Chapter 19*

Regulation of Compensation and Corporate Governance at Financial Institutions

Overview

Politicians and taxpayers have expressed outrage at large bonuses paid to employees of those financial institutions that received federal bailout money. Regulators have raised concerns that the risk-taking incentives in compensation structures at financial firms are partly to blame for causing the financial crisis in the first place. In the midst of a broader public outcry against rising levels of executive compensation throughout corporate America, many in Congress have called for regulation and even caps on pay at financial institutions. Financial firms have countered that such constraints would hamper their ability to attract and retain the executive talent needed to steer them back to health and repay taxpayers.

The Crisis

To what extent were compensation structures at financial firms to blame for the crisis? Although pay practices based on performance measures that failed to account adequately for downside risk may have been an issue at some firms, we do not believe that compensation by itself was a major cause of the crisis. Compensation at financial firms is substantially share-based, so the interests of managers and shareholders tend to be closely aligned. Indeed, top employees at these firms incurred enormous losses of personal wealth in the crisis. The bigger problem for regulators and society is that because of implicit and explicit federal guarantees, the incentive to take large, potentially systemic, risks is built directly into the equity itself. Some bank boards explicitly encouraged the lending practices that helped lead to the crisis. New banking regulation should focus as much on reducing shareholder/regulator conflict as on reducing manager/shareholder conflict, and only as a last resort should go over shareholders' heads to guide managerial compensation.

Current Proposals

Recent "say-on-pay" and corporate governance proposals from Congress empower shareholders at all firms. They give stakeholders the right to a nonbinding vote on executive compensation and proxy access to nominating directors. The proposals mandate better disclosure of incentive compensation and the permissibility of managerial hedging, independence of compensation committees, and clawing back of incentive compensation based on misstated accounting performance. They authorize the use of independent compensation consultants and require shareholder approval of staggered boards. Congress also proposes going over the heads of shareholders at bank holding companies, prohibiting "excessive" compensation.

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The Federal Reserve's proposal for large banking organizations goes further, prescribing specific compensation and governance structures and reserving the right to enforce them. Specifically, the Fed advocates (1) better ex ante risk adjustment in the measures of employee performance that are used to determine compensation, and (2) the use of deferred compensation and longer performance periods, with realized compensation depending on risk outcomes. The Fed also favors involving corporate risk managers in the design of compensation contracts and active oversight of incentive compensation by boards of directors, who would be held responsible for ensuring the organization's safety. In addition, the Fed recommends broad reviews of incentive compensation arrangements at banking organizations to help identify and coordinate the adoption of best practices.

Evaluation of Current Proposals

Congressional proposals to strengthen shareholder control over the compensation process are welcome reforms and may by themselves bring about sufficient compensation reform whenever shareholder interests are aligned with those of society. So to the extent that the conflict of interest between shareholders of financial firms and taxpayers can be resolved -- for example, with correct pricing of federal guarantees -- it may be enough to strengthen shareholder rights to help resolve shareholder/manager conflict and then leave shareholders to dictate managerial compensation themselves.

The Fed argues that because of the federal safety net, shareholder and taxpayer interests cannot be adequately resolved at banking organizations; it therefore seeks to regulate their compensation policies directly. Its ideas of ex ante risk adjustment, deferred compensation, longer performance periods, and ex post settling up are excellent principles for managing risk incentives and reducing moral hazard problems, as are its proposals to strengthen the role of risk management in firm governance. However, while these tenets should serve as important advisory guidelines, the Fed should be cautious about enforcement. Given the heterogeneity of banking organizations and their employees, and thus the diversity of contracts that are likely to be optimal, in our view, the Fed should not attempt to control compensation and governance too tightly. We believe that a reasonable middle ground would be to place the chief risk officer, or even a Fed representative, on the bank's board. The Fed might even broaden the role of bank supervisors to include explicit oversight of compensation policies and outcomes.

The idea of ex ante risk adjustment of performance measures -- so that an employee is essentially charged immediately for the risk consequences of his activities -- is a sound accounting principle. However, where compensation is concerned, it may be difficult to implement adequately because of the complexities of assessing the risks of new activities and the sensitivity of incentives to these measurement errors. For this reason, we believe it is best, whenever possible, to use it in conjunction with the principles of deferred compensation and longer performance periods, with ex post adjustments as needed.

The Fed's plan for a broad review of compensation at banking organizations is excellent and worth expanding to an annual or bi-annual review of firmwide compensation policies and outcomes at systemic firms. This could generate invaluable new information about which schemes work well and which do not. Not only would the review process itself likely spur voluntary improvements, but it would also provide more concrete information than is currently available about those aspects of the process that need regulation.

One idea that seems problematic is the prohibition of “excessive” compensation at financial institutions. Although uniform caps on the level of pay may be popular with voters, they can hamper shareholders’ ability to attract and retain the best talent. They can also fail to serve the regulator/taxpayers’ interest because it is not the level of pay per se, but rather the risk-taking incentives in compensation, that potentially threaten the safety of the banking system. In fact, if employees at financial firms must be forced to bear more downside risk to control their risk appetites, their average pay level may have to go up to keep them on board.