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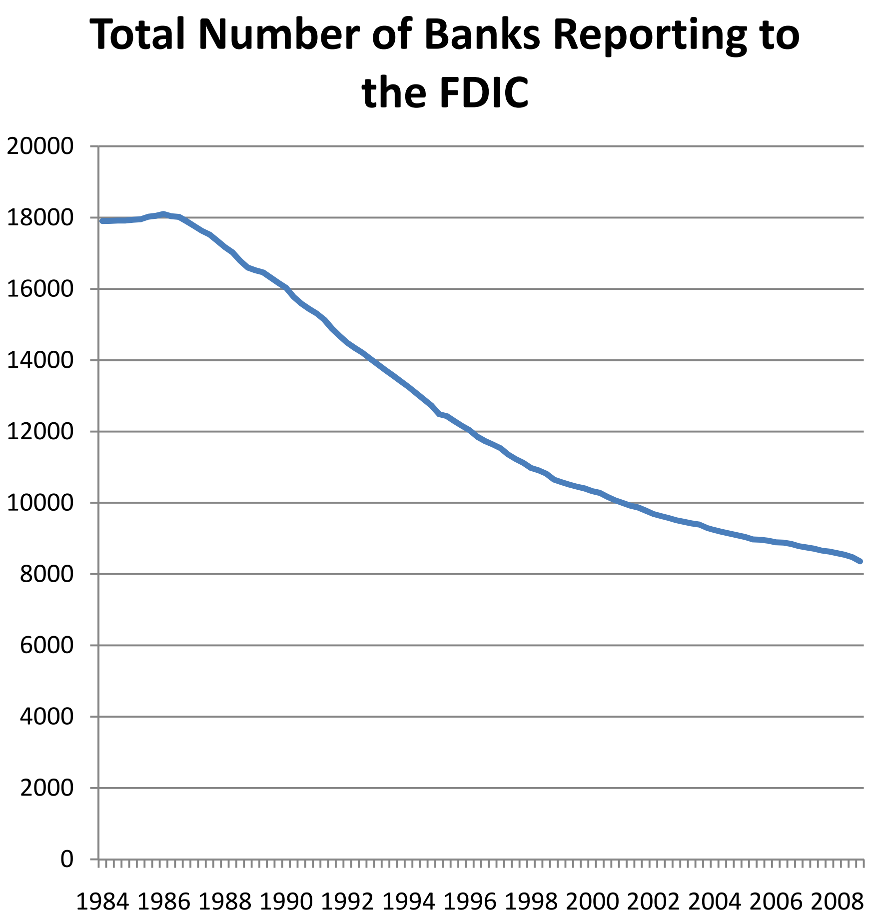
Governance, Executive Compensation and Excessive Risk in the Financial Services Industry

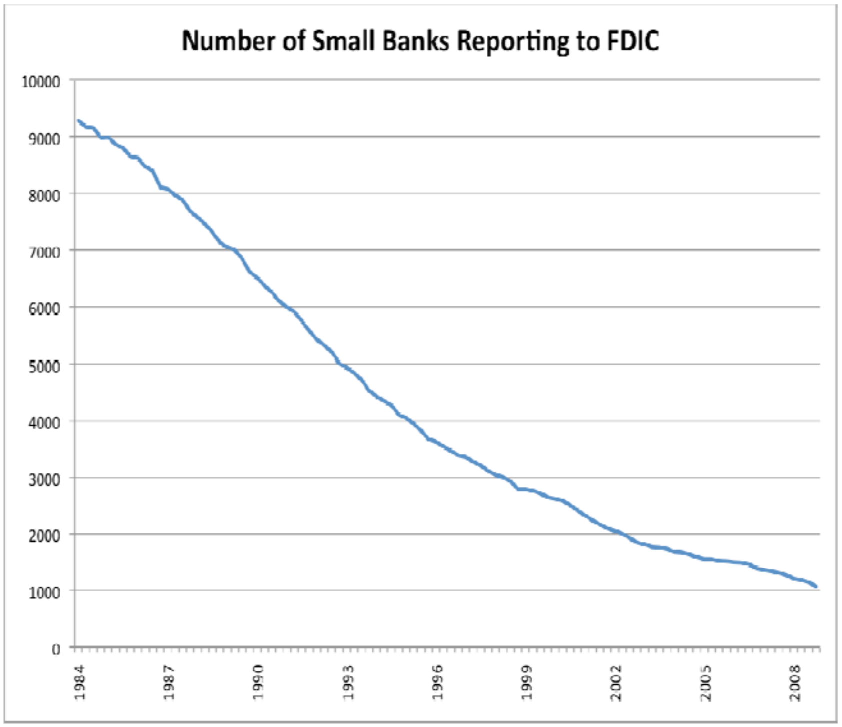
May 28, 2010

Competition over Talent

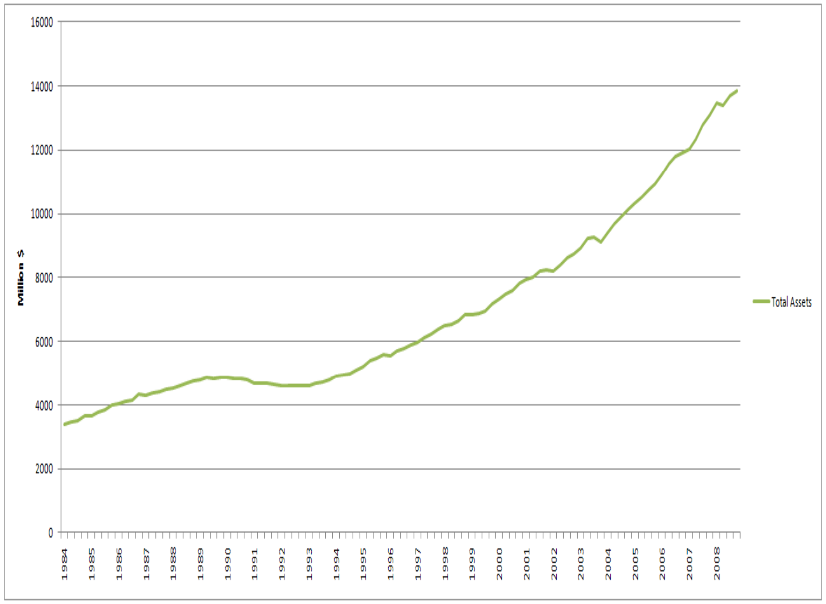
- People are the competitive assets
  - 50% of revenue payout rule of investment banks
  - “Talent” can walk out the door.
- Capital intensity is relatively low compared to manufacturing
  - Entry is relatively easy in many sectors
- Banks and financial institutions make their money off leverage: risk management is central to their business.
  - Failure and consolidation are common.

