CFP | Center for Financial Policy

ROBERT H. SMITH SCHOOL OF BUSINESS
AT THE UNIVERSITY OF MARYLAND

May 3, 2011

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Interagency Notice of Proposed Rulemaking: Incentive-Based Compensation Arrangements

(Docket No. R–1410, RIN No. 7100–AD69)

Dear Chairman Bernanke,

The undersigned faculty associates of the Center for Financial Policy are submitting this comment letter in response to the Notice of Proposed Rulemaking by the Interagency with respect to Incentive-Based Compensation. The Center for Financial Policy was launched in November 2009 and develops thought leadership in financial policy that impacts corporate performance, capital allocation and the stability of the global financial system. Located in both College Park, MD and in Washington, D.C. at the Smith's School's campus in the Ronald Reagan Building and International Trade Center, the center is well-situated to take a leadership role with its globally recognized faculty and its extensive relationships with key policymakers, practitioners and academics.

Our comments focus on various issues of the Notice. Specifically, we comment on the definition of covered institutions, incentive-based compensation, required reports, deferral arrangements, executive compensation, and personal hedging strategies of executives.

**Covered Institutions**

Pursuant to the language on covered financial institutions, we strongly urge the regulators to account for both on-balance-sheet *and* off-balance-sheet assets in determining whether an institution is covered or exempt.

The Dodd-Frank Act Section 965(f) states:

*"(f) EXEMPTION FOR CERTAIN FINANCIAL INSTITUTIONS.—The requirements of this section shall not apply to covered financial institutions with assets of less than $1,000,000,000."*

We encourage the agencies involved to interpret this $1bn threshold as being *inclusive* of all off-balance sheet activity. Including off-balance-sheet positions is essential if the proposed rule is to enable regulators to monitor and supervise institutions that regularly use derivative and other off-balance-sheet instruments to adjust their market exposure. It is both conceivable, and common, that institutions dramatically increase their effective size, as well as their systemic impact, through these off-balance sheet exposures.

## Incentive-based Compensation

As stated in the NPR, the regulations focus on risk taking incentives that arise out of annual compensation *flows*. In our view, this approach isolates only one source of incentives for excessive risk taking. Regulations should aim to assess all economic incentives that may lead to executives taking excessive risk. For instance, executives may have incentives to engage in excessive risks from their equity holdings in a covered financial institution that is levered.

Similarly, incentives to take excessive risk can come from vested or unvested option grants or stock grants from prior years, or more generally, from shares and options beneficially owned by managers. Put another way, risk taking incentives from restricted stock that will vest next month can be substantial but so are risk taking incentives arising out of shares already vested. Effective systemic risk regulation demands disclosure of both sources of incentives.

Moreover, elements of the executive's personal portfolio can alter incentives for risk taking. For instance, if an executive hedges performance incentives through private hedges, this information should be disclosed. Other examples would include defined benefit pension plans or severance packages ("golden handshakes") that are liabilities of the firm, which would be in jeopardy and become impaired should the firm fail. These liabilities, often called "inside debt" by the finance academics, can attenuate incentives for risk taking.

Finally, we recommend that in addition to annual compensation grants, the systemic-risk related compensation disclosures should also cover the level of stock options and stocks beneficially held by executives whether vested or not. The disclosures should also cover any outside hedges or elements of private portfolios of executives and pension or severance packages.

## Required Reports

The regulators should recognize that data for effective systemic risk regulation can be quite different in scope, content, and format from summary disclosures that may suffice for SEC disclosures. The aim should be to be comprehensive, detailed, and standardized to make it comparable across firms and compatible with the analytic infrastructure used by regulators.

In terms of scope, the SEC disclosures demand data for the top 5 paid executives and the list can change from year to year. In contrast, systemic risk regulation should cover any employee who can take excessive risk for any covered financial institution, regardless of whether the employee is among the top 5 paid in a given year or not. For instance, in many covered institutions, traders who have large position limits can expose an institution to substantial risks and should be covered for the purposes of systemic risk regulation.

In terms of content, the principle should be to demand *details* so that the regulators have sufficient data to quantify risk-taking incentives and act on them. Thus, the detailed structure of compensation contracts, particularly incentives, should be obtained. The information should include stock

grants, stock options, cash bonuses, cash and non-cash deferred compensation including stock appreciation rights and pensions, severance packages, etc. In each case, the firm should detail the contract maturity as well as the vesting schedule whether time or performance dependent (if so, the exact contingencies). These disclosures should also extend to the shares and options beneficially owned by executives and shares or options not vested, as discussed above.

