

COMPENSATION IN THE FINANCIAL INDUSTRY

HEARING BEFORE THE COMMITTEE ON FINANCIAL SERVICES U.S. HOUSE OF REPRESENTATIVES ONE HUNDRED ELEVENTH CONGRESS SECOND SESSION

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JANUARY 22, 2010
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COMPENSATION IN THE FINANCIAL INDUSTRY

Friday, January 22, 2010

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Sherman, Moore of Kansas, Miller of North Carolina, Green, Cleaver, Bean, Perlmutter, Donnelly, Foster, Carson, Kilroy, Grayson; Bachus, Hensarling, Garrett, Neugebauer, Campbell, Lee, and Lance.

The CHAIRMAN. The hearing will come to order. And we have 10 minutes on each side. Since there are not many members here, we can get right into the questioning and have some significant—everybody will be able to ask questions. I will say that I want to announce that on February 5th, we are going to have a joint hearing with the Committee on Small Business on the question of why more money isn't being lent. And we are picking February 5th because we agreed to have a joint hearing which means that 100 Members of the House will be the operative body. So this will be one day where, if Members come to us and say I can't make it, we will not be totally unhappy; but we did feel that this is something that the Small Business Committee has a very real interest in this as well.

We have the chairman and the ranking member of the Small Business Committee on this committee so we will do that one together.

And this hearing will now begin. We have 10 minutes on each side for opening statements, and I begin by recognizing for 2 minutes the gentleman from Indiana, Mr. Carson.

Mr. CARSON. Thank you, Mr. Chairman. As we all know, the American taxpayers are angry that their tax dollars lifted many financial firms in the time of crisis while some of these same firms now have reported record profits and are handing out lavish bonuses. Some of these firms have not turned around but continue to follow reckless compensation practices. This is because we currently have an irresponsible corporate culture where American CEOs are awarded large bonuses and generous stock options even when their companies perform poorly.

There has been an increase in the typical CEO pay in the United States during the past 25 years. The total real compensation of CEOs in large publicly traded companies grew sixfold during this

period. The case against the pay of American CEOs looks even more powerful by recognizing that the typical American company head receives greater total compensation than company heads in Great Britain, Canada, Japan, Spain, and in much of all developed countries. Clearly, American CEOs are being rewarded over CEOs elsewhere, even when per capita income of the countries do not differ by very much.

While recent headlines on executive compensation are focused on financial firms, we cannot ignore other sectors. In fact, the corporate library recently ranked five CEOs, all outside of finance, the highest paid, worst performers. These CEOs are taking home more pay, despite the fact that their businesses have done so badly, that their stocks have tanked, and they have laid off many employees.

American compensation structures are out of control and the existing compensation structure cuts to the ability of our corporate governance system to function. As we work to issue new guidelines on executive pay, we need to ensure firms begin to better align pay with stockholder value.

I suggest moving beyond a nonbinding shareholder vote on executive compensation. There is continued frustration with company boards that either failed to act in response to a successful non-binding shareholder resolution or a watered-down implementation of proposals. Boards can too easily amend or rescind board-adopted policies under the umbrella of fiduciary duty obligations.

While I encourage open dialogue between shareholders, directors, and management, I do feel shareholders have the incentive to act responsibly in determining fair and equitable pay for executives of firms.

Thank you, and I yield back the balance of my time.

The CHAIRMAN. The gentleman from Alabama—I believe the gentleman used 2½ minutes, so we will have 7½ left. The gentleman from Alabama for 2½ minutes.

Mr. BACHUS. Thank you, Mr. Chairman. Mr. Chairman, since you have been chairman, I think you have been very fair to committee Republicans. You have invited witnesses that we have requested and often invited more than just one of our choices at certain hearings. Of course, it is traditional that the Republicans get to call one witness at a hearing. I have always appreciated your consideration and I know my colleagues have too. Because you have always been accommodating of our requests, the decision to deny Republicans our witness choice for this hearing is both disappointing and puzzling. I am not sure what makes this hearing any different from any other one.

So I would ask why we were denied our choice of witness. That witness was Ed DeMarco. He is the acting director of the Federal Housing Financial Agency, which oversees Fannie Mae and Freddie Mac. He is the person who, along with the Treasury Department, approved a \$42 million payday for 12 executives of the failed GSEs, including \$6 million to the chief executives.

During this hearing on compensation in the financial industry, we assumed we would be permitted to examine a real-life case of excessive unreasonable executive pay at the two companies which have received more extraordinary taxpayer assistance over—\$110 billion and counting—than any others. But we were wrong.

Mr. Chairman, \$6 million is 15 times more than what the President earns and 30 times more than what a Cabinet Secretary earns. The Christmas Eve announcement of these bonuses was greeted by one commentator by saying the taxpayers got scrooged. Because the regulators failed to use their authority to block these colossal paydays of government employees—you have referred to them as public utilities—Congress should step in.

I and several of my Republican colleagues have introduced legislation to protect taxpayers from having to foot the bill for any more multibillion-dollar tax packages.

Mr. Chairman, I think the taxpayers are right. Whether it is any financial company, if the government is heavily subsidizing that company, they have a right to ask—

The CHAIRMAN. If you wish to continue—

Mr. BACHUS. Another 30 seconds. They have a right to ask: Are my tax dollars subsidizing these large salaries? And they certainly have the right to hear Mr. DeMarco and find out why, on Christmas Eve, they learned that they would be paying some tremendous bonuses.

The legislation also expresses a sense of Congress that each executive should return the executive pay they received in 2009 so we can reduce the Federal budget.

Mr. Chairman, I do appreciate your pledge to invite Mr. DeMarco to testify at a hearing in late February, but I am disappointed that the American taxpayers will have to wait another 5 weeks for an explanation from the Obama Administration about this Christmas Eve raid on the Treasury to pay these executives.

I yield back the balance of my time.

The CHAIRMAN. The gentleman consumed 3 minutes. There will be 7 minutes on his side and 7½ on this side. I recognize the gentleman from California.

Mr. SHERMAN. Thank you.

The CHAIRMAN. For 2½ minutes.

Mr. SHERMAN. Yes. I believe in capitalism, that means shareholder control, shareholder risk. That is why we should have a say on pay and it ought to be binding. After 13 years in Congress, I am not a real fan of nonbinding resolutions. There is a special circumstance where a company is too-big-to-fail because at that point, they have a quasi-Federal Government guarantee. The best solution is to break them up so that we don't have anyone who is too-big-to-fail.

I commend the gentleman from Pennsylvania whose amendment would at least allow the Administration to do just that. Until then, those that are too-big-to-fail should face fees to recoup for the taxpayer the benefits that the organizations get from their implicit Federal guarantee.

The bill we passed in this committee, in this House, does that, and, with Peter's amendment, allows those firms to pay for the past cost of the too-big-to-fail as well as provide it a before-the-fact fund to pay for the too-big-to-fail problems of the future. It also makes sense as long as there are those that are too-big-to-fail and enjoy the implicit Federal guarantee, if they are quasi-government entities or quasi-federally guaranteed, they should play by govern-

ment salary rules, which are a lot different from those that Wall Street is familiar with.

The best solution is for these firms to voluntarily divide themselves so they are not too-big-to-fail. And we can go back to real capitalism—shareholder control, shareholder risk—and a Congress and a Federal Government that doesn't have to concern itself with salaries and other aspects of internal corporate decisionmaking

I yield back.

The CHAIRMAN. The gentleman has consumed, I believe, 1 minute and 20 seconds. So that will leave us on this side about 6½ minutes. And the gentleman from Texas is recognized for 2¼ minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Let me see if I can get this straight. We are going to regulate the compensation for companies that paid the TARP money back, but we approved a multimillion-dollar pay package for Freddie and Fannie who will never pay any of that money back. Now, that is what I call picking winners and losers. And in this case, unfortunately, the losers win.

Since the American people now own almost 80 percent of Fannie Mae, we need good management to stop the bleeding and see if we can recoup at least some of the taxpayers' money. But more importantly, we need consistent policy in this country.

I think it is important to kind of reflect on what is going on today. We are going to regulate compensation, tell companies what they can and cannot do, break them up if some bureaucrat thinks they are too big, tax their products. By the way, I am not talking about Venezuela, I am talking about what is going on in the United States. The American people are getting tired of the government telling them what to do.

So today, we are going to talk about more big-government intervention into America's companies. We are going to try to look tough on the financial institutions so we can appease the anger of the American people for committing trillions of their hard-earned money to bail these entities out in the first place.

If any colleagues were so concerned about the taxpayers and not Wall Street, why did they bail out Wall Street at the expense of the American taxpayers?

What the American people really want us to focus on is how can we raise their wages and create jobs for those who have lost theirs, instead of focusing on issues that don't create jobs and, in fact, are going to cause the American people to lose their jobs.

Mr. President, we need you to focus on jobs, not raising taxes, growing government, and spending money we don't have on flawed stimulus packages. Where are the jobs you promised the American people? Instead of more government, the American people want more jobs. They sent you a wake-up call on Tuesday in Massachusetts, Mr. President. I hope you were listening.

With that, I yield back.

The CHAIRMAN. The gentleman from Kansas is recognized for 2 minutes.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman. Just like reasonable executive compensation rules to increase financial stability should not be bipartisan, reforming Fannie and Freddie should not be either. I am disappointed that some of my friends on the other

side forget that when they controlled Congress for 12 years, they did not enact meaningful reform of Fannie and Freddie.

Last year, the former chair of this committee, Mike Oxley, said, "We missed a golden opportunity that would have avoided a lot of problems we are facing now if we hadn't had such a firm ideological position at the White House and the Treasury and the Fed."

I hope we can come together this time, Republicans and Democrats, to explore good policy options to deal with Fannie and Freddie later this year.

Turning back to executive compensation, I have always felt that financial firms receiving taxpayer assistance should receive the most scrutiny with respect to their executive compensation practices. One example involves reports of large salaries for Fannie and Freddie executives. I wrote them about this last March when we first learned about it, and after receiving an unsatisfactory response from FHFA, I joined Chairman Frank and others to vote for H.R. 1664 to stop those unfair pay practices of TARP recipients. Protecting taxpayers should not be a partisan issue. So I was disappointed that some of my friends on the other side didn't join us to support that commonsense measure.

Finally, for firms who have repaid TARP, I don't think the government should go in and set specific pay levels, but to better protect investors and taxpayers in the future, the government does have a role in looking at how pay is structured more broadly to ensure risk-taking is properly aligned with rewards and doesn't pose a systemic risk.

I look forward to hearing from our witnesses and exploring issues in further detail, and I yield back the balance of my time, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling, for 2½ minutes.

Mr. HENSARLING. Thank you, Mr. Chairman. After upset defeats in the States of New Jersey and Virginia, and a stunning upset defeat in the Commonwealth of Massachusetts, I would have hoped that this Administration and this Congress would have gotten down to job number one, and that is to help create jobs for the American people. Instead, it really appears that the Administration is set upon an adventure in scapegoatism: Let's see if we can find an entity that perhaps is more unpopular than our Administration in the United States Congress. Thus we have this launching of the assault upon the investment community.

Now, are there outrageous compensation systems out there? Yes. I am outraged by late-night comedians who make tens of millions of dollars to be mean to each other. I am outraged by professional athletes who make tens of millions of dollars and abuse their spouses and girlfriends. And, yes, I am outraged by compensation packages on Wall Street as well. But none, none, are more outrageous than those who use taxpayer funds to reward the execs at Fannie and Freddie.

And so on Christmas Eve, this Administration decided to take out all the goodies from the stockings of the American taxpayer and hand it over to the executives of Fannie and Freddie, which are functionally owned by the United States Government, and hand them out, the two CEOs, \$6 million pay packages, \$42 million

for the rest of their execs. And so we are paying these people bonuses to lose tens of billions of dollars for the United States taxpayer. Now, what people do with their money is their business; what they do with the taxpayer money is our business.

And so I echo the comments of our ranking member. I have said privately and publicly that this is a committee that has a reputation for fairness under Chairman Frank.

Now, I am unaware under his leadership, or his Republican predecessor in the 7 years that I have been here, that the Minority has ever been denied their request to have a witness. So we requested a witness, Ed DeMarco, the acting head of FHFA to ask a simple question—

The CHAIRMAN. The gentleman's time has expired. If you want to take more time, it will come out of the 10 minutes.

Mr. HENSARLING. I yield back the balance of my time.

The CHAIRMAN. Well, unanimous consent for an additional 15 seconds to finish that thought, that wouldn't come out of everybody's time, if the gentleman would like.

Mr. HENSARLING. I was hoping that Mr. DeMarco could be here to answer the question why he has spent millions for bonuses to pay people to lose billions of dollars for the taxpayer, and unfortunately again for whatever reason, that request was denied. Thank you, Mr. Chairman.

The CHAIRMAN. I yield myself my remaining time which I think is 3½ minutes; is that correct?

I want to thank both the gentlemen from Texas and the gentleman from Alabama for their comments about the fairness of the committee. I am very proud that I think this committee holds the record for the number of amendments that we are debating on the Floor at markup time.

We do have one difference here. The members of the Republican side have made the distinction between private sector and public sector entities when it comes to compensation. That is why I wanted to defer Mr. DeMarco to a hearing we will have with Mr. DeMarco, and I hope Mr. Lockhart—a Bush appointee who had that position before and it was was a holdover—and Mr. Feinberg, and probably Sheila Bair and Dan Tarullo. That is, I think it makes sense to separate the issues of what we do about private sector compensation where our role is a more limited one, as we all agree, and public sector compensation.

The question for Mr. DeMarco is what do we do about public sector compensation?

Now, I also want to say I am not usually the one who welcomes converts. That has generally not been my side of the street. But I do want to welcome my Republican colleagues to conversion to the notion that we should regulate the pay of Fannie Mae and Freddie Mac.

Last year, this committee twice reported bills to the Floor which explicitly proposed restrictions on the pay of Fannie Mae and Freddie Mac, and the Republicans opposed it in committee and opposed it on the Floor. Indeed, in the case of one of the bills that wasn't on the private sector, because it wasn't clear what the status was at the time. The gentleman from Texas, Mr. Hensarling, offered an amendment to make sure that they were explicitly cov-

ered. We adopted the amendment. But that did not persuade the gentleman from Texas to vote for the bill on the Floor.

So we have had two bills which passed the House which explicitly authorized regulation in the pay of Fannie Mae and Freddie Mac, and all the Republicans on this dais here voted against it both times. One Republican, Mr. Jones, voted for it one time. So I am a little skeptical as to why we have all of this coming up now.

By the way, when we passed the bill that specifically would have done it for public-funded companies, we got a letter on March 20th—which I will put into the record—from James Lockhart, the Bush appointee who was running the Housing Finance Agency, held over, strenuously objecting to it. So it was the Bush Administration that first raised the objections of the Bush Administration holdover.

I think the pay that was given to Fannie Mae and Freddie Mac was too high, and I think this: We will have a hearing with Mr. DeMarco, and others who administer pay schemes for public employees in a month. My colleague from Texas said he wanted to know the answer. I know he is a man of great patience and he has a very strong attention span. I don't think a month from now he will have forgotten the questions he wanted to ask. He could write them down and we will preserve them. But, yes, we will have this.

I also believe what we have here is an embarrassment on the part of my Republican colleagues because they don't want to do anything about the excessive pay in the private sector, nor do they want to appear to not be doing anything about it, so they are changing the subject.

By the way, we do not propose any specific limits on the pay in the private sector. We do say that the shareholders should vote—radical motion—but we also say that there is a public spillover effect; namely, that the structure of those compensation packages often incentivize excessively risky behavior. And we have mandated that the regulators end this “heads they win,” “tails they break even at worst.” So that is what we are talking about, private and public sector. We are dealing with the private sector today, to the discomfort of my Republican colleagues. We will get to the public sector in a month.

The gentleman from—the gentleman's side has 2½ minutes left. Does the gentleman wish to use it?

Mr. BACHUS. I would ask—

The CHAIRMAN. We have 10 minutes for debate.

Mr. BACHUS. I would like to claim 15 seconds.

The CHAIRMAN. The gentleman is recognized for 15 seconds.

Mr. BACHUS. The executive compensation the chairman refers to covered all companies, both private and public. It covered community banks and it covered all employees, not just top executives. It was a political response to AIG, but it was poorly written—

The CHAIRMAN. Does the gentleman yield?

Mr. BACHUS. The Senate has never taken up that bill, and the last time I looked, the Democrats controlled the Senate. They realized it was a bad bill.

Thank you, Mr. Chairman.

The CHAIRMAN. Does the gentleman yield?

Mr. BACHUS. No, my time has expired.

The CHAIRMAN. The gentleman from New Jersey is now recognized for 2 minutes and 15 seconds.

Mr. GARRETT. I thank the chairman, and I thank the ranking member. And as the ranking member has already outlined, and I concur with his position with regard to the appropriate request for someone else at this hearing, the acting head of FHFA, and I appreciate the chairman's explanation of why he thought we should segregate the panels in this manner. But that really doesn't go to the comment that I think the gentleman from Texas made that no one up here can remember the last time that a member of the Minority requested someone to come to the panel, be a witness, and a Majority party refused that appropriate request. As of this point, the chairman has yet to fully explain why they refused that request.

As the gentleman from Texas also points out, Fannie and Freddie are different from these; they are under government control. The chairman of this committee, as a matter of fact, has recently stated they are basically, "public policy instruments of the government." Fannie and Freddie are.

So while I may think the Majority's initiatives in the area of executive compensation in that April legislation are examples of government overreach into the private sector, if there is one example, one case, one line of executive compensation that should be looked at, it is where taxpayer dollars are being used, and that is in the area of Fannie and Freddie.

And beyond this point, the area of executive compensation, there is a bigger issue that really we should be looking at. That is the Christmas Eve announcement, when the Administration took action, without any congressional input whatsoever, of the unilateral lift of the \$400 cap on Fannie and Freddie's bailout and authorized unlimited taxpayer funds to use, both firms, over the next 3 years. Again, we have requested a hearing on this, or the chairman to allow a witness on this, and again he has refused.

Meanwhile, however, the Republican Party has come back with our proposals, but they have been ignored. The Republicans in this committee have put forth proposals to reform these institutions, because it is indisputable that Fannie and Freddie were the central role in the mortgage meltdown that we have experienced. They helped ignite the economic crisis that has left millions of Americans unemployed. So passing stronger GSE reform legislation should be at the very top of this committee's agenda.

Thank you.

The CHAIRMAN. The gentleman's time has expired.

We will now proceed to hear from the witnesses, repeat witnesses in every case, who are always welcome in this committee because they are people who make very significant contributions not just in this testimony but even more importantly, obviously, in the debate over important public issues in the country and the world.

We begin with Professor Lucian Bebchuk, who is a professor of law, economics and finance, and director of the corporate governance program at Harvard Law School.

**STATEMENT OF LUCIAN A. BEBCHUK, WILLIAM J. FRIEDMAN
AND ALICIA TOWNSEND FRIEDMAN PROFESSOR OF LAW, EC-
ONOMICS, AND FINANCE, AND DIRECTOR OF THE COR-
PORATE GOVERNANCE PROGRAM, HARVARD LAW SCHOOL**

Mr. BEBCHUK. Chairman Frank, Ranking Member Bachus, and distinguished members of the committee, thank you very much for inviting me to testify here today.

I would like to devote my introductory comments to making four points.

First, there is a growing acceptance, including among business leaders, that compensation structures have provided perverse incentives. They have encouraged financial executives to seek to improve short-term results even at the expense of an elevated risk of an implosion later on. Let me illustrate this problem with the example of Bear Stearns and Lehman Brothers, the two investment banks that melted down in 2008.

Many commentators have assumed that the executives of these firms sold their own compensation, their own wealth wiped out together with the firms', and then inferred from this assumed fact that the firms' risk-taking could not have been motivated by perverse incentives created by pay arrangements.

In a recent paper, my coauthors and I did a case study of compensation at those two firms between 2000 and 2008, and we find that this assumed effect is incorrect. We estimate that the top five executive teams of Bear Stearns and Lehman Brothers derived cash flows of about \$1.4 billion and \$1 billion, respectively, from cash bonuses and equity sales during 2000 to 2008, and these cash flows substantially exceeded the value of the executives' initial holdings in the beginning of the period. As a result, unlike what happened with the long-term shareholders, the executive net payouts for 2000 to 2008 were decidedly positive.

The second point I would like to make is that we cannot rely solely on existing governance arrangements to produce the necessary reforms. To be sure, some firms have announced reforms of the compensation structures. For example, they indicated that bonuses would be subject to clawbacks. But firms have generally not provided information that would enable outsiders to determine whether the clawbacks would be meaningful and affect behavior or would be merely cosmetic.

This is an area where the devil is in the details. Because the changes that firms adopt appear to be at least partly motivated by desire to appear responsive to outside criticism, there is a basis for concern that arrangements with details that are not disclosed might not be sufficiently effective.

What else should be done? The point I would like to stress is to improve arrangements, pay arrangements in particular, in governance more generally. We have to strengthen shareholder rights.

In addition to introducing say on pay votes, which H.R. 3269 would do, there are other things that need to be done to bring shareholder rights to the same level as the shareholders in the U.K. and other English-speaking countries enjoy. In particular, the following aspects of their existing state first deserves the Commission's attention. Many publicly traded firms still do not have majority voting. Shareholders still like the power to place director can-

didates under corporate bylaws. Many privately traded funds still have staggered boards, and many such firms have supermajority requirements that make it difficult for shareholders to change governance arrangements.

Finally, in addition to strengthening shareholder rights, it remains important to have regulatory supervision of pay structures in financial firms, as the provisions of H.R. 3269 would require.

Opponents of regulatory intervention argue that such regulatory supervision would drive a talent away. However, the regulation under consideration focuses on structure, not on pay levels, and firms would still be able to offer packages that are sufficiently attractive in terms of pay levels. One of the established insights in economics is that it is never efficient to compensate agents using perverse incentives; in the financial sector, an especially important context to apply this established insight. Thank you.

[The prepared statement of Professor Bebchuk can be found on page 45 of the appendix.]

The CHAIRMAN. Next, we have Professor Joseph Stiglitz, university professor at the Columbia Business School.

**STATEMENT OF JOSEPH E. STIGLITZ, UNIVERSITY
PROFESSOR, COLUMBIA BUSINESS SCHOOL**

Mr. STIGLITZ. It is both a source of pleasure and sadness to testify before you today. I welcome this opportunity to testify on this important subject, but I am sorry that things have turned out so badly thus far.

In this brief testimony I can only touch on a few key points, and many of these points I elaborate in my book, "FreeFall," which was published just a few days ago.

Our financial system failed to perform the key roles that it is supposed to perform in our society: managing risk; and allocating capital. A good financial system performs these functions at low transaction costs. Our financial system created risk and mismanaged capital, all the while generating huge transaction costs, as the sector garnered some 40 percent of all corporate profits in the years before the crisis.

So deceptive were the systems of creative accounting the banks employed that, as the crisis evolved, they didn't even know their own balance sheet, so they knew that they couldn't know that of any other bank. We may congratulate ourselves that we have managed to pull back from the brink, but we should not forget that it was the financial sector that brought us to the brink of disaster.

While the failures of the financial system that led the economy to the brink of ruin are by now obvious, the failings of our financial system were more pervasive. Small- and medium-sized enterprises found it difficult to get credit, even as the financial system was pushing credit on poor people beyond their ability to repay.

Modern technology allows for the creation of an efficient low-cost electronic payment mechanism, but businesses pay 1 to 2 percent or more for fees for a transaction that should cost pennies or less. Our financial system not only mismanaged risk and created products that increased the risk faced by others, but they also failed to create financial products that could help ordinary Americans face

the important risk they confronted, such as the risk of homeownership or the risk of inflation.

Indeed, I am in total agreement with Paul Volcker. It is hard to find evidence of any real growth associated with many of the so-called innovations in our financial system, though it is easy to see the link between those innovations and the disaster that confronted our economy.

Underlying all the failures a simple point seems to have been forgotten: Financial markets are a means to an end, not an end in themselves. We should remember, too, that this is not the first time our banks have been bailed out, saved from bearing the full consequences of their bad lending. Market economies work to produce growth and efficiency, but only when private rewards and social returns are aligned. Unfortunately, in the financial sector, both individual and institutional incentives were misaligned, which is why this discussion of incentives is so important.

The consequences of the failures of the financial system are not borne by just those in the sector, but also by homeowners, retirees, workers, and taxpayers, and not just in this country but also around the world.

The externalities, as economists refer to these impacts and others, are massive; and they are the reason why it is perfectly appropriate that Congress should be concerned. The presence of externalities is one of the reasons why the sector needs to be regulated.

In previous testimony I have explained what kinds of regulations are required to reduce the risk of adverse externalities. I have also explained the danger of excessive risk-taking and how that can be curtailed. I have explained the dangers posed by underregulated derivative markets. I regret to say that so far, more than a year after the crisis peaked, too little has been done on either account. But too-big-to-fail banks create perverse incentives which also have a lot to do with what happened.

I want to focus my remaining time on the issue of incentives and executive compensation. As I said, there are also key issues of organizational incentives, especially those that arise from institutions that are too-big-to-fail, too-big-to-be-resolved, or too-intertwined-to-fail.

The one thing that economists agree upon is that incentives matter. Even a casual look at the conventional incentive structures, with payments focused on short-run performance and managers not bearing the full downside consequences of their mistakes, suggested that they would lead to shortsighted behavior and excessive risk-taking. And so they did.

Let me try to summarize some of the general remarks that I make in my written testimony that I hope will be entered into the record. Flawed incentives played an important role, as I said before, in this and other failures of the financial system to perform its central roles. Not only do they encourage excessive risk-taking and shortsighted behavior, but they also encourage predatory behavior.

Poorly designed incentive systems can lead to a deterioration of product quality, and this happened in the financial sector. This is not surprising, given the ample opportunities provided by creative

accounting. Moreover, many of the compensation schemes actually provide incentives for deceptive accounting. Markets only allocate resources well when information is good. But the incentive structures encouraged the provision of distorted and misleading information.

The design of the incentives system demonstrates a failure to understand risk and incentives and/or a deliberate attempt to deceive investors, exploiting deficiencies in our systems of corporate governance.

I want to agree very much with Professor Bebchuk's view of the need for reforms in corporate governance. There are alternative compensation schemes that would provide better incentives, but few firms choose to implement such schemes. It is also the case that these perverse incentives failed to address adequately providing incentives for innovations that would have allowed for a better functioning of our economic system.

[The prepared statement of Professor Stiglitz can be found on page 68 of the appendix.]

The CHAIRMAN. Nell Minow, who is the founder and editor of The Corporate Library.

STATEMENT OF NELL MINOW, EDITOR, THE CORPORATE LIBRARY

Ms. MINOW. Thank you very much, Mr. Chairman, and members of the committee. It is a real honor to be back here again, and, like Professor Stiglitz said, I wish I had better news for you. In previous appearances, I have called executive compensation both the symptom and the cause of the instability of the financial services sector and our capital markets. I regret to say that the problem continues.

Yesterday, the Supreme Court told us that a corporation is a person with First Amendment rights, but as Baron Lord Thurlow told us hundreds of years ago, a corporation has no soul to be damned, no body to be kicked, and that is why corporations essentially get away with murder in matters like compensation.

The boards of Wall Street financial institutions implemented pay plans that were a major and direct cause of the financial meltdown. These purported bastions of capitalism protected themselves from risk by limiting their downside exposure and taking their pay off the top. Second, rinse repeat. They took bailout money and kept paying themselves as though they earned it. What they did before the bailout was counterproductive and misguided. What they have done since the bailout is an outrage, or, as my grandmother would have said, a "shanda."

Since the only portion of pay that TARP did not restrict was base pay, everybody got a raise. For example, Wells Fargo's board approved a 522 percent salary increase for the CEO from \$900,000 to \$5,600,000. The extra was paid in stock, and we have seen this throughout the center. They took the opportunity, when the stock market was at its rock bottom, to load everybody up with buckets of new stock and options. So I am predicting now that the next time you have me back here to speak, we will be talking about how outrageous it is that they got insane pay packages again; but now is when they are happening. And we will see the payout later on.

These enormous grants of stock issued at historic low prices are resulting in enormous payouts based on the infusion from the bailouts in the overall market. I completely agree with what the members of this committee have said about taxpayer money. This is taxpayer money. They are getting paid as though they earned that money, the money that the taxpayers put into it. They are taking a piece off of the top of the taxpayers' money. That is absolutely right. That is an outrage.

So the clawbacks that were required as a result of this committee's work are also being subverted. As Professor Bebchuk said, there is a lot of weasel language being instituted into the clawbacks, saying that bad faith has to be required, or some kind of emotion or feeling or intention has to be required. Clawbacks should apply no matter what the reason for the correction; otherwise, as Professor Siglitz said, they create a perverse incentive.

I ask this committee to lead the way to put an end to too-big-to-fail, the term and the concept. If a company is too-big-to-fail, it is too-big-to-succeed, or, as the title of a thoughtful new book by Robert Pozen puts it, it is "too-big-to-save." If an enterprise is too-big-to-fail, it is a utility and it should be regulated like one and executives should be paid like public servants.

Wall Street boards and executives have abused shareholders by creating perverse incentives for themselves, through their pay plans.

The IMF has a very important new study linking lobbying expenditures and high-risk lending. In other words, it is another example of externalizing the risks onto everybody else and keeping the pay plans. They are now doing their best to perpetuate this system by pouring over \$70 million so far into fighting any meaningful reform. This is just another example of diversion of assets to perpetuate the externalization of risk onto the shareholders and the taxpayers.

I hope that Congress will address this attempt to subvert the efficient oversight of the market and restore the credibility of our financial sector by removing obstacles to effective shareholder oversight of pay.

[The prepared statement of Ms. Minow can be found on page 52 of the appendix.]

The CHAIRMAN. Thank you. Let me begin the question and—I want to give my Republican colleagues credit. They fundamentally want to take the attention away from the subject of excessive compensation, which is a legitimate public sector issue, probably because, as Ms. Minow just noted, they are paying money which they are able to have in part because of a significant public intervention; also because there are effects on the economy as a whole as to the way in which it is structured. And also, of course, because the notion that we are interfering in a private sector sphere when we set the laws for corporate governance is nonsense.

Corporations are a creation of the law, even though the Supreme Court thinks God made them, and this can be regulated by us in many ways. They simply don't want to do anything that would interfere with that, but they have raised the Fannie/Freddie thing.

I want to respond to one point that the gentleman from Alabama raised when I pointed out that the Republicans twice voted in com-

mittee and on the Floor against legislation to give regulators the power over Fannie Mae and Freddie Mac salaries, which they now say they want. He said, well, that was in the bill that covered all the private sector. But there were two bills. The gentleman from Alabama forgot to mention one. The first bill that came forward was H.R. 1664, which specifically covered only those financial institutions that were receiving financial assistance—TARP money and Fannie and Freddie. It had nothing to do with the rest of the private sector.

Page 2 of that bill: No financial institution has received or receives a direct capital investment under the TARP program or with respect to the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation or Federal Home Loan Bank, etc.

