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DURHAM, N.H. – Lucrative incentives for executives at the nation's top banks encouraged them to take excessive risks prior to the financial meltdown that the country still is digging itself out of three years later, according to a new study from the University of New Hampshire.

New research by Brian Bolton, assistant professor of finance at UNH, and his colleague Sanjai Bhagat, professor of finance at the University of Colorado at Boulder, shows that the executive compensation structures in 14 of the largest U.S. financial institutions from 2000 to 2008 led to excessive risk taking that spurred the financial crisis. The research is presented in the working paper "Bank Executive Compensation and Capital Requirements Reform."

Instead of being concerned about the impact to long-term shareholders, these executives were in it primarily for themselves, the researchers found.

"Most investors are long-term investors. We looked at nine years of individual stock trades, which really shows CEO behavior at each firm. We wanted to see if the CEO behavior was consistent with them being long-term investors themselves," Bolton says.

The researchers looked at the executive compensation programs of Bank of America, Bank of New York, Mellon Financial, Citigroup, Goldman Sachs, JP Morgan Chase, Morgan Stanley, State Street, Wells Fargo, Merrill Lynch, Bear Sterns, Lehman Brothers, Countrywide Financial, and AIG.

The issue with executive compensation centers on the ability of executives to sell off significant amounts of vested stock and options, which gives them a strong incentive to focus on short-term earnings and returns.

"Some CEOs behaved very conservatively; others, however, were regularly selling, including one CEO who sold stock on more than 200 days during 2004 and 2006, netting more than $400 million in proceeds. Regardless of the reason, this is not consistent with a CEO who is confident about his firm's future prospects," Bolton says.

The researchers weighed two opposing concepts. First, incentives generated by executive compensation programs led to excessive risk taking by banks that benefited bank executives at the expense of long-term shareholders. This is known as the Managerial Incentives Hypothesis. The second concept, called the Unforeseen Risk Hypothesis, posits that bank executives were faithfully working in the interest of their long-term shareholders; the poor performance of their banks during the crisis was the result of unforeseen risk of the bank's investment and trading strategy.

One of the ways that the researchers looked at the validity of these concepts was to review CEO buys and sells of their bank's stock. Under the Managerial Incentives Hypothesis, executives make an unusually large number of trades prior to and during a financial crisis. In effect, they are taking money off the table because they know, due to their insider knowledge, that the company could experience large negative earnings in a few years. In contrast, the Unforeseen Risk Hypothesis holds that manager trades of shares of their bank's stock are normal prior to and during a financial crisis because they are not concerned about potential problems.

In looking at CEO buys and sells of their bank's stock from 2000 to 2008, the researchers found that the CEOs were 30 times more likely to be involved in a sell trade compared to an open market buy trade. The ratio of the dollar value of their sells to buys was even more lop-sided. The dollar value of sales of stock by bank CEOs of their own bank's stock was about 100 times the dollar value of open market buys of stock of their own bank's stock.

In total, value of the CEO trades during that span totaled $1.77 billion. CEOs bought their bank's stock 73 times during that period, but sold it 2,048 times. At the end of 2008, these 14 CEOs had amassed an estimated net payoff of $648.9 million – even after accounting for what they lost during the collapse in 2008.

When looking at all inside traders, which include officers and directors at the banks, the value of their trades during that period totaled $126.9 billion. These insiders bought their bank's stock 1,671 times but sold it 14,687 times.

"It is important to note that executive compensation reform is not a panacea. While incentives generated by executive compensation programs led to excessive risk-taking by banks contributing to the current financial crisis, there are several more important causes of the current financial and economic crisis," the researchers say.

"For example, the perverse incentives created by Fannie Mae and Freddie Mac encouraged individuals to purchase residential real estate - ultimately at considerable public taxpayers' expense; this is perhaps the single most important cause of the current financial and economic crisis. Ironically, the recent Financial Reform Act signed into law in July 2010 did not even acknowledge, much less address, the perverse incentives created by Fannie Mae and Freddie Mac," they say.

To address the issue of executive compensation and excessive risk taking, the researchers recommend that executive incentive compensation should consist only of restricted stock and restricted stock options – restricted in the sense that the executive cannot sell the shares or exercise the options for two to four years after their last day in office.

"However, to address liquidity concerns, managers should be permitted to annually liquidate about 5 percent to 15 percent of their ownership positions, but these ownership position annual liquidations should be restricted to an amount of $5 million to $10 million. This compensation structure will provide the managers stronger incentives to work in the interests of long-term shareholders, and avoid excessive risk-taking," the researchers say.

The University of New Hampshire, founded in 1866, is a world-class public research university with the feel of a New England liberal arts college. A land, sea, and space-grant university, UNH is the state's flagship public institution, enrolling 12,200 undergraduate and 2,300 graduate students.

PHOTO
Brian Bolton, assistant professor of finance at UNH.
http://www.unh.edu/universityevents/speakersbureau/images/bolton_brian_new.jpg

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Editors and Reporters: Please contact Lori Wright for copies of the working paper "Bank Executive Compensation and Capital Requirements Reform."

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