Section Two: Additional Views

A. Professor Kenneth R. Troske and J. Mark McWatters

We concur with the issuance of the February report and offer the additional observations below. We appreciate the efforts the Panel staff made incorporating our suggestions offered during the drafting of the report.

In these additional views we want to expand on the following passage in the report:

> As a result of providing a "too-big-to-fail" backstop, the government may have eliminated certain disincentives for pay arrangements that encourage excessive risk taking. Too-big-to-fail status permits shareholders and executives to accept substantial amounts of risk, since they can reap the benefits but will not suffer the consequences if the gambles are unsuccessful. Accordingly, some commentators have speculated that government guarantees could spur higher wages for bank employees, as guarantees may have the effect of minimizing the costs to bank shareholders and bondholders of awarding higher compensation to employees, which in turn could skew incentives for executives toward projects that are riskier and produce higher expected returns even if the associated risks ultimately turn out to be excessive.[325] The idea that government involvement in an entity can further distort executive compensation practices has led some lawmakers to argue that recipients of TARP funds should not be held to ordinary standards.[326]

In our view this is a key point for understanding the current state of executive compensation and the potential for future changes in the way executives are paid.

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[325] Incentive Compensation in the Banking Industry, *supra* note 45, at 8-9 ("[P]romises to pay the employee in the event of default are a way of shifting the bank's wage bill onto the government. Government guarantees of financial institution debt may perversely encourage dangerous levels of risk taking and the offloading of employee compensation to the government."). *See also* Stiglitz Written Testimony on Compensation in the Financial Industry, *supra* note 29, at 7 ("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.").

[326] *See, e.g.*, Don't Call it a Bonus, *supra* note 46 (Congressman Elijah Cummings of Maryland stating "When folks come to the government for money, I want them understanding they have to live by new rules, or don't come at all. This is a time when all of America must come together to sacrifice ... Everybody, all of us, needs to be a part of that sacrifice."); Sam Johnson Livid at AIG Bonus , *supra* note 46 ("AIG asserts it can not risk a lawsuit if the company demands the money back. Johnson vehemently disagrees and believes that once the taxpayers own 80% of a company, the company no longer has the right to offer multi-million dollar bonuses to employees, especially those who sparked such extreme economic turmoil.").

As the report points out, there currently exist two main views about executive compensation – those who believe that shareholders have sufficient power to design compensation schemes that will maximize their wealth, and those who believe that executives are able to capture boards of directors allowing them to design compensation schemes that benefit managers at the expense of shareholders. However, as the above passage makes clear, in the presence of a "too-big-to-fail" (TBTF) guarantee provided by the government, both shareholders and executives have an incentive to design compensation schemes that reward executives for investing in risky projects.

In a well-functioning competitive market, both shareholders and creditors have significant incentives to monitor the behavior of executives to prevent them from pursuing projects that expose the firm to excessive risk. However, once the government provides a guarantee that it will step in and bail out creditors and employees if the firm becomes insolvent, then creditors no longer have any incentive to pay attention to the risk the firm is absorbing. In fact, the presence of this government guarantee means that creditors are willing to lend money to the firm at a lower rate than they would charge to a similar firm without the TBTF guarantee.

This lower price for credit causes the firm to rely more on debt to finance projects. In addition, the TBTF guarantee means that shareholders want managers to focus on riskier, higher return projects since shareholders will reap the gains from these higher returns projects but will be protected from the full extent of the loss if projects go bad. Shareholders incentivize managers to pursue riskier projects by compensating them for doing so through the use of bonuses and stock options that reward short-term gains. Firm managers are willing to go along with these plans because they know that the government will protect their pay in the event that the risky projects blow up and the firm begins teetering on the brink of bankruptcy. In addition, in order to encourage managers to invest in high-risk, high-return projects, shareholders are also willing to pay managers upfront bonuses so that, in the event the project turns bad, managers have already received hefty bonuses and are more than happy to "retire" from the firm. The key point is that in the presence of a TBTF guarantee provided by the federal government, the incentives of firm shareholders and executives are aligned – both want compensation schemes that encourage managers to invest in riskier projects.

Recently, Standard & Poor's announced that it believed the market will experience another banking crisis and, in this crisis, the federal government will once again step in and bail out TBTF firms. Consequently, S&P will explicitly account for this TBTF guarantee in their credit ratings.[327] This is a clear sign that the market remains convinced the TBTF guarantee remains in effect and goes a long way towards explaining why there has been very little change in the way Wall Street executives are paid. This also demonstrates why reforms such as say-on-

[327] Standard & Poor's, *Banks: Rating Methodology*, at 16, 48-59 (Jan. 6, 2011) (online at www2.standardandpoors.com/spf/pdf/media/CriteriaFinancialInstitutionsRequestforCommentBanksRatingMethodology.pdf).

pay and independent compensation committees that are part of the recently enacted Dodd-Frank legislation will have little, if any, impact. As long as the government is willing to guarantee the survival of large financial firms, both shareholders and executives will continue to push for compensation plans that reward executives for focusing on risky projects. It seems clear to us that if policymakers want to reform the way Wall Street executives are compensated, then they need to start by having the government stop guaranteeing the survival of “too-big-to-fail” financial firms.