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The mark-to-market valuation and executive pay package regulations within the 2009 US (Bailout) Emergency Economic Stabilization Act

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The paper shows that the effect of the Emergency Economic Stabilization Act (EESA) is ambiguous. It discusses the benefits and costs of mark-to-market valuation and design of executive pay package policies within the US 2009 EESA. It highlights how the mark-to-market valuation standard influenced financial institutions, explains why mark-to-market policy suspension proponents can support the EESA, and realizes how the Financial Accounting Standards Board (FASB) and Securities Exchange Commission (SEC) can count on the EESA while assessing the need and cost of the mark-to-market policy. Also, the paper discusses the promise of executive wage caps within the EESA. Moreover, it differentiates between executive pay packages pre- and post-EESA policies.

Keywords: corporate governance; financial crisis; bailout; EESA; mark-to-market valuation; executive pay package caps

JEL Classifications: G1, G2, J3, K2, L5, M5

Introduction

The autumn of 2008 witnessed what was probably the most extensive and prolonged breakdown of the US credit mechanism that has occurred since the establishment of the banking system. The deadweight losses from bankruptcies, foreclosures and job losses are significant. In February 2009, the number of unemployed persons increased by 253,000 to 12.5 million. Between January 2008 and February 2009, the number of unemployed persons in the US increased by about 5 million, and the unemployment rate has risen by 3.3%.¹ The actions being taken are extraordinary; they aim to stabilize the economy, preserve home-ownership, protect taxpayers, provide no windfalls for certain executives, and strengthen oversight. However, these actions – stated in the Emergency Economic Stabilization Act (EESA) – entail a moral hazard and a potential recession-triggering signal.

The moral hazard can be represented by bailing out firms that have miscalculated in the market. This attitude can shoulder taxpayers with costs that should be borne instead by those who made the mistakes. Any indication from government that it will save one group of investors encourages others to line up for help. The prospect of ultimate protection induces others to make riskier business decisions. The logic, in the case of banking sector, would be that bankers are concerned about the total risk exposure of their loan portfolio. When banks enjoy better creditor protection, the lower expected losses on bad loans enables them to increase operating risk by making more loans per dollar of assets.

A potential recession-triggering signal happens when a wave of bad decisions in one sector of the economy threatens basic operations of the economy by causing unfavorable

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consequences in other economic sectors. In this situation, the government institutions have a critical role to help certain sectors. These institutions are supposed to assure the integrity of the market structure, from the sanctity of contracts to the liquidity of the financial markets. When government fails to carry out this role in critical times, such as its failure to maintain liquidity after the stock market crash of 1929, the results can be catastrophic.

The challenge today is how to reconcile the moral hazard and recession-triggering signals in light of the crisis that has been engulfing financial and equity markets. What is the appropriate role of government institutions such as the Federal Reserve Board, the Securities and Exchange Commission (SEC) and the Treasury? And how do they assure that actions taken to resolve the crisis do not reward investors who should suffer the consequences of their decisions or create incentives for other investors to speculate against the taxpayer? For instance, the government doesn't want banks to overvalue bad loans like Japan did. However, mark-to-market accounting may force banks to raise reserves, worsening the credit crunch. In addition, it is inherently difficult to design executive pay packages to give the correct incentives, because it is controversial to limit executive compensation while asking them to provide more efforts (and sometimes more risk) to enhance firms performance. This paper analyzes the economic benefits and costs of mark-to-market valuation policies and design of executive pay packages within the US 2009 (Bailout) Emergency Economic Stabilization Act.

Mark-to-market accounting policy: costs and benefits

Accounting standards do not usually gain public attention. Manipulating financial statements is legally complex to most US businesses, given the auditing requirements after the Enron and WorldCom scandals in 2001. This does not indicate that financial manipulation cannot occur in the United States, because it can happen. For instance, on March 12, 2009, Bernard Madoff pled guilty to an 11-count criminal complaint admitting to defrauding thousands of investors through a massive Ponzi scheme, which included fabricated gains of almost \$65 billion. However, during autumn 2008, accounting standards were suddenly again in the news while legislators watched closely the ongoing financial crisis. Financial professionals and legal experts are revisiting book-value versus fair-value accounting concepts. The debate over mark-to-market accounting, which is a subset of fair-value accounting, and its role in the financial crisis made its way to Congress during the first half of March 2009. The concern is that banks will not incur the losses booked per mark-to-market accounting as asset values recover over time from today's clearance sale prices. The mark-to-market concept sounds trivial, especially when compared to a \$787 billion rescue plan, but it is a significant step toward addressing the causes of the credit crisis.

