

Executive Pay in the EU

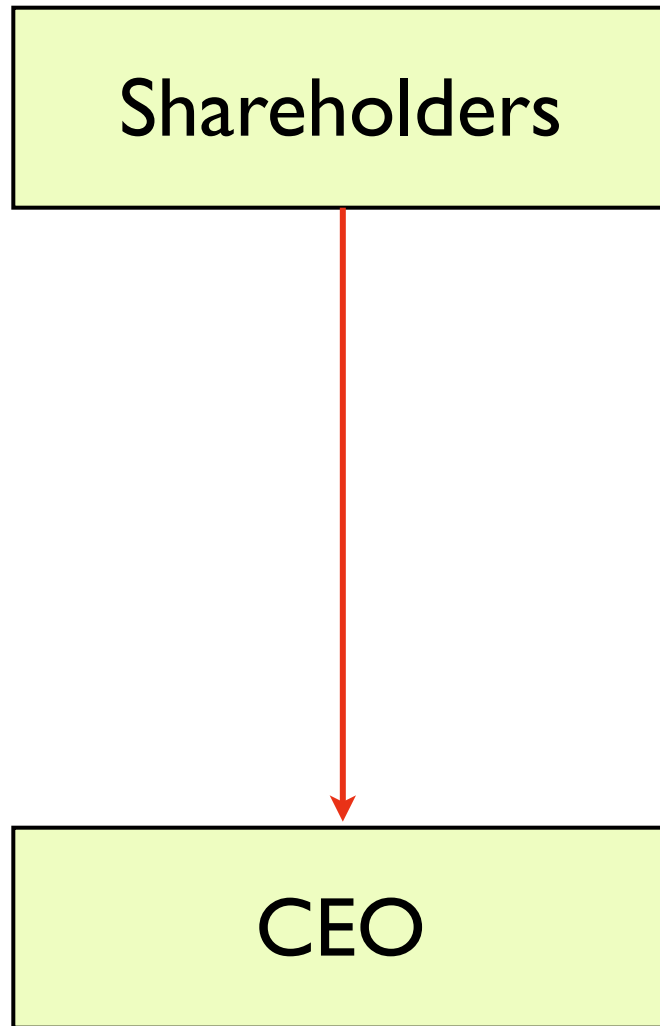
In Anticipation of a Train Wreck

Kevin J. Murphy

27 June 2013

The Excuse for Intervention?

Shareholders



Shareholders want
 $\max(\text{Shareholder Wealth})$

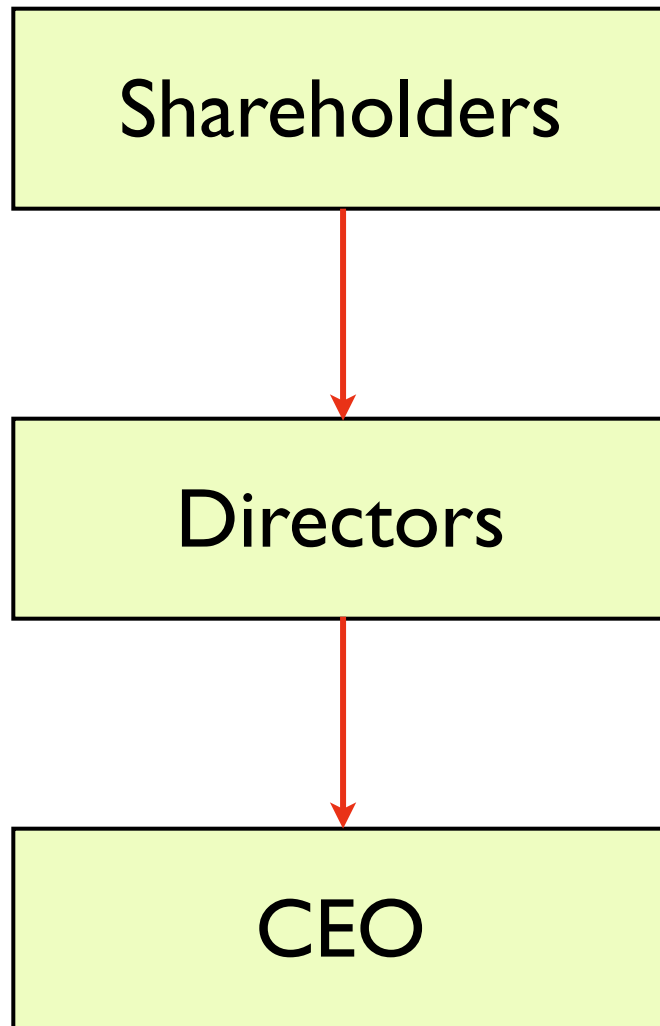
*Inherent conflict of interest over incentives
mitigated by contracts tying
CEO pay to shareholder wealth*

*Inherent conflict of interest over pay levels
mitigated through competition in the managerial
labor market*

CEO

CEOs want
 $\max(\text{Utility})$

The Excuse for Intervention?