Banking consolidation

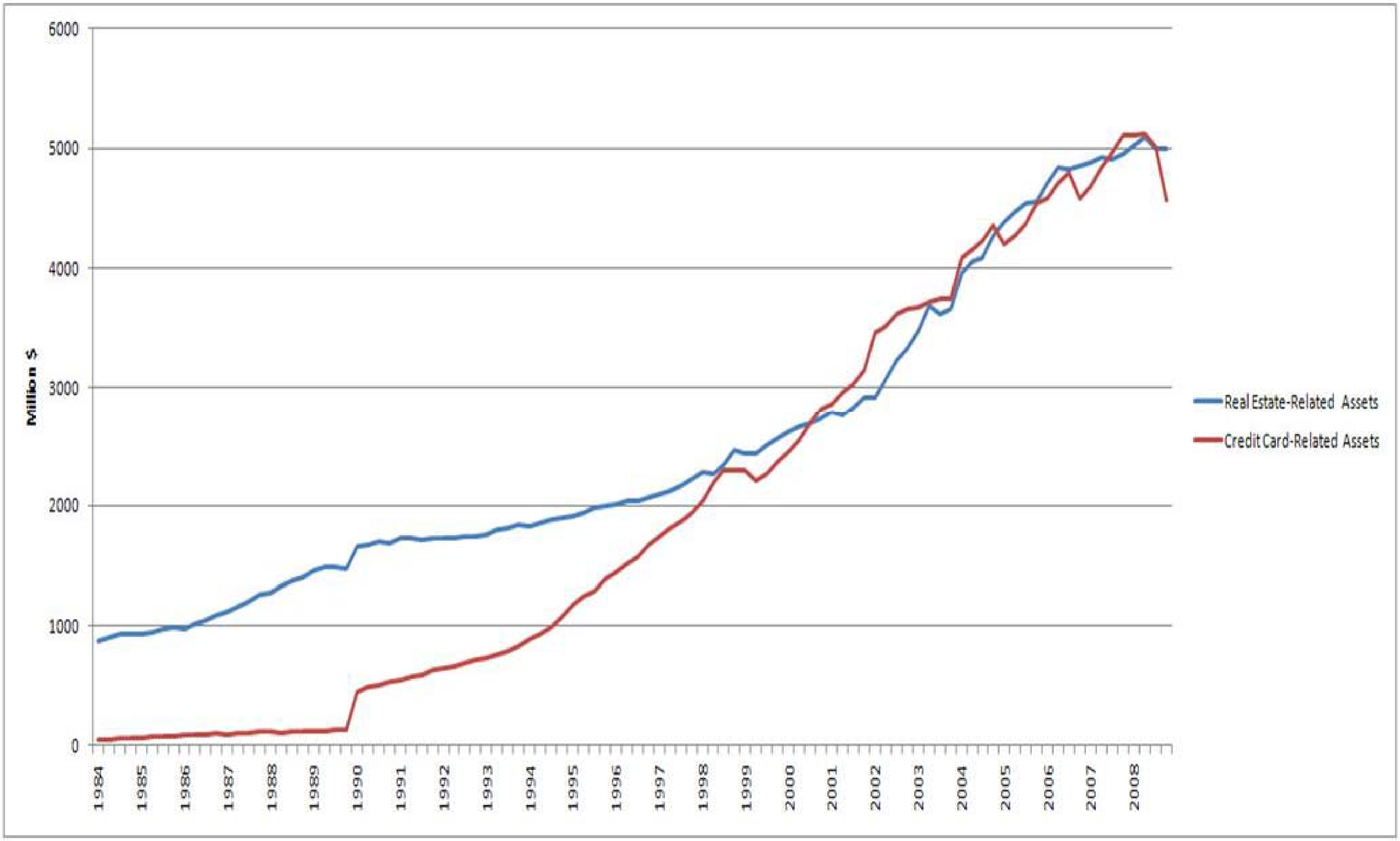




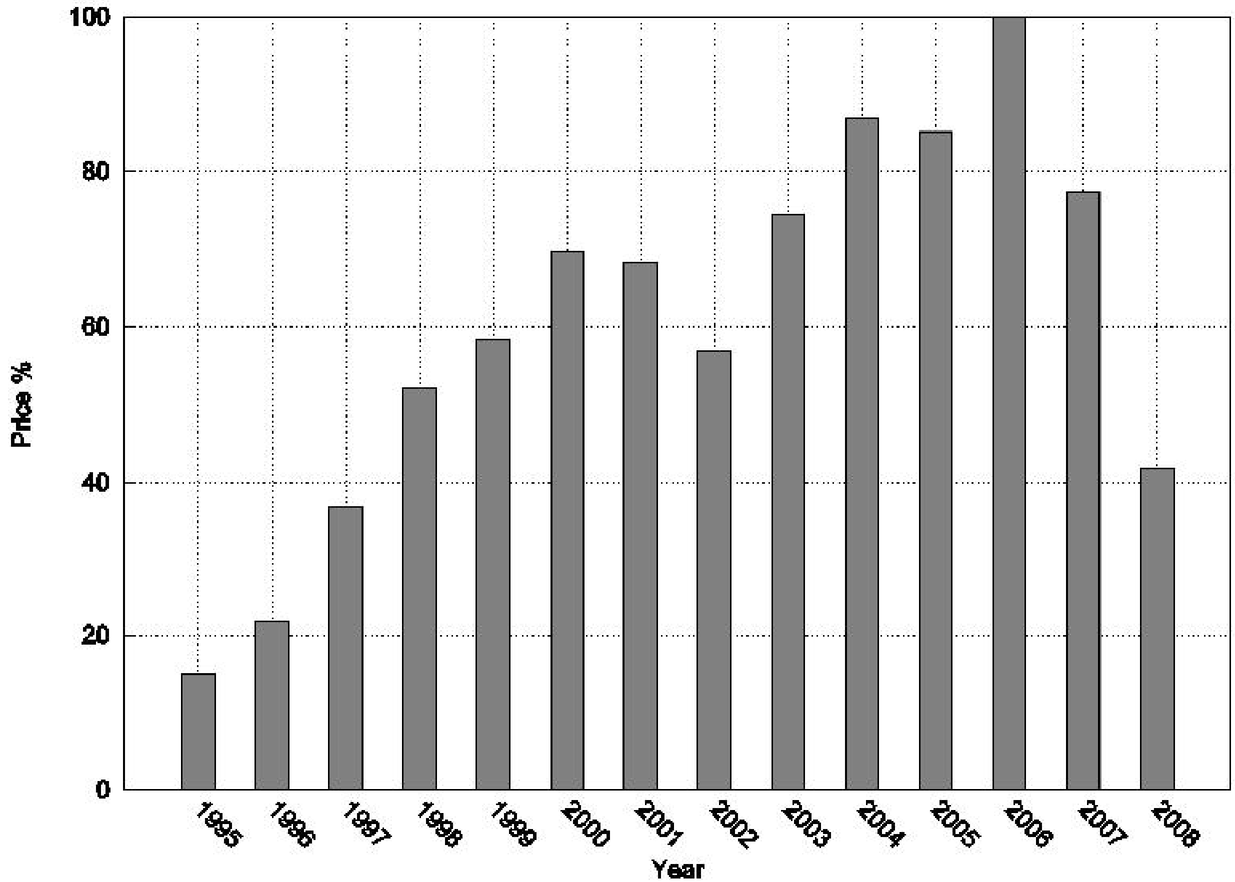
Total Assets Grew –Fewer and Bigger Banks



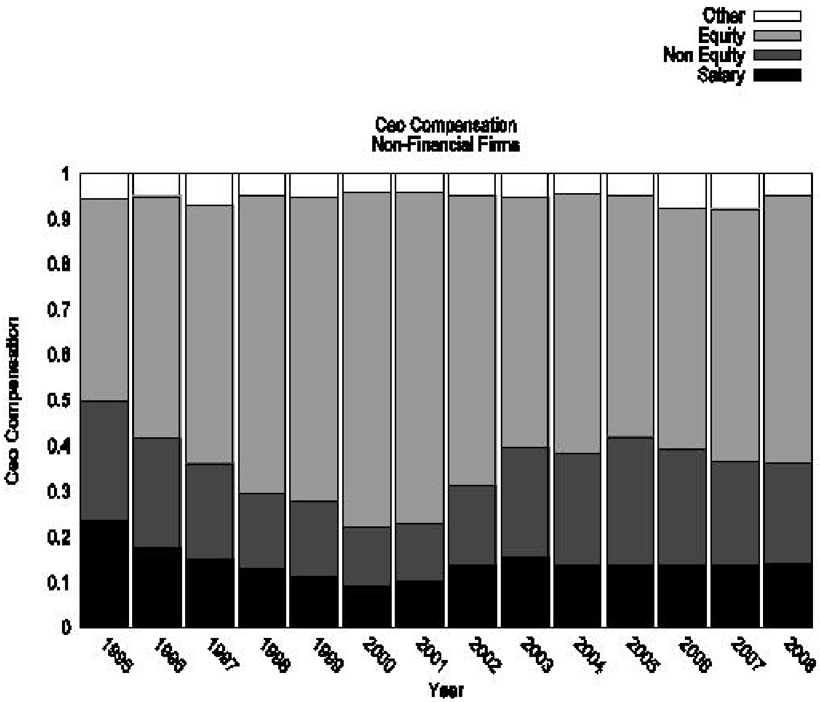
