1. Introduction

INTRODUCTORY REMARKS

We are now six years from the peak of the worst financial crisis for several generations. Scores of books, articles and reports, and millions of pages of copy have been produced by the printed press detailing the mishaps, blunders and greed which characterised the lead-up to the Global Financial Crisis (GFC) which caused it. Much of the literature has centred on the role of executive compensation in causing – at least partially – the collapse of hundreds of financial institutions, and the near death of the global financial system.

The cascade of recent crises would suggest that something is clearly wrong with Western corporate governance and, by extension, with the way in which corporate executives are rewarded. Concentrating on the size of bankers’ pay, and the supposed perverse incentives that massive bank executive compensation packages generated, has become de rigueur in many popular and policy-making circles.1 Criticism of the supposed outsized pay of bankers and other senior employees of financial institutions merely intensified once the effects of the GFC on national economies became clear. Governments assumed the burden of rescuing the financial system and its constituents – at extreme costs to taxpayers – whilst pay practices in the City of London, Wall Street and other major financial centres seemingly remained largely unaffected. When the compounded effects of large fiscal government deficits and reduced tax receipts due to increased unemployment and lower economic output began to bite, disbelief at the scale of the mismanagement involved soon morphed into intense public and political outrage at the ‘business as usual’ approach to bankers’ compensation that appeared to characterise the post-GFC environment.

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Anger and resentment at executive pay levels in the financial sector has therefore characterised much of the reform to the regulation of compensation structures since 2008, yet – as shall be explained later in this book – a natural consequence of reliance on market pricing to determine pay awards gives rise to large amplifications in executive remuneration, independent of incentives. The repeated misconception that market pricing, which is highly imperfect and subject to considerable distortions, may be used to underpin systems of compensation which reduce the incentives of managers and senior executives to adopt excessive risk has meant that despite some considerable changes to the rules governing executive compensation at banks, flaws in remuneration systems remain and corporate collapses are perpetuated. Moreover, these flaws were easily exploited by knowledgeable executives, who repeatedly demonstrated their adeptness at extracting value from corporations based on negligible value creation, the adoption of excessively risky business strategies, or outright fraud.

Naturally, the easiest sticks with which to beat the financial sector have been that of ‘greed’ and ‘recklessness’, as politicians and senior industry regulators have moved to condemn compensation practices to which they had readily consented just a few years earlier. Based on this platform, much progress in the realm of executive compensation at financial institutions has been made. In 2012, in proposing caps to senior bankers’ bonuses, a senior EU banking official claimed that ‘[t]his crisis, which is not over yet, shows the risk and problems posed by some excessive bonuses in the financial sector’.\(^2\) These comments presaged an EU-wide cap on bankers’ bonuses, which was introduced at the beginning of 2014.\(^3\) On the opposite side of the Atlantic, laws restricting pay at financial institutions have been in place since the passage of the Dodd-Frank Act 2010.\(^4\) Moreover, international standard-setters for financial institutions have issued prescriptive rules and guidance on the


composition of bankers’ remuneration, which place restrictions on the composition and frequency of performance-related compensation awards. Each of these sets of regulations has been informed by the perception that large bonuses and performance-linked pay created the conditions necessary for the GFC, and that crises are less likely to erupt if incentives for risk created by compensation systems are restricted.

On the one hand, executive remuneration in the banking and financial sectors was, and remains, massive. Certainly from a purely distributional position, the rewards of top executives seem extraordinary in comparison to the rewards on offer to the average banking employee. Moreover, this trend is replicated across industries in developed countries, and has long been a topic of political and ethical discourse. On the other hand, there is considerable empirical evidence to suggest that incentive-based pay plays a fundamental role in encouraging executives to perform to the highest levels and to create value for their companies, and thereby for national economies. It is an (often uncomfortable) truth that senior executives at financial institutions are often rewarded commensurately with the value they create for the companies, and thereby their investors.

