



Fixing Bankers' Pay

LUCIAN A. BEBCHUK

In the aftermath of the financial crisis of 2008–2009, there are widespread concerns that the compensation structures of financial firms have provided excessive risk-taking incentives. Responding to such concerns, firms are seeking to reform their pay packages to avoid such incentives, and regulators around the world are moving toward setting standards for compensation structures in financial firms. The G-20 leaders, in their September 2009 summit, announced their commitment “to implement

Lucian A. Bebchuk is Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance at Harvard Law School. Although Bebchuk serves as a consultant to the Special Master for TARP Executive Compensation in the U.S. Treasury, the views expressed in this article do not necessarily reflect the views of the Office of the Special Master or any other individual affiliated with it.

strong international compensation standards aimed at ending practices that lead to excessive risk-taking,” and the Federal Reserve Board in October 2009 requested comments on a ‘proposed guidance’ that contemplates scrutiny of compensation structures by banking supervisors.

I have been for some time an advocate of such reform and regulation of financial firms’ compensation structures, making the case in academic articles, congressional testimony, and a series of op-ed articles listed in this article’s bibliography. Below I attempt to synthesize this body of writing and provide a brief statement of the normative case for regulation of pay in financial firms, the relationship between such regulation and the standard prudential regulation of finance,

and what financial regulators should do in this area.

Before proceeding to discuss the role of the government in this area, I begin by describing two distinct sources of risk-taking incentives—two ways in which banks’ standard pay arrangements have insulated their executives from part of the downside of risks they take. (By ‘banks,’ I refer throughout to any financial institutions that are deemed to pose systemic risk and are therefore subject to prudential regulation.) I also analyze how compensation structures can best be redesigned to address these problems. If financial regulators indeed begin to monitor and regulate pay arrangements, they would do well to focus on the design flaws and design solutions discussed below.

INSULATION FROM LONG-TERM LOSSES TO SHAREHOLDERS

Much attention is now focused on the fact that pay arrangements have provided executives with incentives to focus on short-term results. This problem, first highlighted in a book and accompanying articles that Jesse Fried and I published five years ago, has recently become widely recognized—including by business leaders such as the CEO of Goldman Sachs.

Standard pay arrangements reward executives for short-term results even when these results are subsequently reversed. The ability to take a large amount of compensation based on short-term results off the table provides executives with incentives to seek short-term gains even when these come at the expense of long-term value, or at the risk of an implosion later on.

Under the standard design of equity-based compensation, stock options and restricted shares vest gradually over a period of time. Once options and shares vest, however, executives typically have unrestricted freedom to cash them out, and often unload such equity incentives quickly after vesting. This broad

freedom to cash out equity incentives has contributed substantially to creating short-term distortions.

To address these distortions, it is desirable to separate the time that options and restricted shares can be cashed out from the time in which they vest, as Jesse Fried and I proposed in *Pay Without Performance*. 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, and should belong to the executive even if he or she immediately leaves the firm. But the cashing out of these vested options and shares should be 'blocked' for a specified period after vesting—the executive should be allowed to cash them out only down the road.

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 counter-productive 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 the above problems, the period during which the vested options and shares are 'blocked' and may not be cashed out should be fixed. For example, when options or shares of an executive vest in a given year of employment, they could become unblocked, and the executive would subsequently be free to cash them out on the seventh-year anniversary of the vesting. Because the executive can't accelerate the time of cashing out, this arrangement doesn't provide distorted incentives arising from the desire to obtain such acceleration. And as long as an executive is working for the firm and accruing options and shares that continue to vest, he or she will always have an incentive to care about the company's long-term share value.

Bonus compensation also needs to be redesigned. Under standard pay arrangements, executives have been able to cash

bonus compensation based on short-term results and keep it even when those results were subsequently reversed. To address the short-term distortion arising from such arrangements, bonuses should not be cashed right away, but instead placed in a company account for several years and adjusted downward if the company subsequently learns that the reasons for the bonus no longer hold up.

INSULATION FROM LOSSES TO CAPITAL SUPPLIERS OTHER THAN SHAREHOLDERS

Thus far, I have focused on the insulation of executives from long-term losses to shareholders—the problem that has received most attention following the current crisis. However, as Holger Spamann and I analyze in detail in recent work, there is another type of distortion that should be recognized. The payoffs of financial executives have been insulated from the consequences that losses could impose on parties other than shareholders. This source of distortion is separate and 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. Bank executives expect to share in any gains that might flow to common shareholders, but they are insulated from losses that the realization of risks could impose on preferred shareholders, bondholders, depositors or the government as a guarantor of deposits. This causes executives to pay insufficient attention to the possibility of large losses and therefore provides them with incentives to take excessive risks.

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 only 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 reduce their incentives to take excessive risks.

Even the structure described above would cause bank executives to internalize fully the adverse consequences that risk-taking might have for the interests of the government as guarantor of deposits. To achieve that 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 are 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 period ending at the specified time.

Alternatively, one could consider tying executive payoffs 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 will by itself produce a significant improvement in incentives compared with existing arrangements.

Similarly, to the extent that executives receive bonus compensation tied to specified accounting measures, it could be tied instead to broader measures. For example, the bonus compensation of some bank executives has been based on accounting measures that are of interest primarily to common shareholders, such as return on equity or earning per common share. It would be worthwhile to consider basing bonus compensation instead on broader measures such as earnings before any payments made to bondholders.

