Unintended Consequences of Executive Compensation Regulation Threatens to Worsen the Financial Crisis

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Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee, it is a privilege to testify in this forum today. My name is J.W. Verret, and I am an Assistant Professor of Law at George Mason Law School, a Senior Scholar at the Mercatus Center at George Mason University and a member of the Mercatus Center Financial Markets Working Group. I also direct the Corporate Federalism Initiative, a network of scholars dedicated to study of the intersection of state and federal authority in corporate governance.

Today I will discuss executive compensation proposals currently under consideration. I will also highlight a Wall Street norm of issuing, and feeling pressure to meet, quarterly earnings guidance, which is a central cause of short term tunnel vision for Wall Street executives.

There are seven executive compensation initiatives underway. Such a wide array of ideas from disparate corners risks repeating the lack of coordination that contributed to the present crisis.

The multitude of proposals threatens to override two SEC driven initiatives offering some promise in this area. Former SEC Chairman Cox completed an extensive overhaul of executive compensation disclosure in 2006, and Chairman Schapiro is promising further changes. Chairman Cox's reforms offer only two years of working history to assess. I recommend studying the effect of these disclosure changes before instituting proscriptive regulation that risks passing high costs onto investors.

Even with the best of intentions, compensation regulation risks unintended consequences. A glaring example are the 1993 tax code changes to limit the deductibility of non-performance based compensation, originally intended to limit the disparity in pay between executives and the average worker. The result was that executive compensation increased exponentially and the disparity immediately widened.

Pay restrictions will also limit banks in their competition for top talent, which risks exacerbating the banking crisis. Immediately following the announcement of compensation restrictions by the Obama Administration, Bank of America indicated that Deutsche Bank poached 12 of its highest performing executives and other reports indicated that UBS was hiring financial advisors from TARP firms with compensation increases as high as 200%. In a global environment, restrictions may place American banks at a competitive disadvantage.

Pay packages are of necessity complex. Compensation is intended to link pay to the executive's performance running the company, without rewarding or punishing executives for factors outside their control. It would make little sense, for instance, to reward or punish executives for the effect of Federal Reserve policy on a company's stock price. I am concerned that regulatory restrictions may limit a compensation committee's flexibility to achieve this goal.

Further, executive compensation's role in the current crisis is unclear.
Comparing the compensation at banks determined healthy enough to repay their TARP funds to compensation at banks likely to need additional injections of capital reveals little difference in their executive compensation approaches. It is logical to assume that if executive compensation were to blame for excessive risk taking, the differences between the two groups would be more apparent.

Short-term thinking is, however, a significant risk to the safety and soundness of the nation's banking system. But a focus on compensation approaches the issue indirectly and merely scratches at the surface.

Compensation is how executives can be motivated toward short term goals. The real question is why they are directed toward short-term goals in the first instance.

The widely accepted convention of quarterly earnings pressure in capital markets is the root of this short-termism. Companies feel pressured to make quarterly predictions about their earnings, and then cut corners to meet those predictions. Companies that abandon quarterly forecasting find analysts suddenly stop following their stock.

This is a reform issue with broad support among the spectrum of capital market participants. Pension funds, mutual funds, and company issuers all express dissatisfaction with the existing pressures of quarterly earnings guidance, but companies feel that voluntarily opting-out will be taken as a negative signal.

Before consideration of dramatic overhaul in executive compensation, I would urge this committee to wait until executive compensation disclosure reforms have time to bear fruit. I would also urge this committee to consider examining quarterly earnings pressure to get at the root of short term thinking on Wall Street, before making changes to executive compensation practices that may end up unintentionally doing more harm than good.

I thank you again for the opportunity to testify, and I look forward to answering your questions.