Testimony Prepared for the Hearing:

Executive Compensation Oversight after the Dodd-Frank Wall Street Reform and Consumer Protection Act

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By

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Chairman Frank, Ranking Member Bachus and Members of the Committee, it is a privilege to testify to this committee on the topic of the oversight of compensation in financial services companies.

Key Points in this Testimony

- The Dodd-Frank bill has provided a new (and in my judgment very valuable) framework for regulation of financial institutions, however, it leaves to regulators many tasks of implementation.
- The Act gives regulators the authority to set rules for compensation of senior employees of financial institutions.
- The level of pay for executives and other risk-takers (traders, loan officers, investment bankers, brokers and so on) should not be regulated; Dodd-Frank does not mandate regulation of pay levels for executives; regulators should not either.
- Financial regulators have a legitimate interest in setting compensation rules because the *structure* of compensation can have an impact on the level of risk-taking. Decisions made within individual institutions may be excessively risky because executives are counting on government support should the company lose its risky bets.
- To offset this incentive to take excessive risk, a significant part of the pay of executives and other risk takers should be delayed and paid out over several years.
- The Squam Lake proposal is that a portion of each executive's compensation be withheld at the time it is earned and invested in cash-equivalents. This would be paid out to the executive over five years provided the company does not require extraordinary assistance from the government or become bankrupt.
- Imposing claw-back provisions is a mistake because they are unworkable.
- My own view is that regulation of compensation should extend to traders and others within regulated financial institution that can take large financial bets. Regulators should not be involved in setting detailed compensation plans, but senior executives should be expected to explain to regulators how their compensation structure matches their overall risk management strategy. Other members of the Squam Lake Group do not support this position.

Introduction

In the wake of the financial crisis and the bail outs of many financial institutions, the American people became outraged at the very high salaries and bonuses being paid to financial executives and traders. It is understandable that taxpayers do not want government funds be used to pay such bonuses to executives who have contributed to the failure of their companies and the need for taxpayer funds, and Congress and the President responded to the situation by putting in place compensation restrictions administered by a special master.

While the Dodd-Frank Act made important steps forward in improving financial regulation a lot remains to be done during implementation. This is understandable, because the House and Senate are not the right place for detailed rule making and, of course, some important issues, such as capital and liquidity requirements, have to be worked out internationally to ensure a level playing field for US financial institutions. The Basel process has not been either timely or effective in past years, but there are indications now that it is moving more quickly and constructively to develop harmonized standards.

The financial crisis is not over yet; its effects still linger and the recession that it caused is very much still with us, but the subject of this hearing is welcome: to review the supervision of compensation structures within financial institutions. There were many causes of the crisis but one of the contributory factors was that traders and CEOs were often rewarded on the basis of short term profits, encouraging them to take excessive risks that paid off handsomely in the short run but that caused large losses over a longer period. One element of a more stable financial system involves compensation structures for those in financial institutions that do not incent excessive risk taking.

In the fall of 2008 when the financial crisis was in full flight a group of financial economists met for a weekend at a retreat center on Squam Lake New Hampshire to look at longer term issues in policymaking. The aspiration was to help guide the evolving reform of capital markets—their structure, function and regulation. It was a diverse group with a range of academic, private sector and public policy experience. The resulting work of the group was published this year in a book, *The Squam Lake Report: Fixing the Financial System,* by Princeton University Press. In this testimony I will lay out the recommendations made by the Squam Lakers concerning compensation, and comment on the relation between these and the provisions of the Dodd-Frank bill.

I will then also provide a discussion of proposals that have been made elsewhere. US regulators are iterating with private sector institutions to set up improved internal risk management structures and to rely on deferred compensation. The Financial Services Authority in London issued in 2009 its recommendations on compensation.

I then draw my own final conclusion and assessment of the proposals on regulation of compensation.

The Squam Lake Recommendations on Compensation in Financial Services Companies

There are two recommendations from the Squam Lake Report that relate to compensation in financial services companies. The first is to discourage any regulation of the *level* of pay. There has been no convincing evidence that high levels of compensation create an inherent or fundamental risk for these companies or the larger economy. In fact, the report argues that these executives contribute mightily to the success of their employers—even a small difference in talent can translate into tremendous returns given the size and complications present in this business.