So we had a bill that dealt only with TARP recipients, Fannie and Freddie, and put tough restrictions on them to be administered and they voted against it. So it is not my fault that there wasn't the power to do that more.

Yes, I think they got too much money over the Christmas Eve period. I believe, though, that the remedy here is to in fact—as I believe this committee will be recommending—abolish Fannie Mae and Freddie Mac in their current form and come up with a whole new system of housing finance. That is the approach, rather than the piecemeal one.

But the fact is, there were two bills, and Republicans voted against both of them. One covered all private sector and public sector, but one bill they voted against specifically was limited to TARP recipients in Fannie Mae and Freddie Mac, and it passed the House and it failed. The gentleman is right; the Senate didn't take it up. If they want to blame the Senate, that is okay, I guess, for them to say it, but I don't know why the fact that the Senate might not be taking something up is a justification for a Member of the House to vote "no."

So it is very clear, we put forward a bill that would have toughened restrictions on compensation at the TARP recipients and at Fannie Mae and Freddie Mac in April. They voted against it. Now, to divert attention from this subject which makes them uncomfortable because they don't want to do anything about it, they bring it up.

Let me ask one question to Professor Stiglitz and the others. One of the arguments we have gotten against the President's proposal to tax large financial institutions to recoup the money that was paid out through the TARP and elsewhere that was of great assistance to the financial sector, this will diminish the amount of money they have available for loans and it will force them, over their great reluctance no doubt, to raise credit card and other fees.

Does the size of the bonus pool and the amount of compensation have any relevance to that argument? Professor Stiglitz?

Mr. STIGLITZ. Yes, obviously funds are fungible, and money going out to bonuses reduces the capital base of the banks, and to an extent the money that has been paid out in bonuses, whatever the form, reduces their ability to lend. That is obviously a much more significant amount.

Let me just emphasize one point, since we are talking about incentives. The intent of the President's proposal here is changing the current incentives of the banks to have excessive risk-taking, and excessive risk-taking led to the economy being brought to the brink.

The CHAIRMAN. Tax structure—

Mr. STIGLITZ. That is right, these incentives partly arose from the fact that the tax structure was based on the amount of liabilities that they had. It was directed at—

The CHAIRMAN. Tier 1 capital money.

Mr. STIGLITZ. Exactly.

The CHAIRMAN. What is the relationship between the board of directors and the CEO currently?

Ms. MINOW. I know it is difficult for people who know what real elections are to understand that, but we use the term "election" when we talk about boards of directors, even though essentially the CEO controls who is on the board. These arrangements are often very cozy.

It was not that long ago that CEOs of Cummins Engine and Inland Steel served as chairs of each others' compensation committees. At another company, the CEO is the chairman of the local university's board of directors. The provost is on his compensation committee, etc. So therefore it is a very close circle. And until shareholders can replace directors who get it wrong, we are not going to see any change. So many of the directors, almost all of the directors of the bailout companies continue to serve.

The CHAIRMAN. Thank you. The gentleman from Alabama.

Mr. BACHUS. Thank you. Ms. Minow, you have heard the chairman talking about his executive compensation bill that was introduced last year that the Republicans voted against along with many Democrats. You published an article on The Corporate Library Web site entitled, "Right Question, Wrong Answer" that was critical of the executive compensation legislation, and that was the legislation that Chairman Frank incorporated into the bill. He talks about criticizing us for not voting for it.

In the article you say, "I have the utmost respect for politicians and bureaucrats but I also recognize their limits. The government should not micromanage pay."

I happen to agree with that position. Could you elaborate to committee members on your specific concerns about entrusting political figures and government bureaucrats with the responsibility for designing incentive-based compensation structure?

Ms. MINOW. Certainly, as I said repeatedly before this committee, I do not believe that the government should set pay. I do believe in removing obstacles to allowing shareholders to provide that kind of feedback, as I just said to the chairman, by removing directors who do a bad job through say on pay. I think the bill was perhaps necessary but not sufficient, and I do share the concern of the members of the committee that some of the terminology in the bill was not—did not give enough guidance.

Mr. BACHUS. Thank you, I appreciate that. Obviously, the bill gave the Treasury Secretary really carte blanche authority to define unreasonable excessive compensation, and it wasn't just for top

executives, it was for all employees. And I would vote against that bill today if it were up before me.

Professor—is it “Bibcock?”

Mr. BEBCHUK. “Bebchuk.”

Mr. BACHUS. Okay. In the past, you have criticized GSE executive compensation packages as being decoupled from performance. Under the terms of the GSE executive compensation package that was announced Christmas Eve, two-thirds, or \$4 million of the \$6 million cash compensation for each of the two CEOs, is completely unrelated to firm performance or any performance manager.

Would you agree that the latest GSE executive compensation awards still failed to adequately link pay and performance?

Mr. BEBCHUK. The study you mention was one that was probably several years ago, and it was a careful analysis of compensation arrangements at the time, mainly with respect to the chairman at the time, Raines. And those were the conclusions then. I have not studied the most recent decisions and therefore I am not in a position to evaluate them.

Mr. BACHUS. If I say \$4 million of that was not linked to performance and does not link pay and performance, you would still think that—you would still have your same objections to those compensation packages?

Mr. BEBCHUK. I don’t think I can really offer a view about a package that I haven’t really studied.

Mr. BACHUS. All right.

Ms. Minow, in your written testimony you decry compensation arrangements that widen the gulf between pay and performance and between integrity and outrageousness. In your view, do the pay packages of Fannie Mae and Freddie Mac executives, most particularly the \$6 million awarded to each of the CEOs, adequately link pay and performance?

Ms. MINOW. I have been a consistent critic of the pay packages at Fannie and Freddie, going back before the financial meltdown. And, again, they have a corporate governance nightmare. You can’t be both a public and a private enterprise at the same time.

Mr. BACHUS. Do they meet your definition of outrageous?

Ms. MINOW. They are not as outrageous as the previous pay plans at Fannie and Freddie, but I think they are wrong.

Mr. BACHUS. They are wrong, but how about outrageous? Do they meet your definition of outrageous?

Ms. MINOW. No, no. If I am calibrating the word “outrageous,” they are nowhere near the category of outrageous—

Mr. BACHUS. It might be like a class 4 instead of a class 5 outrageous?

Ms. MINOW. They are troubling; how is that? They are troubling but not outrageous.

Mr. BACHUS. Thank you. I appreciate that very much. I yield back the balance of my time.

The CHAIRMAN. The gentleman from Pennsylvania, and I want to take 15 seconds, if he will yield to me.

My friend from Alabama continues to ignore the fact that there were two bills, one on executive compensation involving the private sector, another that only dealt with TARP and Fannie Mae and Freddie Mac, and he voted against it. So what he talked about be-

fore, what he quoted Ms. Minow about, was the one about general compensation.

But there was a separate bill for Fannie Mae, Freddie Mac and the TARP that came after this question, and that is the one he voted against. There is one bill.

It is not my time. The gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you, Mr. Chairman. I will just open up first with some remarks to the panel, and I appreciate your opinions when I get to conclude. Very often, I have had the occasion over the last 6 to 9 months to make a speech in my district because I am trying to reach constituents to understand the overall complex problem of salaries and wages.

Now, as a given factor in my congressional district in Pennsylvania, the average wage is about \$13 an hour. And if you multiply that times 2,000 working hours a year, that comes to an annual income of, on average, \$26,000.

In the last 9 months or a year, I have had several witnesses who have appeared before my subcommittee, and we have gotten to this question of salary and compensation, and what we do about it. I, for one, am not certain that we put enough direct attention to the matter, and could get into difficulty if we start deciding that we are the final arbiter of what a fair salary is, because quite frankly, I will confess, I don't know.

If hiring a brain surgeon, I guess, and I need brain surgery, there is no amount too excessive until after the success of the operation. Then I will be annoyed, whatever the bill.

The reality is—that is not the topic of our discussion today—but in the hedge fund industry, they report—I remember one witness who was a little annoyed involving a cross examination: What did he make and what is his relationship? He earned about \$2.5 billion a year, and I pressed him because I was offended that he only paid a tax rate of 15 percent because of the structure of his salary, putting him in capital gains as opposed to regular tax. After 15 or 20 minutes, with great annoyance, he finally put his hand in his pocket, leaned back and said, “Congressman why are you picking on me? What did I do to you?” I said, “You did nothing; you happen to be a witness and I am trying to extract some information.” He said, “Well, I want you to know I am only the 51st highest-income person in this country.” This astounded me. I thought we had located the highest-income person. I found out he actually was not and is not, and there are some who make a great deal more.

I guess the first question that I would ask is, what is too much? What is too high? Is it \$5 billion, or \$50 billion? And now I pose that question, because we always use numbers, and I go back to my congressional district of \$13 an hour wage. The gentleman who was testifying before me, his hourly wage is \$1,300,000. That is what he makes every hour of the year.

Now, when you do the mathematics of that, he makes 100,000 times the average wage of an average worker in my district. How do we get a sense? Regardless of what compensation we pass here or do on Fannie Mae, they are chickens; what do they get paid, \$6 million a year? That is peanuts.

I am wondering if we are approaching this from perhaps the incorrect direction. Should we be looking at, first of all, what do we

need to get to a balanced budget? Because these people aren't just earning and taking corporate money or profits. These people are not picking up their burden in society in proportion to their income. And as a result now this year, we are ending up with a shortfall that we could make up if we didn't have these extraordinary ways of avoiding income.

I am just wondering, should we approach this from changing the tax structure and perhaps get to a level field that way, as opposed to identifying particular people where we may be able to exercise power and those so that we cannot. And I am just curious. Let me throw that out there very quickly.

The CHAIRMAN. Maybe 30 seconds for an answer.

Mr. STIGLITZ. I agree with you that the basic framework for thinking about equity should be through our tax system. Incentives are related, because the question is, would they work a little bit less hard if they paid higher taxes? I think the answer is clearly no, it would not have a significantly adverse affect.

The issue that I talked about in my testimony is that the structure of the pay of the executives in these banks has strong effects. The reason we are interested in them is because those effects affected the taxpayers because it led to the economy falling apart. These pay structures imposed huge costs on the rest of us, and therefore they are a legitimate source of concern, as opposed to lots of other areas where people get high pay but are not as much a legitimate source of concern. The way we deal with that is through the tax system.

The CHAIRMAN. The gentleman from Texas.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. I think we have heard from the panel on where they think that there have been abuses in the pay structure, the corporate pay structure. I think one of the things that I would like to hear from the panel is who is doing it right? Where is the model that other companies should follow? Mr. Bebchuk?

Mr. BEBCHUK. Yes. I think that there is evidence that firms with shareholder rights are stronger, where you have less arrangement that would make it difficult to pay directors. Compensation in those firms is more sensitive to performance and also CEO turnover is more sensitive to performance. So we have evidence that relates, empirical evidence that relates the level of shareholder rights, both with firm value in general but also with the quality-of-pay structures.

Ms. MINOW. If you would like to have a specific example, I can tell you that Home Depot went from the very bottom of the list to near the top of the list by going from a CEO where 90 percent of his pay was not related to performance to a CEO where 90 percent of his pay is related to performance.

Mr. STIGLITZ. I want to make one remark because we keep talking about pay related to performance. It is very difficult to identify what you mean by performance. When a company does well as measured by the stock going up, but the reason the stock is going up is because the stock market is going up, then it wasn't what an employee did that led to the company's stock going up. One of the points I make in my written testimony was that, in fact, if you look

at the design of many of the so-called “pay for performance,” they are not pay for performance. They merely have that in their name.

Ms. MINOW. I cover that in my written testimony as well.

Mr. NEUGEBAUER. One of the things that concerns me is when you start down the road of government designing these compensation plans—and now really what we are doing is we are saying, there are a few companies out there, and I think everybody is trying to point to the financial institution—but the question is, what about all the other companies that are actually doing it right? How do we justify whether we are going to pick the ones we don’t think are doing it right and we are going to let the others fall?

Mr. BEBCHUK. Nobody is talking about the government really prescribing what the pay arrangements would be but, rather, giving shareholder rights and improving corporate governance arrangements. And if that happens, then the firms that are doing it right will continue to do it right, but those firms that didn’t do it right because those were not sufficiently focused on shorter interest would hopefully improve their pay arrangements.

Mr. NEUGEBAUER. But the shareholder has the ultimate right, don’t they? That is whether to own a share of stock or not. And if I think that company CEO is making too much money and the boys are dividing the pie and the shareholders aren’t getting much return, I just sell my share of stock and I move on.

Mr. BEBCHUK. Your ability to sell the share provides you with no protection. It provides insiders with no incentives to behave well. Why? Because let’s suppose the price right now is \$100, and you believe that if managed well, the company would be worth \$120. If you sell, you would be getting—you would be passing this imperfectly managed share to somebody else who would pay \$100. But your concern is that you should be getting to \$120, and the ability to sell the share on the market for \$100 in no way provides you access nor makes it likely that you will be able to capture the \$120.

Ms. MINOW. I just want to say that is also kind of an outdated approach since up to 70 percent of the stock in most major companies are held by institutional investors that don’t have the luxury of selling out every time; because of transaction costs and other issues, they are pretty much stuck. And so the question is, is it more beneficial for them economically to pursue better pay than to just abandon it and leave and invest in some other company that overpays their executives?

Mr. NEUGEBAUER. I don’t think I can agree that people are stuck in any position. If you own a share of publicly traded company stock, you can send a message to the management. In fact, some of those larger investors can actually send a very strong message. If a large investor in a company moves a very large block of stock, sells that stock, that sends a signal to the rest of the market: Why did he or she do that? So to say I think people are stuck in a position is a little—

Ms. MINOW. The data actually goes the other way on that. And as far as large investors making a difference, you are right; they can call up the board of directors and ask for better. All we are asking is to make it more possible.

Mr. STIGLITZ. Can I make a general point, which is that corporations are a creation of the State. We write the laws that define a

corporation. What I think Mr. Bebachuk and Ms. Minow have been emphasizing is that we want to think about how we write those laws to make sure that our whole corporate sector works more efficiently, which has to do with the systems of corporate governance. But what are those systems?

I think that is really the debate here. There is going to be one system or another, so the question is, can we create a system that is better than the current system?

The CHAIRMAN. The gentleman from California.

Mr. SHERMAN. Thank you. Responding to the gentleman who was just speaking, I would say selling the stock is an imperfect way for shareholders to control things. First, they pay a big capital gains tax when they sell. Then they have transaction costs. As the witness pointed out, they get a low price for the stock because whomever buys it is buying into a company with miscompensated executives. And then finally, they have the opportunity to invest the proceeds into another company which has bad corporate governance and overpaid executives.

I would like to start with an observation. It is obvious that the establishment in this country is under attack by populism in a way that has not occurred in most of our lifetimes. The results in Massachusetts were not the victory I think mostly for any one political party, but a victory for populism against the establishment. And it is not a coincidence the Supreme Court decided yesterday to overrule 100 years of precedents, something they would ordinarily find very painful, in order to arm the death star so that the empire could strike back; and whatever we do, whatever we say here today, could easily be drowned out by unlimited corporate publicity and propaganda.

I want to pick up on the comments of the gentleman from Pennsylvania. I think this committee has done a good job on executive compensation when compared to the Ways and Means Committee which has continued to allow hedge fund managers to pay taxes at only 15 percent unless—I yield to the gentleman.

The CHAIRMAN. If the gentleman would yield. The House in fact voted for the bill the gentleman is talking about. It is in the Senate. In fairness to our colleagues, they did bring up the right bill from our standpoint, which we voted for and sent over there.

Mr. SHERMAN. It is always the Senate. In any case, the tax laws of this country not only allow a 15 percent tax on hedge fund managers, but a zero percent tax if they incorporate their hedge fund in the Caribbean. And you compare that to the probably 28 percent rate paid by the gentleman's constituents in Pennsylvania, and you see that we don't exactly have a fair tax system.

I don't think that the gentleman who makes \$1 million an hour is going to work less hard if his after-tax compensation is reduced to a paltry \$600,000 an hour.

When we talk about compensation, we ought to be talking about the entire compensation package, not just bonuses. And in this committee, we have made life a little difficult for top executives, particularly those who got TARP money. There is some social utility of that, beyond its obvious psychological benefits to those of us in the room. And that is, we have inspired these companies to pay back the TARP money far more quickly than they would have, and

now we are focused on those who are too-big-to-fail. We are inconveniencing them to the greatest extent we can right now, and hopefully that will inspire them to break up so that we will have financial institutions, the demise of any one of which will not imperil the system.

And so here we are, talking about their compensation. Last month, we imposed fees on those of over \$50 billion in size. And I hope that they will get the message and become medium-sized institutions.

The problem I have is in this effort to try to design compensation systems that do not incentivize excessive risk and that properly reward performance; I am not sure we can do it. I would hope that there would be none of these companies getting Federal subsidies or implicit Federal guarantee, in which case I don't think we have to do it. But my problem relates to a circumstance where, let's say, you are trading a portfolio. And your aim, of course, might be to have one great year and get an enormous bonus, because in this country, we tend to tally things up at the end of the calendar year and give you something valuable. Now it said, well, we will give you restricted stock. But that still provides a pretty good incentive to take the big risk and to get the big bonus unless you believe the risks you are taking: (A) will turn out poorly; and (B) will turn out so poorly that they dramatically affect the value of the entire company or that they inspire your other executives to take equally enormous risks.

So assume that somebody is managing 1 percent of the company's money. They do not believe that their behavior will affect their colleagues, and they choose to take enormous risks. They pan out as of the end of the year, they get a gajillion shares of restricted stock. How are they disincentived by getting restricted stock? I don't know if there is time for the answer.

The CHAIRMAN. Let's take 30 seconds for an answer. We don't have an overburdened day.

Mr. BEBCHUK. The Congressman is exactly right. For executives who manage a limited part of the company, like 1 percent, paying them with restricted stock does not give them incentives to avoid taking risks that might implode later on. The only way to do it would be to subject them to a clawback or to put their bonus in the bank that would be adjusted downward, not if the company does not do well on the whole, but when their own unit doesn't do well in the subsequent year.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. Before I make my comments, I would ask unanimous consent to enter two studies into the record relative to the subject: one is entitled, "Compensation in the Financial Industry" by the Center on Executive Compensation; and the other is entitled, "Bank CEO Incentives and the Credit Crisis" from the Fisher College of Business from Ohio State University.

The CHAIRMAN. Without objection, they will both be entered into the record.

The gentleman is recognized.

Mr. HENSARLING. Thank you, Mr. Chairman. Again, the American people were presented with a great outrage on Christmas Eve

when this Administration decided, after tens of billions of dollars in losses, \$110 billion now, now to announce unlimited taxpayer exposure to the Government-Sponsored Enterprises, those that are at the epicenter of the financial crisis, and to simultaneously—for all these losses that are costing the taxpayers all this money—to announce bonus structures of \$6 million to each of the CEOs, \$42 million in total for the executives.

So again, as I said in my opening statement, I had hoped that we would have an opportunity to ask questions of the acting head of FHFA, Mr. Ed DeMarco, about this.

And now I know the chairman in his comments said that we would have that opportunity next month. And he said that I am a patient man. Well, perhaps I am patient, but I am not sure, after the election results in the Commonwealth of Massachusetts, that the American people are patient. They don't want answers a month from now, they want answers yesterday.

And so I am disappointed, again, that for whatever reason, the American people are going to have to wait a month to find out about the bonuses at the Government-Sponsored Enterprises, Fannie and Freddie.

The questions, again, I had were for Mr. DeMarco, I was going to ask, in light of the fact that the companies have averaged \$11 billion in taxpayer subsidized losses over the last 5 quarters, how were the executives chosen to receive the bonuses? Since Mr. DeMarco isn't here, I doubt this panel can answer that question. But if somebody knows Mr. DeMarco, has spoken to him, maybe he has insight.

If not, the second question I had for Mr. DeMarco is, why were the bonuses to be paid in cash? This is an Administration that says, no, we have to make sure that payments are made in stock. We have to have longer-term vesting dates for everybody else, apparently, except the Government-Sponsored Enterprises. So why cash for them and stock for everybody else? I was going to ask Mr. DeMarco that question. Again, I assume you haven't spoken to him. Is anybody qualified to answer that question on Mr. DeMarco's behalf? I assume not.

I don't have to be convinced that there are pay structures that can be poorly designed that can cause companies to fail. I know that. I used to serve on a compensation committee of a publicly traded company, traded on the New York Stock Exchange. I at least have some experience with these matters. I have studied some of these issues. So I know that poorly designed compensation packages can cause companies to fail. You don't have to convince me of that. But you do have to convince me that any one company in America is too-big-to-fail.

And guess what? If you don't bail them out with billions of dollars of taxpayer money, then you don't have to use the heavy hand of government to impose pay structures.

I know the chairman has brought up, on a couple of occasions now, H.R. 1664. I have a couple of observations. Number one, if this Democratic Administration, this Democratic Senate, this Democratic House, were serious about doing something about Fannie and Freddie pay, I assume they could have done it by now.

Second of all, as I think the chairman knows, this just didn't deal with the execs. This was a bill that would have regulated the pay of the janitor at Goldman Sachs and provided a role for the Congressional Oversight Panel in policy matters. And as a former member of that panel, I assure you they are singularly unqualified for the task.

So again I don't see why—the basic proposition is this, again. In America, the principle ought to be what you do with your money is your business; what you do with taxpayer money is our business. And if your compensation structure causes you to fail, don't take money away from the farmers, school teachers, and the firemen to bail them out. The purpose of government is not to bail out. The purpose of government is not to place artificial limits on the American Dream. It is to preserve freedom. I yield back.

The CHAIRMAN. The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman. I believe financial firms receiving taxpayer assistance should receive the most scrutiny with respect to their executive compensation practices. The most obvious and troubling case was AIG that provided \$165 million in bonuses last year after taxpayers invested billions of dollars to keep the company solvent. I and others asked Ed Liddy, the CEO of AIG at the time, if he would encourage his employees to voluntarily return their bonuses. He said he would, and executives later agreed to pay back \$45 million of \$165 million of those bonuses. But in December of last year, we learned that only \$19 million has been repaid.

I have joined Representative Mike Capuano and others to write Secretary Geithner about this, especially in light of another round of bonuses to be issued to AIG in March of this year.

If as much in taxpayer dollars were immediately recovered today and AIG were allowed to go through bankruptcy, I doubt those bonuses would be paid. So I hope we can get some answers soon.

Taking a look at these AIG bonuses, Professor Bebchuk, it is obviously frustrating to taxpayers, because if it were not for them, AIG wouldn't be around to pay out those bonuses in 2009 and 2010. Are there specific things we should learn from the government's intervention with AIG as it relates to executive compensation, sir?

Mr. BEBCHUK. I think I would share your general sentiments that taxpayers have not charged financial firms sufficiently to make up for the substantial level of support that has been extended over the last year. And, more generally, I think that we can think about the pie that is being produced by the financial sector as being a result of contributions by taxpayers, by shareholders who provide capital, and by financial executives. And until now, the taxpayers have not been charging enough and shareholder interests have not been sufficiently protected. And the ultimate result of that is that financial executives—and AIG would be just one example, but more generally the sector—the financial executives might be getting an excessive fraction of this pie.

Mr. MOORE OF KANSAS. Ms. Minow, do you have any thoughts?

Ms. MINOW. Yes, I do. In the future, I hope we never have to do another bailout, but if we do, I hope we impose some conditions before we turn over the money. And condition number one should be

that you take a discount on any incentive compensation for the amount that was subsidized.

Mr. MOORE OF KANSAS. Thank you. Mr. Stiglitz?

Mr. STIGLITZ. I would like to emphasize two things that we did not do when we turned over money to these banks. First, we didn't relate giving them money to their behavior, not just with respect to the issue of compensation schemes, but also with respect to lending, which was the reason we were giving them money. That relates to the issue of jobs that has come up here a number of times. The fact that compensation went out meant there was less money inside the banks and therefore less ability or willingness to lend.

The second point is that the U.S. taxpayer was not, when it gave the banks money, compensated for the risk that they bore. In some cases, we got repaid. But we ought to look at the transaction that Warren Buffet had with Goldman Sachs, which was an arm's-length transaction. If we wanted what would have been a fair compensation to the taxpayer, the bailouts would have reflected the same terms, and we would have gotten back a lot more.

Mr. MOORE OF KANSAS. Thank you, sir. I am interested in better understanding how the culture of excessive lending, abusive leverage, and excessive compensation contributed to the financial crisis. This applies across-the-board for consumers who are in over their head with maxed-out credit cards and homes they couldn't afford, to major financial firms leveraged 35 to 1.

Is there anything the government can and should do in the future to prevent a similar carefree and irresponsible mindset from taking hold and exposing our financial system to another financial crisis? Professor Bebchuk?

Mr. BEBCHUK. Two things. One is, I think in retrospect it is clear that leverage ratios were allowed to be too high and we need to regulate those to be at the lower level. And stopping short of that, the approach that the Administration is proposing of imposing levies on liabilities is a useful approach, and that approach could be useful going forward, regardless of the issue of making up for a past contribution of the taxpayers just in terms of charging financial firms for the risk that larger liabilities are posing to the system and to taxpayer.

Mr. MOORE OF KANSAS. Thank you. Ms. Minow, do you have any comments?

Ms. MINOW. I agree with Professor Bebchuk.

Mr. MOORE OF KANSAS. Mr. Stiglitz?

Mr. STIGLITZ. Yes. Three things very briefly. It is very important to change the incentives, which is the subject of this hearing. If you have incentives for excessive risk-taking, you will do it. These incentives are both at the individual level and the organizational level, which is why the too-big-to-fail bank issue is so critical. Even when we realign incentives, we will never do it perfectly, which is why we need constraints on leverage, on behaviors, and on products like derivatives.

Finally, in order for our economic system to work, there has to be transparency. The way the system is set up right now, it is impossible for capital markets to exercise the discipline that is needed to make our system function well.

Mr. MOORE OF KANSAS. Thank you, sir. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from California.

Mr. CAMPBELL. Thank you, Mr. Chairman. I am going to throw out a few thoughts here on which I would like the panel's observations, or your thoughts. I am going to suggest to you that the executive compensation issues on which we all agree, the excessive risk, the excessive period, the short-term focus, etc., are more the symptom than the disease, and that if we treat the symptom we will be, at best, ineffective and, at worst, perhaps counter-productive. And that includes bills like the one the chairman talked about that was passed, whenever it was last year, the year before, and that the root of the problem—to get at the root of the problem, two things, one of which Ms. Minow already alluded to; and one is the greater ability for shareholders to express their displeasure with executives, the performance of the company, or executive compensation through the board by having an alternative vote of directors, given appropriate thresholds, so that ability is not abused.

And so that would be one suggestion I would have as to get to the root of the problem. Rather than trying to micromanage the pay, give the shareholders a greater ability to express their displeasure, and the way that I think is appropriate is through the board rather than through direct control of the pay.

And the second—and I know the chairman is going to have a hearing on this subject—is the short-term focus on pay, I would like to suggest, is perhaps simply a reflection on the short-term focus of the markets, and that maybe the problem is not so much the pay but the fact that “buy and hold” is dead and all kinds of other things like that, such that we are focused on quarterly earnings, quarterly earnings, and I too operated inside a public company at one time and it was all about this quarter. Everything was about this quarter. The whole world revolved around this quarter, next quarter, next year be damned. And that short term, that the short-term pay and excessive risk-taking in pay is simply a reflection of the short-term focus on the markets; that perhaps we should be looking at are there other things we can do to change that short-term focus on the markets? One of which I suggested is going to semi-annual financial statements rather than quarterly. Now, that is not a panacea, but there may be other things. So I will throw those out and love to hear the panel's thoughts on those thoughts.

Mr. BEBCHUK. The first issue, I completely agree with you, it is actually the main thesis of the book, “Pay Without Performance,” that Jesse Fried and I published 5 years ago, is that executive compensation is a symptom. It is a manifestation of underlying corporate governance problems, and all the panels have been discussing about changing governance arrangements in the ways you mentioned so as to produce better compensation outcomes, rather than micromanaging and dictating them.

Mr. STIGLITZ. Let me add two points. One of them is that I agree with your second point that the deeper problem of trying to make our markets less short-sighted has itself been a long-term problem, but it has gotten much worse. One of the things that can fix this is tax policy. A capital gains tax structure that encouraged longer-

term holding and discouraged shorter-term holding is one of the few things we can do to move in that direction.

Mr. CAMPBELL. What would you define as “long term?”

I am curious. It used to be 1 year.

Mr. STIGLITZ. I would define it as longer than 1 year; 2 to 5 years is longer term.

The second point is that, while the reforms in corporate governance are the root of the problem that we have to deal with, we are always going to be imperfect on that. The result is that when it comes to institutions, like the financial institutions, which can put taxpayer money and our whole economic system at risk, we have to not only get at the root causes and reform corporate governance, but we actually also have to control, try to effect the actual behaviors.

Mr. CAMPBELL. Only basically for those systemically significant?

Mr. STIGLITZ. Exactly, for those that represent a risk to our systemic system. But that may be broader than just the big banks.

The CHAIRMAN. Before we get to the gentleman, particularly with her concern with investors, this is a very important question. I am just going to allow Ms. Minow to go beyond. Please don't be concerned by the red light. I think your input on this issue, the quarterly, semi-annual, is something we very much want.

Ms. MINOW. Thank you, Mr. Chairman. I think that is a crucial question, and I think that one drives the other. I think the short-term focus on pay drives the short-term focus on numbers. It is really important to remember that the financial institutions themselves are very, very large shareholders, and so they look at their own quarterly performance in terms of the money that they invest, you know, so it creates a vicious circle. Clawbacks is one way of addressing that as an issue, because if you know that no matter, 10 years into the future if your numbers are revised, you are going to have to give the money back. That keeps people focused on the long term.

But with regard to the issue of a holding period and looking at that in terms of taxes, I just want to remind the committee that the largest collection of investment capital of all, \$6.3 trillion, is under ERISA, which is indifferent to tax consequences, so they are not going to be affected.

The CHAIRMAN. Would you address the—because you represent investors, and I am attracted by the notion of not requiring quarterly reports, going to semi-annual. The counter argument is that the investors would feel maybe deprived of information.

If the gentleman wouldn't mind, I would interested. We will probably get back to you. But I want to know your view on that, if that is all right with you.

Mr. CAMPBELL. Sure. That is fine.

Ms. MINOW. There is something sort of charming and poignant about making that suggestion in a world of Twitter and instant messages, everything else is becoming faster, and trying to slow that down. I think the fact is that one way or another, investors are going to get day-to-day information.

We are very close to a point now where company financials, which are internally available on an almost real-time basis may someday become available to everybody. So I am not sure that real-

ly solves the problem, but I agree with you that is the right question to ask.

Mr. CAMPBELL. On clawback—

The CHAIRMAN. Take 10 seconds.

Mr. CAMPBELL. We will discuss that another day when we have another hearing. I just wanted one thing on a clawback that I wanted to ask real quick was, you said that if someone—if it is restated. I don't know how that changes the short-term focus. If I am paid entirely on what happens in the next 30 days, that would change the focus on accounting for it, perhaps, but if the consequences of that decision are very bad for a long term, you are not going to claw me back, so that doesn't change my behavior, does it?

