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Congress Gets Punitive on Executive Pay

We want compensation tied to performance.

By LUCIAN BEBCHUK

In a last-minute addition to the stimulus bill passed Friday, Congress imposed tight restrictions on pay arrangements in all financial firms that have or will receive funds from the federal government's Troubled Asset Relief Program (TARP).

While I have long been a critic of corporate compensation practices, these restrictions leave me concerned. They weaken executives' incentives to deliver the long-term performance that is needed to benefit banks, the economy, and taxpayers who have injected vast amounts of capital into these institutions.

While the new restrictions seem to have been motivated by a desire to limit total pay, it is the pay structure that they tightly regulate. The Obama administration's proposals focused on constraining pay unrelated to performance. The stimulus bill takes the opposite approach -- constraining incentive compensation, limiting it to one-third of total pay.

To be sure, incentive compensation in many public companies has been flawed. Some incentive compensation has been so in name only, and some of it has provided perverse incentives to focus on short-term results to the detriment of long-term performance.

But these problems require tightening the link between pay and long-term performance -- not giving up on it altogether. Mandating that at least two-thirds of an executive's total pay be decoupled from performance, as the stimulus bill does, is a step in the wrong direction.

Another wrong step is the bill's categorical prohibition on using any form of incentive compensation other than restricted stock. In the first place, some executives covered by the bill (up to 25 in some firms) run limited parts of the company's operations. Their incentive pay might be best tied to the performance of their unit's particular results, not to that of the whole company.

But even for top executives, the banks' special circumstances may make exclusive use of restricted stock contrary to taxpayer interests. In many banks, the shareholders' equity, which is junior to the government's investments in preferred shares and the claims of bondholders, now represents a small fraction of the bank's capital. Indeed, the value of some banks' common shares might largely represent an "out-of-the-money option," expected to deliver value only if things considerably improve.
In such circumstances, restricted stock may provide incentives for executives to take excessive risks with the bank's survival. Consider the case where an infusion of additional capital would greatly dilute the value of common shares but would be best for the bank, while failing to get that capital would put the bank's future at risk. In such

circumstances, compensation in restricted common shares would provide executives with an incentive to avoid raising capital (which would wipe out their shares' value) and gamble on survival without additional capital.

The compensation restrictions have another adverse effect on incentives. Executives can sidestep them by returning TARP funds and avoiding them in the future. Some observers argue that such actions would be unlikely because they would be costly to the bank. This overlooks the divergence between the interests of the bank and its executives. The bill provides executives with counterproductive and unnecessary private incentives to terminate or avoid TARP funding, even when doing so would not be in the bank's best interest.

The stimulus bill's adverse incentives deserve special attention because of the government's current approach to the banking sector. While infusing large amounts of capital into banks, the government has chosen to leave their management largely to the discretion of bank executives. This makes executive incentives of paramount importance.

Compensation structures with distorted incentives may have already imposed large losses on investors and the economy. Public officials should be wary of introducing new distortions and perverse incentives. With so much hanging in the balance, ensuring that those running the country's banks have the right incentives is as important as ever.

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