



Lombard Street

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The collapse of the world's financial markets has resulted in intense examination of how to restructure and reform regulation for banking, securities, insurance, and other parts of the financial services industry. Various regulatory proposals are already being circulated in academic and public policy circles. Governments around the world are considering reforms. The conversation and decisions surrounding these proposals will fundamentally impact how financial services is structured and conducted across the globe throughout the 21st century.

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About Lombard Street

Lombard Street is the first ever e-journal focused exclusively on financial services regulation. Titled after the famous treatise on banking regulation authored by Walter Bagehot in 1873, this biweekly journal is filled with original pieces from prominent thought leaders across the globe.

Overseen by a multi-disciplinary editorial board led by David S. Evans of the University of Chicago and University College London, Lombard Street delivers original articles that will shape and chronicle the evolution of the impending 21st century financial services regulation reform.

Lombard Street leverages the power of the Web to provide germane and timely thought leadership to a broad and relevant audience. The online format works to fuel interaction between readers and authors, extending the dialogue beyond just the articles.

Lombard Street lives within www.finreg21.com, a non-partisan online media entity developed for, and by, those involved in or affected by financial services regulation. Launched in March 2009, it provides a platform for community members to express a diverse set of opinions, and allows the community to own and operate the discussion. FinReg21 both aggregates and produces a rich mix of content underscoring expert commentary: dedicated experts blogging daily, original reporting from Washington, D.C., virtual roundtable webinars lead by the leading lights in this space, a library of papers and reports, expert-to-expert interviews, among other features.

For more information about contributing to Lombard Street, please contact info@finreg21.com

From the Editor: AIG Aftershocks

David S. Evans

FinReg21 Editor-in-Chief

There are still aftershocks from the AIG bonus fiasco but heads have cooled and a calmer debate over executive compensation is possible. That's where this issue of *Lombard Street* begins -- with a constructive article by **John Buchman** who advocates significant reforms to corporate governance and shareholder involvement in compensation decisions. Buchman wonders where the boards of directors and compensation committees were while executives earned big bucks for making ruinous decisions.

Marc Hodak, meanwhile, in the second of a two-part series, reminds us of the complexity of designing compensation schemes that encourage managers to do the right things while not providing perverse incentives. He notes that when managers aren't eligible for incentive pay for performance they may take excessive risks since they may feel there is little downside.

Treasury Secretary Timothy Geithner's plan is the subject of **David Zaring's** commentary. He observes that some of what's being suggested such as leverage caps is new and provides something for Basel to do in the coming months. The idea of a systemic risk regulator has been bandied about for some time. The current crisis has just breathed new life into old proposals.

Margaret Weichert asks whether banking industry innovation is possible in the current era of heightened regulatory scrutiny. Some past "innovations" have been implicated in the financial crisis and this has made banks skittish about developing and trying new things. But, she argues, innovation is imperative for the survival of banks in the face of greater competition from less-regulated non-banks, and that consumers will benefit from innovation that comes from banks that have a stake in their long-term financial well-being.

We thank these contributors for their provocative articles and encourage readers who have comments to post them on the article page or on the FinReg21 Expert Blog.

“Modest” Reform Proposals for Executive Compensation

John A. Buchman

General Counsel and Corporate Secretary, E*TRADE Bank

By now, all of us are more than familiar with the controversies swirling around the subject of executive compensation - the \$161.5 million golden parachute Stan O'Neal received when he exited Merrill Lynch, the \$165 million in retention pay and bonuses paid to AIG employees, and the \$3.6 billion in eleventh hour payments to employees made by Merrill Lynch just before its acquisition by Bank of America. As Goldman Sachs Chairman and CEO Lloyd Blankfein recently acknowledged, the compensation practices that led to these – and other – pay outs "look self-serving and greedy in hindsight."

We are also aware of the public anger provoked by executive compensation of this magnitude, particularly at companies that are receiving TARP funds. This anger has driven ham-handed, emotional and perhaps unconstitutional efforts by Congress to claw back money already paid out through tax levies, specifically targeting some of these companies and employees.

The outcry is quite understandable given the hundreds of thousands of people who are losing their jobs each month. However, what is oftentimes missed amid the resulting brouhaha is what got us here in the first place - a significant breakdown in corporate governance at many of the companies that made these payments. To paraphrase Judge Stanley Sporkin's famous question from a few years back about the outside lawyers and accountants who were involved with Lincoln Savings & Loan: Where were the boards of directors and their compensation committees?

Somewhere along the line, independent directors forgot that they were supposed to be truly independent of management, and that they were supposed to represent the best interests of the owners of their companies - the shareholders - and not just line the pockets of senior management in good times and in bad.

How this state of affairs came about is fairly obvious. Many independent directors became too cozy with management, and there was little or no incentive for them ever to stand up to management and their compensation demands. After all, when you are making a significant amount of money each year as a director of a public company, the last thing you want to do is to rock the boat and get thrown overboard. Not surprisingly, boards and their compensation

committees did not operate as an effective check on executive compensation, and the salary and benefits arrangements that resulted were not on arm's-length terms.

