Congress, lobbyists debate meaning of risk

Critics say Frank's exec-pay legislation could limit reasonable risk taking

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By Ronald D. Orol
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WASHINGTON (MarketWatch) -- When a divided House of Representatives approved controversial legislation last week to give shareholders a vote on executive compensation, they also OKd an even more contentious provision -- one that would require federal regulators write rules for financial firms prohibiting pay packages they believe are risky enough to bring down the entire economic system.

But what incentives in compensation packages are risky enough to bring down the markets? Could government regulators -- such as the Securities and Exchange Commission or the Federal Deposit Insurance Corp. -- understand what constitutes risk?

This is a matter vehemently disputed among conservatives and liberals, in part because the measure would have regulators write rules limiting risky incentive-based employee pay, in addition to executive payments.

GOP lawmakers say it will take Christmas bonuses away from rank-and-file bank employees, while many Democrats, led by Rep. Barney Frank, D-Mass., the drafter of the provision, saying it is a vital component of reform of the system. See full story.

Another concern is whether the measure will be approved in the Senate, even though Banking Committee Chairman Christopher Dodd, D-Conn., a key lawmaker on the issue, has recently pushed for significant new clamps on big payouts. The Obama administration did not include the measure in its proposal on pay changes and White House spokesman Robert Gibbs said there were "some concerns" about the package.

Nevertheless, the Frank provision was driven, in part, by congressional outrage over million-dollar bonuses going to employees of financial institutions despite their roles in expanding the financial crisis. Case in point: 73 employee portfolio managers at American International Group Inc. , who were specifically responsible for issuing a significant amount of insurance derivative credit default swaps credited with contributing to the financial crisis, received $1 million or more each in bonuses despite the government's decision to provide a $190 billion taxpayer bailout of the troubled institution.

Devil's in the details

According to another report, roughly 4,800 executives and employees of Wall Street's largest financial institutions, many of which received taxpayer bailouts, were paid awards of at least $1 million.

The devil is in the details.

SEC and bank regulators could write rules that do a great job limiting pay packages that encourage dangerously risky behavior, said Mike Garland, a director of investments at CtW Investment Group, an organization that advises unions on pensions.

Garland argues that regulators could write a provision limiting systemic risk by requiring executives and boards to hold a meaningful equity position in the corporations they oversee until after they leave their jobs.

"Holding such a stake for this period could have a meaningful impact on preventing financial markets from imploding because it would encourage long term thinking, as opposed to the short-term, problematic thinking that today's pay structures encourage," he said.

Harvard Law School professor Lucian Bebchuk argues in favor of government intervention in pay practices at financial institutions, in part, because, unlike other failures in other industries, the sudden insolvency of mega-banks results in high bailout costs for taxpayers.

"The government has an interest in how pay structures have an impact on risk-taking of people at financial institutions because of the costs that such risk taking has on taxpayers," Bebchuk said.

"The failure of such companies imposes costs on taxpayers that shareholders do not internalize, shareholders' interests are served by more risk-taking than is socially desirable," Bebchuk said. "Given the government's interest in financial companies' stability, intervention in pay structures is as legitimate as the traditional forms of financial regulation."

Unintended consequences?

However, Tom Quaadman, executive director of the U.S. Chamber of Commerce's Center for Capital Markets, contends that the measure will produce a hodgepodge of unintended consequences that will result in loss of talent to global markets and a dangerous propensity to avoid risk necessary to drive job creation and innovation in American businesses. He argues that it would take away the flexibility that corporate boards have in approving pay packages that make sense for the companies they oversee.

"Legislative fixes like this often backfire and cause bigger problems down the line. We have to be cognizant of the fact that compensation by talent was previously bounded by borders; now that is no longer the case with the global economy," Quaadman said. "It allows financial regulators to regulate the compensation from the CEO to the receptionist, picking winners and losers."

"If we stifle the ability of people to engage in reasonable risk-taking that will hinder businesses' ability to grow today and tomorrow," Quaadman said.

He worries that regulators could write rules expanding on legislation approved by Congress that limits bonuses for banks. The legislation, which was introduced by Dodd, requires banks receiving government bank bailout dollars to limit an executive's bonus to one-third of salary. Quaadman argues that expanding this measure to all financial institutions would have the impact of driving mega-banks to rely more on base salary, which is not tied sufficiently to performance or other problematic metrics.

"We will be very engaged with the Senate on this issue,' he said. "In recent history there has been some willingness to engage a proposal like this."

Nell Minow, founder of the Corporate Library, argues that the provision is unworkable. She worries that the government won't be able to identify "inappropriate risk-taking." Meanwhile, she back's the bill's provision that would empower shareholders to have a say on pay packages of top employees.

"If the people who engineered credit default swaps and other securitization and hedging financial instruments could not externalize their risks onto investors and taxpayers, things would not have spun out of control," she wrote in a blog. "The government should not micro-manage pay. It should instead remove obstacles that currently prevent oversight from those who are best qualified and motivated to manage risk -- the shareholders."

Claudia Allen, partner at Neal Gerber & Eisenberg, said the measure could result in unintended consequences resulting in executives choosing to limit risk taking in anticipation of pay limits, destroying liquidity and investment in the system.

"The federal government getting so involved in compensation could lead to more stagnated growth or, in the worst case, make it more difficult for the economy to come out of the recession," she said. "Not everybody at Goldman Sachs is betting the house on complex financial instruments. However, restrictions could hurt employees and employers there, leading them to go elsewhere."

Nevertheless, Bebchuk argues that people can always raise the specter of unintended consequences, but they should also consider the impact distorted incentives have already played in driving the economic crisis.

"In this case the reasons for reform are strong because we have experience with the consequences of past incentive structures, all of which clearly outweighs the standard claim about unintended consequences," he said.
Which regulator would take charge?

Bebchuk argues that the extent of the impact of the regulation would vary depending on which agency takes the lead in writing pay rules. The SEC has traditionally been responsible for pay regulations, however the Federal Reserve will likely take a larger role in examining systemic risk and consequently could take responsibility for regulating how pay standards at institutions could have an adverse effect on financial stability.

Nevertheless, Bebchuk said it is possible that a powerful council of regulators, sought by some lawmakers and regulators, would be in the best position to exchange information and make rules for pay package incentives because it could bring together the expertise of both the Fed, SEC and other regulators.

"The final bill might break down the division of labor between regulators, which will have a big impact," he said.