Testimony of Professor Lucian A. Bebchuk

William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and Director of the Corporate Governance Program, Harvard Law School*

Before the
Subcommittee on Financial Institutions and Consumer Protection
of the
Committee on Banking, Housing and Urban Affairs Committee
United States Senate

Hearing on Compensation Practices at the Largest Financial Institutions

February 15, 2012

*The views expressed herein are solely my own and should not be attributed to Harvard Law School or any other institution with which I am affiliated. My affiliation is noted for identification purposes only.

Chairman Brown, Ranking Member Corker, and distinguished members of the Subcommittee, I would like to thank you very much for inviting me to testify today. Adequate design of compensation practices at large financial institutions is important for financial stability, and I am honored to have been invited to testify on this subject.

Below I discuss the role that compensation practices played in the financial crisis and how they should generally be designed going forward. I describe two distinct sources of risk-taking incentives: first, executives' excessive focus on short-term results; and, second, their excessive focus on results for shareholders, which corresponds to a lack of incentives for executives to consider outcomes for other contributors of capital. I discuss how pay arrangements should be designed to address each of these problems. The issues I discuss are ones on which I have done a significant amount of academic writing, and my testimony draws on my writing.[1]

My focus throughout is on how senior executives of financial firms should be compensated. Regulators now rightly devote attention to the compensation of all employees of financial institutions who take or influence risk and not just senior executives. However, the pay arrangements of senior executives deserve special attention because such executives have substantial influence both on key risk choices of their firm and on the setting of compensation arrangements for other employees in their firm.

Problem I: Short-Term Focus

Standard pay arrangements have incentivized and rewarded short-term results. Jesse Fried and I warned about this problem and its consequences in our book *Pay without*

[1] My testimony draws on Lucian Bebchuk, Alma Cohen and Holger Spamann, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008," *Yale Journal on Regulation* 27 (2010): 257-282, available at http://ssrn.com/abstract=1513522; Lucian Bebchuk and Jesse Fried, "Paying for Long-Term Performance," *University of Pennsylvania Law Review* 58 (2010): 1915–1960, available at http://ssrn.com/abstract=1535355; Lucian Bebchuk and Holger Spamann, "Regulating Bankers' Pay," *Georgetown Law Journal* 98 (2) (2010): 247–287, available at http://ssrn.com/abstract=1410072; and Lucian Bebchuk, "How to Fix Bankers' Pay," *Daedalus* 139 (2010): 52-60, available at http://ssrn.com/abstract=1673250.

Performance: The Unfulfilled Promise of Executive Compensation, published seven years ago.[2] Under the standard design of pay arrangements, executives have been able to cash out large amounts of compensation based on short-term results. This feature of pay arrangements has provided executives with incentives to seek short-term gains even when doing so creates excessive risk of a later implosion.

In our study "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman Brothers 2000–2008,"[3] Alma Cohen, Holger Spamann, and I 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. Indeed, combining the figures from equity sales and bonuses, we find that, during 2000 to 2008, the top five executives at Bear Stearns and Lehman pocketed about $1.4 billion and $1 billion, respectively, or roughly $250 million per executive.

The divergence between how the top executives and their companies' shareholders fared raises a serious concern that the aggressive risk-taking at Bear Stearns and Lehman (and other financial firms with similar pay arrangements) could have been the product of flawed incentives. The concern is not that the top executives expected their aggressive risk-taking to lead to certain failure for their firms, but that the executives' pay arrangements – in particular, their ability to claim large amounts of compensation based on short-term results – induced them to accept excessive levels of risk.

---

[2] Lucian Bebchuk and Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, Mass.: Harvard University Press, 2004).

[3] Bebchuk, Cohen, and Spamann, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008," *supra* note 1.