Known as mark-to-market, the new standard influenced financial institutions. First, it led them to revalue assets they held to their market value on the day that the reporting period ended. Previously, firms had either used an average value of their assets over a period of time or valued long-term investments that they had no intention of selling at their purchase price until they were eventually sold.

Second, mark-to-market accounting standards introduced more volatility to balance sheets of firms. When asset prices change, book values may generate both regulatory procedures and fear about their feasibility. It is important to remember, nevertheless, that the mark-to-market guiding principle aimed to offer investors a better idea of the present worth of certain assets and to lessen the likelihood of firms manipulating revenues or concealing certain investments.

Third, the devaluation that resulted from the markdown of mortgage-backed securities has forced highly leveraged financial firms to ask for new capital or put liquid assets on sale to bring their leverage down. Those firms that were not able to raise enough cash have found their market value wiped out, and have been obliged to merge with a stronger firm or move toward bankruptcy. This policy set a challenging precedent for accountants who demanded that other financial firms devalue similar mortgage-backed securities under mark-to-market accounting standards. Bankers have been complaining loudly that they have been required to mark assets to an unrealistically low market value.

Fourth, the problem with mark-to-market comes when assets are not easily measured. For example, in November 2007, the Financial Accounting Standards Board (FASB) issued new rules (FAS 157) concerning how firms should value assets for which there is no actual market, making it more challenging for firms to avoid allocating market prices for assets that are hardest to value, commonly-known as Level 3 assets. FASB's timing was not optimal. There was an increasing number of complex assets for which there was simply no market, given the increase in the depth of problems related to mortgage-related securities. Further, various firms have been required to record assets at fire sale prices. The result: firms started to reflect lower value estimates of these assets on their financial statements, even in cases where the firm had planned from the beginning to hold the assets for some time. This did not only misrepresent their real value but also triggered an immediate need to raise more capital, causing more work for regulated entities. The net effect was significant: in November 2007, Bloomberg estimated that reported asset values would be reduced by \$100 billion due to the change in valuation policy.² Moreover, in November 2007, the share price of Morgan Stanley, the second-largest US securities firm dropped by 6% to \$51.19 in New York Stock Exchange. Lehman Brothers Holdings Inc. and Bear Stearns Cos., the Number One and Number Two underwriters of US mortgage bonds, each declined more than 5% in the same month.

Under FASB terminology, Level 1 means mark-to-market, where an asset's worth is based on a real price. Level 2 is mark-to-market model, an estimate based on observable inputs which is used when no quoted prices are available. Level 3 values are based on "unobservable" inputs reflecting companies' "own assumptions" about the way assets would be priced. It is inevitable that more firms will have to revalue at least a substantial portion of assets they currently value using mark-to-market accounting standards as prices of mortgage-related assets decrease due to foreclosures. For instance, Citigroup Inc. has 105% of its equity in Level 3 assets. Morgan Stanley has 251% of its equity in Level 3 assets, making it the most vulnerable to write downs, followed by Goldman Sachs Group Inc. at 185%.

Fifth, the losses are likely to harm bondholders less than stockholders because banks may need to raise capital by selling shares. ABX indices, which investors use to monitor the sub-prime bond market, are showing levels that can wipe out firms' capital if the benchmark prices were used to assess their Level 3 assets. For instance, the ABX-HE-PENN AAA index have stumbled between August 2008 and February 2009, falling 53% from \$57.5 to 37.5, mainly because investors expected rising numbers of borrowers to default on housing loans, limiting the cash flowing to the bonds that box up the mortgages.