Even among those with similar professional qualifications, there are tangible differences in the skills of financial employees, and even a small difference in skill can have an enormous impact on the profits of a financial firm. An extra 1 percent return on a $10 billion investment portfolio adds $100 million to a firm's earnings. An investment banker who structures a transaction incorrectly can quickly transform a large acquisition from a brilliant idea to a $200 billion albatross.

In addition, it is relatively easy for financial executives to move from one firm to another because they rarely rely on firm-specific inputs such as particular machines, patented processes, or other unique forms of capital. When there are synergies within a group of workers, such as an investment-banking team, the whole group can move from employer to employer. This mobility gives employees great bargaining power when negotiating their compensation.

Limits on the level of compensation in the financial services industry are also likely to trigger unintended and undesirable consequences. Pay caps imposed on a subset of firms, for example, could push their most talented bankers, traders, and other key professionals to unregulated firms. Broader limits on the compensation of financial executives may even drive parts of this highly mobile industry to more receptive countries.

Past efforts to cap executive compensation have often created unexpected problems including, in some cases, an increase in the pay of those whose wages were meant to be constrained. A 1982 law aimed at limiting golden-parachute payments in the United States paradoxically extended their use to new firms and new situations. In particular, firms discovered they could circumvent the new taxes on golden-parachute payments by extending the payments to all terminations without cause, not just those associated with a change in control. Similarly, a 1993 American law aimed at limiting the tax deductibility of executive salaries sparked the proliferation of riskier option-based compensation.[i] Today the difficulty remains the same: regulating the level of compensation for financial executives could do more harm than good, both to the firms being regulated and to the overall economy.

Our recommendation that governments should avoid regulating the level of compensation is not a rejection of proposals intended to improve corporate governance, such as say-on-pay votes and tighter standards of independence for compensation committee members. Such proposals may make corporations more productive by increasing management's incentives to act in the long-term interest of shareholders. However, changes that reduce the conflict between management and shareholders can magnify the conflict between financial institutions and society. This is an example of the more general point that regulations can easily have costly unintended consequences.

Although regulators should generally not set the level of compensation for financial executives, the possibility that governments will bail out financial firms during a crisis implies that stakeholders in financial firms—executives, creditors, and shareholders—do not face the full cost of their failure. As a result, these institutions have an incentive to take more risks than they would if they bore all the costs of failure. This, in turn, increases the likelihood of bank failures, the potential for systemic risk, and expected taxpayer costs. These market concerns lead us to recommend regulatory guidelines for the *structure* of compensation in financial institutions.

A major goal of capital-market reform should be to force financial firms to bear the full cost of their actions. In the Squam Lake Report, we propose several mechanisms to help achieve this goal and executive compensation is one such approach for inducing financial firms to internalize the costs of their actions. Specifically, if a significant portion of senior management's compensation is deferred and contingent on the firm surviving without extraordinary government assistance, managers will be less inclined to pursue risky strategies.

Our recommendation is that systemically important financial institutions should withhold a significant share of each senior manager's total annual compensation for several years. The withheld compensation should not take the form of stock or stock options. Rather, each holdback should be for a fixed dollar amount, and employees would forfeit their holdbacks if the firm goes bankrupt or receives extraordinary government assistance.

In effect, holdbacks hold employees directly accountable if their firm fails. They are essentially providing insurance against failure, and like any other insurance provider, they earn a fixed amount (akin to an insurance premium) if the firm does well, and bear a loss if the firm does poorly. As a result, this deferred compensation partially offsets management's incentive to pursue risky strategies that might result in government bailouts. Similarly, rather than wait for a bailout during a financial crisis, the management of a troubled firm would have a powerful incentive to find a private solution, perhaps by boosting the firm's liquidity to prevent a run, raising new capital, or facilitating a takeover by another firm. Because taxpayer losses trigger executive losses, holdbacks better align the personal incentives of managers with the fiscal and systemic goals of taxpayers.

More familiar forms of deferred compensation, such as stock awards and options, do little to reduce the conflict between systemically important financial institutions and society. Managers who receive stock become more aligned with stockholders, but this does not align them with taxpayers. Managers and stockholders both capture the upside when things go well, and transfer at least some of the losses to taxpayers when things go badly. Stock options give managers even more incentive to take risk because they pay off only if the stock price moves up. Thus, compensation that is deferred to satisfy this regulatory obligation should be for a fixed monetary amount. For example, firms might be required to withhold 20 percent of the estimated dollar value of each executive's annual compensation, including cash, stock, and option grants, for five years. At the end of this period, employees would receive the fixed dollar amount of their deferred compensation if the firm has not declared bankruptcy or received extraordinary government support.

