

Chapter 8: Executive Summary

Rethinking Compensation in Financial Firms

Gian Luca Clementi, Thomas F. Cooley,
Matthew Richardson and Ingo Walter

Background

The unprecedented government bailout of financial markets and firms in the current crisis has forced executive compensation in banking and finance into the open. As Paul Volcker noted last April, “The bright new financial system—for all its rich rewards and unimaginable wealth for some—has failed the test of the marketplace by repeatedly risking a cascading breakdown of the system as a whole.” Taxpayers wonder how highly paid banking “talent” could have been instrumental in creating a financial disaster of epic proportions. And having been forced to take equity stakes in most of the largest US and foreign financial firms and guarantee their debt, taxpayers naturally feel that they should have a say in how such people, now in publicly supported private institutions, get rewarded. The defenders of privately determined approaches to compensation in financial institutions might wish otherwise, but this is now a high-profile political issue in the US and elsewhere, inexorably intertwined with re-stabilization of the financial system.

The Issues

In the compensation discussion, two issues appear to stand out – compensation of top management and compensation of key cohorts of “high performance” employees.

1. To the extent that the pay packages of senior management deviate materially from the long-term financial interests of shareholders, any overcompensation problem is a failure of corporate governance. It is important to note, however, that the top executives of banking and financial firms tend to be paid largely in shares, with at least some minimum retention period required. So some of the top executives in the firms that melted down have lost fortunes along with the taxpayers. In that sense, the system actually works. Reward and punishment are to some extent aligned, and powerful signals are sent. It may in fact be possible that the financial industry has a better senior management pay-for-performance track record than many other industries. When the system fails, it often seems to involve massive exit packages (rewards for failure) or executives liquidating shares that turn out, after the fact, to have been overvalued at the time of sale. So the real issue may not require the

wholesale redesign of top management compensation, but rather how to address the difficulties investors have in perceiving risks and accurately valuing the equity of financial firms.

2. It has been suggested that the dynamics of the market for high-performance finance professionals, together with a long-established bonus-pool reward system, has led to an epidemic of “fake alpha” in the industry – that is, compensation based on short-term excess returns through the current bonus pool. Performance over the current accounting period cannot take into account lower returns or losses in subsequent periods for which current activities are responsible. Since it is impossible to determine these until some time has passed, compensation based on current reported earnings may not be justified. This problem has been blamed for perverse incentives facing key employees in the financial industry in areas like sales and trading, securitization and financial engineering. Employees are encouraged to (i) maximize current compensation to themselves, possibly at the expense of shareholders, (ii) maximize the use of leverage without regard to its impact on bankruptcy risk of the firm, and (iii) report to senior management and regulators that all is well when in fact it is not.

To understand how this point is relevant for the current financial crisis, note that financial firms (i.e., the GSEs, banks and broker/dealers) held 48% of the \$1.65 trillion worth of AAA-rated collateralized debt obligations (CDOs) of non-prime mortgages. This is puzzling because the whole purpose behind securitization is to transfer the credit risk away from financial institutions to capital market investors. By holding onto such large amounts of the AAA-rated, non-agency-backed CDOs, the CDO desks of firms were for all economic purposes writing deep out-of-the-money put options on the housing market. In other words, these desks were taking huge asymmetric bets which would pay out in most periods, albeit with a large exposure to a significant economy-wide shock. Because the risk management systems of the firms treated these AAA CDOs (which had a spread roughly double that of other AAA-rated securities) as essentially riskless, the CDO desks booked the premiums as instant profit, thereby receiving big bonuses with the incentive to load up on them – hence, the financial crisis of 2007-2009.

Policy Recommendations

It would be surprising if financial firms – alongside the current epidemic of reduced or forfeited top management bonuses as a result of collapsed business conditions – do not start to think through compensation approaches more closely aligned to risk exposure and shareholder interest. We offer the following policy recommendations to advance and implement such thinking:

1. Greater disclosure and transparency of compensation practices, not necessarily major retargeting of top management compensation, is necessary in order to apply greater market discipline to top management pay practices.

2. For senior management, longer stock holding periods and stricter forfeiture rules would probably make sense – for example, failed senior executives who are ejected might confront a minimum 36 month holding period for the shares they take with them.
3. For high-performance “risk-taking” employees, an interesting idea is the *bonus/malus* approach. In good times, with a rising tide lifting all boats, the combination of the rising tide and leverage makes it impossible to tell good performers from bad ones, since most people generate decent to spectacular returns. It is in bad times that the wheat is separated from the chaff. So compensation should have a multi-year structure, with bad performances subtracting from the bonus pool in the same way that good performances add to it.
4. Given the fluid market for financial talent, no single firm can get very far on its own. Unless there is some consensus on best practices, and the industry moves in tandem toward a new and more rational way of compensating its key performers, individual experiments will surely fail as business picks up, competition intensifies, and happy days are here—again—leaving the taxpayer to pick up the tab once again in the next financial crisis. Consequently, we advocate a “convoy approach” whereby the key financial firms that dominate global markets agree on a basic code of best practice for compensating high-performance risk-taking employees.

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