Pay Now, Lose Later: The Role of Bonuses and Non-Equity Incentives in the Financial Meltdown of 2007-2009

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Abstract: This paper draws attention to and raises questions about an area of executive incentive compensation, bonuses and non-equity incentives, which seems to have disproportionally rewarded executives while shareholders remain exposed to substantial ongoing economic risks. This area of focus has surfaced because, beginning in 2007 and continuing throughout 2008, financial services firms incurred massive losses, while in the years immediately preceding this deluge of losses many executives were awarded substantial bonuses and non-equity incentives. We assess the risks associated with such payments and build a framework for assessing how shareholder and executive interests diverge as a result of bonuses and non-equity compensation. Our analysis is also meant to serve as a building block for future empirical studies about the relationship between executive incentive compensation paid in cash (bonuses and non-equity incentives) and the financial misstatements and overstatements of income that were at the heart of the financial meltdown.

INTRODUCTION

The financial and economic crisis that is currently ripping across the United States (US) as well as the globe has destroyed vast amounts of wealth and economic prosperity and has sparked major actions by governments, financial institutions, companies and individuals in an attempt to cope with the economic destruction and devastation. Many efforts are being directed at both coping with the crisis as well as exploring questions that have surfaced as a result of a significantly shifted landscape. This new landscape allows for new perspectives which can expose previously underestimated limitations, risks and flaws that have been part of generally accepted business practices and assumptions.

Our effort here is directed at drawing attention to and raising questions about an area of executive incentive compensation that seems to have disproportionally rewarded executives while exposing shareholders to substantial ongoing economic risks, i.e. cash-based executive incentives. Cash incentives, which result from bonus plans and non-equity incentive plans, become risk-free to those executives once they receive the cash. However, shareholders continue to bear the economic risk of companies not actually realizing in cash the publicly reported corporate earnings, as well as related asset values, which putatively provided the basis for the incentive compensation payments. We explore the rationale for the cash bonuses and non-equity incentives as well as the implications and appropriateness of executives receiving such incentive payments while shareholders remain exposed to ongoing economic risk.

This area of focus has surfaced because, beginning in 2007 and continuing throughout 2008, many firms in the financial services industry have incurred enormous losses while in the years immediately preceding this deluge of losses many executives received substantial cash incentive payments. Although these executive incentives were paid in cash, the earnings and related asset valuations, that were the basis for the payments, contained substantial ongoing economic risk for shareholders. The fact is that these ongoing economic risks became actual losses as a result of the now well understood economic consequences associated with the meltdown of the mortgage market. We frame an empirical approach for understanding and evaluating the relationship between executive incentives paid in cash, and reported profits - profits that turned out not only to be misstated but in several cases overstated by many multiples. The ultimate question we seek to illuminate in this and further work is whether and in what ways the compensation mechanism contributed to the misstatements and overstatements of income?

Excessive executive compensation, particularly excessive total compensation has been and continues to be an active stream of research [1]. We bring a more targeted emphasis to the bonus and non-equity component of executive compensation with the objective of touting the importance of empirical research on the nature of the economic risk transference which occurs when executive incentives are awarded in cash.

EXECUTIVE COMPENSATION

Executive compensation in the financial industry generally is comprised of an annual base salary component and an executive incentive compensation component. While base salary is normally paid in cash, incentives can take a variety

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of forms. Fundamental to the question of how executives should be compensated and incentivized is the recognition that for public companies there is a separation between shareholders and management. This situation creates what the economics and management literature characterizes as a classic agency problem in that the economic interests of the agents (executives) are not necessarily aligned with the economic interests of the principals (shareholders)[2]. An additional aspect of the separation of management and ownership is the possibility of misused "managerial power" [3].

Generally, a solution to the agency problem requires companies to adopt proactive measures which establish enforceable corporate governance mechanisms that incentivize and/or constrain managers' interests so that shareholders are provided with some assurance that their best economic interests are pursued by managers [2].

Executive incentive compensation, which is an element of such interest-aligning corporate governance mechanisms, provides performance-based bonus opportunities for executives. These mechanisms generally grant executives equity-based incentive awards as well as incentive compensation awarded in cash. The general notion, although not empirically conclusive, is that Chief Executive Officers (CEOs) and other senior corporate executives should be incentivized to produce results that are consistent with the best interests of shareholders: the long term increase in the value of the shares [4, 5].

