Is there a case for regulating pay in the financial services industry?

John Core and Wayne Guay

Wharton
University of Pennsylvania

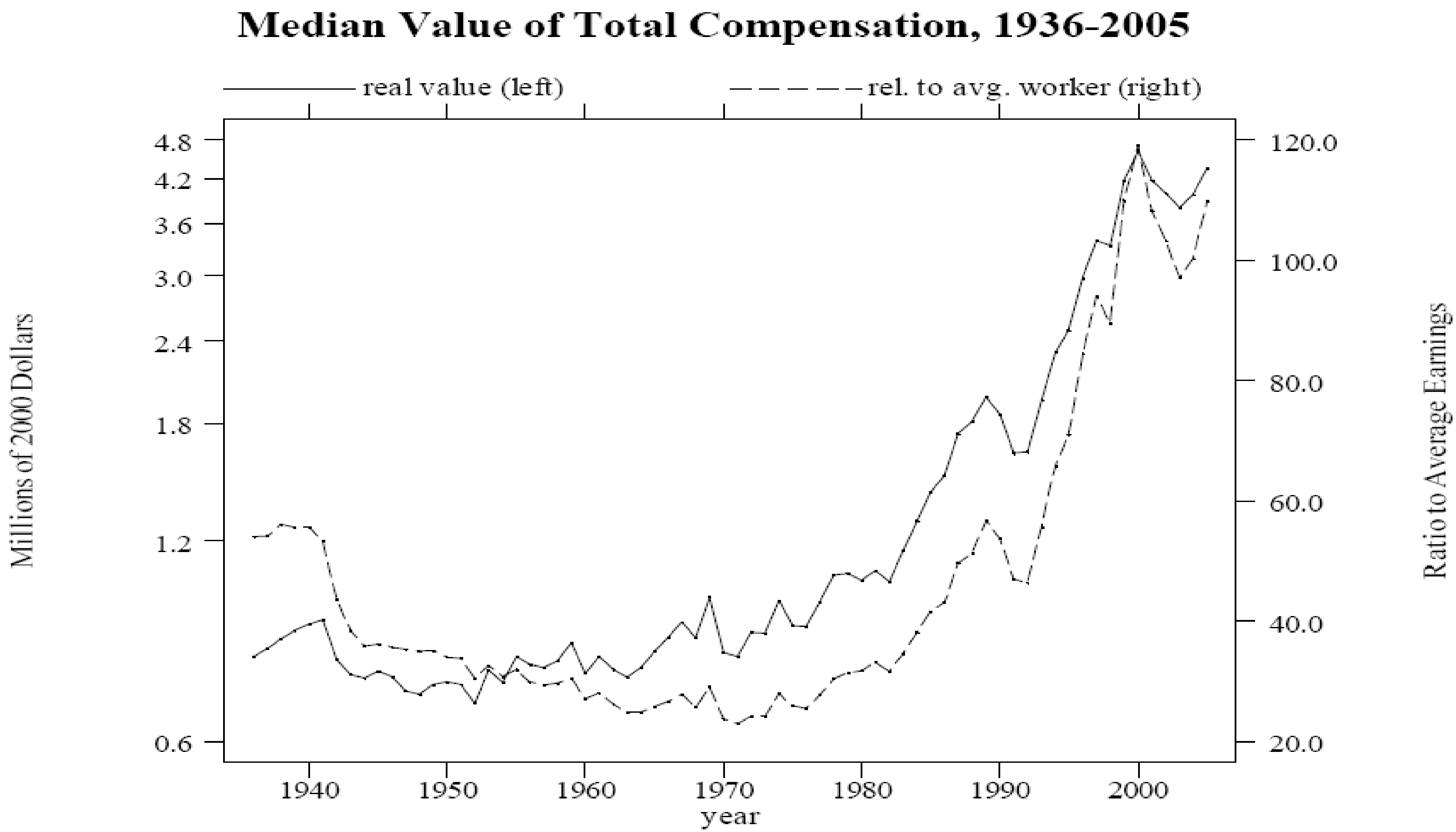
BROOKINGS-TOKYO CLUB-WHARTON CONFERENCE

October 16, 2009

Outline of presentation

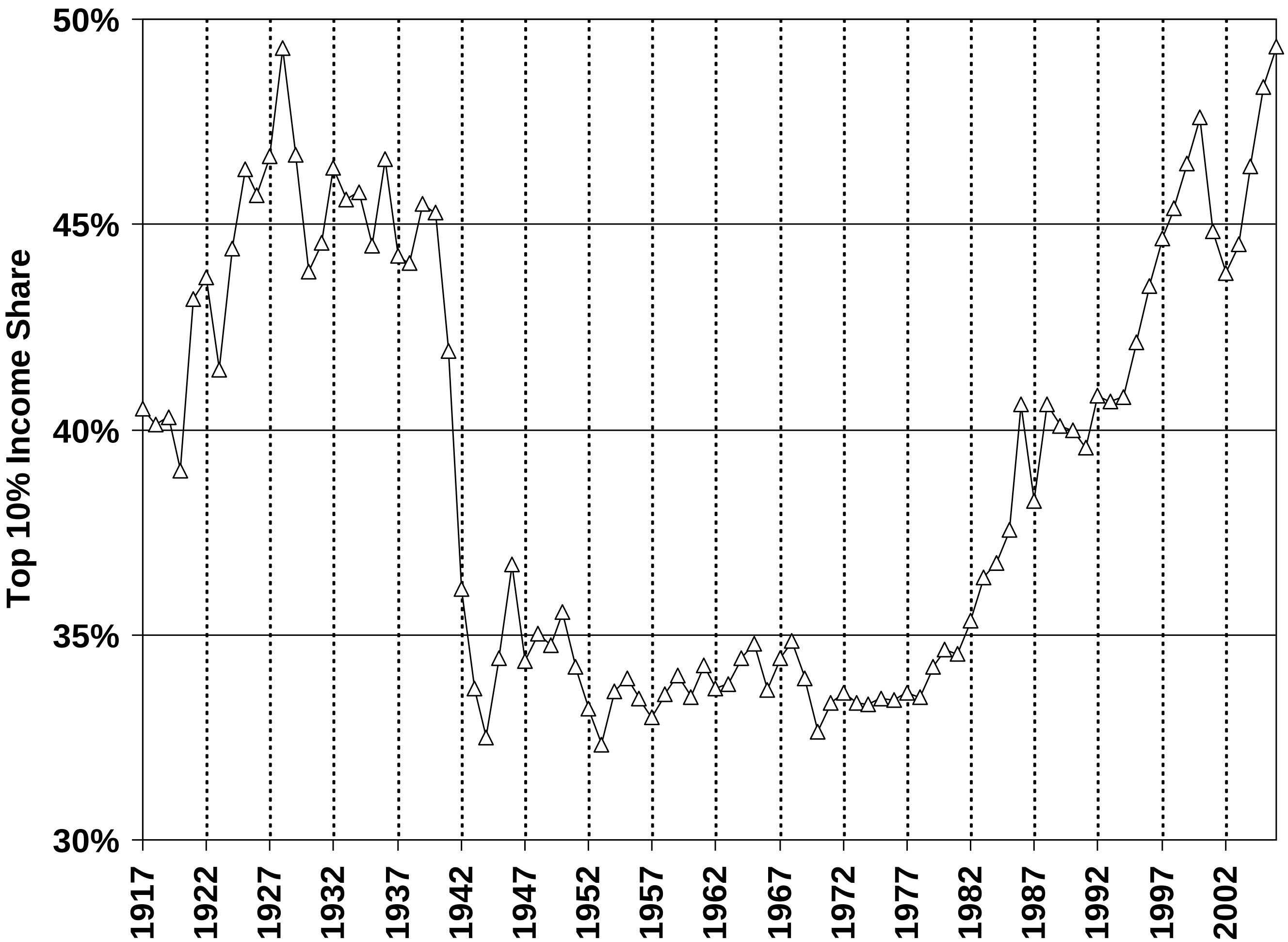
- Is US CEO pay too high?
- Blame pay for crisis?
- Is US CEO pay unusual?
- Is bank pay unusual?
- Did bank pay cause crisis?
- How should bank pay be regulated?