Mr. BEBCHUK. Clawbacks cannot be based—to be effective they cannot be based only on accounting restatements. Even if the accounting was correct, but it turns out that the performance was illusory, the money should be adjusted.

The CHAIRMAN. With the acquiescence of the charming and poignant gentleman from California, we will move on. But that is a question we will be dealing with, and I thank him for raising it. The gentleman from North Carolina.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

Not only do I find myself agreeing with much of what Mr. Campbell had to say, but also with what David Stockman, the Director of OMB under the Reagan Administration, had to say the other day. I am pretty sure the Book of Revelation said that when I agree with both Mr. Campbell and Mr. Stockman, it is one of the signs of the Apocalypse.

Mr. Stockman wrote the day before yesterday in the New York Times in op-ed, "The economy desperately needs less of our bloated, unproductive and increasingly parasitic banking system."

Make no mistake, the banking system has become an agent of destruction for the gross domestic product and of impoverishment for the middle class. Mr. Neugebauer asked earlier, why didn't we have a hearing about jobs? This is a hearing about jobs. How do we stop the excess, the vulgar excess that is not rewarding productive conduct, but is rewarding what economists call "risk seeking," what Dr. Stockman called "parasitic," that is taking money from the middle class and taking money from the real economy. And it is certainly undermining all that we need to be doing to build a sustainable economy that works for the middle class, works for ordinary Americans.

I have a couple of questions. Is the focus on executive compensation part of a bigger problem? I don't really want to regulate compensation. I would much rather the market regulate compensation. But the way the market is supposed to work, where there are competitive forces in place, is that competition squeezes profits and squeezes costs, including compensation; and, instead, in the financial industry we have seen, despite the fact that there are 8,000 banks, or more than 8,000 banks—and God only knows how many other kinds of entities that were doing bank-like things, and four, five, six big banks, profits in that sector ballooned to, a couple years ago, or metastasized a couple of years ago, to more than 40 percent of all corporate profits and compensation was almost twice

what ordinary Americans were making, when historically it had been about what ordinary Americans made.

Are competitive forces working? And why not?

And second, where were the boards of directors? Of all the institutions that failed in the financial crisis, the board of directors has to be near the top. Gretchen Morgenson wrote an article, a column, 3 or 4 weeks ago that looked at what had happened to the board members from all the companies that had failed, and found out they had gone out to serve on other boards with no apparent diminution in their reputation. They were not tarnished in any way.

There was an article in the New Republic that I read last night that was very critical of General Tommy Franks for not having captured or killed Osama bin Laden in Tora Bora in December of 2003. And without necessarily agreeing with everything that he had to say, there was a snide reference he had now retired and joined the board of directors at Bank of America and Chuck E. Cheese, which gave me the impression that boards of directors were really more a part of celebrity culture than they were corporate governance, that a board of directors meeting was a celebrity appearance.

What can we do to make boards of directors a full-time job, a real job, and we don't have people on there who just treat it as a celebrity appearance?

Mr. BEBCHUK. I think, actually, making directors full-time employees is not a good idea because that would make them like insiders, would make them more dependent on the firm.

What we need to do is obviously have them spend enough time, but the most important thing is to make them dependent on the shareholders in a way that would give them the right incentives and the kind of governance arrangements we were discussing. Arrangements that enabled shareholders to replace directors more easily would produce such an outcome. And this would be not replacing market outcomes, it would just enable the market to work better.

Mr. STIGLITZ. I want to make two comments on what you said. The first is when you were talking about that 40 percent of all corporate profits were in the financial sector, we have to remember that a lot of that was phantom profits; that is to say, they weren't real profits. That shows the difficulty of measuring performance in the financial sector. They have enormous discretion to create money, as it were, to create profits, and then later on to have losses, making all the more important the issue that we have been talking about of a long-term perspective.

On the second point, I couldn't agree more. The fact that there is imperfect competition leads to sustainable above-normal profits, and that is particularly true in the big banks. The point is, there has been a large increase in concentration in the financial industry, and when it comes to particular issues like credit cards, it is very clear that they are engaged in anticompetitive practices that allow them to garner those profits and then, obviously distribute those profits to the officials.

Ms. MINOW. May I address the issue of the boards of directors? I feel very strongly about it. My company rates boards of directors like bonds, A through F. And we have really encouraged our cli-

ents, to include director and officer liability insurers, to raise the rates, sometimes to raise them to make it prohibitive for repeat offenders to continue to serve. And I will continue to try to do that.

But when I first came into this business, O.J. Simpson was on five boards. He was on an audit committee. So we have made a little bit of progress. I think Tommy Franks probably was a better director than O.J.

The CHAIRMAN. The gentleman from New Jersey.

Mr. LANCE. Thank you, Mr. Chairman. Good morning to you all.

Regarding your point, Professor Stiglitz, that Warren Buffet had an arm's-length transaction with Goldman Sachs, why don't you think the American people have that same arm's-length transaction? Was it just missteps by those in the Executive Branch?

Mr. STIGLITZ. You might say "missteps." They were very much taken into the view that at that point, they had to give money to the banks; because they thought it was imperative so that the banks could return to the usual role that they had had. But the government officials were captured in an intellectual sense by the banking system. It was a very big mistake.

Mr. LANCE. And do you see improvement with Federal officials at the moment in this area?

Mr. STIGLITZ. If I look at the proposals that are being discussed recently, I see a very marked change. But if you looked at the bailouts that occurred in January, February, and the beginning of this year, they were as bad as those that occurred earlier.

Mr. LANCE. That is my point. And I began my questioning with what occurred at a prior time. But from what I have seen so far this year, there doesn't seem to me to be much of a change, and certainly in both last year, a year-and-a-half ago and in 2009, we the people, you and I together, the American people, were on one side and Warren Buffet with his arm's-length transaction was on another side, a much preferable side. And it seems to me we ought to learn from mistakes. And so far, I haven't seen any great learning curve in this regard.

Ms. Minow, your comments perhaps in this area?

Ms. MINOW. I have seen a learning curve. I think that the initial transaction, the initial bailout transaction was made in a moment of sheer panic, and it reflects that. But I think that the subsequent negotiations, and particularly the Administration's proposal of this week, do show that some lessons have been learned.

Mr. LANCE. Regarding Fannie Mae and Freddie Mac, how could these bonuses possibly have been given, in your opinion, as a matter of the court of public opinion, and what should we do?

Ms. MINOW. Mr. Lance, if these people could be embarrassed, we wouldn't be here talking about them. They seem to be unembarrassable. So the court of public opinion doesn't seem to matter to them.

Mr. LANCE. So what should we do to make sure this doesn't happen again?

Ms. MINOW. With regard to Fannie and Freddie?

Mr. LANCE. Yes.

Ms. MINOW. I support the chairman's notion of essentially re-booting the entire concept.

Mr. LANCE. Professor Stiglitz, your views?

Mr. STIGLITZ. I agree. I think that we really have to reexamine the whole structure of the GSEs: the concept of an institution that was in the private sector, which is what they were, and yet seemed to have by some people's account this kind of public role, which is a very peculiar mixture. We have been talking about corporate governance, and it was a system of governance that was almost bound to fail.

Mr. LANCE. Thank you. Is my time expired?

The CHAIRMAN. No.

Mr. LANCE. Following up on Congressman Campbell, the short-term focus versus the long-term focus, isn't this true throughout the whole society? People don't let me finish a sentence.

The CHAIRMAN. Would the gentleman hurry up, please?

Mr. LANCE. I can never be as witty as the chairman.

Isn't this the nature of society? And how are we going to overcome this? Ms. Minow, your point of view?

Ms. MINOW. It is the nature of humanity, I am afraid, but I do think that we have some structural perversities in the system that can be regularized to calm things down.

Mr. STIGLITZ. We will never perfectly overcome it. But I think some of the things that we have been talking about are ways to mitigate some of the consequences, and we have to recognize that in some ways things have gotten worse; and that shows that whatever it was, you know, is not inevitable. Changes in the rules, the tax structures, and so forth do affect the extent to which there is that shortsightedness.

Mr. LANCE. Thank you. I yield back the balance of my time, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas.

Mr. GREEN. Thank you Mr. Chairman. Mr. Chairman, we are dealing today with the irony of ironies, because most who opposed raising the minimum wage to \$7.25 an hour were supporters and are supporters of maintaining a bonus structure that creates systemic risk.

Now, the public may not understand systemic risk and perverse incentives and proprietary trading, but the public does understand this: that it took us 10 years to raise the minimum wage to \$7.25 an hour. And if a person—and there is such a person—who gets a bonus of \$69.7 million, it will take a minimum wage worker 4,622 years to make \$69.7 million. Some things bear repeating, 4,622 years.

The public understands that when you explain that the CEO or the CEOs of the biggest companies make more in 1 day than a minimum wage worker makes in a year, and this CEO has reason to envy the hedge fund manager who makes more in 10 minutes than the average worker makes in a year, and only pays 28 percent—pardon me, 15 percent, capital gains, not ordinary income.

I am one who supports allowing people to make bonuses as large as they can make, as long as they don't do it based upon perverse incentives that create systemic risk. And that is what this is all about—perverse incentives that create systemic risk.

Let people make as much they can. But let's not allow them to create perverse incentives that will bring down this economy. Enough already with this notion that we should just let the econ-

omy collapse. If we had not bailed out AIG—and I did not want to do it, I had to hold my nose and close my eyes to cast a vote—but if we had not bailed out AIG, Bear Stearns, the auto industry, would the world be a better place today, Ms. Minow?

Ms. MINOW. I think we could have done a better job of bailing them out, but I think we should have bailed them out.

Mr. GREEN. Would the world have been a better place?

Ms. MINOW. No.

Mr. GREEN. Sir, Mr. Stiglitz?

Mr. STIGLITZ. I agree that the way we bailed them out leaves a lot to be desired.

Mr. GREEN. Leaves a lot to be desired. Would the world have been a better place if we had not?

Mr. STIGLITZ. I think that at the time, the perspective was that we thought we had to.

Mr. GREEN. I want speculation. If I may intercede, my time is limited.

Would the world be a better place today? Give me your speculation.

Mr. STIGLITZ. My speculation is the world would be a better place if we had let AIG fail.

Mr. GREEN. The auto industry, Bear Stearns, and AIG?

Mr. STIGLITZ. I think we were forced to have some kind of a bailout for some of these.

Mr. GREEN. Mr. Bebchuk?

Mr. BEBCHUK. I feel the world would have been better had we done a “partial bailout,” for example. Having some of AIG’s counterparties—

Mr. GREEN. If we had taken a laissez-faire, hands-off attitude and let things go, would the world be a better place today?

Mr. BEBCHUK. Compete laissez-faire, no. It would not have been a better place if we just took our attention completely away from those firms. The answer is no.

Mr. GREEN. Just laissez-faire, let the world go wherever it is going.

Mr. BEBCHUK. That would have been a worse outcome.

Mr. GREEN. Do you understand that we have Members of Congress who are advocating we should have just let the world go, just left it alone? Can you imagine where we would be if we had done nothing? Is it irresponsible to do just nothing at a time of crisis like this? Ma’am?

Ms. MINOW. Yes.

Mr. GREEN. Sir?

Mr. STIGLITZ. I agree it would be irresponsible.

Mr. GREEN. Is it irresponsible to do nothing?

Mr. BEBCHUK. It is not the right thing to do.

Mr. GREEN. It is not the right thing to do. All right. I will help you. It is irresponsible.

Friends, we at some point have to become adults about what we are dealing with. We are talking about perverse incentives that create systemic failure. Give me an example, please, ma’am, of a perverse incentive that creates systemic failure, please.

Ms. MINOW. Certainly. In the subprime industry, the individuals were paid on the number of transactions rather than the quality

of transactions. So they had a perverse incentive to create as many transactions as possible.

Mr. GREEN. Mr. Chairman, may I, with unanimous consent, ask that each other witness just give one example of perverse incentive?

Mr. STIGLITZ. The fact that the incentives in the financial sector were based on pay as measured by performance, whether it was through excessive risk-taking, increasing beta, or whether it was the result of greater efficiency, increasing alpha.

Mr. BEBCHUK. The fact that the top executives at Bear Stearns and Lehman Brothers were able to get in 2006 very large bonuses based on earnings which then they were able to keep and they were not clawed back, even though all those earnings, and more, were evaporated in the subsequent period.

Mr. GREEN. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman. I have a number of questions so I am going to try to ask them quickly. But before I ask the questions, I was appointed to this committee in 2005 with Mr. Green—I had to just recheck—and my recollection is that at the time, Mike Oxley was the chairman of this committee and our current chairman was the ranking member. And one of the first things we dealt with when I came on this committee was some proposed reform, assuming by Mr. Oxley, maybe both Mr. Oxley and Mr. Frank, dealing with Fannie and Freddie.

I was talking to a reporter 2 days ago who said one of the problems in Washington is that the truth doesn't matter; it is whether or not you can say a lie over and over and over again so that everybody buys it. So my concern is that history has been a little distorted, because Mr. Oxley proposed trying to deal with the issue of Fannie and Freddie compensation, and as I recall, they didn't get any support from the White House. If I have misspoken, I would like to be corrected.

The CHAIRMAN. If the gentleman would yield, Mr. Oxley's quote in the Financial Times was that what he received from the White House was the "the finger salute."

Mr. CLEAVER. I take that to mean I am correct.

Mr. BACHUS. Would the gentleman further yield?

Mr. CLEAVER. Certainly.

Mr. BACHUS. Chairman Frank opposed that legislation.

The CHAIRMAN. Would the gentleman further yield?

Mr. CLEAVER. Yes.

The CHAIRMAN. The gentleman from New Jersey and the gentleman from Texas derided it as very ineffective and weak, and it failed in the Senate. I voted for the bill in the House and in the committee. When it got to the House Floor and the Republican leadership put in an amendment restricting affordable housing, unrelated to the structural organization of Fannie and Freddie, I then voted against that. But I voted for the bill until they put that amendment in.

I thank the gentleman and he will get an additional minute for yielding.

Mr. CLEAVER. The point I was trying to make, as somebody had said earlier, had transferred the conversation to Fannie and

Freddie, and that we had not tried to deal with compensation with Fannie and Freddie. I wanted to try to clear it up as this reporter told me. It doesn't matter; people are going to continue to say it, just like we will hear over and over again that I guess President Obama started the bailouts.

But where I want to go now is that the too-big-to-fail is a problem because I think they understand clearly that they have what it takes to take what we have. And if that is the attitude they have, which I think it is, we are going to lose.

My questions are though—and I don't know the answer to this, and in this committee you probably should know the answer before you ask the question—but did the firms with better compensation perform better? Those with the better compensation structure, did they end up performing better? Did they get into trouble? Do any of you know that answer?

Mr. BEBCHUK. This is a subject that still needs to be investigated. What makes it not a straightforward question to answer is the question is, what does it mean to be compensated better? So if you believe that better compensation is one that provides less incentives to focus on short term, then you have to measure those dimensions and then to find how they have correlated with performance, and that is not something that has yet been kind of fully done.

Mr. CLEAVER. Don't you think that would be a worthy project to—

Mr. BEBCHUK. Definitely.

Mr. STIGLITZ. Part of the problem is that almost all of the big banks, those that are too-big-to-fail, had similar compensation schemes, so that you probably won't be able to get clear results. The differences were not big enough to overwhelm the perverse incentives that really dominated the whole industry.

Mr. CLEAVER. I was wondering if you could do an overlay with what happened with the mortgages—the banks, mortgage companies, that did not go into the subprime scam even though they didn't make as much money. Now, if you look at their books, they did better. And so the question that I raise was based on what I have seen with the subprime industry.

And do you think that the—particularly the Wall Street so-called investment banks will change their compensation structure without congressional legislative encouragement?

Ms. Minow?

Ms. MINOW. As I discussed in my testimony, the fact that following the bailout just over the last year, they have essentially poured gasoline on the fire of excessive compensation suggests to me that they need a much stronger message from Congress.

Mr. STIGLITZ. I agree. There will be some cosmetic changes, but the question is, will the depth of those changes be anywhere near sufficient to address the kinds of concerns that have been discussed this morning?

Mr. CLEAVER. My final question. In talking with an investment banker in my district in Kansas City, Missouri, I found out that what the investment bankers like to do is—not the people out trying to make the deals, but the execs—give bonuses that stretch over a number of years. And my assumption is that they invest,

you know, they give a bonus over the next 4 or 5 years, and then they invest what they gave, they keep and invest what they gave. And so I am wondering whether or not that kind of system should be outlawed. The executives don't want to give compensation, all compensation in cash up front. They want to stretch it out over the years. Do you understand when I am saying?

Mr. STIGLITZ. Let me make one comment, which is they are very creative in trying to subvert the intention—that we have been concerned with—of getting better incentive systems. One of the concerns is that, if you look in more detail across corporations, much of what is called “incentive pay” is not incentive pay. It is a charade. If you look at overall performance and overall compensation, they are much less closely linked than the name would suggest.

That was evidenced in the AIG case where, when they began to have problems, they just changed the name from “performance pay” to “retention pay.” They are very clever in undermining what we are really concerned about.

Mr. CLEAVER. I know you weren't trying to suggest this, but it almost sounds like you were saying they are trying to trick Congress and the public. Thank you, Mr. Chairman.

The CHAIRMAN. The gentlewoman from Ohio.

Ms. KILROY. Thank you, Mr. Chairman, and thank you to all of the witnesses for your thoughtful testimony. And I thank my colleagues for their questions and discussion that we have had since then. It has been very useful and thought-provoking, and still the whole issue is still difficult to get your arms around here.

Despite the financial crisis in the fall of 2008, and the resulting bailouts and further infusions of cash along the way, here we are again with the public outraged and Wall Street handing out this year a record \$140 billion in bonuses.

When we take a look at that kind of money and try to put it in some kind of perspective, in context, according to the Washington Examiner, this is 10 percent of the entire U.S. deficit, or 3 times the amount budgeted for education, or 4 times the amount for Homeland Security. It is vastly more money than we have pledged for the reconstruction of Haiti and an amount that could prevent millions, hundreds of millions of home foreclosures.

So it is no wonder that hardworking Americans who thought, as was brought out in questioning, that okay, we need to bail out Wall Street, we don't want to go over the cliff, and understood it was their hard-earned dollars that were going towards that, nevertheless wanted to see something other than banks buying up banks and handing themselves out bonuses as a result of trading activity, rather than making those loans or renegotiating those mortgages.

So families understand that they have lost jobs and they have lost homes, and bankers still are getting billions of dollars, and we still haven't gotten a hold over all of the issues about the risky behavior that has brought us here to this date.

Now, I listen to the bankers, and sometimes they tell me that they are offended that we are even talking about regulating their bonuses and their compensation, that we don't understand that they are the best and the brightest, or that it has to be now for retention; otherwise they would, I don't know, go do I don't know what. I get offended when they tell me they are the best and the

brightest, because I happen to think that there are a lot of people who are very bright and very good. In fact, the best are involved and teach for AmeriCorps, in our public schools, or in our hospitals, or social workers, and they seem to work very hard with substantially less pay.

So, you know, I serve on the Homeland Security Committee, and we had the Salahis in last week and they were all primed and dressed up and made up and these gate crashers struck me as incredibly self-centered and without regret, and sometimes, like some of the people that I hear saying that we can't touch their pay, they don't get how angry hard-working Americans are and how people in central Ohio think pay should somehow relate to your productivity. And they don't get it that when you ruin an economy, you get these kind of bonuses.

So, you know, I know we have been around this a few times already, but what advice do you have for us so that we can fairly compensate people and try to define performance? And if the issue is, Ms. Minow, as you suggested, the central issue, board governance, if boards have this attitude that we all deserve that in the financial sector, that kind of compensation, how do we really get into, you know, changing the practices, both in order to protect us from further damage down the road, and to have a better handle on corporations and their governance?

Ms. MINOW. The focus on the post-Enron reform legislation, Sarbanes-Oxley, and the regulations has all been on what I call the supply side of corporate governance, what managers have to do, what accountants have to do. We have not really focused on the demand side, on what shareholders have to do. And the fact is that you should have in here the heads of all the mutual funds, the Assistant Secretary responsible for ERISA, these are people who routinely vote in favor of these boards of directors, in favor of these pay plans because no one is looking at them, no one is paying attention to them. I think we need to remind them what fiduciary obligation is all about and that it is in their economic interest to look at pay as a risk factor, and I think that would make a big difference.

Mr. STIGLITZ. I think the reforms in corporate governance that we have been talking about, both on the demand and supply side, are essential, but in the end I think they won't go far enough, for two reasons. One, those aspects of the structure of the compensation schemes that put at risk the national economy and the taxpayers' money have to be regulated in a whole variety of ways.

The second point is that the tax structure as a whole has to be designed better to address the sense of equity in our system. The arguments that have been made before, that more progressive taxation or that taxing capital gains would have adverse incentive effects, are just wrong. We can have a fair tax system that actually would encourage greater efficiency.

Mr. BEBCHUK. I would put the \$140 billion figure that you mentioned in context, not just by comparing it to the Homeland Security budget, but I would compare it, that would be the most relevant comparison, to what shareholders have received during this period and what taxpayers have received during this period. So what is disproportionate is the \$140 billion relative to the contribu-

tion of the financial sector to the performance of the economy over the last decade. If you look at the numbers, you see that shareholders in the financial sector over the last 10 years still see somewhat negative returns over this long period. And we know about taxpayers.

So what we need is to reallocate the pie, so to speak, in a more efficient way between shareholders, taxpayers, and financial executives, and the way to do it would be for shareholders to have stronger rights so that they can claim their share of the pie, and for taxpayers to begin going forward charging banks adequately for the support the taxpayers are providing.

The CHAIRMAN. The time of the gentleman has expired. I just want to makes an announcement to others. And this again, the gentleman from California, Mr. Campbell, the gentleman from Michigan, Mr. Peterson, there has been a lot of interest in corporate governance. We tried to minimize the involvement of it with the financial regulatory programs. We want to deal with that. We are going to get into the corporate governance issue, and that includes, by the way, I would just say to Ms. Minow, jurisdiction being what it is, I don't think I can summon the Assistant Secretary of Labor before this committee who was the ERISA guy or woman. But we are going to continue with one of the things that the SEC did, which is to require that all these institutions publish how they vote. As you know, there was a lot of resistance to that. And the fact that it was kind of partisan is true, so it was imposed on the mutual funds, and we believe it should be imposed on any fiduciary. If you are the owner of the shares in your own right, you have a privacy right. But if you own shares as a fiduciary, we, I hope, will pass legislation that will require that you have to make public how you voted on all the proxies. We can't force them to do more, but I think that would be useful.

Ms. MINOW. No question about it. I would be delighted and I hope you will allow me to come back and testify in support of that.

The CHAIRMAN. And we will be inviting people to that hearing. Before we get to the last questioner, the gentleman from Florida, one other question, I talked to the gentleman from Alabama, if I have just like 2 minutes, unanimous consent to say, one of the things we are told is well, we are given two arguments on compensation. One, we will all go to some other country. Well, the rest of the world is getting tighter than us. So now the argument is okay, we will go do something else. We will go into some other profession and won't you be sorry, all billion of us will no longer be trading CDSs with each other.

My response is in part, well, I am not sure where you are going to go for that kind of money. But two, what if they did, if, in fact, fewer of the very brilliant people that the gentleman from Ohio was referring to decided that there was no longer enough money to be made in bond trading and went into other lines of work, would that be a social loss? Not that we would drive them away, but is that a by-product that we have to try to avoid?

Ms. MINOW. I was supportive of the remarks you made on this subject earlier this week, Mr. Chairman, when you talked about scheduling this hearing. And in my written testimony, I said I

would love to see the demand curve on that one if all of the Wall Street guys rush out into the market. I think the pay package—

The CHAIRMAN. Well, I think it is twofold. One, what is the demand curve and, two, even if there is a demand what is the social loss?

Professor Stiglitz?

Mr. STIGLITZ. I addressed that in my written testimony. I said that not only is there a misallocation of financial capital, but there is also a misallocation of human capital that is costing our society even more. It would be a good thing for our society to reallocate this human capital.

The CHAIRMAN. Professor Bebchuk?

Mr. BEBCHUK. There is a very interesting study by Claudia Goldin and Larry Katz from Harvard, and they track what happened to Harvard college graduates over a long period of time, and they report that a huge increase in the fraction of the class, the best and the brightest, they go into finance relative to what happened 30 years ago when larger numbers were going into science, engineering, medicine, and so forth. And this partly reflected response to market incentives, and now that we are reconsidering the contribution of financial to the wellbeing of the economy, we might conclude that having a smaller fraction going into finance might not be a bad thing.

The CHAIRMAN. Thank you. Does the gentleman from Alabama want to take 2 minutes?

Mr. BACHUS. Yes, I do want to say this. I think we are dealing with executive compensation, and I think one thing that does trouble most Americans and Members on both sides of the aisle is that some of the very large banks do borrow very cheaply from the Fed, and that is taxpayer subsidized in one way or the other. Whether they invest them in Treasury bonds or carry trade, or whether they use them to trade and make additional profits, the original premise was that money would be loaned, and it is not.

Now, I will say this: The flip side of the argument is that they are using those trading profits to cover some of their lending losses, and in some ways that makes the banks stronger and it may avoid the government having to come up and pick up liability. You know, that is one of their answers.

Another one that they say is that there are no borrowers; they can't find borrowers who are qualified. Now, I talk to many people back in Alabama, and they say when they deal with the large banks, they say they are not interested in loaning someone \$200,000. They are interested in \$100 million deals. So I think that is a real problem. Particularly as banks get bigger and bigger, they are not lending on Main Street. They are lending to large corporations, but smaller businesses can't get loans.

And I do think the American people do believe that by being able to borrow cheaply from the Fed and some of the guarantees that have been extended, that money is finding its way into compensation, which gives the appearance of being excessive. And so I think these are valid concerns.

And also, the last concern, and I will close with this, and I think it is a concern we all have, as they do this trading they tend to be going back and doing what got them in trouble in the first place,

and that is speculating, leveraging, and what happens, do we get right back into the problem we had? And if they are going to get in trouble, they say, you know, you don't want us to make bad loans. That is true. We also don't want them to make trades that are risky. And if anything, the trades benefit themselves, proprietary trading, whereas the lending at least gets the economy going.

The CHAIRMAN. If the gentleman would yield, if they can make enough money doing everything but lending that may be a contributing factor to not lending. We will have an all-day hearing on Friday, February 5th, with borrowers and regulators and lenders, and we want to get into this question about why more loans aren't being made. It is a bipartisan concern. And I do think it is legitimate to inquire to the extent to which other opportunities to make a lot of money displace lending, either directly or indirectly. Let me just now—

Mr. BACHUS. And I do think one answer is to look at whether they are lending, and if they are not lending, the government, if they are going to make money available it ought to be to those institutions that are lending and lending on Main Street, and put some competition out there .

The CHAIRMAN. Yes. And that will be our February 5th hearing. The last questions will be from the gentleman from Florida, Mr. Grayson.

Mr. GRAYSON. Thank you, Mr. Chairman. In capitalism, winners have to win and losers have to lose. People are normally rewarded for success and they are punished for failure. Now, we went through an experience where, between the middle of 2007 and the end of 2008, that 18-month period, we lost \$12 trillion in our country's net worth. According to the Federal Reserve figures, the net worth of America dropped from \$62 trillion to \$50 trillion, by 20 percent in the last 18 months of the Bush Administration.

Is there any sign since these bailouts began that the institutions and the individuals on Wall Street and in major banks who were responsible for the decisions that led to that loss of \$12 trillion actually were held accountable for it? Any sign at all?

Professor Stiglitz?

Mr. STIGLITZ. No.

Mr. GRAYSON. Ms. Minow?

Ms. MINOW. No.

Mr. GRAYSON. Professor Bebchuk?

Mr. BEBCHUK. I think some of them lost their positions. Some of them lost money, but by and large they have not been held sufficiently accountable. And the most important thing is we don't yet have incentives going forward that would make people do the right thing in terms of risk-taking.

Mr. GRAYSON. Well, you raise an interesting point. I actually asked the head of AIG, who actually were the people responsible for their losses that led to the government bailout and he wouldn't even tell me their names. Isn't it possible that the people who actually led to this financial disaster, not only in America, but around the world, are still doing the same jobs, very often down the block from where they were before?

Mr. BEBCHUK. I think some of the key people did lose their positions. So some of the top people at AIG are no longer there. But

I think that I agree with your sentiment that probably they have not been held sufficiently accountable. And most importantly, many of them have been able to pocket and still keep large amounts of money that were based on results that they had in 2006 and 2007, which were disastrously reversed in 2008.

Mr. GRAYSON. What does it mean for a capitalist country like the United States if over a long period of time, failure is rewarded and capital destruction is rewarded? What does that mean in the long run?

Ms. Minow?

Ms. MINOW. Bankruptcy.

Mr. GRAYSON. For the country?

Ms. MINOW. For the country.

Mr. GRAYSON. Professor Stiglitz?

Mr. STIGLITZ. It obviously has a very adverse effect on the efficiency of our economy. I have called it an ersatz capitalism, where you socialize the losses and you privatize the gains. That leads to distorted behavior, which is why a lot of what we are talking about is about going forward, not just dealing with the past. Unless we correct these incentive problems at the organizational and individual level, we are likely to have exactly the same kind of problem again.

Mr. GRAYSON. And Mr. Bechuk?

Mr. BEBCHUK. I really agree. The difference between what Professor Stiglitz called ersatz capitalism and real capitalism is very substantial and costly for the country's well-being.

Mr. GRAYSON. Now, on Wall Street the gearing, the ratio between assets and equity is often 10 to one or more, right? Professor Stiglitz.

Mr. STIGLITZ. If it were only 10 to one, we would think of that as very conservative. It has been up to 30 or 40 to one. That is an example of excessive risk-taking with very little social benefit that you can associate with that high level of risk-taking.

Mr. GRAYSON. Well, let's say it was only 10 to one. Isn't it true that every dollar that is paid on executive compensation means \$10 less in loan ability for these institutions, the ability to lend out money to the rest of America? Professor?

Mr. STIGLITZ. Yes. We were talking about that at the beginning of the hearing, that money that goes out in bonuses is money that is not available in, you might say, the net worth of the bank and therefore not available as the basis of the leverage that the bank can lend out.

Mr. GRAYSON. Now, do the managers of these institutions on Wall Street and the big banks around the country have any incentive all in an economy that is based on incentives like America's, any incentive at all to economize on their own compensation?

Ms. Minow?

Ms. MINOW. No, I think it is the sky's the limit.

Mr. GRAYSON. Professor Stiglitz?

Mr. STIGLITZ. The incentives are distorted. We have been talking about what would happen if they had long run incentives. If they had more effective long run incentives, then of course they would say if they keep the net worth of the company larger, it will make larger profits in the long run. Therefore, in the long run the com-

pany is doing better, and they will get an appropriate return. But that is not the way the current incentive structures are designed.

Mr. GRAYSON. Mr. Bebchuk?

