



# ALL ABOUT FINANCE

A blog by Asli Demirgüç-Kunt, Director, Development Policy, DEC &  
Chief Economist, Finance & Private Sector Development



## The All About Finance Blog Debate:

### Did executive compensation contribute to the financial crisis?

From January 30 - February 16, 2012, the [All About Finance](#) blog hosted a virtual debate on executive compensation. Asli invited Professors Lucian Bebchuk and René Stulz to weigh in on the issue. Readers voted on the question during the course of the debate, with a final tally of 151 "yes" votes (80%) and 38 "no" votes (20%).

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# Executive Compensation: The \$950 Million Dollar Question

Submitted by [René M. Stulz](#) on Mon, 2012-02-13 18:48

The question of the debate is whether executive compensation contributed to the crisis. Does contribute mean that executive compensation affected the behavior of executives, or does it mean that executive compensation made the crisis significantly worse? If it means that it affected the behavior of executives, surely that is the case. With different compensation schemes, the financial system would have been different and the crisis would have been different. If it means that it made the crisis worse, how could we know that executive pay made the crisis worse? It is an empirical issue and only empirical work can resolve it. Unfortunately, there is very little empirical work so far because it is so difficult to determine ex ante what excessive risk-taking is and data on executive compensation is limited.

Most of the studies of compensation arrangements in the financial industry look at the named executive officers in banks (i.e., the CEO, CFO, or President) because we have data on the compensation arrangements of these individuals. There has been much conjecture about compensation arrangements of traders in banks, but there is no data and thus no empirical evidence. In addition, even if we had such data, it could not be understood independently of the risk management practices of the institution. To see this, consider a trader: Risk-taking incentives for the trader can be affected by his compensation but also by how his performance is defined. If his funding cost reflects the risks he is taking, his attitude towards risk will be very different from a trader who pays the same cost that his institution pays regardless of the risks he takes.

Turning to the evidence on compensation arrangements for top executives, the published work is [the paper that Rudiger Fahlenbrach and I published](#) in the *Journal of Financial Economics* and the paper that Lucian Bebchuk published with Alma Cohen and Holger Spamann in the *Yale Journal on Regulation*. Although I discussed my paper already in [my first blog post](#), it is useful to show how different researchers can draw seemingly contradictory conclusions from the same data.

Let's take the example of Dick Fuld, long-time CEO of Lehman Brothers. Dick Fuld sold equity and options worth approximately \$470 million during 2000-2006. At the end of 2006, he held Lehman shares and options worth approximately \$950 million, all of which he lost when Lehman went bankrupt. In my paper with Rudiger Fahlenbrach, we focus on the \$950 million in vested equity that Dick Fuld *voluntarily* held at the end of 2006, and argue that this, together with his reputation, provided powerful incentives to maximize long-term shareholder value going forward. We say, given relatively low cash compensation in investment banks, it is not too surprising that the CEO cashed out one third of his equity holdings to diversify his stake and reduce his exposure to the company. In contrast, Bebchuk, Cohen, and Spamann focus on the \$470 million liquidated between 2000 and 2006, and indirectly argue that this, together with short vesting conditions, gave Dick Fuld such a large wealth that he would be willing to take on

excessive risks. What Bebchuk, Cohen, and Spamann cannot explain is why Dick Fuld voluntarily held \$950 million in equity in his own bank if he knew that he was taking excessive risks. It is simply not true that Dick Fuld had no skin in the game.

Professor Bebchuk is an outstanding exponent of the view that executive compensation aggravated the crisis. I take the various arguments he has made in several papers seriously. We need to be thinking about those issues and make progress on them. However, in the absence of supportive empirical evidence, I cannot agree with his view that executive pay contributed to excessive risk taking. This view presumes that we know that excessive risk taking was taking place before the crisis and that alternative compensation arrangements would have reduced it. Since we had a horrible financial crisis, it is easy to argue *ex post* that there was excessive risk taking. However, realizations of risk are not by themselves evidence of excess risk taking. Whenever one takes risks, bad outcomes are possible, even if they have an extremely low probability of occurring. A bad outcome can occur even if its *ex ante* probability is infinitesimal. One cannot infer from the occurrence of a bad outcome the level of risk that was taken *ex ante*.

Ultimately, to support the argument that executive compensation aggravated the crisis by encouraging excessive risk taking, it has to be shown that risk taking was in fact excessive and that compensation practices made it more so. Excessive risk taking can be understood in two separate ways. First, risk taking could be excessive if a reduction in risk would increase shareholder wealth. Second, risk taking could be excessive even though it maximizes shareholder wealth because it imposes negative externalities on the financial system. The first type of risk taking could be avoided by better governance, including better compensation schemes. The second type of risk taking cannot be avoided by better governance, but requires mechanisms that internalize externalities created by excessive risk taking.

