

# U.S. DEPARTMENT OF THE TREASURY

## Press Center

### Gene Sperling, Counselor to the Secretary of the Treasury, Opening Statement before the U.S. House of Representatives Committee on Financial Services

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Chairman Frank, Ranking Member Bachus, Members of the Committee, I appreciate the opportunity to testify before you on this important topic of systemic risk and executive compensation.

Each of us involved in economic policy has an obligation to fully understand the factors that contributed to this financial crisis and to make our best effort to find the policies that minimize the likelihood of its recurrence. There is little question that one contributing factor to the excessive risk taking that was central to the crisis was the prevalence of compensation practices at financial institutions that encouraged short-term gains to be realized with little regard to the potential economic damage such behavior could cause not only to those firms, but to the financial system and economy as a whole. As Secretary Geithner said yesterday, too often "incentives for short-term gains overwhelmed the checks and balances meant to mitigate against the risk of excess leverage." Compensation structures that permitted key executives and other financial actors to avoid the potential long-term downsides of their actions discouraged a focus on determining long-term risk and underlying economic value, while reducing the number of financial market participants with an incentive to be a "canary in the coal mine."

After one large investment bank suffered large losses, it acknowledged – properly reflecting on what it should have done differently – that it had skewed its employees' incentives by simply measuring bonuses against gross revenue after personnel costs, with "no formal account taken of the quality or sustainability of those earnings." And the potential harm caused by compensation arrangements based on short-term results with little account for long-term risks went beyond top executives. Indeed, across the subprime mortgage industry, brokers were often compensated in ways that placed a high premium on the volume of their lending without regard to whether borrowers had the ability to make their payments. As a result, lenders, whose compensation normally did not require them to internalize long-term risk, had a strong incentive to increase volume by targeting riskier and riskier borrowers – and they did, contributing to the problems that spurred our current crisis.

As we work to restore financial stability, the focus on executive compensation at companies that have received governmental assistance is appropriate and understandable. But what is most important for our economy at large is the topic of this hearing: understanding how compensation practices contributed to this financial crisis and what steps we can take to ensure they do not cause excessive risk-taking in the future. And while the financial sector has been at the center of this issue, we believe that compensation practices must be better aligned with long-term value and prudent risk management at all firms, and not just for the financial services industry.

Yesterday, Secretary Geithner laid out a set of principles for moving forward with compensation reforms. Our goal is to help ensure that there is a much closer alignment between compensation, sound risk management and long-term value creation for firms and the economy as a whole. Our goal is not to have the government micromanage private sector compensation. As Secretary Geithner said yesterday, "We are not capping pay. We are not setting forth precise prescriptions for how companies should set compensation, which can often be counterproductive." We also recognize these principles may evolve over time, and we look forward to engaging in a discussion with this Committee, the Congress, supervisors, academics and other compensation experts, shareholders and the business community about the best path. We begin this conversation recognizing that the reforms we put in place must be based not only on our best intentions, but also a clear-eyed understanding of the need to minimize unintended consequences. But we think these principles offer a promising way forward.

#### 1. Compensation plans should properly measure and reward performance

There is little debate that compensation should be tied to performance in order to best align the incentives of executives with those of shareholders. But even compensation that is nominally performance-based has often rewarded failure or set benchmarks too low to have a meaningful impact.

There is increasing consensus in the expert community that performance-based compensation must involve a thoughtful combination of metrics that is indexed to relative performance as opposed to just following the ups and downs of the market. Performance pay based

solely on stock price can on the one hand, "confuse brains for a bull-market" and in the other scenario, fail to recognize exceptional contributions by executives in difficult times. A thoughtful mix of performance metrics could include not only stock prices, but individual performance assessments, adherence to risk management and measures that account for the long-term soundness of the firm.

