

Obama and Executive Compensation: Real Pressure on Financial Corporations Yet to Come

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Abstract: Executive compensation has become a spark point of anger for Americans following the peak of the financial crisis. As everyday men and women lose their jobs, their homes, their pensions and their savings, it is infuriating and hard to understand how a select few corporate officials receive millions of dollars in bonuses for taking enormous risks and steering major companies, and the economy, into the ground. Worse than that, these men and women have lost billions of dollars in tax payer money, as a result of an economic scheme that encourages wild risk taking and minimizes the potential for personal loss. As a result, Americans have begun to rally against exorbitant corporate bonuses, and increased public pressure has been placed on President Obama and his new administration to change the present reality. Many of the new restrictions on executive compensation fall under the actions of the Troubled Asset Relief Program (TARP), Obama's most thorough effort for reform and restructuring following the financial crisis. These measures, however, lack a true step forward in restricting the power of America's oligarchs. TARP's restrictions are unspecific, provide for loopholes and do not reach the troubled financial sector as a whole. Further steps must be taken for true change and real economic security in the United States.

Obama and Executive Compensation: Real Pressure on Financial Corporations Yet to Come

Today, the reality of the financial crisis has removed the question of whether or not the United States government under the new leadership of President Obama should regulate the financial sector or not. Instead, the issue has become what sort of regulation should be imposed, and to what degree. Executive compensations to high-ranking members of financial corporations such as AIG play a crucial role in these regulation plans. Such exorbitant bonuses, severance packages and "performance rewards" have become a rallying point of anger for investors and tax payers, who (rightfully so) cannot comprehend why they should be tasked with paying for multimillion dollar bonus packages for executives responsible for the extreme risk-taking and irresponsible behavior that has wreaked such havoc on the American economy in the past year and a half. These packages were a large part of the government decision not to provide federal rescue for Lehman Brothers, despite assistance to other companies with similar situations. As late as January 2008, Lehman CEO Richard Fuld had used 10 billion dollars of capital in year-end bonuses to top executives and dismissed suggestions that executives go without bonuses for the good of the company's liquidity, stock prices and public image. These actions led to a perception by both the American people and the federal government that the company had been mismanaged, and had disregarded stockholders and tax payers who could not even begin to comprehend the amount of money these executives were receiving in spite of poor performance. Government officials, who must always keep the idea of re-election in the back of their mind when planning a course of action, were reluctant and eventually unwilling to use taxpayer money to bailout Lehman Brothers and fund such bloated salaries. Beyond the mere anger that excessive executive compensation has inspired, it also indicates a fundamental flaw in the former structure of many companies, one that encouraged wild, high-stakes risk taking with the possibility of enormous

personal benefit and only minimal opportunity for personal loss¹. Therefore, executive compensation is tied to the present problems of risk-taking in many corporations, and must be addressed by President Obama's reform plans in order to truly change the financial structure for the benefit of the American economy.

The issues of executive compensation played an important but sometimes overlooked role in the development and extent of the financial crisis. Alan S. Blinder, a professor of economics and public affairs and a former vice chairman of the Federal Reserve Board, has written extensively on the topic for the Wall Street Journal. The inflated bonus and compensation schemes provide a large incentive for financial executives to take enormous risks with other people's money. According to Binder, intelligent and often young officers of corporations are presented with two potential outcomes from risk taking. Their enormous risks can pay off, and they can receive untold sums of money, or the bet won't pay off and the executive will still receive an enormously above-average salary, with much of the company's losses covered by stockholder's (or government and taxpayer's) money. This structure provides a clear incentive to go for an all-or-nothing approach with the possibility of the kind of payouts that the average American could not dream of receiving. The structure is also exacerbated by similar incentives for CEOs, who can rely on "golden parachute" payments that provide them with enormous sums of money even if their risks are damaging to the company. These safety nets and executive benefits create an environment in which executives are encouraged to take enormous risks with stockholder money, with little concern for potential negative outcomes. Blinder claims that this is why hedge funds operated with so much less risk than banks and other financial institutions, as hedge funds often involve some significant portion of senior partner's own money. With this link between personal and corporate success so firmly established, executives are far less likely to take such enormous risks, for fear of individual loss. Executive compensations have become an enormous part of the risk-taking problems that have pulled the financial sector into ruins². The Obama administration is tasked with overhauling the present system in order to tie corporate responsibility with corporate funds, and prevent these wild, unmitigated risks that are so harmful for the American public.

Present efforts by the presidential administration fall under the category of the Troubled Asset Relief Program (TARP). TARP is the largest sector of the government's efforts for recovery from the sub-prime mortgage crisis and the disintegration of the financial sector in 2008, and involves federal purchase of assets and equity from suffering companies in order to strengthen the economy. Companies that receive payment from the government in order to regroup and strengthen their internal structure must submit themselves to certain restrictions set forth by the Department of the Treasury and the Federal Reserve³. A section of these restrictions pertain to rules for executive compensation. For corporations that accept assistance from TARP, there are four main guidelines that they must adhere to in the realm of executive pay, bonuses and compensation. First, the corporation must guarantee that no senior executive officer (SEO) is provided with a compensation plan that rewards unnecessary and excessive risk that could possibly place the company in danger. Second, SEO bonuses and compensations can be "clawed-back" or rescinded if it is discovered that their amount was based on inaccurate measurement of financial capacity or performance review. Third, golden parachute payments are not permissible to SEO's upon termination, and finally, a cap of \$500,000 is placed upon payment for senior executive officials. This payment is slightly more generous than the lowest

¹ Alan S. Blinder [Crazy Compensation and the Crisis](http://online.wsj.com/article/SB124346974150760597.html#printMode)
<<http://online.wsj.com/article/SB124346974150760597.html#printMode>>.

