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WORKING PAPER

Regulation of Executive Compensation in Financial Services

Squam Lake Working Group on Financial Regulation
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The Squam Lake Working Group on Financial Regulation is a nonpartisan, nonaffiliated group of fifteen academics who have come together to offer guidance on the reform of financial regulation.

The group first convened in fall 2008, amid the deepening capital markets crisis. Although informed by this crisis—its events and the ongoing policy responses—the group is intentionally focused on longer-term issues. It aspires to help guide reform of capital markets—their structure, function, and regulation. This guidance is based on the group’s collective academic, private sector, and public policy experience.

To achieve its goal, the Squam Lake Working Group is developing a set of principles and their implications that are aimed at different parts of the financial system: at individual firms, at financial firms collectively, and at the linkages that connect financial firms to the broader economy.

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INTRODUCTION

Many people argue that inappropriate compensation policies in financial companies contributed to the World Financial Crisis. Some say the overall *level* of pay was too high. Others criticize the *structure* of pay, claiming that contracts for CEOs, traders, and other key professionals induced them to pursue excessively risky and short-term strategies.

In this paper, we first argue that governments should generally not regulate the *level* of executive compensation in financial institutions.¹ We have seen no convincing evidence that high levels of compensation in financial companies are inherently risky for the companies themselves or the overall economy. Moreover, limits on pay are likely to cause unintended consequences. As a result, society is better off if compensation levels are set by market forces.

The *structure* of executive compensation, however, can affect the risk of systemically important financial institutions. Robust financial institutions promote economic growth and employment. As we saw in the crisis of 2008, this often causes governments to intervene when their financial systems are threatened. The result is privatized gains and socialized losses. If things go well, banks' owners and employees claim the profits, but if things go poorly, society subsidizes the losses. Because the owners and employees of financial firms do not bear the full cost of their failures, they have an incentive to take more risk than they otherwise would. This, in turn, increases the chance of bank failures, systemic risk, and taxpayer costs.

The link between the risks financial institutions take and the costs they impose on taxpayers gives society a stake in the structure of executive compensation at systemically important financial firms. To reduce employees' incentives to take excessive risk, we advocate a rule that requires systemically important financial firms to hold back a significant share of each senior manager's annual compensation for several years. Employees would forfeit their deferred compensation if the firm goes bankrupt or receives extraordinary government assistance.

GOVERNMENTS SHOULD NOT REGULATE THE LEVEL OF EXECUTIVE COMPENSATION

The recent crisis has focused attention on highly compensated executives in the financial services industry. Many earn more than ten million dollars a year and are among the highest paid employees in any industry.

Striking though they are, we are not convinced these high levels of compensation are inherently destabilizing to individual firms or to the overall financial system. They are also not obvious evidence of a failure of corporate governance, despite claims to the contrary. Rather, the extraordinary compensation commanded by some finance professionals can arise for a few straightforward but powerful reasons.

First, even among those with similar professional qualifications, there are tangible differences in the skills of financial employees, and even a small difference in skill can have an enormous impact on the profits of a financial firm. An extra 1 percent return on a \$10 billion investment portfolio adds \$100 million to a firm's earnings. An investment banker who structures a transaction incorrectly can quickly transform a large acquisition from a brilliant idea to a \$200 billion albatross.

Second, managers in financial firms generally believe they can identify the employees that drive good or bad results. Many important decisions and tasks are the responsibility of a single individual or small team, and the results of their actions are easy to observe. And, critically, managers typically believe a successful employee will continue to produce large profits.

Third, it is relatively easy for financial executives to move from one firm to another because they rarely rely on firm-specific inputs such as particular machines, patented processes, or other unique forms of capital. When there are synergies within a group of workers, such as an investment-banking team, the whole group can move from employer to employer. This mobility gives employees great bargaining power when negotiating their compensation.

In short, small differences in skill can produce enormous differences in profits, managers believe they can identify these differences in skill, and it is easy for a valued employee to be as productive at another firm. Because of these forces, particularly talented financial employees are able to retain a substantial portion of the large contribution they make to their employer's success. The result is millions in annual pay for top performers.