CEO pay as a % of worker pay 1936-2005



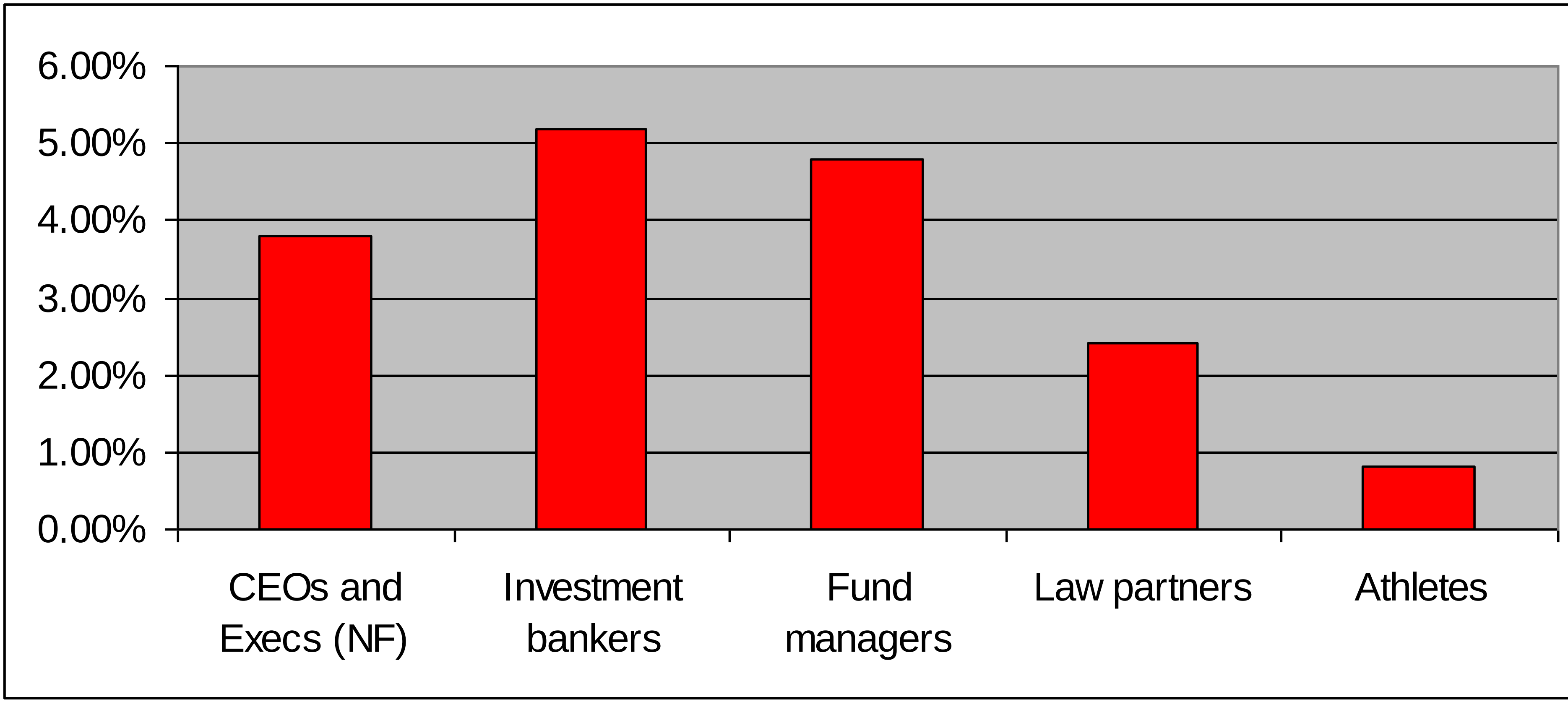
Source: Frydman and Saks (2007)

Growing "income inequality"? Top 10% income / total income



Source: Piketty and Saez (2003)

