HOW TO FIX BANKERS’ PAY

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Discussion Paper No. 677

09/2010

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This paper is also a discussion paper of the
John M. Olin Center's Program on Corporate Governance
How to Fix Bankers’ Pay

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Abstract

This essay – written for a special issue of the American Academy of Arts and Sciences’ Daedalus journal on lessons from the financial crisis – discusses how bankers’ pay should be fixed. I describe two distinct sources of risk-taking incentives: first, executives’ excessive focus on short-term results; and, second, their excessive focus on results for shareholders, which corresponds to a lack of incentives for executives to consider outcomes for other contributors of capital. I discuss how pay arrangements can be reformed to address each of these problems and conclude by examining the role that government should play in bringing about the needed reforms. The essay provides an accessible summary of the analysis developed in Bebchuk and Fried, “Paying for Long-Term Performance” (University of Pennsylvania Law Review, 2010) and Bebchuk and Spamann, “Regulating Bankers’ Pay” (Georgetown Law Journal, 2010).

Keywords: Financial crisis, executive compensation, banking, risk-taking

JEL Classification: G28, K23

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The financial crisis has highlighted the importance of discouraging excessive risk-taking by financial firms. The extent to which firms take on risks can be expected to depend partly on their executives’ incentives. In the aftermath of the financial crisis, G20 leaders announced their commitment “to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking.”\(^1\) But how should bankers’ pay be fixed? The devil, as is often the case, is in the details.

Below I sketch some key principles for reforming bankers’ pay, drawing on my academic work\(^2\) as well as on written testimonies before the Financial Services Committee of the House of Representatives.\(^3\) I describe two distinct sources of risk-taking incentives: first, executives’ excessive focus on short-term results; and, second, their excessive focus on results for shareholders, which corresponds to a lack of incentives for executives to consider outcomes for other contributors of capital. I discuss how pay arrangements can be reformed to address each of these problems and conclude by examining the role that government should play in bringing about the needed reforms.

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Standard pay arrangements have incentivized and rewarded short-term results. Jesse Fried and I warned about this problem and its consequences in our book *Pay without Performance: The Unfulfilled Promise of Executive Compensation*, published six years ago.\(^4\) Under the standard design of pay arrangements, executives have been able to cash out large

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amounts of compensation based on short-term results, which has provided executives with incentives to seek short-term gains even when doing so creates excessive risk of a later implosion.

Modern pay packages are largely performance-based, consisting of both equity-based compensation (such as options and restricted stock) and bonus compensation. Such provisions are intended to provide incentives for improved performance. In the past, however, these critical components of standard pay arrangements have also produced perverse incentives.

Bear Stearns and Lehman Brothers, the firms whose respective meltdowns ushered in the current financial crisis, are illustrative of the problem. Various observers, including *New York Times* and *Wall Street Journal* columnists, largely assumed that the wealth of these firms’ executives was wiped out, together with that of their firms. This “standard narrative” led commentators to dismiss the potential role of flawed pay arrangements in the firms’ risk-taking. Assuming that the executives’ wealth was wiped out alongside the shareholders’, these commentators inferred that the firms’ risk-taking could not have been an upshot of deliberate choices produced by perverse incentives; rather, it must have been the result of the executives’ failure to perceive risks—or their hubris. Alternative pay structures, they argued, would not have made a difference.

In our study “The Wages of Failure: Executive Compensation at Bear Stearns and Lehman Brothers 2000–2008,” Alma Cohen, Holger Spamann, and I examine this standard narrative and find it to be incorrect. We piece together the cash flows derived by the firms’ top five executives using data from Securities and Exchange Commission filings. Our analysis indicates that, notwithstanding the 2008 collapse of the firms, the bottom lines of those executives for the 2000-2008 period were positive and substantial.

Most important, the firms’ top executives regularly unloaded shares and options and thus were able to cash out much of their equity before the stock price of their firms plummeted. Indeed, the top five executives unloaded more shares during the years prior to their firms’ meltdowns than they held when disaster came in 2008. Altogether, during 2000 to 2008, the top

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executive teams at Bear Stearns and Lehman cashed out through equity sales about $1.1 billion and $850 million, respectively.\(^7\)

These payoffs to top executives were further increased by large bonus compensation. During 2000 to 2007, the top executives’ aggregate bonus compensation reached $300 million at Bear Stearns and $150 million at Lehman. Of course, the earnings that provided the basis for these bonuses evaporated in 2008. But the firms’ pay arrangements did not contain any “claw-back” provisions that would have enabled the firms to recoup bonuses that had already been paid.

