Executive Compensation and the Financial Crisis

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Main Questions

- How has executive pay contributed to bringing about the financial crisis?
- How to fix compensation structures?
- What role if any should the government play in reforming executive pay in financial firms?

[For a fuller development of my views on these issues:

-- Bebchuk and Spamann, *Regulating Bankers' Pay*.

-- Bebchuk and Fried, *Reforming Equity-Base Compensation.*

-- Bebchuk, Testimony before the House Financial Services Committee, June 11, 2009.]

The Short-term Distortion

[Bebchuk-Fried, *Reforming Equity-Base Compensation*]

- One major factor that has induced excessive risk-taking is that firms' standard pay arrangements reward executives for short-term gains even when these gains are subsequently reversed.
- Jesse Fried and I warned about this short-term distortion five years ago in our book, *Pay without Performance.* Following the crisis, this problem has become widely recognized.
- To tie compensation to long-term performance:
  - Executives shouldn't be allowed to cash out options and shares for a fixed number of years after vesting.
  - Bonuses should not be cashed right away, but placed in a company account for several years and adjusted downward if it turns out that the reasons for the bonus no longer hold up.

The Leverage Problem

[Bebchuk-Spamann, *Regulating Bankers Pay*]

- In addition to the short-termism problem, there was a second important source of incentives to take excessive risks that has received insufficient attention: executives' payoffs were tied to highly leveraged bets on the value of financial firms' capital.
- Compensation arrangements tied executives' interests to the value of common shares in financial firms or even to the value of options on such shares => executives not exposed to the potential negative consequences that large losses could have for preferred shareholders, bondholders, and the government as a guarantor of deposits => executives incentivized to give insufficient weight to risks of large losses.
- To address this distortion, financial executives' payoffs could be tied not to the long-term value of financial firms' common shares but to the long-term value of a broader basket of securities, including at least preferred shares and bonds.

The Role of the Government

- If pay structures should be reformed, what role if any should the government play in bringing about such reforms?
- Many reforms and reformers focus on improving internal governance processes and thereby trying compensation better to shareholder interests.
  - The Basle Committee of Bank Supervisors has called for close involvement of banks' boards in pay setting.
  - The Obama administration initiated, and the House passed legislation, introducing "say on pay" votes and bolstering the independence of comp committees.
- For non-financial firms, the government indeed should avoid intervening in the substantive choices that firms make. But banks are special – and their special circumstances call for a broader role for the government.

The Role of Government (2)

The moral hazard basis for traditional financial regulation

- Because failure of financial firms will impose costs on the government and the economy that shareholders don't internalize, shareholders' interests would be served by more risk-taking than would be socially desirable => For this reason, financial firms are constrained by a substantial body of regulations that restrict business decisions with respect to investments, lending, and reserves.
- But the traditional regulations of financial firms' actions are imperfect. The regulator is often one step behind => That's why it would be useful to have another tool.

The Role of Government (3)

Why improving internal governance isn't enough:

- Shareholders' interest in more risk-taking implies that they could benefit from providing bank executives with excessive incentives to take risks.
- Therefore, even if internal governance problems in financial firms were to be eliminated, regulators should monitor and regulate executive pay in financial firms.
- Regulators should focus on the structure of pay arrangements – not the amount – and they should seek to limit the use of incentives to take excessive risks.
- Regulators should recognize that decisions about risk-taking are often taken by executives, not shareholders -- regulation of pay structures could make executives work for, not against, the goals of financial regulation.

Objections to Regulating Financial Executives' Pay

- Objection 1: The government doesn't have a legitimate interest in telling shareholders how to spend their money.

Response: Given the government's interest in the safety and soundness of the financial system, intervention in pay structures will be as legitimate as the traditional forms of intervention that limit banks' business decisions.

- Objection 2: Regulators will be at an informational disadvantage when assessing pay arrangements.

Response: (i) More informed players inside firms don't have incentives to take the interests of depositors and the government in setting pay.

(ii) Furthermore, limiting pay structures that incentivize risk-taking isn't more demanding in terms of information than traditional regulations of investment, lending, and capital decisions.

Concluding Remarks on Pay Regulation

- The focus should be on top executives, not on executives in general.
- Regulation of pay can nicely complement the traditional regulation of financial firms.
- At a minimum, when assessing risks posed by any given financial firm, regulators should take into account the incentives produced by the firm's pay arrangements -- when arrangements encourage risk-taking, regulators should monitor the firm more closely and should consider raising its capital requirements.
- Regulating the compensation of financial executives should be a critical instrument in the toolkit of financial regulators. It would help ensure that financial firms and the economy don't suffer in the future from the excessive risk-taking that has contributed to bringing about the current financial crisis.