Usually, boards attempt to justify the compensation packages given to management on the grounds that they were recommended by compensation consultants. And, of course, we have all heard the oft-voiced concern that if companies do not pay well, they will not be able to attract and retain the best talent.

I. Wall Street's Lake Wobegon Effect

What the first justification fails to recognize is the inherent conflict of interest that compensation consultants face. Just like rating agencies and real estate appraisers, they realize that if their recommendations are too "low," they will not be hired for next year's review. As a result, pay consultants do their best to justify senior executive compensation packages that keep up with the Joneses. Add to that tendency the Lake Wobegon effect, which is the notion that since all of the company's senior executives are "above average," they deserve even more than the Joneses, and it is easy to see how executive compensation has spiraled out of control in recent years.

The idea that most senior executives are hired guns who will flee their companies at the first offer of higher pay is also largely a fallacy. How many examples are there of corporate executives switching jobs just or primarily for the money? Practically all high-level job changes are due to other factors such as the attractions of greater responsibilities, running a larger company or having a position that is higher up on the corporate ladder at the new company. And what ever happened to loyalty to one's company and being willing to take a "home team discount?" Are senior executives really that mercenary and only looking out for themselves? If so, perhaps their companies would be better off if executives left for "greener" pastures.

It is clear from all the recent examples of excessive executive compensation that many boards of directors and compensation committees have fallen down on the job. The result is a near-complete disconnect between how much top executives are paid and their companies' financial health and performance over the long-term. In the process, many directors seem to have lost sight of their primary responsibility – to enhance shareholder value.

There is no single answer as to how we get boards of directors and their compensation committees back on track when it comes to deciding how much senior executive should be paid. However, a number of steps should be given serious consideration in order to avoid the need for Congressional legislation, which, as more than one prominent observer has noted, will be inherently suspect in the current environment. What is required, at a minimum, is (1)

increased board independence, (2) greater shareholder involvement, (3) increased transparency and disclosure, and (4) better alignment of the interests of executives and directors with shareholders.

How might these objectives be best achieved?

II. Increased Board Independence

One thing we have learned since Sarbanes-Oxley was enacted in 2002 is that just because a director satisfies the independence requirements imposed by the statute does not mean that he or she is truly independent from management. There is probably no good way to get inside a director's head to find out just how independent he or she will be vis-à-vis senior management. It is also probably not a good idea to scrutinize a director's personal life in an attempt to ascertain whether, for example, their spouses are good friends, they were fraternity brothers or sorority sisters in college, or they belong to some of the same clubs or are involved with the same charities.

That being said, several things can be done to make boards and compensation committees more independent from management:

- **No management involvement in director and committee membership selection.** In addition to requiring that the board's nominating committee consist entirely of independent directors, which is largely the case today, management (including all inside directors) should be precluded from having any input, formal or informal, into the selection of committee members or director nomination decisions made by the nominating committee.
- **Composition of the compensation committee.** Similarly, the board's compensation committee members should be selected only by the board's independent directors. Moreover, individuals who are currently senior executives of other companies should be excluded from compensation committee membership. In order for the compensation-setting process to be more arm's-length, it would be preferable not to have a CEO from another company on the committee thinking, "What would I want to be paid if this were my company's compensation committee?"
- **Term limits on independent directors.** If a director knows that he or she will roll off the board after, say, six years, this knowledge will reduce the incentive that the director might otherwise have to curry favor with senior management in order to ensure continued board membership with all the accompanying compensation, perks, and status. Admittedly, if the limits imposed are for too short a period of time, this could

backfire and actually further entrench management and/or weaken independent board members by making them, in effect, lame ducks. Also, it could be difficult to square this solution with better alignment of the interests of management, directors, and shareholders. Still, the idea is worthy of serious consideration. If requiring lead audit partners rotate off audit engagements after five years, as required under Sarbanes-Oxley, helps enhance auditor independence and improve audit quality, term limits could also work with directors.

Providing independent directors with more independence from management should reduce the likelihood that independent board members will be predisposed to do management's bidding on executive compensation and other matters and will empower boards to ask the "tough questions" about new business strategies, risk management, and other matters that, in many cases during the current financial services crisis, appear never to have been asked.

III. Greater Shareholder Involvement

Perhaps the best litmus test as to whether an executive's pay is excessive is the collective opinion of the company's owners, its shareholders. At least in theory, they are the ones who should best know whether or not senior management and the board have done a good job in enhancing shareholder value. All they have to do is to look at their brokerage account and 401k statements and check stock prices online to see how their companies are performing over the long run.

Besides, what harm is there in having more feedback from shareholders on how they think their companies are being run, in addition to having the opportunity to vote on director elections, unless directors and senior management really do not value their opinions? Limiting shareholder participation in corporate governance to voting on directors and significant corporate transactions and having the now largely theoretical right to bring derivative actions against boards does not go far enough. What else should be done?