Combining the figures from equity sales and bonuses, we find that, during 2000 to 2008, the top five executives at Bear Stearns and Lehman pocketed about $1.4 billion and $1 billion, respectively, or roughly $250 million per executive. The CEOs—James Cayne of Bear Stearns and Richard Fuld of Lehman Brothers—pocketed about $380 million and $520 million, respectively. These cash proceeds are substantially higher than the value of the holdings that the executives held at the beginning of the period. Thus, while earnings for their firms’ long-term shareholders were largely decimated, the executives’ performance-based compensation kept them in positive territory.

The divergence between how the top executives and their companies’ shareholders fared raises a serious concern that the aggressive risk-taking at Bear Stearns and Lehman (and other financial firms with similar pay arrangements) could have been the product of flawed incentives. The concern is not that the top executives expected their aggressive risk-taking to lead to certain failure for their firms, but that the executives’ pay arrangements—in particular, their ability to claim large amounts of compensation based on short-term results—induced them to accept excessive levels of risk.

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To address the problem of short-term focus, financial firms should reform compensation structures to ensure tighter alignment between executive payoffs and long-term results. Senior executives should not be able to collect and retain large amounts of bonus compensation when

\(^7\) All dollar figures are in 2009 dollars.
the performance on which the bonuses are based is subsequently sharply reversed. Similarly, equity incentives should be subject to substantial limitations aimed at preventing executives from placing excessive weight on their firm’s short-term stock price. Had such compensation structures been in place at Bear Stearns and Lehman, their top executives would not have been able to derive such large amounts of performance-based compensation for managing these firms in the years leading up to their collapse.

Equity-based compensation is the primary component of modern pay packages. Under standard arrangements, equity-based awards vest gradually over a period of time. Once they vest, however, executives typically have unrestricted freedom to cash them out and, indeed, often unload such equity incentives quickly after vesting. This right to cash out vested equity incentives freely has contributed substantially to the creation of short-term distortions.

In a recent article, Jesse Fried and I, building on the approach we put forward in Pay without Performance, proposed a detailed blueprint for preventing equity-based compensation, the primary component of modern pay packages, from producing an excessive focus on short-term results. To begin, it is desirable to separate the time that options and restricted shares can be cashed out from the time in which they vest. As soon as an executive has completed an additional year at the firm, the options or shares promised as compensation for that year’s work should vest; it should belong to the executive even if he or she immediately leaves the firm. The executive, however, should not be free to cash out these vested equity incentives; rather, he or she should be permitted to do so only after a substantial passage of time.

Some shareholder proposals and compensation experts have called for allowing executives to cash out shares and options only upon retirement from the firm. Such a “hold-till-retirement” requirement, however, would provide executives with a counterproductive incentive to leave the firm in order to cash out their portfolio of options and shares and diversify their risks. Perversely, the incentive to leave will be strongest for executives who have served successfully for a long time and whose accumulated options and shares are especially valuable. Similar distortions arise under any arrangement tying the freedom to cash out to an event that is at least partly under an executive’s control. To avoid this problem, firms should adopt limitations on unwinding that are not a function of such events.

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8 Bebchuk and Fried, “Paying for Long-Term Performance.”
In particular, unwinding should be subject to a combination of grant-based and aggregate restrictions. Grant-based limitations would require executives to hold equity incentives awarded as part of a given grant for a fixed number of years after vesting. For example, an executive receiving an equity award could be prevented from unwinding any awarded equity incentives for two years after vesting, with each subsequent year freeing another 20 percent of the awarded incentives to be unloaded.

These grant-based limitations, however, might sometimes not be sufficient to secure adequate long-term focus. With only grant-based restrictions in place, long-time executives might amass large amounts of equity incentives that they could immediately unload, which could induce them to pay excessive attention to short-term prices. Therefore, grant-based limitations should be supplemented with aggregate limitations restricting the fraction of an executive’s otherwise unloadable equity incentives that could be sold in any given year. To illustrate, executives could be precluded from unloading, in any given year, more than 10 percent of their total portfolio of otherwise unloadable incentives. By construction, such limitations would ensure that executives would not place substantial weight on short-term stock prices.

