# Regulating executive compensation as a way of enhancing corporate governance after the financial crisis

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## Introduction

Compensation structure for the top managers in banking sector, and precisely in broker-dealer firms (compared to traditional banks), is a key component in the corporate governance structures of firms. This Wall Street bonus culture existed for decades; however it had a tremendous amount of public backlash after the 2008 global financial system meltdown. Throughout the country, the anger at bankers was palpable. This was not a narrow populist phenomenon; rather, it reflects widespread mistrust in the nation's financial institutions. (I Hate Banks ' yields 70,000 Google Index results). Many observers believe that top-level executive compensation is not sufficiently linked to long-term corporate governance. The debate about banking bonuses surfaced in early 2009, with the United States still enmeshed in the financial crisis, reports said that Wall Street bankers were set to receive nearly $20 billion in bonuses for 2008 performance. Bailout-recipient like Merrill Lynch paid nearly $4 billion in year-end bonuses just before its acquisition by Bank of America, American International Group (AIG) was about to pay $168 million 'retention bonuses' to its executives. Receiving bonuses even though the companies were doing poorly and the stock prices were plummeting led to the beliefs amid politicians and public that those bonuses may be the root cause of the crisis. Executives pay and incentives have been carefully scrutinized by the public even before the last financial crisis, especially after the bursting of the dotcom bubble in 2000 and the ensuing corporate scandals triggered a collapse of well-known companies such as Enron, WorldCom, and other important U.S corporations. Newspapers give much more importance to CEO compensations. Reports of salaries, bonuses, profits from selling stock options of the highest paid executives often made the headlines suggesting excessive levels of pay or a very weak relation of pay and performance. Even academic economists have been studying long ago the issues and mechanisms that can lead to an exact measurement of executive compensation package which appeared to be a very difficult and complicated task.

The aim of this paper is to provide a general and theoretical review of CEO compensation debate that appeared in the wake of the last financial crisis. This debate in reality was about flawed corporate governance practices that might lead to the recession. As executives' salaries is a major component in these practices, in addition to the large public and media attention given to this aspect. This debate mainly was about to find the real contribution of Generous compensation packages in the crisis, and then to propose reforms and regulations to solve this dilemma and to prevent similar irregularities in the future.

We will try to explore briefly all the aspects related to this topic. The paper is divided into two sections; the first one contains an overview of CEO compensation from designing the perfect pay package to the importance and arguments supporting the excessive and generous bonuses, and then we'll try to trace the changes in size of this pay in the U.S.A through the time. The second section focus on the debate that surfaced in the U.S political, academic, and populist press circles about the real contribution of these 'obscene' pay packages into the 2008 financial crisis. The debate is divided into three subsections: the first contains a brief review of the crisis; the second discuss the possible contribution of CEO compensation in the crisis, and in the last one we'll try to investigate the effects of U.S regulations on the CEO bonuses.

As mentioned before, the discussion in this paper take for example the case of the U.S financial system considered its development (CEO compensation practices) and because it was the starting point of the crisis. We won't go a lot through a detailed description and discussion of all the theories and arguments that investigate for instance the optimal pay structure, or the causes of its changes. We'll try to convey the whole debate in a short and concise presentation.

**Keywords:** corporate governance, executive compensation, CEO bonuses, Wall Street bonus culture, risk-taking behavior,

## CEO[1] compensation

### The structure of CEO compensation

The average pay of a chief executive officer (CEO) working in one of the 500 largest firms in the United States has increased six-fold over the past three decades. The CEO compensation is paid in today firms through different instruments; it may include salaries, bonuses, payouts from long term incentive plans that specify retirement and severance payments, as well as pensions plans and deferred benefits (and other non-equity plans) , gains from exercising stock options, and the vesting value of restricted shares ( and probably other perks such as annual medical

[1] The acronym "CEO" refers to chief executive officer.

