

Did Bankers' Pay Add to This Mess?

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By Mark Hulbert

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PROPOSALS to cap the compensation of bank C.E.O.'s have gained traction lately as a means of heading off another financial crisis.

World leaders at the G-20 summit meeting last week in Pittsburgh agreed in principle to reform executive compensation, with the goals of reducing risk-seeking behavior and avoiding a future global credit shock.

But will these measures work? And did C.E.O. compensation really play an important role in the recent crisis? Unfortunately, there is no consensus among academic experts.

There is certainly some support for the broad assumptions behind this argument, notably in a working paper by Lucian A. Bebchuk and Holger Spamann, both professors at Harvard Law School, that began circulating earlier this year. It argues that compensation for bank C.E.O.'s is asymmetrical — that they often stand to make much more money when their banks succeed than they could lose if their banks fail.

The professors pointed to the large proportion of C.E.O. compensation that often comes from options, and to the huge leverage implicit in many banks' operations. In short, Professor Bebchuk said in an interview, bank chief executives generally have an incentive for "excessive risk-taking."

Still, René M. Stulz, a finance professor at the Fisher College of Business at Ohio State University, says he has been unable to find empirical evidence that incentives encouraging excessive risk-taking played a large role in the credit crisis. Professor Stulz and a co-author, Rüdiger Fahlenbrach, a finance professor at the Swiss Federal Institute of Technology in Lausanne, examined the relationship between bank performance during the crisis and C.E.O. pay incentives.

Their study has circulated since summer as a working paper from the National Bureau of Economic Research. The study found few significant correlations one way or the other, but to the extent it saw patterns, they generally ran counter to what's often assumed. Instead of performing worse, the banks whose C.E.O.'s had the greatest incentives for excessive risk-taking fared better, on average, than others.

Professor Bebchuk, via e-mail, said he and Professor Spamann had not tried in their study to assess the evidence presented in the Stulz-Fahlenbrach study. But even if one accepted that evidence at face value, he added, it wouldn't mean that bankers' incentives were inconsequential.

Representative Barney Frank, the Massachusetts Democrat and chairman of the House Financial Services Committee, concurs. Mr. Frank, whose committee is considering pay reform legislation,

said in an interview that it is entirely possible that in something as complex as the credit crisis, any one factor taken in isolation can seem insignificant even when it plays a large role.

In any case, Professor Stulz says he agrees that it is important for C.E.O. pay incentives to reward long-term performance and to discourage excessive risk-taking. Still, based on his study, he says that “it is not right to blame the credit crisis“ on C.E.O. pay incentives.

And he says there is little evidence that compensation reform would have helped head off the crisis. For example, he says, “neither bank C.E.O.’s nor regulators thought that banks were taking excessive risks.” So if the risks were viewed as small, he adds, “compensation incentives would not induce them to avoid those risks.”

He points out that in 2006, a collateralized-debt obligation with a triple-A rating didn’t look like a huge risk. “On the contrary, it looked like an extremely low-risk asset,” he says. “Yet, banks incurred extremely large losses on such C.D.O.’s.”

Regulations that would have encouraged executives to take on less risk, he adds, might have made matters worse because executives “might well have chosen to invest even more in AAA-rated C.D.O.’s and other asset-backed securities.”

PROFESSOR STULZ also notes that bank C.E.O.’s lost a lot of their own money during the credit crisis.

He and Professor Fahlenbrach studied 98 banks that were part of the Standard & Poor’s 1500-stock index at the end of 2006, relying on the government’s Standard Industrial Classification system to determine which companies to consider as banks.

They found that the C.E.O.’s of these banks lost more than \$30 million, on average, of their investments in their own banks in 2007 and 2008, and that the executives who headed Bear Stearns and Lehman at the onset of the crisis lost close to \$1 billion each.

“If the prospect of losing those amounts was insufficient to induce the firms’ C.E.O.’s to pursue different policies,” Professor Stulz says, “it’s extremely difficult to imagine any compensation reform package that contains incentives that would do the trick.”

In short, then, we may want to change executive pay practices for a variety of social, political and moral reasons. And it’s plausible that compensation does generally affect risk-taking behavior. But so far, the evidence doesn’t show a specific link between that pay and the recent debacle.

So we may be fooling ourselves if we think that compensation reforms, by themselves, will prevent another crisis.

Mark Hulbert is editor of The Hulbert Financial Digest, a service of MarketWatch.