Pay and Long-Term Performance

Lucian Bebchuk
Harvard Law School

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Main Question

- How to fix pay structures to link executive payoffs tightly with long-term performance and avoid excessive risk-taking?

[Drawing on:

- Bebchuk, Cohen, and Spamann*, The Wages of Failure: Executive Compensation at Lehman and Bear Stearns, Yale Journal of Regulation,* 2010*,* forthcoming*.*
- Bebchuk and Fried, *Paying for Long-Term Performance, University of Pennsylvania Law Review,* 2010, forthcoming*.*
- Bebchuk and Spamann, *Regulating Bankers' Pay*, Georgetown Law Journal, 2010.

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The Short-Term Distortion

- Standard pay arrangements have rewarded executives for short-term gains even when these gains are subsequently reversed => generates incentives to take excessive risks and otherwise trade off long-term shareholder value.

- Jesse Fried and I warned about this short-term distortion six years ago in our book, *Pay without Performance: The Unfulfilled Promise of Executive Compensation.*

  [Ch. 14 of the book devoted to it]

- 2008-2009 crisis: Widespread recognition of costs associated with flawed, short-term pay structures
  - Geithner: pay should be “tightly aligned with long-term value.”

The Wages of Failure

[Bebchuk, Cohen, and Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman Brothers 2000-2008*, *Yale Journal on Regulation*, 2010]

- Some commentators (e.g., Norris, NYTimes, Friedman, WSJ) assumed that the executives of these firms saw their own wealth wiped out together with the firms.

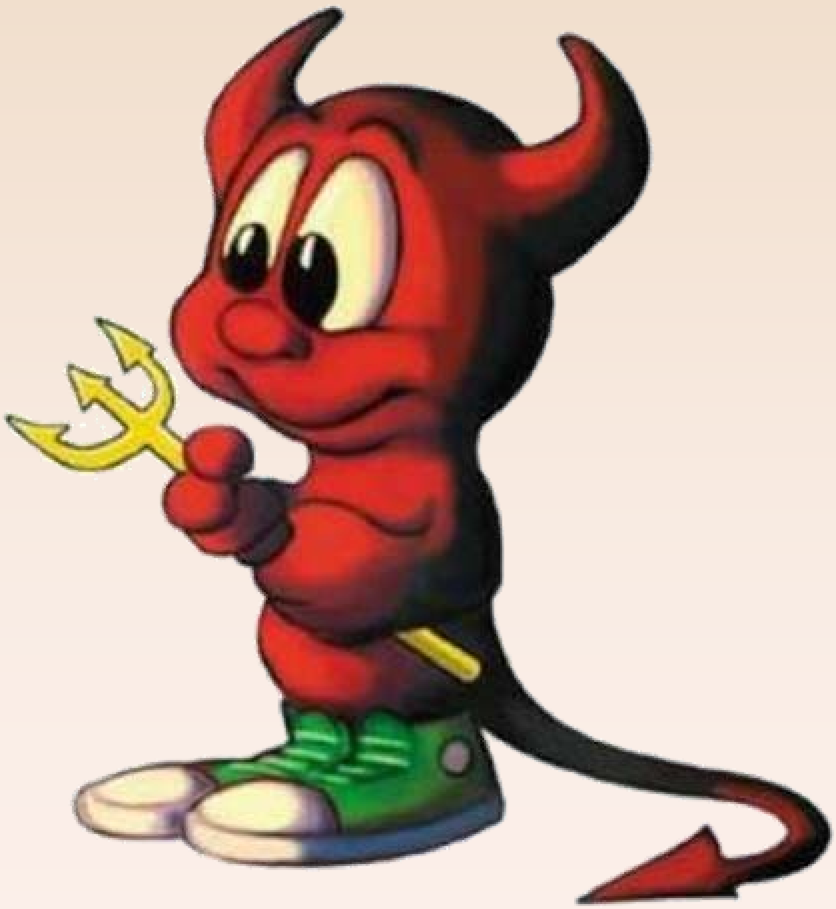
- Inferred that executives' risk-taking might have been the product of mistaken judgments and/or hubris – but could not have been motivated by perverse pay incentives.

The Wages of Failure (cont.)

- We find:
  - During 2000-2008, the top-five executive teams of Bear Stearns and Lehman Brothers derived cash flows of about $1.4 billion and $1 billion respectively from cash bonuses and equity sales during 2000-2008.
  - These cash flows substantially exceeded the value of the executives' initial holdings in the beginning of the period
  - By contrast to shareholders, the executives' net payoffs for the period 2000-2008 were decidedly positive.

How best to tie pay to long-term shareholder value?

The devil is in the details…



Getting the Details Right

- Bebchuk and Fried, *Paying for Long-Term Performance* (forthcoming, *University of Pennsylvania Law Review*) puts forward a detailed blueprint for how to tie executive compensation to long-term performance.

- Focuses on equity compensation, the primary component of modern pay packages.

Need to Prevent Early Unwinding

- Current pay arrangements provide broad freedom to cash out vested equity incentives.
- Distorts incentives:
  - Early unwinding leads executives to focus on short-term at expense of long-term value.
  - Such unwinding should be limited.

Hold-Till-Retirement?

