The Executive Compensation Controversy: A Transatlantic Analysis

Discussion by
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Overall picture

- This chapter is a real *tour de force*.
- Authors put so much information in it, a lot of it from their past work, that one could get a textbook out of it
- I learned a lot about this topic and I am sure even specialists can learn a lot from it

My focus

- Given my corporate finance background, I will focus only on two questions:
  - Have executive incentives contributed to the financial crisis?
  - Should compensation in banks be reformed? And how?

Bank CEO incentives and the credit crisis -1

- Are Wall Street bonuses to blame for the credit crisis?
- Geithner in his testimony to the Congress (6 June 2009):

  "*I think that although many things caused this crisis, what happened to compensation and the incentives in creative risk-taking did contribute in some institutions to the vulnerability that we saw in this financial crisis*"

Bank CEO incentives and the credit crisis -2

- Fahlenbrach and Stulz (2009)
  - No evidence that banks with CEOs whose incentives were better aligned with the interests of their shareholders performed better during the crisis
  - Banks with higher option compensation and higher fraction of compensation in cash bonuses did not have worse performance
  - These results hold for banks that received TARP assistance as well banks that did not

Bank CEO incentives and the credit crisis -3

- **This paper**: compensation structure might encourage excessive risk taking through asymmetric rewards and penalties
- But financial services firms provide significant penalties for failure as salaries are below market levels
- Elasticity of compensation to shareholder value is positive and significant for banking CEO even in Europe (contrary to other sectors)

→ Not a failure of alignment with shareholders

Leverage and risk-taking -1

- **Jensen and Meckling (1976):** in a highly levered firm, being well-aligned with (even long-term) shareholders may still lead to excessive risk-taking from a social perspective
- Asset-substitution (or risk-shifting) effect of debt
- Shareholders have a call option on the value of the assets

Leverage and risk-taking -2

- A simple numerical example
- Firm has 10 in cash and other assets in place that will generate a cash flow equal to 100 in the good state (prob. ½) and to 20 in the bad state (prob. ½).
- Firms has debt with face value equal to 90
- Market value of **equity** is

$$\frac{1}{2} * (110-90) + \frac{1}{2} * 0 = 10$$

- Market value of **debt** is ½ * 90+ ½ * 30 = 60
- Total firm value is 60 + 10 = 70

Leverage and risk-taking -3

- Suppose the firm can invest in a project that costs 10 and yields 0 in the bad state and 18 in the good state
- This is a risky bad project: negative NPV (½ * 18 + ½ * 0 -10 = -1)
- If project is financed using cash on hand, cash flow will be 100+18=118 in the good state and 20+0=20 in the bad state

Leverage and risk-taking -4

- Market value of **equity** is

  ½ * (118-90) + ½ * 0 = 14 (> 10)

- Market value of **debt** is ½ * 90+ ½ * 20 = 55 < 60
- Total firm value is 55 + 14 = 69 < 70
- A manager whose incentives are perfectly aligned with shareholders would go ahead with the project

Leverage and risk-taking -5

- **Asset substitution**: shareholders of a highly levered firm prefer to substitute cash (a safe asset) with a risky asset even though this decision has a negative NPV → transfer of wealth from debtholders to shareholders

  - Limited liability effect: when risky project implemented, downside risk falls on debt holders

Compensation and risk-taking

- Cheng, Hong and Scheinkman (2010):
  - Compensation and risk-taking among financial firms covary with ownership by institutional investors who tend to have short-termist preferences and the power to influence management
  - Institutional investors such as mutual funds want certain firms to take more risks and they give them the incentives to do so
  - It's about shareholders, not about managers' incentives!

Compensation reform - 1

- Squam Lake Group on Compensation (February 2010)
  - **Recommendation 2:** *Systemically important financial institutions should withhold a significant share of each senior manager's total annual compensation for several years. The withheld compensation should not take the form of stock or stock options. Rather, each holdback should be for a fixed dollar amount, and employees would forfeit their holdbacks if the firm goes bankrupt or receives extraordinary government assistance.*

Compensation reform - 2

- Crucial: it's not restricted stock or options. If firm survives for say five years, executives get *fixed amount*
  - "*Employees whose compensation is held back become creditors of their firms. As a result, this deferred compensation reduces management's incentive to pursue risky strategies that might result in government bailouts*".

Compensation reform - 3

- Why not stock or stock options?
  - "*Standard forms of deferred compensation, such as stock awards and options, do little to reduce the conflict between systemically important financial institutions and society. Managers who receive stock become more aligned with stockholders, but this does not align them with taxpayers*".
- Not a panacea but an interesting suggestion
- Details very important

Summing up

- A truly impressive survey on executive compensation
  - I could only discuss one the many issues analyzed in the paper.
- Many interesting and relevant problems still awaiting for new research

- Thank you!