February 3, 2009

Executive Pay and the Bailout

An analysis of new proposals for change

By Sarah Anderson and Sam Pizzigati, Institute for Policy Studies

Introduction

In recent weeks, two legislative initiatives have aimed to crack down on profiteering from the financial bailout. Both were prompted by evidence that the pay restrictions in the original bailout bill have proven largely toothless. Some of the recipients — most notably AIG, Morgan Stanley, and Goldman Sachs — have doled out sizeable bonuses to high-ranking staff since receiving billions in taxpayer support. Wall Street firms as a whole handed out more than $18 billion in bonuses last year. This memo analyzes both initiatives – Sen. Claire McCaskill's proposal to set a fixed ceiling for all employees of bailed-out firms and Rep. Barney Frank's broader reform of the original bailout legislation.

McCaskill's Cap Executive Officer Pay Act

On January 30, Sen. Claire McCaskill (D-MO) introduced a bill that would cap compensation of all employees of bailed-out firms at no more than $400,000 — the salary of the President of the United States. The proposal effectively closes loopholes in other legislation by defining "compensation" broadly to cover all forms, including options, deferred compensation, and retirement fund contributions.

McCaskill is not the first official to call for a fixed pay ceiling. Senators John McCain (R-AZ) and Diane Feinstein (D-CA) have both called for capping compensation at the $400,000 level. Rep. Brad Sherman (D-CA) has called for a cap on all compensation at $1 million.

The Institute for Policy Studies offers an alternate approach that would define the bailout pay cap as either the fixed $400,000 or a ratio between an enterprise's top-paid and lowest-paid staff. Excessive pay gaps within corporate enterprises, as research has shown, undermine enterprise effectiveness. The preeminent business thinker of the 20th century, Peter Drucker, considered a 20- or 25-to-1 compensation ratio between the top of the corporate ladder and the bottom an appropriate pay standard. The President's $400,000 represents about 25 times the annual pay of the federal government's lowest-paid employee.

Any executive pay restrictions in the bailout reforms Congress considers should also apply to the companies hired to manage the bailout's operations. Private firms, as news reports indicate, are already lining up to cash in on the bailout.

Frank's TARP Reform Bill

On January 21, the House of Representatives approved a bill that aims, among other provisions, to tighten executive pay restrictions in the Troubled Assets Relief Program, or TARP. This bill would make some progress towards preventing such bailout profiteering. But the legislation's pay reform provisions leave open loopholes that executives can be expected to exploit.

Significant improvements in the TARP reform legislation

Crafted by House Financial Services Committee Chair Rep. Barney Frank (D-MA), the TARP Reform and Accountability Act would strengthen limits on bailout-related executive pay in three prime areas.

- **Uniform rules:** The Frank bill would replace the multiple and unnecessarily complex triggers for executive pay limits in the original TARP with a reform that would expand the strictest rules to cover all firms receiving bailout dollars. The Treasury Secretary also would be allowed, but not required, to apply these rules retroactively to firms that received taxpayer support via through the first $350 billion TARP tranche.
- **Bonus ban:** The reform would add a new prohibition against bonuses for the top 25 highest-paid employees at each recipient firm.
- **Private jets grounded:** The reform would also add a new ban on the ownership of private jets.

The major shortcoming in the Frank legislation: No limits on total pay
The original TARP executive pay restrictions failed to set any specific limit on executive compensation at bailed-out firms. On this yardstick, the Frank reform proposal also falls short. To be sure, it does place limits on bonuses and severance. But unlike the McCaskill bill, the House proposal would allow the Treasury secretary to look the other way if bailed-out firms continue to hand executives massive amounts of other forms of compensation.

The Frank reform legislation merely requires that the Treasury ensure that "incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution." The legislation does not define what might constitute an "unnecessary and excessive risk." Under this provision, notes Rep. Brad Sherman (D-CA), bailed-out firms would still be able to compensate their executives at a "$1 million-per-month" level.

A detailed analysis of the original TARP executive pay provisions

The current TARP applies three different sets of executive compensation criteria, depending on whether the government:

- provides equity capital to the institution,
- provides direct assistance to a failing institution, or
- purchases troubled assets through auction.

The strictest criteria apply only to "failing institutions."