Moreover, it is clear that the compensation of senior executives at financial institutions, in most circumstances, is determined by two factors which arguably bestow clear legitimacy upon the prevailing levels of remuneration at banks in the pre-GFC era. Firstly, the relative size of pay

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6 For example, the aggregate compensation of the CEOs of two of the highest-profile casualties of the GFC, Bear Sterns and Lehman Brothers in the five years prior to the GFC was over $1 billion. See Lucian A. Bebchuk, Alma Cohen & Holger Spamann, ‘The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008’ (2010) 27 YALE J. REG. 257.

7 In the US, the ratio between the median compensation of CEOs and the median salary of the ‘average’ employee is 273:1. See Lawrence Mishel & Natalie Sabadish, ‘CEO Pay In 2012 Was Extraordinarily High Relative To Typical Workers And Other High Earners’ (2013) Economic Policy Institute Issue Brief No. 367.


packages is largely determined by non-salary elements such as bonuses and stock options. Of course, these provide high-grade incentives for executives to promote the success of their companies, and create value for investors. Simultaneously, the fact that options and bonuses tie so much individual success to corporate value intensifies the risk to executives’ personal wealth and, as importantly, their reputational capital. It is therefore debatable whether restricting the capacity of executives to profit in tandem with investors would have welfare-enhancing effects, because motivating executives to take risk would prove difficult. Secondly, and perhaps most significantly, in developed jurisdictions with free movement of capital and labour, it is the market which sets the competitive rate of pay, at all levels. Unless there are regulations restricting the compensation of senior executives (as are present in some jurisdictions in the case of financial institutions in receipt of governmental support), or the state has a hand in the relevant industry, executive pay levels are legally decided by free and unencumbered bargaining between the board of directors and investors.

Notwithstanding for now the merits or otherwise of the claims concerning the contribution of executive compensation to the GFC, it is clear that the latest crisis exhibited many of the taxonomic features of recent preceding scandals and financial collapses. These episodes included the technology company crash (the so-called dot.com bubble of around the year 2000), the option-rigging scandals which beset many Western companies in the late twentieth century, and the gargantuan frauds which laid waste to huge corporations (most notably Enron) in the early part of the twenty-first century. The asset bubbles which collapsed financial institutions in 2008 centred on the housing sector, but it is clear from empirical research that global asset and commodities markets were almost universally inflated in the lead-up to the GFC, which provided further potential for instability to result from price collapses, each of which in some way may be linked to individual incentives.

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10 ‘In each of [the global] crises, the activities which gave rise to them has enriched many individuals involved, while the aftermath imposed substantial and widely dispersed costs on people outside the industry.’ See John Kay, ‘Should we have ‘narrow banking?’’ in Adair Turner, Andrew Haldane, Paul Woolley, Sushil Wadhwani, Charles Goodhart, Andrew Smithers, Andrew Large, John Kay, Martin Wolf, Peter Boone, Simon Johnson & Richard Layard (eds), *The Future of Finance: The LSE Report* (LSE, 2010) 230.

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recently, the Libor-rigging scandal threatened to plunge several large financial institutions back into crisis. At the time of writing, massive central bank injections of cash into financial markets (so-called ‘quantitative easing’) have led to surges in equity markets, whilst the housing market in the UK appears destined for yet more inflation-busting price rises.

Each time these episodes have threatened Western capital and stock markets, regulators have responded with demands for the introduction of ever higher corporate governance norms, higher financial reporting standards and increased market disclosure. Yet, despite the presence of some of the most prescriptive corporate governance standards in the world, jurisdictions including the US, UK and several large European countries saw their financial sectors decimated by the reckless behaviour of senior bank executives, even as those executives were lionised by politicians. Moreover, bankers have themselves recognised the toxic impact prevailing compensation and incentive systems had in causing the crisis.