- Some executives must hold a fraction of their shares until retirement
  (E.g., Deere, Citigroup)
- Urged by some shareholder proposals and reformers
  (E.g., AFSCME, Jesse Brill)
- But…
  - may cause premature retirement – departure incentives rather than retention incentives.
    - Especially strong for long-serving successful executives with a large portfolio of valuable equity instruments.

Grant-Based Restrictions

[Bebchuk and Fried, *Paying for Long-Term Performance,* 2010]

- Hold awarded equity incentives for fixed number of years after vesting

  (as proposed in *Pay without Performance*)
- Should have gradual unwinding
  - Example: Executive holds equity for 2 years post-vesting, and 20% can then be sold in each of next 5 years.
- Adopted by TARP Special Master Ken Feinberg (2-4 yrs).

Also Needed: Aggregate Limitations on Unwinding

[Bebchuk and Fried, *Paying for Long-Term Performance,* 2010]

- Grant-based restrictions often insufficient:
  - Long-time executives may amass large amounts of equity incentives they may immediately unload.
  - This is what happened at Bear and Lehman.
- Firms should limit how much of otherwise unloadable equity can be sold in each year:
  - E.g, cannot sell more than 10% of equity unloadable at beginning of year (given grant-based restrictions).
- Would avoid short-term focus: at any time, 90% of portfolio must be held for more than next year.

Front-End Gaming

- Executives may time grant awards (spring-loading): leads to decoupling payouts from actual long-term performance
- Remedy: fixed dates for equity grants.

Back-End Gaming

[Bebchuk and Fried, *Paying for Long-Term Performance,* 2010]

- Problems:
  - Executives may use their inside information in deciding when to sell.
  - Executive may use their control of disclosure decisions to raise or keep the price high before they sell.

- Remedy: “Hands-off cashing schedule” that bases payoffs on average price over long period –

  E.g., executives cashing out equity incentives in a given year should get payoffs based on the stock’s average price that year.

Need for Robust Anti-Hedging Policies

[Bebchuk and Fried, *Paying for Long-Term Performance,* 2010]

- Without such policies, executives can use hedging and derivative to undo the effects of the equity incentives.
- Evidence that a significant amount of hedging occurs and that it is partly motivated by inside information.
  (Bettis et al. 2010)
- Grant-based and aggregate restrictions on unwinding will increase incentives to hedge and engage in derivative transactions – and <u>will not work</u> without anti-hedging restrictions.

Need for Robust Anti-Hedging Policies (cont.)

- Hedging and derivative transactions can undermine whatever structure of equity incentives is set by the company → undesirable even if not motivated by inside information

- Companies should generally adopt an anti-hedging provision:
  - Executives should be prohibited from engaging in any hedging, derivative, or any other equivalent transaction that could reduce or limit the extent to which declines in the company's stock price would lower the executive's payoffs

The Leverage Problem (1)

[Bebchuk-Spamann, Regulating Bankers Pay, 2010]

- In addition to the short-termism problem, financial executives had another source of risk-taking incentives – their payoffs were tied to highly leveraged bets on their firms' capital.

- Pay arrangements tied financial executives' interests to the value of common shares or even to the value of options on such shares => executives not exposed to the potential negative consequences that large losses could have for preferred shareholders, bondholders, and the government as a guarantor of deposits.

The Leverage Problem (2)

[Bebchuk-Spamann, Regulating Bankers Pay, 2010]

- To the extent compensation is based on the value of the firm's securities, financial executives' payoffs could be tied not to the long-term value of financial firms' common shares but to the long-term value of a broader basket of securities:

  E.g., instead of giving executives 3% of the value of shares, give them, say, 1% of the value of shares, preferred shares, and bonds.

The Role of Government (1)

- Provide shareholders with rights and tools that would enable them to prevent pay structures that are detrimental to long-term shareholder value.
- US shareholders continue to have much weaker shareholder rights than shareholders in the UK and other English-speaking countries.

[For detailed blueprint for expanding shareholder rights, see Bebchuk, Case for increasing shareholder power, *Harvard Law Review*, 2005; Bebchuk, The Myth of the Shareholder Franchise, *Virginia Law Review*, 2007]

- Note: In companies with a controlling shareholders, the nature of the agency problems – and the desirable shape of shareholder rights is different.

  [Bebchuk and Hamdani, The Elusive Quest for Global Governance Standards, 2009].

The Role of Government (2)

[Bebchuk-Spamann, Regulating Bankers Pay, 2010]

- For non-financial firms, government intervention should be limited to improving internal governance. But the special circumstances of financial institutions call for a broader role for the government.
- The traditional rationale for prudential regulation – recognizing that shareholders' interests would be served by socially excessive risk-taking – implies that making pay structures better reflect shareholder interests wouldn't suffice to discourage all socially excessive risk in finance.
- Some monitoring and regulation of pay structures in financial firms should be part of financial regulators' toolkit,
- Would complement prudential regulation.
  -- With pay structure supervision, other regulations can possibly be less tight.
  -- Without pay structure supervision, other regulations should be tighter.

Conclusion

- Pay arrangements can and should be better designed to align executives' incentives with long-term performance.

- Doing so will improve long-term corporate performance.