<table>
<tr><th>Capital Purchase Program
(The Treasury provides equity capital directly to certain financial institutions)</th><th>Programs For Systemically Significant Failing Institutions
(Treasury provides direct assistance to firms negotiated on a case-by-case basis)</th><th>Troubled Asset Auction Program
(Treasury purchases troubled assets through auction and such purchases exceed $300 million)</th></tr>
<tr><td colspan="2">Limits on pay: Treasury will ensure that "incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution."</td><td>No limits on pay</td></tr>
<tr><td colspan="2">Clawback: Bonuses or other awards based on inaccurate financial reports must be returned.</td><td>No criteria on clawbacks.</td></tr>
<tr><td>Severance: Ban on "golden parachutes" for top five senior executives, based on the Internal Revenue Code provision 280G. This limits such payments to no more than three times the executive's average annual compensation over the five preceding years.</td><td>Severance: Ban on all payments to departing senior executives (most strict).</td><td>Severance: Ban on golden parachutes for executives hired after the auction. For other executives, institution may not deduct certain golden parachute payments to its senior executives and a 20% excise tax will be imposed on the senior executive for these parachute payments.</td></tr>
<tr><td colspan="3">Cap on tax deductibility: Firms will not be allowed to deduct executive pay that exceeds $500,000 per year from their corporate income taxes.</td></tr>
</table>

A detailed analysis of the Frank reform bill executive pay rules

All recipient firms, under the House legislation, would receive the same treatment, regardless of the particular bailout category they fall into. The Treasury Secretary would have the authority, but not a strict mandate, to apply the restrictions retroactively to financial institutions that already have received bailout funds.

Restriction	Analysis
Limits on pay: Treasury will ensure that "incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution during the period that any assistance under this title is outstanding."	**No significant change.** The proposed reform merely extends this language in the existing law to all participating firms.
Bonuses: Prohibits firms from paying or accruing any bonus or incentive compensation for the 25 most highly compensated employees during the period that the assistance is outstanding.	**New.** This is a significant effort to respond to recent bonus scandals, but firms may merely compensate for the loss of bonuses by increasing salary levels.
Clawback: Bonuses or other awards based on materially inaccurate financial reports must be returned to the institution.	**No significant change.** The proposed reform merely extends this language in the current law to all participating firms.
Severance: Ban on "golden parachutes" for all senior executives for the duration of the investment.	**No significant change.** Extends restrictions on failing institutions to all participating firms.
Cap on tax deductibility: Firms will not be allowed to deduct executive pay that exceeds $500,000 per year from their corporate income taxes.	**No change.** The current U.S. tax code places a $1 million cap on tax deductibility for executive compensation, but this provision has been meaningless in practice because it allows exceptions for "performance-based" pay. Most companies simply limit top salaries to around $1 million and then add on to that total various assortments of "performance-based" bonuses, stock options, and other long-term compensation. The TARP closes this loophole by making the exception for "performance-based" pay inapplicable in the case of executives of bailed-out firms.
Private jets: Firms may not own or lease any private aircraft. If they owned an aircraft immediately prior to receiving the assistance, they must demonstrate that they are taking reasonable steps to divest.	**New.** One possible loophole: Firms have already begun chartering private jets instead of owning or leasing them.
Earnings manipulation: The bill includes a prohibition on "any compensation plan that would encourage manipulation of such institution's reported earnings to enhance the compensation of any of its employees."	**New.** This provision is presumably designed to discourage executives from "cooking the books" to inflate the value of their personal stock options. But Treasury officials, as *Los Angeles Times* financial columnist Tom Petruno points out, would likely have problems monitoring this prohibition.

Additional Resources

Institute for Policy Studies, Second Chance: A Sensible Plan for Getting the Recovery Right, January 2009.

Executive Excess 2008: How Average Taxpayers Subsidize Runaway Pay, Institute for Policy Studies and United for a Fair Economy, August 2008.

High Flyers: How Private Jet Travel Is Straining the System, Warming the Planet, and Costing You Money, Institute for Policy Studies and Essential Action, June 2008.

Contacts

Sarah Anderson is the Director of the Global Economy Project at the Institute for Policy Studies and a co-author of 15 IPS annual reports on executive compensation. Contact: saraha@igc.org, tel: 202 234 9382 x 227 (office), 202 299 4531 (cell).

Sam Pizzigati is an Associate Fellow of the Institute for Policy Studies and the author of *Greed and Good: Understanding and Overcoming the Inequality That Limits Our Lives* (Apex Press, 2004). He edits Too Much, on online weekly on excess and inequality. Contact: editor@toomuchonline.org, 301 933 2710.

About IPS

The Institute for Policy Studies, founded in 1963, has published 15 widely publicized annual reports on executive pay. The latest, Executive Excess 2008, released August 25, 2008, finds that five tax loopholes that benefit top executives cost taxpayers more than $20 billion per year.

For more than four decades, the Institute for Policy Studies has transformed ideas into action for peace, justice, and the environment. It is a progressive multi-issue think tank. http://www.ips-dc.org.