## **2. Compensation should be structured in line with the time horizon of risks**

As I mention above, much of the damage caused by this crisis occurred when people were able to capture excessive and immediate gains without their compensation reflecting the long-term risks they were imposing on their companies, their shareholders, and ultimately, the economy as a whole. Financial firms offered incentives to invest heavily in complex financial instruments that yielded large gains in the short-term, but presented a "tail risk" of major losses. Inevitably, these practices contributed to an overwhelming focus on gains – as they allowed the payout of significant amounts of compensation today without any regard for the possible downside that might come tomorrow.

That is why we believe companies should seek to pay both executives and other employees in ways that are tightly aligned with the long-term value and soundness of the firm. One traditional way of doing so is to provide compensation for executives overwhelmingly in stock that must be held for a long period of time – even beyond retirement. Such compensation structures also reduce the risk that executives might walk away with large pay packages in one year only to see their firms crumble in the next year or two. In these cases, the dramatic decline in stock price would effectively "claw back" the previous year's pay. Other firms keep bonuses "at risk," so that if large profits in one year are followed by poor performance in the next, the bonuses will be reduced.

Yet, as Harvard Professor Lucian Bebchuk has written, compensation packages based on restricted stock are not a fool-proof means of ensuring alignment with long-term value, as such pay structures can still incentivize well-timed strategies to manipulate the value of common equity or take "heads I win a lot, tails I lose a little" bets depending on the capital structure and degree of leverage of the firm.

## **3. Compensation practices should be aligned with sound risk management**

Ensuring that compensation fosters sound risk-management requires pay strategies that do not allow market participants to completely externalize their long-term risk, while also ensuring that those responsible for risk management receive the compensation and the authority within firms to provide a check on excessive risk-taking. As the Financial Stability Forum recently stated, "staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm."

This authority and independence is all the more important in times of excessive optimism when consistent – though unsustainable – asset appreciation can temporarily make the reckless look wise and the prudent look overly risk-averse. Former Federal Reserve Chairman William McChesney Martin Jr. once said that "The job of the Federal Reserve is to take away the punch bowl just when the party starts getting interesting." Likewise, risk managers must have the independence, stature and pay to take the car keys away when they believe a temporary good-time may be creating even a small risk of a major financial accident down the road.

Yet there are several reports showing the degree to which risk managers lacked the appropriate authority during the run-up to this financial crisis. Accounts of one Wall Street firm discuss how risk managers who once roamed the trading floors to gain a better understanding of how the company worked and where weaknesses might exist were denied access to that necessary information and discouraged from expressing their concerns.

That is why we believe that compensation committees should conduct and publish a risk assessment of whether pay structures – not only for top executives, but for all employees – incentivize excessive risk-taking. As part of this process, committees should identify whether an employee or executive experiences a penalty if their exceptional performance is based on decisions that ultimately put the long-term health of the firm in danger. At the same time, managers should also have direct reporting access to the compensation committee to enhance their impact.

I should also note that in the rule we released yesterday concerning executive compensation for recipients of assistance through the Troubled Asset Relief Program, we put forward – as the Administration called for on February 4<sup>th</sup> – a requirement that compensation committees not only provide a full risk assessment for their compensation, but that they do so in a narrative form that explains the rationale for how their pay structure does not encourage excessive risk. We believe such a requirement not only increases transparency, but forces firms to think through the basic risk logic of their compensation plans, and we hope it will help begin an important discussion between shareholders, directors and risk managers about the relationship between compensation and risk.

## **4. We should reexamine whether golden parachutes and supplemental retirement packages align the interests of executives and shareholders**

While golden parachutes were created to align executives' interests with those of shareholders during mergers, they have expanded in ways that may not be consistent with the long-term value of the firm, and – as of 2006 – were in place at over 80 percent of the largest firms. Likewise, supplemental retirement packages that are intended to provide financial security to employees are too often used obscure the full amount of "walkaway" pay due a top executive once they leave the firm. Indeed, Lucian Bebchuk and Jesse Fried have shown that there is substantial evidence that "firms use retirement benefits to provide executives with substantial amounts of 'stealth compensation' -- compensation not transparent to shareholders – that is largely decoupled from performance." [1]

Examining these practices is all the more important because when workers who are losing their jobs see the top executives at their firms walking away with huge severance packages, it creates the understandable impression that there is a double-standard in which top executives are rewarded for failure at the same time working families are forced to sacrifice. As Secretary Geithner said yesterday, "we should reexamine how well these golden parachutes and supplemental retirement packages are aligned with shareholder interests, whether they truly incentivize performance and whether they reward top executives even if their shareholders lose value."