Investment industry share of top earners – 2005

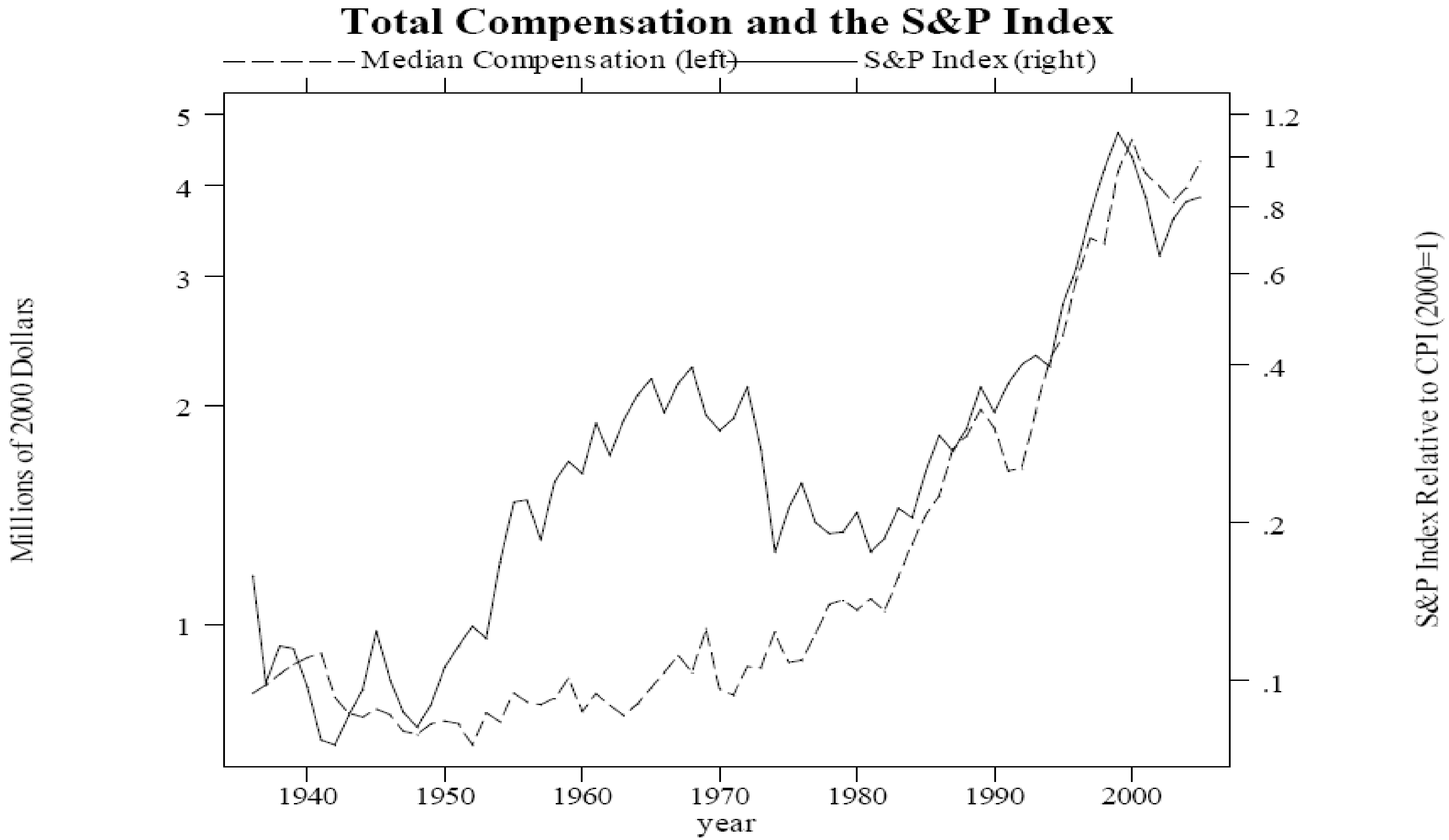


Top 0.1% bracket (>$1.4 million)
(Kaplan and Rauh, Table 14)

Focus on CEO pay and incentives

- Long tradition of claiming CEO pay too high and provides bad incentives:
  - Fairness concerns
  - Clinton 1992 limits on tax deductibility of pay
  - Bebchuk and Fried *Pay without Performance* (2004)
  - Obama / democratic congress
- Given this, somewhat natural to reach for pay as explanation for a crisis?:
  - Tech stock bubble of late 1990s?
  - Accounting scandals of early 2000s?
  - Financial crisis of late 2000s?

As firms grow, so does CEO pay
CEO pay and S&P 500: 1936-2005



Source: Frydman and Saks (2007)

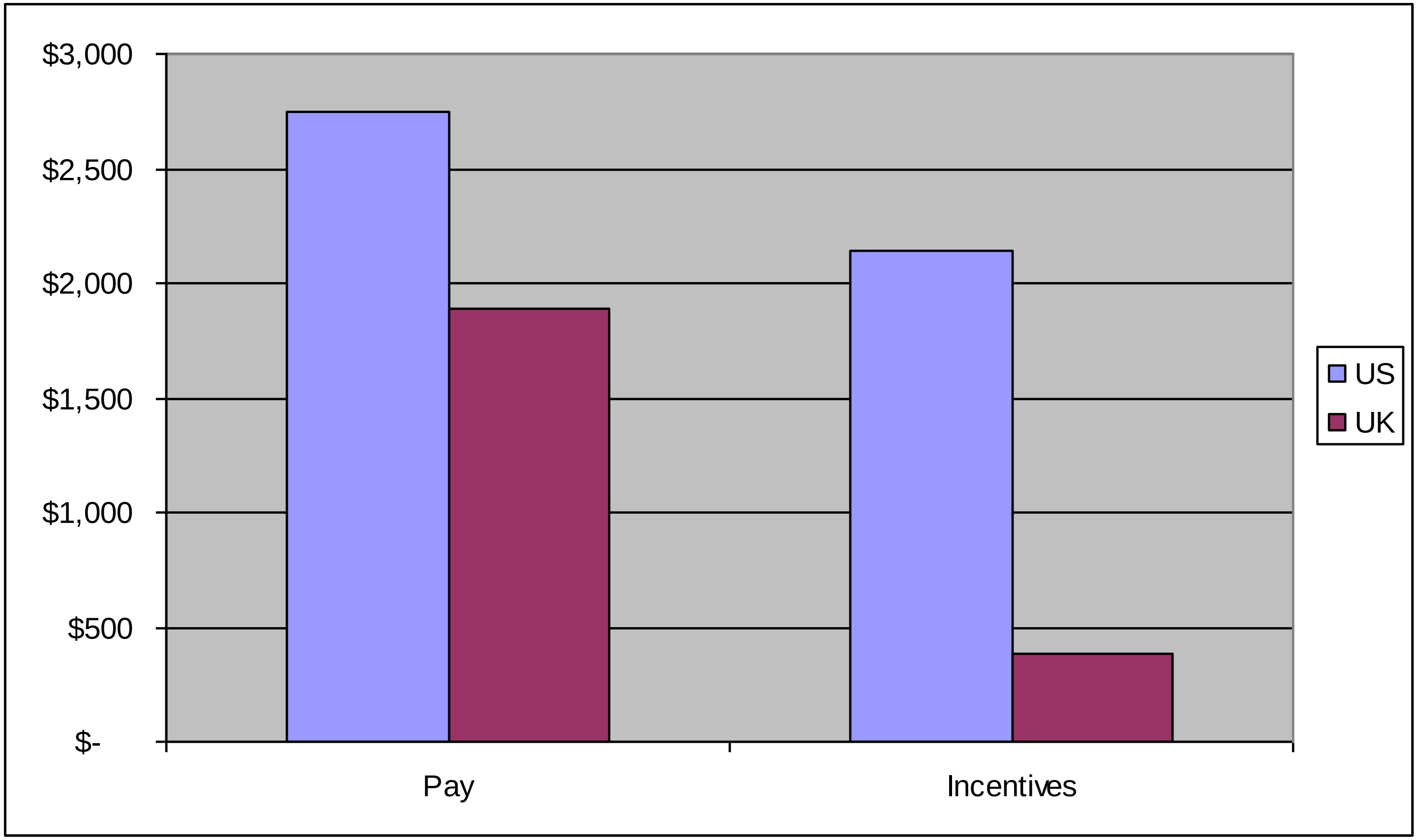
Executive pay as "Asset management fee" 2005