² [Crazy Compensation and the Crisis](#)

³ [Executive Compensation Rules for the TARP Capital Program](http://www.bankbryancave.com/wp-content/uploads/2008/10/tarp-executive-compensation-rules.pdf)
<<http://www.bankbryancave.com/wp-content/uploads/2008/10/tarp-executive-compensation-rules.pdf>>.

restrictions initially proposed in the senate by Senator Clair McCaskill: \$400,000, the same as the President's salary⁴. These restrictions act more as procedural requirements, leaving much of the restructuring up to the actual boards and officials of affected corporations, as well as the decisions of shareholders. While TARP regulations do provide certain specifications, such as the determination of what constitutes an SEO, what constitutes a termination that will render a golden parachute payment impermissible and how long the government will have influence over corporations accepting TARP funds, much is left up to shareholders and the same companies whose structures resulted in many of the country's economic woes. This presents many potential problems, opportunities for loopholes and chances for companies to get around a real restructuring that limits executive pay⁵.

One problem with leaving so much of the future of executive compensation up to the corporations themselves is that companies can place the decision to provide extra compensation packages up to a shareholder vote. It may seem that, with the current climate towards CEOs and other executives, this vote would be guaranteed to yield a result against executive bonuses. Experience, however, has proved this not to be the case. Shareholders for suffering banks including Citigroup Inc. and Bank of America Corp⁶. have so far voted in approval of the executive compensation plans put forward by boards of directors. This is a far different situation from voters in other countries, such as Britain, where stockholders voted down the executive compensation plan submitted by Royal Dutch Shell PLC, the largest oil company in Europe. Shell had claimed that executive bonuses would only be paid out if the company reached certain internal targets, specifically placing as one of the top three of its peers in a ranking of total returns to shareholders. Therefore, the executive bonuses could be called performance-based dividends. Shell finished fourth, and shareholders took a stand in a new wave of activism reflecting anger over enormous boardroom payouts and excess. In Britain, shareholders have also voted down compensation plans from the Royal Bank of Scotland Group, Bellway PLC, and Provident Financial PLC. The compensations provided to executives could practically be called small by the standards of the American financial sector, amounting to about \$1.76 million for Jeroen van der Veer, Shell's Chief Executive. By comparison, Rex Tillerson, the Chief Executive of Exxon Mobile Corp., America's largest oil company, received a compensation package for 2008 amounting to \$23.9 million. Many people blame this voting disparity on the fact that British companies have been subject to an annual advisory vote for their executive pay plans since 2003, and shareholders have gotten used to the power. The vote was new in the United States, introduced by Congress in February of 2009 for companies that would benefit from federal bailout funds. It is possible that there was not enough time for investors to organize campaigns against the pay plans or to exercise the newfound power of their advisory vote⁷. But even if this is the only reason that shareholders in the United States are approving executive pay plans, the trend could yield companies the chance to maintain compensations until they can repay TARP fund assistance, at which point they will be free of the restriction. This is only one of an assortment of way by which companies can get around the restrictions that accompany the acceptance of TARP assistance.

Recently, banks that accepted TARP payments have been moving rapidly to ease their dependence on such funds. Already, these institutions have paid back the aid they received in a sum close to \$40.87 billion. While this may seem to be a beneficial step for the previously suffering institution, the motives behind the rapid repayment are less progressive. Many banks are eager to

⁴ [Executive Compensation Plans for TARP Capital Program](#)

⁵ A. R. Sorkin [Obama's Executive Pay Plan May Have Loopholes](#)

<http://dealbook.blogs.nytimes.com/2009/02/06/obamas-executive-pay-plan-may-have-loopholes/html>

⁶ Chazan, Guy [Shell Investors Revolt Over Executive Pay Plan](#) *Wall Street Journal*

⁷ [Shell Investors Revolt Over Executive Pay Plan](#)

repay because it means they will be free of the restrictions on executive compensation that accompany TARP funds. As a result of the need to repay federal money, banks end up pushing the burden onto investors, in the form of diluted and expensive stock offerings and smaller dividend payouts. Executives have a lot to lose in accepting TARP payments, in the form of dividends they would have received, once again providing incentives for behaviors that negatively impact shareholders and investors in their companies. Banks' actions affect stockholders by providing them with reduced dividends and a discounted stock offering, in order to maintain enough money to be able to pay back the federal government. Many companies continue to under perform, such as the Bank of New York Mellon, whose first quarter profits fell 57%, with smaller revenues and the critical review of being a "challenging environment."⁸ With these actions to raise capital and free themselves from government influence, banks have not discovered a consequence-free solution. As any basic economics course will teach you, there is no such thing as a free lunch. Institutions such as the Bank of New York and Capital One Financial, have taken on millions in underwriting fees. Nevertheless, the impact on shareholders is probably the largest problem accompanying the actions of the institutions to free themselves of TARP restrictions. Obama's plans are providing some unintended incentives to corporations, and are proving ineffective for companies which do not agree to be under the provision of the government through TARP, or who can relieve themselves of their debt and the accompanying restrictions.