Accordingly, it is the contention of this book that we are faced with a problem that cannot be solved simply by tinkering around the edges of

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13 Gordon Brown, then UK Chancellor of the Exchequer, infamously saluted the UK banking industry in 2007, commenting that ‘The financial services sector in Britain and the City of London at the centre of it, is a great example of a highly skilled, high value added, talent driven industry that shows how we can excel in a world of global competition. Britain needs more of the vigour, ingenuity and aspiration that you already demonstrate that is the hallmark of your success … [in this] era that history will record as the beginning of a new golden age for the City of London.’ See Gordon Brown, Speech by the Chancellor of the Exchequer, the Rt Hon Gordon Brown MP, to Mansion House, 20 June 2007, http://webarchive.nationalarchives.gov.uk.

14 In one of the most wide-ranging surveys into the causes of the GFC, the International Institute of Finance surveyed 37 global banks regarding their attitudes to compensation and risk taking. Their conclusion was unambiguous: ‘98% of survey respondents believe that compensation structures were a factor underlying the crisis. To improve the functioning of financial markets, practitioners highlight that compensation needs to be addressed in concert with other issues, especially risk management.’ See International Institute of Finance, Compensation in Financial Services: Industry Progress and the Agenda For Change (2009) 3.
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corporate governance codes, or demanding increased market oversight of corporate disclosure. We cannot rely on greater regulation of executive behaviour by the market: each episode of crisis, more forcefully than the last, has revealed the inability – or indeed, the unwillingness – of market participants to enforce behavioural standards. Instead, the task of real reform requires wholesale changes to the way in which we view the market itself.

On this basis, it is the modest aim of this book to highlight why this change in perception is so important. We, as regulators and proponents of efficient and just exchange, ought to preserve those aspects of the market which give rise to welfare-enhancing trading and developmental outcomes. The market is adept, in most circumstances, at producing allocative efficiency and achieving fair value. In these tasks, it remains supreme. Yet it is also flawed, and its flaws often lead to crises which may have been prevented. One flaw which must be addressed is the virtual wholesale reliance currently placed on the pricing mechanism relating to financial markets to deliver value-based compensation contracts. These prices are in some instances subject to distortions, and permitting financial institutions to rely on them to incentivise their management has cost the economy dear. Reducing this reliance will not only lower the risks to investment, but will improve general economic and social prosperity, a cardinal aim of corporate governance.15

Whilst lessons to be derived from the GFC are legion, some of the most salient can be mined from the corporate governance failures which afflicted financial institutions, and led to the embedding of poor incentives across compensation contracts in the sector. Of course, remuneration systems in financial institutions created perverse incentives, particularly short-termism, which encouraged recklessness. However, further limits to executive compensation efficiency exist due to market price distortions, which may persist for protracted periods. Therefore,

15 ‘Good corporate governance underpins market confidence, integrity and efficiency, and hence promotes economic growth and financial stability.’ See Grant Kirkpatrick, Improving Corporate Governance Standards: The Work of the OECD and the Principles (OECD, 2004) 2; ‘Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.’ See Adrian Cadbury, World Bank: Corporate Governance: A Framework for Implementation (2000) Foreword.
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whilst many of the criticisms of existing compensation arrangements are merited, they ignore crucial questions concerning the integrity of the market pricing mechanism, which remains a central aspect of the methods used to calculate remuneration awards.\footnote{European Central Bank president Jean-Claude Trichet recently pointed out: ‘A large number of aspects of the observed behaviour of financial markets is hard to reconcile with the efficient market hypothesis.’ See ‘Reflections on the Nature of Monetary Policy Non-standard Measures and Finance Theory’, Jean-Claude Trichet, President of the ECB, Opening address at the ECB Central Banking Conference, Frankfurt, 18 November 2010, http://www.ecb.europa.eu/press/key/date/2010/html/sp101118.en.html.}

It will be demonstrated by this book that the market pricing mechanism is, on occasion, highly flawed, and this undermines the use of many forms of incentive-based pay because market prices are often used as benchmarks with which to assess performance (usually through metrics such as stock prices or asset prices):

