement disclosure rules to require each public company to disclose the ratio of the median of the annual total compensation of all employees of the company, except the CEO to the annual total compensation of the CEO.
10. Dodd-Frank Act Section 957, "Elimination of Discretionary Voting by Brokers on Executive Compensation Proposals", amended Section 6(b) of the Exchange Act.
11. Dodd Frank-Act Section 956, "Enhanced Compensation Structure Reporting", applies only to financial institutions with assets of $1 billion or more.

12. Dodd-Frank Act Section 165, "Enhanced Supervision and Prudential Standards for Nonbank Financial Companies Supervised by the Board of Governors and Certain Bank Holding Companies", requires the Federal Reserve to establish prudential standards for nonbank financial companies supervised by it and bank holding companies (BHCs) with total consolidated assets equal to or greater than $50 million, which are more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks to the Nation's financial stability.

Interagency Rules Under Dodd-Frank Act 956

In February 2011, the Office of the Comptroller of the Currency, Treasury (OCC), Federal Reserve System, FDIC, Office of Thrift Supervision, Treasury (OTS), National Credit Union Administration (NCUA), SEC, and Federal Housing Finance Agency (FHFA), proposed rules to implement Dodd-Frank Act Section 956, "Enhanced Compensation Structure Reporting." Section 956 requires the reporting of incentive-based compensation arrangements by a covered financial institution, and prohibits incentive-based compensation arrangements that encourage inappropriate risks by covered financial institutions by providing a covered person with excessive compensation, or that could lead to material financial loss to the covered financial institution. These rules have not been finalized.

FDIC Final Rules

In July 2011, the FDIC issued final rules to implement certain provisions of its authority to resolve covered financial companies under Section 210(s)(3) of the Dodd-Frank Act, which directed the FDIC to promulgate regulations with respect to recoupment of compensation from senior executives or directors materially responsible for the failed condition of a covered financial company. The final rules adopt a rebuttable presumption that certain senior executives or directors are "substantially responsible" for the failed condition of a financial entity company that is placed into receivership under the orderly liquidation authority of the Dodd-Frank Act.

Current Laws and Regulation Are Sufficient

The Dodd-Frank Act and Interagency Guidance on executive compensation and corporate governance promulgated since 2009 give financial institutions and other nonfinancial public companies, the mandates and tools they need to design appropriate compensation plans and give regulators the tools they need to monitor them. The Interagency final rules under Dodd-Frank Act Section 956 will complete the picture.

For financial institutions and their boards of directors, there is no turning back on the good governance reforms and best practices they have adopted since 2008. Boards of directors and compensation committee members are highly intelligent and experienced fiduciaries. They value their reputations. They want to do the right thing. They have learned important lessons from the financial crisis and they have been further empowered by the legislation and regulation promulgated in its wake.

Boards of directors, compensation committee members, and management at financial institutions are taking much more care in the design and implementation of their incentive plans. They are involving more outside independent experts in the process. These independent advisors have provided not only industry specific expertise that the boards or committee members may not possess, but also access to good benchmarking data and independent thought.

Roundtable Study on Incentive-Based Compensation Practices

Roundtable members are cognizant of the risk that faulty compensation practices may result in a material financial loss. In order to gauge what actions industry members are taking with respect to their incentive-based compensation practices, the Roundtable conducted a study of a portion of its membership. The Roundtable collected detailed information and commentary from numerous member companies regarding both their risk management strategies and their procedures for determining compensation.

Roundtable Members are committed to robust planning and oversight of incentive-based compensation plans. Each of the companies who participated in the study maintains a compensation committee of the board of directors that must approve all salary packages for the Chief Executive Officer and other high-level employees. The committee also must approve any material change in the compensation plans of the employees they monitor. At several companies, the compensation committee retains the discretion to reduce any award due to the overall financial performance of the company.

Roundtable members generally use detailed data to create their compensation plans for high-level executives. Nearly 90 percent of study respondents employ a board of director's compensation consultant that conducts a peer-review analysis of the compensation plans put before the board, and 87 percent establish maximum payout targets for high-level executives.

Each of the companies surveyed also employ policies and procedures concerning the incentive-based compensation of mid-level and low-level employees, though these practices vary widely. Some companies report centralized oversight of all incentive-based compensation arrangements. Other respondents make use of external audits. Over 75 percent of companies employ claw back agreements or holdback procedures for the vesting of incentive-based compensation beyond a certain level.

Industry members are actively monitoring and changing the content of their incentive-based compensation programs. All of the companies involved in the Roundtable study reported changes to their incentive-based compensation practices since 2008. An overwhelming majority of these companies, 83 percent, reported that the risk of material financial loss was a leading factor in instituting changes to their past incentive-based compensation systems.

The strategies used by Roundtable companies to address risk vary widely as each company attempts to devise and apply solutions that work for its circumstances. Study participants mentioned more than 15 different approaches that are currently being analyzed and implemented by either the compensation committee or their human resources departments. In all cases, a variety of three or more approaches is being used.

Finally, the statutory and regulatory changes provide great tools sufficient for regulators to examine for appropriate practices, to test for best practices implementation and review results through institution reports.

We appreciate the opportunity to provide this statement to the Subcommittee for its consideration. We would be happy to respond to questions the Subcommittee Members may have.