Wall Street reform gives regulators power over executive pay

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For the all the changes to the regulatory fabric contained in the landmark Dodd-Frank law, none might be more significant to the financial sector's health than Section 956(a).

That largely overlooked provision of the law gives federal agencies expanded powers to write regulations dictating pay at financial firms. How they choose to use these powers could have a major impact on whether banks pursue excessive risks.

"The financial crisis made patently clear that the direct regulation of the choices that banks make is bound to be imperfect because regulators are often following behind," said Lucian A. Bebchuk, a Harvard Law School professor who has advised the Obama administration on executive compensation issues. "It's valuable for regulators to have an extra tool to influence the private incentives that will shape executives' decision-making."

Banking regulators now face a set of choices as they seek to implement the financial pay provisions of the law, which requires action within nine months.

Shortly before the law's passage, regulators issued guidance on bank pay. They can now decide whether to continue with that guidance, which outlines broad principles about how firms should pay their executives, or write specific rules dictating pay schemes.

In either case, they will also have to decide how much compensation packages need to change to discourage bankers from taking excessive risks.

The pay decisions made by regulators will apply not only to banks but also to brokerages, credit unions, investment advisers, Fannie Mae and Freddie Mac, and other financial firms with $1 billion or more in assets.

Many analysts, academics and government officials have blamed the compensation plans that were common on Wall Street before the financial crisis for encouraging executives to take unnecessary risks. These plans put a premium on pursuing short-term profits and increases in stock price.

For now, banking regulators have decided to stick with the guidance-oriented approach they adopted in June. The guidance requires that banks ensure that pay plans reward long-term performance rather than excessive risk-taking; that banks monitor their risks carefully; and that boards play a large role monitoring compensation practices.

Banks must submit plans for overhauling their pay programs to meet the new guidance in coming months, but no deadline has been specified.

Federal regulators considered issuing more specific rules but concluded it was too difficult to come up with pay plans that would meet the needs of the wide range of firms and executives covered, according to sources familiar with regulators' thinking.

But regulators could change their minds, the sources said, speaking on condition of anonymity because they were not authorized to discuss the matter publicly.

A number of leading academics, including Bebchuk, argue that banks need to tie compensation to a broader range of indicators than used previously.

Historically, a company's stock price and annual profits have been among the drivers of banker pay. Academics say these can be good measures for determining compensation but cannot be used alone. For starters, they say, pay should be tied to a bank's stock price and earnings over a three- to five-year period.

But in addition, academics say, bank pay should be tied to more than stock price and annual profits, because the value created for shareholders is not all that a bank represents. The bank has a variety of interests, including bond holders and the government as the ultimate insurer of deposits.

For this reason, compensation should also be linked, for instance, to the value of a bank's debt, according to this view. Alex Edmans and Qi Liu of the University of Pennsylvania described the thinking behind this approach in a recent essay:

"We start with a model in which the CEO chooses between a risky and a safe project. . . . A CEO who holds only equity will take the risky project even when it destroys value because, if he gets lucky and it pays off, his equity will soar; but if it fails, it's bondholders who suffer most of the losses" as in the recent crisis.