- **Give shareholders a say on executive pay.** Letting shareholders vote up or down on what a company's top five executives are paid, over time, will serve to rein in executive compensation and severance packages that, in recent years, have spiraled out of control. The knowledge that shareholders will have the opportunity to vote will be in the back of directors' minds and will help them remember that they are working for the company's owners and not executive management when negotiating compensation arrangements. Also, a positive vote by shareholders will better insulate boards and executives who receive large pay packages from shareholder derivative actions as well as criticisms leveled by Congress and various activist groups. Conversely, a negative vote

will serve as a much-needed reality check for the parties concerned. Just because executives are contractually entitled to what they receive and the payments made are “legal” does not mean they are fair or appropriate. Too often, boards and their compensation committees get lost amongst the myriad of executive benefit plan trees. Say on pay will provide them with a perspective that will better enable them to see the entire forest.

- **Appoint or elect a shareholder Ombudsperson.** While measures such as separating the positions of Chairman of the Board and CEO and appointing lead directors have had a beneficial impact in terms of reducing the incidence of imperial CEOs, they still have not gone far enough in giving company owners a voice at the table. Perhaps what is called for is an independent shareholder Ombudsperson whose sole responsibility is to look out for the best interests of large and small shareholders alike. The Ombudsperson could serve as the main communications channel between shareholders and the board between annual meetings. Shareholders could voice their company performance and corporate governance concerns to the Ombudsperson. Also, the Ombudsperson could take the lead role in negotiating compensation arrangements on behalf of companies.
- **Give shareholders better access to the proxy statement.** The current state of director election affairs is somewhat akin to holding a political election where only one party is permitted to run advertisements. Shareholders should more easily be able to nominate and vote for opposing slates of director candidates through increased proxy access, especially in situations where their companies have not performed well since the prior annual meeting. A number of complex issues remain to be resolved (e.g., whether only large shareholders can propose directors), but the playing field needs to be more level when it comes to election and re-election of directors proposed by board nominating committees.

IV. Increased Transparency and Disclosure

As anyone who has looked at a monthly credit card statement lately knows, more disclosure does not necessarily mean better disclosure. If shareholders are to be enfranchised and given a meaningful say on pay, they need to have better information regarding the compensation their companies are paying senior management.

- **Simplify Proxy Statement Disclosure of Executive Compensation.** The SEC’s Regulation S-K executive compensation disclosures have become so complicated in recent years as to make it very difficult, if not impossible, for shareholders to answer the basic question: How much did senior management make last year in base salary, cash bonuses, vested

restricted stock, exercised stock options, and perks? All the additional charts and detailed information on executive compensation are fine for those who have time to connect the dots, but there also needs to be an executive summary section that is uniform for purposes of comparisons so that shareholders wanting a simple answer to the question of “how much did they make last year” do not get buried in an avalanche of information.

- **Provide More Information on Compensation Consultant Recommendations.** Shareholders need to know what advice compensation consultants are giving their board of directors, and what the rationale is for that advice. If the consultants are making recommendations based on what other companies are paying their executives, what companies are those and why are those comparisons appropriate? More disclosures as to how consultants arrive at their compensation recommendations and compensation committees arrive at their compensation decisions will inject much-needed transparency into the process, will rein in boards’ tendencies to set executive compensation at excessive levels, and will give shareholders a better basis on which to evaluate board compensation decisions for themselves.

V. Better Alignment of Executive, Director and Shareholder Interests

Too often recently, senior management compensation has been based largely on a company’s annual earnings. As a result, executives are motivated to take excessive risks in order to increase short-term profits at the expense of the long-term health of their companies and to the detriment of their shareholders. When their companies do ultimately blow up, executives are frequently rewarded with extremely generous severance packages. It is “heads I win; tails shareholders lose but I still do OK”, plain and simple. Several basic executive compensation reforms are needed to address the underlying moral hazards involved.

- **Pay Executives and Directors Mostly in Stock.** As FDIC Chairman Sheila Bair and others have advocated, to better align management and shareholder interests, senior executives as well as directors should receive the bulk of their compensation in the form of long-term restricted stock and stock options. If the company does well under their stewardship, they will reap the appropriate rewards; if not, they will receive much less. Poor subsequent performance should also trigger compensation clawbacks, and no repricing of previous stock option grants should be permitted.
- **Base Executive Pay on a Company’s Risk-Adjusted Returns on Equity.** Executives should not be judged and compensated based just on earnings in the abstract, but rather on how much their companies earned relative to the risks – investment, operational and

other – that were taken to produce the earnings. If a company earns oversized profits in a particular period but does so by taking excessive risks, management compensation should be adjusted downwards accordingly. Similarly, if a company is profitable but underperforms its peer group, that factor should be taken into account as well.

- **Executives Should Not Receive Severance Payments in Bad Times.** Under the Federal Deposit Insurance Act’s golden parachute provisions, banks and bank holding companies that are in a troubled condition or are expected to become troubled are prohibited from making any severance payments to senior management. The logic behind the law is unassailable: departing executives should not be rewarded for failure. Going forward, companies would be well-advised to include similar golden parachute language in their severance agreements prohibiting senior managers who leave (either voluntarily or involuntarily) when their companies are experiencing financial difficulties from receiving any severance payments unless and until their companies return to financial health.

Excessive executive compensation is an issue that is going to be with us for some time. Boards and their compensation committees are now beginning to get the message that it is no longer business as usual when it comes to paying their top officers. Some companies, too, are starting to adopt compensation reforms, although perhaps not quite as sweeping as those recommended above. However, too many other companies, boards, and executives still fail to grasp the significance of this issue to the public at large and to the Congress.