Irrespective of which definition of excessive risk taking one adheres to, alternative compensation schemes would have been helpful before the crisis in limiting excessive risk taking only to the extent that there was a concern that excessive risk taking was taking place. If we point to the amount of leverage as evidence of excessive risk taking, it is important to note that most banks had room to increase leverage before the crisis given the existing regulatory requirements and chose not to do so. Further, there was no pressure from regulators or from shareholders for banks to reduce leverage before the crisis. In any case, leverage is observable, so that if the board of a financial institution finds it excessive, it can control it by imposing a limit on it. There is no reason to use executive compensation to manage leverage. If we look at the types of assets that institutions were buying before the crisis as evidence of excessive risk taking, we also saw that typical board members and regulators of financial institutions did not have the view that executives were taking excessive risk. Banks made large losses on highly rated tranches of securitizations that were viewed before the crisis as extremely safe. Changing compensation schemes to make executives less willing to take risks before the crisis might possibly have led to a worse crisis as executives might have chosen to have their banks hold more highly rated assets from securitizations.

## **Comments**

### **[Compensation increased cost](#)**

Submitted by Dr. Sapovadia Vrajlal on Wed, 2012-02-15 02:21.

The compensation increased the cost of products & services that customers could not afford which lead to poor recovery. The wealth generated was unevenly distributed and was unjustifiable. This lead to financial instability not only because of finance but confidence of customer was also lost leading to customer loss and revenue loss. Profiteering lead to collapse that we witnessed. The managers sold product to the customers who did not wanted to otherwise buy, many of them were not able to afford, many have not need of the product. The business sustains only if product is needed by customer and they can afford.

- [reply](#)

# Lucian Bebchuk's Response on Executive Pay and the Financial Crisis

Submitted by [Lucian Bebchuk](#) on Mon, 2012-02-13 18:49

In his [opening statement](#), René Stulz relies on the results of the [Fahlenbrach-Stulz study](#) (FS study) to reject the view that executive compensation has contributed to the financial crisis. Stulz argues that the evidence in his study is “inconsistent with the view that banks performed poorly because CEOs had poor incentives.” However, as explained below, the FS study does not provide a good basis for rejecting the poor incentives view.

The FS study attempts to test the “poor incentives” hypothesis by examining whether banks whose CEOs had larger equity holdings performed better during the crisis. Failing to find such an association – and indeed finding that such banks performed worse – the FS study rejects the poor incentives hypothesis. But the poor incentives view does not attribute poor risk-taking incentives to relatively low equity holdings, and the analysis in the FS study does not supply an adequate test of this view.

As I explained in my [opening statement](#), the poor incentives view does not regard large equity holdings as the way to ensure good risk-taking incentives and does not view poor incentives as rooted in insufficient equity holdings. Rather, as I explained, poor incentives have resulted from (i) design of equity compensation (as well as bonus compensation) that rewarded executives even for short-term results that were subsequently reversed, and (ii) linking executive payoffs only to payoffs for shareholders and not also to payoffs for other contributors of capital to financial firms (such as bondholders).

Problem (i) focuses not on the amount of equity compensation but on factors such as the existence and tightness of limitations on unloading equity incentives, as well as on other design elements that make executives more or less focused on short-term prices. Thus, focusing on the correlation between equity holdings and bank performance does not allow us to resolve the extent to which problem (i) played a role during the crisis. Some progress toward such resolution is made by subsequent studies that reach an opposite conclusion to that of the FS study; in particular, [Chesney, Stromberg, and Wagner \(2011\)](#), [DeYoung, Peng, and Yan \(2010\)](#), [Gande and Kalpathy \(2011\)](#) and [Suntheim \(2011\)](#) find that risk taking was associated with the sensitivity of the CEO's wealth to return volatility, and [Bhattacharyya and Purnanandam \(2011\)](#) find that risk taking was associated with the sensitivity of the CEO's compensation to short-term earnings per share.

Problem (ii) focuses on the disproportionate ties that executives had to the interests of shareholders over the interests of the non-shareholder stakeholders in banks. Again, the FS study's finding that banks whose CEOs had larger equity holdings did not perform better during the crisis does not provide any evidence that problem (ii) did not contribute to the financial crisis. On the contrary, the FS study's finding that banks whose CEOs had larger equity holdings might have performed worse during the crisis, and the finding by [Balachandran, Kogut, and](#)

[Hermal \(2010\)](#) that risk taking was positively correlated with CEOs' equity-based compensation, are consistent with the predictions of an analysis focusing on this problem. Further support for the significance of this problem is provided by the findings of [Tung and Wang \(2011\)](#) that risk taking was negatively correlated with inside debt holdings by bank CEOs.

I should stress that the empirical evidence now being accumulated by researchers is unlikely to identify the full extent to which poor incentives contributed to the crisis. To address adequately problem (i), firms should place substantial limitations on the freedom of executives to unload equity incentives (see [Bebchuk and Fried \(2010\)](#) for a detailed blueprint). To address adequately problem (ii), firms should tie the long-term payoffs of executives not only to equity values but also to the value of other slices of the capital structure such as preferred shares and bonds (see [Bebchuk and Spamann \(2010\)](#) for a detailed proposal). Unfortunately, while there has been some variation among the pay structures of financial firms, firms have generally fallen far short of supplying optimal risk-taking incentives, which makes it difficult for researchers to observe the full difference between the actual risk taking in the run up to the crisis and the risk taking that would have taken place under optimal pay structures.

In sum, René Stulz's statement does not provide us with a basis for dismissing the view that poor incentives contributed to the financial crisis. The logic of incentives, and the body of available empirical evidence, suggest that financial economists should take this view seriously. There is a good basis for concern that executive pay has contributed to the financial crisis.