Finally, firms must adopt robust limitations on executives’ use of hedging and derivative transactions, a practice that can weaken the connection between executive payoffs and long-term results. An executive who buys a “put” option to sell his or her shares at the current price, as executives are generally free to do under standard pay arrangements, is “insured” against declines in the stock price below current levels. Empirical evidence indicates that executives engage in a significant amount of hedging, and that such hedging is at least partly motivated by their inside information. Furthermore, the adoption of significant limitations on unwinding would likely increase executives’ incentives to engage in hedging and derivative transactions, as doing so could neutralize the effects of those limitations. Indeed, if executives continued to enjoy the freedom to engage in such transactions, the practical impact of limitations on unwinding would be much reduced.

Whether or not they are motivated by the use of inside information, executives should not be at liberty to use hedging and derivative transactions to undo the effects of equity-pay arrangements put in place by their firm’s board at a cost to shareholders. Rather, executives

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should be precluded from engaging in any hedging or derivative transactions that would reduce or limit the extent to which declines in the company’s stock price would lower executive payoffs.

In Fall 2009, following the anti-hedging approach that Jesse Fried and I advocated, the Special Master for TARP Executive Compensation Kenneth Feinberg required companies subject to his jurisdiction to adopt such an anti-hedging requirement.10 This approach should also be followed by public firms in general. Whatever equity-plan design is chosen by a given company’s board, executives should not be allowed to unilaterally use hedging and derivative transactions that undo the incentive consequences of this design.

In addition to equity compensation, bonus plans also must be redesigned. Under standard pay arrangements, executives have been able to cash bonus compensation based on short-term results and retain it even when those results were reversed. To address the short-term distortion arising from such arrangements, bonuses should not be cashed right away; instead, the funds should be placed in a company account for several years and adjusted downward if the company subsequently learns that the bonus is no longer justified. The need for such a downward adjustment is not limited to firms in which financial results are restated. Even if results for a given year were booked consistent with accounting conventions, executives should not be rewarded for profits that are quickly reversed. Rewarding executives for short-term results distorts their incentives and should be avoided by well-designed compensation arrangements.

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Thus far, I have focused on the insulation of executives from long-term losses to shareholders—the problem that has received the most attention following the recent crisis. However, as Holger Spamann and I analyze in detail in recent work,11 there is another type of distortion that should be recognized: payoffs to financial executives have been shielded from the

10 See testimony of Kenneth R. Feinberg, the Special Master for TARP Executive Compensation, before the House Financial Services Committee, February 25, 2010, http://www.ustreas.gov/press/releases/tg565.htm. Feinberg reports that one of the principles incorporated used in evaluating pay at subject firms was that “employees should be prohibited from engaging in any hedging, derivative or other transactions that undermine the long-term performance incentives created by a company’s compensation structures.”

11 Bebchuk and Spamann, “Regulating Bankers’ Pay.”
consequences that losses could impose on parties other than shareholders. This source of distortion is distinct from the “short-termism” problem discussed above and would remain even if executives’ payoffs were fully aligned with those of long-term shareholders.

Equity-based awards, coupled with the capital structure of banks, tie executives’ compensation to a highly levered bet on the value of banks’ assets. While bank executives expect to share in any gains that might flow to common shareholders, they do not expect to bear (in the event losses exceed the common shareholders’ capital) any part of losses borne by preferred shareholders, bondholders, depositors, or the government as a guarantor of deposits. This state of affairs leads executives to pay insufficient attention to the possibility of large losses sustained beyond the shareholders’ equity; it thus incentivizes excessive risk-taking.

Insulation of executives from losses to parties other than shareholders can be expected to produce at least two types of risk-taking distortions. First, it encourages executives to make investments and take on obligations that can contribute to “tail” scenarios, in which the bank suffers losses exceeding the shareholders’ capital. Second, it creates reluctance to raise capital and fosters excessive willingness to run the bank with a capital level that provides inadequate cushion for bondholders and depositors. The more thinly capitalized banks are, the more severe these distortions become.

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How could pay arrangements be redesigned to address this distortion? To the extent that executive pay is tied to the value of specified securities, such pay could be tied to a broader basket of securities, not merely common shares. Thus, rather than tying executive pay to a specified percentage of the value of the common shares of the bank holding company, compensation could be tied to a specified percentage of the aggregate value of the common shares, the preferred shares, and all the outstanding bonds issued by either the bank holding company or the bank. Because such a compensation structure would expose executives to a broader fraction of the negative consequences of risks taken, it would encourage greater prudence in evaluating risky choices.

