Executive Compensation and the Financial Crisis

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Outline of Remarks

• Executive Compensation and the Financial Crisis: A Paradox
• Key U.S. Regulations of Financial Institutions’ Executive Compensation
• A Better Alternative for Compensation Reform (Bhagat and Romano, 2009)
Introduction: A Paradox

- On a laundry list of causes of the financial crisis, executive compensation would not be near the top
  - Top: Leverage; panic in repo market
  - Further candidates:
    - Government policies (lax interest rates, promotion of subprime risk-taking by GSEs and private financial institutions, capital regulations and reliance on credit rating agencies)
    - Bank managers not subject to market discipline (ownership restrictions, deposit insurance, ineffective prudential regulation, models with unrealistic assumptions, poorly-designed incentive compensation)

- But executive compensation has been at the top of the reform agenda in all nations
Examples

• “French President Nicolas Sarkozy has threatened to walk out of the G-20 summit if leaders don’t adopt strict compensation limits for financial executives.”

• “German Chancellor Angela Merkel’s feisty re-election campaign is focused on putting bonus caps on bankers, especially those in the U.S. who she says caused the global economic slide.”

- Wall St. J. Sept. 19-20, 2009
Why is Executive Compensation the Principal Target of Reform?

• Long history of media attention to, and populist attacks on executive compensation in U.S.
• Looking for scapegoats: Shockingly large compensation of executives of financial firms bailed out by government (paralleling, in prior years, pay of executives of accounting fraud scandal firms)
• Easy target for politicians to deflect attention from government policies that contributed to the crisis
• Special rationale for regulating banks: Taxpayers are firms’ residual claimants given deposit insurance, new bailout programs
Key U.S. Regulations of Bankers’ Pay

• Stimulus Bill (2/09)
  – Bonuses capped at 1/3 total compensation and prohibited unless restricted stock that does not vest until Troubled Asset Relief Program (TARP) obligation period ends (applies to top 25 executives if received $500 million; fewer execs if received less)
  – Bonus clawbacks if based on inaccurate performance metrics (top 25 senior executives – expansion from Bailout legislation and Bush Administration rules)

• Obama Administration Rules (6/09)
  – Special Master appointed to approve executives’ compensation of TARP firms receiving exceptional assistance (AIG, BoA, Citigroup, 4 Auto-related firms)

• Floated forthcoming Administration and Fed Rules (9/09)
  – Bank examiners will approve compensation plans
Studies of Relation between Incentive Pay and Financial Crisis Performance

- Fahlenbrach and Stulz (2009): 98 U.S. banks, assessed over 7/07-12/08
  - No evidence that banks with higher CEO option pay performed more poorly
  - No evidence those with higher CEO equity ownership performed better (some evidence they may have performed worse)

- Erkens, Hung and Matos (2009): 306 financial firms in 31 countries, assessed over 1/07-9/08
  - Firms awarding CEOs more compensation in cash bonuses rather than equity incentives (options, restricted shares, long-term incentive plans) experienced higher losses
  - “U.S.” effect? (higher % equity incentives than any other country)
A Better Compensation Reform Proposal (Bhagat and Romano, 2009)

• All incentive compensation should consist of restricted stock and options
  – Restricted in the sense that shares cannot be sold or options exercised until 2-4 years after last day in office

• Require for financial institutions receiving federal assistance or subsidy (TARP, Fed window, etc.)