- Total pay for top-five executives at all U.S. exchange-traded firms ≈ $50 billion
- Total market capitalization of U.S. firms ≈ $20 trillion
- "Asset management fee" for top-five executives ≈ 0.25%
- By comparison, hedge fund and private equity management fee commonly 2% + 20% of profits

Is US CEO pay unusual? Compare with UK and Europe

- Conyon, Core, Guay (2009)
- 214 UK CEOs of large firms in 2003
- Match to US CEOs based on industry, size, performance, risk, and tenure
- Also 40 European CEOs (fewer CEOS because European pay is poorly disclosed)

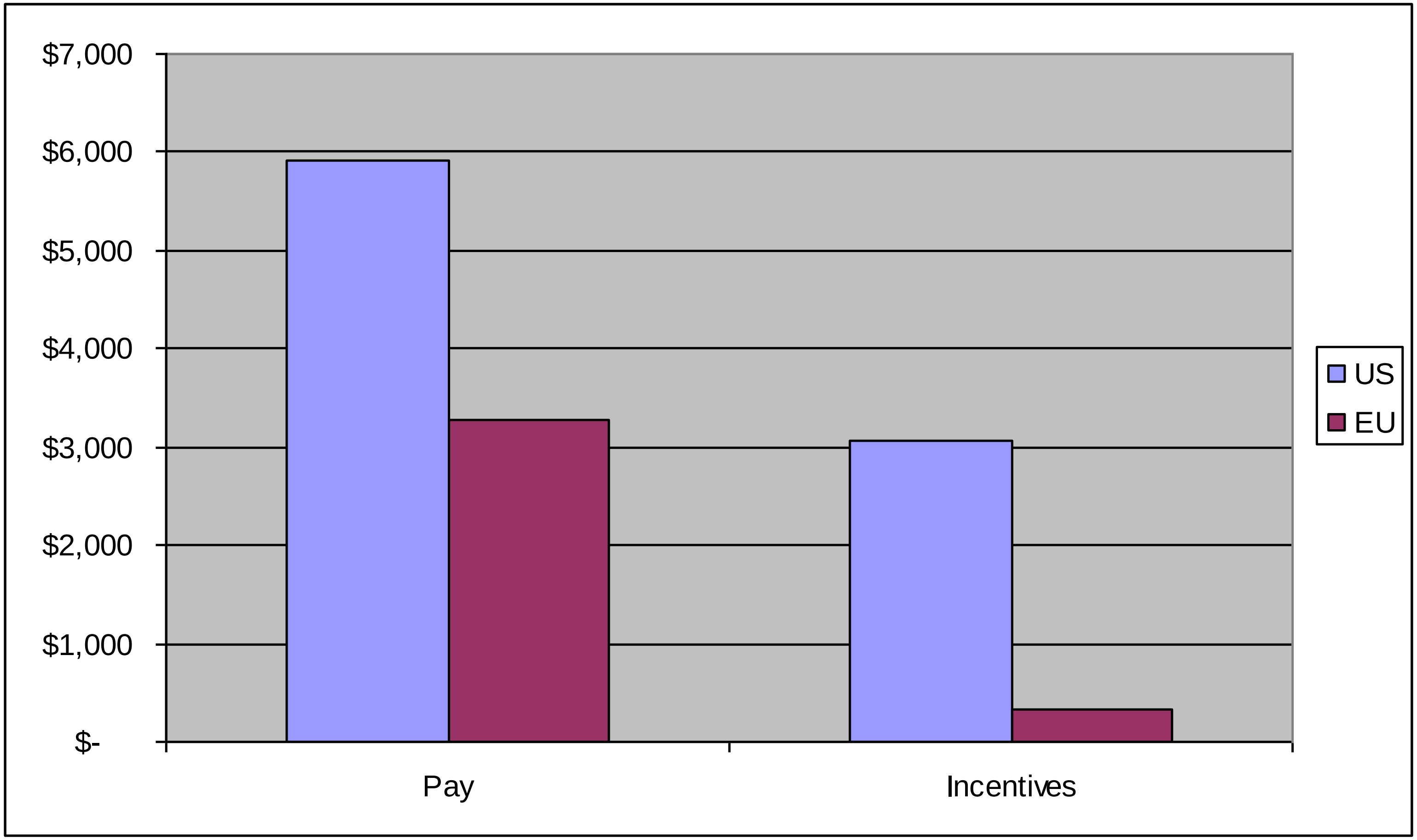
US vs. UK Pay and Incentives (2003; 214 matches ~ $1.5 bb MV)



Pay = Salary + Bonus + Equity (stock + options) + Other

Incentives = $ change in value(stock + options) for 10% price change

US vs. Europe Pay and Incentives (2003; 80 matches ~ $10 bb MV)