THE ROLE OF GOVERNMENT

Having discussed what changes in pay arrangements would curtail incentives to take excessive risks in banks as well as other firms, I turn to the question of what role, if any, the government should play in bringing

about such changes. Some would argue that, even accepting the desirability of significant changes, making such changes should be left to unconstrained choices by private decision-makers and that, at least for firms not receiving public funding, the government should not play any role in the setting of executive compensation.

For public firms outside the financial sector, the government should indeed avoid setting any limits on the compensation structures from which private decision-makers may choose. For such firms, the government should focus solely on improving internal governance processes, and then not intervene in the substantive choices made by shareholders and the directors elected by them.

Some may suggest that government intervention to ensure the adequacy of internal governance processes would be sufficient also in the financial sector. And authorities around the world have been paying increased attention to improving governance in financial firms. The Basle committee of bank supervisors has been stressing the importance of involving banks' boards in pay setting, and the U.S. House of Representatives, with support

from the Obama administration, passed legislation that would introduce say-on-pay votes and bolster the independence of compensation committees.

As is the case for non-financial firms, the government should indeed seek to improve the internal governance and pay-setting processes within banks. In the case of banks, however, the government's role should go beyond governance reforms. Because of the special circumstances of financial firms, financial regulators should monitor and regulate compensation structures. Such pay regulation is justified by the same moral hazard reasons that underlie the long-standing system of prudential regulation of banks.

PAY REGULATION AND PRUDENTIAL REGULATION

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 will impose costs on the government and the economy that shareholders do not internalize, shareholders' interests would be served by more risk-taking than would be 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.

Curtailing agency problems between executives and shareholders, which governance reforms seek to do, could eliminate risk-taking that is excessive even from shareholders' perspective. But it cannot be expected to eliminate incentives for risk-taking that are excessive from a social perspective but not from the perspective of shareholders.

Shareholders' interest in more risk-taking implies that they could benefit from providing bank executives with incentives to take excessive risks. Executives with such incentives could use their informational advantages and whatever discretion traditional regulations leave them to further increase 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. Thus, when executives have incentives to do so, they may be able to take risks beyond what is intended or assumed by the regulators, who may often be one step behind banks' executives.

Because shareholders' interests favor incentives for risk-taking that are excessive from a social perspective, substantive regulation of the terms of pay arrangements—limiting the use of structures that reward excessive risk-taking—can advance the goals of banking regulation. The regulators' focus should be on the structure of compensation—not the amount—with the aim of discouraging the taking of excessive risks. By doing so, regulators would induce bank executives to work for, not against, the goals of banking regulation.

The regulation of bankers' pay could nicely supplement and reinforce the traditional, direct regulation of banks' activities. Indeed, if pay arrangements are designed to discourage excessive risk-taking, direct regulation of activities could be less tight than it should otherwise be. 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 pay arrangements encourage risk-taking,

regulators should monitor the bank more closely and should consider raising its capital requirements.

OBJECTIONS

(1) *It's the Shareholders' Money.* Pay regulation in banks could be opposed on grounds that 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 banks, its intervention here will be as legitimate as the traditional forms of intervention that limit banks' investment and lending decisions.

(2) *Regulators Know Less.* Opponents of regulating executive pay in banks could also argue that regulators will be at an informational disadvantage when setting pay arrangements. But placing limits on compensation structures that incentivize risk-taking would

be no more demanding in terms of information than regulators' direct intervention in investment, lending, and capital decisions. Furthermore, the setting of pay arrangements should not be left to the unconstrained choices of informed players inside banks because such players do not have incentives to take into account the interests of bondholders, depositors, and the government in setting pay.

(3) *Bankers Will Flee*. Opponents may also argue that pay regulation will drive talent away, and that financial firms will lose valuable employees. As I stressed, however, regulation of pay in financial firms should focus on pay structures and should not limit 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 rules 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.

(4) *Regulatory Abuse*. Finally, some opponents may worry that pay regulation would provide regulators with increased power which they might sometimes abuse. Regulators might use their power to advance political objectives, it might be argued, and banks might respond by increasing their investments in political contributions and their efforts to curry favor with the political establishment. However, banking regulators already wield vast powers over banks—and, as long as the existing banking system with its moral hazard problems is retained, such powers appear unavoidable. Indeed, as the Federal Reserve Board's proposed guidance makes clear, banking regulators' power to protect the safety and soundness of the banking system has long provided them with the authority to limit pay arrangements that induce excessive risk-taking—authority that they elected not to use in the past. The main effect of the approach I support thus would not make regulators markedly more powerful but rather encourage

them to expand their toolkit and thereby improve their ability to guard financial stability.

GOING FORWARD

Compensation structures for financial executives should be redesigned in the ways discussed above to avoid the excessive incentives for risk-taking that standard pay arrangements have provided in the past. Regulators have a role in ensuring that such changes take place. Monitoring and regulating the compensation structures of bank executives should be an important instrument in the toolkit of financial regulators.

Letters commenting on this piece or others may be submitted at <http://www.bepress.com/cgi/submit.cgi?context=ev>.

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