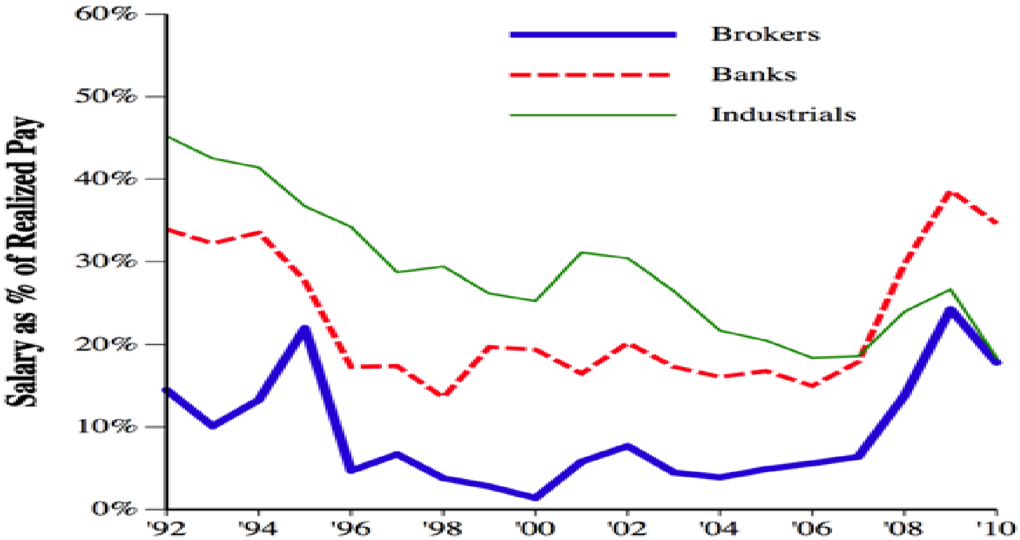
examinations, tax preparation and financial counseling fees, club memberships, security services, and the use of corporate aircraft.

The bonus culture reigning in Wall Street imposed a specific design of compensation that couple low (and relatively stable) base salaries with variable pay that depends to the profitability of the enterprise. For example, in 2006, Bear Stearns' CEO James Cayne received a salary of $250,000, and a bonus of $33.6 million, comprised of cash ($17 million), restricted shares ($14.8 million), and stock options ($1.7 million) in 2007, Goldman Sachs paid its CEO (Lloyd Blankfein) a salary of $600,000 and a bonus of $67.9 million for total compensation of $68.5 million; his salary accounted for less than 1% of his total compensation.

Even with this specific design of compensation, there was recently a shift from salaries and bonuses toward performance-based compensation (stock and options) to make the pay more sensitive to performance. In addition to these explicit (direct) incentives, managers still would be motivated to exert effort due to implicit (indirect) incentive channels. These incentives include career concerns: workers expect to receive offers for better paying jobs after an above-average performance. The second incentive channel is the threat of dismissal following poor performance.

This culture as proven by Murphy (2012) is applied only to broker-dealer firms (especially large ones) and not to other financial services firms. In addition to that, bonus opportunities in non-financial firms are often limited to senior managers and executives, however, it concerns in broker-dealer firms (Even if banks have historically been secretive about the real magnitude and distribution of bonuses to its traders) mostly all the financial staff. Figure 1 shows the average ratio of base salary to total realized compensation for the top 5 executives in broker-dealer firms, banks and industrial. We notice that base salaries constituted a modest fraction of total realized compensation for executives in broker-dealer firms compared to their counterparts in banks and industrials.

**Figure 1 Median Realized Pay for the "Average" Top 5 Executives in Broker-Dealers, Banks, and Industrials, 1992-2010**




**Source: Kevin J.Murphy, pay, politics and the financial crisis; P: 11**

## Why excessive bonuses?

There is a large amount of academic studies discussing executive pay before and after the financial crisis, whether to design the optimal compensation scheme that has a strong relation with the firm performance, or to determine the contribution of these practices to the financial turmoil. Our main aim here is to explain through the review of some arguments and studies why executives and other financial employees are given all these excessive pays? Executive incentives have increased considerably over the last three decades in the financial sector as a whole, and more particularly in broker-dealer firms. Is it appropriate to give high bonuses to executives even in bad earning years?

