Executive Summary*

Executive compensation has been a subject of controversy and debate since long before the 2008 financial crisis. Academics, shareholders, and other experts have long agreed that an executive's pay should accurately reflect his or her contributions to a business and should avoid creating incentives to pursue excessively risky business strategies. Debates have erupted, however, about what these standards mean in practice and about how to structure executive pay appropriately. For example, should corporations pay their executives primarily in stock in hopes of aligning their interests with those of other shareholders? Or would this approach encourage executives to take wild risks in order to increase the value of their own pay? Fault lines have also emerged over which stakeholders should play a role in determining executive pay, which metrics should be used to gauge an executive's performance, and what timeframe should be used in evaluating an executive's contributions, among many other points of contention.

Congress entered this well-worn debate in dramatic fashion in late 2008 and early 2009, when it enacted the Troubled Asset Relief Program (TARP) and subsequently imposed sweeping restrictions on executive pay at institutions that accepted TARP funds. The restrictions generally reflected the notion that, when a company accepts taxpayer money, its compensation practices must shift to take into account factors beyond the customary elements of executive pay. In particular, compensation should reflect the need for taxpayers to recover their investment, should recognize public frustration about taxpayer funds being paid to executives at bailed-out institutions, and should advance the public goal of stabilizing the financial system. These concerns are especially acute at "too big to fail" firms, which survived due to taxpayers' reluctant intervention rather than the competence of the executives who led their companies astray. In keeping with these considerations, Congress banned TARP recipients from compensating executives in ways that encouraged unnecessary and excessive risks; required "clawback" provisions to allow recovery of compensation paid based on inaccurate metrics; limited bonuses and other incentive compensation to one-third of total pay; and imposed several further restrictions.

To implement this Congressional mandate, Treasury established two new offices: the Office of Internal Review (OIR) within the Office of Financial Stability, which reviews and certifies compliance with executive compensation restrictions by all TARP recipients; and the Office of the Special Master for Executive Compensation, which actively negotiates executive pay for the seven institutions that received "exceptional assistance": AIG, Bank of America, Citigroup, Chrysler, Chrysler Financial, General Motors, and GMAC/Ally Financial.

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[*] The Panel adopted this report with a 5-0 vote on February 9, 2011.

Of the two offices, the OIR has attracted less public attention because it merely certifies compliance rather than actively setting pay. Even so, OIR has posed particular problems for oversight. Despite its far-reaching jurisdiction, it has not published a single document. Although OIR provided helpful responses to the Panel's questions, the Panel remains troubled that a body with such significant scope has disclosed so little information to the public. The omission is particularly surprising given OIR's determinations that the vast majority of the companies under its jurisdiction have been compliant with executive pay restrictions – information that would be valuable to the public.

The Office of the Special Master has a far more limited jurisdiction, but it plays an active role in setting executive compensation at the institutions within its purview. In general, the Special Master has achieved significant changes in practices at these firms, including an average percentage decrease in overall compensation of 54.8 percent (with a range between 24.2 percent and 85.6 percent) for the 25 highest-paid employees at each company from 2008 to 2009. The Special Master generally limited cash compensation to $500,000 or less and required that, for the 25 highest-paid employees, stock received as salary should be redeemable only over four years. The Special Master also limited incentive payments to one-third of total compensation, as required by Congress, and tied these payments to specific, observable performance metrics. The Special Master accomplished these changes in a complex environment under a constant media spotlight.

A key focus of the Special Master's work was shifting companies away from guaranteed pay and toward stock-based compensation in an effort to better align the interests of executives with the long-term interests of the company. This shift is broadly in line with current academic thinking and corporate best practices for executive pay. Even so, stock-focused pay packages raise their own concerns. The payment of salary in the form of stock may encourage executives to take unnecessary or excessive risks, especially because the very low stock prices of distressed institutions serve to limit downside losses while still allowing tremendous upside gains. Further, the four-year timeframe for the redemption of certain stock payments may be too short to determine whether an executive's actions have truly created long-term value. Many executives in the early 2000s, for example, gambled on high-risk business strategies that proved unsustainable only when the financial crisis hit in 2008. Even if their firms had followed the pay principles subsequently laid out by the Special Master, these executives would have walked away with dramatically and inappropriately inflated pay packages – precisely the outcome that the Special Master sought to prevent.

Also, pay packages approved by the Special Master have generally been quite uniform despite wide variations in the companies under the office's review. It is unclear whether one size truly fits all and whether the same redemption schedule for salary stock should apply to employees of an automotive company and employees of a large bank. Similarly, a cash salary of

$500,000 might have different ramifications for hiring and retention at an institution based in New York compared to one based in Michigan, given the widely varying costs of living.

A separate concern involves the Special Master's "Look Back Review" of payments to executives at TARP recipients prior to February 17, 2009. Congress instructed the Special Master to "seek to negotiate" with TARP recipients for "appropriate reimbursements" of any payments made prior to that date that were "contrary to the public interest." At the conclusion of the review, the Special Master found that no payments had violated the "public interest," and thus he did not attempt to claw back any pay. Even so, he labeled $1.7 billion in payments as "disfavored" and "not necessarily appropriate." The finding that pay was "disfavored" but not "contrary to the public interest" is troublesome for several reasons: it may appear to the public to be excessively legalistic, it may represent an end-run around Congress' determination that the Special Master should make every effort to claw back wrongful payments, and it may give the impression that the government condoned inappropriate compensation to executives whose actions contributed to the financial crisis.

The application of the "public interest" standard throughout the Special Master's other work also raises questions. Treasury initially defined six factors – including risk, taxpayer return, and appropriate allocation of pay between cash and other forms of pay – that should be considered in determining whether a compensation package met the "public interest" standard. Unfortunately, Treasury provided no guidance on how the six factors should be balanced or prioritized when they conflict. Subsequent statements have provided little public explanation of how the Special Master managed contradictions, noting only that the process is a mixture of art and science. As a result, aspects of the Special Master's work are essentially "black boxes" to the public, and it would be very difficult for any outside expert to replicate the Special Master's efforts.

The "black box" approach is especially troubling given the Special Master's aspiration for his determinations to be used as a model for compensation structures. It is impossible for outside actors to replicate a process that they cannot fully understand. Experts have assessed the broader impact of the Special Master's work as modest and have suggested that Wall Street's pay practices have not changed significantly since the financial crisis. So long as compensation experts on Wall Street and elsewhere lack the information needed to use the Special Master's deliberations as a model, what seemed an opportunity for sweeping reform will be destined to leave a far more modest legacy.