Mr. BEBCHUK. They don't have the right incentives. Privately they would be better off paying, having larger compensation even at some cost to the shareholders. We have seen this in firms that were making decisions whether to return TARP funding, and it seems that some executives were eager to return TARP funding, even when that was costly to their shareholders, as evidenced by market reactions, in order to get out of the restrictions the TARP funding had on the compensation.

Mr. GRAYSON. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the witnesses. We will take further testimony, particularly on the question of how you deal with short-termers and some of these things that are ongoing and also on what I think I will title the "so what" part of this, which is, oh, if you don't let us make all this money, we will go off and do other things. We know they are not going to England. In fact, one of our major bank CEOs—we don't need to mention him here—complained to the Chancellor of the Exchequer that they were driving away his potential investment in Canary Wharf because of their compensation restrictions. So they really are trying to play us off against each other. I will be in Davos next week, and one of the things I will most focus on is reinforcing this agreement, both with compensation and regulation, that we are not going to be played off, and I think in fact America will wind up being a little bit more lax than many of the others. So then the question is, okay, we will go off and engage in other lines of work, and maybe if we got some more family physicians and less people doing mathematical models, it wouldn't be such a bad thing.

Thank you all.

[Whereupon, at 12:19 p.m., the hearing was adjourned.]

A P P E N D I X

January 22, 2010

Statement of Ranking Member Bachus
Full Committee Hearing
“Compensation in the Financial Industry”
Friday, January 22, 2009

Thank you, Mr. Chairman. Since you have been Chairman, you have been very fair to Committee Republicans. You have invited witnesses that we have requested and often invited more than just one of our choices at certain hearings. I have always appreciated your consideration and I know my colleagues have too. Because you have almost always accommodated our requests, the decision to deny Republicans our witness choice for this hearing was very disappointing. What makes this hearing different from any other hearing? Why were Republicans denied our choice of witness?

We wanted to invite Ed DeMarco to the hearing today. Mr. DeMarco is the acting director of the Federal Housing Finance Agency, the overseer of Fannie Mae and Freddie Mac and the person who – along with Treasury Department officials – approved a \$42 million payday for 12 executives of the failed GSEs, including \$6 million to the chief executives. During a hearing called “Compensation in the Financial Industry,” Republicans assumed we would be permitted to examine a real-life case of excessive, unreasonable executive pay at the two companies that have received more extraordinary taxpayer assistance – over \$110 billion and counting – than any others. But we

were wrong. Mr. Chairman, six million dollars is 15 times more than what the President earns and 30 times larger than a Cabinet secretary's pay. The Christmas Eve announcement led one commentator to say: "the taxpayer got scrooged."

Because the regulators failed to use their authorities to block these colossal paydays of *government employees*, Congress should step in. This week, along with several of my Republican colleagues on the Committee, I introduced legislation to protect taxpayers from having to foot the bill for any more multi-million dollar pay packages. Our bill would suspend the compensation packages of executives at Fannie and Freddie that have been approved for 2010, and subject these executives to compensation equal to the rate of pay for comparable Federal employees. The legislation also expresses the sense of the Congress that each executive should return the excessive pay they received in 2009 so we can reduce the federal budget deficit.

Mr. Chairman, I appreciate your pledge to invite the FHFA Acting Director to testify at a hearing to be held in late February. But this Committee should not have to wait another minute – much less five weeks – for an explanation of the Obama Administration's Christmas Eve raid on the treasury to reward the executives of failed companies that have cost the American taxpayer dearly. I yield back the balance of my time.

**Statement For the Record By Ranking Member Spencer Bachus
Full Committee Hearing Entitled, "Compensation in the Financial Industry"**

Friday, January 22, 2009

Chairman Frank has rebutted Financial Services Committee Republicans' criticism of the Christmas Eve compensation packages awarded to Fannie Mae and Freddie Mac executives by blaming Republicans for opposing executive compensation legislation that passed the House in April 2009 (but was never considered in the Senate) that included a provision prohibiting Fannie and Freddie from making any compensation payments that are "unreasonable or excessive," and any bonus payment that is not "performance-based," so long as taxpayers' investment in the firms remains outstanding (H.R. 1664).

In response it is important to note the following:

- The provision cited by the Chairman was part of a larger bill that Republicans (and some Democrats) opposed on the House floor. The bill which the Chairman touts has never been taken up in the Senate, which the last time I checked is still controlled by his party.
- That larger bill – which was hastily thrown together as a political response to the public outcry over bonuses paid to executives at AIG – was a bad bill, and I make no apologies for opposing it.
- H.R. 1664 would have given government bureaucrats virtually unbridled authority to write compensation rules for *all* institutions receiving direct capital investments by the government, including community banks across America that received funds under the Capital Purchase Program (5% loans and warrants). It was an overly broad bill that applied to all employees rather than just top executives. While supposedly targeted at compensation practices at large financial institutions like AIG, it unfairly penalized small community banks with responsible compensation arrangements that had nothing to do with the excesses on Wall Street.
- The bill gave the Treasury Secretary carte blanche to define "unreasonable and excessive" compensation, and set performance-based measures. It authorized him, with the approval of the members of the Federal Financial Institutions Examination Council and in consultation with the Chairperson of the TARP Congressional Oversight Panel, to become the arbiters of what is "unreasonable or excessive" compensation.
- Given its limited mandate, the Congressional Oversight Panel and its chairman, Elizabeth Warren, have no expertise on the issue of executive compensation, no expertise on the subject of corporate governance and no formal legal standing even to issue recommendations on policy questions.

**Written Testimony Submitted by
Professor Lucian A. Bebchuk
William J. Friedman and Alicia Townsend Friedman Professor
of Law, Economics, and Finance and
Director of the Corporate Governance Program
Harvard Law School
Before the
Committee on Financial Services
United States House of Representatives
Hearing on Compensation in the Financial Industry
January 22, 2010**

Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee, thank you very much for inviting me to testify today.¹

Below I provide a brief account of some of the key issues facing us in examining compensation in the financial industry. My views on some of these issues are provided in more detail in the following three research papers from which this written testimony draws:

- The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008 (with Alma Cohen and Holger Spamann)
Harvard Law and Economics Discussion Paper No. 657, (December 2009).
Forthcoming, Yale Journal on Regulation (2010).
Available at SSRN: <http://ssrn.com/abstract=1513522>
- Paying for Long-Term Performance (with Jesse Fried)
Harvard Law and Economics Discussion Paper No. 658 (December 2009).
Available at SSRN: <http://ssrn.com/abstract=1535355>
- Regulating Bankers' Pay (with Holger Spamann)
Harvard Law and Economics Discussion Paper No. 641 (October 2009).
Forthcoming, Georgetown Law Journal (2010).
Available at SSRN: <http://ssrn.com/abstract=1410072>

Incentives for Risk-Taking

Standard compensation arrangements in publicly traded firms have rewarded executives for short-term results even when these results were subsequently reversed. Such arrangements have provided executives with excessive incentives to focus on short-term results. This problem, first

¹The views expressed herein are solely my own and should not be attributed to Harvard Law School or any other institution with which I am affiliated. My affiliation is noted for identification purposes only.

highlighted in a book and accompanying articles that Jesse Fried and I published five years ago,² has become widely recognized in the aftermath of the financial crisis. In financial firms, where risk-taking decisions are especially important, rewards for short-term results provide executives with incentives to improve such results even at the risk of an implosion later on.

Standard pay arrangements have thus produced a divergence between the payoffs of long-term shareholders and the payoffs of executives. The *Wages of Failure* paper noted above provides a case study of this divergence in the case of Bear Stearns and Lehman Brothers, the two investment banks that melted down in 2008. Assuming that the executives of these firms saw their own wealth wiped out together with the firms, commentators have inferred from this assumed fact that the firms' risk-taking could not have been motivated by perverse incentives created by pay arrangements.³ Our analysis of pay arrangements at Bear Stearns and Lehman Brothers during 2000-2008 concludes that this assumed fact is incorrect.

We find that the top-five executive teams of these firms cashed out large amounts of performance-based compensation during the 2000-2008 period. During this period, they were able to cash out large amounts of bonus compensation that was not clawed back when the firms collapsed, as well as pocketing large amounts from selling shares. Overall, we estimate that the top executive teams of Bear Stearns and Lehman Brothers derived cash flows of about \$1.4 billion and \$1 billion respectively from cash bonuses and equity sales during 2000-2008. These cash flows substantially exceeded the value of the executives' initial holdings in the beginning of the period, and the executives' net payoffs for the period were thus decidedly positive.

Designing Equity Compensation to Reward Long-term Performance

To better link equity compensation to performance, it is desirable to separate the time that equity-based compensation can be cashed out from the time in which it vests, as Jesse Fried and I proposed in *Pay without Performance*. As soon as an executive has completed an additional year at the firm, the equity incentives promised as compensation for that year's work should vest, and should belong to the executive even if he or she immediately leaves the firm. But the cashing out of these vested equity incentives should be "blocked" for a specified period after vesting – say, five years after the vesting.

² *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004), Chapter 14.

³ See, e.g., Floyd Norris, "It May be Outrageous, but Wall Street Pay Didn't Cause this Crisis," *New York Times*, July 31, 2009; Jeffrey Friedman, "Bank Pay and the Financial Crisis," *Wall Street Journal*, September 28, 2009.

In addition, executives should be permitted to cash out in any given year no more than a specified fraction of the portfolio of equity incentives that they hold. For example, an executive may be limited to unloading no more than 20% of his or her portfolio of equity incentives in any given year. Such a limitation would substantially limit the weight that the executive places on short-term stock prices.

Furthermore, to tighten the link between the value of equity compensation and long-term shareholder value and to prevent “gaming” of such compensation, it is desirable to adopt several additional design features that are described in detail in *Paying for Long-Term Performance*, a paper I co-authored with Jesse Fried. In particular, the principles below are worth following:

- (i) The timing of equity awards to executives (option grants, restricted stock awards, etc.) should not be discretionary. Rather, such grants should be made only on pre-specified dates.
- (ii) The terms and amount of post-hiring equity awards should not be based on the grant-date stock price.
- (iii) The payoffs from the unloading of executives’ restricted stock or options should be tied to the average price over a reasonably long period of time: If executives are permitted to choose the timing of unwinding, such decisions should be announced in advance; alternatively, the unloading of executives’ equity could be effected according to a pre-specified schedule put in place when the equity is originally granted.
- (iv) Executives should be contractually prohibited from engaging in any hedging, derivative, or other transactions with respect to equity-based awards granted as incentive compensation (such as buying puts, selling calls, or employing other risk-minimizing techniques) and be subject to penalties (including, but not limited to, forfeiture of any profits made from such transactions) if they engage in such prohibited transactions.

Designing Bonus Compensation

Two important principles for a desirable design of bonus schemes are worth noting. First, firms should avoid rewarding executives with bonus compensation that they may keep even when those results are subsequently reversed. To address the short-term distortion arising from such arrangements, bonuses should not be cashed right away, but instead placed in a company account for several years, and they should be adjusted downward if the company subsequently learns that the reasons for the bonus no longer hold up.

Second, firms should avoid using guaranteed bonuses. An analysis of the effects of such guarantees shows that they create perverse incentives to take excessive risks.⁴ Indeed, guaranteed bonuses are worse for incentives than straight salary. Guaranteed bonus schemes insulate executives from the downside of risks they take but leave them with the upside, and they consequently encourage risk-taking.

Steps Taken by Financial Firms

Some firms have announced changes to their compensation structures aimed at tightening the link between compensation and long-term results. In particular, firms have announced increases in the fraction of compensation paid in stock that will have to be held for a specified period. However, for executives who are responsible for units whose performance does not have a substantial effect on the firm's overall performance, having to hold stock cannot produce the desirable link between the executive's compensation and the unit's long-term performance. To do so, it is necessary to have the executive's compensation for a given year adjusted downward if the unit's results are subsequently reversed, and paying the executive with stock that must be held for a certain period would not have such an effect.

Firms have also announced that bonus compensation will be subject to clawbacks. But the devil is in the details, and firms have not provided sufficient information for outsiders to be able to assess whether the adopted clawbacks are meaningful or merely cosmetic.

Because the changes adopted by firms appear to be largely driven by a desire to appear responsive to outside criticism, there is a basis for concern that arrangements whose details are not disclosed might not be sufficiently effective. Past experience with the arrangements adopted by firms suggests that strengthening of shareholder rights and regulatory monitoring are necessary to ensure that excessive incentives for risk-taking are fully eliminated.

Strengthening Shareholder Rights

Shareholders have a strong interest in preventing pay structures that are detrimental to long-term shareholder value. But shareholders should have tools and rights that would enable them to secure such a state of affairs.

⁴ See Bebchuk, Bonus Guarantees Can Fuel Risky Moves, *Wall Street Journal Online*, August 27, 2009.

H.R. 3269 would establish say-on-pay votes. I testified in favor of introducing such votes in the past, and I continue to view their introduction as warranted.

Say-on-pay votes, however, are only part of the reform of shareholder rights that is necessary. In the United Kingdom, shareholders have say on pay votes, but they also have other rights that make directors more attentive to their interests and more likely to be influenced by the preferences expressed by shareholders. Shareholders in the United States continue to have much weaker shareholder rights than shareholders in the UK and other English-speaking countries. In particular, the following aspects of the existing state of affairs excessively weaken shareholder rights and limit the extent to which public firms can be expected to be run in their interests:

- (i) A substantial fraction of publicly traded firms still do not have majority voting, with a small number of “for” votes being sufficient to elect directors;
- (ii) A substantial fraction of publicly traded companies still have staggered boards, which make board replacement more difficult;
- (iii) A substantial fraction of public firms have supermajority requirements making it difficult for shareholders to amend the company’s bylaws and giving boards excessive control over the company’s governance arrangements;
- (iv) Shareholders still lack the power to place director candidates on the corporate ballot; and
- (v) Shareholders lack the power to bring to a shareholder vote proposals to amend the corporate charter or reincorporate in another state.

Reducing the extent to which shareholders rights are weakened in these ways would make boards more attentive to shareholder interests – both in general and with respect to the setting of pay arrangements.

Regulation of Compensation Structures

In addition to strengthening shareholder rights and improving corporate governance, there is another rule that the government should play. As the provisions in H.R. 3269 would require regulators to do, regulators should monitor and place limits on compensation structures in financial firms. Such a regulatory role is called for by the very same reasons that provide the basis for the long-standing prudential regulation of financial firms.

Curtailing corporate governance problems in financial firms could eliminate risk-taking that is excessive even from shareholders’ perspective. But it cannot be expected to eliminate incentives for risk-taking that are excessive from a social perspective but not from the perspective of shareholders.

Shareholders' interest in more risk-taking than is socially desirable implies that they could benefit from providing financial executives with incentives to take excessive risks. Executives with such incentives could use their informational advantages and whatever discretion traditional regulations leave them to further increase risks. Given the complexities of modern finance and the limited information and resources of regulators, the traditional regulation of financial firms' actions and activities is necessarily imperfect. Thus, when executives have incentives to do so, they may be able to take risks beyond what is intended or assumed by the regulators, who may often be one step behind financial executives. Because shareholders' interests favor incentives for risk-taking that are excessive from a social perspective, substantive regulation of the terms of pay arrangements – limiting the use of structures that reward excessive risk-taking – can advance the goals of financial regulation. By doing so, regulators would induce financial executives to work for, not against, the goals of financial regulation.

The regulation of pay in financial firms could nicely supplement and reinforce the traditional, direct regulation of such firms' activities. Indeed, if pay arrangements are designed to discourage excessive risk-taking, direct regulation of activities could be less tight than it should otherwise be. Conversely, as long as the pay arrangements of financial firms are unconstrained, regulators should be stricter in their monitoring and direct regulation of these firms' activities.

At a minimum, when assessing the risks posed by any given financial firm, regulators should take into account the incentives generated by the firm's pay arrangements. When pay arrangements encourage risk-taking, regulators should monitor the financial firm more closely and should consider raising its capital requirements.

Objections to Regulatory Intervention

Opponents of the above regulation may argue that it will drive talent away, and that financial firms will lose valuable employees. However, the regulation prescribed by H.R. 3269 would explicitly focus on compensation structures and would not limit compensation levels. Thus, to the extent that the use of pay structures that eliminate perverse incentives would be less attractive to some executives, financial firms would be able to compensate those executives with higher levels of expected pay. Even when such an increased pay level proved necessary, providing more efficient incentives would be worthwhile.

Opponents may also oppose regulation on grounds that the government does not have a legitimate interest in telling shareholders how to spend their money. Choices of compensation structures, it might be argued, inherently belong to the province of private business decisions where regulators should not trespass. This objection is not persuasive, however, because the government does have a legitimate interest in the compensation structures of private financial

firms. Given the government's interest in the safety and soundness of financial firms, its intervention here will be as legitimate as the traditional forms of intervention that limit firms' investment and lending decisions.

Finally, opponents may also argue that regulators will be at an informational disadvantage when setting pay arrangements. But placing limits on compensation structures that incentivize risk-taking would be no more demanding in terms of information than regulators' direct intervention in investment, lending, and capital decisions. Furthermore, the setting of pay arrangements should not be left to the unconstrained choices of informed players inside financial firms because such players do not have incentives to set risks at levels that are socially desirable.

**Committee on Financial Services
Hearing on Compensation Structure and Systemic Risk
January 22, 2010**

**Testimony from Nell Minow
Editor, The Corporate Library**

Mr. Chairman and Members of the Committee, thank you very much for inviting me back to continue the discussion of executive compensation. In previous appearances before this committee before and after the economic meltdown of 2008, I have called executive compensation both symptom and cause of the instability in the financial services sector and our capital markets. I regret to say that the problem continues.

Compensation has played and continues to play a significant role in providing perverse incentives and rewarding strategic decisions that are contrary to sustainable growth. This is true at the macro level, as the "too big to fail" culture is promoted by a transaction-based fee structure that awards mergers without regard to the value they create. And it is true at the micro level, where pay for the quantity of transactions rather than the quality of transactions was a key element in the explosion of the sub-prime and derivative markets. In both of these examples, as in many others, the structure of the incentive compensation was a direct and even controlling factor.

In the post-meltdown world, the pay packages and especially the bonuses continue to widen the gulf between pay and performance – and between integrity and outrageousness. What was once unfortunate excess has now become appalling, an embarrassment not just to the brand of Wall Street but to the very essence of American capitalism. As my grandmother would say, it is a shonda, Yiddish for a humiliation that reflects badly on the community as a whole.

I remember another bailout by the US taxpayers, the then-astronomical \$1.5 billion loan guarantee given to Chrysler in 1979. CEO Lee Iacocca took \$1 a year in salary and escalated stock options that would not be worth anything unless the stock price had a substantial increase. He accomplished two things. In the short term, he immediately established his credibility and accountability with investors, employees, suppliers, and taxpayers. In the long term, he made a lot of money. But that was after he performed. He knew that the essence of leadership is that he got paid only when he delivered and only after everyone else.

But that is not what happened here. Instead, first, the boards of Wall Street financial institutions implemented pay plans that were a major and direct cause of the financial meltdown. These purported bastions of capitalism protected themselves from risk by limiting their downside exposure while taking their pay off the top. Second, rinse and repeat – they took bailout money and kept paying themselves as though they earned it.

We don't ask Wall Street to be able to set public policy or be humanitarians. We ask only that they can do math. Their math was wrong. We can understand that; people make mistakes. And we were glad to help out. But they have failed to show any sense of responsibility for the failures of the past. Instead they have exhibited a sense of entitlement and shown contempt for shareholders and taxpayers by making cosmetic changes and hoping we do not notice.

For example, our Senior Research Associate specializing in executive compensation, Paul Hodgson, noted that instead of fixing the problem, Wall Street is attempting to disguise the problem: "it's euphemism time. The latest filing from Goldman Sachs apparently makes no mention of the word bonus at all, referring only to discretionary compensation. Even the comp consultants are getting in on the game. No bonuses now, only incentives." Who do they think this will fool?

A story from Reuters on this subject has a revealing comment:

Alan Johnson, a compensation consultant with his own New York-based firm, said the change in language is no coincidence. He has been advising his clients, which include the largest investment and commercial banks, to banish the word "bonus" and use "incentives" instead.

"We try to avoid the term wherever we can because it is a flash point," Johnson said. "We're going back to using what it really is, it's an incentive."

Johnson said for the top earners on Wall Street, their bonuses can be anywhere from 50 to 90 percent of their annual compensation, and is a built-in part of compensation, not an extra.

This is like something Lewis Carroll would think up. If it is built-in, how is it an incentive?

I am here as a passionate capitalist. I believe in the market. But I believe executives and their boards of directors have hijacked the market to externalize risk and it is doing critical damage to capitalism. All I am asking is for them to put their money where their mouths are. If they are not willing to bet on themselves, shareholders should not be willing to bet on them. And if they truly believed they had a good case to make, they would not rely on obfuscatory language. But then, if they truly believed in what they were doing, they would not insist on guaranteed pay.

What they did before the bailout was counterproductive and misguided. What they have done since the bailout is an outrage. Since the only portion of pay that TARP did not restrict was base pay, everyone got a raise. For example, Wells Fargo's board approved a 522 percent salary increase for the CEO, from \$900,000 to \$5,600,000. The extra was paid in stock, just over 180,000 shares at August's rock-bottom prices. Thanks largely to the government bailout, two months later this was worth over \$5.7 million.

These enormous grants of stock issued at historic low prices are resulting in enormous payouts based on the infusion from the bailouts and the overall market. It has nothing to do with the performance of the individuals involved. Even worse than large grants of stock are the grants of stock options that are so big that we have termed them mega-grants. Many of these were issued during the first two months of 2009 – before the pay limits were in place – when stocks were at their lowest possible ebb.

Companies in this category include:

Synovus Financial Services 750,000 stock options to the CEO with an exercise price of \$13.18 Regions Financial 800,000 stock options at \$21.94 US Bancorp 1.5 million stock options at \$31.04 Wells Fargo 2 million stock options at \$31.40 Citigroup 3 million stock options at between \$24.40 and \$36.60 JPMorgan 2 million stock options at \$39.83 E*Trade 4 million stock options at \$4.27 Advanta 1 million stock options at \$5.39 Broadpoint 2 million stock options at either \$3 or \$4

Each of these stocks has risen in value since January and February 2009, some very substantially, resulting in instant profits for CEOs while shareholders are still a long way from regaining the value of their investment.

Americans are generous in times of need and forgiving of mistakes. But we are outraged at injustice. If people make poor choices, we understand. But if they profit at our expense from the consequences of those choices, we are appalled. There is simply no excuse for handing out stock or options without a discount to offset the subsidies from the bailout and an indexed formula so they pay out only when the company outperforms its peer group. Executives should be paid for their performance, not the market's performance.

Congress responded to our urging that companies must have clawbacks, so that any bonuses awarded on the basis of financial reports that are later corrected must be returned. However, too many companies have adopted the weakest possible clawback provisions, requiring a finding of malfeasance before the money must be repaid. If executives are paid on the basis of numbers that turn out to be false, all of the payments must be returned, no matter what the intention was. It was never their money and if we make returning it depend on proof of bad motives, we do not provide enough of an incentive to get the numbers right the first time.

It is also infuriating to hear the executives complain that they need these compensation plans to provide an incentive for performance because these pay plans are the opposite of pay for performance. If these people are as capitalistic and entrepreneurial and risk-taking as they say, they should be the first to insist on indexed options and long-term incentives tied to their performance rather than the performance of the market. The same goes for the even more absurd argument that these plans are necessary for retention, essentially conceding the pay for performance argument. I am all for closing the loophole to bring some sanity into the world of hedge fund fees, but even if we do

not do that, I am enough of a free marketer to look forward to seeing the demand curve plummet as a bunch of sulky executives pour into the hedge fund marketplace. Anyone who says he or she will not stay without a guaranteed payout should be escorted out of the building. Putting pay at risk is the reason we pay them the big, big, big bucks.

We like to see:

1. Indexing options and tying option and stock grants to specific performance goals, as discussed above. Regardless of the form of compensation, if relative performance is being measured, executives should only be rewarded for levels of performance that are at or above the median of the peer group.

2. Banking of bonuses, preferable to clawbacks, a kind of escrow to ensure that any adjustments to the financial reports will result in adjustments to the bonus. This is essential not just in cases of fraud but also in cases of mistake, even honest mistake, because (a) there is no reason that executives should be unfairly enriched due to a mistake, (b) there is no reason that shareholders should have to pay for a mistake within the authority of the executives, (c) a bonus that is all upside and no downside provides a perverse incentive to be careless at best and manipulative at worst in preparing financial reports, and (d) intention is relevant to proving fraud but it is not relevant to determining the appropriate level of bonus. Just because a clerk at a retail store makes a mistake in giving you too much change does not mean you are entitled to keep it.

In the case of cash compensation deferral should be mandated for a minimum of three years and should apply to at least 50 percent of any award. In the case of equity compensation deferral should be mandated until three years into the executive's retirement and should apply to at least 75 percent of any award 3. Severance under any "not for cause" termination should be limited to a single year's salary and benefits, plus any unvested stock awards should continue to vest on their normal schedule for only that 12-month period.

4. Incentive compensation should be based on more than one performance metric. Different performance metrics should be rewarded from within a single incentive plan rather than multiple plans each measuring a single metric.

5. Incentive compensation should measure performance over periods of one year or more. Multi-year vesting schedules do not measure long-term performance, so any long-term incentive compensation must be based on the measurement of two or more performance metrics over periods of three years or more.

6. We support rigorous and extended stock holding requirements, including substantial stock holdings for three years after leaving the company.

7. Companies should ensure that compensation policies are easy for both executives and shareholders to understand and should avoid multiplication of compensation plans, particularly incentive plans
8. Long-term performance-based compensation should always make up the majority of total realizable compensation for the most senior executives at the company.

We like to see non-performance-based compensation play a fairly small role in total compensation. Many of the companies that do best for long-term investors pay executives below-median base salaries. And they are careful about what their performance goals are. It works well to base performance pay on some form of return on capital measure – often a better measure of value growth than earnings – and, in many cases, these return measures also take into account the cost of capital, rendering the metric an even more efficient measure of value growth. There is no one best practice for the form of long-term incentive practice. Some companies opt solely for stock options, some for time and/or performance-restricted stock, and some for other performance-related long-term incentives.

But the key is the board. It is unfathomable to me that many of the very same directors who approved the outrageous pay packages that led to the financial crisis continue to serve on boards. We speak of this company or that company paying the executives but it is really the boards and especially their compensation committees and until we change the way they are selected, informed, paid, and replaced we will continue to have the same result. Until we remove the impediments to shareholder oversight of the board, we cannot hope for an efficient, market-based system of executive compensation.

Directors should not be allowed to serve unless they have received majority vote of the shares cast. That way, investors will be able to remove directors who approve dysfunctional pay packages. I support “proxy access,” to permit shareholders to have their candidates for the board on the company’s proxy, but I expect that to be used in a fraction of a percent of the elections each year. “Say on pay” would be useful but not sufficient for meaningful change. Every director should have to earn the support of a majority of investors every year; that will do more than any other change to ensure that directors remember where they owe their loyalty.

The government has done a poor job of making it possible for regulated institutional investors like mutual funds, banks, money managers, pension funds, and foundations to cast proxy votes in an economically optimal manner. Due to the collective choice problem and conflicts of interest, proxy voting has too often been compromised and “rationally ignorant.” As we look at the “supply side” of executive compensation, management and boards, we must also look at the “demand side” to make sure our investor community has the information, tools, and ability to respond effectively.

I ask this committee to lead the way in putting an end to “too big to fail,” the term and the concept. If a company is too big to fail, it is too big to succeed. Or, as the title of a

thoughtful new book by Robert Pozen puts it, it is "Too Big To Save." If an enterprise is too big to fail, it is a utility and should be regulated like one. And executives should be paid like public servants.

Banking is now divided into two parts -- public utility and casino. The public utility is the part that is explicitly or implicitly guaranteed by the taxpayers. The part where executives take risks, in theory, is the part that under Glass-Steagall had to be separate. It is only allowing these two to be combined that creates a huge "handle" to support these pay levels. And it is only by allowing what used to be partnerships to sell stock that allows them to have the access to capital of a public company but the percentage of revenues allocated to compensation of a private company. It is this fundamental structural problem that was in part perpetrated by the pay structure and abusive pay will not be fixed until it is addressed.

Wall Street boards and executives have abused shareholders by creating perverse incentives for themselves through their pay plans. And they are now doing their best to perpetuate this system by pouring over \$70 million so far into fighting any meaningful reform. This is just another example of diversion of assets to perpetuate the externalization of risk onto the shareholders and the taxpayers. I hope that Congress will address this attempt to subvert the efficient oversight of the market and restore the credibility of our financial sector.

I would like to thank Paul Hodgson and the staff of The Corporate Library for their assistance in preparing this testimony and the underlying data and analysis. I look forward to your questions.

Additional Materials**Compensation Committee Lists:**

- **Goldman Sachs**
 - James A. Johnson, Chair
 - John H. Bryan
 - Claes Dahlbäck
 - Stephen Friedman
 - William W. George
 - Rajat K. Gupta
 - Lois D. Juliber
 - Lakshmi N. Mittal
 - Ruth J. Simmons

- **Wells Fargo**
 - *The HRC, in its capacity as the compensation committee of the Board
 - Stephen W. Sanger, Chair
 - John S. Chen
 - Susan E. Engel
 - Donald M. James
 - Richard D. McCormick
 - Mackey J. McDonald
 - Donald B. Rice
 - Michael W. Wright

- **Synovus Financial Service**
 - T. Michael Goodrich, Chair
 - V. Nathaniel Hansford
 - Mason H. Lampton

- **Regions Financial Corporation**
 - Claude B. Nielsen, Chair
 - George W. Bryan
 - Earnest W. Deavenport, Jr.
 - Susan W. Matlock
 - Lee Styslinger

- **US Bancorp**
 - Arthur D. Collins, Jr.
 - Jerry W. Levin, Chair
 - Richard G. Reiten
 - Patrick T. Stokes

- **Citigroup**
 - C. Michael Armstrong

- Alain J.P. Belda, Chair
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- **J.P. Morgan Chase & Co.**
 - Stephen B. Burke
 - David C. Novak
 - Lee R. Raymond, Ph.D., Chair
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- **E*Trade Financial Corporation**
 - Robert Druskin
 - Ronald D. Fisher, Chair
 - George Hayter
 - Lewis E. Randall
- **Advanta Corp.**
 - Dana Becker Dunn
 - Max Botel, Chair
 - Ronald Lubner
- **Broadpoint Gleacher Securities Group, Inc.**
 - Marshall A. Cohen
 - Robert A. Gerard, Chair
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Investing in Corporate Governance: Return Of the Mega-Grant

The 1990s was the last time there was a significant number of companies awarding mega-grants of stock options (a mega-grant is any equity grant that exceeds half a million stock options). Such mega-grants have led to some of the largest stock option profits ever made. For example, Michael Eisner, former CEO of Walt Disney; Lawrence Ellison, CEO of Oracle; and Barry Diller, CEO of IAC/Interactive each made, over several years, well over half a billion dollars each in stock option profits on mega-grants made during the 1980s and 1990s. But with the change in accounting practice in 2005 that led to companies having to recognize the cost of stock options on their balance sheets, mega-grants became less common.

