# Yesterday's Heroes: Compensation and Creative Risk Taking

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Columbia University
Conference on Governance, Executive Compensation, and Excessive Risk in the Financial Services Industry
May 2010

# Compensation and risk-taking

- Panel data on US financial industry indicate that compensation of top executives and risk-taking are positively correlated in the cross-section.
- Correlation may result from
  1. Governance: Mis-alignement between manager's and shareholders interests.
  2. Investor's Demand: Risk-taking a result of shareholders with short horizons incentivizing managers to take short-term risk
     - Bolton, Scheinkman and Xiong (2006) - investor's demand fed risk-taking during a "quant-bubble."
  3. Supply, or "Firm Culture": Risk-taking as part of firm's culture, and short-term investors invest in these firms.
     - Bear Stearns' "cowboy culture" of risk-taking.

# Compensation and risk-taking

- Argue that this correlation is more likely a result of shareholder pressure (Hypotheses 2 and 3) than of mis-alignment of interests of shareholders and managers (Hypothesis 1).
- Causality and normative statements are more difficult, but important to establish even robust facts to inform debate and policy

# Measuring short-termism

- Use a new measure of short-termism relative to literature which has focused on insider ownership
- Look at total direct compensation (bonuses, salary, non-cash pay) to top 5 executives.
  - Control for firm size since best people work for biggest firms, different finance industries
- Looking at what firms pay annually can pick up short-term pressure and **firing** incentives for top management
  - Better picks up firm-wide compensation *practices* (risk managers may be more important than CEOs for risk-taking)
  - Control for insider ownership (Fahlenbrach and Stulz 2010)

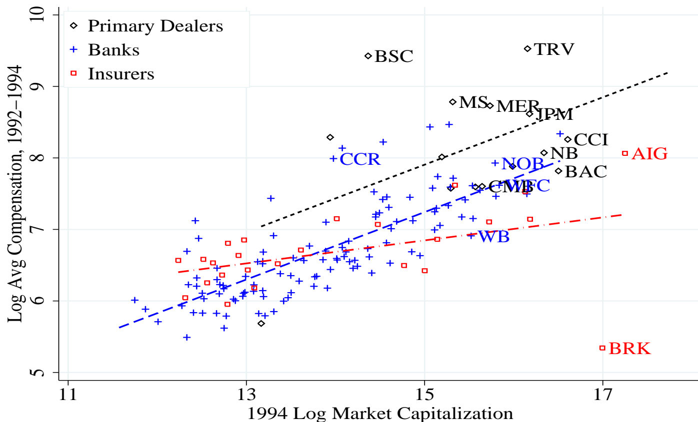
# Empirical design

- Data on compensation (Execucomp) and several sources for risk-taking (1992-2007)
- Ad-hoc split for simplicity. Similar results when pooling data
- Early sample
  - 1992-1994 for compensation
  - 1995-2000 for risk taking measure
- Late sample
  - 1998-2000 for compensation
  - 2001-2007 for risk-taking

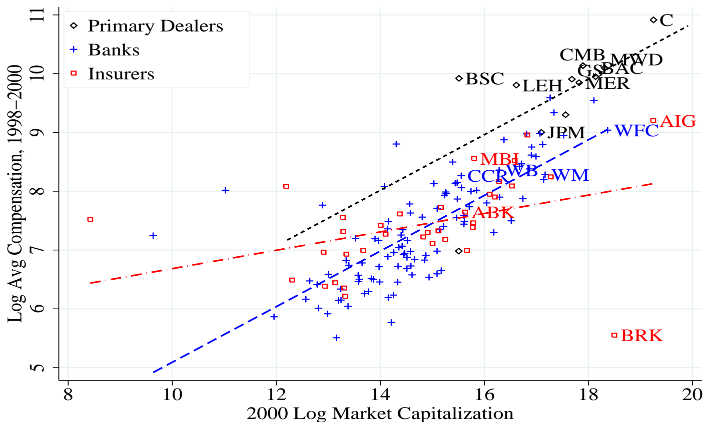
# Classification of financial firms

- Primary dealers
  - Include bank holding companies with primary dealer subsidiary.
- Banks, lenders and bank-holding companies with no primary dealer subsidiary.
- Fire, marine, casualty and surety insurers

# Residual compensation 1992-1994



# Residual compensation 1998-2000



# Persistence

- Rankings of residual compensation has .6 correlation across the two periods
- Effect of stock returns very small
- Persistence unrelated to CEO turnover.

