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The Real Bank Pay Scandal

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It's that most wonderful time of the year. A time that quickens the pulse of real estate agents and luxury goods purveyors. A time that gladdens the hearts of restaurateurs and wine-sellers. Break open the cigars. It's bonus time!

There has already been plenty of drama played out over Wall Street bonuses this year, well in advance of the ultimate payout. Goldman Sachs became the canary in the coal mine for the entire industry by leaking the projection that their bonus pool would hit record numbers ($23 billion). And CEO Lloyd Blankfein suggested they were "doing God's work." (Which god?, one might ask. Mammon? Château Pétrus?)

The backlash from that little affair was pretty powerful and has led to some changes in pay practices for the current year. But, somewhat surprisingly, there is not the deep sense of outrage in the U.S. about Wall Street pay that there seems to be in most of Europe, where draconian taxes on bonuses have been proposed and cheered.

It's not as if the naysayers don't have a basis for complaint. Regulators have raised concerns that the risk-taking incentives in compensation structures at financial firms are partly to blame for causing the financial crisis in the first place, and many in Congress have called for regulation and even caps on pay at financial institutions.

Financial firms have countered that such constraints would hamper their ability to attract and retain the executive talent needed to steer them back to health and repay taxpayers. But so far, moves to actually curb excessive pay in the U.S. have been largely restrained, and the public response to pay issues in the financial sector has, at least so far, been fairly muted.

Aside from the fact that Wall Street seems to have a tin ear and an unhealthy sense of entitlement when it comes to issues of compensation, it is worth considering how good or bad the incentive systems are on Wall Street and elsewhere in the corporate sector. There are several distinct issues that are important in thinking about compensation. At its most elemental, however, this is a classic principal-agent problem. How should we structure rewards for agents (managers) so that they make decisions that are in the long-term interests of the principals (the shareholders)? Aligning those interests over a long time horizon should lead to wise decisions on the part of managers.

The theory can be complicated, but the applied implications are fairly transparent and sensible. Lots of research shows that the best way to align interests is to give managers significant stakes in the future value of the company in the form of deferred compensation and restricted stock grants, the value of which can only be realized over longer time horizons if the firm does well.

How successfully do current compensation arrangements align those interests? My colleague Gian Luca Clementi and I have been studying the theory and the facts about executive compensation in the United States using the publicly available data that must be filed with the Securities and Exchange Commission on Schedule 14A. There are a couple of simple visual summaries that come out of this research that are worth thinking about. The observations cover the years 1992 to 2006. Our sample consists of information on 31,587 executives, employed by 2,872 companies, for a total of 33,896 company-executive matches and 167,822 executive-year observations.

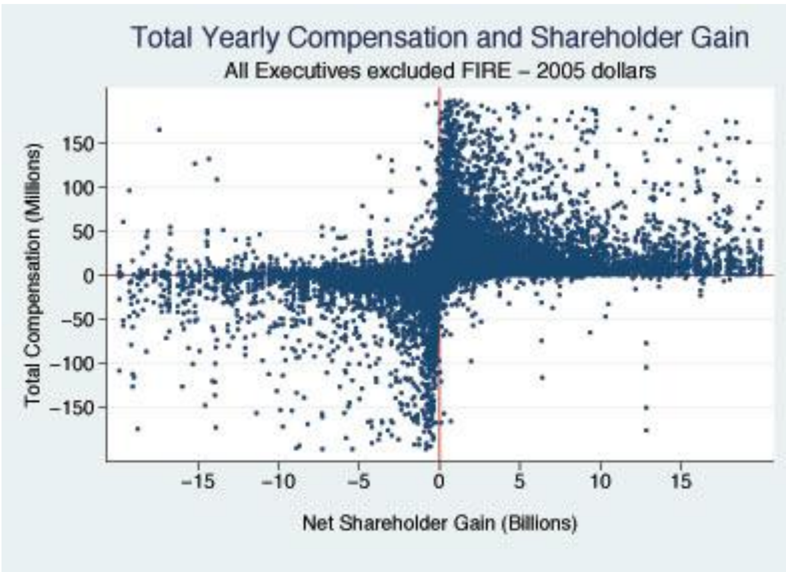
The first figure shown below is a plot of net shareholder gain in billions of 2005 dollars (the horizontal axis) against total compensation in millions of 2005 dollars (the vertical axis) for CEOs of all publicly traded companies in all sectors excluding finance, insurance and real estate, collectively known as FIRE. The figure just below that shows the equivalent data for executives in the FIRE sector.

What one would hope to see in such a plot is that the observations would lie in the lower left and upper right quadrants, which by and large they do. Observations in the upper left quadrant would mean executives are being rewarded when shareholders are losing. There are some observations there to be sure, and one can identify them by name, date and company. The important point is that there are very few.

The equivalent plot for the FIRE sector is, if anything, more encouraging. There are very few observations that lie in the upper left quadrant, suggesting that shareholders and CEOs' interests are very much aligned.

The reason for this alignment is that stock grants have become a much more important component of CEO compensation. Yearly compensation reflects the changes in the value of their stock holdings.

What do we find if we look further down the management chain? The SEC also collects data for other top executives in these firms. The figures below show the equivalent measure for the rest of top management reported to the SEC by these same companies. Here we see more evidence of compensation that is less sensitive to shareholder gains, but by and large the evidence is consistent with an alignment of managers' and shareholders' interests.



These pictures suggest that, in a very real sense, the compensation practices, while not without some anomalies, do align the incentives of shareholders and managers.

But it is also important to understand what they don't tell us. They say nothing about the appropriateness of the levels of compensation in any of the sectors, or disparities between the largest players and smaller companies. Further, these charts don't say anything about the alignment of managers' and shareholders' interests with those of society or taxpayers.

The latter is a particularly troublesome issue when we are talking about banking and finance. At the heart of the anger about bankers pay is the very legitimate concern that the bankers and their shareholders and debt holders benefit from a subsidy paid for by taxpayers--the subsidy that is implied by the notion that they are too big to fail. That subsidy empowers them to take bigger risks and earn bigger returns for themselves and their shareholders with all of the down side risk born by Main Street. That is the real outrage.

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