The need to give high pay to executives is one of the main results of agency problem; the separation of ownership and control of the firm implies that the owners have to provide incentives to the CEO in order to align his interests with those of the firm owners. This called 'moral hazard' problem. In the presence of this problem, the optimal pay contract or executive compensation should vary with the result of the firm or the added value that the CEO brings to the firm. This is the reason why the optimal pay structure should combine incentives and insurance. i.e. part of the compensation should be variable through the use of stocks or stock options as mentioned above, while the second part should not be subject to risk such as the annual salary that provides an insurance to the CEO against bad firm performance due to factors that he cannot control.

There is a second reason that can justify the high level of executive pay is the scarce supply of individuals with the highly specialized skills that are specific to this industry: Individuals with the ability to understand and trade in increasingly complex derivative instruments. The market for such individuals is global with little respect for international boundaries, thus the rewards in this sector should be higher than other industries to attract the best and brightest college, MBA and PhD graduates into financial services. So obviously compensation levels are determined by competitive market forces. Executives are an important production factor, and in a capitalist free-market economy, resources are allocated and moved to higher – valued uses.

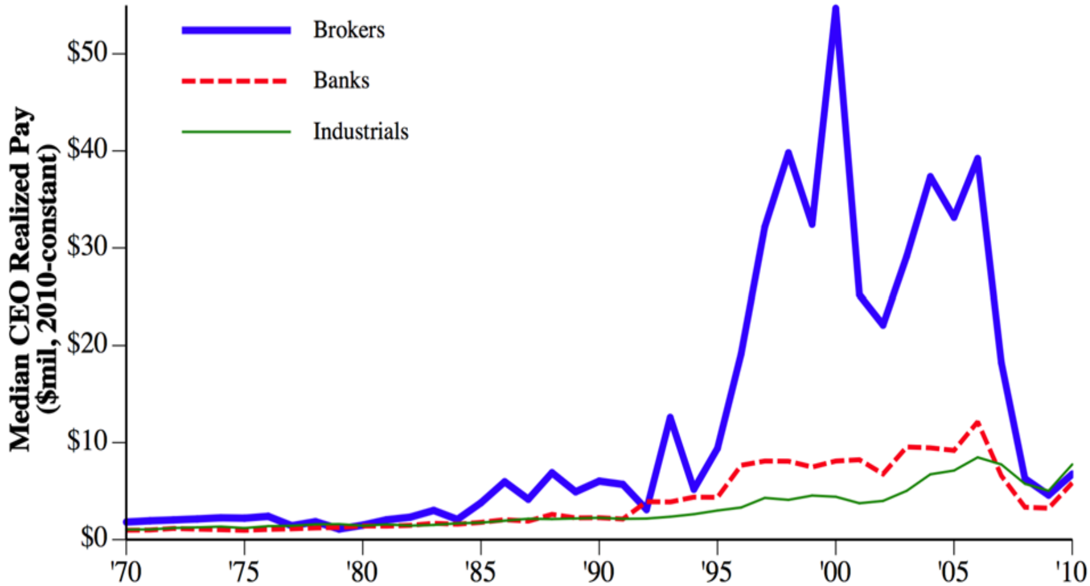
Empirical evidences (Gabaix and Landier (2008))[2] have shown recently that the cost of CEO compensation for firms may not be so economically significant. However, the economic consequences of not providing the right incentives appear to be potentially large. Companies benefit highly from providing the right level of incentives (ranging from $83 million to $263 million in 1977 dollars[3]). While providing these incentives imply a modest cost to induce this high effort.

Tracing the evolution of CEO compensation since the 1930s, reveal that its level decreased sharply after the World WarII. It had a modest level of growth of 0.8 percent for the following 30 years, and moderate rates of growth in the 1970s then it rose much faster in the most recent decades. The level of pay has surged since the 1980s, and it reached an annual growth rates above 10 percent in the period of 1998-2007. (figure table)

**Figure 2 Median Realized Compensation for CEOs in S&P 500 Broker-Dealers, Banks, and Industrials, 1970-2010**

[2] This study has reported an average value of CEO over firm earnings of 0.5 percent during the period 1992-2003. Other study made by Bennedsen, Pérez-Gonzalez , and Wolfenzon (2007) used data from Danish firms from 1992 to 2003 to estimate the effect of the CEO's death on firm performance. The results report a decrease of 1.7 percent in case of CEO's death, and a decrease of 0.7 percent after a close family member of the CEO is died.