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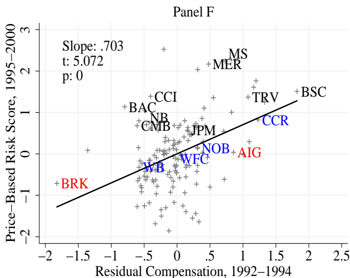
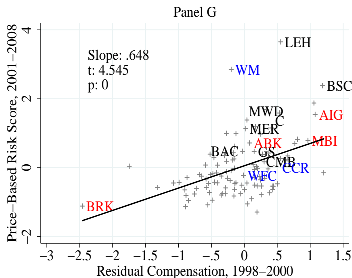
# Excess compensation and risk

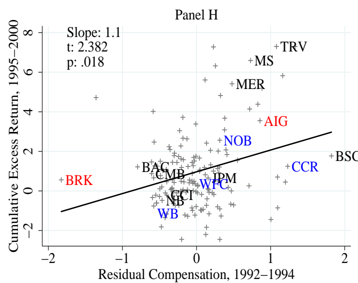
- Compensation of executives, corrected for size, is correlated with riskiness of firms
  - Sensitivity to ABX (AAA) returns
  - Betas
  - Return volatility.

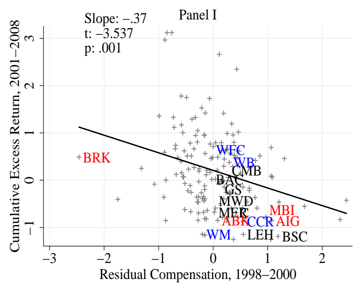
# Excess compensation and sensitivity to average price-based risk score



# Excess compensation and performance



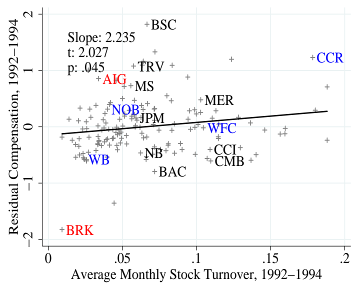
# Robustness

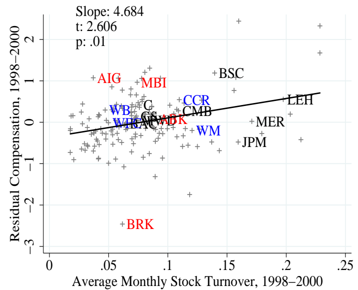
- Robust to
  - Exclusion of subindustries
  - Calculating compensation controlling for asset (instead of market) value.
  - Controlling for book leverage on the right hand side (heterogeneity not just book leverage)
  - Excluding CEO when computing residual pay
  - Works in manufacturing industries but much weaker.
  - Using an annual pooled regression.
  - Controlling for inside ownership (Fahlenbrach and Stulz for returns)
- High residual comp list includes a variety of firms, big and small, in various industries
  - Fremont, BSC, MBIA

# Governance vs. shareholders' choices

- Governance measures (entrenchment measures, outside directors) do not correlate with residual compensation, risk taking or returns.
- High residual compensation, high risk-taking stocks, also have high institutional ownership and high turnover
  - Consistent with theory where speculative investors incentivize managers to take risks
  - Also consistent with short-term investors selecting into firms with a culture of taking risks

# Turnover and excess compensation



# Michael Lewis, "The Irresponsible Investor", *NYT*, June 6, 2004.

*"The investor cares about short-term gains in stock prices a lot more than he does about the long-term viability of a company. Indeed, he does not seem even to notice that the two goals often conflict. .... The investor, of course, likes to think of himself as a force for honesty and transparency, but he has proved, in recent years, that he prefers a lucrative lie to an expensive truth. And he's very good at letting corporate management know it."*

# Summary

- Evidence that high compensation related to high risk and tail performance
  - Compensation story emphasizing high-powered/shorter-term incentives
- Evidence that excessive risk taking by firms was a response to shareholders demands.
  - Emphasis on governance may be misplaced
- Regulation
- Voting power according to holdings horizon?