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Committee on Financial Services

Hearing

"Compensation Structure and Systemic Risk"

Testimony of

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Introduction and Summary

Compensation in the financial services industry became highly controversial in early 2009 amid revelations that Merrill Lynch paid substantial year-end bonuses to its executives and employees after receiving Federal bailout funds and just prior to completion of its acquisition by Bank of America. The outrage heightened following the revelation that AIG (which had received over $170 billion of federal bailout funds) was in the process of paying $168 million in "retention bonuses" to its executives. The anger over these bonuses – coupled with suspicions that the Wall Street bonus culture is a root cause of excessive risk taking that helped create the ongoing global financial crisis – has led to an effective prohibition on cash bonuses for participants in the government's Troubled Asset Relief Program (TARP), and is leading us today towards more-sweeping regulation of compensation in financial services firms.

Political pressures to reform pay have escalated in spite of limited evidence that compensation structures have, in fact, been responsible for excessive risk taking in the financial services industry. Indeed, the pressures have emerged even without a definition of "excessive risk taking" or how we might distinguish excessive risk from the normal risks inherent in all successful business ventures. While inappropriately designed compensation structures can certainly encourage risk taking, the risk-taking incentives caused by compensation in financial services are small relative to those created by "Too Big to Fail" guarantees, loose monetary policies, social policies on home ownership, and poorly implemented financial innovations such as exotic mortgages, securitization, and collateralized debt obligations. Moreover, the compensation constraints currently on TARP recipients will likely destroy these organizations unless they can quickly repay the government and avoid the constraints. Furthermore, regulating compensation in financial

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[1] This testimony is based in part on my joint work with Michael C. Jensen to be published in *CEO Pay and What to Do About It: Restoring Integrity to Both Executive Compensation and Capital-Market Relations* (forthcoming, Harvard Business School Press, 2010).

services will cripple one of our nations most important, and historically most productive, industries.

Risk Taking and the Wall Street Bonus Culture

The heavy reliance on bonuses has been a defining feature of Wall Street compensation for decades, going back to the days when investment banks were privately held partnerships. Such firms kept fixed costs under control by keeping base salaries low and paying most of the compensation in the form of cash bonuses that varied with profitability. This basic structure remained intact when the investment banks went public, but the cash bonuses were replaced with a combination of cash, restricted stock, and stock options.

The primary way that such structures might encourage excessive risk taking is through asymmetric rewards and penalties; that is, high rewards for superior performance but no real penalties for failure. Financial services firms provide significant penalties for failure in their cash bonus plans by keeping salaries below competitive market levels, so that earning a zero bonus represents a penalty. Indeed, much of the outrage over bonuses in financial services reflects the fact that, in most industries, a "bonus" connotes an extraordinary reward for extraordinary performance added on top of generous above-market salaries. But, the facts are that salaries in financial service firms represent a small portion of total compensation and the "bonuses" are not bonuses on top of normal salaries, but are rather a fundamental part of competitive compensation. Take away the bonuses, and the banks will have to raise salaries or find other ways to pay, or they will lose their top talent.

Table 1 shows that bonuses for Chief Executive Officers (CEOs) in companies receiving TARP funding declined substantially from 2007 to 2008. The sample is based on all companies in the S&P 500, S&P MidCap 400, and S&P SmallCap 600 in which the same executive served as CEO in both 2007 and 2008. Average CEO bonuses in 36 TARP-recipient companies fell 84.3% from over $2.3 million in 2007 to only $363,082 in 2008. In contrast, CEO bonuses in 23 financial services firms not receiving TARP funds fell by only 13%, while CEO bonuses in 684 other non-TARP firms fell by 9.9%.