Assets moved to high risk consumer loans

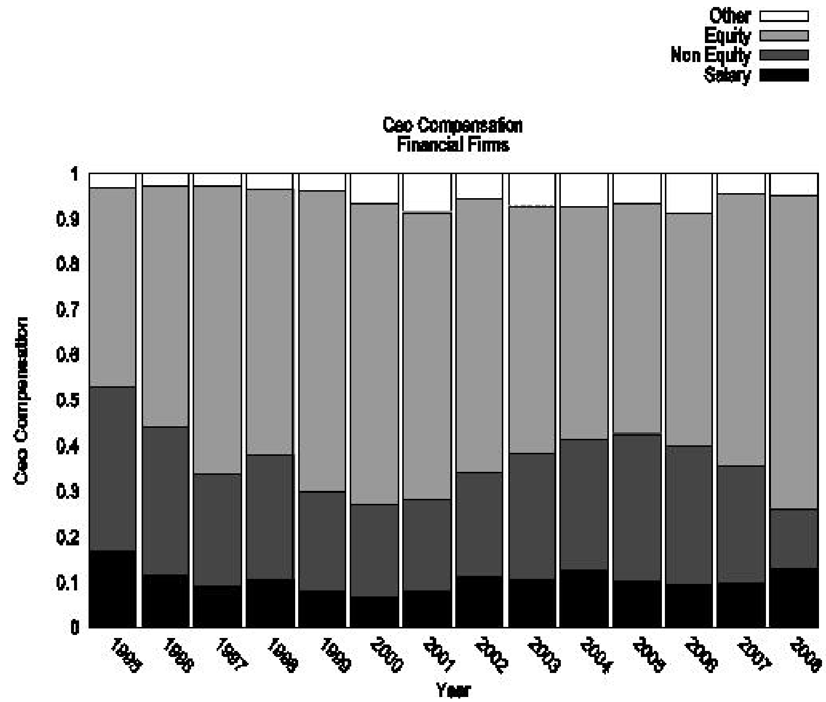


Banks Assets and Crisis



Pay for Performance by Equity has been important for financial firms….