## Comments

### [Inappropriate Incentives](#)

Submitted by [FERGUS O'ROURKE](#) on Wed, 2012-02-15 03:51.

It really is not controversial anywhere that poor design of incentive compensation is undesirable. (Disagree ? Find me someone who advocates it, then). Where it occurs, it is really only an aspect of bad management.

There is, however, disagreement on which designs are overly short-termist in nature, and whether specific schemes actually do reward for gains that are artificial and are quickly reversed after the incentive is "pocketed".

But the real question is: did excessive and/or poorly designed executive compensation

(a) cause the crisis in itself,

and/or incentivise behaviour that was either

(b) itself the cause or

(c) part of a network of causation ?

I say that it was not (a) by itself, and the evidence for (b) is unconvincing, but I doubt if (c) will ever be completely ruled out.

The research, and discussion of it, needs to continue.

- [reply](#)

# CEO Pay at Banks is Not to Blame for the Credit Crisis

Submitted by [René M. Stulz](#) on Tue, 2012-01-31 10:47

Conventional wisdom has it that compensation in the financial industry is responsible for much of the credit crisis. For instance, Paul Krugman [states](#) that “reforming bankers’ compensation is the single best thing we can do to prevent another financial crisis a few years down the road.” Unfortunately, the facts are stubborn and they do not fit this conventional wisdom.

Rüdiger Fahlenbrach and I study the incentives of bank CEOs before the start of the crisis and how the performance of banks is related to these incentives in [a paper](#) published in the **Journal of Financial Economics**. Our sample includes 95 large banks for which we have detailed information on CEO compensation, option holdings, and equity holdings. The paper shows that the value of the shares held by CEOs in the companies they managed in 2006 was roughly ten times the value of their total annual compensation. Such large holdings dwarfed annual bonuses (see Table 1). Experts in governance would have argued before the crisis that the interests of these CEOs were well aligned with the interests of the shareholders because they had so much skin in the game. The CEOs of Lehman Brothers and Bear Stearns had equity holdings in their firms worth approximately one billion dollars in 2006. With such holdings, it would have made little sense for CEOs to take actions that knowingly decreased shareholder wealth.

**Table 1 : Executive compensation and equity ownership at the end of fiscal year 2006**

	CEO	
	Mean	Median
<b>Annual compensation</b>		
Total compensation	7797.7	2453.5
Salary	761.5	747.8
Cash bonus	2137.7	636.8
Dollar value of annual stock grant	2652.7	295.7
Dollar value of annual option grant	1608.3	196.0
Other compensation	637.5	129.0
Cash bonus/salary	2.8	0.9
<b>Bonus paid for 2006 performance</b>		
Total bonus	5314.2	1370.0
Cash bonus	2390.1	637.8
Equity bonus	2924.1	409.5
Total bonus/salary	7.1	1.8
Cash bonus/total bonus	0.6	0.6
<b>Equity portfolio value</b>		
Value of total equity portfolio	87,466.9	35,557.0
Value of shares	61,189.6	22,255.3
Value of exercisable options (Black-Scholes)	17357.7	5729.1
Value of unexercisable options (Black-Scholes)	3242.6	929.3
Value of unvested restricted stock	5677.0	0.0
Value of total equity portfolio/total annual compensation	17.3	8.1
Value of shares/salary	102.6	25.7
<b>Equity portfolio incentives</b>		
Percentage ownership from shares	1.6	0.4
Percentage ownership	2.4	1.0
Dollar gain from +1%	1119.3	467.8
<b>Equity portfolio risk exposure</b>		
Percentage equity risk	0.4	0.3
Dollar equity risk	189.0	53.1

Note: The table shows summary statistics for key compensation variables for a sample of 95 bank holding companies and investment banks for fiscal year 2006. The data are from the Compustat Execucomp database. Values are reported in thousands of dollars. For further details, see "[Bank CEO incentives and the credit crisis](#)," Journal of Financial Economics, 2011, v99, 11-26.

Our results show that there is no evidence that banks with a better alignment of CEOs' interests with those of their shareholders—as measured by equity holdings—had higher stock returns during the crisis and some evidence that banks led by CEOs whose interests were better aligned with those of their shareholders had worse stock returns and a worse return on equity. In particular, whether our sample includes investment banks or not, stock return and accounting equity return performance are negatively related to bank CEOs' dollar incentives, measured as the dollar change in a CEO's wealth for a 1% change in the stock price. This effect is substantial and is not explained by a few banks where CEOs had extremely high ownership. An increase of one standard deviation in dollar incentives (which means better alignment of CEO incentives with shareholder interests) is associated with lower stock returns of 9.6%. Similarly, a bank's accounting return on equity in 2008 is negatively related to its CEO's holdings of shares in 2006—a one standard deviation increase in dollar incentives is associated with approximately a 10.5% lower return on equity. Though options have been blamed for leading to excessive risk-taking, there is no evidence in our sample that greater sensitivity of CEO pay to stock volatility led to worse stock returns during the credit crisis. These results imply that it cannot be the case

that banks would have performed better during the crisis had the incentives of CEOs been better aligned with the interests of shareholders.