[3] See Arantxa Jarque, CEO compensation: Trends, Market changes, and Regulation, Federal Reserve Bank of Richmond Economic Quarterly, P:272.




**Source: Kevin J.Murphy, pay, politics and the financial crisis; P: 08**

## The change in the level of executive compensation

Different sides (aspects) of executive compensation have been studied and documented by a very large body of scientific literature, and there are theories in each side, for example, theories to explain the relation between CEO pay and firm performance or between CEO pay and executive performance, theories to find the optimal combination of compensation, theories to explain the increasing sensitivity between CEO wage and performance, and last but not least, theories to explain the change in CEO pay in the last three decades.

The increases in total compensation were particularly pronounced in the manufacturing and financial services sectors, where CEOs have historically earned above-average compensation. Compensation increased both in small and large corporations, but remained substantially higher in larger firms.

Several arguments have been presented to justify the upward trend in the level of compensation observed in recent years and to answer this importance question: are today's level justified? among them we mention the explanation given by Gabaix and Landier (2008). They argue that the six-fold increase in pay since 1980s can be explained by the six-fold increase in the market value of U.S firms in the same period[4].they show in their model that the CEO pay increases both with size of the

[4] See Arantxa Jarque, CEO compensation, P: 272.

firm and the average size of the firm in the economy[5]. Other authors propose explanations starting from the hypothesis that the observed compensation contracts are suboptimal, among these explanations we cite:

- The increase in CEO pay can be explained by the recent increase in the use of option grants to compensate executives due to the tax and accounting advantages related to them, however, options are in fact a very expensive way of compensation, CEOs demand a high risk premium for the options (while firms valuate a cost that is approximated to the Black-Sholes value) because : risk aversion, combined with the impossibility of hedging, as well as the high percentage of human and monetary wealth that CEOs invest in their own firm, and the positive probability of being unable to exercise the options if they are fired before the options become vested[6].
- Other explanation is the entrenchment model given by Bebchuck and several coauthors (2003-2004) which suggests that executives control the board of directors; hence they actually determine their own pay. However, it worth noticing that this model is not different than the classic moral hazard model (shareholders maximizing their value subject to the incentive constraints of CEOs). In addition to that the entrenchment model does not really explain the increase level of executive pay since the1980s since corporate governance practices have been improving during this period.
- In a study made by Murphy (1999), he provides another explanation based on how firms decide the annual options to be awarded to executives, they typically use the average compensation given in a peer group for reference (the herd behavior), in addition to this practice, 40 percent of firms have compensation plans that specify the number of option to be granted rather than the value of option. As a result, these two practices lead to a “ratchet effect” which means an escalation in total pay in times of growing stock market as opposed to rewarding exceptional performance of the individual CEOs[7].

## Executive bonuses and the 2008 financial crisis

The 2008 financial crisis was precipitated by the collapse of a housing bubble and then the failure of venerable financial institutions such as Lehman Brothers and Merrill Lynch. The supply of private capital to the financial sector dried up, credit

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[5] Though the same author mentioned other comprehensive study made by Frydman and Saks (2007) in which database is from 1936 to 1992, their results were consistent with the result of the above mentioned study starting from 1970s, however CEO pay was stagnant from 1940s to 1970S a period during which there was considerable growth of firms- particularly during the 1950s and the 1960S.
[6] Results of Murphy and Jensen (1999), Murphy and wruck (2004).
[7] See Arantxa Jarque, CEO compensation, P: 274.

markets froze, consumer confidence collapsed, and stock markets dropped. The crisis spread rapidly around the world threatening an immediate and severe economic contraction. The debate in both academic and policy circles has been mainly on how to respond the financial meltdown and to understand the real causes of this crisis in order to prevent it from happening in the future.