Source: Balachandran, Kogut, and Harnal, 2010

Our Conference

Did bad governance explain why financial firms take on too much risk?

Did executive pay lead to excessive risk taking?

Did executive pay cause excessive risk in financial institutions? –Balachandran, Kogut, Harnal

- 117 Financial Institutions with panel data between 1995 and 2008
- 2008 provides the primary exogenous shock, but other years are also ‘mini stress tests’, e.g. 2000.
- Standard Altman model to predict default failed us because all the firm shown to default
- Solution was to estimate the probability or risk of default.

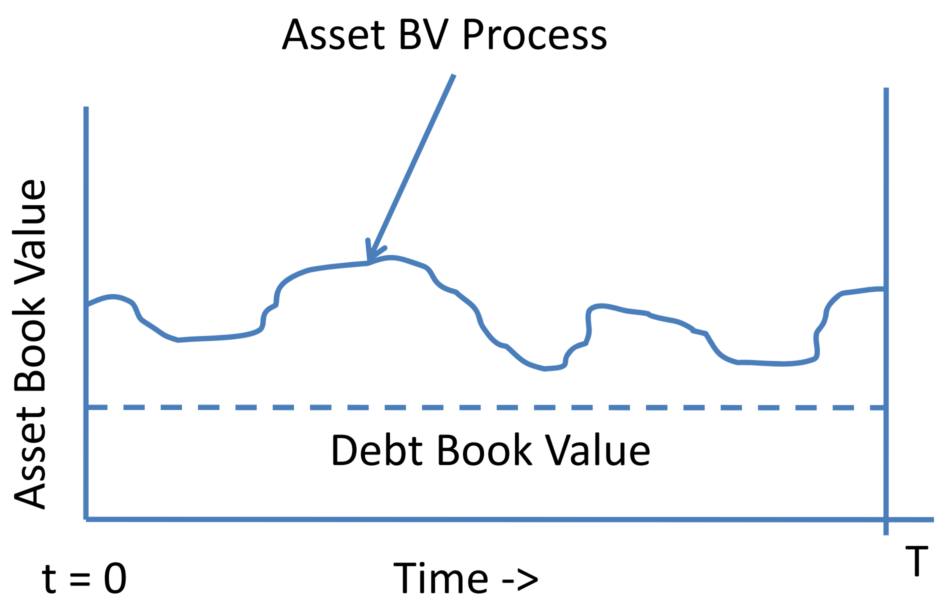
Problem statement

To calculate the default probability measures

Known
Equity data
Liabilities data
Interest Rate

Unknown
Asset Prices
Parameters for Asset price process and asset volatility process
Probability of default