Many observers have blamed the crisis on the so-called bonus culture of banks. We also investigate this issue. The average base salary for the CEOs in our sample is \$760,000 in 2006. On average, the base salary is less than 10% of a CEO's compensation. Most of a CEO's compensation is therefore incentive based. On average, a CEO's cash bonus was 2.8 times his base salary. Bonuses tied to the achievement of goals in terms of accounting performance are paid both in cash and in shares. In 2006, on average, 40% of the bonus was paid in shares and 60% was paid in cash. Interestingly, the fraction of the bonus paid in equity was larger for better-performing banks. We investigate whether the performance of banks during the crisis is related to the size and composition of bonuses. When we control for bank characteristics, we find no evidence that banks that paid a higher cash bonus relative to the base salary in 2006 performed worse during the crisis.

Our analysis focuses on whether incentives created by compensation plans of CEOs help explain the performance of bank stocks during the crisis. The bottom line of our paper is that our evidence is inconsistent with the view that banks performed poorly because CEOs had poor incentives. On the contrary, CEOs had strong incentives to maximize shareholder wealth because they owned so much stock in their firms. If one were to conclude that shareholders had incentives to take more risk than was socially optimal for economic stability, then the problem was not compensation but the incentives of shareholders. Setting compensation within financial firms is extremely complicated because assessing performance in relation to the risks taken is difficult and because compensation decisions have to be made in the midst of what is often intense competition. Certainly, errors were made. However, more regulatory intervention in the pay process is unlikely to make the financial system safer, and it would seem that better tools than regulating compensation are available to make the financial system safer. The last time regulators attempted to address executive pay, limits on the tax deductibility of cash salaries were established. Unintended consequences involved a dramatic growth in option compensation, which is now viewed as part of the problem.

## Comments

### [Measuring the alignment of interests](#)

Submitted by A skeptical observer on Thu, 2012-02-02 09:26.

How much confidence should we have that the research accurately measures the degree to which a CEOs' interests are actually aligned with those of bank shareholders?

This seems like an extraordinarily complex and nuanced notion that must be based on the details associated with each CEO contract within the context of each bank.

Without questioning any of the econometrics, can we really measure the extent to which incentives are aligned across so many different banks and CEOs?

- [reply](#)

### **Your claim that executives**

Submitted by SS on Thu, 2012-02-02 13:05.

Your claim that executives were primarily paid in stocks, thus aligning their pay with shareholder interest is flawed in my opinion. You also have to look at how/when these stock/stock option pay can be converted to cash. If they are paid in stocks that they can cash out at exit, this would incentivize executives to prioritize short term stock gains and prop up exactly the sort of bubbles that led to the housing crisis by taking excessive risk. Short term gains would be preferred over long term health of the company under this pay scheme. I disagree with your claim that executive pay at banks did not, at the margins, contribute to the credit crisis.

- [reply](#)

# Executive Pay and the Financial Crisis

Submitted by [Lucian Bebchuk](#) on Tue, 2012-01-31 10:52

Yes, there is a good basis for concern that executive pay arrangements have contributed to excessive risk-taking during the run-up to the financial crisis. To be sure, other factors were clearly at work: the environment within which firms operated grew riskier due to asset bubbles generated by macro policies and global factors, and regulatory constraints on risk-taking and capital requirements were too lax. As financial economists generally recognize, however, for any given environment and outside constraints, the performance and risk choices of firms depend substantially on the incentives of firms' executives. Unfortunately, rather than provide incentives to avoid excessive risk-taking, the design of pay arrangements in financial firms encouraged such risk-taking.

Of course, despite incentives to take excessive risks, some executives might have avoided doing so due to professional integrity, reputational concerns, or fiduciary duty norms. And some executives taking excessive risks might have done so due to their under-estimation of the risks taken. But economics and finance teach us that incentives often matter. Thus, to the extent that pay arrangements provided significant incentives to take excessive risks, the possibility that such incentives in fact contributed materially to the excessive risks taken in the run-up to the crisis should be seriously considered.

In fact, pay arrangements did provide substantial incentives for excessive risk-taking. Under the standard design of pay arrangements, executives were fully exposed to the upside of risks taken but enjoyed substantial insulation from part of the downside of such risks. As a result, executives had incentives to increase risk-taking beyond optimal levels.

The first feature of pay arrangements that generated excessive risk-taking incentives was the partial insulation of executives' payoffs from effects on long-term shareholder value. Both bonus and equity compensation have had excessive focus on short-term results. Jesse Fried and I warned about this problem and its consequences in our 2004 book [Pay without Performance: The Unfulfilled Promise of Executive Compensation](#). Under the standard design of pay arrangements, executives were able to pocket bonuses based on short-term results and were permitted to unload substantial parts of their equity incentives based on short-term stock prices. These arrangements provided executives with incentives to seek short-term increases in profits even when these came at the expense of piling up latent and excessive risks of an implosion later on.

