Executive Compensation Controversy Creates More Unintended Consequences

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There is no surer way to create unintended economic consequences than to regulate compensation plans. Connecticut's Senator Dodd made a last-minute contribution to the stimulus bill that places severe restrictions on executive pay for TARP recipients. As reported in the NY Times Dealbook Blog, one compensation consultant noted, "Any smart executive will (a) pay back TARP money ASAP or (b) get another job." These new pay rules may well be the single worst part of the flawed stimulus package.

I spoke to an executive, a personal friend, at one bank that had been considering TARP funding. This is a well-managed bank that didn't need the funds, but thought that it would be prudent to shore up their balance sheet in case the recession lasted longer than they anticipated. This additional capital would give them more flexibility and comfort in lending — indeed, it has been one of the banks in the forefront of making credit available in its area. My source said that at least in part because of the executive pay restrictions, they will now forgo TARP.

Senator Dodd's restrictions will result in more firms avoiding TARP capital or repaying the TARP sooner than they would have otherwise. At the end of the day, this will mean less lending. More challenging will be the situation for firms which have no choice but to stay with TARP capital. These firms will be forced to either increase their executives' salaries or provide compensation that falls well below market levels. The former seems politically unfeasible. In the case of the latter, a "brain drain" is likely to result — a terrible outcome considering the taxpayers' investment in these firms.

What's the real risk of the flight of executives from these TARP recipients? The common counter-argument has been, "Who will hire these people? They ruined their firms." This is simplistic and wrong. While CEOs and Risk Management chiefs certainly should bear consequences of their failures, many high-paid executives successfully ran business lines which had no connection to the disastrous choices of their colleagues. A quick perusal of the most highly compensated executives at Bank of America, for example, suggests that perhaps half had absolutely nothing to do with the balance sheet impairment that the corporation acquired courtesy of the purchase of Merrill Lynch. This isn't to say that their pay shouldn't be affected by their company's fortunes. However, the company should certainly be able to have the tools to retain people like, for example, the head of IT, who surely is marketable to any number of corporations.

I've argued in a piece on Forbes' website, that earlier regulations governing executive pay fostered Wall Street's disastrous bonus culture. Corporate governance expert, Lucian Bebchuk, writes of the risks in the way Dodd's amendments restrict variable compensation to stock awards. A list of similar examples of problems would go on and on. The bottom line is that companies need flexibility in setting compensation. Federal regulation of compensation is a pathway littered with unintended consequences, and has there ever been a “good” unintended consequence?

Disclosure: some of our clients hold positions in BAC, other financial companies and TARP recipients.