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Role of Performance-Related Pay in the Global Financial Crisis

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ABSTRACT

The global financial crisis has been fiercely debated. Researchers have proposed several reasons ranging from weak regulatory mechanisms to fiscal policies as leading to the ultimate crash of the financial markets. In this article, we discuss how performance-related pay¹ (PRP) played a crucial role. This article argues that PRP encouraged quantity over quality, and short-termism over long-termism thereby affecting the stability of the financial system. Furthermore, pay design was structured in a manner that it was insulated from long-term shareholder value and losses to capital contributors other than shareholders, which led to executives indulging in risk taking because their focus was short term. This is not to say that one can negate other factors responsible for the crisis, such as regulatory shortcomings² with regard to risk taking and capital requirements, and asset bubbles due to global factors making the operational environment of the companies riskier. Nonetheless, a firm's performance and risk choices are significantly influenced by the incentives offered to its executives.

Keywords: Performance-related pay, Incentives, Performance, Risk, Financial crisis, Pay arrangements, Executive compensation

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INTRODUCTION

Many economists (Krugman, 2009; Rodrik, 2009; Sen, 2009; Stiglitz, 2018) consider the financial crisis of 2007–2008 to be the worst since the 1930s Great Depression³. In the United States it began in 2007, in the subprime mortgage market and with the collapse of Lehman Brothers⁴ on September 15, 2008 developed into an international banking crisis. The financial impact was magnified and spread globally due to the disproportionate risk taking at investment banks. Governments worldwide implemented preventive measures to avoid world financial system's collapse but, nonetheless, the crisis led to global economic downturn. The various commissions⁵ and agencies set up to investigate the causes of the crisis have pointed to a number of reasons ranging from high-risk, complex financial products to failures in corporate governance and risk management at several leading financial institutions⁶.

The role of performance-related pay (PRP), specifically executive incentives⁷, has been widely debated since the financial crisis. Analysts (Walker, 2009; Silverthorne, 2018; Ackerman and Hoffman, 2019) have stated that comprehensive investigation regarding role of executive pay arrangements⁸ in the crisis should be carried out. In the UK, Financial Services Authority (FSA) Chairman, Adair Turner, claimed that a major factor that contributed to the financial crisis was the non-aligned incentive structure (Turner, 2009: 80), while the US Financial Crisis Inquiry Commission (FCIC) said that failure of Lehman's was partly because of major issues in its corporate governance,... aggravated by executive compensation... that was mainly based on short-term profits (FCIC, 2011: 343)⁹. Sizeable incentives for excessive risk taking were provided through pay arrangements. Under the typical pay arrangements, the benefits of risks were passed onto employees but were shielded from the problems because of such risks. As a result, executives engaged in risk taking beyond permissible limits.

CHANGES IN PAY POLICIES POST THE ECONOMIC CRISIS

It was widely agreed by political authorities and regulators that a major reason behind the global financial crisis was executive compensation by promoting excessive risk-taking. Tim Geithner, Former US Treasury Secretary, testifying before Senate Appropriations Subcommittee in June 2009, argued: "...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.” Risk is, however, an integral part of banking activity and it cannot be completely eliminated. Therefore, it is necessary that compensation schemes take this into account and any extreme positions taken in this regard such as by Cheng et al. (2015) who claim that risk insurance must be done for bank executives should be avoided. In short, an optimal compensation system must strike a balance between profitability and risk.

In response to the financial crisis, governments across the world agreed to develop a more stable financial system based on shared policies and principles. At the 2009 G20 London Summit, it was decided that as a successor to the Financial Stability Forum (FSF), Financial Stability Board (FSB) should be established and should include members of the G20 that previously were not FSF members. The US Treasury Secretary Tim Geithner described the FSB as “in effect, a fourth pillar” of the architecture of global economic governance. At the G20 meeting, it was also decided that the FSB would frame guidelines for compensation practices in financial institutions keeping in view the stability of the system.