Finally, illiquidity leads expected losses based on credit fundamentals to divert substantially from mark-to-market losses. Liquidity premium is the key difference given there is no exact measures of illiquidity discount or of expected losses based on fundamentals. The Bank of England (2008) estimated, based on actuarial methods, that the realized sub-prime related losses would reach \$170 billion. From another perspective, a market value-based estimate gives an expected loss of \$380 billion. This result is interestingly uncommon:

every comparison between market price-based measures and actuarial measures shows a similar trend; mainly that write-downs measured with market value-based measures are significantly higher than expected losses using different valuation methods. Conventional knowledge about the effect of illiquidity on prices makes this observation new but not surprising.

Mark-to-market opponents and supporters can make their cases. Mark-to-market opponents should support the EESA. Section 132 of the Act authorizes the SEC to suspend mark-to-market accounting rules “with respect to any class or category of transaction if the Commission determines that is necessary or appropriate in the public interest and is consistent with the protection of investors”. Section 133 ordered the SEC to “conduct a study on mark-to-market accounting standards as provided in FASB 157, as such standards are applicable to financial institutions, including depository institutions”. On the other side, supporters of mark-to-market accounting principle can make their case too. The problem is: although the application of the mark-to-market rules can include flaws, removing it would be no more accurate.

While financial statements of firms following mark-to-market valuation concept look more attractive in an unstable market, they would still not mirror reality using historical cost generally accepted accounting principles. Put simply, mark-to-market valuation means that firms should assess their assets using current market prices, not the price the firm originally paid for them. In principle, this can be a good policy – if a firm holds stock. For instance, a stock would be assessed at the trading price rather than the price the firm paid for the same stock perhaps ages ago. While investors and regulators can make better decisions if they know the real value of a company, other investors prefer a valuation that hides gains or losses.

A value investor may value a stock differently from how the market perceives it. Such valuation may be consistent with the price paid, not subject to fluctuations, and (or) not constrained by liquidity issues. A relevant example is Warren Buffett, who descends from the Benjamin Graham School of value investing. Value investors look for securities with prices that are unjustifiably low based on their intrinsic worth. When discussing stocks, determining intrinsic value can be tricky as there is no universally accepted way to obtain this figure. Most often, intrinsic worth is estimated by analyzing company fundamentals. Like bargain hunters, value investors seek products that are beneficial and of high quality but under-priced. In other words, the value investor searches for stocks that he or she believes are undervalued by the market. Like the bargain hunter, the value investor tries to find those items that are valuable but not recognized as such by the majority of other buyers.

The rules now under attack are neither as significant nor as inflexible as critics charge. Mark-to-market is generally limited to investments held for trading purposes, and to certain derivatives. For many financial institutions, these investments represent a minority of their total investment portfolio. A recent study by Bloomberg columnist David Reilly of the 12 largest banks in the KBW Bank Index shows that only 29% of the \$8.46 trillion in assets are at mark-to-market prices. In General Electric’s case, the portion is just 2%.³ Why is that so? Most bank assets are in loans, which are held at their original cost using amortization rules, minus a reserve that banks must set aside as a safety cushion for potential future losses.

Mark-to-market rules also give banks a choice. Mark-to-market accounting is not required for securities held to maturity, but a firm needs to demonstrate a “positive intent and ability” that it will do so. Further, an SEC 2008 report found that “over 90% of investments marked-to-market are valued based on observable inputs.”⁴

Financial institutions had no problem in using mark-to-market to benefit from the drop in prices of their own notes and bonds, since the rule also applies to liabilities. And

when the value of the securitized loans they held was soaring, they eagerly embraced mark-to-market. Once committed to that accounting discipline, though, they were obligated to continue doing so for the duration of their holding of securities they've marked-to-market. The question here is: are firms equally as willing to forego mark-to-market for valuing the same illiquid securities in client accounts for margin loans as they are for their proprietary trading accounts?

The FASB and SEC must stand firm in their respective efforts to ensure that investors get a true sense of the losses facing banks and investment firms. To be sure, mark-to-market accounting should be more precise, following, for example, the counsel of the President's Working Group on Financial Markets and the SEC's December 2008 recommendations for achieving greater clarity in valuation approaches.