Such incentives were not unique to these two firms: a subsequent study by Sanjai Bhagat and Brian Bolton finds 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.[4] There is also empirical evidence indicating that risk-taking was associated with the extent to which the CEO's compensation was sensitive to the volatility of the company's stock returns,[5] as well as with the sensitivity of the CEO's compensation to short-term earnings per share.[6]

Solving Problem I: Paying for Long-Term Performance

To address the problem of short-term focus, financial firms should reform compensation structures to ensure tighter alignment between executive payoffs and long-term results. Senior executives should not be able to collect and retain large amounts of bonus compensation when the performance on which the bonuses are based is subsequently sharply reversed. Similarly, equity incentives should be subject to substantial limitations aimed at preventing executives from placing excessive weight on their firm's short-term stock price. Had such compensation structures been in place at Bear Stearns and Lehman, their top executives would not have been able to derive such large amounts of performance-based compensation for managing these firms in the years leading up to their collapse.

Equity-based compensation is the primary component of modern pay packages. In a recent article, Jesse Fried and I, building on the approach we put forward in *Pay without*

---

[4] Sanjai Bhagat and Brian Bolton, "Bank Executive Compensation and Capital Requirements Reform," Working paper (2011), available at http://ssrn.com/abstract=1781318.

[5] See Marc Chesney, Jacob Stromberg, and Alexander Wagner, "Risk-Taking Incentives and Losses in the Financial Crisis," Swiss Finance Institute Research Paper No. 10-18 (2010), available at http://ssrn.com/abstract=1595343; Robert DeYoung, Emma Peng, and Meng Yan, "Executive Compensation and Business Policy Choices at U.S. Commercial Banks," *Journal of Financial and Quantitative Analysis*, forthcoming, available at http://ssrn.com/abstract=1544490; Amar Gande and Swaminathan Kalpathy, "CEO Compensation at Financial Firms," SMU Working Paper (2011), available at http://ssrn.com/abstract=1865870; and Felix Suntheim, "Managerial Compensation in the Financial Service Industry," Working paper (2011), available at http://ssrn.com/abstract=1592163.

[6] Sugato Bhattacharyya and Amiyatosh Purnanandam, "Risk-Taking by Banks: What Did We Know and When Did We Know It?," Working paper (2011), available at http://ssrn.com/abstract=1619472.

Performance, proposed a detailed blueprint for preventing equity-based compensation from producing an excessive focus on short-term results.[7]

First, the time that options and restricted shares can be cashed should be separated from the time in which they vest. As soon as an executive has completed an additional year at the firm, the options or shares promised as compensation for that year's work should vest; it should belong to the executive even if he or she immediately leaves the firm. The executive, however, should not be free to cash out these vested equity incentives; rather, he or she should be permitted to do so only after a substantial passage of time.

Second, unwinding should be subject to a combination of grant-based and aggregate restrictions. Grant-based limitations would require executives to hold equity incentives awarded as part of a given grant for a fixed number of years after vesting. For example, an executive receiving an equity award could be prevented from unwinding any awarded equity incentives for two years after vesting, with each subsequent year freeing another 20 percent of the awarded incentives to be unloaded.

These grant-based limitations, however, are not sufficient to ensure adequate long-term focus. With only grant-based restrictions in place, longtime executives might amass large amounts of equity incentives that they could immediately unload, which could induce them to pay excessive attention to short-term prices. Therefore, grant-based limitations should be supplemented with aggregate limitations restricting the fraction of an executive's otherwise unloadable equity incentives that could be sold in any given year. To illustrate, executives could be precluded from unloading, in any given year, more than 10 percent of their total portfolio of otherwise unloadable incentives. By construction, such limitations would ensure that executives would not place substantial weight on short-term stock prices.