Table 1
Comparison of 2007 and 2008 Bonuses for CEOs of TARP and Non-TARP Recipients

	TARP Recipients	Non-TARP Banks	Other Non-TARP Companies
Number of CEOS	36	23	684
Average 2007 Bonus	$2,307,430	$1,809,640	$1,641,880
Average 2008 Bonus	$363,082	$1,573,910	$1,479,360
Change in Bonus from 2007 to 2008	-$1,944,348 (-84.3%)	-$235,730 (-13.0%)	-$162,520 (-9.9%)

Notes: Sample includes executives in S&P 500, S&P MidCap 400, and S&P Small Cap 600 Firms who held the title of Chief Executive Officer in both 2007 and 2008. Compensation data from S&P's ExecuComp database. TARP recipients include companies receiving money from the TARP as of May 7, 2009, extracted from http://www.usatoday.com/money/economy/tarp-chart.htm. Non-TARP banks defined as companies with SIC codes between 6020 and 6211 and include commercial banks, savings institutions, mortgage banks, and security and commodity brokers. Bonuses include discretionary bonuses and payments under non-equity incentive plans.

Table 2 repeats the analysis in Table 1 for all proxy-named executives (typically the four highest-paid executives in addition to the CEO). Average bonuses for 170 executives in TARP-recipient companies fell by 82%, compared to a 24% decline for 119 executives in financial services not receiving TARP funding, and a 13% decline for 3,454 executives in non-TARP non-financial firms.

Table 2
Comparison of 2007 and 2008 Bonuses for *All Executives* of TARP and Non-TARP Recipients

	TARP Recipients	Non-TARP Banks	Other Non-TARP Companies
Number of Executives	170	119	3,454
Average 2007 Bonus	$1,800,090	$912,585	$806,249
Average 2008 Bonus	$323,663	$690,326	$703,207
Change in Bonus from 2007 to 2008	-$1,476,427 (-82.0%)	-$222,259 (-24.4%)	-$103,042 (-12.8%)

Notes: Sample includes proxy-named (top 5) executives in S&P 500, S&P MidCap 400, and S&P Small Cap 600 Firms serving in both 2007 and 2008. Compensation data from S&P's ExecuComp database. TARP recipients include companies receiving money from the TARP as of May 7, 2009, extracted from http://www.usatoday.com/money/economy/tarp-chart.htm. Non-TARP banks defined as companies with SIC codes between 6020 and 6211 and include commercial banks, savings institutions, mortgage banks, and security and commodity brokers. Bonuses include discretionary bonuses and payments under non-equity incentive plans.

Table 3

Comparison of 2007 and 2008 Year-End Values of Stock Options and Restricted Stock for CEOs of TARP and Non-TARP Recipients

	TARP Recipients	Non-TARP Banks	Other Non-TARP Companies
Number of CEOs	36	23	684
Percentage of Options in the Money			
2007 Fiscal Year-End	41.8%	92.1%	71.5%
2008 Fiscal Year-End	10.6%	53.0%	38.4%
Average Intrinsic Value of In-The-Money Stock Options			
2007 Fiscal Year-End	$8,694,980	$21,909,390	$17,977,100
2008 Fiscal Year-End	$428,880	$7,550,710	$6,379,220
Change in Intrinsic Value of Options	-$8,266,100 (-95.1%)	-$14,358,680 (-65.5%)	-$11,597,880 (-64.5%)
Average Value of Restricted Shares			
2007 Fiscal Year-End	$6,802,410	$2,447,470	$4,414,270
2008 Fiscal Year-End	$1,284,590	$1,390,980	$2,744,920
Change in Intrinsic Value of Options	-$5,517,820 (-81.1%)	-$1,056,490 (-43.2%)	-$1,669,350 (-37.8%)

Notes: Sample includes executives in S&P 500, S&P MidCap 400, and S&P Small Cap 600 Firms who held the title of Chief Executive Officer in both 2007 and 2008. Option and stock data from S&P's ExecuComp database. TARP recipients include companies receiving money from the TARP as of May 7, 2009, extracted from http://www.usatoday.com/money/economy/tarp-chart.htm. Non-TARP banks defined as companies with SIC codes between 6020 and 6211 and include commercial banks, savings institutions, mortgage banks, and security and commodity brokers. Intrinsic value equals the year-end spread between the stock price and exercise price for all in-the-money options. Average value equals the restricted shares held at the end of the fiscal year multiplied by the year-end stock price.