Unfortunately, the FASB's proposal of 16 March 2009⁵ represents capitulation. It calls for "significant judgment" by banks in determining if a market or an asset is "inactive" and if a transaction is "distressed". This would give banks more discretion to throw out "quotes" and use valuation alternatives, including cash-flow estimates, to determine value in illiquid markets. In other words, it allows banks to substitute their own judgments of value for market prices.

The FASB is also changing the criteria used to determine impairment, giving companies more flexibility to not recognize impairments if they don't have "the intent to sell". Banks will only need to state that they are more likely than not to be able to hold onto an underwater asset until its price "recovers". Chief Financial Officers will also have a choice to divide impairments into "credit losses" and "other losses", which means fewer of these charges will be counted against income. If approved, companies could start this quarter to report net income that ignores sharp declines in securities they own.

While aiming to enhance the relevance and timeliness of accounting standards, politics within the FASB could reduce transparency and reliability of accounting standards creation process. For instance, not all business types are represented at FASB while developing accounting standards. The effect of the mark-to-market accounting principle on a firm's financial statements is ambiguous in the long run. The exact contribution of mark-to-market accounting to bank failures in 2008 is still unpredictable. FASB should consider the impact of such rules on the quality of financial information available to investors and other decision makers.

Faced with this dilemma, the FASB, along with the SEC, can be a problem-solver. Rather than abandoning mark-to-market, it can issue a revised guideline for interpreting FAS 157 on how to apply that rule to troubled assets. Among other things, the new guidance can provide firms and their accountants with added flexibility in making fair valuations under Statement 157 in the current market environment. Additionally, it can clarify that (1) management may consider internal assumptions (that is, expected cash flows) in making fair value determinations when relevant market evidence is not present, (2) broker quotes should not necessarily be determinative of fair value when an active market does not exist, (3) the results of disorderly transactions should not be determinative of fair value, and (4) while transactions in inactive markets may be input when measuring fair value, they should likely be not determinative.

The International Accounting Standards Board (IASB) and the FASB have already agreed to work jointly and expeditiously towards common standards that deal with off-balance sheet activity and the accounting for financial instruments. They will also work towards analyzing loan loss accounting within the financial instruments project. The boards will work together towards common standards by developing the IASB projects on consolidation and recognition as joint projects once the FASB has completed its short-term

amendments to its existing standards. Furthermore, the boards have agreed to issue proposals to replace their respective financial instruments standards with a common standard in a matter of months, not years. As part of this project, the boards will examine loan loss accounting, including the incurred and expected loss models. The boards will continue to draw on expertise provided by the Financial Crisis Advisory Group (FCAG), a high level advisory body formed to guide the boards in their joint response to the financial crisis. Composition of the FCAG includes current and former investors, regulators, central bankers, finance ministers and others from industry and the public sector. The group has met on three occasions, and will summarize their recommendations in a report which is expected to be published in the second quarter of 2009.

The G20 and other international bodies have called for standard-setters to seek global solutions to a global crisis. This is not always easy to achieve and there may be areas where, because of the extent of existing guidance, the two boards find it difficult to reconcile differences in the existing standards in the immediate term. That is why, in important areas such as financial instruments, a common standard that significantly improves financial reporting and leads to a less complex approach is required. The path to achieving convergence will undoubtedly be challenging, but the remit coming from policy-makers is clear.

While some investors and banks have blamed mark-to-market accounting rules for accelerating the financial crisis, off-balance sheet accounting rules that allowed banks to hide exposure to risky investment vehicles have also come under harsh criticism. The US FASB already has eliminated an accounting concept known as the “qualifying special-purpose entity” that banks used to keep assets like mortgage-backed securities and special investment vehicles off their balance sheets.

In summary, the analysis of the causes of the financial crisis implies the need for major changes in the approach to capital, liquidity, accounting and institutional coverage. However, the crisis also raises important questions about the illusory effect of mark-to-market profits in a rising market.