The structure described above would not by itself cause bank executives to internalize fully the adverse consequences that risk-taking might have for the interests of the government as
guarantor of deposits. Achieving such fuller internalization would require broadening further the set of positions to whose aggregate value executive payoffs are tied. One could consider, for example, schemes in which executive payoffs were tied not to a given percentage of the aggregate value of the bank’s common shares, preferred shares, and bonds at a specified point in time, but rather to this aggregate value minus any payments made by the government to the bank’s depositors, as well as other payments made by the government in support of the bank, during the specified time period.

Alternatively, executive payoffs could be tied to the aggregate value of the bank’s common shares, preferred shares, and bonds at the specified time minus the expected value of future government payments as proxied by the product of (i) the implied probability of default inferred from the price of credit default swaps at the specified time, and (ii) the value of the bank’s deposits at that time. Even if such schemes are not used, however, tying executive pay to the aggregate value of common shares, preferred shares, and bonds would by itself produce a significant improvement in incentives compared with existing arrangements.

Similarly, in firms in which executives receive bonus compensation tied to specified accounting measures, bonuses could be linked instead to broader metrics. For example, the bonus compensation of some bank executives has been dependent on accounting measures that are of interest primarily to common shareholders, such as return on equity or earning per common share. Such plans could be redesigned to be based on more expansive measures, such as earnings before any payments made to bondholders.

Ensuring that executives internalize perfectly the expected losses that choices would impose on contributors of capital other than shareholders is far from straightforward. But doing so imperfectly would likely be better than not doing so at all. Requiring financial executives to expand their focus beyond consequences for shareholders would significantly improve their risk-taking incentives.

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Having discussed changes in pay arrangements that would curtail incentives for banks and other firms to take excessive risks, I turn to the question of what role, if any, the government should play in implementing reform. Some will argue that, however desirable such reforms may
be, introducing changes should be left to the marketplace. According to this standpoint, private players can be fully expected to draw lessons from past problems and adopt whatever reforms are desirable. In my view, however, the government has two important roles to play.

The first function the government should perform—both in the financial firms that are the focus of this essay and in other public firms—is to improve governance arrangements. In particular, the government should ensure that shareholders have sufficiently strong rights to discourage choices adverse to their interests, including the adoption of pay arrangements that insulate executives from long-term losses of shareholder value.

The new Dodd-Frank bill, the Wall Street Reform and Consumer Protection Act, introduced “say on pay,” which enables shareholders to express their views on the pay arrangements of public firms in advisory votes. To the extent that directors would seek to avoid a negative say on pay vote, the introduction of such votes could help prevent some egregious cases. But advisory votes by themselves cannot ensure that directors are sufficiently attentive to and focused on shareholder interests. To provide directors with such incentives, a broader reform is necessary—and indeed long overdue.

Shareholders in the United States have long had weaker rights than they have in the United Kingdom and other common law countries. As I discuss in detail in a series of recent articles, shareholder rights should be strengthened in two important ways. To begin, the power of shareholders to replace directors should be turned from myth into reality. Existing rules and arrangements provide incumbent directors with a substantial advantage over outside challengers. For example, whereas challengers from outside the firm must bear their campaign expenses themselves, incumbents have their expenses fully covered by the company. Moreover, the boards of many companies are “staggered,” which requires challengers seeking to gain control of the board to win two elections one year apart. Such existing impediments to shareholders’ ability to replace directors should be dismantled.

In addition, shareholders should have the power to propose and vote to adopt “rules of the game” decisions—that is, decisions to amend the corporation’s governance arrangements. Current

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Arrangements give directors the sole power to initiate changes in the company’s charter or state of incorporation, and severely limit the scope of bylaw provisions that shareholders may initiate and adopt. This state of affairs gives directors an unwarranted role in determining the rules that regulate their own conduct. Shareholders should be given the power to shape governance arrangements.

A reform that strengthens shareholder rights would limit deviations from shareholder interests. Among other things, it would discourage pay arrangements that reward executives for short-term gains and insulate them from losses to long-term shareholder value. This development would help eliminate risk-taking incentives that are excessive even from the shareholders’ perspective. Still, there would remain the problem of risk-taking incentives that are favored by shareholders but that, once the interests of other stakeholders are taken into account, are undesirable from a society’s standpoint. This point brings us to the second role that the government should play.

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Outside the financial sector, the government should limit itself to strengthening shareholder rights; it should not intervene in the substantive terms of pay arrangements. In the case of banks, however, the government’s role should extend beyond governance reforms: financial regulators should monitor and regulate firms’ compensation structures. Such pay regulation is justified by the same moral hazard reasons that underlie the long-standing system of prudential regulation of banks.