A salient example [of supposed good corporate governance] can be found in the recent enthusiasm for ‘incentivizing’ corporate officers and directors by compensating them primarily, or even solely, through options and stock-based compensation schemes. If market prices do not closely reflect actual expected risks and returns, this single-minded focus on share price is a recipe for mismanagement.\footnote{Lynn A. Stout, ‘The Mechanisms of Market Inefficiency: An Introduction to The New Finance’ (2003) 28 J. CORP. L. 635, 641 (hereinafter Stout, ‘Mechanisms’).} 

This book will provide strong evidence that the predominant view of financial market operation is limited in explaining both investor behaviour and the formation of market prices. On this basis it contends that compensation packages pegged to the short-term whims of financial markets are an inefficient form of corporate remuneration; they do not provide corporate executives with the necessary incentives to motivate them to maximise corporate value or provide long-term growth and sustainability. Instead, they incentivise executives to adopt short-term, high-risk business strategies, particularly through the use of leverage and credit, or through data manipulation. On this theme, the UK Parliamentary Commission on Banking Standards, formed following several banking scandals in the UK, commented:

Remuneration has incentivised misconduct and excessive risk-taking, reinforcing a culture where poor standards were often considered normal. Many bank staff have been paid too much for doing the wrong things, with bonuses
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awarded and paid before the long-term consequences become apparent. The potential rewards for fleeting short-term success have sometimes been huge, but the penalties for failure, often manifest only later, have been much smaller or negligible. Despite recent reforms, many of these problems persist.  

What each driver of market pricing failure in relation to the relevant instances has in common is the wholesale destruction of corporate value in the wake of huge preceding gains for senior executives. These instances have serious ramifications for the almost singular focus on corporate data such as stock prices in determining executive remuneration, as they demonstrate that market inefficiencies are not only common, but often give rise to crises, which may become so grave as to threaten the entire financial system. If links may be established between market pricing failure, compensation incentives and crisis, a strong case may be advanced for greater regulation of executive remuneration.

THE STRUCTURE OF THIS BOOK

This book is divided into six substantive chapters aside from this brief introduction, and a brief conclusion. The next chapter deals with the issue of executive compensation in modern markets on a theoretical basis, by surveying the theories which dominate the system of executive compensation in modern corporations. Executive compensation packages at public companies comprise common elements such as a base salary and performance-target-related pay. This, theoretically, ought to mitigate potential conflict between the principal and agent, by making a proportion of the executive’s pay contingent on firm performance. This aligns the interests of shareholders (superior firm performance and increased profits) with those of management (commensurate performance-adjusted rewards). This performance-related pay often includes an element with a specific link to the stock price of the corporation that the executive is employed by. Thus the more shareholder value that executives create, the more pay they receive. Executive remuneration rewards are therefore based, to a great extent, on the market price of companies (or their market capitalisation). However, the widespread adoption of equity-based compensation has led to a damaging obsession with short-term

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19 Calculated by multiplying the number of outstanding shares in a company by the current per-share market price.
market price movements, contributing to corporate scandals based on systematic abuse of financial reporting, and financial structures.

Chapter 3 both discusses modern finance theory and analyses the various challenges to the hegemony of modern finance theory in explaining financial market behaviour. In doing so, it highlights the challenges that face the use of predictive tools concerning individual behaviour in formulating executive compensation levels in contemporary public securities markets. In fact, the utility of compensation contracts is entirely based on a system of near-flawless market pricing. This chapter therefore addresses the notion that market pricing is flawless; that is, the price of a security is always equal to its value (the so-called Efficient Markets Hypothesis, or ‘EMH’). If the value of securities is flawless so, by proxy, must be a firm’s market capitalisation. The EMH bases its predictive qualities upon the rational investor model.20 A further and essential tenet of the EMH is that there is no such thing as an ‘over-valuation’ of assets: market prices are always correct because agents are rational and will arbitrage away any price anomalies extremely quickly. Financial crisis is therefore unpredictable – and therefore unavoidable – and crashes simply mark departures from equilibrium. In this vein, the chapter proceeds to discuss both behavioural finance and other theories of financial market operation which highlight instances in which the market pricing mechanism has failed to deliver efficient pricing, and accordingly undermined equity-based compensation systems. In particular, the chapter considers the most obvious challenge to the notion that market prices are efficient: asset bubbles. Standard financial theory does not recognise the possibility of asset bubbles, yet every major financial crisis has been preceded by one.21 Each of the theories conceived to explain these phenomena, in contrast to the EMH, provides explanations for the departure of price from value for sustained periods, although each is limited in providing