Firms should not make limitations on unwinding a function of events under the control of executives. Some reformers have urged using, and some firms have been using, "hold-till-retirement" requirements that allow executives to cash out shares and options only upon retirement from the firm. Such requirements, however, provide executives with a counterproductive incentive to leave the firm in order to cash out their portfolio of options and shares and diversify their risks. Perversely, the incentive to leave will be strongest for executives who have served successfully for a long time and whose accumulated options and shares are

[7] Bebchuk and Fried, "Paying for Long-Term Performance," *supra* note 1.

especially valuable. Similar distortions arise under any arrangement tying the freedom to cash out to an event that is at least partly under an executive's control.

Third, firms should generally adopt robust limitations on executives' use of hedging and derivative transactions, a practice that can weaken the connection between executive payoffs and long-term results. An executive who buys a "put" option to sell his or her shares at the current price is "insured" against declines in the stock price below current levels, which undermines incentives and the effectiveness of limitations on unwinding. Therefore, whether or not they are motivated by the use of inside information, executives should be precluded from engaging in any hedging or derivative transactions that would reduce or limit the extent to which declines in the company's stock price would lower executive payoffs. In 2009, following the anti-hedging approach that Jesse Fried and I advocated in our book, the Special Master for TARP Executive Compensation Kenneth Feinberg (whom I served as an adviser) required companies subject to his jurisdiction to adopt such an anti-hedging requirement.[8] This approach should be followed by financial firms in general. Whatever equity-plan design is chosen by a given bank's board, executives should not be allowed to unilaterally use hedging and derivative transactions that undo the incentive consequences of this design.

In addition to equity compensation, bonus plans should also be designed to encourage long-term focus. Bonuses should commonly be based not on one-year results but on results over a longer period. Furthermore, bonuses should not be cashed right away; instead, the funds should be placed in a company account for several years and adjusted downward if the company subsequently learns that the bonus is no longer justified. The need for such a downward adjustment is not limited to firms in which financial results are restated. Even if results for a given year were booked consistent with accounting conventions, executives should not be rewarded for profits that are quickly reversed. Rewarding executives for short-term results distorts their incentives and should be avoided by well-designed compensation arrangements.

[8] See testimony of Kenneth R. Feinberg, the Special Master for TARP Executive Compensation, before the House Financial Services Committee, February 25, 2010, http://www.treasury.gov/press-center/press-releases/Pages/tg565.aspx. Feinberg reports that one of the principles used in evaluating pay at subject firms was that "employees should be prohibited from engaging in any hedging, derivative or other transactions that undermine the long-term performance incentives created by a company's compensation structures."

Problem II: Excessive Focus on Shareholder Interests

Thus far, I have focused on the insulation of executives from long-term losses to shareholders – the problem that has received the most attention following the recent crisis. However, as Holger Spamann and have highlighted in our research,[9] there is another type of distortion that should be recognized: payoffs to financial executives have been shielded from the consequences that losses could impose on parties other than shareholders. This source of distortion is distinct from the "short-termism" problem discussed above and would remain even if executives' payoffs were fully aligned with those of long-term shareholders.

Equity-based awards, coupled with the capital structure of banks, tie executives' compensation to a highly levered bet on the value of banks' assets. While bank executives expect to share in any gains that might flow to common shareholders, they do not expect to bear (in the event losses exceed the common shareholders' capital) any part of losses borne by preferred shareholders, bondholders, depositors, or the government as a guarantor of deposits. This state of affairs leads executives to pay insufficient attention to the possibility of large losses sustained beyond the shareholders' equity; it thus incentivizes excessive risk-taking.

Insulation of executives from losses to parties other than shareholders can be expected to produce at least two types of risk-taking distortions. First, it encourages executives to make investments and take on obligations that can contribute to "tail" scenarios, in which the bank suffers losses exceeding the shareholders' capital. Second, it creates reluctance to raise capital and fosters excessive willingness to run the bank with a capital level that provides inadequate cushion for bondholders and depositors.

The above analysis is consistent with empirical evidence indicating that risk-taking was positively correlated with CEOs' equity-based compensation;[10] that risk-taking was negatively

---

[9] Bebchuk and Spamann, "Regulating Bankers' Pay," *supra* note 1.