In addition to cash bonuses, executives and senior managers in financial services receive much of their compensation in the form of restricted stock and options, and these instruments also provide strong penalties for failure. Table 3 shows that less than half (41.8%) stock options held by CEOs of TARP recipients were "in the money" (that is, had a stock price above the exercise price) at the end of the 2007 fiscal year, and that these stock options had an average "intrinsic value" (that is, the positive spread between the stock price and exercise price) of $8.7 million. Stock prices for companies that would become subsequent TARP recipients were already depressed by year-end 2007, as reflected by the relatively low percentage of options in the money compared to companies that would not require TARP funding. But, by year-end 2008, only 10.6% of the CEO options were in the

Table 4
Comparison of 2007 and 2008 Year-End Values of Stock Options and Restricted Stock for *All Executives* of TARP and Non-TARP Recipients

	TARP Recipients	Non-TARP Banks	Other Non-TARP Companies
Number of Executives	170	119	3,454
Percentage of Options in the Money			
2007 Fiscal Year-End	45.8%	71.9%	70.3%
2008 Fiscal Year-End	12.0%	42.2%	36.8%
Average Intrinsic Value of In-The-Money Stock Options			
2007 Fiscal Year-End	$5,196,570	$6,610,250	$7,408,160
2008 Fiscal Year-End	$334,458	$2,175,610	$2,412,230
Change in Intrinsic Value of Options	-$4,862,112 (-93.6%)	-$4,434,640 (-67.1%)	-$4,995,930 (-67.4%)
Average Value of Restricted Shares			
2007 Fiscal Year-End	$3,092,570	$1,624,700	$1,986,200
2008 Fiscal Year-End	$872,808	$818,858	$1,303,470
Change in Intrinsic Value of Options	-$2,219,762 (-71.8%)	-$805,842 (-49.6%)	-$682,730 (-34.4%)

Notes: Sample includes proxy-named (top 5) executives in S&P 500, S&P MidCap 400, and S&P Small Cap 600 Firms serving in both 2007 and 2008. Option and stock data from S&P's ExecuComp database. TARP recipients include companies receiving money from the TARP as of May 7, 2009, extracted from http://www.usatoday.com/money/economy/tarp-chart.htm. Non-TARP banks defined as companies with SIC codes between 6020 and 6211 and include commercial banks, savings institutions, mortgage banks, and security and commodity brokers. Intrinsic value equals the year-end spread between the stock price and exercise price for all in-the-money options. Average value equals the restricted shares held at the end of the fiscal year multiplied by the year-end stock price.

money, and the average intrinsic value had fallen by 95% to only $428,880. The average value of the CEO's restricted stockholdings also declined dramatically in 2008, falling over 80% from $6.8 million in 2007 to only $1.3 million at the end of 2008.

The statistics in Table 3 understate the losses incurred by individual CEOs, since they are based only on CEOs serving continuously through 2007 and 2008 and ignore losses realized by CEOs losing their jobs as a consequence of the crisis. Moreover, these statistics only include firms that continued to operate at the end of 2008, thus ignoring losses at Bear Stearns, Lehman Brothers, Washington Mutual, Wachovia, Countrywide, and other casualties of the crisis.

Table 4 shows that the losses in equity-based compensation for TARP recipients were not limited to CEOs. In particular, the average intrinsic value of options held by 170 executives in TARP-recipient companies fell by 94% in 2008, while the average value of restricted shares fell by 72%.

Given the penalties for poor performance inherent in both cash and equity incentive plans, there is nothing inherent in the current structure of compensation in financial service firms that lead to obvious incentives to take excessive risks. To the extent that the firms, indeed, took such risks, we need to look beyond the compensation structure to explain it. However, there are valid reasons to be concerned about excessive risk taking in future years. First, as shown in Table 4, most of the stock options held by financial services executives by the end of 2008 were well out-of-the-money, which provides the type of asymmetric rewards and penalties that can lead to risk taking. Even more troublesome is the concept of "Too Big to Fail" guarantees applied to the financial service firms that essentially operate in-house hedge funds with hedge-fund-style incentive arrangements. If the government is very clear that there is no "Too Big to Fail" guarantee, there is no need for government oversight. But, if the guarantee is offered or implied there are massive problems with monitoring and restraining executives from taking excessive risks. Assuming that "Too Big to Fail" survives as a policy, it is critical that boards enforce strong internal penalties for risk-management failures.