Pay = Salary + Bonus + Equity (stock + options) + Other

Incentives = $ change in value(stock + options) for 10% price change

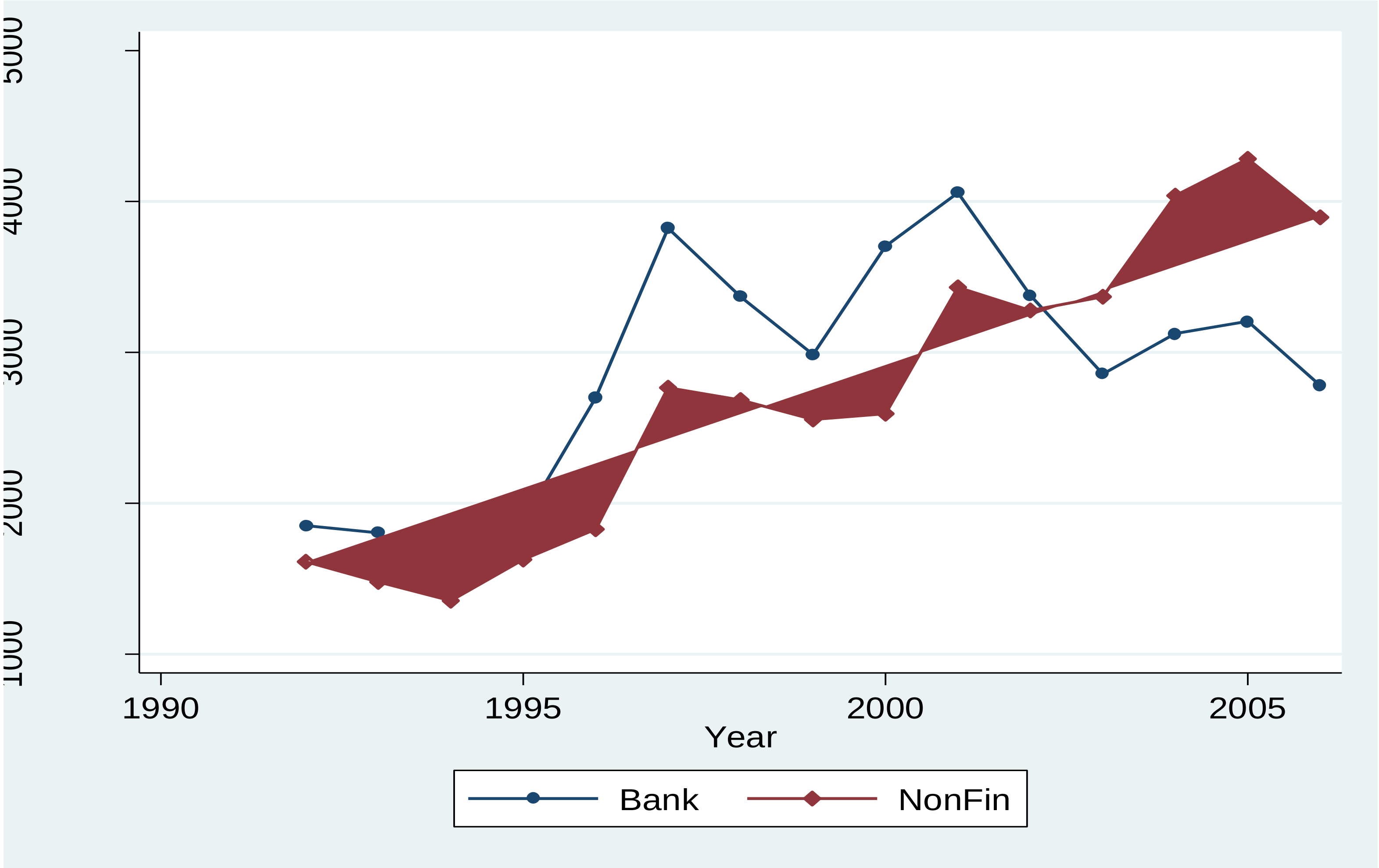
Searching for explanations for the credit crisis…

- Sec. Geithner:
  - "This financial crisis had many significant causes, but executive compensation practices were a contributing factor."
  - "Incentives for short-term gains overwhelmed the checks and balances meant to mitigate against the risk of excess leverage."
- Alan Blinder:
  - Poor incentives are "one of [the] most fundamental causes" of the credit crisis
- Obama administration:
  - "More closely align pay with long-term performance"
  - Give more voice to shareholders through "say on pay"