Suddenly, however, with the collapse in stock prices that has occurred since fall 2008, like some creature from the deep, the mega-grant has returned. This has largely been occasioned by the fact that boards are fixated on—regardless of the value of the company stock—delivering a certain level of target compensation to CEOs. The thought process seems to be that if a stock price is very low, then in order to achieve that elusive “target” level, many, many more options need to be awarded. The value of a stock option award (using, for example, the Black-Scholes valuation model) is predicated on a number of variables, including stock price volatility and the life of the option, but the two most important predicates are the number of options and the exercise or strike price. If the strike price goes down, in order to maintain value, the number of options must go up. It appears not to have occurred to boards that almost everyone’s stock price is depressed—price depression is consistent particularly among companies within the same industry sector—therefore the desire to “keep up with the Joneses” by designing “competitive” pay packages needs to be adjusted similarly.

What is wrong with the mega-grant?

So what is wrong with the mega-grant? Fundamentally, like all market-priced stock option awards, executives benefit from the entire increase in the company’s stock price whether it was due to market forces or the excellence of their management skills. If the option award is very large, this means that very small increases in stock price can lead to very significant rewards. A \$1 increase over the exercise price of an award of 1 million stock options leads to a profit of \$1 million. In other words, the award of mega-grants of stock options leads to executives benefiting from a potentially enormous upside. If the market recovers and stock prices rebound, shareholders will “recover” most of the value of their investments, and CEOs will make potentially millions of dollars worth of profits. This does not align the interests of executives and shareholders, it divorces them. The award of stock options with an exercise price at a significant premium to current depressed prices is the only way to align executives’ interests with shareholders’ in this kind of market, but few if any companies have taken this route.

The current report focuses on 12 mega-stock and stock option awards granted since October 2008 that The Corporate Library has identified. We have already written about the awards at SunTrust Banks in *2009 Proxy Season Foresights #4: CEO Compensation at the 20 Largest TARP Funding Recipients*, and this triggered our interest in identifying whether other companies were taking such ill-advised actions.



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 Portland, Maine 04103
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About the mega-grants

Table 1 in the appendix gives the basic details of the grants. All but one of the grants in the table is a stock option award, though in some cases other equity grants accompanied the stock option award, such as at SunTrust and Seagate Technology. The only award that was not an option was the grant of phantom stock units at Dynegy. At almost 1.6 million shares, with essentially an exercise price of zero (this is outright stock, not options to buy stock, thus the exercise price of zero), the potential value of this is even higher than the stock option awards in the table, and this is why it is included.

The "grant date value" is a company-provided figure drawn from the SEC-required "Grants of Plan-Based Awards Table" that is a mandated part of each company's proxy statement. However, not every company provided a value in this table, as many of the awards were disclosed in other filings and in other forms. As an example of the effect of granting large numbers of stock options at depressed prices, our first step was to identify what had happened to the companies' stock prices since the dates of grant. We set a date of April 4, 2009 to collect stock price details and calculated the amount of profit CEOs had already made, sometimes in less than a month. The largest profit is associated with the largest stock option award, of 3.5 million shares at Seagate Technology. In only just over two months, the Seagate CEO has an intrinsic profit of more than \$8 million with a stock price increase of barely more than \$2. This amounts to more than \$128,000 per day. At three companies, the stock price has fallen since the grant, so no profits are recorded, but the nine other CEOs have already seen potential profits that average almost \$2.2 million.

Interestingly, two of the grants have performance conditions attached to them, though only to a fraction of the total award, at PNC Financial Services and Coca-Cola Enterprises.

12-month high and "all-time" high

While significant paper profits have been seen already, they are insignificant compared to the profits that could be made if the relevant stock prices rebounded to the high for the 12 months ending April 4, 2009. In this scenario, the average potential profit is almost \$24 million. Again, Table 2 shows the highest potential profit is at Seagate at \$65.6 million, but other CEOs at SunTrust, Ameriprise Financial, Capital One, and PNC Financial all could see profits of more than \$30 million.

The numbers get even higher when the highest stock price recorded in a company's Outstanding Equity Awards Table is used to calculate potential profits. In this case, the average rises to more than \$30 million. While the highest price recorded in the "Outstanding Equity Awards Table" is not strictly speaking the "all-time" high stock price, it does represent the highest exercise price at which stock options have been awarded at some time in the last decade (the life of an option is typically 10 years). Since the overwhelming majority of options granted in the U.S. are market-priced, it is a good approximation of the company's highest stock price over the last decade.

For almost all of the companies, the exercise price of the mega-grant is far lower than the highest price for outstanding equity, which illustrates that share prices have declined precipitously. As seen in Table 3, only at TD Ameritrade is the highest price for the CEO's outstanding equity lower than the exercise price for the mega-grant. However, the company's stock price has continued to fall from the \$18.21 price on October 10, 2008, and it once traded at \$23.49 during the 12 months prior to April 4, 2009.



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 Portland, Maine 04103
 (877) 479-7500
 (207) 874-6921
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Majority have underwater options

All but one of the CEOs in the study has outstanding stock options that are far underwater. Options are termed "underwater" or "out-of-the-money" if their exercise price is higher than the current market price. Only the CEO at TD Ameritrade does not have any outstanding underwater stock options – although, of course, because the company's stock price has continued to fall, the new mega-grant is now out-of-the-money.

Table 4 looks at the number of stock options awarded as a mega-grant and compares that to the number of outstanding stock options that are underwater (this latter figure excludes the latest mega-grant of options). As can be seen, 90 percent or more of the outstanding awards are underwater for ten of the 12 CEOs. Indeed, eight of them have no options that are in-the-money except for the new grant. In many cases – at Coca-Cola Enterprises, Seagate Technology, Brookfield Homes, NightHawk Radiology, and Teradata – the new mega-grant is almost equivalent to or far exceeds the number of underwater stock options. This – as we have already pointed out in *2009 Proxy Season Foresights #4* and *2009 Proxy Season Foresights #8* – is repricing in another guise.

Conclusion

Why do investors need to concern themselves with the return of the mega-grant? It is because such a practice sends a number of messages about governance at a company. First, especially in this kind of economic circumstance, it is one of the worst kinds of 'pay for failure'. It allows executives to profit handsomely from a market recovery that may have nothing to do with their actions. Second, equity compensation is supposed to align the interests of management and shareholders, but such grants have the opposite effect; like repricing or exchanging stock options, they give executives a chance to wipe out losses – a chance that is not extended to shareholders. Finally, mega-grants tell a story about the relationship between the board and the CEO, indicating that the board's priority appears to be to ensure that the CEO receives a large amount of compensation rather than effectively motivating the CEO to see to it that the value that shareholders have lost gets returned to them. After all, the surest way to incentivize a CEO to restore a stock price to its former level is to award stock options that are priced just at that level so that the only way for the management to make a profit is to fully restore the stock price to that former level. Setting such a target would not necessarily mean CEOs would not get adequately paid for the work involved in such a rebound; it would only ensure that such pay is earned.

Paul Hodgson, Senior Research Associate
 June 1, 2009



56 Northport Drive
 Portland, Maine 04103
 (877) 479-7500
 (207) 874-6921
 info@thecorporatelibrary.com
 www.thecorporatelibrary.com

Appendix

Table 1: Mega-Grants Immediate Gain on 4/4/09 (Source: The Corporate Library)

Company Name	CEO	Number of options awarded	Exercise price	Date of grant	Grant Date Value (if given)	Close on 4/4/09	Profit/gains at 4/4/09
Ameriprise Financial	James M. Cracchiolo	1,028,531	\$21.34	2/2/2009		\$22.84	\$1,542,797
Brookfield Homes	Ian G. Cockwell	1,000,000	\$2.65	2/2/2009	\$1,620,000	\$3.66	\$1,010,000
Capital One Financial Corporation	Richard D. Fairbank	970,403	\$18.28	1/29/2009	\$4,000,000	\$13.82	\$0
Coca-Cola Enterprises	John F. Brock	1,010,600	\$9.82	10/30/2008	\$2,617,454	\$14.09	\$5,325,862
Dynegy	Bruce Williamson	1,592,291	\$0.00	3/4/2009	\$1,799,289	\$1.64	\$812,068
NightHawk Radiology Holdings	David M. Engert	750,000	\$3.65	2/23/2009 & 12/22/2008		\$2.94	\$0
PNC Financial Services	James E. Rohr	690,400	\$31.07			\$35.80	\$3,265,592
Seagate Technology	Stephen J. Luczo	3,500,000	\$4.05	1/30/2009		\$6.40	\$8,242,500
St. Jude Medical, Inc.	Daniel J. Starks	600,000	\$30.58	12/15/2008	\$6,424,380	\$35.07	\$2,694,000
Sun Trust Banks	James Wells	550,000	\$9.06	2/10/2009		\$12.70	\$2,002,000
TD Ameritrade Holding Corporation	Frederic J. Tomczyk	1,150,000	\$18.21	10/10/2008	\$10,402,670	\$14.38	\$0
Teradata Corp.	Michael Koehler	679,612	\$13.77	12/2/2008	\$3,606,672	\$16.38	\$1,773,787
Average							\$2,222,384



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 (207) 874-6921
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Table 2: Mega-Grants Potential Gains based on 12-Month High (Source: The Corporate Library)

Company Name	CEO	Number of options awarded	Exercise price	Date of grant	Grant Date Value (if given)	12-month high at 4/4/09	Potential profit if stock price reaches 12-month high
Ameriprise Financial	James M. Cracchiolo	1,028,531	\$21.34	2/2/2009		\$55.97	\$35,618,029
Brookfield Homes	Ian G. Cockwell	1,000,000	\$2.65	2/2/2009	\$1,620,000	\$18.04	\$15,390,000
Capital One Financial Corporation	Richard D. Fairbank	970,403	\$18.28	1/29/2009	\$4,000,000	\$63.50	\$43,881,624
Coca-Cola Enterprises	John F. Brock	1,010,600	\$9.82	10/30/2008	\$2,617,454	\$24.52	\$14,855,820
Dynegey	Bruce Williamson	1,592,291	\$0.00	3/4/2009	\$1,799,289	\$9.92	\$15,795,527
NightHawk Radiology Holdings	David M. Engert	750,000	\$3.65	2/23/2009 & 12/22/2008		\$9.78	\$4,594,500
PNC Financial Services	James E. Rohr	690,400	\$31.07			\$87.99	\$39,297,568
Seagate Technology	Stephen J. Luczo	3,500,000	\$4.05	1/30/2009		\$22.78	\$65,572,500
St. Jude Medical, Inc.	Daniel J. Starks	600,000	\$30.58	12/15/2008	\$6,424,380	\$48.49	\$10,746,000
SunTrust Banks	James Wells	550,000	\$9.06	2/10/2009		\$64.00	\$30,217,000
TD Ameritrade Holding Corporation	Frederic J. Tomczyk	1,150,000	\$18.21	10/10/2008	\$10,402,670	\$23.49	\$6,072,000
Teradata Corp.	Michael Koehler	679,612	\$13.77	12/2/2008	\$3,606,672	\$27.32	\$9,208,743
Average							\$24,270,776



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Table 3: Mega-Grants Potential Gains based on Highest Price of Outstanding Options (Source: The Corporate Library)

Company Name	CEO	Number of options awarded	Exercise price	Date of grant	Grant Date Value (if given)	Highest price of outstanding options	Potential profit if stock price reaches highest price
Ameriprise Financial	James M. Cracchiolo	1,028,531	\$21.34	2/2/2009		\$58.73	\$38,456,774
Brookfield Homes	Ian G. Cockwell	1,000,000	\$2.65	2/2/2009	\$1,620,000	\$52.00	\$49,350,000
Capital One Financial Corporation	Richard D. Fairbank	970,403	\$18.28	1/29/2009	\$4,000,000	\$87.28	\$66,957,807
Coca-Cola Enterprises	John F. Brock	1,010,600	\$9.82	10/30/2008	\$2,617,454	\$25.81	\$16,159,494
Dynegy	Bruce Williamson	1,592,291	\$0.00	3/4/2009	\$1,799,289	\$9.67	\$15,397,454
NightHawk Radiology Holdings	David M. Engert	750,000	\$3.65	2/23/2009 & 12/22/2008		\$21.75	\$13,572,000
PNC Financial Services	James E. Rohr	690,400	\$31.07			\$74.65	\$30,087,632
Seagate Technology	Stephen J. Luczo	3,500,000	\$4.05	1/30/2009		\$24.63	\$72,047,500
St. Jude Medical, Inc.	Daniel J. Starks	600,000	\$30.58	12/15/2008	\$6,424,380	\$51.91	\$12,798,000
SunTrust Banks	James Wells	550,000	\$9.06	2/10/2009		\$85.06	\$41,800,000
TD Ameritrade Holding Corporation	Frederic J. Tomczyk	1,150,000	\$18.21	10/10/2008	\$10,402,670	\$12.92	(\$6,083,500)
Teradata Corp.	Michael Koehler	679,612	\$13.77	12/2/2008	\$3,606,672	\$27.98	\$9,657,287
Average							\$30,016,704



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Table 4: Underwater Options as a Percentage of Outstanding Options (Source: The Corporate Library)

Company Name	CEO	Number of options awarded	Underwater options	Number of underwater options	% of outstanding options that are underwater
Ameriprise Financial	James M. Cracchiolo	1,028,531	Yes	3,039,327	96
Brookfield Homes	Ian G. Cockwell	1,000,000	Yes	330,000	100
Capital One Financial Corporation	Richard D. Fairbank	970,403	Yes	8,336,112	100
Coca-Cola Enterprises	John F. Brock	1,010,600	Yes	1,388,300	100
Dynegy	Bruce Williamson	1,582,291	Yes	2,538,980	100
Nighthawk Radiology Holdings	David M. Engert	750,000	Yes	64,318	100
PNC Financial Services	James E. Rohr	690,400	Yes	2,353,027	100
Seagate Technology	Stephen J. Luczo	3,500,000	Yes	110,000	100
St. Jude Medical, Inc.	Daniel J. Starks	600,000	Yes	1,056,000	49
SunTrust Banks	James Wells	550,000	Yes	953,000	100
TD Ameritrade Holding Corporation	Frederic J. Tomczyk	1,150,000	No	0	0
Teradata Corp.	Michael Koehler	679,612	Yes	332,915	92



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You may be interested in the governance risk profiles of the following companies mentioned in this report:

Ameriprise Financial	IAC/Interactive	St. Jude Medical, Inc.
Brookfield Homes	NightHawk Radiology Holdings	SunTrust Banks
Capital One Financial Corporation	Oracle	TD Ameritrade Holding Corporation
Coca-Cola Enterprises	PNC Financial Services	Teradata Corp.
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By: Paul Hodgson, Senior Research Associate; Kimberly Gladman, Director of Research and Ratings; Sandy Warrick, Adjunct Research Associate

Published: May 11, 2009

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Incentives and the Performance of America's Financial Sector

House Committee on Financial Services

Hearing on Compensation in the Financial Industry

Testimony by Joseph E. Stiglitz¹

January 22, 2010

It is both a source of pleasure and sadness to testify before you today—I welcome this opportunity to testify on this important subject, but at the same time, it is a source of sadness that you should have to hold hearings on this matter, more than two years after the onset of the Great Recession of 2008.

In this brief testimony, I can only touch on a few key points. Many of these points I elaborate in my book *Freefall*,² which was published just a few days ago.

Our financial system failed to perform the key roles that it is supposed to perform for our society: managing risk and allocating capital. A good financial system performs these functions at low transaction costs. Our financial system created risk and mismanaged capital, all the while generating huge transaction costs, as the sector garnered some 40% of all of corporate profits in the years before the crisis.

The sector is also responsible for running the payments mechanism, without which our economy cannot function. But so badly did it manage risk and misallocate capital that our payments mechanism was in danger of collapse. So deceptive were the systems of creative accounting that the banks had employed that, as the crisis evolved, they didn't even know their own balance sheets, and so they knew that they couldn't know that of any other bank. No wonder then that no bank could trust another, and no one could trust our banks. No wonder then that our system of credit—the lifeblood on which the economy depends—froze. We may congratulate ourselves that we have managed to pull back from the brink, but we should not forget that it was the financial sector that brought us to the brink of disaster.

¹ The author is University Professor at Columbia University, teaching in the Department of Economics, the Graduate School of Business, and the School of International and Public Affairs. He formerly served as Chairman of the Council of Economic Advisers (1995-1997) and as Chief Economist and Senior Vice President of the World Bank (1997-2000). He was awarded the Nobel Memorial Prize in Economics in 2001 and was a lead author of the Intergovernmental Panel on Climate Change Report of 1995; the IPCC shared the Nobel Peace Prize in 2007. The work for which he was awarded the Nobel Memorial Prize in Economics is related to financial markets and incentives, the subject matter of this hearing.

² Published by W.W. Norton, 2010.

I should qualify these remarks, and much of what I shall say later, by a general caveat: parts of our financial system have done an excellent job. Later, when I write disapprovingly about the financial sector's mistakes, its misallocation of resources, its mismanagement of risk, and its predatory activities, I should emphasize that there were other parts of the financial sector that did what they were supposed to do and even tried to put a check on the misbehavior of others. America's venture-capital firms help provide finance to some of America's innovative firms and play an important role in the economy's long-term success. But these firms are a small part of the financial industry. Money that went into housing that buyers could not afford could have been used to finance new investment that would have increased the long-run productivity of our economy. Resources are scarce, and our financial sector misallocated these scarce resources on a massive scale. The crisis has reportedly forced venture-capital firms to cut back investment; these dynamic parts of America's economy will be forced to pay a high price for others' mistakes.

While the failures of the financial system that led the economy to the brink of ruin are, by now, obvious, the failings of our financial system are more pervasive. Small- and medium-sized enterprises found it difficult to get credit, even as the financial system was pushing credit on poor people beyond their ability to repay. Modern technology allows for the creation of an efficient, low-cost electronic payment mechanism; but businesses pay 1 to 2 per cent or more in fees for a transaction that should cost pennies or less.

Our financial markets not only mismanaged risk—and created products that increased the risk faced by others—but they also failed to create financial products that would help ordinary Americans face the important risks that they confronted, such as the risks of home ownership or the risks of inflation. Indeed, I am in total agreement with Paul Volcker—it is hard to find evidence of any real growth associated with the so-called innovations of our financial system, though it is easy to see the link between those innovations and the disaster that confronted our economy.

Underlying all of these failures is a simple point, which seems to have been forgotten: *financial markets are a means to an end, not an end in themselves*. If they allocate capital and manage risk well, then the economy prospers, and it is appropriate that they should garner for themselves some fraction of the resulting increases in productivity. But it is clear that pay was not connected with *social* returns—or even long-run profitability of the sector. For many financial institutions, losses after the crisis were greater than the cumulative profits in the four years preceding the crisis; from a longer-term perspective, profits were negative. Yet the executives walked off with ample rewards, sometimes in the millions. Most galling for many Americans was the fact that even when profits were negative, many financial institutions proposed paying large bonuses.

We should remember this is not the first time that our banks have been bailed out, saved from bearing the consequences of their bad lending. While this is only the second major bailout in twenty years in the US, past responses to financial crises

abroad – in Mexico, Brazil, Russia, Indonesia, Thailand, Argentina, and many others – were really bailouts of American and European banks, at the expense of taxpayers in these countries, engineered through the bankers’ allies at the IMF and the US Treasury. In each of these instances, the banks had made bad lending decisions, lending beyond the ability or willingness of borrowers to repay.

Market economies work to produce growth and efficiency, but only when private rewards and social returns are aligned. Unfortunately, in the financial sector, both individual and institutional incentives were misaligned. The consequences of the failures of the financial system were not borne just by those in the sector but by homeowners, retirees, workers, and taxpayers, and not just in this country but also around the world. The “externalities,” as economists refer to these impacts on others, were massive. There were huge private profits in the short run, in the years before the crisis, offset by the even larger losses during the crisis. But the banks and the bankers reaped the benefits of the former without paying proportionately for the costs of the latter. Alan Greenspan, in his famous *mea culpa*, explained his misguided confidence in self-regulation—he had assumed that bankers would do a better job in managing risk, in doing what was in their own interests. Even this diagnosis was flawed: he was right about the failure to manage risk, but it was not so obvious that what they did was not in their own interests. But all of this misses the real reason for regulation. If I gamble in Las Vegas and lose, only I (and my family) suffer. But in America’s casino capitalism, when the banks gambled and lost, the entire nation paid the price. We need regulation because of these externalities.

So far, I have made four key points:

1. Banks have consistently failed to fulfill their basic societal mission.
2. Banks have repeatedly been bailed out from bearing the consequences of their flawed lending.
3. Incentives within the financial system are distorted at both the individual and institutional level—at both levels private rewards and social returns are misaligned.
4. The financial sector has imposed large costs on the rest of society—the presence of externalities is one of the reasons why the sector needs to be regulated.

In previous testimony³, I have explained what kinds of regulations are required to reduce the risk of adverse externalities. I have also explained the danger of excessive risk taking and how that can be curtailed. I have explained the dangers posed by under-regulated derivative markets (including credit default swaps). I regret to say that so far, more than a year after the crisis peaked, too little has been done on either account.

³ Testimony at hearing on “The Future of Financial Services Regulation” House Financial Services Committee, October 21, 2008.

Incentives and Executive Compensation

I want to focus my remaining time on the issue of incentives and executive compensation. There are also key issues in organizational incentives, especially those that arise from institutions that are too big to fail, too big to be resolved, or too intertwined to fail. Again, I have previously testified on this critical issue⁴, and again, I regret that it appears that little if anything is likely to be done about these institutions. Too much attention has been focused on how to deal with the consequences of a failure of these institutions; what is required is prevention: preventing financial institutions from becoming too big to fail or too intertwined to fail.

The one thing that economists agree upon is that incentives matter, and even a casual look at the conventional incentive structures—with payment focused on short-run performance and managers not bearing the full downside consequences of their mistakes—suggested that they would lead to short-sighted behavior and excessive risk taking. And so they did. Leverage ratios in excess of 30 to 1 meant that even a 4% decline in asset prices would wipe out an institution's net worth, and with even smaller declines a bank would fail to meet basic standards of capital adequacy. To put this in perspective: average housing prices have fallen from their peak by nearly 30%.

In some ways, the "apparent" incentive structures were worse than this, because compensation typically increased with stock prices, which provided incentives for management to provide distorted information that would result in higher stock prices. The banks excelled at this, moving risks off balance sheet, with consequences that I have already described. Markets can only work well when there is good information, and the banks' incentive structures encouraged the provision of distorted and misleading information.

Moreover, management was rewarded for higher returns, whether those returns were produced merely by increasing risk (higher beta, in the parlance of finance) or by truly outperforming the market (higher alpha). Anyone can do the former; the latter is almost impossible. Again, no wonder that all the financial wizards took the easier route—and it was this excessive risk taking that helped bring capitalism to the brink.

These problems in incentive pay have long been recognized. Unless appropriate care is paid to the quality of what is produced, those who are paid on the basis of the quantity produced will put more effort into quantity than quality. And that is what happened in finance; with fees based, for instance, on the amount of mortgages written, there was little attention paid to the quality of the mortgages—and not surprisingly, quality deteriorated markedly, especially with securitization.

⁴ Joint Economic Committee hearing on "Too Big to Fail or Too Big to Save? Examining the Systemic Threats of Large Financial Institutions," April 21, 2009.

Opportunities for “product deterioration” are especially large in the financial sector, since the risks associated with, say, poorer mortgages (mortgages with a higher probability of default) won’t be evident until years after the fees are earned. The financial sector has been particularly creative in finding accounting frameworks that increase apparent profits in the short run—with losses revealed only later. While some of the accounting practices may have gone outside the law, there are still ample opportunities within the law.

There is an ongoing dispute: was it poor models (which predicted that events such as those that occurred in 2007-2008 would occur less often than once in the lifetime of the universe), poor risk management, or the off-balance-sheet shenanigans that nearly brought down our banking system and with it the global economy? None of these possibilities puts a positive light on our bankers. But incentives played a key role in each of these interpretations. They had an incentive to engage in excessive risk taking, they had an incentive to engage in deceptive accounting, and they had an incentive to use—and seemingly believe—models that allowed them to undertake excessive risk. They had an incentive not to enquire too deeply into the assumptions used in those models. And they had an incentive not to think too deeply about how their incentive structures distorted, and continue to distort, behavior. And while they continue to emphasize the importance of incentive pay, they have been slow to acknowledge the failings in the incentive structures and to look for alternatives.⁵

Things might have been worse were it not for the fact that much of the so-called incentive (performance) pay was a mere charade: pay was high when performance was good, but as the country saw in 2008 and 2009, pay was also high when performance was poor. Only the name of the pay changed, e.g. from “incentive” bonus to “retention” bonus. Studies in other downturns have shown the same pattern.⁶

Indeed, had our bankers been serious about designing an efficient *performance-incentive* system, it would have been markedly different, with pay related to relative performance, not to the vagaries of the overall economy and the stock market.

While the financial sectors’ failure to perform its essential functions, all the while garnering high profits, casts a poor light on the sector, their predatory lending and deceptive credit card practices cast an even darker shadow. They have used all their political muscle resisting curbing these practices. The irony is that the bankers were hoisted on their own petard—it was the subprime mortgages, irresponsible

⁵ There have been some efforts to make more of the compensation based on long-term performance, but little effort to separate out performance which is related to “better alpha” rather than “beta” or to outcomes that are the consequences of general market factors and outcomes that are the consequences of managers’ contributions. (Systems based on *relative* performance can be shown to be far better than those currently in fashion. See, e.g. B. Nalebuff and J. E. Stiglitz, 1983, “Prizes and Incentives: Towards a General Theory of Compensation and Competition.” *Bell Journal of Economics*, 14(1): 21–43.)

⁶ See, for instance, J. E. Stiglitz, *Roaring Nineties*, New York: W.W. Norton, 2003.

loans made to uninformed individuals beyond their ability to pay, designed to generate bankers fees as they robbed the poor of the life savings, that began the unraveling of our financial system. Our bankers discovered that there was money at the bottom of the pyramid, and they did everything they could to make sure that it moved to the top.

Having done little to change either the incentives or the constraints facing the financial sector, we cannot expect a marked change in behavior. Of course, in the immediate aftermath of the crisis, they and their supervisors may be chastened, though at least for some seemingly far less than one might have thought, given the enormity of the recent calamity.

In some quarters, for instance, there is a concern that programs to restructure mortgages have given rise to new fees, added on to what is already owed. Rather than a reduction in what is owed, in some cases it may be increasing. Recorded profits—and bonuses—may increase, with little regard to the risks of non-payment in the future.

Critics of regulation worry that such regulation will stifle innovation. As I argued earlier, it is hard to identify significant social benefits – and easy to identify large social costs – associated with some of the recent financial innovations. Bankers were more innovative in figuring out ways of exploiting American consumers and extracting fees than they were at designing products that would help consumers manage the risks that they face. Their failure in this respect has had not only an economic cost, but also a large social cost: foreclosures this year, estimated between 2.5 and 3.5 million, are expected to be even larger than in the last two years.

At the same time, as I have noted, the financial sector not only has not innovated in ways that would have lowered transaction costs, increased the efficiency of capital allocation, or led to less societal risk, but in some cases they have even resisted such innovations. The new mortgages led to higher, not lower, default rates: they clearly made it more difficult for individuals to manage the risk of home ownership. In my book *Freefall*, I document other examples.

None of this should be a surprise: flawed incentives affect incentives to innovate. A better alignment of private rewards and social returns and better regulation—including regulations that affect incentive structures—holds out the prospect of better innovation.

I can summarize our discussion of incentives as follows:

1. Flawed incentives played an important role in this and other failures of the financial system to perform its central roles. They encouraged excessive risk taking and shortsighted behavior. They encouraged predatory behavior.
2. Flawed incentives also explain the failure of the financial sector to innovate in ways that would have served society better, e.g. better mortgages and an efficient electronic payment mechanism.

3. Poorly designed incentive systems can lead to a deterioration of product quality, and this happened in the financial sector. This is not surprising, given the ample opportunities provided by creative accounting.
4. Many of the compensation schemes actually provided incentives for deceptive accounting. Markets only allocate resources well when information is good; but the incentive structures encouraged distortions in the provision of information.
5. The design of the incentive system demonstrates a failure to understand risk and incentives and/or a deliberate attempt to deceive investors, exploiting deficiencies in our system of corporate governance.
6. There were alternative compensation schemes that would have provided better incentives, but few firms chose to implement such schemes.
7. Matters might have been worse but for the fact that some of the discussion of incentive pay was simply a charade: pay was high when performance was good, but pay was also high when performance was poor. Only the name of the compensation changed. There was less “pay for performance” than claimed.

Concluding Comments

Market economies yield growth and efficiency when private rewards and social returns are aligned. Unfortunately, in the financial sector, both individual and institutional incentives were misaligned. The result of the flawed incentives, perhaps even worse in the aftermath of the crisis, can be called ersatz capitalism, with losses socialized and profits privatized; it is an economic system that is neither fair nor efficient.

But in some critical ways, incentives are actually worse now than they were before the crisis. The way the bank bailout was managed—with money flowing to the big banks while the smaller banks were allowed to fail (140 failed in 2009 alone)—has led to a more concentrated banking system. Incentives have been worsened too by the exacerbation of the problem of moral hazard. A new concept—with little basis in economic theory or historical experience—was introduced: the largest financial institutions were judged to be too big to be resolved. We saved not just the banks, but also the bankers, the shareholders, and the bondholders.

I want to end with two broader notes on the societal impacts of compensation in the financial sector. The first has to do with the exploitive behavior of those in the financial sector, to which I have briefly referred earlier. The bankers have been criticized for their excessive greed. First-time homebuyers were deliberately exploited. Similar criticisms can be made about the exploitive behavior of credit card companies. I don't think that those who went into finance are greedier or more deficient in moral scruples than others. But the incentive structures led them to behave in the way that they did. Economists have an expression: “everyone has their price,” and in finance, for too many, the rewards were simply too great to resist. The system even affected how they thought. In most professional jobs, one takes pride in one's work; one gives one's all. We don't pay heart surgeons on the

basis of success, arguing higher pay will provide an incentive to exert more effort to save his patient. What kind of person says to his employer, "If you only pay me \$5 million, I'll give you only half my effort? If you want me to really exert my energies, you have to pay me more if I succeed in increasing profits." But for those in finance, this kind of reasoning became not only acceptable but also became the conventional wisdom—with little thought, as we have seen, to the relationship between these "measured" profits and either long-term firm performance or, more importantly, societal returns.

