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Let the Good Times Roll Again?

By Lucian Bebchuk

Goldman Sachs announced this month plans to provide bonuses at record levels, and there are widespread expectations that bonuses and pay in many other firms will rise substantially this year. Should the good times start rolling again so soon?

Not without reform. Indeed, one key lesson of the financial crisis is that an overhaul of executive compensation must be high on the policy agenda.

Indeed, pay arrangements were a major contributing factor to the excessive risk-taking by financial institutions that helped bring about the financial crisis. By rewarding executives for risky behavior, and by insulating them from some of the adverse consequences of that behavior, pay arrangements for financial-sector bosses produced perverse incentives, encouraging them to gamble.

One major factor that induced excessive risk-taking is that firms' standard pay arrangements reward executives for short-term gains, even when those gains are subsequently reversed. Although the financial sector lost more than half of its stock-market value during the last five years, executives were still able to cash out, prior to the stock market implosion, large amounts of equity compensation and bonus compensation.

Such pay structures gave executives excessive incentives to seek short-term gains – say, by making lending and investment decisions that would improve short-term earnings – even when doing so would increase the risks of an implosion later on. Jesse Fried and I warned about this short-term distortion five years ago, in our book *Pay without Performance* . Following the crisis, this problem has become widely recognized, including by business leaders such as Goldman Sachs' CEO Lloyd Blankfein. But it still needs to be effectively addressed: Goldman's recent decision to provide record bonuses as a reward for performance in the last two quarters, for example, is a step in the wrong direction.

To avoid rewards for short-term performance and focus on long-term results, pay structures need to be re-designed. As far as equity-based compensation is concerned, executives should not be allowed to cash out options and shares given to them for a period of, say, five years after the time of “vesting” – that is, the point at which the options and shares have been “earned“ and may not be taken away from the executive.

An executive's inability to cash out shares and options for a substantial period would tie his or her payoff to long-term shareholder value. The length of this period should be fixed, and should not depend on actions or conditions that are at least partly under executives' control. By contrast, prohibiting executives from cashing out shares and options until they leave the firm would provide executives who have accumulated shares and options with a large monetary value with counter-productive incentives to depart.

Similarly, bonus compensation should be redesigned to reward long-term performance. For starters, the use of bonuses based on one-year results should be discouraged. Furthermore, bonuses should not be paid immediately, but rather placed in a company account for several years and adjusted downward if the company subsequently learns that the reason for awarding a bonus no longer holds up.

In addition to the excessive focus on short-term results, a second important source of incentives to take excessive risks has thus far received little attention. The payoffs of financial-sector executives were tied to highly leveraged bets on the value of their firms' capital.

Executives' interests were tied to the value of their firms' common shares – or even to the value of options on such shares. As a result, executives were not exposed to the potential negative consequences that large losses could bring about for preferred shareholders, bondholders, and the government as a guarantor of deposits. These structures provided executives with incentives to give insufficient weight to the possibility of large losses, which in turn motivated executives to take excessive risks.

To address this distortion, the payoffs of financial executives should be tied not to the long-term value of their firms' common shares but to the long-term value of a broader basket of securities. This basket should include, at the very least, preferred shares and bonds. Such structures would provide incentives to take risks that are closer to the optimal level.

Reforming pay arrangements in ways such as those proposed here would help ensure that firms and the economy don't suffer in the future from the excessive risk-taking that has contributed to bringing about the financial crisis. A thorough overhaul of compensation structures must be an important element of the new financial order.

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