#### **5. We should promote transparency and accountability in setting compensation**

Many of the excessive compensation practices in place during the financial crisis likely would have been discouraged or reexamined if they had been implemented by truly independent compensation committees and were transparent to a company's owners – its shareholders. Companies often hire compensation consultants who also provide the firm millions of dollars in other services – creating conflicts of interest. According to one Congressional investigation, the median CEO salary of Fortune 250 companies in 2006 that hired compensation consultants with the largest conflicts of interest was 67 percent higher than the median CEO salary of the companies that did not use consultants with such conflicts of interest. [2]

That is why we hope to work with Chairman Frank and this committee to pass "say on pay" legislation, requiring all public companies to hold a non-binding shareholder resolution to approve executive compensation packages. We believe that "say on pay" will place a greater check on boards to ensure that their compensation packages are aligned with the interest of shareholders. Indeed, in Britain, where "say on pay" was implemented in 2002, it has – according to a study by Professor Stephen Davis at Yale's Millstein Center for Corporate Governance and Performance – been associated with greater communication between boards and shareholders, while a recent paper by Fabrizio Ferri and David Maber of Harvard Business School has found that say on pay made CEO compensation more sensitive to negative results. [3] As a result, the resolutions have gained more and more support, with 76 percent of Chartered Financial Analysts now in favor of say on pay. [4]

In addition, we want to work with this committee and the Congress to pass legislation directing the SEC to put in place independence rules for compensation committees analogous to those required for audit committees as part of the Sarbanes-Oxley Act. Our goal is to move compensation committees from being independent in name to being independent in fact. Under this proposal, not only would committee members be truly independent, but they would also be given the authority to appoint and retain compensation consultants and legal counsel, along with the funding necessary to do so. This legislation would also instruct the SEC to create standards for ensuring the independence of compensation consultants, providing shareholders with the confidence that the compensation committee is receiving objective, expert advice.

I am pleased today to be testifying here alongside my colleagues from the SEC and the Fed. We are encouraged by the efforts of the SEC to seek greater transparency and disclosure on compensation, and by the commitment of the Federal Reserve and other bank supervisors to ensure compensation practices are consistent with their fundamental duty to promote the safety and soundness of our financial system. As Secretary Geithner announced yesterday, we also hope to work further with other agencies on this issue by asking the President's Working Group on Financial Markets to provide an annual review of compensation practices to monitor whether they are creating excessive risks.

As we move to repair our financial system, get our economy growing again and pursue a broad agenda of regulatory reform, we must ensure that the compensation practices that contributed to this crisis no longer put our system and our economy at risk. I commend the committee for holding these hearings, and I look forward to approaching this difficult issue with a degree of seriousness, reflection and humility – seriousness over the harm excessive risk-taking has caused for so many innocent people; reflection over the lessons we have already learned; and humility in recognizing the complexity of this issue, its potential for unintended consequences, and the importance of testing each of our ideas against the most rigorous analysis.

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[1] Quoted in Lucian Bebchuk and Robert J. Jackson, Jr., "Executive Pensions," *NBER Working Paper #11907*, December 2005.

[2] House Oversight Committee Majority Staff, "Executive Pay: Conflicts of Interest Among Compensation Consultants," Report Published December 2007.

[3] Stephen Davis, "Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable," Millstein Center Policy Briefing No. 1, 2007; Fabrizio Ferri and David Maber, "Say on Pay and CEO Compensation: Evidence from the UK," Harvard Business School Working Paper, 2009.

[4] Keith L. Johnson and Daniel Summerfield, "Shareholder Say on Pay: Ten Points of Confusion," Briefing Prepared for Shareholder Forum Program on Reconsidering "Say on Pay" Proposals, October 2008.