[Bebchuk, Cohen, and Spamann \(2010\)](#) illustrate the problem through a case study of compensation at Bear Stearns and Lehman Brothers. We document that, notwithstanding the 2008 meltdown of the firms, the bottom lines for the period 2000-2008 were positive and substantial for the firms' top five executives. These top executives regularly unloaded shares and options, and thus were able to cash out a lot of their equity before the stock price of their firm plummeted. The top executives' payoffs were further increased by large bonus compensation during 2000-2007; while the earnings providing the basis for these bonuses evaporated in 2008, the firms' pay arrangements did not contain any "claw-back" provisions that would have enabled

recouping the bonuses that had already been paid. Altogether, while the long-term shareholders in these firms were largely decimated, the executives' performance-based compensation kept them in decidedly positive territory. [Bhagat and Bolton \(2011\)](#) find a similar pattern – pre-crisis cashing out of large amounts of compensation by the CEO that exceeded losses suffered by the CEO from stock price declines during the crisis – for other large financial firms that had to be bailed out during the financial crisis.

The second relevant feature of pay arrangements, analyzed in detail in [Bebchuk and Spamann \(2010\)](#), was the insulation of executives' payoffs from potential losses to contributors of capital other than the shareholders – such as bondholders, preferred shareholders, and the government as guarantor of deposits. Consequently, in considering choices that could impose large losses on such stakeholders, executives had insufficient incentive to internalize these potential losses. Thus, executives had insufficient incentives to avoid risk-taking that was beneficial for equityholders but whose potential consequences for bondholders and other stakeholders made them excessive on the whole. This second problem reinforced the incentives to take excessive risks produced by the first problem.

Going forward, these two problems can and should be addressed by improved design of pay arrangements. To address the first problem, pay arrangements should generally tie executives' payoffs to long-term results (along the lines proposed in [Bebchuk and Fried \(2010\)](#) or otherwise). To address the second problem, executives' payoffs should be tied not only to long-term results for shareholders but also (as [Bebchuk and Spamann \(2010\)](#) advocate) to long-term results for other contributors of capital to their financial firm. Had financial firms used such arrangements in the past, they would have avoided providing excessive risk-taking incentives.

While [Fahlenbrach and Stulz \(2009\)](#) (as well as follow-up work by [Erel, Nanda, and Stulz \(2011\)](#)) did not find evidence supporting the hypothesis that pay structures have contributed to risk-taking, a substantial number of subsequent studies provide such evidence. Several studies find that risk-taking was associated with the sensitivity of the CEO's wealth to return volatility ([Chesney, Stromberg, and Wagner \(2011\)](#), [DeYoung, Peng, and Yan \(2010\)](#), [Gande and Kalpathy \(2011\)](#) and [Suntheim \(2011\)](#)). Risk-taking was also identified to have been associated with the sensitivity of the CEO's compensation to short-term earnings per share ([Bhattacharyya and Purnanandam \(2011\)](#)). Furthermore, consistent with the view that risk-taking incentives were generated by the tying of executive interest to results for equityholders but not for bondholders, risk-taking was found to be negatively correlated with inside debt holdings by bank CEOs ([Tung and Wang \(2011\)](#)) and positively correlated with CEOs' equity-based compensation ([Balachandran, Kogut, and Hermal \(2010\)](#)). Finally, consistent with the view that executives did at least partly perceive the significant risks they were taking, [Cziraki \(2011\)](#) finds that insiders of banks with the highest exposure to subprime risk increased their equity selling starting in mid-2006.

While the above evidence is telling, it is worth stressing that the body of empirical work beginning to accumulate is unlikely to reveal the full extent of the contribution of incentives to risk-taking. While there is some variation that has enabled researchers to obtain the above results, the variation in the available data is insufficient to identify the full effects of flawed incentives. While some pay arrangements were marginally better than others in relevant respects,

financial executives' pay arrangements generally provided substantially more exposure to short-term results, and substantially less exposure to payoffs of bondholders and other stakeholders, than was necessary to provide optimal risk-taking incentives. Thus, it will be difficult for researchers to identify in pre-crisis data the full difference between actual risk-taking levels and those that would have been chosen under optimal pay arrangements.

The view that compensation incentives likely have an important effect on executives' decisions has rightly led financial economists to provide strong support to providing executives with incentive compensation. This view also warrants serious concerns about the risk-taking incentives that financial firms provided (and to a substantial extent continue to provide) their executives. Giving these concerns the weight they deserve is important not only for understanding the recent past – which it is – but also for according adequate priority to the task of fixing pay arrangements. Fixing these arrangements to eliminate excessive risk-taking incentives would contribute significantly to maintaining financial stability in the future.

## Comments

### [Executive Compensation and Performance](#)

Submitted by Samuel Munzele Maimbo on Tue, 2012-01-31 16:11.

I agree with the authors view that executive pay had a significant impact on the financial crisis. Human beings respond to incentives and we simply do not have a formula for 'fixing' compensation in way that eliminates EXCESSIVE risk-taking. I am very much of the view expressed by Bruno Frey and Margit Osterloh in this months Harvard Business Review that we should stop tying pay to performance. It does not work. Worse: it induces executives to take company-killing risks; and forces a short-term perspective of the decisions making process. Although stock bonuses mitigate excessive decision making, they do not sufficiently compensate for the lure of cash bonuses tied to short run performance.

- [reply](#)

### [Executive Pay and the Financial Crisis](#)

Submitted by Anonymous on Tue, 2012-01-31 18:18.