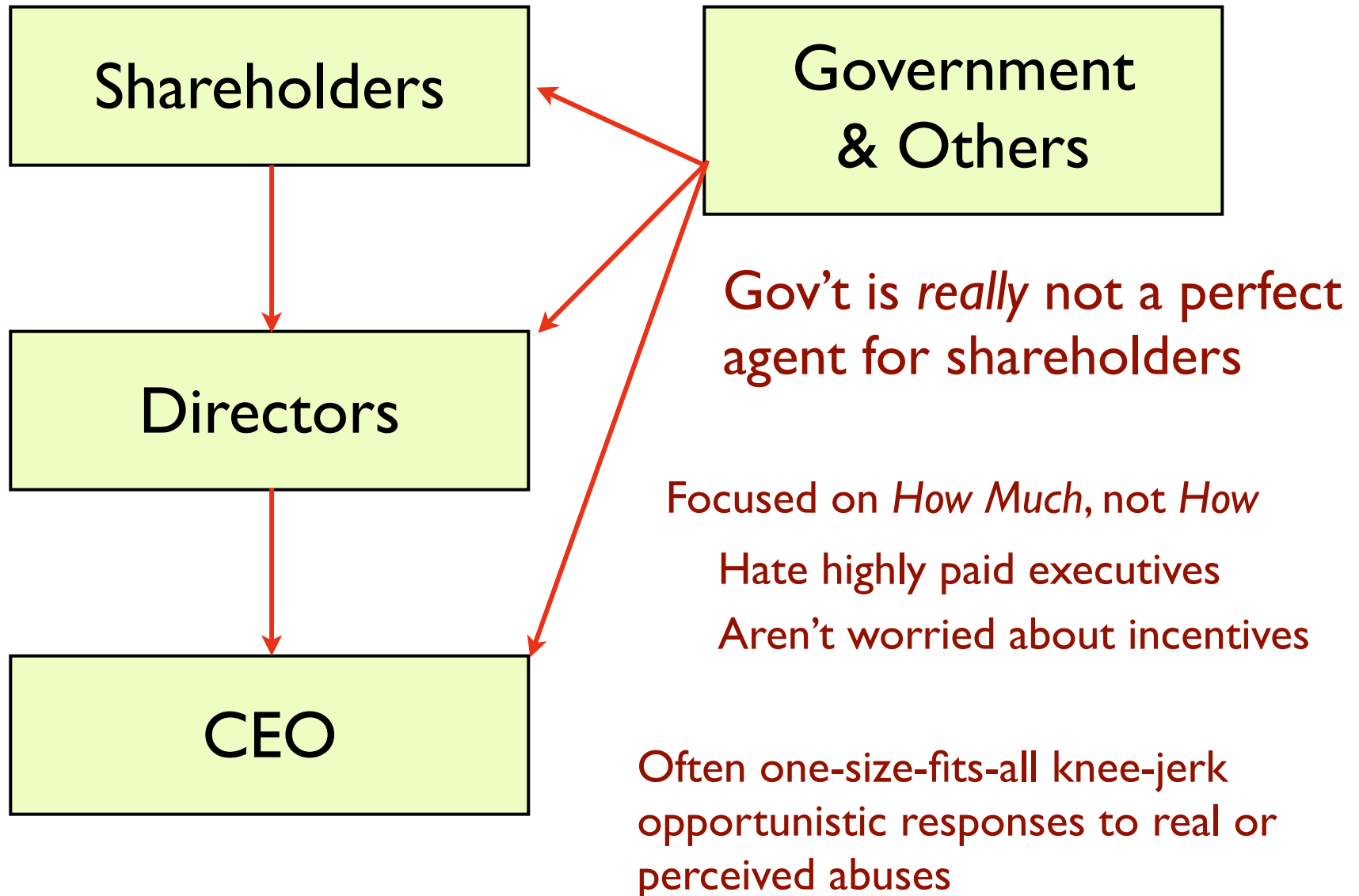


Directors are elected by,
but are not perfect agents for
shareholders

Paying with other people's money
Like high incentives
Aren't worried about over-paying

Market imperfection to be solved
by gov't intervention!

The Excuse for Intervention?