[10] Sudhakar Balachandran, Bruce Kogut, and Hitesh Harnal, "The Probability of Default, Excessive Risk, and Executive Compensation: A Study of Financial Services Firms from 1995 to 2008," Columbia Business School Research Paper (2010), available at http://ssrn.com/abstract=1914542.

correlated with inside debt holdings by bank CEOs;[11] and that banks whose CEOs had larger equity holdings performed worse during the crisis.[12]

<u>Solving Problem II: Linking Executive Pay to the Payoffs of Non-Shareholder Stakeholders</u>

How should pay arrangements be designed to address the above problem? To the extent that executive pay is tied to the value of specified securities, such pay could be tied to a broader basket of securities, not merely common shares. Thus, rather than tying executive pay to a specified percentage of the value of the common shares of the bank holding company, compensation could be tied to a specified percentage of the aggregate value of the common shares, the preferred shares, and all the outstanding bonds issued by either the bank holding company or the bank. Because such a compensation structure would expose executives to a broader fraction of the negative consequences of risks taken, it would encourage greater prudence in evaluating risky choices.

One could broaden further the set of positions to which executive payoffs are tied by using the value of credit default swaps. Because the value of credit default swaps is associated with increases in the risk posed by the bank's operations, adjusting executives' long-term payoffs by an amount dependent on changes in the value of credit default swaps would provide executives an incentive to take into account the effects of their risk choices on non-shareholder stakeholders.

Similarly, in firms in which executives receive bonus compensation tied to specified accounting measures, bonuses could be linked instead to broader metrics. For example, the bonus compensation of some bank executives has been dependent on accounting measures that are of interest primarily to common shareholders, such as return on equity or earning per common share. Such plans could be redesigned to be based on more expansive measures, such as earnings before any payments made to bondholders. Alternatively or in addition, bonuses could be paid

---

[11] Frederick Tung and Xue Wang, "Bank CEOs, Inside Debt Compensation, and the Global Financial Crisis," Boston Univ. School of Law Working Paper No. 11-49 (2011), available at http://ssrn.com/abstract=1570161.

[12] Rüdiger Fahlenbrach and René Stulz, "Bank CEO Incentives and the Credit Crisis," *Journal of Financial Economics* 99 (2011): 11-26, available at http://ssrn.com/abstract=1439859.

not in cash but rather in the form of a subordinated debt obligation of the bank payable in several years.

Ensuring that executives perfectly internalize the expected losses their choices would impose on contributors of capital other than shareholders is far from straightforward. But doing so imperfectly would likely be better than not doing so at all. Requiring financial executives to expand their focus beyond consequences for shareholders would significantly improve their risk-taking incentives.

The Role of Regulations

Outside the financial sector, the government should not intervene in the substantive terms of pay arrangements. In the case of banks, however, financial regulators should monitor and impose meaningful regulations on financial firms' compensation structures. Such pay regulation is justified by the same moral hazard reasons that underlie the long-standing system of prudential regulation of banks.

When a bank takes risks, shareholders can expect to capture the full upside, but part of the downside may be borne by the government as guarantor of deposits. Because bank failure imposes costs on the government and the economy that shareholders do not internalize, shareholders' interests may be served by greater risk-taking than is in the interest of the government and the economy. This moral hazard problem provides a basis for the extensive body of regulations that restrict the choices of financial firms with respect to investments, lending, and capital reserves.

Aligning the interests of executives with those of shareholders, which some governance reforms seek to do, could eliminate risk-taking that is excessive even from the shareholders' perspective. But it cannot be expected to get rid of incentives for risk-taking that are excessive from a social standpoint but not from the shareholders' perspective.

