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THE UNINTENDED CONSEQUENCES OF EXECUTIVE COMPENSATION REGULATION

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Statutory and regulatory mandates to change or limit executive compensation structures threaten to worsen the current financial crisis. Historically, compensation regulation has resulted in unintended consequences that weaken the overall financial system. Past regulation has actually increased the disparity between worker and executive compensation and the current proposal would make it harder for firms to hire and retain top talent. Better corporate governance structures would ensure that executives' salaries reflect the value they provide to their company and shareholders.

RESEARCH FINDINGS

- History shows that restrictions on pay may widen the disparity between executives and employees. The 1993 tax code change, limiting the deductibility of non-performance based compensation, was intended to limit the disparity in pay between executives and the average worker. The actual result was that executive compensation increased exponentially, and the disparity immediately widened. New restrictions may create similar unintended consequences.

- The Securities and Exchange Commission's role: In 2006, former SEC Chairman Chris Cox completed an extensive overhaul of executive compensation disclosure in 2006. There has only been two years to assess the effectiveness/necessity of that effort. Further, current Chairman Mary Shapiro is promising further changes to disclosure requirements. More time is needed to determine the effectiveness of the 2006 initiative, and to let the SEC and the new Chairman analyze the need for any additional changes.

- Executive compensation's role in the current crisis is unclear. Comparing the compensation at banks likely to need additional injections of capital with those that have recently repaid their TARP loans reveals little difference in their executive compensation approaches. If executive compensation were to blame for excessive risk taking, the differences between the two groups would be more apparent.

- Why has executive compensation increased in recent decades? Some argue that increased CEO compensation is the result of "entrenched CEOs" who have influenced directors of boards to grant themselves excessive pay to the detriment of shareholders.
  - However, CEO compensation continues to increase even while boards of directors become increasingly independent of management. From 1997 to 2007, a period during which executive compensation grew, the percentage of outside directors serving on boards was increasing and the percentage of insider-dominated boards was decreasing.
  - CEOs promoted within the company earn about 15 percent less than CEOs hired from outside. This premium for external hires grew throughout the 1970s, 1980s, and 1990s.

- Getting what you pay for: Despite the very visible recent examples in some financial firms, a substantial body of recent empirical research finds that executive compensation is primarily the result of the increased value of corporate assets and the increased competitive pressures faced by executives and corporations. MIT researchers found that CEO compensation rose in proportion to the increase in the market capitalization of the largest firms between 1980 and 2000. Limiting a firm's ability to compete for top talent will make it more difficult for financial institutions to recover.

OPPORTUNITIES FOR CHANGE

- Reform quarterly earnings practice: Compensation can motivate executives toward short term goals; however the real question is why they are directed toward short-term goals in the first place. The widely accepted convention of quarterly earnings pressure in the capital markets is the root of this short-termism. Companies feel pressured to make quarterly predictions about their earnings, and then cut corners to meet those predictions. This is an area for reform with broad support among capital markets participants.

- Allow the SEC's new executive compensation disclosure forms time to bear fruit.

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HOUMAN B. SHADAB AND J.W. VERRET IN THE NEWS

Interview regarding banks' stress tests, *News Channel 8*, May 6, 2009.
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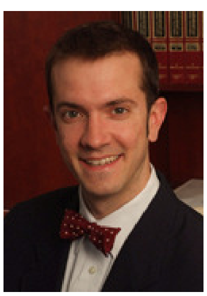
ABOUT J.W. VERRET



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