It is worth noting the parallels between financial managers and many other professions, including actors, musicians, and athletes. A gifted actress, for example, can have an enormous impact on ticket sales when she stars in a movie, and her contribution to the movie's success is apparent on the screen. Moreover, experienced actresses can capture much of their value added; if one studio will not meet a star's price, she can easily move on to the next project. Indeed, compensation for top entertainers and athletes often exceeds compensation for top financial executives.

As a result of the recent financial crisis and government bailouts, policymakers around the world are considering proposals to limit the compensation of financial executives. Economic logic and history both tell us, however, that market prices are typically the best way to allocate resources. If policymakers distort those signals, highly talented workers are less likely to find their most productive occupation. This would slow growth in economy-wide output and average standards of living.

Limits on the level of compensation in the financial services industry are also likely to trigger unintended and undesirable consequences. Pay caps imposed on a subset of firms, for example, could push their most talented bankers, traders, and other key professionals to unregulated firms. Broader limits on the compensation of financial executives may even drive parts of this highly mobile industry to more receptive countries.

Past efforts to cap executive compensation have often created unexpected problems including, in some cases, an increase in the pay of those whose wages were meant to be constrained. A 1982 law aimed at limiting golden-parachute payments in the United States paradoxically extended their use to new firms and new situations. In particular, firms discovered they could circumvent the new taxes on golden-parachute payments by extending the payments to all terminations without cause, not just those associated with a change in control. Similarly, a 1993 American law aimed at limiting the tax deductibility of executive salaries sparked the proliferation of riskier option-based compensation.² Today the difficulty remains the same: regulating the level of compensation for financial executives could do more harm than good, both to the firms being regulated and to the overall economy.

The market does not allocate human capital perfectly, but it almost certainly does a better job than government officials would. This argument leads to our first recommendation.

Recommendation 1. *Governments should not regulate the level of executive compensation in financial firms.*

As a result of the recent bailouts, governments are currently the dominant shareholder in many financial institutions around the world. Standard governance arguments suggest that, while they are shareholders, governments representing the economic interest of taxpayers should advise management about compensation and related strategic issues. In principle, they should do so with the objective of maximizing the value of taxpayers' stakes in financial institutions. Broader political considerations should not distort management decisions. This could be achieved by having shareholder governments delegate compensation decisions to third parties such as firms that advise boards and shareholders on executive compensation.

Our recommendation that governments should not regulate the level of compensation is not a rejection of proposals intended to improve corporate governance, such as say-on-pay votes and tighter standards of independence for compensation committee members. These and similar proposed regulations may make corporations more productive, but they also may create significant costs and unintended consequences. Some economists, for example, advocate constraints on the structure of executive compensation that are meant to increase management's incentives to act in the long-term interest of shareholders. But as we emphasize below, changes that reduce the conflict between management and shareholders can magnify the conflict between financial institutions and society.

DEFERRED COMPENSATION: CHANGING THE STRUCTURE OF EXECUTIVE COMPENSATION TO REDUCE RISK TAKING AND THE POSSIBILITY OF TAXPAYER BAILOUTS

Although regulators should generally not set the level of compensation for financial executives, the possibility that governments will bail out financial firms during a crisis implies that stakeholders in financial firms—executives, creditors, and shareholders—do not face the full cost of their failure. As a result, these institutions have an incentive to take more risks than they would if they bore all the costs of failure. This, in turn, increases the chance of bank failures, systemic risk, and taxpayer costs.

A major goal of capital-market reform should be to force financial firms to bear the full cost of their actions. In related papers, we propose several mechanisms to help achieve this goal. One is systemically sensitive capital requirements that force larger and more-complex banks to hold more capital.³ Another is the creation of a long-term debt instrument that converts to equity during a crisis so that an undercapitalized or insolvent bank can transform into a well-capitalized bank at no cost to taxpayers.⁴

Executive compensation presents an additional mechanism for inducing financial firms to internalize the costs of their actions. Specifically, if a significant portion of senior management's compensation is deferred and contingent on the firm surviving without extraordinary government assistance, managers will be less inclined to pursue risky strategies.

