HBR EDITORS' BLOG

Executive Compensation: The Leadership Failure that Led to Pay Caps

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Companies receiving TARP funds appeared to have dodged a bullet when the Obama Administration announced its executive pay initiative. Politically, the administration had to do *something* to quell populist fury over CEO pay if it hoped to pass the stimulus bill and gain credibility with its new credit-loosening proposals, including TARP II (which had other credibility problems).

But under the guidance of Treasury Secretary Geithner and White House economic czar Larry Summers, the initiative was much more about process than substance. It used more "soft" caps than "hard" caps on pay, and was much more bark than bite.

Hard caps ($500,000 in pay plus restricted stock that only vested when TARP money was paid back) applied just to companies who did "exceptional" deals with the government--but only prospectively. The initiative didn't apply to past special deals with AIG, Citi and Bank of America.

Soft caps applied, in the future, to all other TARP companies (those receiving "general" assistance with the same terms for all recipients). A similar $500,000 pay cap plus restricted stock with delayed vesting could be waived if the "general" TARP company does three things: Discloses compensation for senior executives; shows how the comp strategy encourages sound risk management; and puts the comp plan to a "say for pay" shareholder vote (which was coming this year in the financial services sector anyway).

The Administration hoped that companies would take these procedural prompts seriously and produce a variety of plans which would then be analyzed further to see if more regulation was needed to align compensation with proper risk management and long-term value and growth. It sensibly envisioned a public dialogue on this tough issue, not hard and fast rules now.

But, to the consternation of Geithner and Summers, Senator Christopher Dodd, chair of the Senate Banking Committee, put some hard and fast rules in an amendment to the stimulus package. In Dodd's amendment, TARP companies that receive more than $500 million are prohibited from giving the top five officers and 20 most highly paid employees (e.g. traders) a bonus of more than one-third of total annual compensation--and that bonus must be in restricted stock which doesn't vest until the government is repaid.

This rule applies to companies that have already received funds, not just to those that may in the future. Although it doesn't set a flat cap on salary, the cap on bonuses at one-third of total compensation is a flat rule. (The rule applies to fewer officers/employees if companies receive less than $500 million).

Questions remain about the amendment (does it apply to '08 bonuses?), but it's clearly more rigid and draconian than the Administration initiative. Critics have already argued that it encourages companies to set annual salaries too high and does nothing to relate compensation to longer-term performance (a critical goal). Critics also speculate it could start an exodus of talent from TARP companies, right when talent (including new faces not responsible for past transgressions) is needed most. Lastly, Dodd's plan may also force fast paybacks to the government when there are better uses of capital in a crisis.

Having sown the executive compensation wind, the financial sector is now reaping the whirlwind. When the salary issue moved from the Administration to Congress, which is more responsive to widespread public anger, it spun out of control.

The anger over executive pay stems from any number of sources: the apparent lack of penalty to executives who caused the credit crisis and the financial service meltdown; the pay systems that rewarded paper

churning and greed, not risk management and value creation; the seeming inability or unwillingness of companies that caused the problem to loosen credit since the fall; and the tone deaf symbolic acts (plane purchases, office decorations and billions in bonus) that the sector was too insensitive to explain (even if good explanations were to be had, at least as to planes and bonuses for some who deserved them).

But more profoundly, the failure of financial sector leadership what's led us to the Dodd Amendment.

Almost no financial services CEOs or Board leaders have stood up and said, Here is what went wrong. Here is how compensation contributed to the problem. Here is how we are going to fix it.

The need for such constructive candor has been obvious for six months. But instead of candor, in general we've gotten silence. Even when the eight financial service CEO's testified before Congress, their written testimony had very little analysis, if any, on executive compensation--even as the storm warnings were everywhere, including just down the corridor in the Conference Committee.

Such a forthright discussion couldn't have stopped action in Washington on executive compensation, but it might have been enough to let the Admninistration's more nuanced, less punitive initiative take root.

In sum, the Dodd Amendment will feed the populist impulse but, as a policy matter, may well impair efforts to fix the financial sector, unless the Administration can work out some future modification. But financial sector leaders bear heavy blame--not only for causing the problem, but for failing to confront exec pay reform candidly, leaving its shape and direction to the political whirlwinds which sweep through the halls of Congress in times of stress.

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