Regulators need to specify clearly what events would trigger the loss of holdbacks. The triggers should include capital injections like those of the Troubled Asset Relief Program. Another should be unusual guarantees by the government of a firm's debt. We do not think triggering events should include less extreme events like borrowing from the Federal Reserve discount window.

Resignation from the firm should not accelerate the payment of an employee's holdbacks. Accelerating payment for employees who quit would weaken their concern about the long-term consequences of their actions. Moreover, it could create an incentive to quit, particularly if the employee discovers the firm may be in trouble. In the same spirit, managers should not be rewarded for taking their firm into bankruptcy. If a firm declares bankruptcy, its managers should receive their holdbacks only after its other creditors have been made whole.

This positioning of managers' claims means that a firm's obligation to pay deferred compensation does not affect its payments to other creditors in bankruptcy. Moreover, managers have no reason to push their firm into bankruptcy in an effort to collect compensation holdbacks. Thus, commitments to pay accumulated holdbacks do not put the financial institution or its other creditors at risk. Assets the firm holds to pay these obligations are capital that is available to pay other debts. Large firms that implement aggressive holdbacks can boost by billions of dollars the capital they have available to buffer against a major shock.

Compensation holdbacks are not a panacea. No single tool can perfectly align the incentives of stakeholders in financial companies with society's desire to avoid systemic financial distress. However, transparent compensation holdbacks with clearly specified trigger mechanisms would help reduce the chances of another crisis.

Compensation Oversight in the Dodd-Frank Bill in Relation to Squam Lake[1]

The portion of the Dodd-Frank Wall Street Reform and Consumer Protection Act that addresses executive compensation adheres to our first recommendation. The Act avoids rigid limits on the level of executive compensation at financial institutions and public companies of the kind that were part of the TARP legislation. In regard to our second recommendation, the act articulated principles for executive compensation but, understandably, left the specific provisions to be jointly enumerated by various government regulators.

The major components of this portion of the Act deal with financial institutions but also other public companies. They specify heightened disclosure of information related to executive compensation, rules to maintain the independence of compensation committees, a greater say for company shareholders, and a claw-back provision. For example, the law calls for the SEC to issue disclosure rules for the relationship between compensation and company performance as well as the ratio between the median

[1] Since reading legal documents is not my strongpoint, I have relied in part on detailed summaries of the bill, notably the summary provided by Davis Polk.

employee and CEO compensation. The claw-back provision enables the recovery of excess incentive-based compensation following a restatement of company earnings.

For shareholder issues, broker discretionary votes are eliminated for certain matters and shareholders are now required to have non-binding votes on executive compensation and golden parachutes. This may further align shareholder and management interests, but as mentioned above, this is not the same as alignment with taxpayer interests.

In terms of executive pay at financial institutions, the Act calls on federal regulators to jointly prescribe regulations for 1) disclosure of all incentive-based compensation structures at covered institutions and 2) prohibiting pay arrangements that incentivize inappropriate risk-taking by employees, directors or principal shareholders that could lead to material financial loss to the covered financial institution.[2]

Federal regulators charged with enforcing these provisions include the SEC, the Federal Reserve, the OCC, the FDIC, OTC, the National Credit Union Administration Board and FHFA. The principle for establishing these standards, as discussed in the Act, is the Federal Deposit Insurance Act.

As it stands, therefore, the Dodd-Frank bill does not include explicit provisions for deferred compensation that would be forfeit in the event that a financial institution were to fail or obtain material assistance from the government. However, the fact that the Act prohibits pay arrangements that incentivize inappropriate risk taking allows regulators to promulgate rules that would accomplish this goal.

Proposals Formulated by US Regulators

In October 2009 the Federal Reserve requested comment on "Proposed Guidance on Sound Incentive Compensation Policies." After reviewing 34 comments, the Fed--along with the OCC, OTS, and FDIC—released final guidance on compensation structure on June 21, 2010. These 3 principles are:

- Incentive compensation arrangements at a banking organization should provide employees incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk.
- These arrangements should be compatible with effective controls and risk-management.
- These arrangements should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

[2] Covered financial institutions include depository institutions and depository institution holding companies, broker dealers, credit unions, investment advisors, Fannie Mae and Freddie Mac, and any other financial institution determined by the appropriate federal regulators. Covered financial institutions with assets of less than $1 billion are excluded.