EQUITY-BASED COMPENSATION

Equity-based incentive compensation awards provide executives with an equity interest in a company giving them a direct economic interest in the future appreciation of the stock price. Executives' direct personal economic interest in the company's future stock appreciation is the crucial point of alignment with shareholders' economic interests - both groups share a long-term linked common economic interest.

Equity-based incentive compensation awards exist in a variety of forms, including restricted stock, restricted stock units (RSU's) and stock options grants. These forms of executive compensation have become broadly accepted by companies as providing for effective alignment of shareholder and management economic interests [6].

There is substantial research in support of the effectiveness of equity-based compensation as well as cautionary work which identifies risks that may exist with respect to equity-related incentive compensation. Issues examined include raising shareholder awareness with respect to the possibilities that self-interested executives, with private information about a firm, and who hold options, have incentives to reveal positive information about the firm, but not negative information [7]. Additionally, certain studies have linked the retraction and restatement of financial statements as well as fraud to equity-based compensation [6]. While corporations have adopted equity-linked incentive compensation, this mechanism has not been without controversy, for example, options back dating issues [8, 9], nor has academic research unambiguously concluded that equity-linked compensation is an effective incentive mechanism [10, 11].

While equity-linked compensation is not a panacea for solving the overriding principal agent problem, the equity-based component of incentive compensation has become much more widespread and gained general acceptance in the business community. A limited review of the proxy statements for leading financial services firms [12-14] reveals that, within the financial services industry and more narrowly within the investment banks, the rate of growth of equity-based compensation has often exceeded the rate of growth of executive incentives paid in cash. However, as the importance of equity-based compensation was increasingly recognized, it was often the case that equity-based compensation was incrementally added to the cash incentives as opposed to being considered either a full or partial replacement. Consequently, given the growth in earnings of the investment banks over the past decade, ***both*** components of incentive compensation grew to a very substantial level. A former senior human resource executive from the financial services industry conveys that the philosophy underlying compensation awards on Wall Street reflects a culture of "more is better, with the most being best"[1]. Within that cultural mindset, what may be viewed as excessive from the outside, can simply be viewed as appropriate rewards to those on the inside.

NON-EQUITY COMPENSATION AND BONUSES

Non-equity incentive compensation and bonuses represent the two categories of executive incentive compensation paid in cash. The term "non-equity incentive plan compensation" was formally introduced in 2006 by the Securities and Exchange Commission (SEC) in the regulations amending required disclosure of executive compensation in financial statements [15]. The principal modifications of the 2006 executive compensation disclosures involved changes to the reporting of equity-based compensation. However, the revised disclosures added a requirement that a new category, non-equity incentive plan compensation, be incorporated into the **Summary Compensation Table** presented in the Annual Proxy statement[2]. This new category was designed to capture executive incentives awarded in cash which are based upon specific pre-established performance-based goals. To the extent that cash incentives are not specifically linked to specific pre-established performance-based incentives, they continue to be reported in the annual bonus category. Prior to these rule changes, all annual cash incentive payments awarded to executives were reported in the **Summary Compensation Table** as the bonus component of annual compensation.

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[1] Anonymous interview held February 2009.

[2] Annual Proxy Statement - The SEC requires that shareholders of a company whose securities are registered under Section 12 of the Securities Exchange Act of 1934 receive a proxy statement prior to a shareholder meeting, whether an annual or special meeting. The information contained in the statement must be filed with the SEC before soliciting a shareholder vote on the election of directors and the approval of other corporate action. http://sec.gov/answers/proxy.htm. Annual Proxy statements are required to include a section on Executive Compensation which includes a compensation table.

