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# CURRENT GLOBAL FINANCIAL CRISIS: AN INCENTIVE PROBLEM

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## Abstract

This article discusses the current global financial crisis as a consequence of common (although inadequate) corporate governance practices. More specifically, it indicates that stock options lead to excessive risk taking, like subprime mortgage securities, because they have no penalty for the manager nor damage to her/his wealth in the case of collapse. In tandem, golden parachutes and other exit packages incite termination of the employment contract since they reward failure, providing little incentive for the executive to perform adequately.

**Keywords:** global financial crisis; incentives.

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## CURRENT GLOBAL FINANCIAL CRISIS: AN INCENTIVE PROBLEM

Many causes have been blamed for the current global financial crisis including an uncontrolled real estate market, the large amount of subprime mortgages in the United States, and even the global neo-liberalism guiding philosophy. It is my contention that one of the main underlying causes of the current crisis is nothing but an incentive problem.<sup>1</sup>

Incentives can be simply defined as something that stimulates one to take certain actions. We face constant incentives and we learn to respond to them early in life. As a child, for example, your parents might promise to take you to the movies if you eat all your vegetables, or you get a new videogame if you bring home straight A's from school. But incentives also take the form of punishments. If you break curfew, you get grounded. If a company spews too much chemical matter into the water, it is fined for each pound of pollutants over the legal limit.

In simple terms, an incentive is a means of urging people to do more of a good thing and less of a bad thing. Yet incentives may have unexpected consequences. Consider the architectural landscape of Amsterdam. Do you know why houses are so unique in this beautiful city? This was done because property taxes depended on the frontage of the residence. As a result, home builders decided to construct very tall, narrow buildings that extend a long way back, with narrow, steep stairways. Given that it is impossible to bring in furniture through these stairways, houses were built with hooks at the top and windows that were almost as wide as the house. I am fairly sure that the tax officials originally had greater tax revenues in mind rather than promoting a different architectural style.

Incentives are the cornerstone of corporate life, particularly when it comes to executives, and understanding them is the key to solving just about any organizational riddle. Yet current practices in corporate governance, including those related to executive pay, are called into question these days. The reason may be based on recommendations derived mostly from what is called "agency theory" (Fama, 1980; Jensen and Meckling, 1976). Agency theory has long been the dominant framework used to approach executive pay issues. In the basic agency setting, it assumed that principals (shareholders), whose primary (and unique) objective is the maximization of the firm's value, delegate tasks to an effort- and risk-averse, rational, and self-centered agent

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<sup>1</sup> I do not pretend to minimize incentive problems. On the contrary, it may be the ultimate culprit of the crisis. I recognize that post-rationalizing and purporting to discover the roots of problems after they have happened is arguably of little merit, and certainly has an unpleasant forensic flavor. However, in my defense, I must point out that I have criticized current compensation practices extensively in previous works.

(manager). Principals design compensation contracts to ameliorate manager opportunism derived from the information asymmetries between agent and principal.

Based on this logic, a number of “best practices” were established, including board independence, separation of chairman and CEO positions and the use of outcome-based compensation tools. But many of the recently-failed companies followed all these practices. Take for instance the case of Lehman Brothers. This company adopted almost all the governance practices,<sup>2</sup> and even reserved a special place on their website to explain that it had sound corporate governance structures in place, including compensation guidelines, and even a Code of Ethics (see <http://www.lehman.com/shareholder/corpgov/>).<sup>3</sup>

Among these best practices, there is one that stands out. It refers to long-term, outcomes-based incentives such as stock options which are believed to create better alignment between managers and shareholders by encouraging employment-undiversified executives to take appropriate risks that bring value to shareholders (Eisenhardt, 1989; Jensen et al., 1976).

In most (if not all) of the companies that failed in the 2008 financial crisis, the majority of executive compensation packages were provided in the form of a variable, performance-based annual incentive delivered in both cash and equity awards. According to the last proxy statement presented by Lehman Brothers, its CEO received over \$34 million as his annual compensation and 85% of it was in the form of stock and options (yet, by that time the average shareholder has lost almost all shareholder value).<sup>4</sup> And this is customary in the industry. Similar compensation practices have long been the norm in large financial services firms such as Bank of America Corp., The Bear Stearns Companies Inc., Citigroup Inc., The Goldman Sachs Group, Inc., JPMorgan Chase and Co., Merrill Lynch and Co., Inc., Morgan Stanley, Wachovia Corp., and Wells Fargo and Co., among others in the investment banking sector. In many cases, this is not only with the argument that it will reduce information asymmetry problems but also out of a desire to keep pace with or even be ahead of other firms practicing clearer corporate disclosure (Westphal and Zajac, 2001).

One of the problems of stock options and similar instruments is that executives rewarded with stock options benefit when the stock price rises but experience no reduction in real wealth if the stock price declines. Managers may respond to these instruments with excessive risk-taking actions since they would not see their wealth damaged in the case of stock price drops. This is probably the main reason why companies like Lehman Brothers, Fannie Mae or Freddie Mac got involved in very risky ventures like mortgage securities. Managers could have potentially high earnings, though highly uncertain, with no downside risk on their wealth. Moreover, executives need only short-time improvements in share value to exercise their options. In fact, executives are not required to hold the stocks for more than one day (Pfeffer, 2007). Raising a company’s stock price for a single day clearly is not a real advance for the business. Rather, this stimulates balance sheet misrepresentation, tax evasion and other corporate malfeasances.

But things get worse. There is an additional extended practice that actually goes against the intended shareholders’ goals. This refers to exit packages often called “golden parachutes”.

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<sup>2</sup> As an exception, its CEO doubled as Chairman.

