Statement of the Shadow Financial Regulatory Committee

Proposed Interagency Rule on Executive Compensation

February 14, 2011

On February 7th, the FDIC became the first agency to issue a proposed interagency rule aimed at restricting the risk sensitivity of executive compensation structures at financial firms. The proposed “pay” rules seek to prevent compensation structures for “covered persons” at “covered institutions” (large financial firms) from encouraging “excessive” and “inappropriate” risk-taking. The pay rules supplement existing standards, rules and guidance already issued and enforced by the regulators of covered firms.

The Shadow Financial Regulatory Committee believes that the proposed pay rules are vague and unenforceable. For example, “inappropriate risk-taking” is defined nonobservationally (as in the Dodd-Frank Act) as arrangements that could lead to “material financial loss” (Notice of Proposed Rulemaking on Incentive-Based Compensation Arrangements, p. 33). The Committee believes that before any new pay rules are adopted regulators have to be more specific about the meaning of “excessive risk-taking” and “inappropriate risk-taking,” and other poorly defined terms used in the proposal.

Responsibility for confronting the operational issues imbedded in the rules is punted to covered institutions and their boards of directors without offering much constructive guidance. Just as the Dodd-Frank Act (DFA) passed the most complex issues in financial reform to the regulatory agencies, the proposed pay rules shift the
problems of writing detailed and enforceable specifications to their clienteles. Predictably, a spokesperson for the American Bankers Association (ABA) expressed his satisfaction with this fox-in-the-henhouse approach as follows: “It is good to leave the discretion in the hands of the board because they are ultimately in charge of the risk-taking the institution assumes.”

While some classes of covered persons are specified (e.g., executive officers), the rule requires that covered institutions develop policies and procedures for designating additional covered persons and for boards or their subcommittees to see that these procedures are followed. Rules for covered persons focus on requiring some deferral of risk-based compensation. A three-year pattern of deferral of at least 50 percent of this compensation for covered persons is mandated at especially large covered institutions. Opportunities for employees to hedge the effects of regulatory restrictions by direct and indirect programs of hedging activity are acknowledged, but are not encompassed by proposed rule.

One place for boards and regulators to find guidance is to identify what are regarded as the best compensation practices already followed at many firms. It would have been useful for regulators to identify a set of “best pay practices” which they believe all institutions should adopt in order to achieve the public policy goals which underlie the new regulations. Such guidance would require an internal reporting and information system that would measure on a real-time basis the risk exposures associated with “covered persons.” It would also identify pay structures that would meet regulatory standards. The Committee recommends that such structures include: deferral of some portion of pay over a reasonable period of time, “claw back” provisions, and enforceable company policies that prohibit “covered persons” from engaging in hedging practices that alter the fundamental incentive attributes of their compensation structure.

Most of the proposed rules are prescriptive rather than proscriptive. Only one paragraph (on p. 30) deals with prohibitions, even though current crisis experience could have been used to develop a catalogue of dangerous practices. Britain’s Financial Services Authority, for example, has compiled a list that interagency rulemakers in the US could have used as a model.

Most importantly, the rules do not address a key foundational question: how will the information government examiners collect about compensation structures be used to achieve the public-policy goal of reducing taxpayer exposure to loss from having to underwrite the risks imbedded in the federal safety net?