Companies’ failure to improve corporate governance and change common executive compensation practices could end up being costly, not only to shareholders but also to senior management itself. If reforms in this area are not instituted voluntarily, Congress could attempt to “solve” the problem itself. Given how the new executive compensation restrictions imposed by Congress have significantly dampened industry enthusiasm for participating in Treasury’s TARP program, this would almost certainly be the worst outcome for everyone.

*John Buchman is General Counsel and Corporate Secretary of E*TRADE Bank, a \$46 billion asset bank subsidiary of E*TRADE Financial Corporation located in Arlington, VA, and is a member of the adjunct faculty at The George Washington University Law School. Prior to joining the Bank in November 2000, John worked as a banking attorney in Washington both in private practice and with the government.*

The Radical Experiment in Pay Regulation under TARP

Mark Hodak

Managing Director, Hodak Value Advisors

This is the second in a two-part series on executive compensation and financial service regulation. Part one examines the history of executive compensation and how it is influencing today's policy debate over regulation reform. Refer to [Volume 1, Issue 2](#) of Lombard Street.

Most people in and out of the financial industry believe that perverse incentives were at least partly responsible for the crisis prompting the TARP program, initiated in the Emergency Economic Stabilization Act (EESA). Stronger alignment of managers and shareholders would likely have prevented much of the damage we are now facing, and it's sensible that financial services reforms address those incentives. EESA includes a provision that calls on the elimination of compensation that creates "unnecessary and excessive risks," a provision reiterated in the American Recovery and Reinvestment Act (ARRA).

Unfortunately, EESA and AARA depend on the Treasury Secretary to make distinctions about what incentives do or do not contribute to excessive and unnecessary risk. This is not an easy call. Even the most seasoned corporate boards, with considerable experience in managing or overseeing financial services firms, have a very difficult time distinguishing compensation-induced risk, even without the political considerations that might drive directors to conflate governance risk and business risk.

For instance, most people equate compensation plans with steep pay-for-performance lines as "riskier" than plans with weaker incentives. Critics argue that stronger incentives induce reckless behavior. In fact, shareholders have been placed in far more danger when the incentive leverage is zero than when it's steep. The area below targets or goals where there is no longer any more pay-for-performance is where the trader finds his or her greatest temptation to double down in the hope of getting back into the green. This phenomenon is well known in banking circles as the "trader's option." The fundamental problem is not the steepness of the plan when the participants are on the incentive line, but the discontinuous incentive leverage across the spectrum of performance. This problem is reinforced by discontinuities across time, characteristic of bonus plans with specific end dates, like the November 30 fiscal year-end for many banks, which means to a manager that anything that happens after that date is of no consequence to my bonus this year. These discontinuities create asymmetry between the risk preferences of the employee versus the shareholders.

I. Keeping Key Executives on the Incentive Line

Directors would benefit from better understanding where these discontinuities exist in their firm's incentive structures. Boards should be wary of any incentive plan that suddenly kicks in millions of dollars, or their share-equivalent, for hitting a specific achievement target, something known as performance-based cliff-vesting, which happens to be very popular among governance critics right now. Most governance risk faced by shareholders appears in that area in front of the cliff, where plan participants have powerful incentives to do silly things.

Boards should be wary of any plan that takes key employees they intend to keep off the incentive line. The point where they no longer have upside potential, they also no longer have any downside accountability. Most "annual plans" look like this in bad years. Corporate critics, however, are appalled that anyone should have any bonus opportunity in a range of below-target performance.

In principle, a performance-based claw-back mechanism could help overcome time discontinuity. If a bonus were based on performance that turned out to be unsustainable, a portion of the prior earned amount, presumably held in a deferred account, would be returned in accordance with the performance shortfall. I have actually designed performance-based 'claw-backs' like this at client firms. When implemented correctly, such a mechanism eliminates many incentives for short-term behavior, both in reporting misleading results and in pursuing unsustainable strategies. A couple of major financial institutions are now adopting these mechanisms. But they are not costless, in the sense that making bonuses more deferred and conditional requires tolerating a greater retention risk or offering a higher target level of compensation.

The EESA includes a claw-back provision, but this rule merely expands a prior restriction introduced by Sarbanes-Oxley to require repayment of bonuses based on false results. It doesn't apply to results that were correctly reported, but were simply not sustainable.

Ironically, one can eliminate virtually all "unnecessary and excessive risk" by eliminating all objectivity from the awarding of bonuses. Adopting subjectivity flies in the face of decades of good governance recommendations, but it solves both the problem of discontinuous incentive leverage and the problem of short-term versus long-term. A subjective plan has no identifiable incentive leverage to game. A supervisor can judge the sustainability of performance meriting a bonus far better than could any bonus formula. It might be no accident that the two major financial firms with the most subjective bonus plans, Goldman Sachs and J.P. Morgan Chase, were among the least affected by the subprime crisis, and the firms with the most rigidly formulaic bonus plans were Bear Stearns and Lehman Brothers.