Risk and Performance Measurement

Another way that compensation can lead to risk taking is through inappropriate performance measures. For example, consider mortgage brokers paid for writing loans rather than writing loans that the borrowers will actually pay back. In the years leading up to its dramatic collapse and acquisition by JPMorgan Chase at fire-sale prices, Washington Mutual rewarded its brokers for writing loans with little or no verification of the borrowers' assets or income, and paid especially high commissions for selling more-profitable adjustable-rate mortgages.[2] In the end, WaMu got what it paid for, and similar scenarios were being played out at Countrywide Finance, Wachovia, and scores of smaller lenders who collectively were not overly concerned about default risk as long as home prices kept increasing and as long as the lenders could keep packaging and selling their loans to Wall Street. But, home prices could not continue to increase when prices were being artificially bid up by borrowers who could not realistically qualify for or repay their loans. The record number of foreclosures in 2008, and the associated crash in home values, helped send the US economy (and ultimately the global economy) into a tailspin.

A solution to this performance-measurement problem is to pay people to write "good loans" and penalize them for writing "bad loans". The challenge is identifying a good loan without waiting up to 30 years to find out whether the loan is actually repaid. The answer involves basing bonuses on subjective assessments of loan quality. Unfortunately, most current and proposed regulations go in the opposite direction and require that bonuses be based solely on objective measures of performance, such as the quantity (rather than the quality) of loans. These regulatory demands reflect a suspicion that boards and managements will be unable to make and enforce the required subjective assessments, thus substituting the judgment of government for the business judgment of directors. This is a dangerous path to go down.

Fixing Compensation: Is Regulation the Answer?

Compensation practices in financial services can certainly be improved. For example, cash bonus plans in financial services can be improved by introducing and enforcing bonus banks or "clawback" provisions for recovery of rewards if and when there is future revision of critical indicators on which the rewards were based or received. Several banks, including Morgan Stanley, UBS, and Credit Suisse have introduced plans with clawback features over the past several months, and I applaud these plans as moves in the right direction.

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[2] See Peter S. Goodman and Gretchen Morgenson, "By Saying Yes, WaMu Built Empire on Shaky Loans," New York Times (December 27, 2008.

Bonus plans in financial services can also be improved by ensuring that bonuses are based on value creation rather than on the volume of transactions without regard to the quality of transactions. Measuring value creation is inherently subjective, and such plans will necessarily involve discretionary payments based on subjective assessments of performance.

Compensation practices in financial services can undoubtedly be improved through government oversight focused on rewarding value creation and punishing value destruction. However, it is highly unlikely that compensation practices can be improved through increased government rules and regulations. Indeed, Washington has a long history of attempts to regulate executive pay that have systematically created unanticipated side effects that have generally led to higher pay levels and less-efficient incentives. Consider, for example, the following case studies:

Golden Parachutes and Section 280(G)

In 1982, Bendix CEO William Agee launched a hostile takeover bid for Martin Marietta, which in turn made a hostile takeover bid for Bendix. Bendix ultimately found a "white knight" and was acquired by Allied Corp., but only after paying CEO Agee $4.1 million in a Golden Parachute payment. The payment sparked outrage in Congress, which quickly introduced Section 280(G) of the tax code, imposing severe personal and corporate tax penalties on golden parachute payments exceeding three times the executive's average recent compensation.

Ironically, although Section 280(G) was meant to reduce the generosity of parachute payments, the government action increased such payments: the new rules were followed by the introduction of golden parachutes in hundreds of companies that previously had no change-in-control agreements. Moreover, Section 280(G) triggered the proliferation of "employment agreements" for CEOs and other top-level executives in most large firms since the mid-1980s. Section 280(G) applies only to severance payments contractually tied to changes of control. Individual employment agreements typically provide for severance payments for all forms of terminations without cause, including (but not limited to) terminations following control changes. Therefore, companies could circumvent the Section 280(G) compensation limitations (at a potentially huge cost to shareholders) by making payments available to all terminated executives, and not only those terminated following a change in control.

