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Compensation for Crises

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Abstract:
Whenever the economists talk about the reasons behind any particular crises, much is debated about the fault lines that existed in the economies. The crises may vary from a debt fueled crises to a financial crises or an economic crisis. The government and the central bank in an effort to deal with the crises come up with various tools in their monetary and fiscal capacity like injecting liquidity, quantative easing programs, regulatory measures but often seem to ignore one important component underlying the crises. In this paper, I argue how the incentive structure of the top executives is structured in a manner which further exacerbates the existing fault lines. The incentive structure plays out differently for different financial market participants and also how it often becomes a one way bet where everything to lose if for the shareholders and the common public and everything to gain for is for the top executives in the financial sector.

1. Introduction

This paper seeks to evaluate the role of compensation structure in spurring up the financial crises of 2008. The paper will discuss the pre-crisis and post-crisis scenario regarding the top executive compensation structure in the banking institution and will try to see whether the problem and has been addressed and what kind of risk does it pose to the health of the financial system.

Whenever a crisis or a situation of recession happens there are always attempts to know what actually caused the crises or the recession. There are many theories, which are floated around. In light of the 2008 financial crises, one such theory that was contended was that of the compensation structure of the executives. The crisis is mainly attributed to a housing bubble crisis, where the banks traded heavily in mortgaged backed securities. Most of the banking institutions were largely optimistic about the housing market boom and were had highly leveraged positions on it. Post crisis, incentive structure of the executives at these institutions were also identified as a factor, which led to the crisis. Since 2008 onwards, leading world economists have been vocal about expressing their views on how the incentives at these banks led the executives to indulge in decision-making, which led to the point of crisis. Raghu ram rajan, one of the leading economists was quick to show his concern regarding the compensation factor. He was of the view that the incentives were not aligned to the shareholder's interest and that these gave perverse incentives to the top executives to indulge in excessive risk taking which was beneficial from their own point of view[i]. Economists like Stieglitz and Andrei shlifer have also expressed concerns regarding the incentives available to these top executives to indulge in excessive risk taking which is not desirable from the point of view of the institution or the shareholders. Shliefer in his post crisis analysis highlights four important factors that led to the crisis. One of the factors which he talked about was Agency problem and risk taking inside bank. He remarked that compensation structure of these executives was tilted towards the profit and they do not pay for the losses. Also, he highlighted the alarming fact that such risk taking undertaken by institutions leads to the situation where the possibility of systemic risks increases[ii].

1.1. Pre-crises

The compensation structure in many banking institutions are basically divided into components like fixed salary, restricted stock option, cash bonuses etc. The compensation structure is set in a manner, which is optimally efficient from the point of view of the institution and the shareholder. It has been largely debated that the compensation structure was not optimal in the lead up period to the financial crises. Some of the indicators for optimality include how much of compensation is linked to the performance of the executives or how much is tied to long-term performances of these executives. Analyzing the compensation structure set by the institutions before the crises period can look into these aspects. The data on how the compensation was divided between fixed salary, stock options and cash bonuses reveal that most of the incentive was linked to short-term performances, i.e., between cash bonuses and stock options and which incentivized the executives to take excessive-risk, which had negative value effect on the firm's value[iii]. Cash bonuses and stock options are source of the problem as they measure the executive's performance in a short term without showing or providing with the long-term effects of those decisions. Considering that the basic human nature is a greedy one, every individual wants to maximize the amount of money or profit he can earn. In turn, the executives are incentivized to take decisions which are excessively risky from the point of the firm or the shareholder but which have no downside effect on the executive's compensation. Taking such negative-expected-value "bets" may nevertheless be attractive from the perspective of a private actor if the actor expects to capture a share of possible gains while bearing a smaller share of possible losses.To illustrate this let us suppose that the value of stock of company X is priced at $100 and the executive is given a stock option where is allowed to cash in at $80[iv]. Now considering this situation, the executive has an incentive to take decisions which involve substantial amount of risk as if it the risk payoff he will entirely capture the upside in the market but even if it proves to be detrimental it will have no effect on the pocket of the