Summary Compensation Table

Name and Principal Position on November 30, 2005	Annual Compensation				Long Term Compensation Awards		
	Fiscal Year	Salary	Bonus	Other Annual Compensation (a)	Restricted Stock Unit Awards (b)	Securities Underlying Options	All Other Compensation (c)
R.S. Field	2005	$750,000	$13,750,000	-	$ 14,942,021	450,000	$17,791
Chairman and Chief	2004	750,000	10,250,000	-	10,357,143	450,000	16,028
Executive Officer	2003	750,000	6,650,000	-	8,000,000	450,000	14,439
J.M. Gregory	2005	$450,000	$11,550,000	-	$11,542,211	350,000	$9,748
President and Chief	2004	450,000	9,050,000	-	7,214,285	350,000	8,782
Operating Officer	2003	450,000	5,050,000	-	5,714,629	350,000	7,912
D. Goldfarb	2005	$450,000	$5,550,000	-	$5,199,709	300,000	$ 0
Chief Administrative	2004	450,000	3,950,000	-	4,357, 143	250,000	0
Officer	2003	450,000	2,550,000	-	3,571,643	200,000	0
T.A. Russo	2005	$450,000	$4,550,000	-	$3,314,100	150,000	$ 0
Chief Legal Officer	2004	450,000	3,350,000	-	2,928,571	150,000	0
	2003	450,000	2,550,000	-	2,857,314	50,000	0
J. Beyman	2005	$200,000	$3,100,000	-	$3,142,682	0	$ 0
Chief of Operations and	2004	200,000	2,800,000	-	2,857,143	20,565	0
Technology	2003	200,000	2,200,000	-	1,714,404	66,781	0

Source: Lehman Brothers Holdings Inc. 2006 Annual Proxy Statement [17].

Because many executive incentive compensation plans in the financial services industry are not linked to specific pre-established performance-based incentives, a number of firms have continued to report cash-based executive incentive awards as bonuses. For example, the 2008 Annual Proxy for JPMorgan Chase includes the following as a footnote to the **Summary Compensation Table**:

> "The plan allows the Compensation Committee substantial discretion, which the Compensation Committee uses consistently in establishing compensation following the completion of a fiscal year. Accordingly, we report amounts paid under this plan as "bonus" and not "non-equity incentive compensation" [16].

To provide a real world context for the amount of compensation involved, we have provided the table above which is a copy of the **Summary Compensation Table** included in the 2006 Annual Proxy Statement for the now defunct firm Lehman Brothers Holdings Inc. This table, which was prepared when the proxy rules required that cash incentive payments be labeled Bonus, also reveals data on equity-based compensation presented under the Long-Term Compensation Award heading.

As can be seen from the table above, the cash bonuses paid based on 2004 and 2005's net earnings for the highest paid executive (the CEO) totaled $10,250,000 and $13,750,000 for the years 2004 and 2005, respectively. For 2006 and 2007, the comparable amounts are $6,250,000 and $4,500,000, respectively [18]. A footnote included with the table above states the following:

> "While the Company generally seeks to deliver the majority of an executive officer's total annual compensation in the form of equity awards, additional factors that influenced the amount of cash and RSUs (restricted stock units) awarded to each executive officer included: the portion of total annual compensation paid in equity awards to other senior executives; the executive officer's existing individual equity holdings in the Company; the terms of the RSUs, including the impact on their value due to vesting requirements and restrictions on sales; and accounting expense."

While informative, this disclosure, as well as more elaborate disclosures which are typically included in proxy statements, lacks unequivocal clarity and precision with respect to the rationale for determining either the absolute amount of non-equity compensation or the relative proportion of equity-based versus non-equity based incentive compensation. This lack of precision in the disclosure, as well as the underlying discretion which compensation committees have[3], raises questions about the fundamental relationship

[3]New York Stock Exchange listed companies must have a compensation committee composed entirely of independent directors. The compensation committee must have a written charter that includes - (i) the committee's purpose and responsibilities - which, at minimum, must be to have direct responsibility to: (A) Review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO's compensation level based on this evaluation; and (B) make recommendations to the board with respect to non-CEO compensation, incentive-compensation plans and equity-based plans; and (C) produce a compensation committee report on executive compensation as required by the SEC to be included in the company's annual proxy statement or annual report on Form 10-K filed with the SEC. http://www.nyse.com/pdfs/finalcorpgovrules.pdf

between executive incentives paid in cash and shareholder interests.

