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Hearing on
Pay for Performance: Incentive Compensation at Large Financial Institutions

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Chairman Brown, Ranking Member Corker, and distinguished members of the Subcommittee, I am honored to be here today to testify today about incentive pay at America’s largest financial institutions.

The financial crisis of 2008 brought the dangers associated with giving bankers incentives to pursue short-term gains at the expense of systemic stability into sharp relief. In 2010, Congress responded with the Dodd-Frank Wall Street Reform and Consumer Protection Act, which included several important new rules that now govern executive pay. Many of those rules, like the say-on-pay provisions that give shareholders a voice in setting compensation, have been the subject of considerable public debate. But the most expansive pay-related provision in Dodd-Frank has received much less attention. That provision, Section 956, gives nine federal agencies, including the Federal Reserve, the Federal Deposit Insurance Corporation and the Securities and Exchange Commission, unprecedented authority to ensure that bonus practices at our largest banks never again endanger financial stability. Section 956 gives the agencies two key powers in regulating banker bonuses, requiring the agencies both to prohibit any bonus payment that gives bankers excessive pay or could lead to material losses and to require banks to disclose the structures of all bonuses so that those who oversee our financial institutions can identify incentives that could cause bankers to take excessive risk. In Section 956, Congress and the Administration gave federal regulators the broad powers they need to ensure that bonus practices do not threaten the safety and soundness of America’s financial system.

Last April, the agencies proposed rules to implement the important protections in Section 956. Unfortunately, these proposals fall far short of the rigorous oversight of banker pay that Congress authorized. In this testimony, I will provide three reasons why the Subcommittee should not expect these rules to change bonus practices at America’s largest banks, and describe
four suggestions for reform that would help ensure that bonus structures give bankers reason to pursue long-term value creation rather than the illusory, short-term profits that led to the crisis.

First, although the rules require some bankers to receive their bonuses over time, so that more can be known about the risks they’ve taken before bonuses are paid, these rules apply only to a few top executives. Yet one of the few clear lessons from the crisis was that bankers who are not executives can cause a great deal of systemic damage. None of the employees at American International Group’s Financial Products division, the unit that contributed to the system’s collapse in September 2008, was an executive. Nor was the Citigroup trader who earned more than $100 million in bonuses each year in the run-up to the crisis. If those bankers were doing today exactly what they did before the crisis, the key rules under Section 956 would not apply to their bonuses. Now, Congress and the Administration understood that, even though they are not executives, these employees’ incentives demand scrutiny. That is why both Congress’s rules and the Treasury Department’s oversight for bonuses at recipients of financial assistance under the Troubled Asset Relief Program applied well beyond top executives. That is also why Section 956 says that it applies not only to bonuses paid to “executive[s]” but also to all “employee[s].” But the agencies’ new rules, by and large, apply only to a few top executives, leaving bonuses for key risktakers at our largest financial institutions unregulated. Thus, my first recommendation is that new rules on bankers’ bonuses should apply to all risktakers, not just a few top executives.

Now, that is not to say that executives’ incentives are not important. They certainly are. But the agencies’ rules for executives are no different from the way that banks have paid top executives for years. Indeed, as I noted in my written testimony, the evidence on executive pay shows that large banks required executives to defer more of their bonuses between 2002 and 2006 than the agencies’ rules do today. And in many ways the rules lag behind the practices that
large banks have used for years to address executives’ incentives. For example, the rules do not prohibit executives from hedging—that is, from using derivatives to undermine the incentives that are created when bonuses are paid in stock. Many large U.S. banks have prohibited executives from hedging for years, and empirical evidence clearly shows that, if they are not prohibited from doing so, executives will in fact use hedging to undermine much of the incentive effect of stock-based pay. Indeed, the most prominent example of executives’ hedging involves Hank Greenberg, who as CEO of AIG hedged about $300 million worth of AIG stock in 2005, avoiding $280 million in losses when the company collapsed in 2008. That is why Treasury’s Office of the Special Master for TARP Executive Compensation has prohibited hedging for all of the employees at all of the firms it supervises. But the proposed rules under Section 956 would not stop the executives who run our largest banks from using hedging to undermine the incentives created by stock-based pay. This leads me to my second recommendation: rules on executive pay should go further than the practices banks have been using for years to address top executives’ incentives.

The second problem with the new rules is that they leave it to the banks themselves to do two important things: first, identify which bankers take the kinds of significant risks that could threaten the system, and second, decide how those bankers should be paid. Neither of these decisions should be left up to the banks.