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20 In relation to the supposed futility of governmental fiscal policy, for example, neoclassical economic theory holds that ‘... markets will adjust instantaneously [to new information]. For because expectations are rational, optimizing agents will take predictable countercyclical government fiscal and monetary policy into account in their behaviour. Policy can only have effects if it “surprises” agents, and rational expectations ensure that policy that systematically surprises agents is not possible.’ See Simon Mohun, ‘New Classical Economics’ in William Outhwaite (ed), *The Blackwell Dictionary of Modern Social Thought* (John Wiley & Sons, 2002) 433.

solutions for the normative design of more appropriate financial regulatory structures.

On this basis, Chapter 4 analyses Minsky’s so-called ‘Financial Instability Hypothesis’ (‘FIH’), which I consider to be the most comprehensive and accurate explanation for the fact that financial markets experience periods of boom and bust, and thereby undermines the view that financial markets are stable and equilibrium-seeking. The FIH holds that euphoric expectations of future expansion will affect an economy’s debt structure, leading to financial instability and eventual widespread corporate distress. The chapter will address the way in which the capital structure of corporations – particularly banks – may be arranged so as to increase their profitability, based purely on asset expansion and leverage. This permits executives to capture gains derived from changes in leverage levels, and through recourse to financial measurements of performance which may be inflated through use of more leveraged capital structures. Tinkering with capital structure in this way will often appear to improve short-term profitability, but will do so at the expense of long-term stability.

Chapter 5 proceeds with an examination of the contribution of executive remuneration to the GFC, which arguably exploded modern finance theory and supports the consideration of a new economic paradigm. The GFC demonstrated that, consistent with the predictions of the FIH, common causes drive most significant financial crises, and exposed the role of debt-fuelled expansion in creating financial conditions of fragility. Equity-based compensation provided executives at financial institutions with serious incentives for this expansion. Many investors were caught up in the market euphoria of the years preceding the crash despite warning signs that a financial crash was imminent being sounded before 2007, when the crisis began. The market pricing mechanism did not reflect the likelihood that this was the case. Market discipline was insufficient to guard against consequences which flowed from poor incentives and rent seeking. Economic units, particularly financial institutions, migrated towards unstable financial structures, as entities in the shadow banking system and traditional banks sought to increase returns via unprecedented credit expansion. To support this position, the chapter utilises data from the financial sector which demonstrates that leverage in the financial system increased significantly in the build-up to the crisis and the sub-prime mortgage backed asset market was expanding at a rate which did not reflect underlying fundamentals. At the same time, executive pay levels, based on weak incentives for risk management and related to a large extent on the inflation of asset values, burgeoned. This chapter also notes a further paradox in relation to this theme; the very compensation
policies that executives push for (equity-based remuneration) may in themselves drive financial institutions to become more unstable, and thereby may distort the market pricing mechanism.

The final two substantive chapters, in light of previous discussions of the integrity of market pricing, consider both the reforms made to compensation systems in the financial sector, and make some proposals for reform to executive compensation contracts, to reduce reliance – directly or indirectly – on market prices. Chapter 6 discusses the reforms made in the major/Western financial centres since the GFC. Chapter 7 considers further reforms to existing compensation mechanisms, in some cases simply augmenting those already present in the banking sector. Markets are prone to extreme oscillations in price and it may require observation for a protracted period for fundamental value to emerge in order to ‘screen out’ the possible effects of market irrationality and failed investor learning. Added complexity in business and financial markets has provided executives with the opportunities to exploit methods through which to capture additional rents. The proposed reforms will arguably increase the level of protection for the financial system by reducing the opportunities for this conduct.