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Bankers had cashed in before the music stopped

By Lucian Bebchuk, Alma Cohen and Holger Spamann
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According to the standard narrative, the meltdown of Bear Stearns and Lehman Brothers largely wiped out the wealth of their top executives. Many – in the media, academia and the financial sector – have used this account to dismiss the view that pay structures caused excessive risk-taking and that reforming such structures is important. That standard narrative, however, turns out to be incorrect.

It is true that the top executives at both banks suffered significant losses on shares they held when their companies collapsed. But our **analysis**, using data from Securities and Exchange Commission filings, shows the banks' top five executives had cashed out such large amounts since the beginning of this decade that, even after the losses, their net pay-offs during this period were substantially positive.

In 2000-07, the top five executives at Bear and Lehman pocketed cash bonuses exceeding $300m and $150m respectively (adjusted to 2009 dollars). Although the financial results on which bonus payments were based were sharply reversed in 2008, pay arrangements allowed executives to keep past bonuses.

Furthermore, executives regularly took large amounts of money off the table by unloading shares and options. Overall, in 2000-08 the top-five teams at Bear and Lehman cashed out close to $2bn in this way: about $1.1bn at Bear and $850m at Lehman. Indeed, the teams sold more shares during the years preceding the firms' collapse than they held when the music stopped in 2008.

Altogether, equity sales and bonuses over that period provided the top five at the two banks with cash of about $1.4bn and $1bn respectively (an average of almost $250m each). These cash proceeds considerably exceed the value of the executives' holdings at the beginning of 2000 (which we estimate to be in the order of a respective $800m and $600m).

Of course, the executives would have made much more had the banks not blown up. By contrast to shareholders who stuck with the banks, however, the executives' total pay-offs during the period were decidedly in the black.

Our analysis undermines the claims that executives' losses on shares during the collapses establish that they did not have incentives to take excessive risks. The fact that the executives did not sell all the shares they could prior to the meltdown does indicate that they did not anticipate collapse in the near future. But repeatedly cashing in large amounts of performance-based compensation based on short-term results did provide perverse incentives – incentives to improve short-term results even at the cost of an excessive rise in the risk of large losses at some (uncertain) point in the future.

To be sure, executives' risk-taking might have been driven by a failure to recognise risks or by excessive optimism, and thus would have taken place even in the absence of these incentives. But given the structure of executive pay, the possibility that risk-taking was influenced by these incentives should be taken seriously.

The need to reform pay structures is not, as many have claimed, simply a politically convenient sideshow. Even if the type of incentives given to executives of Bear and Lehman – and others with similar pay structures – were not the cause of risk-taking in the past, they could be in future. Financial institutions, and the regulators overseeing them, should give the necessary priority to redesigning bonuses and equity-based compensation to avoid rewarding executives for short-term results that are subsequently reversed.

The stories of Lehman and Bear will undoubtedly remain in the annals of financial disaster for decades to come. To understand what has happened, and what lessons should be drawn, it is important to get the facts right. In contrast to what has been thus far largely assumed, the executives were richly rewarded for, not financially devastated by, their leadership of their banks during this decade.

The writers are affiliated with Harvard Law School's corporate governance programme, which issued their study, "The Wages of Failure: Executive pay at Bear Stearns and Lehman 2000-2008". Although Mr Bebchuk is a consultant to the US Treasury's office of the special master for Tarp executive compensation, the views expressed should not be attributed to that office