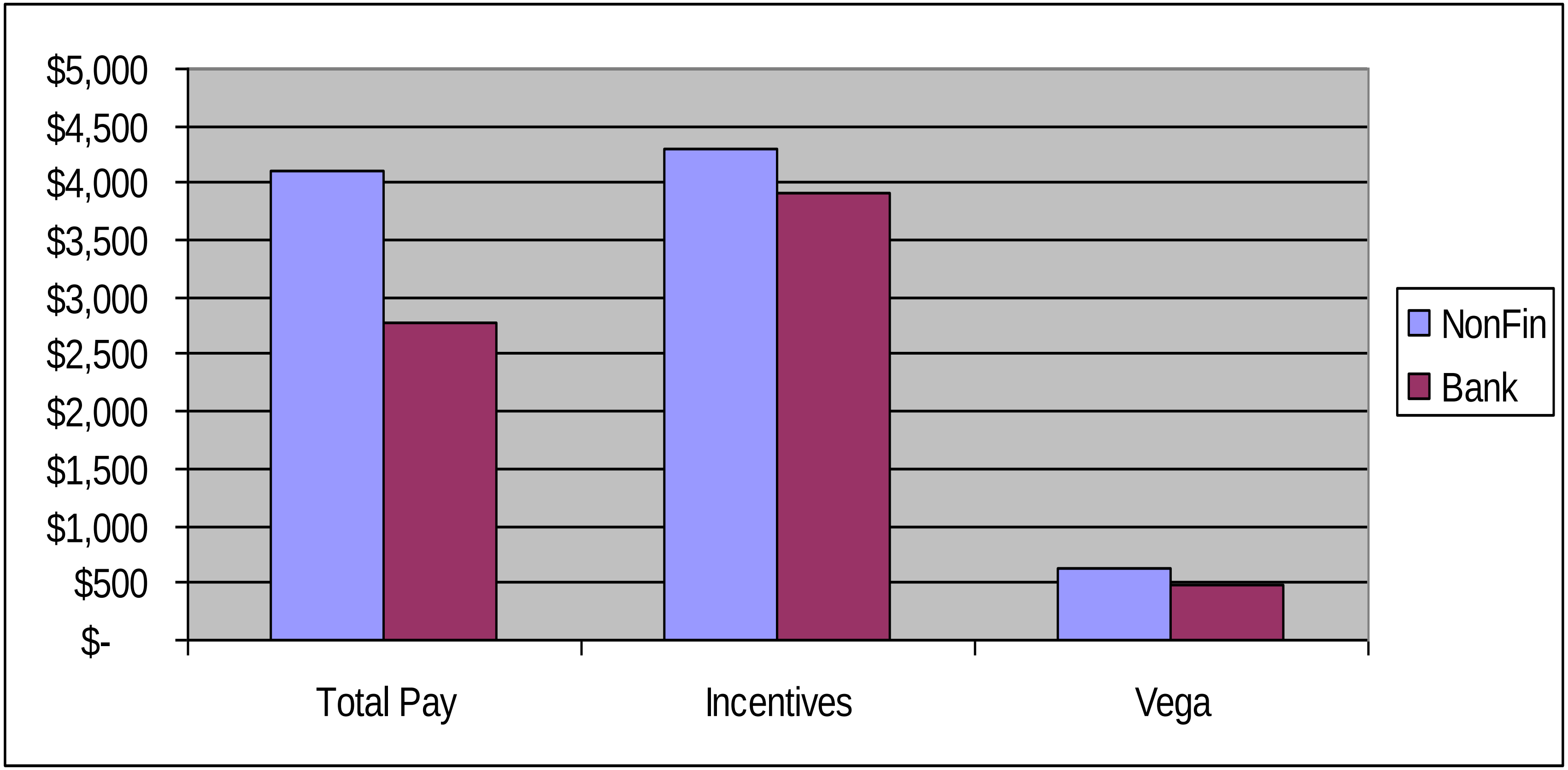
Is bank pay unusual? Compare with nonfinancials

- 95 bank CEOs in 2006 (year before crisis)
- Match to non-financial CEOs ("NonFin")
- Match based on size, performance, risk and tenure
- Also examine separately CEOs of the 24 largest banks in 2006

Bank vs. NonFin pay: 1992-2006



NonFin vs. Bank Pay and Incentives (2006 ; 95 matches ~ $3 bb MV)

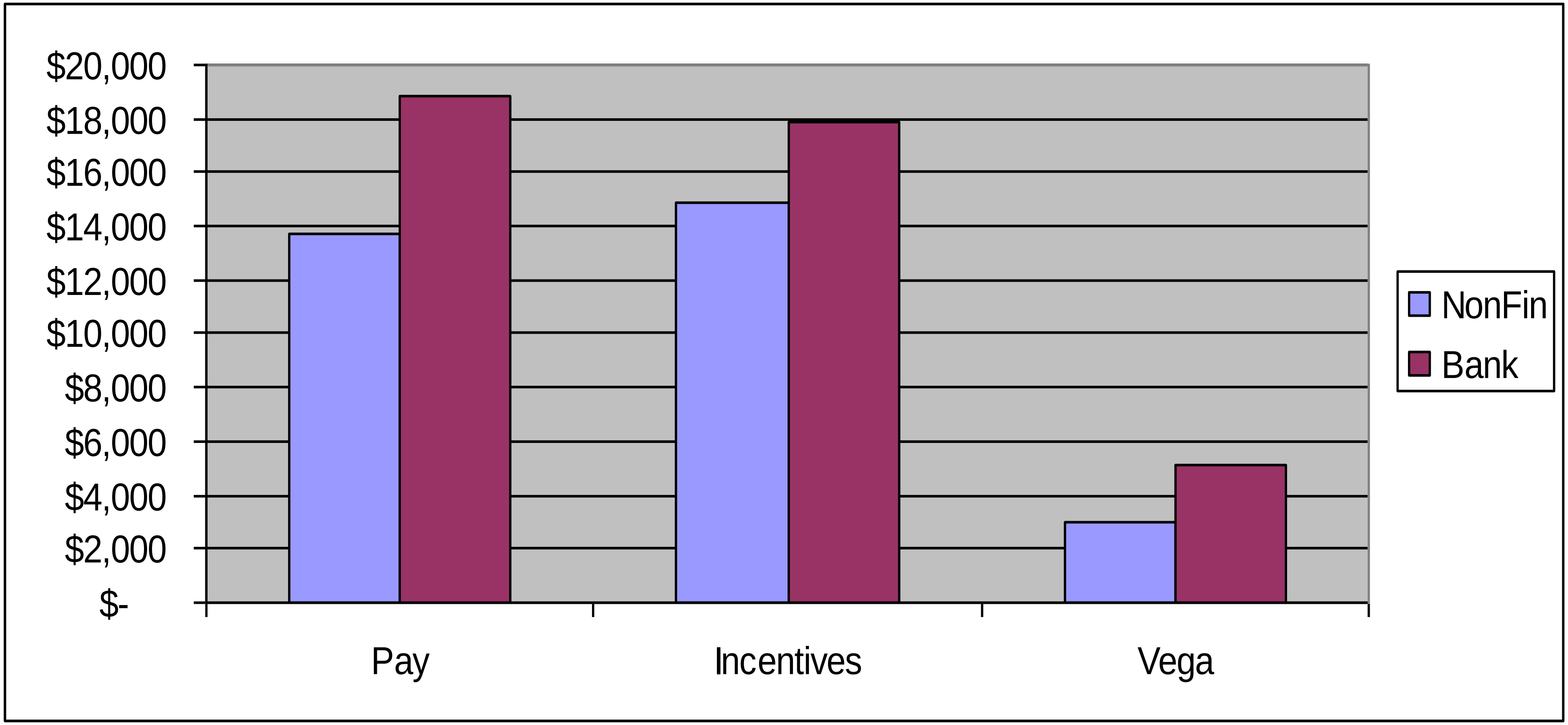


Pay = Salary + Bonus + Equity (stock + options) + Other

Incentives = $ change in value(stock + options) for 10% price change

Vega = $ change in value(options) for increase in volatility of 10%

NonFin vs. Large Banks
(2006 ; 24 matches ~ $25 bb MV)

