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Statement of the Shadow Financial Regulatory Committee on

Regulation of Executive Compensation

December 14, 2009

As a byproduct of the dramatic federal bailout of "systematically important" firms, popular outrage has focused regulatory attention on compensation practices of firms that received substantial assistance as well as financial institutions that are protected by the federal safety net. Today, a pay czar is charged with setting the level and regulating the structure of compensation for a limited number of firms that received extraordinary assistance. Additionally, the Federal Reserve is seeking to limit forms of compensation that encourage risk taking to assure the "safety and soundness" of banks. Internationally, the United Kingdom and France are focusing upon levels of compensation.

While appropriate compensation is difficult to determine, compensation packages should correspond to the value that the employee adds to the enterprise and also minimizes the uncompensated risks to the taxpayer. Given the government's informational disadvantages, the government may have little comparative advantage in setting compensation levels. Indeed, historically compensation has proved difficult to regulate.

It is important to appreciate who bears the costs of compensation regulation. Many commentators seem to believe that limiting compensation only reduces an employee's compensation. However, limiting an employee's compensation indirectly affects the value of the firm. In the competitive market for highly skilled talent, firms subject to such regulation are likely to lose their best talent to firms that can pay more or these employees will utilize their time in other ways. As a consequence, the restrictions instituted by the pay czar may reduce the relative market values of the companies in which the government's ownership interest is largest. It is ironic that the regulatory response to public outrage about extraordinary government subsidies and the compensation levels of key personnel could destroy value in exactly those firms in which the government has the greatest stakes.

Although regulating levels of compensation may be self defeating, the Shadow Financial Regulatory Committee believes that the federal safety net and possible externalities in the costs of firm failures may make it appropriate to regulate the form and portion of compensation that is deferred with the goal of aligning the incentives of each employee with the long-term goals of the firm and society. In this regard the pay czar has required that a significant portion of bonuses be deferred in an attempt to deemphasize short-term risk taking. In the same vein, the G-20 has developed specific guidelines about the mix of cash and deferred compensation and recommended that deferred compensation be a higher fraction of overall compensation for higher level executives.

In imposing restrictions on the private sector, the authorities always need to be cognizant of the likelihood of unanticipated consequences. As one example, the limitation on the corporate deductibility of non-performance-based compensation not to exceed $1,000,000 annually per employee enacted in 1993 led to an increased use of employee stock options, increasing the incentive to take short-term risks to increase the value of these options, which increased total compensation in the booming stock market of that era. Indeed, the proper mix of current and deferred compensation is not easy to determine.