## An overview of the housing bubble crisis

The recent crisis was the result of macroeconomic factors, flawed government policies, and flawed incentives for several players in the financial markets. The confluence of these factors led to excessive risk-taking that was facilitated by the creation of complex, illiquid mortgage securities. It was first started by an excessive confidence about increasing house prices which led to a high demand for homes. This demand was met primarily through debts from banks, which relaxed credit standards and made risky loans, including subprime loans. The repayment of these loans predicated on house price appreciation rather than borrower income, so banks effectively made risky bets on house prices.

Banks took this risk due to several factors: the most important one is the U.S government policy that started pro-housing initiatives through the extensive support for government-sponsored entities (GSEs) like Freddie Mac and Fannie Mae that were enabled and encouraged to buy vast pools of mortgage debt. These two institutions were private in theory but in practice their debt was viewed as carrying a government guarantee, giving them access to cheap funding and facilitating social policies on home ownership (home ownership raised to an historically 70%). This initiative was coupled with the loose money policies of the U.S Federal Reserve after the dotcom crash which led to a huge supply of capital for the risky mortgages. The second major factor was the high leverage of banks that encourages extra risk-taking to reward shareholders with the implicit insurance that large institutions cannot fail and will be bailed out in the event of distress (which is known as ‘too big to fail’ TBTF). Another contributory factor was regulations that pushed investors to buy instruments with high credit rating. This demand was met by a supply of innovative mortgage-backed securities. Although these securities (MBS) received high credit ratings, they were complex illiquid claims whose high ratings turned out to be unrealistic. In the middle of this financial disorder, the size of pay package of many employees at failed institutions became the target of public anger. It was believed that those large bonuses gave incentives to managers to take riskier decisions which could contribute to the crisis.

In an influential paper written by Murphy (2012), he compared realized pay perceived by the “top 5” executives in S&P 500 firms in the period of 1992-2010.

The results show a high average of compensation in broker-dealer firms ($43 million) compared to traditional banks ($4.7million) and industrials ($3.2 million)[8]. Since the bonus culture exists mainly in the financial sector, two different but opposed questions have to be asked. Did the excessive compensations cause or contribute to the financial crisis? Were CEO bonuses affected by the new rules and regulations set as direct response to the financial crisis? We will try to explore and discuss these two questions in two separate subsections.

## The contribution of bonuses in the financial crisis

The public and political anger over CEO overly generous compensation package in the aftermath of the housing bubble and the subprime debacle was driven by two factors: the first is the outrage that the banks would pay any bonuses at all given their objective failure and their reliance on government bailouts (especially for the participants in the government's Troubled Asset Relief Program (TARP)). These bonuses were perceived by many to be an undeserved direct transfer of wealth from taxpayers to already-wealthy bankers[9]. As well as the believe that the financial meltdown involved banks, banks rely heavily on bonuses, and pay levels in banks are high, thus the banking bonuses have caused the crisis. The second factor is the belief that CEO compensation provides incentives for excessive risk taking of the sort that facilitated the crisis.

Executive compensation encourages risk taking through two channels: asymmetric rewards and penalties, and performance measures that reward risky behavior. Murphy (2012) defines the first factor as follows: 'the asymmetric exists when executives (or traders or brokers) receive rewards for upside risk, but are not penalized for downside risk'[10]. In this case, they will naturally take greater risks than if they faced symmetric consequences in both directions. The second factor appears through several performance metrics that reward risk-taking such as:

- Rewarding quantity rather than quality: for example the famous reward system used in banks that pay high commissions and bonuses to loan officers when they manage to write more loans(with little or no verification of the borrowers assets or income) rather than to write "good loans" (that is, loans with a decent chance of actually being paid). Murphy (2012) points here to a very important idea; if this reward system is being characterized as promoting risky behavior, paying on the quantity rather than the quality is in fact a universal practice that does not concern

[8] For further information, see Kevin J.Murphy, pay, politics and the financial crisis; Forthcoming in economic lessons from the financial crisis, P: 09.

[9] See K.Murphy, P :17.

[10] See K.Murphy, P :17.

banking sector only and which can be considered as a performance-measurement problem[11] rather than performance measures that reward excessive risk taking.