FINANCIAL CRISIS IMPACT ON BONUSES AND NON-EQUITY COMPENSATION

It is at this point that the storyline gets more complex as a result of the financial crisis. A hidden or underappreciated risk to shareholders, that did not fully surface until the recent crisis, is the risk of a firm not realizing in cash either reported earnings and/or the value of the financial assets on which cash-based compensation has already been paid to executives. Reported earnings, which are a key performance goal of a great number of incentive compensation plans, include for many financial institutions "paper profits" that were never realized in cash. Financial assets that a firm owns, including mortgage-backed securities, also have real economic risks related to the ultimate realization in cash, of the carrying value of these securities. To the extent executives were paid both base salary and incentive awards in cash, they became immunized against how these particular economic risks would unfold.

Critically important is that in this financial crisis, the full cash realization of the paper profits and the asset valuations has turned out to be fiction. Fiction in the sense that substantial components of the reported earnings and asset values were never in fact actualized, meaning never realized in cash. Cash was never realized because certain business, accounting and economic estimates and judgments that were used in the determination of reported earnings and asset valuations ultimately, in fact, turned out quite differently. Consequently, these circumstances have contributed to the substantial losses that many financial institutions have recently reported.

When executive incentives are paid in cash, on earnings which later prove to be illusory, this results in a disjunction of interests between shareholders and management [19]. With equity-linked incentives, risks and opportunities are shared by management and shareholders. However, with executive cash incentives, management benefits with the rewards, but shareholders continue to be exposed to the economic risks. Viewed in this context, it is worth asking what the underlying rationale is for awarding cash incentives to executives.

One element of the rationale for awarding cash incentives on reported earnings, which were not yet actualized in cash, is that Generally Accepted Accounting Principles (GAAP) provided the rules and principles for the formulation of reported earnings. Very generally, these accounting principles and rules are designed to be conservative which implies that reported earnings would reflect activities that one could reasonably be assured would be realized in cash. In many ways that is a critical point. Given the various economic and accounting assumptions that underlie reported earnings and related asset valuations, there may always be hidden and misunderstood risks in earnings. These risks may unfold over the ensuing months or maybe years. Put simply, if the GAAP rules function as they are intended to, it should minimize the extent to which cash incentives will result in a divergence of interests between shareholders and management.

The sheer amount of cash-based incentive compensation paid to individual executives in the financial industry is also central to this discussion. It is noteworthy that as recently as 2005, amounts such as $18 million and $12 million were paid out to individual CEOs as incentive bonuses. Recent newspaper accounts reported that the aggregate level of incentive compensation since 2005 totaled $464 million at the seven financial institutions that have failed to date with almost half paid as cash compensation [20]. Enormous sums of money have been paid in cash for earnings that turned out to be fiction.

Compensation committees, boards and shareholders would be well advised to revisit bonus and non-equity incentive plans. With the benefit of the information from the financial crisis, they should also examine the realizable risk associated with the earnings and asset valuations. A challenge then is for shareholders, boards and compensation committees to more fully evaluate the nature and properties of earnings that form the basis for the payment of incentive compensation. With renewed vigilance, there needs to be a recognition of the potential misalignment between the ongoing risks that shareholders take and the basis for paying cash incentives.

FURTHER RESEARCH

Our analysis suggests a number of areas of future empirical research and moral analysis. First, an overarching empirical question that needs to be addressed is whether the disjunction of economic outcomes between executives of financial institutions and shareholders reflect the normal timing, pace and undulations of market events and business activities or whether patterns of incentive compensation, particularly executive incentives awarded in cash, reveals causal link with financial and accounting irregularities.

A second recommended area of empirical examination is the focus on effective corporate governance practices in select developed countries to determine whether the disjunction of shareholder and executive economic interests is attributed to national or cultural variables.

A final area for future work pertains to ethics. Our analysis in this paper suggests that the moral status of non-equity incentives and bonuses depends on an empirical study which provides evidence as to whether the disjunction of shareholder and executive interests was due to the unpredictable vagaries of time and the market or whether the risk shifting involved was deliberate and knowing, that is, managers sought to maximize their own personal wealth at the expense of the shareholders to whom they owed a fiduciary duty. Further analysis of the relevant moral principles and their application to the facts is certainly warranted.

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