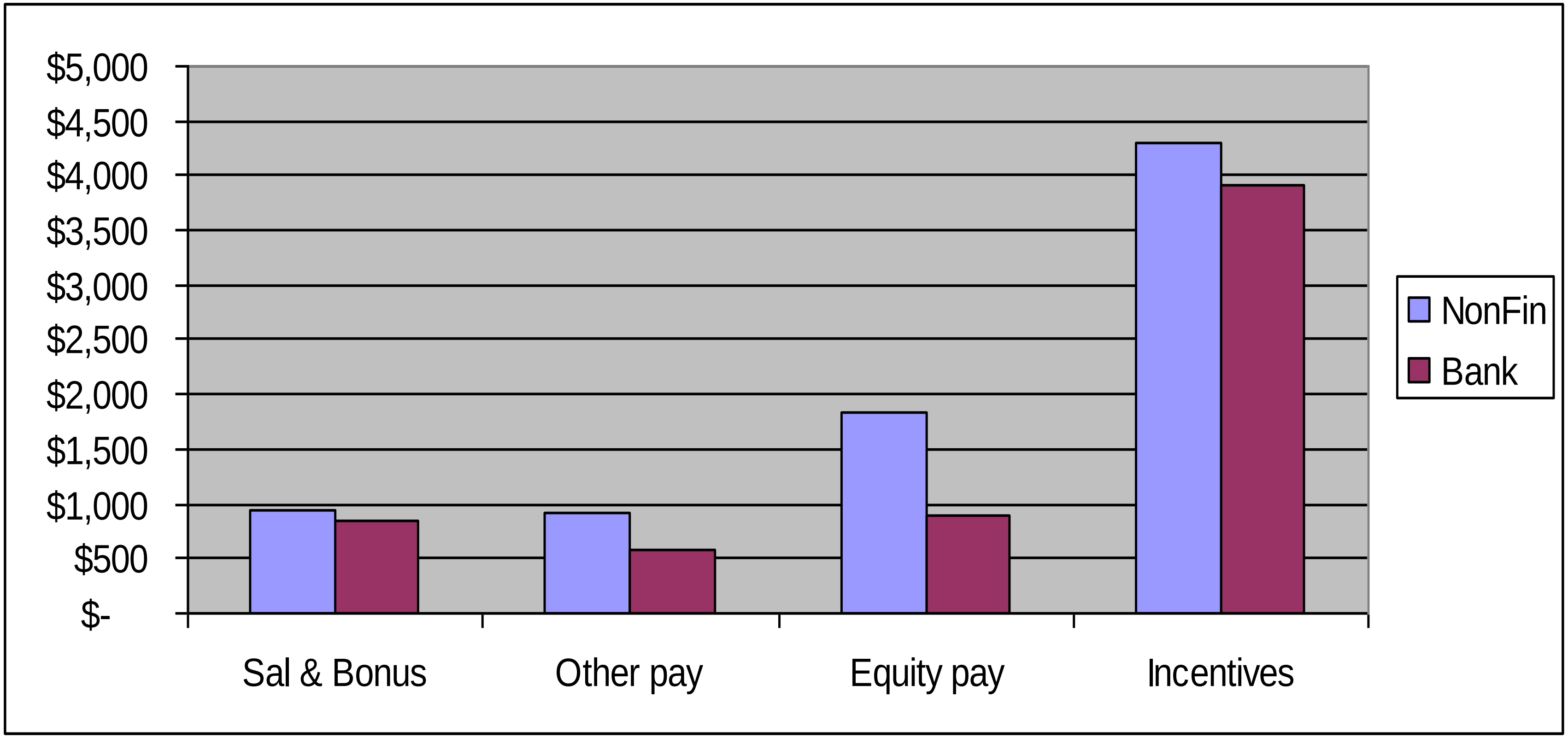


Pay = Salary + Bonus + Equity (stock + options) + Other

Incentives = $ change in value(stock + options) for 10% price change

Vega = $ change in value(options) for increase in volatility of 10%

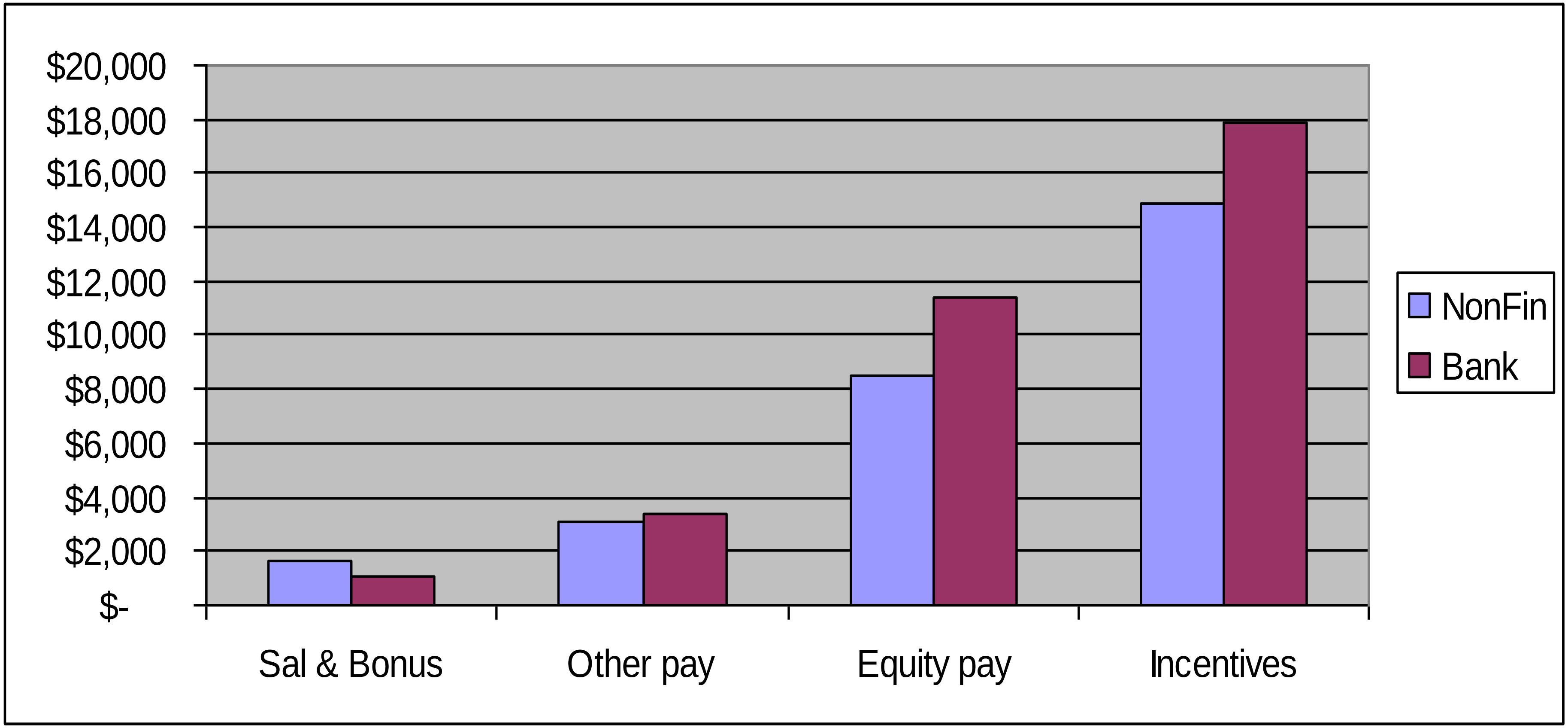
NonFin vs. All Banks
Pay and incentive composition



