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Executive Compensation and Market Risks

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"Compensation practices at some banking organizations have led to misaligned incentives and excessive risk-taking, contributing to bank losses and financial instability."

—Federal Reserve Chairman Ben S. Bernanke, October 22, 2009

The government gave vast amounts of assistance to firms facing bankruptcy during the financial meltdown, so the public outcry against hefty compensation for these executives is not surprising. Moreover, some critics have blasted this method of compensation as one of the fundamental problems that caused the financial crisis. In particular, executives had incentives to "win big and lose little," thereby exposing firms to more risks than necessary. Although policymakers agree that the dysfunctional system needs to be fixed, they should also consider the possible drawbacks if reforms are implemented.

Basic economics states that people respond to incentives; variable pay such as bonuses encourages people to work harder, whereas fixed pay such as a base salary ensures some stability for employees. While incentive schemes have important implications for any firms, they had an enormous, albeit unintentional, consequence for the financial sector. The schemes encouraged executives and other employees such as traders to do "make-or-break" deals. The bigger the deal, the bigger the monetary bonuses employees received; and if the deal turned sour, the employee still received his or her annual salary. This limited penalty and virtually unbounded reward system encouraged employees at some financial institutions to make risky deals at the expense of their firms. This system, by and large, enabled many financial institutions to buy and sell subprime mortgages and mortgage-backed securities that contributed to a loss of more than $379 billion at the world's biggest banks and securities firms when the crisis erupted.

Recognizing the problem of financial incentives, the Federal Reserve Board proposed supervisory initiatives to discourage employees from taking excessive risks. The Fed's proposal, which addresses both large and small banking institutions, is intended to ensure that firms do not design compensation packages that may lead to inappropriate risks. Another proposal by Kenneth Feinberg from the U.S. Department of the Treasury plans to limit executive pay in firms that received funds under the government Troubled Asset Relief Program (TARP). Cash salaries for most executive members would be capped at $500,000 with a majority of the pay awarded after three years, and all pay would be subject to a "clawback" provision—that is, an executive must pay back his or her compensation if the success of the company is short-lived. These reforms, according to the Treasury, are designed to encourage long-term growth, discourage excessive risk-taking strategies, and curb pay without performance.

Although the goal is to fix the incentive scheme, the consequences of such regulation can be unintended and unpredictable. Enhanced regulation of employee compensation at banks and other institutions could cause employees to be more risk-adverse than necessary, potentially slowing the growth of the financial sector. Steven Kaplan from the University of Chicago worries that a salary cap would discourage talented people from working at these regulated financial institutions. In addition, onerous regulations may encourage firms to wastefully use their resources on ways to get around the salary caps.

The intended focus of regulations on executive compensation is to closely align pay with long-term performance. One way to do so is to have chief executive officers (CEOs) hold more shares of their firms. However, there is no clear evidence that such alignment would help banks perform better. Fahlenbrach and Stulz, researchers from The Ohio State University, show that firms with CEOs who held more shares actually performed worse during the 2008-09 crisis.

Instead of relying mainly on government regulation, some economists argue that perhaps firms should take the initiative of changing executive pay. Instead of an artificial salary cap, economist Alan Blinder advocates reforms in pay structures. For example, executives can be paid in stocks that materialize at a later date, thereby abolishing "go-for-broke" incentives. To address the potential problems associated with self-regulation, firms can fine employees for failing to adequately account for their behavior that leads to excessive risk-taking strategies. From an economic perspective, the failure to create a better incentive system may increase the likelihood of market distortions and lead to unintended consequences.

—By Chanont Banternghansa, Research Associate, Federal Reserve Bank of St. Louis

The views expressed are those of the author and do not necessarily reflect the official positions of the Federal Reserve Bank of St. Louis, the Federal Reserve System, or the Board of Governors.

Recent Articles and Further Reading on Executive Compensation

"The U.S. Financial Sector's Value Added: Trends Now and Then" by Chanont Banternghansa and Adrian Peralta-Alva, Federal Reserve Bank of St. Louis *National Economic Trends*, June 2009.

This article looks at the trend of labor income in the financial and nonfinancial sectors.

Special Report on Regulatory Reform, Congressional Oversight Panel, January 2009.

The report discusses ways in which policymakers can better prevent future crises.

"Do Not Destroy the Essential Catalyst of Risk" by Lloyd Blankfein, CEO of Goldman Sachs.

This article notes the important balance between self-regulation by firms and regulation by policymakers. It also stresses the importance of risk-taking in financial markets but warns not to rely solely on market mechanisms.

Free Data Sources and Reports

Data: CEO compensation of the 500 biggest U.S. companies
Description: Data on CEO pay, shares owned, age, and an efficiency index for the 2008 fiscal year
Published by: Forbes
Location: http://www.forbes.com/2009/04/22/executive-pay-ceo-leadership-compensation-best-boss-09-ceo_land.html

Data: Rulings from the Special Master for TARP Executive Compensation
Description: A comprehensive list of all the rulings on TARP recipients
Published by: U.S. Department of the Treasury
Location: http://www.financialstability.gov/about/executivecompensation.html

Data: CEO compensation of bailout firms vis-à-vis others
Description: Compares CEO compensation of firms who received government bailouts to an average U.S. worker and lists legislators' efforts to curb CEO compensation
Published by: Institute for Policy Studies
Location: http://www.docstoc.com/docs/document-preview.aspx?doc_id=10647179

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