According to the press release, “The Federal Reserve, in cooperation with the other banking agencies, has completed a first round of in-depth analysis of incentive compensation practices at large, complex banking organizations as part of a so-called horizontal review, a coordinated examination of practices across multiple firms. Last month, the Federal Reserve delivered assessments to the firms that included analysis of current compensation practices and areas requiring prompt attention. Firms are submitting plans to the Federal Reserve outlining steps and timelines for addressing outstanding issues to ensure that incentive compensation plans do not encourage excessive risk-taking.

“During the next stage, the banking agencies will be conducting additional cross-firm, horizontal reviews of incentive compensation practices at the large, complex banking organizations for employees in certain business lines, such as mortgage originators. The agencies will also be following up on specific areas that were found to be deficient at many firms, such as:

- Many firms need better ways to identify which employees, either individually or as a group, can expose banking organizations to material risk.
- While many firms are using or are considering various methods to make incentive compensation more risk sensitive, many are not fully capturing the risks involved and are not applying such methods to enough employees.
- Many firms are using deferral arrangements to adjust for risk, but they are taking a "one-size-fits-all" approach and are not tailoring these deferral arrangements according to the type or duration of risk.
- Many firms do not have adequate mechanisms to evaluate whether established practices are successful in balancing risk.

“In addition to the work with the large, complex banking organizations, the agencies are also working to incorporate oversight of incentive compensation arrangements into the regular examination process for smaller firms. These reviews are being tailored to take account of the size, complexity, and other characteristics of these banking organizations.” (This quotation is taken from: http://www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm)

The approach being used by the Federal Reserve and other financial regulators is to iterate with financial companies and other interested parties in order to determine what approach to compensation regulation will be workable, reduce risk and avoid undermining the incentives for real performance. This is a good approach to use, although with the caveat that the approach to risk management must adequately take into account the interests of taxpayers and not just align employee and shareholder interests.

Private Companies are Changing their Compensation Practices.

The idea of withholding some fraction of employee compensation for a period of time is not a new one, indeed several banks already had in place such plans. My Brookings colleague Douglas Elliott has written about executive compensation based on his experience at JP Morgan Chase, where he was an investment banker. JP Morgan has had in place a plan for several years where bonuses are paid out over time.[3]

On October 20, 2009 the Swiss bank Credit Suisse announced new rules for how it would pay its top employees. First, a higher portion of total compensation will come in the form of fixed monthly salary. Second, a higher proportion of variable compensation (bonus pay) will be deferred. Third, deferred variable compensation will be more closely tied to performance as measured by share price, return on equity, and the profit/loss of the employee's unit.

These provisions may not dramatically alter or even lower the level of compensation for executives, the goal is to align better pay practices with long-term employee and shareholder interests.

The reforms being introduced in private companies, including some practices that were in place prior to the crisis, indicate that enlightened financial institutions can see that it is in their own interests to follow risk-reducing policies. Their policies are designed to align employee incentives more closely with shareholder incentives and the longer run stability of their companies.

Compensation Principles Proposed by the UK's Financial Services Authority

The UK suffered in the financial crisis at least as badly as did the United States. The FSA is widely considered to have failed in its mission to supervise and regulate financial institutions based in the UK prior to the crisis, and the apparent lack of communication between the FSA and the Bank of England contributed to the severity of the crisis. Despite these historical shortcomings, there are good reasons to look at developments in the regulation of compensation of financial companies in the UK. London has been and will continue to be one of two large global financial centers, together with New York, and an important competitor to it. New York and London should compete for financial business, but they should have compatible policies in dealing the problem of excessive risk-taking. Moreover, the FSA did not have a monopoly on making mistakes in the period leading up to the crisis.

In March 2009 the FSA released a Consultation Paper on remuneration practices in financial institutions.[4] The paper states that it is not concerned about the absolute level of compensation (in line with the Squam Lake position), but that it is concerned about "remuneration practices which may pose risks to the firm and be inconsistent with effective risk management."

The paper proposes a rule, which states: "A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote

[3] His work can be found at http://www.brookings.edu/papers/2010/0111_wall_street_elliott.aspx

[4] Financial Services Authority, *Consultation Paper 09/10, Reforming remuneration practices in financial services,* March 2009.

effective risk management." In accordance with the traditional approach to regulation in the UK, the FSA states that the way in which this rule is met will depend upon the nature of the individual financial institutions. However, it does propose a set of ten principles that it believes should govern compensation structures and the following four are of particular interest.