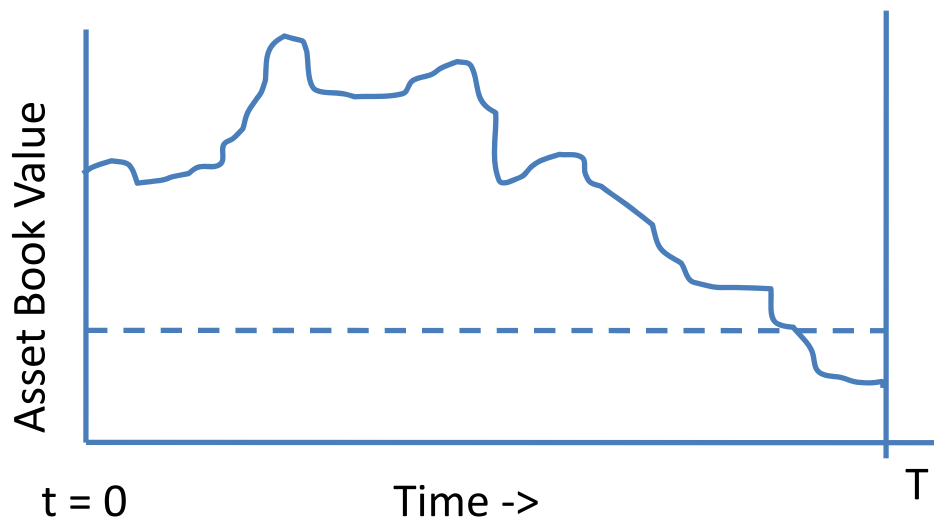
Seeing problem graphically



Whether the company defaults or not depends on the Net Asset BV of company at T

Seeing problem graphically

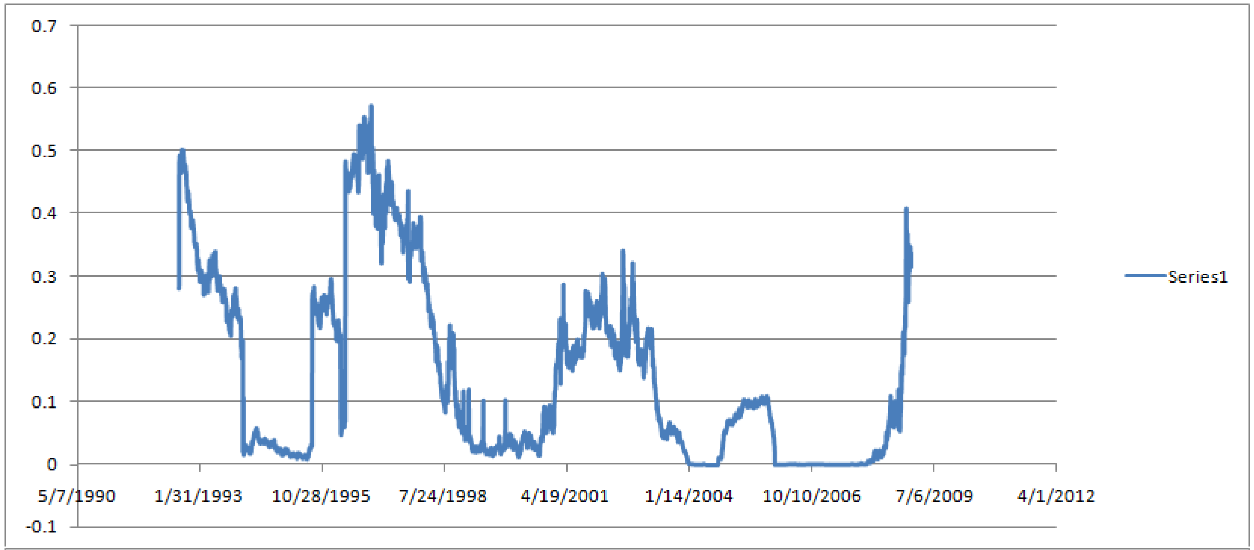
Company defaults



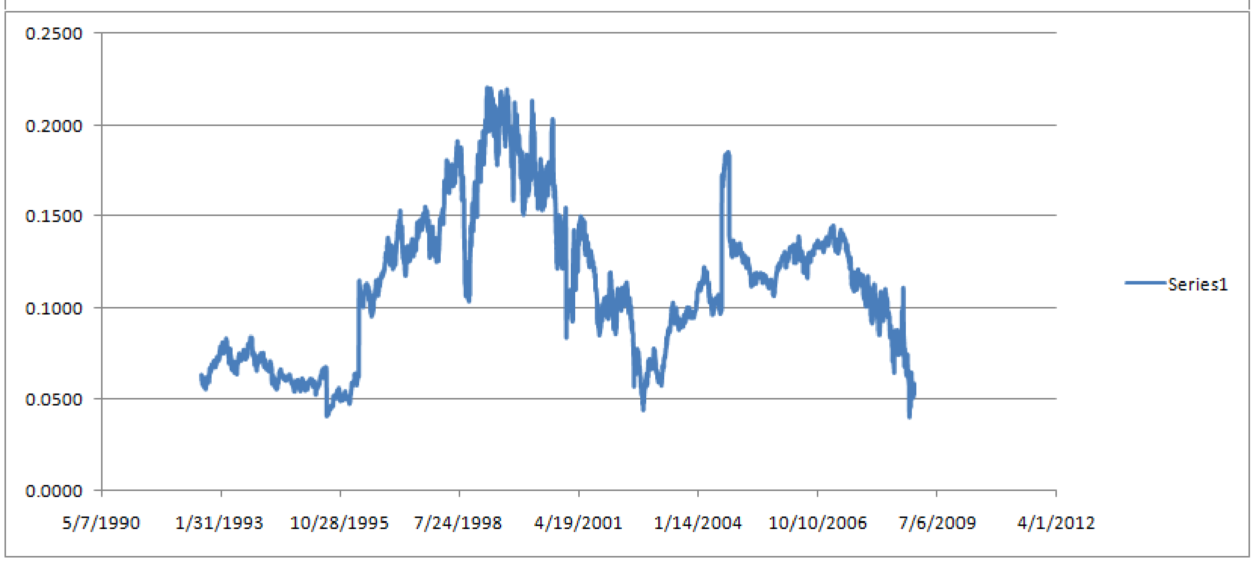
Final Equity BV is zero

Results

Probability of default
JPM

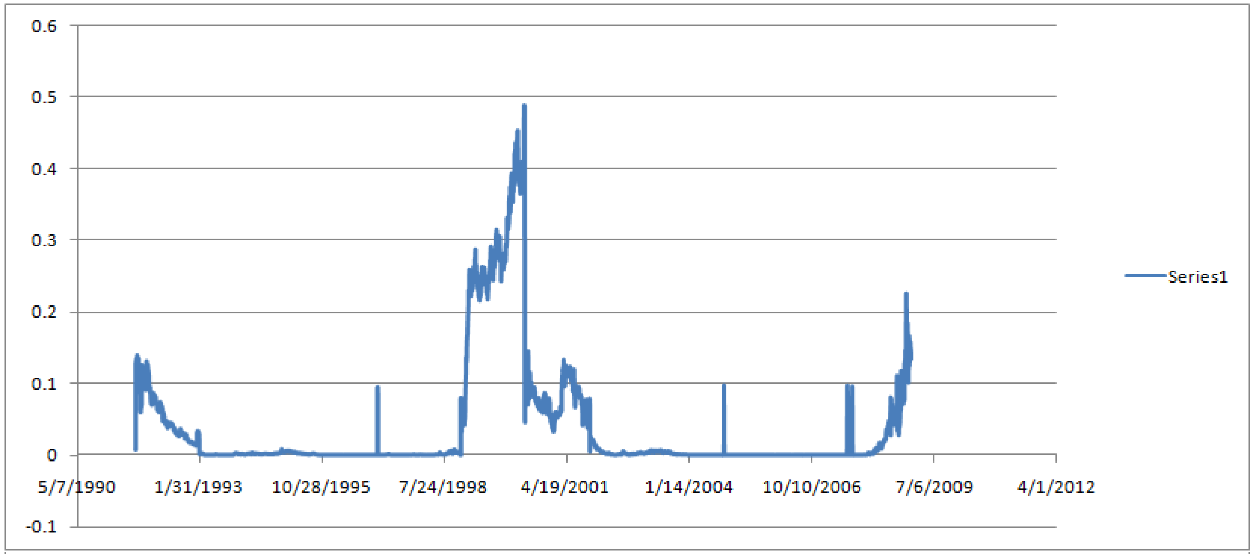


Equity
Smoothened liability

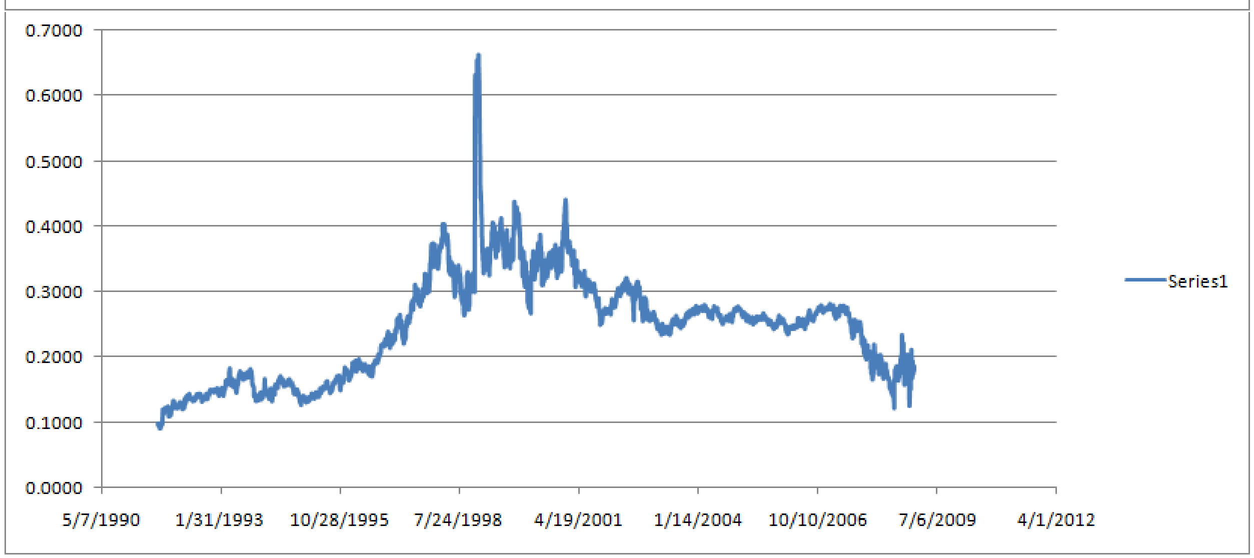


Results

Probability of default
WFC

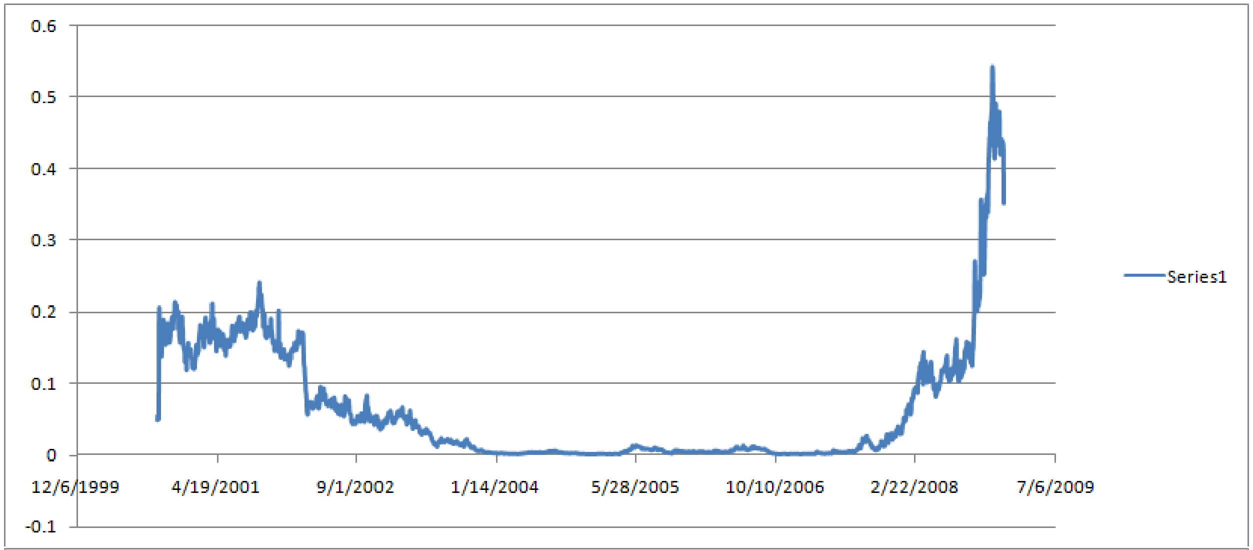


Equity
Smoothened liability

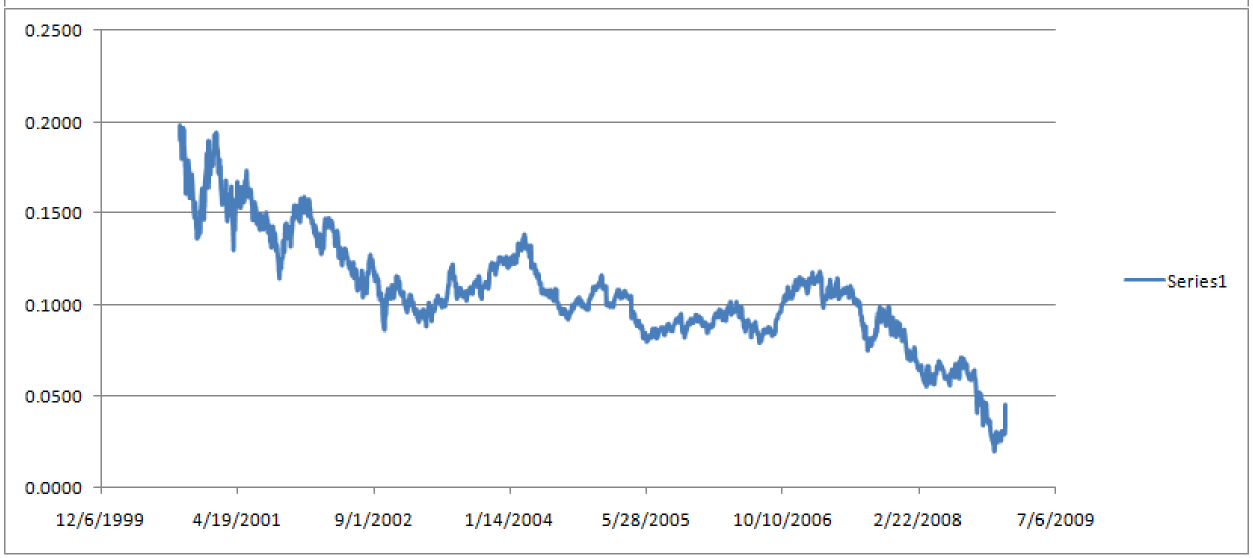


Results

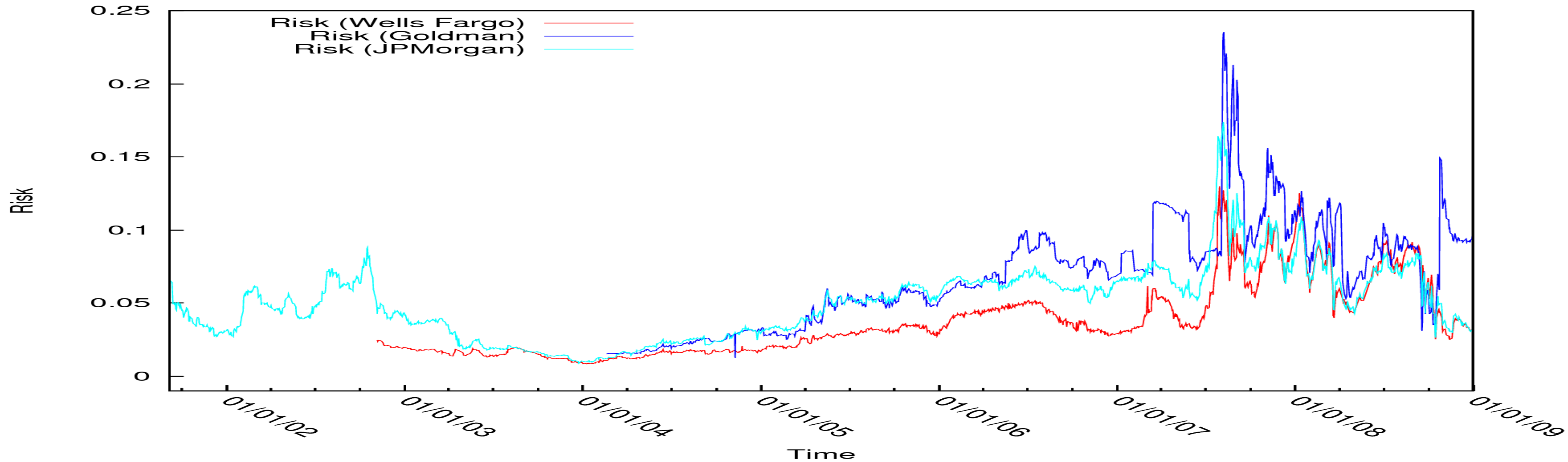
Probability of default
GS



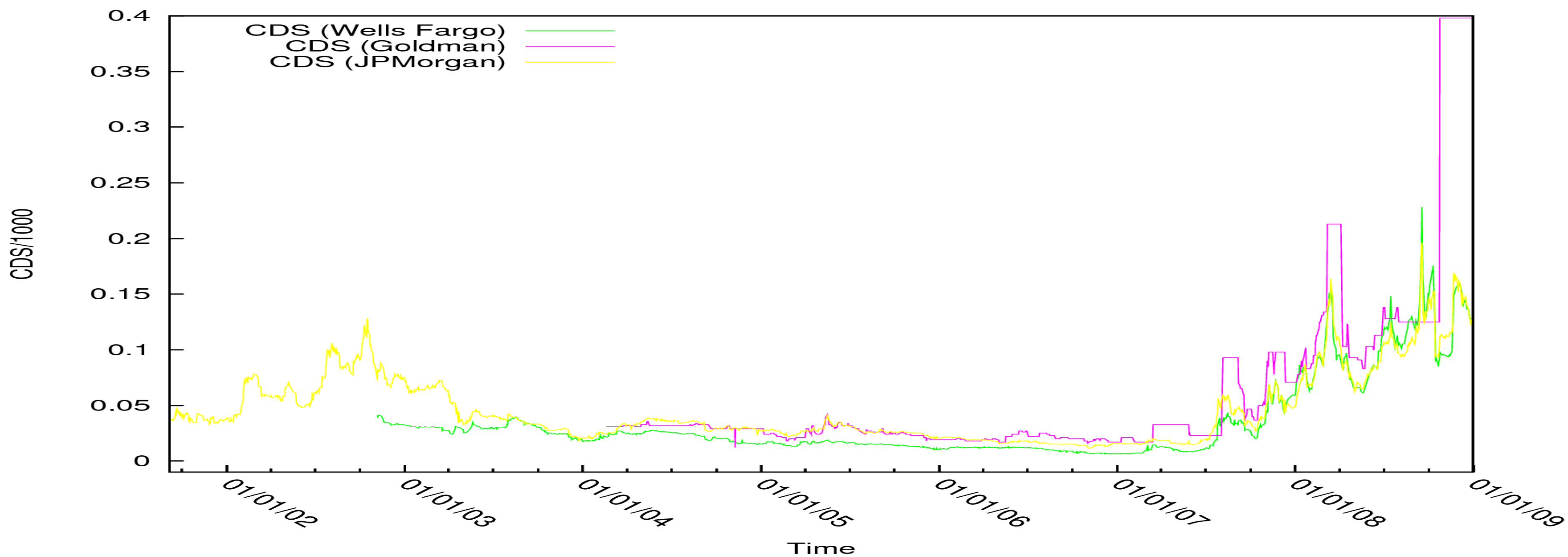
Equity
Smoothened liability



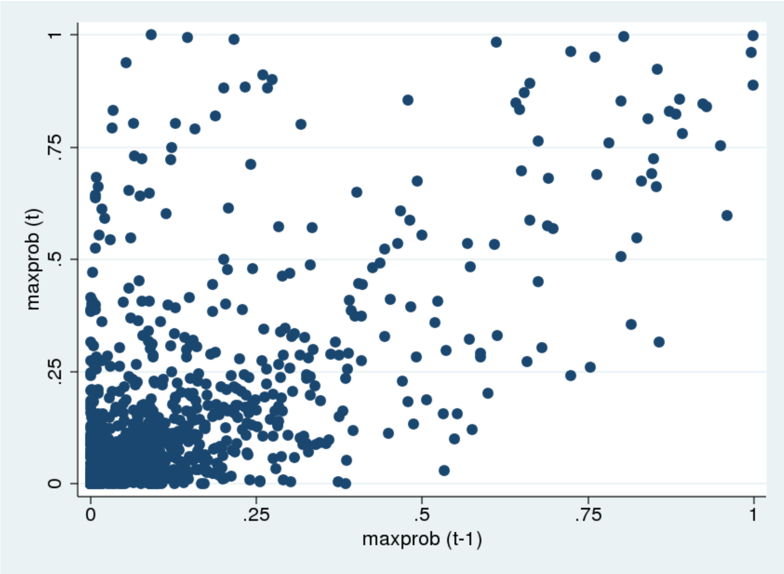
Risk