executive as he has the option to cash in on the stock option. Also, in pre-crises evaluation the banking institutions in the U.S were rolling out about 80-90% of compensation in the form of stock options or cash bonuses, which were effectively indicators of what was happening in the short term. A comparative study shows that the international counterparts for e.g. banking institutions in U.K had a far more conservative structure which had a large proportion of compensation tied up to the long-term performance of these executives[v]. The problem of compensating through stock options also gets magnified because just before the crises, around 2006-07, analyses of financial sector S&P shows that the stock prices were at their peak just before the housing bubble burst. This allowed the executives to cash in at that point of time, which made their profits superficial relative to their performance and reality of what was going to happen.

1.2. Bailout Program

After the collapse of the Lehman brothers and the danger of potential collapse of few other large financial institutions, the Federal Reserve quickly intervened and proposed a bailout program for the troubled financial institutions. The bailout programs were primarily had to be used to save thousands of homeowners who were affected by the crises but ended up being as an indirect way to provide the financial institution with protection out of the taxpayer's money. Initially, the federal reserve proposed to purchase these troubled mortgages from these financial institutions in order to "clean up" the books of these institutions and provided money in order to ensure liquidity in a hope that these institutions will lend more and the chain will indirectly help both the effected, the homeowners as well as the troubled institutions. Now, the focus of the analysis will just be on the provisions related to the compensation structure.

With the bailout programs the Fed introduced certain restrictions on the way compensation was to be structured to the recipients of such programs. The fed also instituted an oversight authority, which would ensure that the recipients would meet and abide by the standards set for executive compensation. The measure included: -

- Limits on compensation to restrict executive decision making which is highly risky and unnecessary from point of view of firm's value.
- Claw back provision- to permit the recovery of compensation paid to executives, which is against the public interest.
- Prohibition of golden parachute and severance payments[vi].

The idea behind these measures were to tie the compensation of the top executive to certain indicators which reflect the long term performance of the executives rather than tying these compensations to indicators like stock options which allow the executives to cash in huge amount of compensation based on short term results which can be driven by excessively risky decisions[vii]. Even after the restrictions placed by these programs, the compensation structure largely remained the same, instead one analyses of Goldman sach's compensation practices after the crises show an increase in the amount of stock options which were largely based on looking at ROE (return on equity) for the period of 2 years.

Also, it is interesting to note the point that the federal reserve from the very beginning of such bailout programs were under a pressure from the public as well as the congress to ensure that the billions of dollars of taxpayer's money are used effectively and is not wasted. So there was an exceeded expectation or a burden on the Federal Reserve to ensure that these firms operate in such away that they are able to pay back the financial assistance provided to them[viii]. So, keeping this in mind the companies at the end had a better bargaining position regarding the compensation levels as they argued that it was essential for them to pay good sum in compensation which were in turn contravening to the provisions of the bailout program. The reports of the Special inspector also highlight the fact that there were no mechanisms or ways to ensure that the companies followed the provisions effectively.

Another provision which was the part of compensation structure was that there would be an attempt to tie maximum amount of compensation of the executives to certain indicators which reflects the long term value of the firm and also that the executives are not allowed to cash in on their compensation over a short period of time[ix]. While going through the data which shows how the compensation was allocated in terms of different indicator, it was interesting to note that in none of the firms was this criterion followed and also the congress oversight committee highlighted the issue that there was no indicator specified or mentioned so as to properly evaluate what really constitutes as a long term indicator or not. It is important to bring in the issue that there were provisions that were put in place to check the compensation structure but the lack of effective guidance and compliance mechanism gave the institutions a leeway where they used the provisions to their own benefit. The lack of effective checks and balance system didn't help the cause to provide an effective framework regarding compensation.