Shareholders' interest in greater risk-taking implies that they stand to benefit when bank executives take excessive risks. Given the complexities of modern finance and the limited information and resources of regulators, the traditional regulation of banks' actions and activities is necessarily imperfect. Regulators are often one step behind banks' executives. Thus, executives with incentives to focus on shareholder interests can use their informational advantages and whatever discretion traditional regulations leave them to take excessive risks.

Because shareholders' interests favor incentives for risk-taking that are socially excessive, substantive regulation of the terms of pay arrangements – that is, limiting the use of structures that reward risky behavior – can advance the goals of banking regulation. Regulators should focus on the *structure* of compensation – not the amount – with the aim of discouraging excessive risk-taking. By doing so, regulators would induce bank executives to work for, not against, the goals of banking regulation.

The regulation of bankers' pay could well supplement and reinforce the traditional direct regulation of banks' activities. Indeed, if pay arrangements are designed to discourage excessive risk-taking, direct regulation need not be as stringent as would otherwise be necessary. Conversely, as long as banks' executive pay arrangements are unconstrained, regulators should be stricter in their monitoring and direct regulation of banks' activities. At a minimum, when assessing the risks posed by any given bank, regulators should take into account the incentives generated by the bank's pay arrangements. When the design of compensation encourages risk-taking, regulators should monitor the bank more closely and should consider raising its capital requirements.

Before concluding, it is worthwhile to respond to objections that have been raised against a meaningful governmental role in this area. First, regulation of pay structures may be opposed on grounds that it is the shareholders' money and the government does not have a legitimate interest in telling bank shareholders how to spend their money. The government, however, does have a legitimate interest in the compensation structures of private financial firms. Given the government's interest in the safety and soundness of the banking system, intervention here is no less legitimate than the government's established involvement in limiting banks' investment and lending decisions.

Second, opponents of meaningful regulation have argued that one size does not fit all and that regulators are at an informational disadvantage vis-à-vis decision-makers within each firm. But the knowledge required of regulators to effectively limit compensation structures that incentivize risk-taking would be no more demanding than that which is requisite to regulators' direct intervention in investment, lending, and capital decisions. Furthermore, setting pay arrangements should not be left to the unconstrained choices of informed players inside banks;

while such players might be best informed, they do not have incentives to take into account the interests of bondholders, depositors, and the government.

Proposed Regulations

The case for meaningful regulation of pay structures in large financial firms is strong. Although regulators issued proposed rules for incentive-based compensation arrangements in April 2011, they have not thus far adopted final rules. Furthermore, and importantly, the proposed regulations should be tightened to ensure that firms take the steps discussed above as necessary to eliminate excessive risk-taking incentives.

The proposed regulations should be revised to include robust and meaningful rules requiring large financial firms to subject all equity compensation of senior executives not only to vesting schedules but also to grant-based limitations on unwinding for a substantial period after equity incentives are vested, as well as to aggregate limitations on unwinding. The proposed regulations should also be revised to require large financial firms to prohibit their senior executives from engaging in any hedging or derivative transactions that would reduce or limit the extent to which declines in the company's stock price would lower executive payoffs. Adopting the rules discussed in this paragraph would serve both financial stability and the long-term interests of shareholders.

In addition, the proposed regulations should be revised to include rules that would induce firms to make the variable compensation of senior executives significantly depend on long-term payoffs to the bank's non-shareholder stakeholders and not only on the payoffs of shareholders. In designing such rules, regulators should recognize that securing risk-taking incentives that are optimal from shareholders' perspective would be insufficient to eliminate risk-taking incentives that are excessive from a social perspective.

***

To reduce the likelihood of future financial crises, it is important to pay close attention to the incentives provided to financial firms' senior executives. The structure of pay should induce executives to focus on long-term rather than short-term results, as well as to take into account the consequences of their decisions for all those contributing to the bank's capital (rather than only for shareholders). Because of the importance of providing such incentives for financial stability, ensuring that financial firms design pay arrangements to provide such incentives should be regarded as a regulatory priority.