II. Specific TARP Limits on Compensation

Congress has always hated golden parachutes. “Golden parachutes” is actually slang invented by the press. No executive agreement actually uses the term. Nevertheless, Congress banned “golden parachutes” for top executives of TARP firms in the EESA. In the ARRA, they amended the law to actually include a legal definition of that term.

This ban is the clearest illustration both of the degree to which Congress legislates based on the critics’ depictions of compensation, and the general belief that such features -- whatever they are called --are gratuitous benefits born of managerial power, simply tossed into a pile by complacent boards rather than incentives that are actually worth more than the actual cost to the company. At the very least, this ban will force boards to renegotiate with their CEOs with one less benefit to offer that will eventually need to be replaced by another.

The boldest proposal in EESA is the \$500,000 tax limit on the top corporate officers. Unlike the current \$1 million limit on tax-deductible pay Congress passed in 1993, this \$500,000 limit has no performance-based exceptions. On the one hand, it eliminates the artificial preference for variable compensation, which may restore some balance between fixed and variable pay. But we can soon expect to see the first multi-million dollar salaries in the financial services sector, albeit with much smaller bonuses or equity grants for these executives. All of the resulting tax penalty, aimed at the executives, will initially hit the shareholders, and eventually workers and customers, too. Congress will have to learn another lesson in tax incidence.

ARRA includes some additional provisions in direct reaction to the headlines since the passage of EESA, specifically the \$18.4 billion in bonuses paid out to Wall Street employees for 2008, which still added up to below-target compensation for most of the recipients. ARRA’s key provisions include:

- Bonus limited to 50 percent of salary for top earners, which bonus may be taken only in restricted stock, i.e., vested when they repay TARP funds,
- Prohibition on any incentive plan that would encourage manipulation of the reported earnings,
- Board committee to review expenditures on “luxury” items,
- General requirement for Treasury to judge if compensation is “unreasonable or excessive” or “in the public interest.”

The law nominally imposes its bonus limits on up to the top 20 “most highly-compensated employees” (for the largest recipients) plus the five “senior officers.” But this restriction poses a

logical quandary. Somebody has to be the 26th highest paid person. One possible consequence is that every employee at a major bank becomes limited to a bonus that brings their total compensation no higher than 150 percent of the salary of the 25th highest salaried employee. If that is how the rule gets implemented, the first thing we should expect is a rapid increase in salaries at TARP recipient firms, which I believe we are starting to see. There are other interpretations to this rule, but they don't make any more sense than this scenario.

A reasonable interpretation of the second item would be that earnings can no longer be used as a bonus metric, since any incentive to achieve is indistinguishable from an incentive to cheat. This would also rule out most forms of profit sharing, and probably any financial metric, since all of them affect earnings and are, in principle, subject to manipulation. That basically leaves non-financial metrics, which, while notoriously manipulable, are allowed only as long as they can't influence earnings. The safest bet would be to award bonuses based purely on subjective assessments that, as mentioned earlier, are something governance critics generally oppose.

The clearest evidence of popular envy being the root of these provisions is the clause requiring the board to review "luxury" expenditures—a kind of Optics Committee—for items like office decorations and corporate jets. Clearly, these expenditures are far more material to the press and public than they are to the shareholders. Does it really matter to the shareholders if the company's most valued employees benefit from nice offices? Sure, there is a crude sense of entitlement that drives an executive to spend a lot on lavish appointments, but such appointments tend to be personalized, which arguably creates a retention benefit, especially in situations where bonuses are otherwise being suppressed. Corporate jets might be a frivolous expense, or they may be a cost effective way to provide efficient and secure transportation to busy executives. The ARRA law leaves it up to the board to make such determinations on behalf of the shareholders, but this is a canard; boards already make these determinations. The real purpose of this clause is use public sentiment to eliminate perks on no firmer grounds than the grade school "chewing gum rule"—if I can't have some, nobody else can.

The most vexing limits associated with ARRA will be the ones executives didn't know existed because the Treasury Secretary was later embarrassed by some aspect of the plan and decided that paying under a contract, even one approved by the government, was "contrary to the public interest," a term necessarily left undefined in the law. This provision was not even broad enough to catch most of the infamous AIG bonuses, which were otherwise protected by contract protections of the law. But these impediments to Treasury's recovering bonuses not "in the public interest" are up for grabs in proposed legislation.

III. An Uncertain Trend

In all of these pronouncements, Congressional leaders are asserting that they don't want taxpayer money to be "wasted" on certain forms of compensation. But if the only difference between TARP and other troubled firms is the composition of the ownership, i.e. whether or not taxpayers are among the shareholders, then this claim is tantamount to saying that the proscribed forms of compensation are always wasted. What, then, will prevent Congress from using that rationale to more broadly apply these kinds of standards?

As long as new laws continue to be written in response to the newest headlines, it's difficult to anticipate what the government will do next. In the immediate aftermath of the AIG-FP bonus flap, the House passed an incredible 90 percent tax on the bonuses of all financial services employees making over \$250,000 in family income. The Senate and White House were lukewarm to this, on Constitutional grounds as well as common sense, and the measure has since been watered down to merely expand the Treasury Secretary's power to determine what is "unreasonable or excessive" under older agreements as well as new ones.