Recommendation 2. *Systemically important financial institutions should withhold a significant share of each senior manager's total annual compensation for several years. The withheld compensation should not take the form of stock or stock options. Rather, each holdback should be for a fixed dollar amount, and employees would forfeit their holdbacks if the firm goes bankrupt or receives extraordinary government assistance.*

Employees whose compensation is held back become creditors of their firms. As a result, this deferred compensation reduces management's incentive to pursue risky strategies that might result in

government bailouts. Similarly, rather than wait for a bailout during a financial crisis, the management of a troubled firm would have a powerful incentive to find a private solution, perhaps by boosting the firm's liquidity to prevent a run, raising new capital, or facilitating a takeover by another firm. Because taxpayer losses trigger executive losses, holdbacks better align the personal incentives of managers with the fiscal and systemic goals of taxpayers.

Standard forms of deferred compensation, such as stock awards and options, do little to reduce the conflict between systemically important financial institutions and society. Managers who receive stock become more aligned with stockholders, but this does not align them with taxpayers. And options actually increase managers' incentives to take risk. Thus, compensation that is deferred to satisfy this regulatory obligation should be for a fixed monetary amount. For example, firms might be required to withhold 20 percent of the estimated dollar value of each executive's annual compensation, including cash, stock, and option grants, for five years. At the end of this period, employees would receive the fixed dollar amount of their deferred compensation if the firm has not declared bankruptcy or received extraordinary government support.

Regulators need to specify clearly what events would trigger the loss of holdbacks. The triggers should include capital injections like those of the Troubled Asset Relief Program. Another should be unusual guarantees by the government of a firm's debt. We do not think triggering events should include less-extreme events like borrowing from the Federal Reserve discount window.

Resignation from the firm should not accelerate the payment of an employee's holdbacks. Accelerating payment for employees who quit would weaken their concern about the long-term consequences of their actions. Moreover, it could create an incentive to quit, particularly if the employee discovers the firm may be in trouble. In the same spirit, managers should not be rewarded for taking their firm into bankruptcy. If a firm declares bankruptcy, its managers should receive their holdbacks only after its other creditors have been made whole.

This positioning of managers' claims means that a firm's obligation to pay deferred compensation does not affect its payments to other creditors in bankruptcy. Moreover, managers have no reason to push their firm into bankruptcy in an effort to collect compensation holdbacks. Thus, commitments to pay accumulated holdbacks do not put the financial institution or its other creditors at risk. Assets the firm holds to pay these obligations are capital that is available to pay other debts. Large firms that implement aggressive holdbacks can boost by billions of dollars the capital they have available to buffer against a major shock.

CONCLUSIONS

Executive compensation in financial firms is often faulted for the global financial crisis. We draw an important distinction between the *level* and *structure* of executive compensation. Governments should generally not regulate the level of executive compensation in financial institutions. However, governments have a legitimate interest in the structure of executive compensation in financial firms. To force financial institutions to bear the full social cost of their actions, we recommend that government regulators require systemically important financial firms to hold back for several years a fraction of each employee's annual compensation. Employees would forfeit these holdbacks if the firm declares bankruptcy or receives extraordinary government assistance.

Compensation holdbacks are not a panacea. No single tool can perfectly align the incentives of stakeholders in financial companies with society's desire to avoid systemic financial distress. However, transparent compensation holdbacks with clearly specified trigger mechanisms would help avoid ad hoc measures such as those taken in the current crisis.

Endnotes

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1. Of course, governments are currently the dominant shareholder in many banks around the world, and while they are it may be appropriate for them to advise management on compensation and other strategic issues. We discuss this issue below.
 2. Kevin J. Murphy discusses these examples in his testimony, “Compensation Structure and Systemic Risk,” before the U.S. House of Representatives Committee on Financial Services, June 11, 2009.
 3. Squam Lake Working Group on Financial Regulation, “Reforming Capital Requirements for Financial Institutions” (Council on Foreign Relations Press, April 2009).
 4. Squam Lake Working Group on Financial Regulation, “An Expedited Resolution Mechanism for Distressed Financial Firms: Regulatory Hybrid Securities” (Council on Foreign Relations Press, April 2009).

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