Pay = Salary + Bonus + Other + Equity (stock + options)

Incentives = $ change in value(stock + options) for 10% price change

Large NonFin vs. Large Banks
Pay and incentive composition



Pay = Salary + Bonus + Other + Equity (stock + options)

Incentives = $ change in value(stock + options) for 10% price change

Were bank CEOs aligned with shareholders?

- Held large amounts of equity incentives
- Substantial wealth losses with negative returns.
- If CEOs are aligned with shareholders, will they let traders take too much risk?

Did bank CEOs take risks that they knew were bad for shareholders?

- If so, would expect them to have sold shares ahead of the crisis.
- Fahlenbrach-Stulz (2009) investigate insider trading of bank CEOs in 2007-2008.
- Find no evidence that CEOs traded out of their positions. In fact, CEO holdings of shares on net increased.
- CEOs therefore made large losses on their holdings of shares and options.
- On average, CEOs in sample lost at least $30 million and the median CEO loss is more than $5 million.

What are goals of regulation?

- Areas that may be regulated:
  - Level of top executive pay
  - Top executive incentives (pay-for-performance; risk-taking; alignment of CEO interests with shareholders)
  - Lower-level employee (e.g., traders) incentives (short-term focus; internal controls)
- Begin with firms where taxpayers have direct financial interest: e.g., TARP firms
- …as a way to get foot in the door for more overarching regulation?

Statement by Sec. Geithner (June 10, 2009)

1. Pay should be tied to performance
2. Pay should account for time horizon of risks
3. Pay should reflect sound risk management
4. Are golden parachutes and executive retirement plans good for shareholders?
5. Pay should be transparent:
   - "Say on pay"
   - Compensation committee independence.

Statement by Sec. Geithner (June 10, 2009)

1. Pay should be tied to performance
2. Pay should account for time horizon of risks
3. Pay should reflect sound risk management
4. Are golden parachutes and executive retirement plans good for shareholders?
5. Pay should be transparent:
   - "Say on pay"
   - Compensation committee independence.

Red = May address cause of credit crisis

Interim Final Rule on TARP Standards (June 10, 2009)

1. "Limits executive compensation":
   - Limit bonus to 1/3 pay; bonus in stock.
   - Encourage salary in stock
   - No parachutes; clawbacks
2. "Special master" (Feinberg)
3. Other:
   - Risk analysis of pay
   - "Say on pay"
   - Disclosure of comp consultants
   - No tax gross-ups ; luxury policies

Interim Final Rule on TARP Standards (June 10, 2009)

1. "Limits executive compensation":
   - Limit bonus to 1/3 pay; bonus in stock.
   - Encourage salary in stock
   - No parachutes; clawbacks
2. "Special master" (Feinberg)
3. Other:
   - Risk analysis of pay
   - "Say on pay"
   - Disclosure of comp consultants
   - No tax gross-ups ; luxury policies

Red = May address cause of credit crisis

Regulate incentives?

- Emphasis on “excessive risk-taking”
- Executives (and people generally) typically require more returns for taking more risk:
  - Key concern is often to motivate executives to take enough risk, not too much
  - But moral hazard problem when firms expect government to bail out bad outcomes
- Include debt holdings in incentive mix?
- Penalize CEO for excess risk (Bebchuk)?

Regulate incentives?

- Risk-adjusted performance
  - CEO equity compensation is already risk-adjusted
  - Lower level employees / traders performance likely requires risk-adjusting
- Hard for regulator to determine when executives have incentives to take "excessive risk"?
  - Further, if CEO incentives and board of directors structured appropriately, difficult to see why CEOs allow bad practices for traders' pay and incentives
- Yet, augmented disclosure of "pay-for-risk" in executive incentives may be helpful

Clawback provisions?

- Difficult to object to in principle
  - When bonus is obtained on distorted accounting numbers – disgorge bonus
- Practically, clawback applied to accounting restatements and/or fraud
- Typically these are egregious infractions where CEO is already substantially penalized
  - Difficult to envision that clawback provision will provide significant incremental incentives
  - But may be valuable for lower-level

Deferred compensation

- Match duration of compensation with duration of payoffs from investment
- For CEOs (and top executives):
  - Already have substantial equity incentives with holding requirements / vesting restrictions
  - Recent proposal to defer portion of salary is "drop in the bucket"
  - Defer into bonds instead?
- Lower level executives and traders
  - Deferred compensation may sensibly align incentives with duration of investment decisions

Encourage shareholder input?

- Hard to argue against ease of input by well-informed, well-motivated shareholders
- However, delegation of decision rights to board of directors has long history and is the governance structure used in virtually every type of organization – and for good reason
- Implications for "Say on pay" proposals and greater access to proxy materials by shareholders

Conclusion

- Discomfort over executive pay levels
- Tempting to blame executive incentives for crises
- Insufficient pay-for-performance unlikely to be the problem
- Difficult for regulators to determine when CEO pay and risk-taking incentives are “excessive”
- Key roles for regulators:
  - Ensure quality disclosure of pay and incentives
  - Reduce frictions that allow well-functioning board and director decision-making
  - Consider incentives related to creditors’ interests in some cases