Finally, I have emphasized how our financial sector failed in its essential societal roles, especially with respect to the allocation of capital, and how the sector's incentive structures may have contributed to that failure. But there is another misallocation of resources that resulted from the sector's compensation policies, one whose effects are graver and longer lasting, and one which, as a teacher, I have felt intensely. There was a misallocation of scarce human capital, as some of America's most talented young succumbed to the lure of easy money—brilliant minds that, in another era might have made real discoveries that enhanced our knowledge or real innovations—that would have enhanced societal well being. In earlier decades, our best students went into a variety of areas—some into medicine, many into research, still others into public service, and some into business. Each found fulfillment of their potential at the same time they served their communities in one way or another. At Amherst College, where I serve as a trustee, we talk of helping our youth live lives of consequence. In this modern era of a finance-dominated economy, unfortunately, a disproportionate share of our most talented youth went into finance, lured by the outsized compensation. The costs to our society of this misallocation are incalculable.

COMPENSATION IN THE FINANCIAL INDUSTRY

**Hearing Before the
House Committee on Financial Services**

January 22, 2010

Statement Submitted for the Record



1100 THIRTEENTH STREET | SUITE 850
WASHINGTON DC 20005
202.408.8181 | FAX 202.789.0064 | WWW.EXECCOMP.ORG

Chairman Frank, Ranking Member Bachus and Members of the House Financial Services Committee:

The Center On Executive Compensation is pleased to submit testimony on the role of compensation in linking executive pay to company performance while mitigating the potential for excessive risk within and beyond the financial services industry. As the Committee continues to review these issues, the Center believes that certain foundational principles regarding risk and disclosure of the nexus between pay and performance should be followed.

The Center On Executive Compensation is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is a division of HR Policy Association and represents companies from a broad cross section of industries. Because the senior human resource officers play a unique role in supporting the compensation committee chair, we believe that our Subscribers' views can be particularly helpful in understanding how executive compensation plans are constructed and executed across industry generally.

I. Significant Differences in Pay Structures Between the Financial and General Industry But Changes Are Starting to Occur

As the Committee reviews potential further compensation and governance reforms, we urge you to consider the differences in pay arrangements and time horizons for companies outside the financial industry and those within the financial industry. A majority of total compensation for senior executives in general industry has been in long-term compensation – that which is earned over three or more years. Prior to the meltdown, that was not necessarily the case in the financial services industry, where the pay mix had been much more heavily weighted toward annual incentives. In fact, 50 percent or more of total pay opportunity in the financial industry was often provided through annual bonuses that consisted mostly of discretionary cash payments, with only 30 to 40 percent provided in long-term compensation.

Those practices are now changing in the financial industry, with compensation structures becoming more like the structure in general industry. Pay arrangements are starting to more closely mirror the time horizon for risk through bonus banks or “malus” plans that hold bonus or incentive pay for a certain amount of time in an account that fluctuates with company performance. Clawback policies are being implemented and short-term incentives are becoming more directly linked to performance, rather than being purely discretionary. These changes are an important step in linking compensation more directly with long-term performance while mitigating the potential for excessive risk.

II. The Board's Focus Should Be Mitigating Excessive Risk in Incentive Programs

We have seen frequently over the past two years that despite the economic recession, there is still a market for talent in key industries, and that this market drives the level of compensation and the ability of companies to retain key individuals. Prior Congressional attempts to limit the amount of compensation, whether through the tax code or other approaches, are widely acknowledged to have backfired. Rather than continue down this failed path, Congress should focus on ensuring that the Board is doing its job and reinforce the Board's oversight role rather than watering down its authority. The Board is responsible for ensuring that senior executive compensation is structured to incentivize and reward executive achievement appropriately, and that the company's compensation structure is appropriately monitored by management to mitigate the potential of excessive risk.

With this background in mind, the question for the Committee should continue to be whether the Board of Directors is properly exercising its oversight role in identifying and mitigating the role of excessive risk in incentive compensation programs that could have a material adverse effect on the company. After all, incentive programs are structured to encourage management to achieve the company's business strategy set by the Board. Thus, the Compensation Committee is in the best position to assess the appropriate relationship between the risk inherent in compensation arrangements and how that level of risk corresponds to the overall business strategy and competitive environment of the company. That said, the riskier the business strategy, the more important it is that incentives are properly structured. The SEC recently promulgated rules requiring proxy disclosure of such risks where they exist, and we will begin to see the effects of the rules in the 2010 proxy season.

In response to questions from large companies outside the financial industry, early last year, the Center created a checklist for Boards and Committees to follow in assessing the potential for "excessive risk" among executive compensation plans and to mitigate this risk.¹ The checklist asks the following questions:

1. Do the performance criteria and corresponding objectives represent a balance of performance and the quality and sustainability of such performance?
2. Is the mix of compensation overly weighted toward annual incentive awards or is there a balance of annual and long-term incentive opportunities?
3. When compared to a carefully chosen peer group, is the relationship between performance and incentive plan payouts within the range of competitive practices?

¹ Center On Executive Compensation, Compensation Committee Checklist for Assessing Risks in Incentives, available at <http://www.execcomp.org/docs/Compensation%20Committee%20Checklist%20for%20Assessing%20Incentives%20and%20Risk.pdf>.

4. Is the relationship between performance criteria and payouts under the annual incentive award consistent with targeted performance under the long-term incentive awards?
5. Are the long-term incentive performance measures or equity devices overly leveraged and thereby potentially encourage excessively risky behavior?
6. Is there a requirement that a meaningful portion of the shares received from incentive award payouts be retained by the participants?
7. Has the Board of Directors adopted a recoupment policy which provides for the clawback of incentive payouts that are based on performance results that are subsequently revised or restated and would have produced lower payouts from incentive plans?
8. Does the Compensation Committee discuss the concept of risk when establishing incentive performance criteria and approving incentive payouts? Are such discussions recorded in the minutes of the Committee meeting? Does the Compensation Discussion and Analysis articulate how the company's incentive plans mitigate risk?

Rather than exploring solutions that are likely not to have an effect on sound compensation design, and that could have competitive effects far beyond the financial industry, we would encourage the committee to review whether companies are following these or similar steps in assessing whether excessive risk is being mitigated.

III. Clearer Disclosure of Executive Pay and Performance Is A Better Solution Than a Mandated Vote on Pay

It has been proposed that a shareholder vote be expanded even beyond the version that passed the House to address the pay of lower level employees such as traders. As the Center has indicated many times before, we believe that say on pay is unnecessary for senior executives, that it would undermine the role of the Board of Directors and that expanding the vote to lower-level employees takes another step toward shareholder management of the company. The Center believes that a more effective approach would be to provide clearer disclosure of the link between pay and performance in the proxy to help shareholders understand the rationale behind their pay programs. The Center's "Pay for Performance at a Glance" approach is an attempt to achieve this clarity. It involves two summary disclosures that show what a CEO actually made for a year and also more clearly describes how future potential pay is linked to future performance, thus enabling investors to make a decision as to whether the Board is doing its job.

The disclosures are made in the form of two tables intended to be inserted at the front of the CD&A.

- The first table shows what the CEO actually received in the current year: salary, annual incentive, and long-term incentives paid out and the performance results that generated the compensation. In the case of long-term incentive payouts, gains on stock options exercised and restricted shares that vested during the year,

the table shows awards that were earned over multiple years but realized in the reporting year.

- The second table discloses the accounting estimates of restricted stock, stock options, performance shares and long-term incentive plan payouts and the performance that must be achieved for the executive to earn the estimated payments. This approach separates future potential pay from actual pay, thereby allowing investors to assess whether the compensation committee's determination of future pay appears to be a reasonable approach to linking compensation to the creation of shareholder value.

The Center believes that this would summarize information on pay and results in the reporting year in one place and thus make it easier for shareholders to understand whether compensation is linked to performance. We would be happy to provide the committee with further information about the proposal at its convenience.

IV. Say on Pay

The Center opposes a mandated shareholder vote on pay for senior executives and would oppose any expansion of this concept to more junior executives or individuals. Shareholders currently have many opportunities to provide their perspectives on pay. In addition to the shareholder resolution process, which has proven to be an effective means of negotiation and dialogue on issues of concern between shareholders and companies, new methods of engagement have emerged in the past two years and are quickly becoming best practice among leading U.S. companies. The Center believes that mandated say on pay is unnecessary for the following reasons:

- Shareholders, when given an opportunity to support say on pay, have not decisively endorsed it, with only 30 percent of the resolutions seeking say on pay receiving majority shareholder support in 2009.
- In recent years there have been considerable governance and compensation changes that have fostered a greater link between pay and performance and have engendered increased dialogue between shareholders and boards voluntarily.
- Say on pay would undermine the authority of the Board of Directors under the U.S. system of corporate governance. The Board has a fiduciary duty to represent the interest of all shareholders in managing the company and setting appropriate executive compensation packages. Setting executive compensation involves linking executive incentives to the company's business strategy, which in many cases includes the use of confidential information that is only available to the Board. As the *Washington Post* editorialized, "boards of directors, fearing bad publicity, will shape compensation policy to the anticipated opinions of shareholders, who may be greedy for short-term profits themselves – or insufficiently informed about the finer points of retaining talent. . . . If you like the way California governs by referendum, you'll love say on pay."

- Even though nonbinding, the existence of a shareholder vote is likely to cause Boards to change pay arrangements to conform to shareholder expectations. This result would significantly weaken the pay for performance link companies strive to achieve in their compensation programs.
- Proponents of mandated say on pay in the U.S. point to the experience in the United Kingdom (UK), which has had a mandated annual vote since 2002. Yet, according to academic research, pay in the UK has actually continued to increase, not decrease as many U.S. proponents claim it will.
- A mandated annual vote on pay would enhance the clout of the proxy advisory services, which conduct research and often vote the proxies on the shareholders' behalf. Many institutional investors will not take the time to evaluate the executive compensation policies of the publicly held companies in their portfolios; instead, they will defer to the proxy advisory services' recommendations.

In sum, say on pay is counterproductive to our system of governance. Expanding the concept to include votes on rank-and-file pay or all executive pay will only further expand disclosures and make pay information even more difficult to understand. The Center urges rejection of a say on pay mandate and instead hopes for focus on clearer disclosure of the pay for performance link.

Conclusion

The Center appreciates the opportunity to provide its views on these extremely important policy matters. We look forward to working with you on legislation that reinforces the role of the Board in promoting sound compensation strategies.

Bank CEO Incentives and the Credit Crisis

Rüdiger Fahlenbrach and René M. Stulz*

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Abstract

We investigate whether bank performance during the credit crisis of 2008 is related to CEO incentives and share ownership before the crisis and whether CEOs reduced their equity stakes in their banks in anticipation of the crisis. There is no evidence that banks with CEOs whose incentives were better aligned with the interests of their shareholders performed better during the crisis and evidence that these banks actually performed worse both in terms of stock returns and in terms of accounting return on equity (ROE). Further, banks with higher option compensation and with a larger fraction of compensation given in the form of cash bonuses did not have worse performance during the crisis. All these results hold for banks that received TARP assistance as well as other banks that did not. The incentives of non-CEO top executives are unrelated to bank performance during the crisis. Bank CEOs did not reduce their holdings of shares in anticipation of the crisis or during the crisis; there is also no evidence that they hedged their equity exposure. Consequently, they suffered extremely large wealth losses as a result of the crisis.

Keywords: Financial crisis; CEO compensation; CEO incentives; insider trading

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*Fahlenbrach is Swiss Finance Institute Assistant Professor at Ecole Polytechnique Fédérale de Lausanne. Stulz is the Everett D. Reese Chair of Banking and Monetary Economics, Fisher College of Business, Ohio State University, and affiliated with NBER and ECGL. We thank an anonymous referee, Graef Crystal, Francois Degeorge, Joseph Grundfest, Michael Jensen, Steve Kaplan, Ira Kay, Andrew Kuritzkes, Frédéric Lelièvre, Claudio Loderer, Hamid Mehran, Jean-Charles Rochet, Myron Scholes, Lemma Senbet, and seminar and conference participants at the European School of Management and Technology Berlin, University of Lugano, the 4th Swiss Finance Institute annual meeting, and the 9th FDIC-JFSR Annual Bank Research Conference for helpful comments and suggestions. Mike Anderson, Jérôme Taillard, and Scott Yonker provided excellent research assistance. Fahlenbrach acknowledges financial support from the Dice Center for Research in Financial Economics. Address correspondence to René M. Stulz, Fisher College of Business, The Ohio State University, 806 Fisher Hall, Columbus, OH 43210, stulz@cob.osu.edu.

In the search of explanations for the dramatic collapse of the stock market capitalization of much of the banking industry in the U.S. during the credit crisis, one prominent argument is that executives at banks had poor incentives. For instance, Blinder argues that these poor incentives are “one of [the] most fundamental causes” of the credit crisis.¹ The argument seems to be that executives’ compensation was not properly related to long-term performance, leading the Obama administration to discuss ways to change compensation practices “to more closely align pay with long-term performance”² and to give more voice to shareholders through the adoption of “say on pay” for firms that received public funds through the Troubled Asset Relief Program (TARP).³

We investigate in this paper how closely the interests of the bank CEOs were aligned with those of their shareholders before the start of the crisis, whether the alignment of interests between CEOs and shareholders can explain the banks’ performance in the cross-section during the credit crisis, and how CEOs fared during the crisis.

Traditionally, corporate governance experts and economists since Adam Smith have considered that management’s interests are better aligned with those of shareholders when managers’ compensation increases when shareholders gain and falls when shareholders lose. As Murphy (1999) puts it in a widely cited review of the academic literature on managerial compensation, “Stock ownership provides the most direct link between shareholder and CEO wealth.” Yet our results show that there is no evidence that banks with a better alignment of CEOs’ interests with those of their shareholders had higher stock returns during the crisis. There is actually some evidence that banks led by CEOs whose interests were better aligned with those of their shareholders had worse stock returns and a worse return on equity. Though options have been blamed for leading to excessive risk-taking, there is no evidence in our sample that greater

¹ “Crazy compensation and the crisis,” by Alan Blinder, *The Wall Street Journal*, May 28, 2009.

² “U.S. eyes bank pay overhaul: Administration in early talks on ways to curb compensation across finance,” *The Wall Street Journal*, May 13, 2009.

³ “U.S. targets excessive pay for top executives,” by David Cho, Zachary A. Goldfarb and Tomoeh Murakami Tse, *The Washington Post*, June 11, 2009; “US SEC proposes say on pay for TARP companies,” by James Pehtokoukis, *Reuters*, July 1, 2009.

sensitivity of CEO pay to stock volatility led to worse stock returns during the credit crisis. We also do not find evidence that bank returns were lower if CEOs had higher cash bonuses. A plausible explanation for these findings is that CEOs focused on the interests of their shareholders in the build-up to the crisis and took actions that they believed the market would welcome. Ex post, these actions were costly to their banks and to themselves when the results turned out to be poor. These poor results were not expected by the CEOs to the extent that they did not reduce or hedge their holdings of shares in anticipation of poor outcomes.

There are many versions of the poor incentives explanation of the crisis. One version is that CEOs had strong incentives to focus on the short run rather than the long run. Another version is that option compensation gave incentives to CEOs to take more risks than would have been optimal for shareholders. A third version is that the high leverage of financial institutions implies that CEOs can increase the value of their shares by increasing the volatility of the assets since the shares are effectively options on the value of the assets. Though the incentives of CEOs can be such that they focus too much on the short run, that they take too much risk, and that they choose excessive leverage, it is by no means obvious that CEO incentives in banks had these implications. In particular, large holdings of equity by CEOs could in fact lead them to focus appropriately on the long run, to avoid some risks that might be profitable for shareholders, and to avoid excessive leverage.

To the extent that the market for a bank's stock is efficient, changes in a bank's long-term performance will be properly reflected in the stock price. Thus, greater sensitivity of a CEO's wealth to his bank's stock price will make it advantageous for the CEO to improve his bank's long-term performance when it makes economic sense to do so. Focusing on the short run rather than the long run would be costly for CEOs since their stock price would be lower than if they had taken actions to maximize shareholder wealth. This argument is ignored by most critics who have blamed the crisis on compensation structures and who have focused on the "Wall Street bonus culture". The above conclusion would not hold if the market is not efficient, since in that case the

market might put more weight on short-run results and misvaluation could create pressure on management to take actions it would not take in an efficient market.⁴ In an inefficient market, CEOs might have concluded that they had no choice but to focus on short-run profit maximization because they feared losing their job had they not grown aggressively, e.g., the subprime securitization business, as the market might have reacted poorly to lack of growth even though shareholders would have benefitted in the long run. The above conclusion would not hold either if executives paid more attention to incentives promising immediate cash payouts than to incentives paid in paper gains not realizable until long in the future.

Much attention has been paid to the role of options in compensation. However, the incentive effects of options depend on the CEO's holdings of shares since they would be diluted in the CEO's portfolio if he had large holdings of shares. Further, when the CEO's portfolio of options is composed mostly of in-the-money options, the incentive effects of options do not differ much from the incentive effects of common stock holdings. Keeping the CEO's wealth constant, greater sensitivity of his wealth to increases in the volatility of his firm's stock return brought about by greater stock option holdings would increase the CEO's incentives to take risks as long as these options are not too much in the money, but generally granting options also affects the CEO's wealth which can change his willingness to take risks (see Ross (2004)). Whether greater sensitivity of CEO wealth to volatility makes the CEO's interests better aligned with the interests of shareholders would seem to depend on many considerations. For example, if the CEO's holdings of stock make him more conservative, greater sensitivity of his wealth to volatility would help in aligning the CEO's incentives with those of shareholders.

For given asset volatility and expected cash flows from assets, an increase in bank leverage would lead to an increase in the value of equity since equity is an option on the value of the assets for levered firms. However, higher leverage can also have costs. Many lines of business of banks

⁴ See Bolton, Scheinkman, and Xiong (2006) for a model where optimal compensation puts more weight on short-run results to take advantage of speculative behavior in the stock market, and Jensen (2005) for an analysis of the implications of overvalued equity for the incentives of management.

are sensitive to the risk of their senior claims. For instance, derivatives trading businesses generally require a high credit rating for senior claims. Further, even if an increase in leverage increases stock prices, CEOs with a large equity stake in their firm may choose more conservative leverage to reduce the risk of their wealth.

CEOs with greater incentive alignment would therefore be expected to take different risks from those with weaker incentive alignment. To the extent that the bank exposures that performed poorly during the crisis were viewed as risky by CEOs in 2006, we would expect that bank CEOs with greater incentive alignment would have chosen to take fewer such exposures than CEOs with poor incentive alignment: CEOs with low holdings of shares would have had much less to lose in the event of bad outcomes as a result of these exposures. Further, it is an empirical issue whether CEOs with more options in their portfolio relative to shares would have been more willing to take risky exposures.

We find that bank CEOs had substantial wealth invested in their banks. For the median CEO, the value of stock and options in his portfolio was more than eight times the value of his total compensation in 2006. Consequently, changes in his bank's stock price could easily wipe out all of a CEO's annual compensation. The median CEO owned 0.4% of the outstanding shares of his bank. Taking into account vested, but unexercised options, this fraction increases to 1.0%. The large holdings of vested unexercised options are striking. They are not consistent with the view that somehow the typical CEO knew that there was a substantial risk of a crash in the stock price of his bank.

A bank's stock return performance in 2007-2008 is negatively related to the dollar value of its CEO's holdings of shares in 2006. This effect is substantial. An increase of one standard deviation in dollar ownership is associated with lower returns of 9.6 percentage points. Similarly, a bank's return on equity in 2008 is negatively related to its CEO's holdings of shares in 2006 – a one standard deviation increase in dollar ownership is associated with a lower return on equity of 10.5 percentage points. This evidence suggests that CEOs took exposures that they felt were profitable

for their shareholders *ex ante* but that these exposures performed very poorly *ex post*. The convexity introduced by options does not appear to have had an adverse impact on stock return performance or accounting performance measured by the return on equity (ROE) or by the return on assets (ROA).

Much concern has been expressed about the incentives of non-CEO bank executives. For instance, Blinder states that the top executives face incentives such that “For them, it’s often: Heads, you become richer than Croesus ever imagined; tails, you receive a golden parachute that still leaves you richer than Croesus. So they want to flip those big coins, too.”⁵ Data is available on the compensation of the top four highly paid non-CEO bank executives. We use that data to examine whether the incentives of non-CEO bank executives are related to bank performance during the crisis. We do not find evidence that the incentives of non-CEO executives are related to bank performance. However, if we look at the sum of the incentives of the top five executives, we find that our results on CEO incentives are robust to this alternative specification.

It could be that the incentive effects of compensation policies were different for the subset of banks that made large losses or that were more systemically important. One way to identify such a subset is to examine firms that received funding from the Troubled Asset Relief Program (TARP). When we look at the subset of the 54 banks that received such funding in our dataset we find that there is no statistically significant difference in the relation between dollar equity incentives and returns in the subsamples of TARP and no-TARP recipients.

CEOs could have sharply decreased their holdings after 2006 but before the full impact of the crisis, so that they did not have to bear the cost of the exposures they took. In that case, they would have appeared to have incentives aligned with those of the other shareholders in 2006, but they would have traded out of these incentives or would have hedged them. Consequently, their behavior in 2006 might have been based on their knowledge that they would trade out of these incentives before the value of their portfolio fell substantially. For such a strategy to make sense,

⁵ See footnote 1.

CEOs would have had to be able to anticipate the crisis. We investigate the insider trading of bank CEOs in 2007-2008. We find no evidence that they traded out of their positions. CEOs therefore had to bear the losses associated with the poor outcomes of the exposures their banks had at the end of 2006. Our evidence on CEO trading of shares in 2007 and 2008 is consistent with the hypothesis that the crisis and its evolution were unexpected for bank top executives; it is also inconsistent with the hypothesis that CEOs focused knowingly and suboptimally on the short term. Some might argue that they should have known better, but our evidence also shows that they had stronger incentives than most to understand the risks they were taking and the overall performance of their bank.

There is a long literature on the compensation of bank CEOs that helps put our results in perspective. This literature shows that CEO compensation depends on stock return and accounting performance (Barro and Barro (1990)) as does the compensation of CEOs generally, but also that the composition of pay differs from CEOs of other industries. In particular, the share of pay in the form of stock and options for bank CEOs is lower than in other industries (e.g., Adams and Mehran (2003) or Houston and James (1995)). More recently, Kaplan and Rauh (2009) estimate and compare adjusted gross incomes for non-financial firm executives and financial service sector employees. Their evidence indicates that the financial industry has relatively more highly compensated individuals than the non-financial industry. Several papers investigate the impact of deregulation and greater competition on bank CEO compensation. In particular, Hubbard and Palia (1995) and Crawford, Ezzell, and Miles (1995) conclude that deregulation led to greater pay-for-performance sensitivity of CEO pay at banks. Finally, Mehran and Rosenberg (2007) investigate the incentive effects of option grants for bank CEOs. They find that asset volatility is higher for banks that grant more options, but at the same time these banks have less leverage, showing that the effects of option grants on bank policies are complex. Cheng, Hong, and Scheinkman (2009) examine size-adjusted annual compensation and show that it is related to risk-taking measures.

Though much of the recent debate concerns the alignment of incentives between managers and shareholders, the existing literature suggests that greater pay-for-performance sensitivity may lead to more systemic risk, indicating that there may be a conflict between shareholder wealth maximization and financial stability. In particular, Crawford, Ezzell, and Miles (1995) find that, following deregulation, pay-for-performance sensitivity of CEO pay increased more at less well-capitalized institutions. They interpret this result as evidence of a moral hazard problem induced by the existence of deposit insurance priced in a way that does not reflect the risks taken on by individual banks. More recently, a series of papers has analyzed whether bank CEO compensation is optimally designed to trade off two types of agency problems: the standard managerial agency problem as well as the risk-shifting problem between shareholders and debtholders that may be particularly severe in highly leveraged institutions (e.g., John, Mehran and Qian (2008) and John and Qian (2003)). These papers argue that leverage should reduce the pay-for-performance sensitivity of bank CEOs compared to other CEOs because of monitoring by debtholders. Accordingly, John and Qian (2003) show that bank CEOs have lower pay-for-performance sensitivity than other CEOs. This literature emphasizes that it may be optimal for shareholders to take more risks because doing so increases the value of the put granted to banks by the FDIC. John, Saunders, and Senbet (2000) develop a model in which it is optimal for the FDIC to set insurance premiums taking into account the compensation contract of the bank's CEO.

The paper proceeds as follows. In Section 1, we introduce our sample of banks. In Section 2, we present data on CEO compensation and equity ownership at the end of fiscal year 2006. We then turn to the relation between CEO compensation, equity ownership, and bank performance during the crisis in Section 3. In Section 4, we investigate the relation between the incentives of the top 4 non-CEO executives and bank performance. Section 5 examines the incentive structure and its relation to performance in banks that received money from the Troubled Asset Relief Program, and Section 6 analyzes the trading of CEOs in shares of their own bank after the end of 2006 and how their equity ownership evolves during the crisis. We conclude in Section 7.

1. The sample of banks

Our study requires compensation data. This data is available through Standard and Poor's Execucomp database. We use that database as the starting point for the formation of our sample. We download all firm-year observations for firms with SIC codes between 6000 and 6300 in fiscal year 2006. This yields 132 unique firms. We exclude firms with SIC codes 6282 (Investment Advice), because these are not in the lending business (e.g., Janus, T Rowe Price). In addition, we manually go through the list of firms in SIC codes 6199 (Finance Services) and SIC code 6211 (Security Brokers and Dealers). Such a manual search is necessary because SIC code 6211 includes not only investment banks but also pure brokerage houses such as Charles Schwab.⁶ Though our sample has investment banks, we exclude pure brokerage houses. We also report tests that exclude investment banks. Further, SIC code 6199 contains both American Express and Citigroup even though American Express is not a bank in the traditional sense. For increased transparency, we show the firms we exclude from our analysis and those we include in Appendices A and B. Our final raw sample contains 98 firms. Three of those banks do not have complete data on CEO compensation and equity holdings. In addition to compensation data, we obtain accounting data from Compustat, additional banking data from Compustat Bank, insider trading data from Thomson Financial, and stock return data from CRSP.

Table 1 provides summary statistics for our sample of banks. It shows that we cover very large financial institutions. This is not surprising since Execucomp is biased towards larger firms. The median asset value is \$15.5 billion, and the mean asset value is \$129.3 billion. The sum of total assets of sample firms at the end-of-fiscal year 2006 is \$12.3 trillion. At the end of 2006, the average (median) market capitalization of sample banks is \$18.7 billion (\$2.8 billion). The average net income over assets (over equity) is 1.2% (13.5%). We also report two measures of capital strength, the Tier 1 capital ratio and the tangible common equity divided by tangible assets. The

⁶ Using the finer North American Industry Classification System (NAICS) does not resolve the issues. For example, Goldman Sachs Group is classified as 523110 (Investment Banking & Brokerage) while Bear Stearns is classified as 523120 (Securities Brokerage).

Tier 1 capital ratio is on average 9.7%, while the tangible common equity ratio is 6.7% at the end of fiscal year 2006. The average Tier 1 capital ratio makes these banks well capitalized. Even the lowest Tier 1 ratio (5.73%) is substantially above the regulatory minimum of 4%. No bank in our sample has negative net income in 2006.

Our study examines the accounting and stock return performance of the sample banks until the end of 2008. Table 2 shows the attrition of sample firms from fiscal year end 2006 to the end of 2008. Of the 95 banks with complete CEO compensation data in 2006, 77 survived until December 2008. 12 banks were acquired, and 6 banks delisted from the exchange due to a violation of listing requirements or bankruptcy.

2. CEO compensation and equity ownership at the end of fiscal year 2006

We now turn to an examination of CEOs' and other proxy-named executives' compensation and of their equity and option holdings at the end of 2006. In 2006, the Securities and Exchange Commission (SEC) adopted new disclosure requirements concerning, among other items, executive compensation. The amendments to the compensation disclosure rules were intended to provide investors with a clearer and more complete picture of the compensation of named executive officers. The new rules were designed to improve tabular presentation, and to offer material qualitative information regarding the manner and context in which compensation is awarded and earned. Firms had to comply with the new rules if their fiscal year ended on or after December 15th, 2006. We use the new table on outstanding equity awards at fiscal year-end that provides detailed information on exercise prices and expiration dates for each outstanding option grant to calculate the option's Black-Scholes value as well as its sensitivity to volatility and stock price changes. In addition, we use the narrative on executive compensation to analyze what fraction of the annual accounting bonus was paid in cash and what fraction was paid in equity. The summary tables on executive compensation, which are available through ExecuComp, report equity grants for annual performance in the year the grant was made, and not in the year during which

performance was measured.⁷ Hence, we manually retrieve the information on the decomposition of the annual bonus for operating performance into cash bonus and equity bonus by reading the narrative on executive compensation and by looking at the following year's proxy statement.⁸

Five of our sample firms have fiscal years ending before December 15th, 2006 (Bear Stearns, Goldman Sachs, Lehman Brothers, Morgan Stanley, and Washington Federal Savings) and do not report executive compensation according to the new disclosure rules. For those firms, only aggregate information on exercisable and unexercisable past option grants is available. We use the methodology of Core and Guay (2002) to calculate the average characteristics of previously granted unexercisable and exercisable options. Core and Guay (2002) treat all previously-granted unexercisable and all previously granted exercisable options as two single grants. The exercise price of each "grant" is then derived from the reported average realizable value of the options. In addition, Core and Guay (2002) assume that unexercisable options have a time-to-maturity that is three years greater than that of the exercisable options (please refer to their paper for details). We use the two "grants" and their imputed characteristics to approximate the Black-Scholes value and delta and vega of the previously granted options for these five firms. Core and Guay (2002) show the validity and robustness of their approximation.

Columns 1 and 2 of Table 3 provide means and medians of CEOs' compensation, annual bonus for 2006 performance, equity portfolio, equity incentives, and equity risk. Columns 3 and 4 provide statistics for the next four highest paid executives, measured by total pay. We first average compensation variables by firm across the four non-CEO executives and then calculate the cross-

⁷ For example, the proxy statement of CitiGroup for fiscal year 2006 (filed in March 2007) accurately describes the problem: "In accordance with SEC regulations, the stock awards granted in January 2006 in respect of the executive's performance during 2005 are required to be reported in this proxy statement, which generally describes awards made in respect of performance in 2006. Barring a change in the SEC regulations, the stock awards granted in January 2007 in respect of each executive's 2006 performance will be reported in the Grants of Plan-Based Awards Table in the 2008 proxy statement if the executive is a named executive officer in 2007."

⁸ We are unable to identify equity grants for 2006 performance for about 20% of the sample because of turnover or because the equity grants are not separated into grants for annual operating performance and other long-term objectives such as retention.

sectional mean and median. Columns 1 and 2 have 95 observations because three firms do not report CEO equity holdings for 2006 as a result of a change in CEO. The total compensation (including new option and stock grants, but excluding gains from exercising options) of sample CEOs was on average \$7.8 million for 2006, and the median compensation was \$2.5 million. The next five rows split the total pay into its components. The majority of CEO compensation stems from performance-based pay, as the average base salary of 760,000 is less than 10% of the average total compensation. John and Qian (2003) use a sample constructed similarly to ours and investigate compensation for 120 commercial banks from 1992 to 2000. In that study, they find that the ratio of average salary to average total direct compensation is higher than what we find (16% versus 10%). Note however that the distribution of that ratio is skewed. The median base salary of \$750,000 is about 30% of the median total compensation. The last row in the first part of the table shows that cash bonuses are large relative to cash salary. The average value of cash bonus (measured as the sum of non-incentive based pay, bonus and long-term incentive plan payouts) over cash salary is 2.8, with a median of 0.9. When executives receive high cash bonuses for success but when bonuses cannot go below zero for failure, executives potentially have incentives to take risks that are not in the interests of the shareholders or of the safety and soundness of their institutions because that part of their compensation is not affected by the size of the loss that results from their actions. Consequently, we include the ratio of cash bonus to salary in all regressions.