The ARRA requires of all TARP companies annual approval of executive compensation in a non-binding shareholder vote. The intent is for shareholders to keep boards honest in awarding compensation. Looking ahead, we will almost certainly see this "say on pay" requirement expanded to all public corporations, very likely in this session of Congress. Since this requirement is entirely underpinned by the managerial power thesis, the least likely outcome of its adoption will be a reduction in CEO pay. Its most likely effect will be greater politicization of executive compensation, which is how the union pension funds that are its main proponents appear to define corporate governance.

It is fashionable to joke about how much bankers can really be worth, given the mess in which banks now find themselves. But for a sector as important as financial services, especially to the extent that any specific group is responsible for our current crisis, doesn't that make it all the more necessary to get the right talent into key positions? Isn't it critical to insure that this talent is motivated to do the right things? By belittling or ignoring the need to attract and retain talent in financial services, the prospect for future legislation does not bode well for a balanced treatment of executive compensation in this sector.

IV. Conclusion

The government certainly has the prerogative to create crazy restrictions on the companies it owns, including with regards to pay. But it can't argue that such restrictions are good for the taxpayers-as-owners when they're not. In thinking about a world after TARP, it is important for

regulators to broaden the discussion of executive compensation beyond an incomplete assessment of alignment and an obsessive focus on cost. To the extent that government must address cost for political reasons, policy makers are more likely to gain traction on controlling cost by abandoning the “managerial power” theory in favor of one that better explains why costs have soared. They must realize that permanently increased politicization of compensation and increased complexity are not the shareholder’s friend, and consider how their direct involvement has and might affect these vitally important issues.

These suggestions assume that Congress is truly motivated by a desire to improve corporate governance for the benefit of the shareholders, when, in fact, its behavior often demonstrates otherwise. The “g” word we continuously hear in their debates is not “governance” but “greed.” Greed is distinguished solely by the raw size of the paychecks being discussed, which obliterates any discussion of the governance trade-offs associated with pay.

Marc Hodak is Managing Director of Hodak Value Advisors, a firm specializing in the finance and compensation issues of corporate governance. Marc teaches corporate governance at New York University’s Leonard N. Stern School of Business.

What's New in Geithner's Financial Reform

David Zaring

Assistant Professor of Law, The Wharton School of the University of Pennsylvania

What should financial regulatory reform look like? Treasury Secretary Timothy F. Geithner has announced the outlines of a plan, and Federal Reserve Chairman Ben Bernanke has testified to its benefits. There is a lot to their proposal, parts of which are quite new, and other parts that have been around for some time.

Financial reform always works this way. It follows crises, like the panic of 1907 that led to the establishment of the Federal Reserve, the 1929 stock market crash that led to the creation of the Securities and Exchange Commission, and the collapse of Enron and WorldCom that resulted in the passage of Sarbanes-Oxley in 2002. Reform proposals, on the other hand, are less cyclical, and so they tend to accumulate in the crisis interstices, waiting for the critical legislative mass for enactment that only a panic, apparently, can bring.

The legislative cycle means that one of the fundamental ideas in Geithner's plan has been around for some time. The consolidation of regulation and creation of a systemic regulator is something that Americans have been talking about for years. The Europeans have urged it upon us for at least as long. On the other hand, a second reform proposal, that banks should be permanently de-levered, strikes me as quite new, quite tailored to the particular perceived flaws that led to the current crisis, and decidedly un-European. Both reforms have some slightly counter intuitive implications.

I. Leverage Caps

The locus of a not-very-European rule that would impose leverage caps on banks could be, interestingly enough, in Switzerland, where the Basel Committee on Banking Supervision can be found. Why would Basel be the place for the de-levering regime, rather than the Fed? It could be that American regulators believe that, in the end, putting together the domestic political will to cut down monster banks would be, in the end, quite difficult. Or it could be that the prospect of competing with super-large European and Japanese institutions is unpalatable, creating the need for a global rule.

Basel is not without its accomplishments, and, somewhat counter intuitively, the fact that some of the failures of regulation during the financial crisis attest to this. After all, the first financial institutions to fail were, at least in the view of the SEC, adequately capitalized under Basel II up

to the moment they failed. This was the case for both Bear Stearns and Lehman Brothers. There is no question that the Basel II will be reevaluated sooner than later, but perhaps one lesson of the crisis is how important this relatively young international institution is: It was the Basel Committee that set the standards that Bear Stearns, Lehman Brothers, and the big European banks met in practice, and it was Basel II that did not, in the end, sufficiently keep the banks solvent.

Nonetheless, Basel has been very quiet since the failure of Bear Stearns. It has produced speeches on the importance of coordinated supervision, and has announced far-off deadline plans to rethink the basics of capital adequacy supervision. Its recent decision to expand the size of the group to something that resembles the G20 underscores just how important the G20 has become vis a vis Basel. What Basel has not done is provide a means of coordinated crisis response. That silence at Basel on that score is quite notable, since Basel was created to do something about international banking crises, and the prevention of them is its *raison d'être*.