- Rewarding short-term rather than long-term results: this can easily destroy long-run value. Traders will focus on the trades (or decisions) that generate quick (if illusionary when they have inside information that the trades are likely to go sour after the bonuses are paid) gain and they are not accountable for long-term results. Murphy(2012) argues in his paper that this is not a risk-taking problem since the projects that provide profits in the short-run are likely less risky than trades providing profits in the longer-run
- The reliance on option rather than restricted stock may encourage risk-taking: The value of a stock option increases monotonically with stock-price volatilities. This can create an incentive for executives to take risks that increase such volatilities. There has been a dramatic increase in the executive stock options since the 1980s. for instance, the average grant-date value of options soared from near zero in 1970 to over $7 million in 2000. Although this value fell to $4,4 million in 2002, by 2005 it had come back to about $6 million[12]. Option grants became an important component of pay not only for CEOs, but for executives below the top executive level. Between the mid-1999s and the end of 2004, the fraction of option grant to employees and executives ranked below the top five had risen from less than %85 to over %90.

In summary, Wall Street bonus culture (in banking sector, more precisely in broker-dealer firms) can effectively encourage risk-taking behavior through the above mentioned channels. Nonetheless, empirical evidence has shown that in fact, the reliance in financial sector on low base salaries coupled with bonuses (a major part of bonuses are paid in the form of unvested stock or unexercisable stock options) compared to other sectors can in reality solve the asymmetric problem. This compensation plan provides significant penalties for failure by keeping salaries below competitive market levels, so earning a zero bonus represents a penalty. In addition, this design creates incentives to focus on long-run value creation since the value of bonuses is highly related to the subsequent performance[13]. These results according to Murphy (2012) concern only top-level banking executives and cannot be extrapolated to low-level employees who have less accumulated wealth and therefore less to lose. Overall, there is little evidence

[11] Financial innovation like "securitization" contributed to this measurement problem.

[12] Base salaries accounted for %38 of average total CEO pay in 1992, they accounted for only %17 in 2000.

[13] See : See K.Murphy, P :30.

that executive compensation provided incentives for risk-taking among top-level executives and thus caused the financial crisis. Yet, the bonus culture attracts a disproportionate share of risk takers (traders, brokers, bankers) with high ability, highly motivated, talented, and highly confident that may contribute in the financial disorder. But it cannot be blamed and cannot solve all internal organizational problems.

## The effects of U.S regulations on executive compensation after the 2008 financial crisis

We will try in the following subsection to investigate the effects of U.S regulations on CEO compensation; and thus on corporate governance by presenting the main acts stipulated by the U.S government to address these issues.

Regulation has been introduced in recent years to improve corporate governance practices in the United States, and as a response to popular anger toward the current levels of CEO compensation that are perceived to be excessive and unjustified. This change in government regulation was not necessarily related to the recent financial crisis, but it appeared in the early1990s with the big increase in CEO pay and simultaneously in the popular rejection.

Before the late financial meltdown and after corporate accounting scandals at Enron and WorldCom, the Sarbane-Oxley act or (SOX) was introduced in 2002 to increase the legal responsibilities of CEOs. This act covered only the CEO and chief financial officer (CFO). It was applied to all firms and covered only accounting restatements.

In the aftermath of the financial crisis, several acts were introduced until the recent Dodd-Frank reform act (2010-2011). We will try to summarize the content and aims of these acts through the following table:

| Act | Description | Application | Content |
|---|---|---|---|
| The Sarbane-Oxley Act (2002) | | It was applied to all publicly traded firms, and covered the CEO and CFO. | |
| The Emergency Economic Stabilization Act (EESA) (2008) | Introduced on September 19, 2008 after the bankruptcy of Lehman Brothers and the acquisition of Merrill Lynch by Bank of America, and passed by Congress on October 3rd | It was applied to exceptional assistance firms (which specifically identified AIG, Bank of America, and Citigroup), and covered the top-five executives and not just the CEO and CFO. | -Limits the IRS[14] cap on deductibility of top-5 executive pay to $500,000 instead of $1 million, with no exception for performance-based pay.<br>-No new severance agreements for top 5, and no payments for top 5 executives under existing plans exceeding 3times base pay |
| The American Reinvestment and Recovery Act (ARRA) (the Dodd Amendments)[15] (2009) | Passed by President Obama on February 17, 2009 | It was applied to all TARP recipients, and covered 25 executives in these firms. | -allowed only two types of compensation: base salaries (which were not restricted in magnitude), and restricted stock (limit to grant-date values no more than half of base salaries)<br>-disallows all payments (not just excess payments).<br>- |
| The Dodd-Frank Executive Compensation Reform Act (2010-2011) | Signed by President Obama in July 2010 | It was applied to all financial institutions (TARP recipients and non-recipients, public and private, including Fannie Mae and Freddie Mac and US-based operations of foreign banks) | All financial institutions are required to identify:<br>-any incentive-based compensation or incentive plan that encourages inappropriate risks, or that provides excessive compensation, fees, or benefits, or that could lead to material financial loss to the covered financial institution.<br>-individuals who have the ability to expose the firm to substantial risk, and demands that (for the larger institutions) such individuals have at least 50% of their bonuses deferred for at least three years; deferred amounts would be subject to forfeiture if subsequent performance deteriorates. |

[14] IRS : Internal Revenue Service : the U.S government agency responsible for tax collection and tax law enforcement.

[15] This law was implemented by the treasury through the creation of the Office of the Special Master of Executive Compensation (also known as the PayCzar).

The Dodd-Frank act was enforced by an additional reform of executive compensation and corporate governance imposed on all large publicly traded US firms across all industries. This reform includes the following measures:

- **SAY ON PAY:** Shareholders will be asked to approve the company's executive compensation practices in a non-binding vote occurring at least every three years. Because senior executives have inordinate influence over the board, and over the compensation committee in particular, shareholders need a more direct mechanism for influencing the level and structure of executive compensation with the assumption that the shareholders are as informed and experienced in assessing pay package as the members of the board of directors.
- **CLAWBACKS:** Companies must implement and report policies for recouping payments to executive based on financial statements that are subsequently restated. This rule applies to any current or former executive officer, and applies to any payments made in the three-year period preceding the restatement.
- **COMPENSATION COMMITTEE INDEPENDENCE:** Publicly traded companies are required to have compensation committees comprised solely of outside independent directors.
- **PROXY ACCESS:** Shareholders are allowed to nominate their own director candidate in the company's annual proxy statement.

## Conclusion

Based on all what we have mentioned before, executive remuneration has a good side. It can serve as a key mechanism for corporate governance with its potential role to align managerial incentives with those of shareholder in making important investment and financing decisions. Recent study by Fahlenbrach and Stulz (2009) of a sample of bank CEOs reports that the wealth of these CEOs increase by an average of about $24 for every $1,000 of stakeholder value created. But if incentive alignment can lead to value creation and contribute to overall economic growth and employment, there is also a dark side to compensation. Flawed compensation scheme can lead to value destruction. For instance, excessive focus on short-term outcomes attributable at least in part to incentives can lead executives to pass up promising long-term investments. Also The academic literature suggests that when corporate governance mechanisms are weak, managers tend to have greater influence on the process that determines their own compensation, thus the escalation in their pay reflects inefficient transfers of wealth from shareholders to executives.

The brief review of the above mentioned acts (and other non-cited bills) and measures shows the intense commitment of politicians to destroy Wall Street bonus culture. However, it is clear that the aim of the EESA, ARRA and Dodd-Frank is to provide pay restriction and to attack perceived excesses in pay level rather than to protect taxpayers. The optimal compensation arrangement (particularly to attract the most talented people and to facilitate the transition of executives leaving the company) cannot be designed under the actual pay restrictions; therefore the current legislation did not help to solve an existing economic problem or to improve the existing compensation practices since it did not provide the exact definition of excessive risk or excessive compensation. It just aimed to punish the executives and firms to be responsible for the crisis. The fact that pay is being determined by competitive market forces which imply the best and efficient allocation of resources, lead to conclude that the intention of decision makers is far beyond concerns that such bonuses motivated excessive risk taking.

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