There is little doubt in my mind that executive pay and incentives contributed to the crisis. At the same time though, I am afraid that the herd mentality of the markets played a huge role as well. Seemingly, when things are good they can only get better (bubbles by definition), and when things are bad they can only get worse (see Europe). The psyche of all the actors involved, be it from house (flipping) buyers all the way to the financial firms that packaged real estate loans and sold them to markets that seemed not be getting enough of them all contributed to the downfall. It reminds me of my grand father, if it seems to good or too easy to be true, it probably is. The herd mentality of the market generates these massive booms and busts, everybody is feeding on them, some more, some less, from households, to real estate agents, to mortgage brokers, to tax services, Bank and financial firms all the way through to investors everybody wants to be on the

gravy train. Even once there are clear signs that speculation is a significant proportion of the trades driving prices up, no one wants to be left behind. Everybody contributed to the financial crash, the problem is that while just about everybody had to take a hair cut as a consequence, most CEOs, and much of the top brass in the financial sector came away pretty much unscathed even when they benefitted from a massive bailouts. Why?

- [reply](#)

### [Why were the culprits allowed to go free?](#)

Submitted by Ukachukwu on Wed, 2012-02-08 07:23.

Anonymous, you really hit the nail on its head. I think the issue is not whether compensation contributed and everyone was carried along with the market; but Why the financial sector that caused all the problems did not get a fair share of the losses that they inflicted on everyone. It has been reported that the financial sector workers make up the highest earning in the US and UK (and I think about every other place) in recent times. one thing humans may not like is unfairness and very high income inequality and where most of these high earners (e.g. some of the culprits in the crisis) are earning so much and seemingly contributing little to the real economy. Financial services firms seemed to be paying so much to employees and with this crisis, one wonders whether they were really contributing so much to real economic growth and well-being to match their wages (<http://www.economist.com/node/21543178>). As stated in Economist article "Mr Kaplan and Joshua Rauh of Northwestern University note that investment bankers, corporate lawyers, hedge-fund and private-equity managers have displaced corporate executives at the top of the income ladder. In 2009 the richest 25 hedge-fund investors earned more than \$25 billion, roughly six times as much as all the chief executives of companies in the S&P 500 stock index combined...But the relatively large role of the financial sector in English-speaking countries could also be a factor: even more of the top 1% work in finance in Britain than in America".

As Demirguc-kunt and Serven (2010:94) stated "it is the duty of regulators to identify and remedy gaps in information well in advance, and recognize the gradual reduction in transparency that comes with financial engineering and regulatory arbitrage and to nip it in the bud by demanding improvements". This suggests that some financial engineering may not be economically useful and pose great risks to the economic system. So why encourage more of financial engineering for products we do not even understand, maybe under the faith that the markets cannot be wrong in their valuation and the rating agencies cannot be wrong. If the markets are right and the financial models are built on sound economic theories, why worry? But the key issue remains: WHY WERE THE FINANCIAL SECTOR ACTORS, FROM CEOS TO OTHERS, NOT MADE TO PAY A FAIR SHARE OF THE FALL-OUT FROM THEIR ACTIVITIES? I hope going forward, we will not keep assuming that the market is ALWAYS RIGHT and that all kinds of financial instruments from financial engineering always reduce systemic risk and are better for the real economy. Moreover, we may need to encourage talented people to go into more economically productive activities that we understand well enough instead of the esoteric financial engineering activities that they carry out in financial firms. we are watching

- [reply](#)

## **Regulation of compensation and activities in financial services**

Submitted by Chuks Ukachukwu on Fri, 2012-02-10 08:26.

Just to add to the issue of possible solutions going forward, I think it is important that for financial stability, we should not be too afraid of increased regulation of compensation packages for those in the financial services industry, from the CEO to others, and activities in the financial services sector. There should also be increased regulation of financial engineering. Since financial system stability is critical to economic stability and growth, after this crisis, I do not think it is prudent to leave financial service workers to do as they please.

The mainstream economic view was voiced by Demirguc-Kunt and Serven (2010:118) when they stated that " Despite their inherent fragility, financial systems underpin economic development. The challenge of financial sector policies is to align private incentives with public interest without taxing or subsidizing private risk-taking [actually not taxing or subsidizing private risk-taking seems utopian to me as I wonder how this can ever be done in the real world]. Public ownership or too aggressive regulation would simply hamper financial development and growth. But striking this balance is becoming increasingly complex in an ever more integrated and globalized financial system". The authors argue that striking a balance is difficult, but also have obviously argued against state/public ownership and aggressive regulation (not sure what aggressive regulation means since we may not really know the right balance and may have to keep trying different types of regulation-both direct and indirect). But state/public ownership and regulation are not always undesirable and can be beneficial if done well as the Chinese state seems to be doing now. Part of getting the balance is to keep experimenting. A recent Economist report (<http://www.economist.com/node/21542924>) on China stated that "The party has cells in most big companies—in the private as well as the state-owned sector—complete with their own offices and files on employees. It controls the appointment of captains of industry and, in the SOEs, even corporate dogsbodies. It holds meetings that shadow formal board meetings and often trump their decisions, particularly on staff appointments. It often gets involved in business planning and works with management to control workers' pay. The party state exercises power through two institutions: the State-Owned Assets Supervision and Administration Commission (SASAC) and the Communist Party's Organisation Department. SASAC, which holds shares in the biggest companies, is the world's largest controlling shareholder and the state-capitalist institution par excellence. It has been spearheading the policy of creating national champions by consolidating and pruning its portfolio: the number of companies under its supervision has declined from 198 in 2003 to 121 today. It has also been implementing the party's policy of creating a "harmonious society" by regulating pay. In 2009 the average SOE boss earned \$88,000 and the highest-paid, the chairman of China Mobile, \$182,000. High pay in SOEs has been a big source of disharmony". In essence, the public interest may demand trading off more financial engineering and high economic growth for the financial engineering and economic growth that the public thinks creates a harmonious society and in which other human goods are protected. As long as financial innovation and high economic growth are not the only arguments in the objective function of the public, then a balance is required. We may need to learn from the Chinese State capitalism model on how to find the true balance as requested by Demirguc-Kunt

