

Analysis of Treasury Department Rules on Executive Compensation for Bailout Firms



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On October 14, 2008, the Treasury Department issued rules for executive pay for firms participating in the government’s financial sector bailout. These rules clarify some provisions of the bailout legislation, but reinforce the law’s major shortcoming: the failure to set any specific monetary limits on the pay of top executives at bailed-out companies.

The bill applies three different sets of executive compensation criteria, depending on whether 1) the government provides equity capital to the institution, 2) provides direct assistance to a failing institution, or 3) purchases troubled assets through auction. The strictest criteria apply to the failing institutions.

SUMMARY OF EXECUTIVE PAY RULES

Capital Purchase Program (Treasury provides equity capital directly to certain financial institutions)	Programs For Systemically Significant Failing Institutions (Treasury provides direct assistance to firms negotiated on a case-by-case basis)	Troubled Asset Auction Program (Treasury purchases troubled assets through auction and such purchases exceed \$300 million)
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.”		No limits on pay
Clawback: Bonuses or other awards based on inaccurate financial reports must be returned.		No criteria on clawbacks.

<p>Severance: Ban on “golden parachutes” for top five senior executives, based on an Internal Revenue Code provision that limits such payments to no more than three times the executive’s average annual compensation over the five preceding years.</p>	<p>Severance: Ban on all payments to departing senior executives (most strict).</p>	<p>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.</p>
<p>Cap on tax deductibility: Firms will not be allowed to deduct executive pay that exceeds \$500,000 per year from their corporate income taxes.</p>		

DETAILED ANALYSIS

Major shortcoming: No set limits on compensation

The key rule on executive compensation allows the Treasury Secretary to look the other way if bailed out firms continue to hand out massive paychecks to executives. The rule 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.” Neither the legislation nor the Treasury Department rules define what might constitute an “unnecessary and excessive risk.”

There is nothing in the Treasury Department’s new rules that would prevent a nationalized bank’s board of directors from approving a \$20 million CEO pay package — unless the Treasury Secretary decides that reward poses an excessive risk to the institution. And without clear limits on pay, the public is being asked to put their trust in Secretary Paulson, a man who made hundreds of millions of dollars as a Wall Street CEO, to decide what’s “excessive.”

The Institute for Policy Studies has calculated that the nine major banks receiving massive capital infusions from the Treasury paid their CEOs a combined \$289 million in 2007, including stock options.

Nationalized banks	CEO in 2007	Total Compensation (2007)
Merrill Lynch,	John Thain	83,092,713
Goldman Sachs	Lloyd Blankfein	53,965,418
Morgan Stanley	John Mack	41,734,815
J.P. Morgan Chase	James Dimon	28,856,330
Bank of New York Mellon	Robert Kelly	20,515,810
State Street	Ronald Logue	19,551,400
Wells Fargo	Richard Kovacevich	18,510,694
Citigroup	Vikram Pandit*	3,160,000
Bank of America	Kenneth Lewis	20,040,000
Total		289,427,180

* Pandit was promoted to CEO in Dec. 2007, 8 months after joining Citigroup.

Source: Associated Press inter-active online survey. Includes salary, bonuses, perks, above-market interest on deferred compensation and the value of stock and option awards. Stock and options awards were measured at their fair value on the day of the grants.

A Bright Spot: Cap on Tax Deductibility Strengthened

The Treasury rules expand the \$500,000 cap on tax deductibility to all participating firms. The bailout legislation applied that cap only to firms that sell assets to the government through auction.

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 executive 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 bailout legislation (and the new Treasury rules) closes this loophole by making the exception for “performance-based” pay inapplicable in the case of executives of bailed-out firms.

Additional Rules

Golden parachutes: The top five senior executive officers of participating firms will face varying degrees of restrictions on severance payments. The strictest rule will apply to executives of “failing institutions,” who cannot receive any type of payment upon leaving the company. For firms receiving equity capital from the government, parachute payments will be limited to no more than three times the executive’s average annual compensation over the five preceding years. In other words, if an executive averaged \$1 million in compensation per year, he could not receive more than \$2.9 million in severance. The relevant tax code provision, 280G, is explained in detail in an IRS memo posted on the Treasury Department web site (see link below). For firms that sell assets to the government through auction, the golden parachute criteria will only apply to managers hired after the auction.

Clawback: Executives of bailed-out firms who receive bonuses or other awards that later turn out to be based on “materially inaccurate” financial reports will need to give that money back. This rule applies only to firms that receive direct government assistance.

ADDITIONAL RESOURCES

Broader Critique of the Bailout Bill

For additional IPS analysis on the broader aspects of the bailout bill, see: www.ips-dc.org. These materials include a “Sensible Plan for Recovery” that calls for a “green” stimulus for the real economy, measures to make Wall Street speculators pay for the U.S. bailout, and regulations to shut down the global financial casino.

Government Documents

Treasury Department, “Executive Compensation Rules Under the Emergency Economic Stabilization Act”:

<http://treas.gov/press/releases/2008101495019994.htm>

Internal Revenue Service, explains the fine print of the Treasury Department Rules:

<http://www.irs.gov/pub/irs-drop/n-08-94.pdf>

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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.

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