The illusory affect can arise from mark-to-market profits in a rising market. The banking system holds a net long position in assets which are marked-to-market. As a result, if irrational exuberance pushes the price of assets to irrationally high levels, mark-to-market accounting will swell declared profit in an unsustainable way. The Turner Review (Financial Services Authority 2009) showed that a significant element of trading book profits recorded in the years running up to the crisis proved in retrospect illusory. These illusory profits were, however, used as the basis for bonus decisions, and created incentives for traders and management to take further risk. This carries implications for remuneration policies, and these are considered in the following section, which analyzes the economics of the cap that the EESA introduces on executive pay packages.

Design of executive pay packages

The EESA makes it clear that executives who made bad decisions should not be allowed to dump their bad assets on the government and then walk away with millions of dollars in bonuses. The EESA sets boundaries on both the compensation and termination – commonly known as “golden parachutes” – which executives receive. These boundaries try to avert the executives who may be less risk-averse or who have endangered their companies through riskier or poor decisions from benefiting from the plan. In order to participate in this program, companies will lose certain tax benefits and, in some cases, the EESA requires that unearned bonuses be returned.

The EESA draws important distinctions with respect to handling particular cases. For instance, executives are not allowed to receive severance pay wherever the government takes over a firm. The US government has followed this practice while dealing with Fannie Mae and Freddie Mac, although the case of American International Group (AIG) is still controversial. In addition, the Treasury would impose similar restrictions on severance pay for the five most highly paid executives in such firms whenever the purchases of troubled assets from this firm reach or exceed \$300 million. Moreover, the EESA does not allow this firm to deduct from its taxes any salary costs in excess of \$500,000. In an attempt to increase transparency and accountability, the Treasury Secretary is expected to issue guidelines that determine when and to whom to apply such restrictions. This condition may urge court cases by executives who maintain contractual rights to this now-prohibited reimbursement. These court cases could bind the reserves to the taxpayers if the government is strained to pay successful executives' claims pursuant to the Constitution's Takings Clause or Due Process clause for the loss of money that might occur through the operation of this executive pay control.

The EESA attacked high-level executive pay at US corporations. It is difficult to predict the effect of these requirements, and hence compensation plan qualification. For instance, firms can use these exemptions to reduce their after-tax cost of executive compensation. Also, incentive plans can be restructured using salary, cash bonuses, stock awards and stock options, as each of them can be qualified for exemption. If the tax cost of paying non-deductible salary exceeds the implicit cost of qualifying performance-based pay, firms may shift from salary to tax-advantaged performance-based pay. This would tend to shift the compensation mix toward performance-based pay and away from salary as a fraction of total compensation. Indeed, Rose and Wolfram (2000) suggest, by using empirical evidence, that effects on the overall level of executive pay are less clear, casting doubt on the legislation's efficacy in constraining CEO pay.

Similarly, firms may replace reimbursement plans with incentive plans whenever the costs of losing discretion over extra and long-term incentive compensation is less than the tax remuneration of reward expenses under qualified plans. As it imposes little boundary on *ex post* option grants, this trade-off supports stock options plans. In this case, shareholders would need to approve just two factors of a stock options plan to qualify it; its overall size (total number of options during plan life) and the maximum (cumulative) limit on options to be awarded to any individual under the plan. Then, on an annual basis, boards of directors can decide individual option awards, and options would be treated as performance-based compensation if their exercise prices are equal to or greater than the stock price. These characteristics seem to make options plans more likely than other performance-based plans. The ease of qualifying options compensation makes them more attractive. Hall and Liebman (2000) note that option compensations have accounting and tax advantages compared to cash compensation.

The effect of wage caps, as provided within the EESA framework, on the volatility of pay-for-performance at firms with qualified plans is ambiguous. The pay-for-performance volatility increases as salaries move toward performance-based pay, all else held constant. Correspondingly, payouts that are related to conventional measures used in compensation regressions may be generated when reducing discretionary pay components in bonus and long-term incentive plans and linking payments to performance measures. This would tend to raise the responsiveness of pay to these variables. However, all else may not be constant. For example, boards of directors can narrow the range of payouts generated by plans if objective, non-discretionary compensation plans are perceived as generating a greater compensation discrepancy than would awards of performance-based pay, particularly in

states over which executives may have little control or influence. This can tend to counter-balance effects that increase the pay-for-performance volatility.