Unreasonable Compensation and Section 162(m)

The controversy over CEO pay became a major political issue during the 1992 US presidential campaign. After the 1992 election, president-elect Clinton re-iterated his promise to disallow deductions for all compensation above $1 million for all employees. Concerns about the loss of deductibility contributed to an unprecedented rush to exercise options before the end of the 1992 calendar year, as companies urged their employees to exercise their options while the company could still deduct the gain from the exercise as a compensation expense. In anticipation of the loss of deductibility, large investment banks accelerated their 1992 bonuses so that they would be paid in 1992 rather in 1993. In addition, several publicly traded Wall Street firms, including Merrill Lynch, Morgan Stanley, and Bear Stearns, announced that they were consider returning to a private partnership structure if Clinton's plan were implemented.

By February 1993, President Clinton backtracked on the idea of making all compensation above $1 million unreasonable and therefore non-deductible, suggesting that only pay "unrelated to the productivity of the enterprise" was unreasonable. In April, details of the considerably softened plan began to emerge. As proposed by the Treasury Department and eventually approved by Congress, Section 162(m) of the tax code applies only to public firms and not to privately held firms, and applies only to compensation paid to the CEO and the four highest-paid executive officers as disclosed in annual proxy statements (compensation for all others in the firm is fully deductible, even if in excess of the million-dollar limit). More importantly, Section 162(m) does not apply to compensation considered "performance-based" for the CEO and the four highest paid people in the firm.

Academic research has concluded that Section 162(m) has contributed to the increase in executive compensation. First, since compensation associated with stock options is generally considered "performance-based" and therefore deductible, Section 162(m) helped fuel the option explosion in the 1990s. Second, while there is some evidence that companies paying base salaries in excess of $1 million lowered salaries to $1 million following the enactment of Section 162(m), many others raised salaries that were below $1 million to exactly $1 million. Finally, since discretionary bonuses are not considered performance based (and therefore subject to the $1 million cap), companies were encouraged to replace their discretionary plans with overly generous and less-effective formula-based plans.

Deferred Compensation and Section 409(A)

Enron, like many other large companies, allowed mid-level and senior executives to defer portions of their salaries and bonuses through the company's non-qualified deferred compensation program. When Enron filed for Chapter 11 bankruptcy protection in December 2002, about 400 senior and former executives became unsecured creditors of the corporation, eventually losing most (if not all) of the money in their accounts. However, just before the bankruptcy filing, Enron allowed a small number of employees to withdraw millions of dollars from their deferred compensation accounts. The disclosure of these payments generated significant outrage (and lawsuits) from Enron employees who lost their money, and attracted the ire of Congress.

As a direct response to the Enron situation, Section 409(A) was added to the Internal Revenue Code as part of the "American Jobs Creation Act of 2004." In essence, the objectives of Section 409(A) were to limit the flexibility in the timing of elections to defer compensation in nonqualified deferred compensation programs, to restrict withdrawals from the deferred accounts to pre-determined dates (and to prohibit the acceleration of withdrawals), and to prevent executives from receiving severance-related deferred compensation until six months after severance. Section 409(A) imposes taxes on individuals with deferred compensation as soon as the amounts payable under the plan are no longer subject to a "substantial risk of forfeiture." Individuals failing to pay taxes in the year the amounts are deemed to no longer be subject to the substantial forfeiture risk owe a 20% excise tax and interest penalties on the amount payable (even if the individual has not received or may never receive any of the income).

Section 409(A) restricts compensation committees from offering many incentive arrangements that are in the best interest of shareholders. For example, while restricted shares and traditional stock options (i.e., options with an exercise price equal to the market price on the date of grant) are exempt from the guidelines, discount options (i.e., options with an exercise price below the market price on the date of grant) are subject to the new rules. Such options are often in the interest of shareholders, especially when employees "purchase" the discount options through explicit salary reductions or outright cash exchanges.

In each of the above cases, the regulations resulted in less-effective compensation arrangements and imposed large costs on shareholders. Part of the problem is that regulation – even when well-intended – inherently focuses on relatively narrow aspects of compensation allowing plenty of scope for costly circumvention. An apt analogy is the Dutch boy using his fingers to plug holes in a dike, only to see new leaks emerge. The only certainty with pay regulation is that new leaks will emerge in unsuspected places, and that the consequences will be both unintended and costly. I therefore strongly recommend that the Committee consider carefully this history before inevitably repeating the mistakes of the past.