Principle 4 states that bonus pools for employees should be based on profits and the size of the pool should include an adjustment for current and future risk, and take into account the cost of capital employed and the liquidity required. Principle 5 states that the performance-based portion of compensation should be based on longer term performance. Principle 6 states that performance assessment should be based significantly on non-financial metrics, including adherence to effective risk management and compliance with the regulatory system, including relevant overseas regulatory requirements. Principle 9 states that the majority of any significant bonus should be deferred with a minimum vesting period. In the guidance for this principle, the FSA states that at least two-thirds of the bonus be deferred. Principle 10 links the deferred elements of the compensation structure to the firm's future performance.

Conclusions on a Safer Compensation Structure for Financial Institutions

The financial crisis revealed failures in both financial markets and regulation. We cannot rely simply on market forces to prevent another crisis nor can we expect that regulators will be able to foresee and then forestall the next bubble or crisis. The best approach is to get market forces and regulatory rules and principles working together to reduce risk-taking while preserving competition and innovation. The Dodd-Frank act was an important step towards improving regulation and supervision but much of the work of implementation remains to be done. US regulators, together with the international process at Basel, will have to establish rules that are effective and efficient. This Committee has an important interest in following this process to make sure its intentions area followed.

The Squam Lake group identified a market failure in that individuals and particular financial institutions do not take into account the systemic risk that can be caused by their risk taking activities. This market failure is exacerbated by the fact that in the past policymakers have stepped in to rescue institutions that are in danger of bankruptcy and, despite the best of intentions, there is always the possibility that they will do so again in the future. At some point in the years ahead, traders or senior executives may make decisions without adequately taking into account the risks, counting on government support to bail them out in the event of disaster. Thereby, these institutions impose costs on taxpayers and the overall economy. In order to offset this problem, we proposed that a portion of bonuses be paid out over up to five years and that the amounts held in escrow are forfeit in the event that the institution receives substantial government assistance. The five year time frame is longer than in most other proposals. And another important element of the Squam Lake proposal is that the amount that is held in escrow would be in fixed income assets and not in shares or options of the company. In our judgment, having bonuses tied to the future value of the company's shares will increase the alignment between the incentives given to employees and those desired by shareholders, but comes at the expense of a more secure financial system and places greater risk on taxpayers. The best economic interest of shareholders will not be perfectly aligned with the best interest of the financial system and the economy. This argument puts our position at variance with many of other proposals described here that tie the eventual bonus to the performance of the company.

I do have concern that the Squam Lake proposal may not go far enough in giving the right incentives to traders or others that may make large bets on the market but are not part of the team of people managing the company. Tying individual compensation to overall company performance may make the trigger for forfeiture seem remote to employees in a large and international company. On the other hand, I do not want regulators determining the details of company compensation structures, which should be a managerial initiative. I believe that regulators should require top management to explain their compensation structure and how this structure is consistent with their own overall risk management procedures.

This was not the view agreed to by the whole group, where several members were concerned about too much interference by regulators. They noted that if the CEO and other very senior management have their own pay on the line in the event of a company failure, then they have an incentive to structure pay within their companies to avoid excessive risk-taking that would endanger the company and hence put taxpayers at risk.

I support the efforts now underway by the FED and other regulators to work in an iterative fashion with the significant financial institutions to work out compensation rules that support stability while allowing the companies to attract the talent they need to compete. These regulators must make sure that systemic risk is adequately considered and that it is not enough to align employee and shareholder interests.

One of the great challenges of this crisis is to ensure that the rules of the game be set to reduce the risk of another devastating crisis, but at the same time maintain the incentives for risk taking that are the essence of a dynamic and growing economy. In the boom, risks were taken that threatened the collapse of the whole financial system. Risk premia were too low. Right now, risk premia are very high. There are massive amounts of cash being held in companies or by banks in the form of excess reserves, while the economy stagnates. Regulatory rulemaking going forward should not discourage all risk taking, but rather should work with financial institutions themselves to figure out the specific structure that will incent effort and good judgment while protecting taxpayers and the economy.

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[i]. Kevin J. Murphy discusses these examples in his testimony, "Compensation Structure and Systemic Risk," before the U.S. House of Representatives Committee on Financial Services, June 11, 2009.