As I noted in my written testimony, at the height of the financial crisis just six of our largest banks employed more than 1.3 million people, more than 4,500 of whom received bonuses of more than $1 million in 2008. It is critical to identify, among this massive group, which bankers take the kinds of risks, and have the kinds of incentives, that demand further scrutiny. One might expect, for instance, that the rules would require that the banks identify at
least those employees who, according to banking regulators’ risk models, are responsible for the bank’s most significant exposures to loss. Instead, however, the rules leave the decision about which bankers to identify to the banks themselves, providing only a vague standard for the banks to follow. This approach is likely to lead to inconsistent methods among banks, some of whom will identify too many risktakers, giving too little attention to each banker’s incentives, and some of whom will identify too few which will leave the bonuses of significant risktakers unregulated.

Moreover, even if the banks correctly identify their significant risktakers, the rules are very unlikely to eliminate incentives to take excessive risk. That is because, once the bankers have been identified, all the rules require is that the bank’s own board of directors approve their incentives. The problem with this approach is that, as a matter of law, the board owes its duties strictly to its shareholders. It is now well accepted that shareholders in large banks prefer that the bank take excessive risk, because shareholders capture the full upside from such risktaking, while some of the downside of bank failures is borne by the government. So even if the bank correctly identifies the employees who have incentives to take excessive risk, its board will have no legal obligation to eliminate those incentives. In short, it is not the board’s job to ensure that its bankers take the socially appropriate level of risk, and we should not expect them to do so. That is why Section 956 requires the regulators, and not the banks themselves, to prohibit bonuses that could give bankers incentives to take too much risk; if Congress and the Administration had preferred to leave those decisions to the banks themselves, Section 956 would not have been necessary. Thus, my third recommendation is that **the agencies should set clear rules for identifying significant risktakers, and bonuses for these risktakers should be reviewed by regulators, not the bank’s own board of directors.**
The final problem with the proposed rules is that they do not require banks to disclose any detailed numbers describing their bonus structures. While we can and should debate how, and how much, we should regulate banker bonuses, there is no question that the agencies need detailed information on bonus payments in order to do their job under Section 956. Congress and the Administration understood as much; that is why Section 956 gives the agencies the authority to require that banks disclose detailed information about their incentives. But the new rules only require the banks to describe their bonus plans to the agencies in general terms. For one thing, these rules simply duplicate the disclosures that banks have been required to provide under SEC rules for years—although even those rules require the banks to provide a table describing the exact amounts that will be paid. But much more importantly, because they consist only of general language rather than detailed figures describing bonus amounts and structures, they have very little chance of giving regulators the information they need to identify the bonuses that could lead bankers to take excessive risks.

To see why general language provides inadequate disclosure, consider the unloading problem that Professor Bebchuk has just described. Suppose that a large bank discloses to the agencies that its bonuses are paid in stock. Regulators might well conclude that these bankers have strong incentives to increase the value of the firm, because the bankers will suffer personal losses if the bank’s stock price falls. But this assumes that the bankers have not “unloaded” their shares—that is, sold a sufficient number of shares to eliminate the incentives created by the stock-based bonus. In a paper that will be published in the Columbia Law Review this May, I show that such unloading is common, both for top executives and for other significant risktakers. Without knowing how much stock the bankers have unloaded, the regulators will not be able to distinguish between a banker whose pay is actually tied to the long-term future of her firm and a
banker who has unloaded, taking advantage of short-term increases in value before the systemic consequences of her risktaking can be known. Indeed, although all agree that the amount of stock held by top bankers significantly influences their incentives to take risks, the new rules do not require banks to provide any information to the agencies about the bankers’ holdings of stock.

Despite the sweeping language of Section 956, the disclosure rules on banker pay give us no new information on incentive compensation at America’s largest banks. This leads me to my fourth recommendation: banks should be required to provide regulators with detailed numerical data on the structure of incentives for all bankers who take significant risk.

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Bankers’ incentives remain a significant concern for all Americans who rely upon the safety and soundness of our financial system. In Section 956, Congress and the Administration provided federal regulators with the authority they need to ensure that bankers do not have incentives to pursue short-term gains that could compromise systemic stability. The new rules on banker pay are, however, inadequate to the regulators’ critical task. More diligence from Congress, from the Administration and from the regulators themselves is needed to make certain that the agencies use this new authority to ensure that banker incentives are aligned with all Americans’ interest in a safe and secure financial system.

Thank you once again for the opportunity to testify about this important issue. This statement concludes my formal testimony; I will of course be pleased to answer any questions that you or your staff may have.