The guidelines that were produced by the FSB, titled the Principles and Standards for Sound Compensation Practices, are aimed at reducing excessive risk taking that could be an outcome of a firm’s compensation scheme structure. The implementation of these guidelines in FSB jurisdictions were from January 2011 and EU countries adopted them from January 2014 through Capital Requirements Directive IV. The major features of these guidelines that organizations have to comply with when setting their compensation structure are as follows:

1. The compensation of the manager should be designed according to their contribution to risk of bank.
2. The variation in the compensation must be symmetrical and based on outcomes of both performance and risk. It should also take factor in the time required between action and risk materialization.
3. To reduce disproportionate risk taking, banks should have an optimal combination between equity and cash rewards.

EFFECTS OF FSB'S PRINCIPLES AND STANDARDS

A comprehensive study of the effects of the FSB's Principles and Standards was conducted in 2017 by Cerasi et al. The study involved 173 banks in 36 countries. The participating banks were divided into two categories: banks that were affected by the FSB's new guidelines (treated banks) and banks that were unaffected (non-treated banks), i.e., the control group. After controlling for characteristics specific to bank, factors at macroeconomic level, and differences at institutional level, the researchers concluded that the Principles and Standards were effective, especially in banks that had earlier given less priority to risk management. Further, the analysis showed that CEO compensation was reduced in treated banks post 2010, whereas this was not the case in non-treated banks.

The FSB's regulations highlighted the need for greater risk management, but there exist multiple unanswered questions concerning executive compensation. For instance, greater understanding of the optimal amount of risk is needed. Also, the FSB's guidelines are not a one-size-fits-all solution. Rather, banks will have study their own compensation and corporate structure and apply the guidelines accordingly, as a balance must be struck between long-term growth and financial stability. It will require a regulatory structure that goes beyond limiting risk by inducing a 'healthy' level of risk considering the differences in the models of bank business (Cerasi et al., 2017).

Kohn (1993) argues that there is no firm basis to assume that PRP will motivate employees to work harder or improve work quality. He further argues that a simplistic PRP approach is coercive and can promote improper behavior. Similarly, Pfeffer (1998) argues that individual PRP promotes individual effort thereby negatively affecting teamwork. It can promote short-termism over long-termism, and conformity over challenge. Stout (2011) argues that incentive schemes motivate employees to engage in selfish behavior. The result is that PRP promotes selfish opportunism over unselfish pro-social behavior and the observation of ethical rules. Furthermore, PRP schemes could also promote illegality by encouraging the cutting of ethical and legal corners to gain personal rewards. Last, organizations that emphasize PRP tend to attract individuals that are more inclined to selfish behavior. The

financial crisis is an apt case study providing evidence to support Kohn's, Pfeffer's, and Stout's positions on PRP.

PERFORMANCE-RELATED PAY

The benefits of PRP have been highlighted in a number of theories from psychology (equity, expectancy, goal setting, and reinforcement theories) and from economics (efficiency wage, implicit contract, and marginal productivity theories). Although there are differences in both sets of the theories that have significant PRP implications, a theme that is common in both sets is the supposition that PRP should increase performance (Kaufman, 1989; Tetlock and Goldgeier, 2000). PRP has been adopted by several organizations to promote performance at the workplace (Kessler and Purcell, 2007). However, since its introduction, organizational psychologists, reward strategists, and academics have disputed whether PRP is an effective motivational tool (Burgess and Ratto, 2003; Kohn, 1988; Cotton and Cook, 1982). Several reasons, ranging from damage to intrinsic motivation to negative effects on teamwork, have been put forward to demonstrate that PRP is not the sole crusader that results in effective performance.

Jonathan Ford raises important questions in the *Financial Times* about the role of PRP in the financial crisis. PRP and sales targets were introduced in the banking system in the 1980s and 1990s. This promoted risk taking by staff trying to secure financial incentives. Ford states that poorly designed incentive schemes are responsible for many scandals that we are still discovering. Banks lost £35bn because of payment protection insurance. The corporate offices of banks gave financial incentives to their executives to promote this unnecessary product. Banks are trying to assure the public that competition will no longer lead them to formulate imprudent pay practices. Mechanisms in written contracts have been put in place that will claw back bonuses if an employee's activities lead to future losses (Ford, 2017). Similarly, McRitchie (2012) argues that US legislators made a colossal mistake in the 1990s by passing a bill that allowed organizations to write off executive compensation amounting to more than \$1 million provided specific performance goals were met. The result was that \$1 million was set as the baseline and the next quarter's share price became the focal point of the incentives. McRitchie (2012) concludes that there is need to reform the overall culture of

investment banks, and the first step in that direction should be the removal of the bonus culture.

