Executive Compensation and Risk Taking

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Main Questions

- How to fix compensation structures to make excessive risk-taking less likely?
- 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, *Written Testimony before the House Financial Services Committee*, June 11, 2009 and January 22, 2010. ]
The Short-term Distortion

- Excessive risk-taking may be generated by pay arrangements rewarding 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*.
  
  [Ch. 14 of the book devoted to it]

- Following the crisis, this potential problem has become widely recognized.

- But some observers question whether this problem played a role in the 2008-2009 financial crisis.
The Wages of Failure


- Some commentators (e.g., Norris, NYTimes, Friedman, WSJ) assumed that the executives of these firms saw their own wealth wiped out together with the firms, and inferred that the executives’ risk-taking could not have been motivated by perverse pay incentives.

- We find: The top-five executive teams of Bear Stearns and Lehman Brothers derived cash flows of about $1.4 billion and $1 billion respectively from cash bonuses and equity sales during 2000-2008. Unlike shareholders, the executives’ net payoffs for the period were decidedly positive.
Addressing Short-Term Distortions


- Design equity-based compensation to be based on long-term stockholder value, not short-term stock prices.
- Design bonus compensation to depend on long-term performance measures through the use of bonus banks and clawbacks.
How to Tie Equity Compensation to Long-Term Results (1)


- The time when executives become free to unwind equity incentives must be separated from the time the incentives vest.
- Requiring executives to hold equity incentives till retirement is not the way to go.
- Rather use a combination of:
  -- Grant-based limitations on unwinding
  -- Aggregate limitations on unwinding
How to Tie Equity Compensation to Long-Term Results (2)


- Anti-gaming arrangements: Take gaming out of the cashing of equity incentives:
  -- Advance notice of cashing out
  -- “Hands-off” cashing out

- Anti-hedging arrangements: Adopt a robust prohibition on any hedging or derivative transaction that would produce a benefit in the event of a stock price decline and weaken the link between executive payoffs and long-term stock prices.
The Leverage Problem (1)

[Bebchuk-Spamann, Regulating Bankers Pay, Georgetown Law Journal, 2010]

- 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.
The Leverage Problem (2)

[Bebchuk-Spamann, Regulating Bankers Pay, Georgetown Law Journal, 2010]

- To the extent compensation is based on the value of the firm’s securities, 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 Government (1)

- Provide shareholders with rights and tools that would enable them to prevent pay structures that are detrimental to long-term shareholder value.
- Shareholders in the United States continue to have much weaker shareholder rights than shareholders in the UK and other English-speaking countries.

The Role of Government (2)

[Bebchuk-Spamann, Regulating Bankers’ Pay, 2010]

- For non-financial firms, government intervention should be limited to improving internal governance. But financial institutions are special – and their special circumstances call for a broader role for the government.

- The traditional rationale for prudential regulation – the recognition that shareholders’ interests would be served by risk taking that is socially excessive – implies that shareholders and shareholder-regarding directors would still have an interest in excessive risk-taking that does not fully take into account the interests of other capita contributors.
Pay structure supervision as supplement for Prudential Regulation

- Supervisors 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.

- Supervision of pay structures could make executives work for, not against, the goals of financial regulation.

- Complements prudential regulation.
  -- With pay structure supervision, other regulations can possibly be less tight.
  -- Without pay structure supervision, other regulations should be tighter.
Objections to Regulating Financial Executives’ Pay (1)

- **Objection**: 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.
Objections to Regulating Financial Executives’ Pay (2)

- **Objection:** 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

- Compensation structures are an important determinant of how the financial system performs – and whether financial firms take excessive risks.

- To avoid excessive risk-taking, compensation structures should be reformed to:
  - Link payoff to long-term results
  - Define long-term results more broadly than maximizing long-term shareholder value.

- To bring about such reforms:
  - Shareholder rights need to be strengthened
  - In addition, monitoring and regulating the compensation of financial executives should be added to the toolkit of financial regulators.