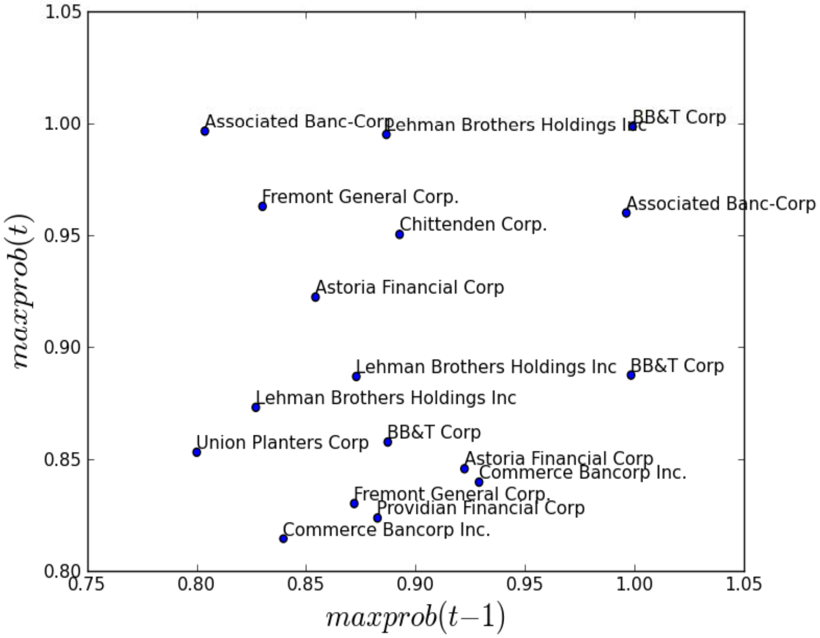

Risk (Wells Fargo)
Risk (Goldman)
Risk (JPMorgan)
0.25
0.2
0.15
0.1
0.05
0
Risk
01/01/02
01/01/03
01/01/04
01/01/05
01/01/06
01/01/07
01/01/08
01/01/09
Time

Cds


CDS (Wells Fargo)
CDS (Goldman)
CDS (JPMorgan)
0.4
0.35
0.3
0.25
0.2
0.15
0.1
0.05
0
CDS/1000
01/01/02
01/01/03
01/01/04
01/01/05
01/01/06
01/01/07
01/01/08
01/01/09
Time

Econometric Problem: Endogeneity and Persistence





Fundamental result: pay for performance leads to excessive risk

Primary Result

- Dynamic Panel Analysis, using a Bond-Blundell estimation (GSM with lagged instruments)
- Equity-linked pay increases excessive risk
- Non-equity: significant and negative sign –cash reduces risk

Robustness

- Endogenize Equity Pay: no change
- Use Equity Pay as instrument: no change
- Consider New CEO as a new contract/less wealth: not significant and equity pay results hold