For that reason, as well as for the rule-oriented leverage-cap concept, a decision to give the Basel Committee something to do is quite notable in and of itself. But the substantial importance of the rule makes it only more so. Even though the Basel Committee has played a relatively minor role thus far in responding to the crisis, the decision will cheer proponents of global coordination to hear that it may be tasked with an important part of the solution. Leverage caps means that Basel does not appear to be gone from an important place on the national stage.

II. Systemic Regulator

What about the older idea: a consolidated regulator modeled on Britain's Financial Services Authority? The politics of making such a regulator happen may turn on who trusts the Federal Reserve. It is a likely home for a systemic regulator, though Geithner's proposal has been coy about where, exactly, that regulator might be.

The Fed is not the only home that has been proposed. In Henry Paulson's blueprint, financial regulation would have – it seems, at least – been centralized in the Treasury Department. Paul Volcker, with Geithner's pre-appointment approval, also wanted to centralize and consolidate the American regulatory apparatus, but apparently in an independent regulator – he may have been thinking of the Fed -- more resistant to the political winds than Treasury.

If one way to understand the Geithner plan, and financial reform more generally, is to think of it as a set of options, three options look like this: keep the regulatory system as either fragmented, the way it was, semi-centralized, the way it has become during this crisis, or

bureaucratized and rationalized, along the lines that Paulson, Volcker, and now Bernanke and Geithner seem to suggest.

A lot of people want that Weberian rationalization. But really, there is a very long pedigree for the system we used to have - decentralized, functionalist, open to regulatory competition and races to the top. Amid all the cries for reform, the advantages of mess -- that is, a system where small states like Delaware play roles along with the federal government, where agencies like the SEC and the Commodity Futures Trading Commission (CFTC) compete for business - are easy to overlook.

After all, super-regulators don't face competitive pressure to be good regulators, unless you believe that globalization can provide that competition.

But there is a final candidate for the home of the systemic regulator, and it is looking like quite a strong one. The President's Working Group already requires the patchwork quilt of regulators that we now have to meet. Perhaps the President's Working Group will be given the job of systemic regulation, which would make this reform just regulation by committee with monthly meetings.

Entrusting the President's Working Group with the role of systemic risk regulation is not likely to create over-regulation, or overweening, powerful financial bureaucrats. And it is less independent, and bank-focused, than the Fed.

The problem, however, is that it may not be much of a change at all.

David Zaring is Assistant Professor of Law at the Wharton School of the University of Pennsylvania. His research is focused on international economic regulation and administrative law. He has published articles in the NYU, Michigan, and UCLA law reviews, and in peer-reviewed journals including the Annual Review of Law & Social Science, the Journal of Tort Law and the Journal of Empirical Legal Studies. He clerked on the D.C. Circuit, worked at the Department of Justice, and was educated at Harvard Law School and Swarthmore College.

Innovation in an Era of Regulation: Is it the Impossible Dream?

Margaret Weichert

Founder & CEO, The Morgan Weichert Group

In times when survival, not growth, is the primary objective, innovation is often first on the chopping block. Functions such as research and development, strategy, business development and innovation are viewed as luxuries during difficult economic times. Nowhere is this truer than in the financial services industry today.

Banks, in particular, face difficult choices as they consider whether to eliminate or reduce investments in the wake of regulatory and financial forces that are driving some institutions to curtail innovation altogether. This environment has evolved, in part *because* of innovations in mortgage lending, student lending and investment banking, all of which have led to the current financial crisis. As a result, many traditional bankers and regulators fear innovation. And the populist cries in newspapers, on radio talk shows and on Capitol Hill -- all calling for new safeguards and laws to prevent the excesses of the past -- add to those fears.

And yet, financially vulnerable consumers and businesses still need reliable financial services from reputable institutions to repair their lives and businesses. Unfortunately, these same customers may be turned away from traditional banks or steered toward less-regulated, "non-banks" such as money transfer companies, payday lenders, prepaid card providers, and bill-pay kiosk companies. Many of these so-called non-banks are not capable or interested in helping customers build long-term fiscal fitness.

Now more than ever, it is critical to ask the question: Is banking industry innovation possible in an era of heightened regulatory scrutiny? This article argues that innovation is imperative for traditional banking for two key reasons: aggressive regulation, which threatens the industry's profitability and viability, and increased competition in high-profit industry segments from less-regulated non-banks.

I. Regulation, Litigation and Product Maturity

Even as traditional banks struggle to deal with today's economic crises, banks' current strategic investments will continue to affect their future. Therefore, it is critical that efforts to regulate past problems do not unintentionally prevent banks from innovating in the future. This is

particularly important since many non-bank innovations start in completely unregulated environments, with all the attendant potential risks.

At the same time that business fundamentals are challenging profitability, increased regulatory scrutiny threatens many of the still promising profit pools in consumer banking. For example, proposed Unfair and Deceptive Advertising Practices (UDAP) legislation may severely constrain banks' ability to charge fees for overdrafts, late payments and other adverse activities. In addition, due to the financial crisis, Congress, the FDIC and other national regulators may impose other stricter laws and regulations on banking across the board, which could both limit revenue opportunities and increase the cost of doing business. Although well-intentioned, these added rules and regulations could have a burdensome effect on bank costs and priorities, without solving the underlying issues.