When a bank takes risks, shareholders can expect to capture the full upside, but part of the downside may be borne by the government as guarantor of deposits. Because bank failure imposes costs on the government and the economy that shareholders do not internalize, shareholders’ interests may be served by greater risk-taking than is in the interest of the government and the economy. This moral hazard problem provides a basis for the extensive body of regulations that restrict the choices of financial firms with respect to investments, lending, and capital reserves.

Aligning the interests of executives with those of shareholders, which some governance reforms seek to do, could eliminate risk-taking that is excessive even from the shareholders’
perspective. But it cannot be expected to get rid of incentives for risk-taking that are excessive from a social standpoint but not from shareholders’ perspective.

Shareholders’ interest in greater risk-taking implies that they stand to benefit when bank executives take excessive risks. Given the complexities of modern finance and the limited information and resources of regulators, the traditional regulation of banks’ actions and activities is necessarily imperfect. Regulators are often one step behind banks’ executives. Thus, executives with incentives to focus on shareholder interests can use their informational advantages and whatever discretion traditional regulations leave them to take excessive risks.

Because shareholders’ interests favor incentives for risk-taking that are socially excessive, substantive regulation of the terms of pay arrangements—that is, limiting the use of structures that reward risky behavior—can advance the goals of banking regulation. Regulators should focus on the structure of compensation—not the amount—with the aim of discouraging excessive risk-taking. By doing so, regulators would induce bank executives to work for, not against, the goals of banking regulation.

The regulation of bankers’ pay could well supplement and reinforce the traditional direct regulation of banks’ activities. Indeed, if pay arrangements are designed to discourage excessive risk-taking, direct regulation need not be as stringent as would otherwise be necessary. Conversely, as long as banks’ executive pay arrangements are unconstrained, regulators should be stricter in their monitoring and direct regulation of banks’ activities.

At a minimum, when assessing the risks posed by any given bank, regulators should take into account the incentives generated by the bank’s pay arrangements. When the design of compensation encourages risk-taking, regulators should monitor the bank more closely and should consider raising its capital requirements.

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Before concluding, it is necessary to respond to the main objections that could be raised against a government role in this area. First, pay regulation in banks could be opposed on grounds that it’s the shareholders’ money; the government does not have a legitimate interest in telling bank shareholders how to spend their money. Choices of compensation structures, it might be argued, inherently belong to the province of private business decisions where regulators
should not trespass. This objection is not persuasive, however, because the government does have a legitimate interest in the compensation structures of private financial firms. Given the government’s interest in the safety and soundness of the banking system, intervention here would be no less legitimate than the government’s established involvement in limiting banks’ investment and lending decisions.

Second, opponents of regulating executive pay in banks could also argue that regulators know less—that is, regulators will be at an informational disadvantage when setting pay arrangements. But the knowledge required of regulators to effectively limit compensation structures that incentivize risk-taking would be no more demanding than that which is requisite to regulators’ direct intervention in investment, lending, and capital decisions. Furthermore, setting pay arrangements should not be left to the unconstrained choices of informed players inside banks; these players do not have incentives to take into account the interests of bondholders, depositors, and the government.

Third, opponents may also argue that bankers will flee—that is, pay regulation will drive talent away, and financial firms will lose valuable employees. As I stressed, however, regulation of pay in financial firms should focus on pay structures, not on limiting compensation levels. (Prudential regulation may, of course, impose such limits to the extent that compensation level might result in cash outflows that would leave the bank with insufficient capital.) Indeed, the bill passed by the House of Representatives, and the Federal Reserve Board’s proposed guidance, explicitly rule out intervention in pay levels. Thus, to the extent that the use of pay structures that eliminate perverse incentives would be less attractive to some executives, banks would be able to compensate those executives with higher levels of expected pay. Even when such an increase proved necessary, however, providing more efficient incentives would be worthwhile.

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To reduce the likelihood of future financial crises, we should not only constrain what banks may do but also pay close attention to the incentives provided to the executives who will make choices within these constraints. There are simple but useful ways to induce executives to focus on long-term rather than short-term results, and to take into account the consequences of their decisions for all those contributing to the bank’s capital, rather than only for shareholders.
Monitoring and encouraging such compensation structures should be an important instrument in the toolkit of financial regulators. Fixing bankers’ pay would reduce the likelihood and costs of future financial crises.