- Drop 2008: results attenuated –thus the interpretation of stress testing compensation incentives
- Unreported: pay slice of CEO (measure of CEO power/greed) has no effect; cannot detect meaningful board effects, e.g. outside directors, Gompers index, board interlocks.

Standard Theory: Puzzles

What is the effect of compensation incentives on someone who is very wealth and has high income?

Why did top CEOs often keep their wealth undiversified and invested in their companies?

What was the role of overconfidence?

Alternatives to Paulson

1. Bebchuk Plan: Long-term debt is converted into equity, shareholders have the option to redeem the equity at the value of the debt. No external valuation required; no government intervention.
2. Incentivizing managers:
    1. they are required to be paid in debt and equity and thus are sensitive to the costs of default risk.
    2. Options must be expensed, discouraged, etc…
3. Principle-based regulation that says
    1. No incentives for excessive risk taking
    2. Compatible payment with risk management controls
    3. Strong culture of governance to oversee and enforce prudent risk.
4. And many more suggestions….

Conclusions

- Compensation matters to risk taking

- Pay for performance does not make sense when
  - There is moral hazard for executives and shareholders
  - Top executives are very rich
  - Stock prices depart from fundamentals and are dangerous pro-cyclical influences on behaviors

- Why such risks were taken might be explained by rational calculations that went bad, or by other motivations, such as overconfidence or contagion