The compensation structure even after the crises remains to be the same. The fact that many of the large institutions that were affected by the financial crises still engage in practices in which the executives have the optimal incentives to take excessive risks. The fact that there is an asymmetric payoff between what the executives will gain and lose contributes to excessive risk taking appetite. Bank managers could recognize the possibility of such losses; yet rationally decide that they were outweighed by the possibility of continued profitability of the risky lines of business. Illustration to this point can be an individual who is given the opportunity to bet all her wealth on one or more spins of a standard roulette wheel. A rational, risk-averse individual who does not obtain any utility from the act of gambling itself would decline this opportunity: any chance of winning would be counterbalanced by an equally large chance of losing, and a risk averse individual would find such a gamble unattractive. Now imagine a fictitious roulette game with asymmetric payoffs. In particular, imagine that bets on black yield four times the betted amount if successful. This bet on black could be attractive even to a rational and (moderately) risk-averse individual. We do not need to resolve here what number of rounds we should expect the individual to play as long as the individual keeps winning, but we would not be surprised to see the individual play one or more rounds. If the individual happened to lose all of her wealth playing this game, we would expect the individual to regret, ex post, having made the bet, but we would hardly conclude from the loss of the individual's wealth that this rules out, or is in any way inconsistent with, her choosing rationally to make the bet and her being drawn to it by the asymmetric payoffs[x].

This helps us to understand that even if certain decisions were excessively risky for the institutions, it was not necessary that it was the same for the managers or the executives who maximized their own incentives.

In light of the crises, it can be said that behavioral economics has a part in how the individuals or various stakeholders base their decision regarding the effective opportunity cost and other risk factors. The financial crises show that these institutions are riddled with dysfunctional incentives. There is a strong need to structure the compensation level in such a way which aligns the interest of the executives and the various shareholders[xi]. As already we have seen there has been a clear ineffective regulation policy followed by the government who were unable to prevent the crises and also by the Federal Reserve who were unable to rectify for it even after the crises. The fact that compensation levels were deemed to be one of the aspects of these crises, there needs to be effective regulation, which ensures optimality of these compensation structure.

1.3. Measures

In today's world where globalization is a rule rather than an exception, the measures should be taken keeping in mind the level of financial globalization in today's world. The "too big to fail" institutions are not just geographically restricted but have their presence in several countries. The risk of systemic failure is larger than ever and failure of even one institution in one economy can trigger a global financial crisis. In light of this here are few measures that can help in providing a check and balance system for the compensation structure and which would provide an effective way in curbing the excessive risk taking by the firms.

1.3.1. Independent Commission

An independent commission should be set up to monitor and regulate the compensation structures of the employees who effect the decision making of the firm. The employees should be held accountable for the amount of risk they are taking and whether it has positive or negative value effect on the financial system or not. Complete information regarding the decisions and use of derivatives should be made available to these commissions who in turn can decide and issue guidelines as to what amount of risk the firm is getting into and issue warnings regarding the same. Basically, the point is to bring in effective compliance of these independent body's regulations or guidelines.

1.3.2. Achievement of Objective Performance Goals

Incentive compensation should be based on performance metrics that are measurable, enforceable, and actually enforced if not met. The company's independent compensation committee must take an active role in both the design process of incentives and the review and measurement of achievement.

1.3.3. Long-term Structures

A significant amount of compensation should reflect a company's long-term performance and value, often using grants of company stock. In most circumstances a large proportion of compensation should be held or deferred for a period of at least three years. In addition, the vesting of an employee's right to a payment and the actual monetization or redemption of the payment should be partially or wholly separated. For example: Cash incentive payments should generally be delivered in multiple tranches and not as single lump sums, with subsequent tranches deferred for at least a year after payment of the initial tranche. Stock salary must generally be redeemable ratably over a period of years, and no portion of an executive's stock salary should be redeemable in less than one year.

It is important to deal with the situation of the compensation structure in order to contain the situation of systemic risks. The financial crises reflect how it played a role in excessive risk taking environment and how there is an asymmetry between the payoffs. It is long before that these aspects should be dealt with effective regulations and provisions before they play a part in inducing another crisis.

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