Many retail bank fees have also come under increased legal scrutiny in the last five to 10 years. From ATM fees to interchange fees, class action lawyers have targeted banks, challenging almost every type of fee revenue bankers have imposed. In some cases, these fees are the not the only source of revenue for a particular product (e.g. credit cards and deposit accounts). In other cases, however, popular, widely-used products and services like debit cards, ATMs and gift cards have no other source of revenue besides the fees that are being challenged.

Most traditional banks depend on a series of mature businesses for profitability. Deposits and mortgages, the two most basic banking products, are heavily impacted by business cycles, rate environments, and population trends, driving heavy competition. These basic banking products face intense public scrutiny that could impact profitability. For example, credit cards, once a significant engine of interest income, have been surpassed by debit cards, as consumers rationalize debt and borrow less. At the same time, customers with lower credit scores, once a source of growth in the credit card industry, are defaulting at higher rates than ever. Even rewards programs and "elite" cards, once strong product differentiators, have become ubiquitous and commoditized. The combination of these trends places significant pressure on the core banking businesses at a time when bank viability is critical to the US economy.

II. The Relevancy Factor

Given these severe challenges to core bank revenue streams, new product and business model innovation may be the only way to protect bank profitability and viability. These challenges are compounded by the fact that less-regulated, non-banks continue to enter high-profit areas of financial services. In addition, many of these non-banks have found novel ways to offer financial services at a profit in segments where banks historically have been irrelevant. In fact, some of the fastest growing US consumer populations are already being served by innovative non-banks,

populations working, for example in hourly (often minimum wage) service sector jobs who need help managing finances and bill payment between paychecks. Growth in the Hispanic population growth brings another large group of customers to the US with no historical experience with traditional banks. Finally, as the tech-savvy “millennial generation” grows up, consumer expectations will continue to shift to new and evolving technology platforms.

Less-regulated non-banks, which typically face less regulatory scrutiny than traditional banks, are extremely interested in these high profit areas and have introduced a range of innovative products and services for underserved customer segments with the expectation of healthy profits while doing so. Many of these companies are reputable and responsible but some have been associated with serious consumer complaints, and others are fraudulent, involved in money laundering and usury.

To combat the “bad actors,” a host of federal and state laws have been enacted to reign in excess and protect consumers. Pro-consumer laws including Unfair or Deceptive Acts or Practices (UDAP), Equal Credit Opportunity Act (ECOA), Community Reinvestment Act (CRA), Fair Housing legislation, the Talent Amendment, state money transmitter laws, all aim to reduce abusive financial services practices while ensuring equal access to financial services. Recent economic events make it clear that these regulations failed to prevent all abuses, and some laws created unintended, negative consequences. For example, some critics argue that aggressive ECOA and CRA targets led to unsustainable innovation in the subprime mortgage segment. Most of these innovations were pioneered by non-banks.

Another example is the cap on military loans enacted in 2007. The original legislation was in response to the findings of a Pentagon study on the financial health of the armed services. The legislation passed quickly as part of the Defense Authorization Act, but before an analysis could determine what effect the loan cap would have. After the law was enacted, according to an article in the Small Loan Interest Rate Cap Review, the Department of Defense concluded that provisions in the amendment would have the unintended consequence of “severely restricting” access to fair and affordable credit for countless service members and their families.

Likewise, more recently passed legislation could also have unintended consequences creating innovation opportunities for non-banks, while adding to compliance costs for traditional banks. The Home Ownership and Equity Protection Act (HOEPA), the SAFE Act, UDAP, Protecting Consumers from Unreasonable Credit Rates Act, and the Interest Rate Equity Act all are examples that could have positive or negative consumer impacts. Some critics express concerns that this legislation could ultimately limit access to credit, and even drive consumers with legitimate credit needs toward unsavory credit sources.

III. Conclusion

Financial institutions have proven that they can innovate during stable times. Mobile banking, remittance and unsecured credit solutions are examples of this kind of successful innovation. Increased scrutiny from regulators, legislators and the press may threaten these tendencies. For example, Anti Money Laundering and Office of Foreign Assets Control regulations have caused many banks to reconsider remittance products and commercial relationships with money service providers. State regulations combined with some serious lawsuits caused many banks to exit the gift card and other prepaid businesses. At the same time, companies like Vodafone and Obopay jumped in with remittance innovations, while non-banks came to dominate the prepaid card market.

Similarly, banks with compliant unsecured loan programs struggled with profitability and press backlash stemming from claims that these products targeted illegal immigrants. CRA home loans also came under attack as part of the subprime debacle. Each setback caused banks to become more conservative, even as less-regulated players continue to innovate.

The lesson here is that innovation will occur with or without regulation, and thus it is important to ensure that “good actors,” including banks and traditional financial services companies, aren’t handicapped around innovation. In an environment of aggressive regulation, this is more important than ever.

Margaret Weichert is the Founder and CEO at The Morgan Weichert Group, LLC, a financial services consulting firm. Weichert recently served as the eCommerce/ATM Business Planning and Analytics Executive at Bank of America (BAC), with responsibility for strategy, innovation, business development, business intelligence and analytics for eCommerce, ATM and mobile channels.