• Why advocate this proposal?
  – Although incentive compensation did not cause crisis, increasing regulation inevitable given political climate and prudential concern in protecting the fisc
Advantages of Proposal

• Meets desirable criteria: simple and transparent
• Superior incentives to unrestricted plans
  – Diminishes incentive to accept undue risk, manage earnings or make public statements that increase short-term stock price appreciation
• Automatic clawback feature
  – Receive less if price drops
  – Easier to administer than statutory clawbacks
• Superior to caps and restrictions on form of pay
  – *Empirical research* indicates companies find a way to circumvent restrictions, resulting in higher and more opaque pay and adjustments with perverse incentives
Examples

• After Congress limited tax deductibility of non-incentive based, cash compensation to $1 million, there was a large increase in equity incentive compensation; some studies link that change to subsequent fraud and accounting restatements

• After Congress required clawbacks of incentive pay, there was an increase in non-forfeitable fixed salary components, reducing the sensitivity of pay to performance
Rationale for Restriction

- 2 year minimum: Management’s discretionary authority under U.S. accounting conventions to manage earnings generally unravels in 1-2 year period
- 4 year maximum: Intermediate-term results of manager’s decisions likely to come to fruition in 4 years
- Better incentive-horizon match than Congress’ restriction to repayment of TARP indebtedness
  - avoids incentive to repay prematurely at potential expense of long-term value
Issues Raised by Proposal

• Increases executive’s underdiversification
• Loss of liquidity
• Tax liability for receipt of restricted stock and options
• Premature departures of executives
• Appropriateness for lower-level managers
• Relative performance pay
Dealing with Underdiversification

• Grant additional restricted shares and options

• To prevent undoing of incentives, would need to restrict derivatives transactions that hedge specific risk from having to hold restricted stock and options

• Board of directors or compensation committee approval required for other derivative transactions (e.g., a put on broader securities)
Dealing with Liquidity and Tax Liability

• Higher tax-deductible cash compensation and no incentive pay limit ($2 million, compared to $500,000 limit for banks for all pay)

• Permit small percent of incentive pay to be realized earlier (at least enough to cover increased tax liability, recommend 10-15%)
  – Median CEO tenure is 5 years, delay of compensation receipt for 7-9 years parallels time frame in which most of private equity partners’ profits are realized (carried interest realized at end of partnership life, usually 7-10 years)
Dealing with Premature Departure

• Realization of 10-15 percent mitigates concern
• Managers who develop a reputation for early departures are likely to impact negatively future career opportunities
  – Evidence of reputational effects in market for managers: managers of firms filing for bankruptcy do not show up as heads of another public company (Gilson, 1989)
• Increased deductible cash pay of $2 million is more than the adjusted gross income of top 0.1% taxpayers in 2004 ($1.4 million)
Dealing with Lower-level Managers

• Criticism: Lower-level managers should not be paid in restricted stock because their pay should relate to unit’s performance

• Restricted stock and options of those managers can be allocated according in proportion to their unit’s accounting performance compared to rest of company
  – Note: We prefer stock prices to benchmark performance over accounting-based measures of a unit’s performance, which are themselves manipulable
Relative Performance

• Controlling for industry or market performance arguably a better measure of manager’s contribution

• At odds with aim of proposal to render compensation simple and transparent
  – Complicated to determine appropriate benchmarks
  – Executive can receive significant compensation even though shareholders incur large losses, which can undermine credibility with investors and public
Comparing an Alternative

• Bebchuk and Spamann (2009) propose linking compensation to payoffs of security holders in banks’ capital structure

• Feasibility and transparency problems with Bebchuk-Spamann proposal:
  – How to value when many of those securities are illiquid and have no market prices
  – Need to rebalance frequently to maintain proportionate interest in claims
  – May not eliminate incentive to benefit equity at expense of fisc (gain on equity position may exceed loss on senior securities in portfolio)
Conclusion

• Congress’ and Administration’s approach are not smart solutions to incentive problems of bank compensation and are likely to create perverse incentives
• Bhagat-Romano proposal of incentive pay in the form of restricted stock and options over long horizon equally protects the fisc while providing superior incentives for executives to manage financial institutions’ risk in investors’ long-term interests
• But compensation reform will not prevent repeat plays of the crisis, because compensation was not a prime cause of the crisis (more pressing need for financial regulation to address capital requirements, leverage and repo market issues)