Finally, in terms of format, the data should be provided electronically and follow standardized markup fields and formatting. The goal should be to facilitate analytic processing by the regulators and academics assessing risk taking incentives. Standardization is especially important to avoid large scale data dumps in non-standard formats that may not contain essential information for risk assessment or mask such information amidst unnecessary detail or excessive verbosity.

**Deferral arrangements required for executive officers**

We recommend deferral and vesting rules that match executive payouts to the time horizon over which the covered institution can precisely assess the performance of the assets put in place by the executive. The principle here is that, if managers make decisions or invest in assets that have a five-year horizon, covered institutions should require executives to have "skin-in-the-game" for the entire five years. We recommend that the minimum deferral period for incentive-based compensation be equal to the *average maturity* of the assets held by the covered institution. In particular, we stress that the rule should cover both the on-balance sheet assets and the off-balance sheet assets, such as derivatives, including an assessment of counterparty risks and the notional value of the derivatives to which the covered institution is counterparty.

**Excessive compensation**

The proposal advances a general rule that a "covered" financial institution may not establish or maintain an incentive-pay arrangement that encourages a "covered" person to expose the institution to *inappropriate* risks by providing the person with *excessive compensation*. Implicit in this rule is that excessive compensation leads to excessive risk-taking.

We argue that the primary objective should be to disclose and regulate the *structure* of pay rather than the *level* of pay to monitor excessive risk taking. This is because the structure of pay (e.g., whether it is straight salary or it is bonus, equity-linked grants, severance packages, etc.) determine the incentive to take risk (see also our above commentary on incentive compensation). We point out the evidence from past attempts to regulate pay levels through preferential tax treatment. Section 162 (m) of the tax did not permit firms to claim tax deductions for compensation expenses above $1 million unless it was performance related. Rather than limiting pay levels, Section 162(m) had the counterintuitive effect of increasing pay levels as firms circumvented the 162(m) restrictions through aggressive stock option grants, which led to inappropriate pay-performance and risk taking incentives.

We recognize that excessive pay is critical when the payouts seriously impair a firm's capital base. This is particularly important when the financial condition of the institution is shaky or unhealthy to

begin with but it can arise even when risks are not excessive. Even if this is the intent of the Act, the standards proposed by the regulators do not lend themselves to monitoring of excessive risk-taking.

In particular, we wish to single out item # 4 pertaining to *comparable* institutions for the determination of excessive pay. It is critical to devise an appropriate peer group, because if companies are left to their devices, they can game the system by devising a peer group that is overly represented by highly paid executives to ratchet up the median for the institution. Therefore, the regulatory assessment should explicitly require firms to submit in machine readable format the set of peers used for comparison. Furthermore, regardless of what peer group is chosen by a firm, the covered firm should additionally report a benchmark based on all firms deemed by the regulator to be in the same industry within 50% to 200% of the asset size of the covered institution. Given the size of covered institutions, senior executives will be drawn from national and international talent markets making geographic considerations less relevant.

Finally, let us emphasize again that the peer group monitoring does not imply that the regulators *mandate* the level of pay, but the analysis should focus on generating information for the purpose of regulation.

**Personal Hedging Strategies**

We do appreciate the awareness of the agencies for "covered" individuals to engage in personal hedging strategies that alter the appropriate risk-reward balance in compensation arrangements. The worst case scenario is when individuals end up locking in all the upside and walk away from the down-side, exacerbating incentives for excessive risk-taking.

We do not believe, though, that the right approach for this is *prohibition* of use of hedging instruments, such as derivatives. We think that this is perhaps excessively invasive, especially because there are legitimate purposes for engaging in such hedging transactions when "covered" individuals are exposed excessively to the riskiness of the "covered" institution and need to rebalance their personal portfolio. Moreover, there is an advantage in hedging away market risks (e.g., interest risks) which would have otherwise made it difficult to disentangle performance that is attributable to the individual performance from the one attributable to the market (beyond the control of the individual).

We believe the more appropriate rule, rather than prohibition, would be to require full disclosure of all outside transactions in financial markets by the "covered" individual, including hedging transactions, to the extent that these transactions affect the pay-performance sensitivity. This disclosure should be made to compensation committee of the board and the appropriate regulator, and the board should attest to the fact that these transactions do not distort proper risk-reward balance in the compensation arrangement. The additional mechanism for mitigating abuses in hedging activities is a well-functioning board with an independent and financial literate compensation committee, which should be a requirement of rules governing compensation arrangements.

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In summary, we support the general spirit of this Interagency NPR, which seeks "to strengthen the incentive compensation practices at covered institutions by better aligning employee rewards with longer-term institutional objectives." We believe implementation of our comments would further strengthen this objective.

Yours sincerely,

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