<sup>3</sup> As of October 8, 2008, Lehman’s website was still available, although I am not sure how long it will last.

<sup>4</sup> When Richard Fuld, chief executive of Lehman Brothers, recently testified in the Congress, the chairman of the committee held up a chart suggesting that Fuld’s personal remuneration totaled \$480 million over eight years – including payouts of \$91 million in 2001 and \$89 million in 2005.

A golden parachute is a clause in an executive's employment contract specifying that s/he will receive certain benefits (usually money and/or stocks) in the event that the employment relationship is terminated (due to acquisition, bankruptcy or simply termination of the contract). The argument that compensation experts normally use to justify golden parachutes is that they protect managers from risks beyond their control. But these exit packages may represent exorbitant amounts of money. Take, for instance, the former CEO of Hewlett Packard, Carly Fiorina, who received \$21 million in severance pay when she was fired as CEO in 2005. She received an additional \$21 million when Hewlett Packard's board bought out her company stock options and pension benefits. So, having in place such ridiculous exit packages may have undesired effects because, simply put, they reward failure. What incentive does a manager have to perform well in the company if s/he gets compensated in the case of failure? Does not this provide an incentive to managers to lead the company to extremes if the future doesn't look so rosy? On a related matter, these practices certainly cause frustration among other employees in the company, as they are unlikely to have a golden parachute to fall back on, which damages morale and teamwork and creates a sense of unfairness. That is why the recently-approved bailout plan states that "institutions that sell assets to Treasury... must meet executive compensation standards that will prohibit golden parachute payments... Golden parachutes will be completely prohibited for covered executives in the case".<sup>5</sup>

Despite the wealth of research and studies in executive pay, both incentives and golden parachutes have been mostly analyzed in isolation and we know very little about the combined effect of different incentive practices. They may be pushing in opposite directions; if they are, then golden parachutes seem to be winning. Indeed, current practices may be encouraging irresponsible behavior with lethal effect not only for these companies and employees but for society in general. Just consider that, according to a US Congress top budget analyst, Americans' retirement plans have lost as much as \$2 trillion in the past 15 months.

One positive aspect of this crisis is that one hears (if only occasionally) of exemplary acts such as that of Robert Willumstad, who served as CEO to the insurance giant AIG. He rejected a \$22 million golden parachute, stating: "I prefer not to receive severance payments while shareholders and employees have lost considerable value in their AIG shares". Unfortunately, the crisis also demonstrates the other side of the coin. Soon after the federal government committed \$85 billion to bail out AIG, some executives headed for a week-long retreat at a luxury resort and spa. The trip cost more than \$440,000, including nearly \$200,000 for rooms, \$150,000 for meals and \$23,000 in spa charges. This, clearly, is not only opportunistic and fraudulent behavior - it is unbridled greed.

The 2008 financial crisis provides at least two important lessons regarding incentives. First, we still need to learn a lot about risks. Not all risks are born equal, and excessive risk can be even more dangerous than not taking any risk. While it is clear that in business one has to take risks to get returns, there were excessive risks taken prior to this crisis with harmful consequences. Thus, setting pay strategies that encourage managers to simply take risks without any further consideration may be lethal for the long-term survival of companies. Moreover, current risk management tools do not fully capture the intrinsic traits of risk and uncertainty. They have been proved to be inadequate and in need of revision - or elimination perhaps - in order to

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<sup>5</sup> I personally consider that the language in the bailout bill is excessively vague, in particular when it refers to barring incentives for "unnecessary and excessive risks". The bill doesn't specify how to determine what constitutes unnecessary and excessive risk.

avoid subsequent chaos, particularly considering the interlocking nature of modern finance. In this respect, Nassim Taleb (2007) was categorical (and surprisingly prophetic):

*“Globalization creates interlocking fragility, while reducing volatility and giving the appearance of stability. In other words it creates devastating Black Swans. We have never lived before under the threat of a global collapse. Financial Institutions have been merging into a smaller number of very large banks. Almost all banks are interrelated. So the financial ecology is swelling into gigantic, incestuous, bureaucratic banks – when one fails, they all fall. The increased concentration among banks seems to have the effect of making financial crisis less likely, but when they happen they are more global in scale and hit us very hard. We have moved from a diversified ecology of small banks, with varied lending policies, to a more homogeneous framework of firms that all resemble one another. True, we now have fewer failures, but when they occur... I shiver at the thought.*

*The government-sponsored institution Fannie Mae, when I look at its risks, seems to be sitting on a barrel of dynamite, vulnerable to the slightest hiccup. But not to worry: their large staff of scientists deems these events ‘unlikely’”.*

Second, current pay practices have outraged public and government leaders. Recently, the United Kingdom Prime Minister Gordon Brown stated “I am angry – I am angry at irresponsible behavior... the days of big bonuses are over”, although some remain skeptical (Gapper, 2008). In my opinion, the way current compensation is set up cries for a re-examination, especially of the compensation for senior executives since they may generate billions in the short run but destroy long-term value. Current systems do not incite managers to perform adequately. Rather, they apparently encourage executives to play the system by showing good performance in the more immediate horizon in order to get their yearly bonus and exercise their options. Instead of promoting beneficial actions for shareholders, these systems may spawn opportunistic behaviors.

While optimistic, I recognize that there is no easy solution for incentive problems. Many compensation designs look “unbeatable” on paper but have unintended – sometimes deleterious – consequences in practice. Compensation design is not an exact science and there is a lot of trial and error in this discipline. Unfortunately, the dominant theory has fallen short of providing satisfactory answers to the question of how to align interests among shareholders, managers and society as a whole. Thus, both practitioners and academics need to join forces and rethink current compensation practices.

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