Annual bonuses for achievements of accounting based goals are paid both in cash and equity to align incentives of CEOs and shareholders. The next subset of statistics shows the decomposition of the annual bonus for 2006 performance into cash and equity grants. A significant fraction of 40% of the annual bonus for accounting performance is paid in equity. Furthermore, this statistic is somewhat understating the true significance of equity bonuses, because the higher the total bonus for 2006 performance, the higher the fraction that is paid in equity (the correlation between cash bonus / total bonus and total bonus is -0.22). This result has important implications for critics' argument that annual bonuses are distorting incentives – more than forty percent of the annual

bonus is paid in equity which will not vest for several years to come. Given the size of the annual bonuses, it is not surprising that the cash flows to executives from cash bonuses and sales of vested shares were large.⁹ However, our focus is not on the size of compensation but on the incentive effects of compensation and more precisely on the incentives of CEOs immediately before the crisis.

As Hall and Liebman (1998) and Core and Guay (1999) point out, most CEO equity incentives stem from the existing portfolio of stock and options, and not from annual grants. A similar result holds for our sample. We define the total dollar value of equity of a CEO at the end of fiscal year 2006 as the sum of unrestricted and restricted shares held multiplied by the end-of-year share price plus the Black-Scholes value of exercisable and unexercisable stock options plus the fair value of unearned equity incentive plans.¹⁰ The mean (median) value of the CEO's equity stake is \$87.5 million (\$35.6 million). There are 21 CEOs in our sample who have equity stakes valued at more than \$100 million. The top 5 equity positions at the end of fiscal year 2006 are held by James Cayne (Bear Stearns, \$1,062 million), Richard Fuld (Lehman Brothers, \$911.5 million), Stan O'Neal (Merrill Lynch, \$349 million), Angelo Mozilo (Countrywide Financial, \$320.9 million), and Robert J. Glickman (Corus Bankshares, 281.1 million).

Most of the value of the executives' equity portfolio stems from shares and vested, exercisable options, which are voluntarily held.¹¹ The value of the equity portfolio is large relative to the total annual compensation. The median ratio of the value of the overall equity portfolio divided by total

⁹ Bebchuk, Cohen, and Spamann (2009) provide statistics on the cumulative cash flows to executives at Bear Stearns and Lehman from cash bonuses and share sales.

¹⁰ The treatment of restricted shares in the 'ownership by officers and directors' table, from which ExecuComp derives the total number of shares held by executives, is not consistent across firms. We manually go through the proxy statements and determine whether unvested restricted shares are counted towards the number of shares held by executives. If not, we add the number of unvested restricted shares to the number reported in the beneficial ownership table to determine the total ownership from shares. For an example, see the proxy statement of Goldman Sachs filed on February 21, 2007.

¹¹ Many companies have established target stock ownership plans for their executives, so that the executive is not free to sell his or her entire stake (see, e.g., Core and Larcker (2002)). These target plans typically require the CEO to hold three to five times his base salary in stock. These values are largely exceeded in our study. For example, Table 3 shows that the median CEO holds shares worth more than 25 times his base salary.

annual compensation is 8.1 for CEOs. The median CEO ownership percentage from shares in our sample is 0.4. John and Qian (2003) found median CEO equity holdings of 0.25% for their sample of commercial banks. The median percentage ownership from shares and exercisable options, as reported in the bank's proxy statement, is 1.0%.

We use the detailed option plan table (or the Core and Guay (2002) approximation) to calculate the delta and vega of each option grant (current and past grants). To calculate delta and vega, we need the option's exercise price, expiration date, volatility, the current stock price, the relevant interest rate, and the dividend yield. Option exercise price and expiration date come directly from Execucomp. We use the fiscal year-end closing price of 2006 as the current stock price, the 3-year lagged volatility at the end of 2006 as an estimate of the volatility, and the annual cash dividend for 2006 divided by the fiscal-year end closing price as an estimate of the dividend yield. The 10-year treasury rate is used as an estimate of the risk-free interest rate.

Table 3 presents two measures of sensitivity of the equity portfolio of the CEO to changes in the bank's stock price. We show that the average (median) CEO ownership from shares and delta-weighted options (percentage ownership) represents 2.4% (1.0%) of the outstanding shares. In other words, the average (median) CEO's wealth increases by \$24 (\$10) for every \$1,000 in created shareholder wealth. By way of comparison, Murphy (1999) shows that the median gain for the CEO of a firm in the largest half of the S&P 500 is \$4.36 for every \$1,000 in created shareholder wealth in 1996, which is much less than the median gain for the bank CEOs in our sample. The second measure is the dollar gain for a 1% increase in shareholder value (dollar ownership). Table 3 shows that the average (median) dollar gain is \$1.1 million (\$0.5 million) for a 1% change in firm value.

We calculate the percentage change in the equity portfolio value of a CEO for a one percent increase in volatility using options only. We call this measure percentage equity risk sensitivity. Although common stock has some exposure to volatility (because it can be considered as a call option), Guay (1999) shows that for the typical firm, the volatility exposure of common stock is

negligible. This result may not apply to banks because they are highly levered. Nevertheless, we use the traditional approach to estimate the equity risk sensitivity since its interpretation is well understood. It is possible that by proceeding this way we understate the equity risk sensitivity of CEOs. The median CEO in our sample stands to gain 0.3% of his total portfolio value if the stock price volatility increased by 1%. Alternatively, we can estimate the change in the dollar value of the CEO's wealth for a 1% increase in stock price volatility. We call this measure the dollar equity risk sensitivity. In our sample, the median dollar equity risk sensitivity is \$53,100. A risk-averse CEO would have to trade off the monetary value of an increase in volatility against its impact on the volatility of his wealth.

Columns 3 and 4 show the decomposition of total pay for non-CEO executives. While the level of total pay is lower, the decomposition of pay is remarkably similar. In particular, non-CEO executives also receive a significant cash bonus. The ratio of cash bonus over salary is very similar to the ratio for CEOs. Non-CEO executives also hold large equity portfolios, holding on average (median) \$20.2 million (\$6 million) worth of equity. There are 19 non-CEO executives who hold in excess of \$100 million in equity and 12 of these executives work for investment banks. However, options contribute more to the value of the equity portfolio than they did for CEO equity portfolios. For non-CEO executives, the median percentage ownership is 0.2%, and the median dollar ownership is \$83,000. Concerning the equity risk measures, for non-CEO executives, the percentage equity risk sensitivity is slightly larger than for CEOs, because their equity portfolio consists proportionally of more options.

It is interesting to compare two ratios between non-CEOs and CEOs. The ratio of cash bonus to salary for non-CEOs is high. This appears to be a distinguishing feature of the financial industry – the average ratio of cash bonus to salary for non-CEO executives for non-financial firms in the Execucomp universe is only 1.1 for fiscal year 2006, compared to 3.2 for sample firms. There is no statistically significant difference between CEOs and non-CEOs. However, the relative measure of the importance of equity incentives, value of total equity portfolio divided by the total annual

compensation, is much smaller for non-CEO executives than for CEOs. These results suggest that cash bonuses are more important for non-CEO executives.

3. CEO incentives and bank performance during the crisis

In this section, we investigate the relation between CEO incentives as of the end of fiscal year 2006 and bank performance during the crisis. For the purpose of this paper, we consider the returns of banks from July 1, 2007, to December 31, 2008, to correspond to the returns during the crisis period. Admittedly, the crisis did not end in December 2008. Bank stocks lost substantial ground in the first quarter of 2009. However, during the period we consider the banking sector suffered losses not observed since the Great Depression. The subsequent losses were at least partly affected by uncertainty about whether banks would be nationalized. Since it is not clear how the impact on bank stocks of the threat of nationalization would be affected by the incentives of CEOs before the crisis, it may well be that it is better to evaluate returns only until the end of 2008.

There is a longstanding debate in the corporate finance literature on how to assess long-run performance (see Fama (1998) and Loughran and Ritter (2000)). One approach is to use buy-and-hold returns. Using buy-and-hold returns is generally a better approach when attempting to explain the cross-sectional variation in performance when performance can be affected by many factors. Another approach is to construct portfolios and evaluate the abnormal performance of these portfolios from the intercept of regressions of the returns of the portfolios on known risk factors. This approach has the advantage of evaluating performance in the context of a portfolio strategy. In this paper, we report buy-and-hold returns.¹²

¹² However, we have verified that using long-short portfolios sorted on executive ownership and equity risk characteristics yields similar results. The characteristics-adjusted alphas (using the three Fama-French factors) for portfolios long in high equity ownership (equity risk) and short in low equity ownership (equity risk) portfolios are qualitatively similar to the results reported in Table 4, but generally of lower significance.

We use five measures of incentives. We first study the ratio of cash bonus to cash salary. The next two measures are dollar ownership and dollar equity risk sensitivity. The last two measures are percentage ownership and percentage equity risk sensitivity.

We investigate the determinants of returns of individual banks using multiple regressions of buy-and-hold returns of banks from July 1, 2007, to December 31, 2008, on various bank characteristics.¹³ The first five regressions of Table 4 use each one of our incentive measures respectively. Our other determinants of stock performance are the performance of the bank's stock in 2006, the equity book-to-market ratio, and the log of the bank's market value. Past returns, the book-to-market ratio, and the log of market value are all variables known to be related to returns. However, here, these variables could affect performance for other reasons than for their role as risk factors that affect expected returns. For instance, it could be that larger banks were able to take more risks. A log transformation is applied to both the percentage ownership and the percentage equity risk sensitivity. This transformation reduces the influence of extreme values of these variables and makes the distribution closer to the normal distribution (e.g., Demsetz and Lehn (1985) and Himmelberg, Hubbard, and Palia (1999)). We winsorize the dollar incentive measures at the 2nd and 98th percentile. Regressions (1) through (5) regress the buy-and-hold returns on each of the five incentive measures without controls. Regression (1) uses the measure of cash bonus over salary as an indicator of high short-term CEO incentives. The coefficient is negative and statistically significant, suggesting that firms with CEOs who receive more short-term incentives have lower returns. However, this result is not robust to the inclusion of control variables in columns 6 through 9.¹⁴ Column 2 examines the logarithm of dollar ownership. The coefficient on dollar ownership is significantly negative, and remains significant in all specifications. The coefficient on percentage ownership in regression (3) is negative as well but not significant. We

¹³ If banks delist or merge prior to December 2008, we put proceeds in a cash account until December 2008. We have verified that our results are qualitatively and quantitatively similar if proceeds are put in the bank industry index (using the Fama-French 49 "bank" industry) instead.

¹⁴ The effect does not disappear because of the inclusion of several incentive measures. The significant coefficient on cash bonus disappears once we control for the market value and the book-to-market ratio.

also estimate this regression without the log transformation, in which case the coefficient on percentage ownership is negative and marginally significant. However, the significance is driven by a few large values and disappears when we winsorize percentage ownership at the 5% level. We then turn to equity risk incentives. Regression (4) uses the dollar measure. The coefficient is negative and insignificant. In regression (5), the coefficient on the percentage measure is positive and significant.

In regressions (6) through (9) respectively, we use cash bonus, dollar and percentage incentive measures and control for other determinants of performance measured as of the end of 2006. In regression (6), the dollar ownership measure has a negative significant coefficient. This effect is economically significant. The standard deviation of the logarithm of dollar incentives is 1.54. Consequently, an increase of one standard deviation in dollar ownership is associated with lower returns of 9.6% (0.062×1.54). Neither the cash bonus nor the equity risk measure are significantly different from zero. Also, a bank's return during the crisis is negatively related to the bank's stock return performance in 2006, although the result is not statistically significant. Beltratti and Stulz (2009) find this result – but with statistical significance – for a sample of international banks. This result suggests that banks that took on more exposures that the market rewarded in 2006 suffered more during the crisis. We find next that banks with a higher book-to-market ratio in 2006 have worse performance during the crisis. A possible explanation for this result is that banks with less franchise value took more risks that worked out poorly during the crisis. Turning to regression (7), percentage ownership has a negative insignificant coefficient and percentage equity risk sensitivity has a positive insignificant coefficient. The coefficients on the other explanatory variables are similar to those of regression (6). Regressions (8) and (9) require information on the Tier 1 capital ratio of banks. This requirement removes from the sample all non-depository banks. In particular, all investment banks drop out of the sample. Banks that were better capitalized at the end of 2006 fared better during the crisis. The coefficients on the incentive variables of CEOs are largely the

same. It follows therefore that our results cannot be explained by the large share ownership of some CEOs of investment banks that performed poorly.

The results of Table 4 are robust to changes in the sample period or variables. In regressions not reproduced here, we use tangible common equity to assets as a measure of the capital ratio and obtain similar results. We also find similar results if we use returns from January 1, 2007, to December 31, 2008, or if we use only 2008. The same results hold if we do not winsorize dollar incentives or if we truncate dollar incentives.

So far, we have focused on bank performance measured by stock returns. We now turn to the performance of banks using two measures of accounting performance: Return on assets (ROA) and return on equity (ROE). In Figure 1, we show the evolution of quarterly ROA from 2005Q4 to 2008Q3. Not surprisingly, the average ROA plummets in 2008. For our regression analysis, return on assets is defined as the cumulative quarterly net income from 2007Q3 to 2008Q3 divided by total assets at the end of 2007Q2. For return on equity, we divide the cumulative quarterly net income by the book value of equity at the end of 2007Q2. Table 5 shows results for ROA; Table 6 shows results for ROE. In the regressions we report in Tables 5 and 6, we use the same control variables as those used in Table 4. The first two regressions use all banks; the last two regressions require availability of the Tier 1 capital ratio and thus exclude investment banks. Table 5 shows that the CEO dollar incentive measure has a significantly negative relation with ROA. A one standard deviation increase in dollar ownership (1.54) decreases the ROA by 0.77%, which appears economically significant relative to the sample mean ROA of 1.13%. The result is robust to the exclusion of investment banks (column 3). Regarding the other ownership measures we examine, the percentage ownership measure is statistically significantly negative in the subsample that excludes investment banks. The economic magnitude is smaller than that of dollar ownership – a one standard deviation increase in percentage ownership is associated with a higher ROA of 0.52%. With the equity risk sensitivity measures, neither the dollar measure nor the percentage measure is significant. Our measure of short-term incentives, cash bonus divided by salary, is not

related to ROA. The only other explanatory variable that is significant in the regressions is the book-to-market ratio.

Turning to the four ROE regressions in Table 6, we see that the CEO's dollar incentive measure always has a negative significant coefficient. The economic magnitude appears large – a one standard deviation increase in dollar ownership decreases ROE by 10.5% (11.2%) in column 1 (column 3). These effects are similar in magnitude to the effects reported for the buy-and-hold return regressions in Table 4. In regression (4), which uses the sample of depository banks only, the percentage ownership measure also has a negative significant coefficient. Neither the cash bonus nor the risk sensitivity measures are significant. In addition to book-to-market, the lagged ROE is significant in regressions (1) and (2).

We estimate other regressions using ROA and ROE that we do not reproduce in a table. First, we estimate regressions where the additional explanatory variables besides the CEO incentive measures are the log of the bank's market value at the end of 2006, the volatility of its stock return in the three previous years, and the Tier 1 capital ratio. We find that the coefficient on dollar equity incentives is negative and significant in the ROE regression. The coefficient on volatility is negative and significant. We also estimate these regressions on changes in ROA and changes in ROE. The dollar equity incentive has a significant negative coefficient and the dollar equity risk sensitivity measure has a positive significant coefficient.

4. Non-CEO executive incentives and bank performance during the crisis

While there is a long-standing tradition in executive compensation to treat the CEO as a sufficient statistic for the rest of the organization (e.g., Jensen and Murphy (1990), Hall and Liebman (1998), and Core and Guay (1999)), there have been pervasive concerns that the incentives of non-CEO bank executives led to excessive risk-taking. For instance, the Federal Reserve stated in a press release that "Flaws in incentive compensation practices were one of many factors contributing to the financial crisis. Inappropriate bonus or other compensation practices can

incent senior executives or lower level employees, such as traders or mortgage officers, to take imprudent risks that significantly and adversely affect the firm.”¹⁵ To examine this issue, we analyze the relation between stock and accounting performance and the average incentives for the next four highest paid non-CEO proxy-named executives (measured by total compensation). In addition, we show regressions that use the sum of the incentives of the top 5 executives, including the CEO, to analyze whether our conclusions from the previous section are robust to this alternative specification.

Table 7, Panel A, shows the results for buy-and-hold returns and non-CEO incentives. Similar to the results for CEOs, we find some weak evidence that the ratio of cash bonus to salary is negatively related to buy-and-hold returns; but again, once we include control variables, this result disappears. In regressions including firm-specific control variables (columns 6 through 9), none of the non-CEO incentive measures have explanatory power for buy-and-hold returns. Table 7, Panel B, analyzes the sum of the incentives of the top five executives, including the CEO. The results are consistent with our earlier analysis of CEOs only. In particular, the dollar ownership displays an economically strong inverse relation with buy-and-hold returns.

Panels A of Tables 8 and 9 analyze the relation between non-CEO executive incentives and ROA and ROE, respectively. We do not find evidence that non-CEO executive incentives are associated with ROA or ROE in any of the specifications.

Panels B of Tables 8 and 9 examine the sum of the incentives of the top five highest paid executives and corroborate our earlier findings for CEOs only. There is some weak evidence of a relation between dollar ownership of the executive team and return on assets in the specification that excludes investment banks (Table 8, Panel B, column 3). In addition, there is a strong link between dollar ownership of the entire executive team and return on equity (Table 9, Panel B,

¹⁵ See Press Release of October 22, 2009, announcing a “proposal designed to ensure that incentive compensation policies of banking organizations do not undermine the safety and soundness of their organizations.”

columns 1 and 3). For all other incentive measures, we do not find coefficients that are statistically different from zero.

Overall, the evidence in this section suggests that the relation between executive incentives and performance of sample banks is driven by the incentives of the CEO.

5. Executive incentives and bank performance for TARP recipients

A possible concern with our analysis is that incentives might have played a different role in banks that made larger losses or were more systemically important. One approach to identify such banks, albeit ex-post and with inherent selection biases, is to use the subset of banks that received funding from the Troubled Asset Relief Program (TARP). Since there are obvious concerns with respect to stock returns (the granting of TARP money could have increased returns towards the end of our sample period relative to the returns of other banks), we focus in this section on the accounting returns that are measured at the end of the third quarter of 2008 and thus prior to the distribution of TARP money.

We identify sample banks that received TARP funding from a comprehensive list of TARP recipients published by USA Today.¹⁶ In our sample of 98 banks, 54 received TARP money. In Table 10, we re-estimate the regressions of Tables 5 and 6, column 1, and Tables 8 and 9, column 1 of Panel A, but interact the incentive measures with an indicator variable equal to one if a firm received TARP money. To avoid having outliers determine the regression estimates in the subsamples, we truncate ROA and ROE at the 1% level. In all regressions in Table 10, the coefficient on the incentive measure indicates the association between the incentive measure and the return for the group of non-TARP firms. The coefficient on the interaction term of TARP and the incentive measure shows how the association between the incentive measure and the return

¹⁶ <http://www.usatoday.com/money/economy/tarp-chart.htm>. In unreported regressions, we also added firms that would in all likelihood have received TARP funding, but did not survive long enough (e.g., Bear Stearns, Lehman Brothers, Countrywide, IndyMac, WashingtonMutual, and Wachovia). Adding these firms does not change our results reported in Table 10.

differs between TARP firms and non-TARP firms. Statistical significance on the interaction term hence demonstrates that there is a statistically different association in firms that receive TARP funding and those that do not.

The first two columns in Table 10 show the results for ROA. There is no evidence that incentives in TARP firms had a different effect on the ROA than incentives in non-TARP firms. Columns 3 and 4 show the results for ROE. Again, there is no evidence that incentives had a different impact for TARP firms than other firms.

6. CEO equity losses during the crisis

We have uncovered no evidence supportive of the view that better alignment of incentives between CEOs and shareholders would have led to better bank performance during the crisis or that option compensation is to blame for the poor performance of banks. Our evidence is consistent with the hypothesis that CEOs who took exposures that performed poorly during the crisis did so because they thought that doing so was good for shareholders as well as for themselves. Our evidence provides no support for the hypothesis that option compensation led CEOs to take on more exposures that performed poorly during the crisis. Finally, our evidence is consistent with the hypothesis that CEOs did not expect these exposures to work out poorly.¹⁷

So far we proceeded with our analysis using CEO share and option holdings at the end of 2006. If CEOs saw the crisis coming some time after the end of 2006, they could have sold their holdings – at least as long as they were not concerned about or could avoid insider trading litigation risks – and hence would not have been affected adversely by their decisions. We investigate in this section how share ownership of CEOs evolved during the crisis. For this analysis, we use Execucomp and the database on insider transactions from Thomson Financial. We aggregate CEO transactions by

¹⁷ We focus in this section on chief executive officers, because we did not find any associations of incentives and returns for non-CEO executives.

firm and quarter. We are able to match 88 of the 95 bank CEOs in Execucomp to the Thomson Financial database.

Figure 2 reports the quarterly mean CEO net share purchases between 2007Q1 and 2008Q4, divided by their ownership from shares at the end of 2006. We do not include ownership through options in the denominator, because most of the options are underwater by the end of 2008. Scaling by ownership from shares at the end of 2006 thus takes better into account the effective sales of the CEOs. Throughout the crisis period, in all but one quarter, CEOs sell around 2% of their holdings per quarter. In any given quarter, less than fifty percent of all CEOs trade at all. The exception is for the quarter ending in September 2008, when, conditional on trading, CEOs sell almost 10% of their holdings on average. It is common for executives to sell shares because their portfolio tends to become less diversified as they exercise options and receive stock grants. Figure 2 also shows the increase in ownership of CEOs through new grants of stock. They receive grants throughout the period. Overall, taking sales and new grants into account, there is no evidence of large selling efforts by CEOs. The solid line, capturing total changes in CEO ownership, oscillates around zero through the sample period.

In Table 11, we attempt to estimate the dollar loss of CEOs in our sample on their stock holdings resulting from the fall in the value of their holdings over the period from the end of fiscal year 2006 through December 31, 2008. Our starting point for each CEO is the shares held at the end of 2006. We use the insider trading data to evaluate the price at which the CEO sold shares, if he sold shares.¹⁸ The CEO's total dollar loss is then defined as the loss in value of the shares not sold, evaluated using the price of the shares at the end of December 2008 or when the CEO loses his job plus the loss from selling shares, measured as the difference between the value of shares at the end of 2006 and the price of the shares sold. The average value of shares held at the end of 2006 is \$61.503 million. On average, a CEO lost \$28.771 million on the shares not sold and \$2.719

¹⁸ We exclude sales of stock linked to option exercises, because we study losses from *shares* held at the end of 2006.

million on the shares sold. More than three quarters of the CEOs did not report any insider sales. On average, a CEO lost \$31.490 million. The median loss is sharply less, however, at \$5.084 million. It follows from Table 11 that CEOs made large losses on their wealth during the crisis and that most of these losses come from holding on to their shares. Had CEOs seen the crisis coming, they presumably could have avoided most of these losses by selling their shares. They clearly did not do so.

We also investigate what happened to the options held by CEOs. Strikingly, only 12% of the options granted before 2007 were out of the money at fiscal year-end 2006. In contrast, approximately 70% of all options granted before 2007 were out of the money at the end of the sample period. Consequently, CEOs suffered large losses on their option portfolios as well.

A valid concern is whether we overestimate the equity losses of insiders. We could be missing hedging activities by insiders that are carried out through off-market equity transactions such as zero-cost equity collars, exchange funds, or variable prepaid forward contracts.¹⁹ All these transactions have in common that the insider does not sell the shares and thus retains the voting rights of the stock while receiving significant downside protection.

It is important to note that the SEC has mandated reporting of such hedging transactions since 1996. Thomson Financial, our data provider for insider transactions, has specific fields that capture trading of prepaid variable forward contracts, exchange funds, and equity swaps. When we search for zero-cost collars, exchange funds, and prepaid variable forward contracts by the CEOs of sample banks, we do not find a single hedging transaction. When we expand the search to all bank insiders between January 2007 and December 2008, we find less than 10 transactions, mostly prepaid variable forward contracts by non-executive directors.

The lack of reported hedging activities is not surprising in light of the sample sizes of two comprehensive studies on off-market equity transactions. Bettis, Bizjak, and Lemmon (2001) study all filings by all insiders between January 1996 and December 1998 and are only able to identify 85

¹⁹ The use of equity swaps disappeared in the mid-nineties because of their disadvantageous tax treatment.

zero-cost collars. Jagolinzer, Matsunaga, and Yeung (2007) examine prepaid variable forward transactions and are able to find only 174 contracts from the universe of filings between August 1996 and June 2004, with roughly a third of them carried out by CEOs.

While there is some debate on the issue of whether insiders underreport hedging transactions, it is argued by most legal experts that not reporting hedging transactions is illegal (see the discussion in Smith and Eisinger (2004)). Overall, we have no reason to believe that significant hedging activities attenuate the finding of large equity losses documented in Table 11.

7. Conclusion

Based on our evidence, lack of alignment of bank CEO incentives with shareholder interests cannot be blamed for the credit crisis or for the performance of banks during that crisis. Whether we look at depository banks only or at a larger sample that includes investment banks as well, there is no evidence that banks with CEOs whose incentives were less well aligned with the interests of their shareholders performed worse during the crisis. When we attempt to explain the performance of banks in the cross-section, we find evidence that banks where CEOs had better incentives in terms of the dollar value of their stake performed significantly worse than banks where CEOs had poorer incentives. For the whole sample, neither cash bonus nor stock options had an adverse impact on bank performance during the crisis. We also investigate whether CEO and non-CEO incentives in banks that received TARP funds have a different relation to bank performance than that observed in banks that did not receive TARP funds. We find that the relation between bank performance and CEO incentives does not differ between TARP and non-TARP banks.

A possible explanation for our results is that CEOs with better incentives to maximize shareholder wealth took risks that other CEOs did not. Ex ante, these risks looked profitable for shareholders. Ex post, these risks had unexpected poor outcomes. These poor outcomes are not evidence of CEOs acting in their own interest at the expense of shareholder wealth.

Support for this possible explanation is provided by our examination of the wealth consequences of the crisis for bank CEOs. If CEOs took risks that they knew were not in the interests of their shareholders, we would expect them to have sold shares ahead of the crisis. We find that this did not happen. In fact, CEO holdings of shares on net increased. CEOs therefore made large losses on their holdings of shares and on their holdings of options. On average, CEOs in our sample lost at least \$30 million and the median CEO loss is more than \$5 million.

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Appendix A: List of excluded financial firms in SIC codes 6000 – 6300

We download all firms that are in Standard and Poor's Execucomp database in 2006 and have an SIC code between 6000 and 6300. From this list, we exclude the following firms because they are mostly concerned with investment advice, pure brokerage business, or wire transferring and do not match well our definition of a lending institution:

A G Edwards
Affiliated Managers Group Inc.
American Express
Americredit Corp
Bankrate Inc.
Bisys Group
Capital One Financial
Charles Schwab
CIT Group
CME Group
Eaton Vance Corporation
E-Trade Financial Group
Federated Investors Inc.
Financial Federal Corporation
Finova Group
Franklin Resources Inc
Intercontinental Exchange
Investment Technology Group
Janus Capital Group Inc
LaBranche & Co
Legg Mason Inc
Mellon Financial Corp
Metavante Technologies
Moneygram International
Nuveen Investments
Price (T Rowe) Group
Raymond James Financial
SEI Investments Company
Southwest Securities Group (SWS Group)
State Street Corporation
TD Ameritrade Holding
Tradestation group
Waddell&Reed

Appendix B: Sample firms

1	ANCHOR BANCORP INC/WI	50	INVESTORS FINANCIAL SVCS CP
2	ASSOCIATED BANC-CORP	51	IRWIN FINANCIAL CORP
3	ASTORIA FINANCIAL CORP	52	JEFFERIES GROUP INC
4	BANK MUTUAL CORP	53	JPMORGAN CHASE & CO
5	BANK OF AMERICA CORP	54	KEYCORP
6	BANK OF HAWAII CORP	55	LEHMAN BROTHERS HOLDINGS INC
7	BANK OF NEW YORK MELLON CORP	56	M & T BANK CORP
8	BB&T CORP	57	MAF BANCORP INC
9	BEAR STEARNS COMPANIES INC	58	MARSHALL & ILSLEY CORP
10	BOSTON PRIVATE FINL HOLDINGS	59	MERCANTILE BANKSHARES CORP
11	BROOKLINE BANCORP INC	60	MERRILL LYNCH & CO INC
12	CASCADE BANCORP	61	MORGAN STANLEY
13	CATHAY GENERAL BANCORP	62	NATIONAL CITY CORP
14	CENTRAL PACIFIC FINANCIAL CP	63	NEW YORK CMNTY BANCORP INC
15	CHITTENDEN CORP	64	NORTHERN TRUST CORP
16	CITIGROUP INC	65	PNC FINANCIAL SVCS GROUP INC
17	CITY NATIONAL CORP	66	POPULAR INC
18	COLONIAL BANCGROUP	67	PROSPERITY BANCSHARES INC
19	COMERICA INC	68	PROVIDENT BANKSHARES CORP
20	COMMERCE BANCORP INC/NJ	69	REGIONS FINANCIAL CORP
21	COMPASS BANCSHARES INC	70	SLM CORP
22	CORUS BANKSHARES INC	71	SOUTH FINANCIAL GROUP INC
23	COUNTRYWIDE FINANCIAL CORP	72	SOVEREIGN BANCORP INC
24	CULLEN/FROST BANKERS INC	73	STERLING BANCORP/NY
25	DIME COMMUNITY BANCSHARES	74	STERLING BANCSHRS/TX
26	DOWNEY FINANCIAL CORP	75	STERLING FINANCIAL CORP/WA
27	EAST WEST BANCORP INC	76	SUNTRUST BANKS INC
28	FANNIE MAE	77	SUSQUEHANNA BANCSHARES INC
29	FIFTH THIRD BANCORP	78	SVB FINANCIAL GROUP
30	FIRST BANCORP P R	79	SYNOVUS FINANCIAL CORP
31	FIRST COMMONWLTH FINL CP/PA	80	TCF FINANCIAL CORP
32	FIRST FINL BANCORP INC/OH	81	TD BANKNORTH INC
33	FIRST HORIZON NATIONAL CORP	82	TRUSTCO BANK CORP/NY
34	FIRST INDIANA CORP	83	U S BANCORP
35	FIRST MIDWEST BANCORP INC	84	UCBH HOLDINGS INC
36	FIRST NIAGARA FINANCIAL GRP	85	UMPQUA HOLDINGS CORP
37	FIRSTFED FINANCIAL CORP/CA	86	UNIONBANCAL CORP
38	FIRSTMERIT CORP	87	UNITED BANKSHARES INC/WV
39	FLAGSTAR BANCORP INC	88	UNITED COMMUNITY BANKS INC
40	FRANKLIN BANK CORP	89	WACHOVIA CORP
41	FREMONT GENERAL CORP	90	WASHINGTON FED INC
42	GLACIER BANCORP INC	91	WASHINGTON MUTUAL INC
43	GOLDMAN SACHS GROUP INC	92	WEBSTER FINANCIAL CORP
44	GREATER BAY BANCORP	93	WELLS FARGO & CO
45	HANMI FINANCIAL CORP	94	WESTAMERICA BANCORPORATION
46	HUDSON CITY BANCORP INC	95	WILMINGTON TRUST CORP
47	HUNTINGTON BANCSHARES	96	WILSHIRE BANCORP INC
48	INDEPENDENT BANK CORP/MI	97	WINTRUST FINANCIAL CORP
49	INDYMAC BANCORP INC	98	ZIONS BANCORPORATION

Table 1: Sample summary statistics for calendar year 2006

The table shows summary statistics for key variables for a sample of 95 bank holding companies and investment banks for fiscal year 2006. Sample selection criteria are described in Section 2. The list of sample banks is provided in Appendix B. The data are from the Compustat annual and Compustat Bank annual databases. Tier 1 capital ratio is calculated according to the Basel Accord for reporting risk-adjusted capital adequacy and is taken from the Compustat Bank database. The tangible common equity ratio is defined as tangible common equity divided by total assets less intangible assets (including goodwill). Those data are provided by the Compustat annual database.