and Serven (2010), while overcoming some of the defects, especially as regards fighting corruption and nepotism. we are watching as things unfold

- [reply](#)

### **The huge bonuses grow best where the profits are huge.**

Submitted by [Per Kurowski](#) on Tue, 2012-02-14 15:53.

Contributed? Yes! Caused? Absolutely not!

In order to pay those exorbitant bonuses you need exorbitant profits and those were handed to the banks, against basically nothing I would say, by the regulators, by means of amazingly low capital requirements which allowed, just as an example, a bank to lend to Greece leveraging over 60 times.

If your expected risk-weighted return when lending to Greece was one percent, you could then look forward to yearly return on equity over 60 percent on that, and that is truly something to write home about... and to collect big bonuses on.

The saddest part though of this crisis, and perhaps even the most expensive, might be all the opportunities which got lost forever, when banks abandoned traditional bank business, like lending to "risky" small businesses and entrepreneurs, since in that case the banks are only allowed to leverage 12 times... meaning no fun... no bonuses.

Occupy Basel! <http://bit.ly/dFRiMs> We must stop the regulator nannies from infantilizing our banks!

- [reply](#)

## **Has executive compensation contributed to the financial crisis?**

Submitted by [Asli Demirgüç-Kunt](#) on Mon, 2012-01-30 11:27

### **The AAF Virtual Debates: Join Rene Stulz and Lucian Bebchuk in a Debate on Executive Pay**

In the aftermath of the financial crisis there has been no shortage of finger-pointing in the attempt to identify its underlying causes. The list of potential culprits is long and ranges from bank deregulation to the "alchemy" of credit ratings and structured finance. This debate focuses

on one factor that has allegedly contributed to the crisis: greedy bankers and the executive compensation packages that tempted them to, quite literally, bet the bank.

The spectacular collapse of banks whose executives were allegedly paid for performance clearly raises many questions about the link between executive pay and risk-taking. [In a recent paper](#), Thomas Philippon and Ariell Reshef of New York University show that while in 1980 bankers made no more than their counterparts in other parts of the economy, by 2000 wages in the financial sector were 40% higher for employees with the same formal qualifications. The last time such a discrepancy was observed was just prior to the Great Depression—an irony which has not been lost on critics of bank compensation, ranging from regulators to the Occupy Wall Street protesters. But the level of compensation alone may not be the real problem. Many leading economists (see, for instance, op-eds from [Alan Blinder](#) and [Raghuram Rajan](#)) have emphasized that a much more important (and difficult) question to answer is how the structure of performance pay may encourage excessive risk-taking at all levels of the institution, from traders and underwriters right up to the firm's CEO.

But how exactly the structure of executive pay affects risk-taking is still a topic of heated debate. Some have argued that—even before the crisis—executive compensation at banks had several features that should have discouraged short-termism and excessive risk-taking: paying bankers with equity or stock options, for instance, should ensure that if the firm's market value gets wiped out the same fate awaits the paycheck of its senior management. But matters may be more complex. Incentive schemes may emphasize immediate revenue generation over a prudent long-term assessment of credit risk (as was likely the case in mortgage lending); and bonuses awarded today may entail risks that do not become apparent until much later. Both aspects of bank compensation have become the focus of increased regulation intended to discourage bank executives from excessive risk-taking. But our understanding of how incentives at banks translated into actual risk-taking behavior is still limited and regulators struggle to come up with rules that can rein in reckless risk-taking without extinguishing banks' ability to reward actual performance.

What do you think? I've asked Rene Stulz of Ohio State University and Lucian Bebchuk of Harvard Law School to kick off the debate. Please join us and let us know which side you are on. They'll be posting opening statements later this week on the question: "Has executive compensation contributed to the financial crisis?" The comments section will be open, and we'll also be featuring a poll that will allow our readers to weigh in on the issue.

<b>Pro</b> Lucian Bebchuk	<b>Con</b> René M. Stulz
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William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance at Harvard Law School

[Read more about Professor Bebchuk.](#)



Everett D. Reese Chair of Banking and Monetary Economics at Ohio State University

[Read more about Professor Stulz.](#)

## Comments

### [I would like to hear to hear](#)

Submitted by Martin on Tue, 2012-02-14 15:04.

I would like to hear to hear people's thoughts on the idea that this would have happened regardless of executive compensation.