Jaggia and Thosar (2017) investigate the impact of PRP on excessive risk taking in the finance sector during the period surrounding the financial crisis. They find a strong association between compensation of CEO and accounting-based return on asset performance measures in the pre-crisis period. This relationship is amplified in bigger organizations. They conclude that PRP schemes for senior executives in the finance sector should be discontinued. Furthermore, their findings show that compensation practices followed in the financial sector affect the stability of the entire system.

Murphy (2012) argues that performance-based compensation structures rewarded quantity over quality in the years leading up to global financial crisis. Washington Mutual¹⁰ mortgage brokers were rewarded for writing loans without conducting comprehensive verification of borrowers' assets or income. Additionally, higher commissions were awarded when brokers sold more-profitable adjustable-rate (as opposed to fixed-rate) mortgages. Therefore, there was a basic problem in the design of PRP schemes that placed importance on quantity over quality of loans. The result was as expected, Washington Mutual ended up with bad loans. Countrywide Financial¹¹, Wachovia¹², and several smaller lenders had similar scenarios.

PAY ARRANGEMENTS

There were various features of pay arrangements that provided substantial incentives for risk taking. Other factors also contributed to the foundation of the financial crisis, such as macro policies that generated asset bubbles, global factors, which made the environment within which firms operated riskier, and insufficient constraints in terms of regulation on risk taking and capital requirements. However, executives' incentives played a major role in firms' performance and risk choices.

The first aspect of pay arrangements that encouraged disproportionate risk taking was that executives' payoffs were partially insulated from long-term effects on shareholder value. Short-term results were major considerations in the calculation of both bonus and equity

compensation (Bebchuk and Fried, 2004). Under the regular design of pay arrangements, short term results formed the basis on which bonuses were awarded to executives and based on short-term stock prices they could also sell major parts of their equity incentives.

Thus, executives were motivated to target short-term increases in profit at the cost of indulging in excessive risk taking, which would later implode. These results are consistent with the findings of Bhagat and Bolton (2013) who studied the structure of executive compensation in the 14 largest US financial institutions during 2000–2008 and concluded that incentives part of executive compensation program was responsible for disproportionate risk taking by banks, which resulted in the financial crisis. Furthermore, their results are by and large not supportive of the conclusions drawn by Fahlenbrach and Stulz (2011) that during the crisis unforeseen risk played a major role in the poor performance of banks.

A case study of Bear Stearns¹³ and Lehman Brothers compensation structure by Bebchuk, Cohen, and Spamann (2010) reveals that, for the 2000–2008 period, the bottom lines for the firms' top five executives were positive and substantial. Unloading of shares and options were regularly carried out by these top executives and before the plummeting of their firm's stock price, they were thus able to sell a major portion of their equity. Additionally, during the period 2000–2007, large bonus compensation also contributed toward an increase in the top executives' payoffs, while the earnings on which these bonuses were based evaporated in 2008. There were no provisions in the firms' pay arrangements through which to recover the bonuses that had been paid. Whereas, in these firms, while long-term shareholders were largely decimated, the performance-based compensation of executives kept them in decidedly positive territory. A similar pattern was found by Bhagat and Bolton (2013) at other big financial companies that had to be bailed out during the crisis: namely, large amounts of compensation being cashed out by the CEO in the pre-crisis period, which exceeded the losses suffered by them from the decline in stock prices during the crisis.

Bebchuk and Spamann (2010) analyzed the second aspect of pay arrangements which was executives' payoffs insulation from possible losses to capital contributors excluding the shareholders, such as preferred shareholders, bondholders, and the government as deposits

guarantor. As a result, when deciding options that could bring substantial losses on such shareholders, executives did not have enough incentive to prevent these potential losses. Thus, sufficient reason was not provided to executives to steer clear of risk taking that was favorable for equity holders but whose possible cost were too much for stakeholders such as bondholders. Bebchuk and Spamann (2010) conclude that this second problem further encouraged to indulge in unnecessary risks produced by the first problem.

