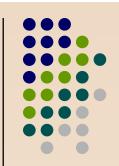


Executive Compensation and Risk Taking

Lucian Bebchuk, Harvard university Columbia University, May 2010



Main Questions



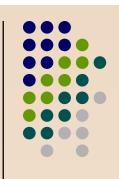
- How to fix compensation structures to make excessive risktaking less likely?
- What role if any should the government play in reforming executive pay in financial firms?

[For a fuller development of my views on these issues:

- -- Bebchuk and Spamann, *Regulating Bankers' Pay*, Georgetown Law Journal, 2010.
- -- Bebchuk and Fried, Paying for Long-Term Performance, University of Pennsylvania Law Review, 2010, forthcoming.
- -- Bebchuk, Cohen, and Spamann, The Wages of Failure: Executive Compensation in Lehman and Bear Stearns, Yale Journal of Regulation, 2010, forthcoming
- -- 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

[Bebchuk, Cohen, and Spamann, The Wages of failure: Executive Compensation in Bear Stearns and Lehman Brothers 2000-2008, *Yale Journal on regulation*, 2010]

- 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.

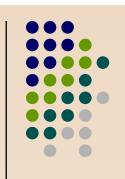
Addressing Short-Term Distortions

[Bebchuk-Fried, Pay without Performance, 2004, Paying for Long-Term Performance, *U Pennsylvania Law Review* 2010]

- 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)

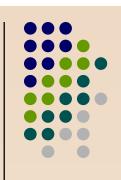
[Bebchuk-Fried, Paying for Long-term Performance, University of Pennsylvania Law Review, 2010]



- 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)

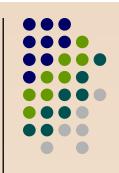
[Bebchuk-Fried, Paying for Long-term Performance, University of Pennsylvania Law Review, 2010]



- 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)

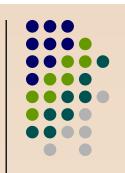
[Bebchuk-Spamann, Regulating Bankers Pay, Georgetown Law Journal, 2010]



- 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.

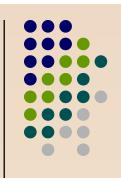
The Leverage Problem (2)

[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.

[For detailed blueprint for expanding shareholder rights, see Bebchuk, Case for increasing shareholder power, *Harvard Law Review*, 2005; Bebchuk, The Myth of the Shareholder Franchise, *Virginia Law Review*, 2007]

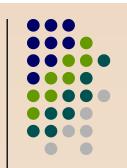
The Role of Government (2)

[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 risktaking that does not fully take into account the interests of other capita contributors.

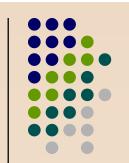


Pay structure supervision as supplement for Prudential Regulation



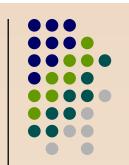
- Supervisors should focus on the structure of pay arrangements – not the amount – and they should seek to limit the use of incentives to take excessive risks.
- Supervision of pay structures could make executives work for, not against, the goals of financial regulation.
- Complements prudential regulation.
 - -- 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.