Once someone had the idea of making it possible to lend to people who would be likely to default, and those people were willing to take out these mortgages and loans everyone else was forced down that path; the firms engaged in these practices, from the making of loans to the trading in derivatives were making good profits, if a firm sat on the sidelines it would show poorer results, investors would either leave or force a change management because it was being outperformed by the competition and appeared incompetent.

Perhaps our salvation lay elsewhere and not in change of compensation?

- [reply](#)

### [Cause of economic crisis](#)

Submitted by Anonymous on Tue, 2012-02-14 19:45.

My view in this issue is that the 2008 financial crisis was the result of the regulatory weakness of governments. To avoid such crisis in future there is necessary of establishing a super financial regulator similar to ICAO in the aviation sector. The super financial regulator would oversee and

control international finance in different ways such as establishing a harmonic control system in the member countries. . The member countries will be responsible to regulate their domestic market in harmonic ways matching to the guidelines of the international regulator.

There is also necessary to regulate the so called innovation in soft technology which has syphoned the poor people's money in the hand of the new richs. It started with the New Economy phenomina especially after 2000. For example the mobile technology. It is changing month after month.

A poor man who does not have sufficient money even to their food, cloth, education and health needs has compulsive wishes to buy newer sets by any means. Ultimately compromising their basic needs. What is the use of a mobile set with camera to a poor man? This and other soft technologies such as television and internet has diverted the income to a certain group of investors. To regulate this phenomina is very much necessary so that product of innovation should be of upgradable type so that their one time investment will not go in wastage. How can we overcome this technological empire which is unjustifiably exploiting the income of the poors and the middle income families?

- [reply](#)

### **There is relationship but that is not all.**

Submitted by Lydia Ochieng-Obbo on Tue, 2012-02-14 23:28.

Although there is a strong correlation between Executive Pay and the Financial Crisis the short-termism and excessive risk taking is also rooted in high stakeholder expectations which puts unrealistic pressure on management mainly due to run away competition ( you can read it as excessive ostentetiousness, greed )

I would also like to point out that there was excessive laxity on the part of the regulatory framework in all spheres of the financial system. While we in Africa were being told to regulate and regulate our colleagues in the developed world were taking free market economics to another level. De regulation became the order of the day.

So with unreasonable expectations from the shareholders pushed by the increased consumerism and living larger that life ( earning a lot for doing very little) that most elites have adopted, a lax regulatory and supervisory framework, who is surprised that the Executives took advantage deliberately or not - took unprecedented risks to satisfy their greed and that of their employers.

- [reply](#)

### **Financial crises happen from**

Submitted by Anonymous on Wed, 2012-02-15 01:59.

Financial crises happen from time-to-time. Greed is almost always a factor. The extent of the present crisis, however, was really a result of government mis-management. When bank failure is staring one in the face, the last thing a government should do is force the bank to close.

Successful banking is wholly dependent on public confidence. Bank failure destroys public confidence. Greed certainly set off the crisis, though what the internal controllers, regulators and auditors were doing whilst the crisis was developing is a mystery, but if governments had acted to shore up the banks at the outset, as ultimately they were forced to do anyway, the crisis of confidence would have passed quickly and then the other problems could have been sorted out. But governments refuse to take responsibility and look for other scapegoats. It is wholly correct to reduce compensation in the financial sector partly because it encourages risk-taking but what has happened now is that banks take no risk at all (and still the massive compensation!). Banking is a business. I don't know of any other business that is not expected to take risk. It is abnormal risk that should be guarded against. Currently, the 'products' that banks offer pass all the risk to the customer. That is also a dangerous prospect.

- [reply](#)

### **Financial crises**

Submitted by mhd issa on Wed, 2012-02-15 18:48.

first we have to admit that this crises is the top of the ice-berg , governments refuse to take responsibility and bankers are passing the bucket .we must restructure the monetary regulation according to equitable means.

- [reply](#)

### **Government failed to check 2008 crisis?**

Submitted by Dr. Sapovadia Vrajlal on Thu, 2012-02-16 02:40.

My question is: are governments sincere to detect reasons and check the causes? May be few governments fall in the line. Rest are cutting the time of their regime and not bothered what happens to economy of the country. Otherwise, if government wishes, early alarm is always possible to ring. Government is sole organ, but thoughts and actions are department wise and there is no coordination among different department or people. This lead to incompatibility among them and hence failure occurred in 2008.

- [reply](#)

### **Multiple factors have contributed to this financial crisis**

Submitted by [Dr. Ashish Manohar Urkude](#) on Fri, 2012-02-17 10:07.

No entity is perfect in this world. Greed of few. Hegemonies of few. Imperialism of few entities. Marketing economies. Communist economies. Mixed economies. Utopian economists. Corruption. Either Unwillingness or Helplessness of governments to solve problems. Blackmailing from few economies. Loyalty to own economy to save job/authority/power/lives. Equally responsible are few more classical problems, which includes, pleasing our own

community/country and avoiding to thinking about its effects (bad or good) on other entities.....  
Thus, the list is unending, and all 7 billion humans on earth are responsible for this crisis.  
Thus, mine is the neutral path and I'm neither supporting PRO nor to CON. However, both may express their opinion on this broader vision.

- [reply](#)