However, certain ideas are missing from the EESA. First, the EESA should threaten, in certain cases, severance packages. In order to guarantee that ineffectual executives do not benefit from their conduct, offended parties should be able to exercise their rights to recover extra payouts or termination compensation obtained in abuse of law or in break of fiduciary responsibility.

Second, the EESA entails new delegations to the Secretary of the Treasury. The agreement directs the Secretary to set standards for executive compensation and allows him to exercise the powers that come with equity ownership, including some degree of direct corporate control. This goes along with his ability to spend up to \$700 billion to buy troubled assets. These delegations raise concerns, as they can permit elimination of compensation to which an executive has a right. In particular, these legal deviations suggest policy direction as well. The President is supposed to execute laws. However, with the new policy, Congress delegates vast new authority to the executive area office to “fix” the problem *de jure*, and then tries to invent new ways to handle the exercise of the authority. This power-sharing relationship violates the separation of powers perfected by the Constitution. Ignoring that command ignores a great and resilient instrument of accountability and transparency that empowers citizens to penalize officials whose action is sub-par.

Third, the EESA places caps on executive compensation. A pay cap on financial executives who caused trouble would be counter-productive; able executives may leave to firms not affected by the proposed rescue plan and less-abled executives may replace able executives in damaged firms. Placing damaged firms in the hands of less-able executives enhances the chance of mismanaged firms. Compensation should be decided by the firm, its shareholders and the executive, not managed by a congressman or a bureaucrat. In fact, using a 15-year panel data set of CEOs in the largest, publicly traded US companies, Hall and Liebman (1998) documented a strong relationship between firms’ performance and CEO compensation. This relationship is generated almost entirely by changes in the value of CEO holdings of stock and stock options. In addition, they showed that both the level of CEO compensation and the sensitivity of compensation to firms’ performance have risen dramatically since 1980, largely because of increases in stock option grants. Moreover, congressional endeavors to inflict pay caps failed because the market devised new compensation traditions. Empirically, Jensen and Murphy (1990) hypothesized that public and private political forces impose constraints that reduce the pay-performance sensitivity. Declines in both the pay-performance relation and the level of CEO pay since the 1930s are consistent with this hypothesis. Similarly, using panel data on 147 banks over the decade of the 1980s, Hubbard and Palia (1995) found evidence supporting the hypothesis that competitive corporate control markets (that is, where interstate banking is permitted) require talented managers with higher compensation levels.

The Institute of International Finance (2009) shows leading market practices with respect to compensation. The study aims to encourage aligning compensation payouts to the risk–time horizon of the business by (1) measuring performance over a multi-year period where appropriate, (2) deferring compensation delivery in businesses that have a multi-year risk time horizon, (3) paying compensation in units with value that is linked to the individual’s future performance (that is, company stock may not always be the best currency), thus focusing deferrals on alignment with performance development over time rather than on retention, and (4) introducing forward-looking long-term incentive plans for executives and key strategic roles, based on performance achievements beyond total shareholder return metrics.

Fourth, the EESA excludes “incentives for senior executive officers of a financial institution to take unnecessary and excessive risks that threaten the value of the financial institution during the period that the secretary holds an equity or debt position in the financial institution”. According to the provisional ultimate rule, this standard requires the compensation committee of the financial firm to evaluate incentive compensation plans for Senior Executive Officers (SEOs) to assume that these plans do not encourage unnecessary and excessive risks, and then to certify to having done so in the company’s compensation discussion and analysis. By doing so, the EESA gives substantial concern to firms’ compensation committees to review whether their own firms’ plans meet the EESA standard, and therefore the degree of its impact will depend on how stringently compensation committees read between its lines and how forcefully the government enforces it. In many cases, compensation committees may be unenthusiastic to subject CEOs to incentive standards dissimilar to those for non-CEOs. In some cases, this may prejudice compensation committees to make an understanding that is more “liberal” (that is, favoring CEOs) as to an encouragement in order to stay away from subjecting its CEOs to a standard diverse from that valid for other executives participating in the identical incentive program. On the other hand, some compensation committees may take the converse approach, modifying incentive standards not only for senior executives but for other executives too.