This is not the first time the federal government has attempted to restrict executive pay. In 1993, President Clinton attempted to cap the amount of money going towards corporate compensations that companies could write off as tax deductions at \$1 million. Clinton's actions were similarly affected by the tide of popular opinion against high-earning corporate officials who had steered companies into economic quagmires. Clinton made packages that were tied to company performance exempt from restriction, which made it easy for companies to dodge the rules. His plan affected only a few, and had not potential for the sweeping reform he aimed for. Over time, Clinton's efforts for regulation in this area have become an economic joke. His plan allows corporations to deduct payment that is tied to any sort of performance or goal-achievement, no matter how vague, including companies which have deducted for the "individual achievement of personal commitments" or maintaining a "fun" working environment⁹. The policies were ineffective and in fact led to an enormous hike in the quantity of executive compensation. Some go so far as to blame Clinton for ushering in the period of exorbitant corporate bonuses and spending¹⁰. It is highly possible, and perhaps beneficial, that Obama's policies are impacted by fear of introducing similar negative incentives, but the same sorts of problems are arising from the executive compensation restrictions included in TARP. Obama needs to take more broadly effective action that targets the real problems and the structural implications of high executive pay. He must close loopholes, ensure the firm assistance of federal guidelines and make efforts to reach corporations that do not accept government assistance.

There exists an unpopular but not entirely illogical argument that executive pay should not be curbed at all, especially not now. Now is the time when companies would benefit most from bright, talented leadership, but also the time when corporate executive positions have become least desirable. The position requires a dramatically increased time commitment, responsibility and personal risk, and an excessively diminished opportunity for the sort of benefit the position once carried. Without

⁸ D. Weidner [Banks Kick the TARP Habit, but Keep Another Vice](http://online.wsk.com/article/SB124223172335815695.htm#printMode)
<<http://online.wsk.com/article/SB124223172335815695.htm#printMode>>.

⁹ H. Gleckman [Executive Pay: Clinton's Curbs are Out of Touch—And Out of Bounds](http://www.businessweek.com/archives/1993/b331025.arc.htm)
<<http://www.businessweek.com/archives/1993/b331025.arc.htm>>.

¹⁰ [How Bill Clinton Helped Boost CEO Pay](http://www.businessweek.com/magazine/content/06_48/b4011079.htm)
<http://www.businessweek.com/magazine/content/06_48/b4011079.htm>.

executive compensation, it becomes a simple matter of a good offer from a foreign company to attract away some of the brightest minds of the United States. In a way, the country could suffer from a reverse of the “brain drain” that has become such a problem for the developing world, who send their best and brightest abroad to receive an education and rarely, if ever, see them return to the lower pay and job security they offer at home. Perhaps now is the time when those who could steer companies with the most effective leadership should be given incentives to take these now-undesirable jobs, for the good of the financial sector and the American economy¹¹. This argument may make sense to a certain degree, but another thing that most economics courses will teach you is the disparity between what makes good economic sense and what makes good political sense. Obama, like all presidents before him, has been and will be influenced by public opinion, since his power as an elected official comes from his voting constituency. Even if executive compensations made the best economic sense now, it is likely that restriction would continue, as so much of America, the oft-referred to “Main Street” is furious with the exorbitant annual pay that high-ranking officials can rely on despite the failure of their respective companies. Right now, as Obama and the federal government have chosen the path of restriction on executive compensation, it is crucial that the restriction become more of a reality. Obama’s plans, at the present moment, do not apply to all companies, provide loopholes for other methods of executive compensation, and introduce negative incentives for companies and top officials. Real pressure on the companies that pulled down the national economy has yet to be applied, and real change to the corporate structure of executive compensation still waits in the wing. The final objective of the plan is to restructure corporate pay strategies, strengthen the financial sector, reduce the amount of money going to inflated executive salaries and improve the public image of America’s financial system. This will not be achieved until Obama improves, strengthens and tightens TARP’s restrictions on executive compensation. Though TARP provides, at this moment, Obama’s best option to truly take on executive compensation, it is weak. It needs to be applied to a broader spectrum of business, and Obama needs to step forward, not shy away, from challenging the giants of Wall Street. TARP and the President cannot waffle on an issue so linked to the financial crisis, the confidence of the American public and the country’s economic well-being. Obama needs to attack bloated salaries, corporate excess and irresponsible corporations head on. If he cannot achieve this, the damaging business structure will remain, and it may prove impossible for this country to learn from its financial mistakes.

¹¹ G. Davis [In Defense of Director Pay](http://online.wskj.com/article/SB123913868134198323.html#printMode)
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