Author's Statement and Qualifications

I am currently the Kenneth L. Trefftzs Chair in Finance at the University of Southern California Marshall School of Business. I have been a full professor of the Department of Finance and Business Economics at the USC Marshall School since 1995. In addition, I hold joint appointments in the USC School of Law (as Professor of Business and Law) and in the USC College of Letters, Arts, and Sciences (as Professor of Economics). I served as chair for the Marshall School's Department of Finance and Business Economics from 2003-2004, and as the Marshall School's Vice Dean of Faculty and Academic Affairs from 2004-2007. From 1991 to 1995, I was an Associate Professor of Business Administration at the Harvard Business School, and from 1983 to 1991, I was an Assistant and Associate Professor at the University of Rochester's William E. Simon Graduate School of Business Administration.

I received a Ph.D. in Economics from the University of Chicago in 1984, where my honors included a National Science Foundation Fellowship, Milton Friedman Fund Fellowship, and a Social Science Foundation Dissertation Fellowship. I also have an M.A. in Economics from the University of Chicago, and a B.A. degree (summa cum laude) from the

University of California, Los Angeles. I am a member of Phi Beta Kappa, the American Economic Association, and the American Finance Association. I am an associate editor of the *Journal of Financial Economics* and the *Journal of Corporate Finance,* a former associate editor of the *Journal of Accounting and Economics*, and serve as referee to over thirty professional and academic journals. I am the former chairman of the Academic Research Committee of the American Compensation Association.

I am a recognized expert on executive compensation, and have written and published extensively on issues related to executive compensation. During 1992 and 1993, I conducted annual surveys of executive compensation practices in the 1,000 largest U.S. corporations. The surveys, sponsored by the United Shareholders Association, were used extensively by institutional investors and large shareholders in evaluating and comparing the effectiveness of compensation policies. I also advised the SEC in formulating their 1992 disclosure rules for top management pay, and was a prominent member of the 1992 and 2003 National Association of Corporate Directors' Blue Ribbon Commissions on Executive Compensation, which issued reports calling for the overhaul of CEO pay practices. I have written more than forty articles, cases, or book chapters relating to compensation and incentives in organizations. Results from my research on executive compensation have been widely cited in the press (including the *Wall Street Journal, New York Times*, *Washington Post*, *Los Angeles Times*, *Chicago Tribune*, *USA Today*, *Economist*, *Fortune*, *Forbes*, *Business Week*, and *Time*) and on national television (including CNN and CBS news). I have given speeches and presentations on compensation and incentives to a variety of academic and practitioner audiences, including the Conference Board, the American Compensation Association, and the Board of Governors of the Federal Reserve.

My university teaching at USC, Harvard, and Rochester encompasses a wide variety of courses at the undergraduate, MBA, Ph.D., and executive levels. I have developed and taught undergraduate, MBA, and Ph.D. courses in compensation, incentives, human resource management, corporate finance (including mergers, acquisitions, and leveraged buyouts), and corporate governance.

I have testified as an expert witness in multiple proceedings in federal and state courts; my testimony has focused on virtually all aspects of compensation. I have consulted with organizations and conducted research on compensation and incentives in professional partnerships and corporations. I have consulted with, or given speeches to, top managers and compensation committees at several large corporations, including IBM, AT&T, Merck, Bristol-Myers-Squibb, Genzyme, Procter & Gamble, Philip Morris, General Motors, Prudential, and Chubb. I spent the 1994-1995 academic year on leave from Harvard as the Visiting Scholar and Consultant at Towers Perrin, a major benefits and compensation consulting firm, where my activities included making formal presentations and leading informal roundtable discussions on executive compensation to clients nationwide, as well as being involved in a variety of consulting engagements.

I have not received any Federal grants or contracts (including subgrants or subcontracts) since October 1, 2006 related to my testimony, and I am not representing any organization that has received such grants related to my testimony.