	N	Minimum	Lower Quartile	Median	Upper Quartile	Maximum	Mean	Std Dev
Total assets	95	2008.5	6717.6	15497.2	60712.2	1459737.0	129307.2	303878.5
Total liabilities	95	1788.8	6083.5	14685.0	56768.3	1324465.0	119265.6	280902.5
Market capitalization	94	366.5	1222.5	2788.4	13273.0	273598.1	18725.5	44489.8
Net income / total assets	95	0.03%	0.84%	1.16%	1.45%	2.55%	1.17%	0.47%
Net income / book equity	95	0.33%	10.42%	13.01%	16.63%	29.18%	13.46%	5.67%
Cash / total assets	95	0.38%	1.63%	2.26%	2.79%	6.47%	2.35%	1.20%
Dividend per share	95	0.00	0.45	0.88	1.30	2.32	0.93	0.58
Book-to-market ratio	94	0.27	0.43	0.50	0.64	0.87	0.53	0.15
Tier 1 capital ratio	83	5.73%	8.43%	9.42%	11.09%	19.04%	9.70%	2.00%
Tangible common equity ratio	83	1.63%	5.32%	6.36%	7.40%	22.91%	6.69%	2.73%

Table 2: Attrition of banks included in sample

The sample includes 95 commercial and investment banks covered by Execucomp in fiscal year 2006. *Remaining in sample* signifies that the bank is still listed on a major U.S. exchange in December 2008. *Merged or acquired* signifies that the bank left the sample due to an acquisition or merger during the sample period, and *Delisted by exchange* signifies a delisting of the bank due to a violation of listing requirements or bankruptcy.

<u>Event</u>	<u>Number of Obs.</u>	<u>Frequency [%]</u>
Remaining in sample	77	81.1
Merged or acquired	12	12.6
Delisted by exchange	6	6.3

Table 3: Executive compensation and equity ownership at the end of fiscal year 2006

The table shows summary statistics for key compensation variables for a sample of 95 bank holding companies and investment banks for fiscal year 2006. The data are from the Compustat Execucomp database. Values are reported in thousands of dollars. Most of the variables of the table are directly taken from Execucomp. Columns 1 and 2 show the means and medians for CEOs only, while columns 3 and 4 show means and medians for the average values of the next four highest paid proxy-named executives. *Cash bonus* is defined as the sum of bonus and non-equity incentive awards payouts. *Bonus for 2006 performance* shows the total bonus if the portion of equity awards explicitly granted in 2007 for 2006 performance is allocated to 2006. *Percentage ownership from shares and exercisable options* is from the proxy statement and counts exercisable options and options that become exercisable within 60 days after the record date as shares using a delta of 1. *Percentage ownership* uses the detailed information on current and previous option grants to calculate the options' delta and multiplies the number of options held in each series by its delta when calculating the percentage ownership. *Dollar ownership* is equal to the dollar change in the executive's stock and option portfolio value for a 1% change in the stock price. *Percentage equity risk* is defined as the percentage change in the equity portfolio value for a 1% increase in stock volatility and is calculated from all option series held by the CEO. *Dollar equity risk* is equal to the dollar change in the executive's equity portfolio value for a 1% change in stock volatility.

	CEO		Average of non-CEO executives	
	Mean	Median	Mean	Median
Annual Compensation				
Total compensation	7797.7	2453.5	3791.6	1104.6
Salary	761.5	747.8	392.4	351.4
Cash bonus	2137.7	636.8	1363.0	257.1
Dollar value of annual stock grant	2652.7	295.7	1112.5	97.0
Dollar value of annual option grant	1608.3	196.0	549.2	115.7
Other compensation	637.5	129.0	370.7	80.2
Cash bonus / salary	2.8	0.9	3.2	0.7
Bonus paid for 2006 performance				
Total bonus	5314.2	1370.0	3102.8	619.5
Cash bonus	2390.1	637.8	1517.1	262.8
Equity bonus	2924.1	409.5	1588.4	216.3
Total bonus / salary	7.1	1.8	7.4	1.6
Cash bonus / total bonus	0.6	0.6	0.6	0.6
Equity Portfolio - Value				
Value of total equity portfolio	87466.9	35557.0	20156.0	5993.0
Value of shares	61189.6	22255.3	11014.1	3151.9
Value of exercisable options (Black/Scholes)	17357.7	5729.1	4934.6	1073.9
Value of unexercisable options (Black / Scholes)	3242.6	929.3	1586.7	277.4
Value of unvested restricted stock	5677.0	0.0	2602.0	8.5
Value of total equity portfolio / total annual compensation	17.3	8.1	7.6	4.2
Value of shares / salary	102.6	25.7	28.5	8.6
Equity Portfolio - incentives				
Percentage ownership from shares	1.6	0.4	0.2	0.1
Percentage ownership from shares and exercisable options	2.4	1.0	0.4	0.2
Percentage ownership	2.4	1.0	0.4	0.2
Dollar ownership	1119.3	467.8	278.1	83.2
Equity Portfolio - risk exposure				
Percentage equity risk	0.4	0.3	0.6	0.5
Dollar equity risk	189.0	53.1	60.4	19.5

Table 4: Buy-and-hold returns and CEO annual cash bonus, ownership incentives, and equity risk sensitivity

The table shows results from cross-sectional regressions of buy-and-hold returns for banks from July 2007 to December 2008 on CEO cash bonus, equity incentives, equity risk, and firm characteristics measured at the end of fiscal year 2006. Cash bonus / salary is the dollar amount of the annual bonus for 2006 performance paid in cash divided by the cash salary. Ownership (\$) is the dollar change in the value of the CEO's equity portfolio for a 1% change in the stock price. Ownership (%) is the sum of all shares (restricted and unrestricted) and delta-weighted options (exercisable and unexercisable) held by the CEO divided by the total number of shares outstanding multiplied by 100. Equity risk (\$) is defined as the dollar change in the equity portfolio value for a 1% increase in stock volatility. Equity risk (%) is defined as the percentage change in the equity portfolio value for a 1% increase in stock volatility and is calculated from all option series held by the executive. A log transformation is applied to both the percentage ownership and percentage equity risk measure. The firm characteristics are measured at the end of year 2006. These characteristics include the stock return in 2006, the book-to-market ratio, the natural logarithm of the market capitalization, and the Tier 1 capital ratio. Standard errors are reported in parentheses. Statistical significance at the 1%, 5%, and 10% level is indicated by ***, **, and *, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Cash bonus / salary	-0.010** (0.004)					-0.003 (0.005)	-0.003 (0.005)	0.014 (0.025)	0.015 (0.025)
Ownership (\$)		-0.078*** (0.022)				-0.062* (0.030)		-0.079** (0.035)	
Ownership (%)			-0.025 (0.027)				-0.036 (0.030)		-0.049 (0.032)
Equity risk (\$)				-0.013 (0.017)		0.025 (0.020)		0.030 (0.024)	
Equity risk (%)					0.030* (0.018)				
Stock return in 2006						-0.148 (0.279)	0.022 (0.019)	-0.295 (0.302)	0.023 (0.310)
Book-to-market						-0.607*** (0.234)	-0.280 (0.234)	-0.583** (0.240)	-0.577** (0.240)
Log (market value)						-0.027 (0.032)	-0.064** (0.026)	0.014 (0.042)	-0.035 (0.036)
Tier 1 capital ratio									0.038** (0.018)
Observations	93	94	94	90	90	88	88	77	77
R-squared	0.06	0.12	0.01	0.01	0.03	0.20	0.20	0.23	0.23

Table 5: ROA and CEO annual cash bonus, ownership incentives, and equity risk sensitivity

The table shows results from cross-sectional regressions of the return on assets on CEO cash bonus, ownership incentives, equity risk exposure, and control variables. Return on assets is defined as the cumulative quarterly net income from 2007Q3 to 2008Q3 divided by the total assets at the end of 2007Q2. Ownership (\$) is the dollar change in the value of the CEO's equity portfolio for a 1% change in the stock price. Ownership (%) is the sum of all shares (restricted and unrestricted) and delta-weighted options (exercisable and unexercisable) held by the CEO divided by the total number of shares outstanding multiplied by 100. Equity risk (\$) is defined as the dollar change in the CEO's equity portfolio value for a 1% increase in stock volatility. Equity risk (%) is defined as the percentage change in the equity portfolio value for a 1% increase in stock volatility and is calculated from all option series held by the executive. A log transformation is applied to both the percentage ownership and percentage equity risk measure. The control variables include the natural logarithm of the market capitalization, the Tier 1 capital ratio, and the book-to-market ratio, all measured at the end of fiscal year 2006. Lagged return is the lagged return on assets, measured over the five previous quarters to be consistent. Standard errors are reported in parentheses. Statistical significance at the 1%, 5%, and 10% level is indicated by ***, **, and *, respectively.

	(1)	(2)	(3)	(4)
Cash bonus / salary	0.000 (0.000)	0.000 (0.000)	0.000 (0.002)	0.000 (0.002)
Ownership (\$)	-0.005* (0.003)		-0.007** (0.003)	
Equity risk (\$)	0.002 (0.002)		0.002 (0.002)	
Ownership (%)		-0.003 (0.002)		-0.004* (0.002)
Equity risk (%)		0.002 (0.001)		0.002 (0.002)
Lagged ROA	-0.126 (0.236)	-0.131 (0.235)	-0.360 (0.513)	-0.386 (0.512)
Book-to-market	-0.053** (0.020)	-0.052** (0.020)	-0.066*** (0.022)	-0.066*** (0.022)
Log (market value)	0.000 (0.002)	-0.003 (0.002)	0.005 (0.003)	0.000 (0.003)
Tier 1 capital ratio			0.002 (0.002)	0.002 (0.002)
Observations	84	85	73	73
R-squared	0.13	0.13	0.22	0.22

Table 6: ROE and CEO annual cash bonus, ownership incentives, and equity risk sensitivity

The table shows results from cross-sectional regressions of the return on equity on CEO cash bonus, ownership incentives, equity risk exposure, and control variables. Return on equity is defined as the cumulative quarterly net income from 2007Q3 to 2008Q3 divided by the book value of common equity at the end of 2007Q2. Ownership (\$) is the dollar change in the value of the CEO's equity portfolio for a 1% change in the stock price. Ownership (%) is the sum of all shares (restricted and unrestricted) and delta-weighted options (exercisable and unexercisable) held by the CEO divided by the total number of shares outstanding multiplied by 100. Equity risk (\$) is defined as the dollar change in the CEO's equity portfolio value for a 1% increase in stock volatility. Equity risk (%) is defined as the percentage change in the equity portfolio value for a 1% increase in stock volatility and is calculated from all option series held by the CEO. A log transformation is applied to both the percentage ownership and percentage equity risk measure. The control variables include the natural logarithm of the market capitalization, the Tier 1 capital ratio, and the book-to-market ratio, all measured at the end of fiscal year 2006. Lagged return is the lagged return on equity, measured over the five previous quarters to be consistent. Standard errors are reported in parentheses. Statistical significance at the 1%, 5%, and 10% level is indicated by ***, **, and *, respectively.

	(1)	(2)	(3)	(4)
Cash bonus / salary	0.000 (0.004)	0.000 (0.004)	0.009 (0.021)	0.009 (0.020)
Ownership (\$)	-0.068** (0.027)		-0.073** (0.028)	
Equity risk (\$)	0.025 (0.016)		0.022 (0.019)	
Ownership (%)		-0.043 (0.026)		-0.051** (0.024)
Equity risk (%)		0.024 (0.015)		0.019 (0.017)
Lagged ROE	-0.532** (0.249)	-0.533** (0.248)	-0.406 (0.474)	-0.426 (0.472)
Book-to-market	-0.754*** (0.232)	-0.748*** (0.231)	-0.821*** (0.239)	-0.820*** (0.239)
Log (market value)	0.016 (0.025)	-0.028 (0.022)	0.043 (0.033)	-0.008 (0.029)
Tier 1 capital ratio			0.019 (0.018)	0.020 (0.018)
Observations	83	83	74	74
R-squared	0.21	0.23	0.29	0.29

Table 7: Buy-and-hold returns and executives' annual bonus, ownership incentives, and equity risk sensitivity

The table shows results from cross-sectional regressions of buy-and-hold returns for banks from July 2007 to December 2008 on cash bonus, equity incentives, equity risk, and firm characteristics measured at the end of fiscal year 2006. Cash bonus / salary is the dollar amount of the annual bonus for 2006 performance paid in cash divided by the cash salary. Ownership (\$) is the dollar change in the value of an executive's equity portfolio for a 1% change in the stock price. Ownership (%) is the sum of all shares (restricted and unrestricted) and delta-weighted options (exercisable and unexercisable) held by the executive divided by the total number of shares outstanding multiplied by 100. Equity risk (\$) is defined as the dollar change in the equity portfolio value for a 1% increase in stock volatility. Equity risk (%) is defined as the percentage change in the equity portfolio value for a 1% increase in stock volatility and is calculated from all option series held by the executive. A log transformation is applied to both the percentage ownership and percentage equity risk measure. The firm characteristics are measured at the end of year 2006. These characteristics include the stock return in 2006, the book-to-market ratio, the natural logarithm of the market capitalization, and the Tier 1 capital ratio. Panel A shows results using average incentives and equity risk of the top 4 non-CEO executives. Panel B shows results using the sum of the top five executives' incentives, including the CEO. Standard errors are reported in parentheses. Statistical significance at the 1%, 5%, and 10% level is indicated by ***, **, and *, respectively.

Panel A: Non-CEO executives

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Cash bonus / salary	-0.011** (0.004)					-0.006 (0.005)	-0.006 (0.005)	0.000 (0.020)	0.000 (0.019)
Ownership (\$)		-0.041* (0.023)				0.023 (0.044)		0.046 (0.051)	
Ownership (%)			0.055 (0.036)				0.046 (0.042)		0.063 (0.043)
Equity risk (\$)				-0.008 (0.017)		0.024 (0.020)		0.018 (0.026)	
Equity risk (%)					0.020 (0.018)		0.029* (0.017)		0.020 (0.022)
Stock return in 2006						-0.181 (0.273)	-0.178 (0.268)	-0.402 (0.291)	-0.386 (0.290)
Book-to-market						-0.728*** (0.231)	-0.724*** (0.228)	-0.649** (0.260)	-0.649** (0.258)
Log (market value)						-0.076* (0.035)	-0.032 (0.029)	-0.047 (0.041)	0.016 (0.036)
Tier 1 capital ratio								0.039** (0.019)	0.041** (0.019)
Observations	96	96	96	92	92	91	91	79	79
R-squared	0.07	0.03	0.02	0.00	0.01	0.22	0.23	0.24	0.24

Panel B: Sum of incentives of all top five executives

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Cash bonus / salary	-0.010** (0.004)					-0.002 (0.005)	-0.002 (0.005)	0.003 (0.021)	0.004 (0.022)
Ownership (\$)		-0.078*** (0.022)				-0.070* (0.038)		-0.073* (0.041)	
Ownership (%)			-0.016 (0.031)				-0.052 (0.035)		-0.051 (0.036)
Equity risk (\$)				-0.013 (0.017)		0.026 (0.020)		0.032 (0.022)	
Equity risk (%)					0.017 (0.017)		0.022 (0.016)		0.019 (0.020)
Stock return in 2006						-0.237 (0.269)	-0.237 (0.270)	-0.378 (0.287)	-0.395 (0.294)
Book-to-market						-0.716*** (0.222)	-0.726*** (0.223)	-0.713*** (0.237)	-0.711** (0.239)
Log (market value)						-0.021 (0.034)	-0.069* (0.028)	0.017 (0.039)	-0.027 (0.036)
Tier 1 capital ratio								0.037** (0.018)	0.038** (0.018)
Observations	96	96	96	95	95	94	94	82	82
R-squared	0.06	0.12	0.01	0.01	0.03	0.22	0.22	0.23	0.22

Table 8: ROA and executives' annual cash bonus, ownership incentives, and equity risk sensitivity

The table shows results from cross-sectional regressions of the return on assets on executive cash bonus, ownership incentives, equity risk exposure, and control variables. Return on assets is defined as the cumulative quarterly net income from 2007Q3 to 2008Q3 divided by the total assets at the end of 2007Q2. Ownership (\$) is the dollar change in the value of the executive's equity portfolio for a 1% change in the stock price. Ownership (%) is the sum of all shares (restricted and unrestricted) and delta-weighted options (exercisable and unexercisable) held by the executive divided by the total number of shares outstanding multiplied by 100. Equity risk (\$) is defined as the dollar change in the executive's equity portfolio value for a 1% increase in stock volatility. Equity risk (%) is defined as the percentage change in the equity portfolio value for a 1% increase in stock volatility and is calculated from all option series held by the executive. A log transformation is applied to both the percentage ownership and percentage equity risk measure. Panel A shows results using average incentives and equity risk of the top 4 non-CEO executives. Panel B shows results using the sum of the incentives of the top 5 executives, including the CEO. The control variables include the natural logarithm of the market capitalization, the Tier 1 capital ratio, and the book-to-market ratio, all measured at the end of fiscal year 2006. Lagged return is the lagged return on assets, measured over the five previous quarters to be consistent. Standard errors are reported in parentheses. Statistical significance at the 1%, 5%, and 10% level is indicated by ***, **, and *, respectively.

Panel A: Non-CEO executives

	(1)	(2)	(3)	(4)
Cash bonus / salary	-0.000 (0.000)	-0.000 (0.000)	-0.001 (0.002)	-0.001 (0.002)
Ownership (\$)	0.004 (0.003)		0.002 (0.004)	
Equity risk (\$)	0.001 (0.001)		0.002 (0.002)	
Ownership (%)		0.005 (0.003)		0.004 (0.003)
Equity risk (%)		0.002 (0.001)		0.002 (0.002)
Lagged ROA	-0.040 (0.234)	-0.091 (0.237)	-0.021 (0.514)	-0.012 (0.511)
Book-to-market	-0.049** (0.020)	-0.050** (0.020)	-0.056** (0.023)	-0.056** (0.023)
Log (market value)	-0.005* (0.003)	0.001 (0.002)	-0.001 (0.003)	0.003 (0.003)
Tier 1 capital ratio			0.002 (0.002)	0.002 (0.002)
Observations	87	87	75	75
R-squared	0.14	0.15	0.19	0.19

Panel B: Sum of incentives of all top five executives

	(1)	(2)	(3)	(4)
Cash bonus / salary	0.000 (0.000)	0.000 (0.000)	-0.000 (0.002)	-0.000 (0.002)
Ownership (\$)	-0.003 (0.003)		-0.005* (0.003)	
Equity risk (\$)	0.002 (0.001)		0.002 (0.002)	
Ownership (%)		-0.002 (0.003)		-0.004 (0.003)
Equity risk (%)		0.001 (0.001)		0.002 (0.002)
Lagged ROA	-0.159 (0.236)	-0.179 (0.239)	-0.165 (0.238)	-0.187 (0.506)
Book-to-market	-0.058*** (0.019)	-0.059*** (0.019)	-0.066*** (0.021)	-0.067*** (0.021)
Log (market value)	-0.001 (0.002)	-0.003 (0.002)	0.004 (0.003)	0.000 (0.003)
Tier 1 capital ratio			0.001 (0.002)	0.001 (0.002)
Observations	90	90	78	78
R-squared	0.13	0.13	0.20	0.20

Table 9: ROE and executives' annual cash bonus, ownership incentives, and equity risk sensitivity

The table shows results from cross-sectional regressions of the return on equity on executive cash bonus, ownership incentives, equity risk exposure, and control variables. Return on equity is defined as the cumulative quarterly net income from 2007Q3 to 2008Q3 divided by the book value of common equity at the end of 2007Q2. Ownership (\$) is the dollar change in the value of the executive's equity portfolio for a 1% change in the stock price. Ownership (%) is the sum of all shares (restricted and unrestricted) and delta-weighted options (exercisable and unexercisable) held by the executive divided by the total number of shares outstanding multiplied by 100. Equity risk (\$) is defined as the dollar change in the executive's equity portfolio value for a 1% increase in stock volatility. Equity risk (%) is defined as the percentage change in the equity portfolio value for a 1% increase in stock volatility and is calculated from all option series held by the executive. A log transformation is applied to both the percentage ownership and percentage equity risk measure. Panel A shows results using the average incentives and equity risk of the top 4 non-CEO executives. Panel B shows results using the sum of the incentives of the top 5 executives, including the CEO. The control variables include the natural logarithm of the market capitalization, the Tier 1 capital ratio, and the book-to-market ratio, all measured at the end of fiscal year 2006. Lagged return is the lagged return on equity, measured over the five previous quarters to be consistent. Standard errors are reported in parentheses. Statistical significance at the 1%, 5%, and 10% level is indicated by ***, **, and *, respectively.

Panel A: Non-CEO executives

	(1)	(2)	(3)	(4)
Cash bonus / salary	-0.003 (0.004)	-0.002 (0.004)	-0.004 (0.016)	-0.004 (0.016)
Ownership (\$)	-0.001 (0.039)		0.009 (0.042)	
Equity risk (\$)	0.021 (0.016)		0.008 (0.021)	
Ownership (%)		0.020 (0.037)		0.017 (0.036)
Equity risk (%)		0.024 (0.015)		0.012 (0.018)
Lagged ROE	-0.452* (0.262)	-0.508* (0.263)	-0.213 (0.495)	-0.188 (0.493)
Book-to-market	-0.830*** (0.245)	-0.848*** (0.245)	-0.819*** (0.263)	-0.818*** (0.263)
Log (market value)	-0.015 (0.032)	0.004 (0.024)	0.011 (0.034)	0.026 (0.030)
Tier 1 capital ratio			0.018 (0.019)	0.017 (0.019)
Observations	86	86	75	75
R-squared	0.17	0.18	0.23	0.24

Panel B: Sum of incentives of all top five executives

	(1)	(2)	(3)	(4)
Cash bonus / salary	0.001 (0.004)	0.001 (0.004)	-0.001 (0.017)	0.001 (0.017)
Ownership (\$)	-0.074** (0.032)		-0.072** (0.033)	
Equity risk (\$)	0.022 (0.015)		0.020 (0.018)	
Ownership (%)		-0.058** (0.029)		-0.058** (0.028)
Equity risk (%)		0.020 (0.013)		0.013 (0.016)
Lagged ROE	-0.590** (0.248)	-0.610** (0.249)	-0.279 (0.465)	-0.326 (0.463)
Book-to-market	-0.892*** (0.222)	-0.908*** (0.223)	-0.884*** (0.234)	-0.898*** (0.234)
Log (market value)	0.025 (0.027)	-0.029 (0.023)	0.049 (0.031)	-0.006 (0.029)
Tier 1 capital ratio			0.014 (0.017)	0.015 (0.017)
Observations	89	89	78	78
R-squared	0.21	0.22	0.28	0.28

Table 10: TARP recipients, incentives, and ROA and ROE

The table shows results from cross-sectional regressions of the return on assets (columns 1 and 2) and the return on equity (columns 3 and 4) on executive cash bonus, ownership incentives, equity risk exposure, and control variables. Return on assets (return on equity) is defined as the cumulative quarterly net income from 2007Q3 to 2008Q3 divided by the book value of assets (common equity) at the end of 2007Q2. Ownership (\$) is the dollar change in the value of the executive's equity portfolio for a 1% change in the stock price. Equity risk (\$) is defined as the dollar change in the executive's equity portfolio value for a 1% increase in stock volatility. TARP recipient indicator is an indicator variable equal to one if the bank received funding from the Troubled Asset Relief Program, and zero otherwise. Columns 1 and 3 show results using only CEO incentives. Columns 2 and 4 show results using the average incentives of the top 4 non-CEO executives. The control variables include the natural logarithm of the market capitalization and the book-to-market ratio, all measured at the end of fiscal year 2006. Lagged return is the lagged return on assets (equity), measured over the five previous quarters to be consistent. Standard errors are reported in parentheses. Statistical significance at the 1%, 5%, and 10% level is indicated by ***, **, and *, respectively.

	ROA		ROE	
	CEOs only	Non-CEO executives	CEOs only	Non-CEO executives
TARP recipient indicator	-0.016 (0.024)	0.008 (0.018)	-0.281 (0.230)	0.133 (0.189)
Cash bonus / salary	0.000 (0.000)	0.000 (0.001)	0.006 (0.004)	0.001 (0.005)
TARP indicator x cash bonus / salary	0.001 (0.002)	-0.000 (0.001)	-0.003 (0.016)	0.004 (0.008)
Dollar ownership	-0.006* (0.003)	0.006 (0.004)	-0.086*** (0.032)	0.022 (0.043)
TARP indicator x dollar ownership	0.005 (0.005)	-0.003 (0.005)	0.066 (0.049)	-0.036 (0.055)
Dollar equity risk	0.001 (0.002)	-0.000 (0.002)	0.020 (0.017)	0.002 (0.017)
TARP indicator x dollar equity risk	-0.001 (0.004)	0.006 (0.004)	-0.007 (0.036)	0.039 (0.040)
Lagged return	-0.176 (0.235)	-0.108 (0.233)	-0.471** (0.227)	-0.485** (0.242)
Log (market value)	-0.002 (0.003)	-0.006** (0.003)	0.008 (0.027)	-0.028 (0.033)
Book-to-market	-0.049** (0.024)	-0.050** (0.020)	-0.687*** (0.217)	-0.858*** (0.231)
Observations	83	86	82	85
R-squared	0.19	0.22	0.28	0.24

Table 11: Dollar losses of CEOs' equity portfolios during the credit crisis

The table shows the cumulative trading losses and the losses from shares held from the beginning to the end of the sample period. The sample contains 80 bank CEOs. A CEO who turned over prior to September 2007 is excluded from the sample. Cumulative trading losses are calculated as shares sold multiplied by the difference of the price at the 2006 fiscal year end and the transaction price. Only insider sales unrelated to option exercises are included in the calculations. The 'loss from not acting' is calculated as the shares held at the end of the sample period multiplied by the difference of the 2006 fiscal year end price and the stock price at the end of the sample period. End of the sample period is defined as either December 2008, the month of the turnover of the CEO, or the month of the corporate event (merger, delisting), whichever comes first. The 'total loss' is calculated as the sum of the cumulative trading loss and the loss from not acting. If Thomson Financial does not report a sale of shares unrelated to options, it is assumed that the CEO did not sell any of his shares, and cumulative trading losses are set to zero. All numbers, except for stock prices, are reported in thousands of dollars.

	Mean	Minimum	Q1	Median	Q3	Maximum
Stock price end of fiscal year 2006	40.36	11.12	23.95	35.58	48.75	152.48
Stock price end of sample period	21.91	0.10	7.98	14.72	32.38	89.65
Total value of shares held end of fiscal year 2006	61503.82	347.48	7065.16	23628.25	57337.03	894128.54
Loss from not acting	28771.49	-13628.19	784.05	5076.10	19150.44	368429.27
Cumulative trading loss	2719.45	-686.16	0.00	0.00	56.63	201538.71
Total dollar loss	31490.94	-13628.19	916.83	5084.30	20315.48	368429.27

Figure 1: Evolution of the return on assets 2005Q4 – 2008Q3

The figure plots the evolution of average and median return on assets, defined as net income / total assets, of a sample of 95 bank holding companies and investment banks for 12 quarters from 2005Q4 to 2008Q3.

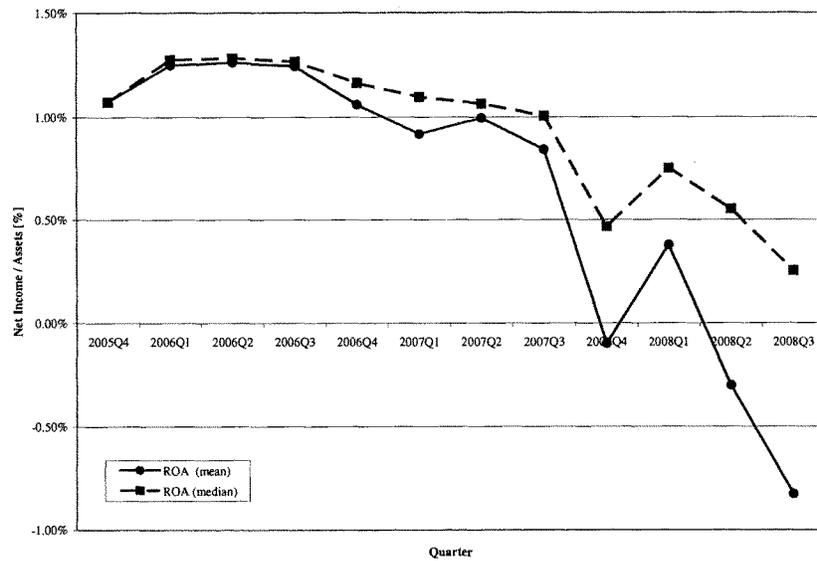


Figure 2: CEO insider trading

The figure shows the average total changes in CEO ownership and ownership changes caused by trading and new grants. The sample contains 80 bank CEOs that are covered by both Execucomp and Thomson Financial's insider trading database. A CEO who turned over prior to September 2007 is excluded from the sample. For each CEO, all insider transactions unrelated to option exercises reported by Thomson Financial are aggregated by firm and quarter. If a CEO does not trade or does not receive new grants, he is included in the cross-sectional average for a given quarter with a value of zero. The change in ownership is defined as the number of shares traded/granted divided by the total CEO ownership from stocks, excluding options, at the end of fiscal year 2006.