In the future, improvement in pay arrangements design can help resolve these two problems. The first problem can be addressed by linking executives' payoffs to long-term results. The second problem can be addressed by further linking executives' payoffs to other capital contributors and not limiting the linkage to shareholders long-term results. Excessive risk taking by executives could have been avoided were such measures in place previously. Although studies by Fahlenbrach and Stulz (2011) and Erel, Nadauld, and Stulz (2014) did not find evidence to support the argument that risk taking was incentivized by pay structures, such evidence was provided by a large number of subsequent studies. Studies by Gande and Kalpathy (2011), Suntheim (2010), Chesney, Stromberg, and Wagner (2010), and DeYoung, Peng, and Yan (2010) have found that risk taking was linked with the CEO's wealth sensitivity to return volatility.

CONCLUSION

There is sufficient basis to conclude that PRP encouraged excessive risk taking during the pre-crisis period. Other factors, such as asset bubbles generated because of macro policies, weak regulatory mechanisms on capital requirements and risk taking, and global factors, also contributed to the magnitude of the financial crisis. Nonetheless, aside from the external environment and regulatory constraints, financial economists recognize that executive incentives play a significant role in the performance and risk choices of organizations. In the case of financial firms, performance-based compensation structures rewarded quantity over quality, and short-termism over long-termism in the years leading up to global financial crisis. Performance-based pay arrangements were structured in a manner that it was insulated from long-term shareholder value and losses to capital contributors other than shareholders, which led to executives indulging in risk taking because their focus was short term. This is not to say

that some executives may not have engaged in excessive risk taking due to fiduciary duty norms, professional integrity, and reputational concerns. However, evidence suggests that incentives play a significant role and therefore their contribution to excessive risk taking should be considered. In future, such a consideration will help better design pay arrangements that eliminate or minimize risk taking and thereby maintain the system's financial stability.

ENDNOTES

¹ In this article we have focused on individual PRP and give special attention to the compensation structure. In the article, we discuss the various features of pay arrangements, specifically variable pay (bonuses and incentives) and how these features contributed to the financial crisis.

² Trading of derivatives over the counter instead of through a clearing house led to insufficient tracking and clamping down by regulators; the externalization of the risk to investors allowed banks to appear resilient and their equity ratios to seem comfortable; and the repeal of the Glass Steagall Act in 1999 weakened the regulatory mechanisms that had been put in place to check excessive leverage and risk taking.

³The Great Depression began in the 1930s in the United States. It was a severe worldwide economic depression which occurred in many countries.

⁴Lehman Brothers Holdings Inc. filed for bankruptcy in 2008. In the United States it was one of the largest investment banks.

⁵ Financial Crisis Inquiry Commission (FCIC) was created by the United States Congress to study the causes that led to the financial crisis of 2007–2010.

⁶ In this article we have focused on the financial industry, which includes investment banks and institutions providing diversified financial services. These institutions have structural differences but given that these different institutions fall under the financial industry, we have focused on the industry as a whole and how its compensation practices led to the financial crisis.

⁷ Incentive can be defined as rewards given in the form of financial or non-financial benefits to improve the productivity of the employees at the workplace.

⁸ Executive pay arrangement can be defined as consisting of six different compensation

components: salary, yearly incentives, long-term incentives, benefits, perquisites and severance/change-in-control agreements.

⁹ See also Walker 2009.

¹⁰Washington Mutual, Inc. was America's largest savings and loan association until its collapse in 2008.

¹¹Countrywide Financial Corp. nearly collapsed into bankruptcy as its financing dried up. The company was acquired by Bank of America in 2008.

¹²Wachovia was a diversified financial services company in the United States. Based on total assets Wachovia was the fourth-largest bank holding company. Wachovia was acquired by Wells Fargo on December 31, 2008, after a government-forced sale to avoid Wachovia's failure.

¹³The Bear Stearns Companies, Inc. was a New York-based global investment bank that failed in 2008 due to global financial crisis and as a result sold to JPMorgan Chase.

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