The impact of the EESA on executive compensation is ambiguous. Most of the effect will be on senior executives of sheltered institutions and not on executives at those institutions that are not covered by the EESA. Nevertheless, there can be implications for executive compensation that go beyond the instant impact of the EESA. For instance, there possibly will be a trickle-down effect to lower-level executives at corporations subject to other the EESA programs in the future. In addition, the definition of financial institutions in the EESA is so broad that it probably will be extended beyond banks. The main beliefs personified in the EESA can be unlimited to firms other than those within the original purpose of the EESA. This could occur in various ways. Certain congressional leaders may indicate that such doctrine should apply to executive compensation more generally (not just to financial institutions). A number of non-financial institutions may themselves set on to employ some of the standards, perhaps encouraged by shareholder activists as a matter of different corporate governance tool.

As to the EESA itself, congressional leaders, who are calling for broader executive compensation limitations, proposed tightening the EESA provisions. They suggested (1) eliminating haven limitations on severance payments constituting “golden parachute” payments, and (2) applying the limitation to any severance payments.

Preceding the EESA, five categories of compensation were barred from the subtraction limit: (1) commission-based salary; (2) performance-based reward that met outside director and shareholder approvals; (3) payments to tax-qualified pension plans; (4) amounts excludable from the employee’s gross income; and (5) compensation payable under a written compulsory agreement valuable on 17 February 1993 and not materially modified thereafter. New Section 162(m)(5) decreases the subtraction limit to \$500,000 for executive remuneration and deferred deduction executive remuneration, attributable to services performed by sheltered executives for a relevant employer during a valid taxable year. A valid employer is any financial firm, whether publicly traded or privately held, from which the Treasury acquires over \$300 million of troubled assets by public sale or a combination of public sale and direct purchase, but not a financial firm from which the Treasury makes only direct purchases.

In a nutshell, the EESA provides guidance on executive compensation rules that apply to financial firms that partake in the Treasury’s programs under the 2009 Emergency

Economic Stabilization Act. It is important that participating financial firms, their senior executive officers and companies that do business with them understand this guidance.

Conclusion

This paper attempted to provide a critique of mark-to-market valuation and executive pay packages in the context of specific legislative changes in the United States during early 2009, resulting from a deep financial crisis, the genesis for which was the sub-prime loans defaults. It aimed to address the pros and cons of the legislation and its practical applications. This paper discussed the benefits and costs of mark-to-market valuation and design of executive pay package policies within the US 2009 (Bailout) Emergency Economic Stabilization Act (EESA). It highlighted how the mark-to-market valuation standard caused acute impact on financial institutions. The paper explained why those who favored, previously, mark-to-market policy suspension are expected to support the EESA. At the same time, the paper realized that, regardless of its controversial status, the mark-to-market policy has certain benefits that the Financial Accounting Standards Board as well as the Securities and Exchange Commission can count on while assessing the need and cost of such a valuation policy. The appropriate way forward on accounting now needs debating between regulators and the bodies that set published accounting standards, the International Accounting Standards Board and the Financial Accounting Standards Board. The paper then showed how the EESA makes it clear – by drawing key distinctions on how to handle particular cases – that executives who made bad decisions should not be allowed to dump their bad assets on the government and then walk away with millions of dollars in bonuses. It discussed the potential effects and promise of executive wage cap within the EESA. Moreover, it differentiated between executive pay package pre- and post-EESA. Finally, the paper showed that certain ideas are missing from the EESA and that the effect of the EESA on executive compensation generally is difficult to predict. Future research can develop an empirical model with a set of control variables to explore the effects of capping executive pay, and to investigate the determinants and consequences of firms' qualification decisions. Consequently, further studies can explore and suggest international applications for the United States' crisis management model. Other questions should be raised too, including: (1) Why did the United States' loan loss reserving system produce such a low level of reserves at the beginning of the 2008 downturn? (2) What credible changes should bankers consider to avoid that pro-cyclical outcome in the future?

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