Knee-jerk Opportunistic Responses



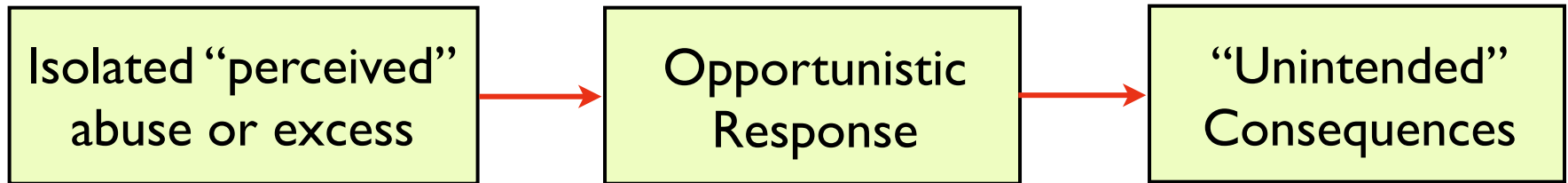
Bendix and Golden Parachutes (1986)

Bendix's Bill Agee gets \$4.1mil
Golden Parachute (1982)

IRS Section 280G
& 4999 Excise Taxes

Explosion in GPs
Tax gross-up provisions
Shorter vesting periods
Early exercise
More employment agreements

Knee-jerk Opportunistic Responses



Tyco and Sarbanes-Oxley (2002)

Tyco's Dennis Kozlowski forgives loans (2002)



Sarbanes-Oxley prohibits *all* loans to executives



Forbids many arrangements good for shareholders:
Optimal signing bonuses
Relocation loans
Loans to purchase stock
Cashless exercise programs

Knee-jerk Opportunistic Responses



Utility Share Options and Greenbury/Hampel

UK utility execs make huge gains from underpriced 1990 pre-IPO options

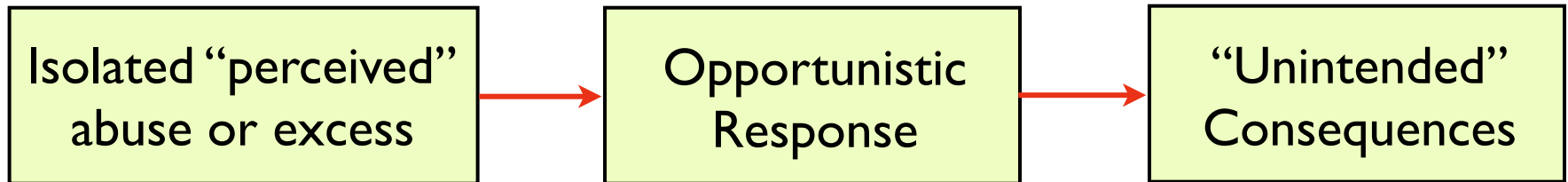


Greenbury (1995) prescribes restrictions on all option plans, and adds sweeping new disclosure rules



Options in the UK implode, just as they explode in the US

Knee-jerk Opportunistic Responses



Toothpaste and Binding Say-on-Pay in Switzerland (2013)

Toothpaste CEO Minder lost in SwissAir's 2001 bankruptcy, and was enraged that SwissAir's new CEO received severance equal to 5-year's salary

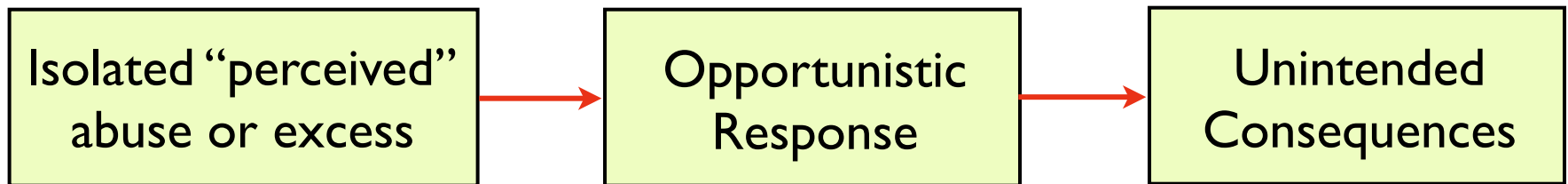


Collects 100,000 signatures for referendum against "rip-off salaries"

Gets \approx 68% of vote

- BINDING Say-on-Pay
- Ban on all severance payments
- Preclusion of any hiring bonuses
- Ban on incentive payments linked to the sale or disposition of a company
- Mandatory annual election of all members of the board of directors (incl. chairperson)
- Disclosure of, and shareholder votes on, compensation and benefit programs:
 - Credits, loans, pension benefits and equity-based programs for board members
 - Terms of employment agreements for senior executives
 - Maximum number of independent board members
- Mandatory disclosure of voting by pension funds, including on compensation matters
- Prohibition on depository bank voting without explicit instruction
- Penalties for violation of these provisions include imprisonment for up to three years and fines of up to six times' annual remuneration

Knee-jerk Opportunistic Responses



Banking Bonuses in the EU

Anger over bonuses paid in bailed-out banks



Up to 60% of banking bonuses deferred for at least 3 years



Where to begin ...

“These tough new rules will transform the bonus culture and end incentives for excessive risk taking” – Arlene McCarthy (EP member)

EU Parliament not satisfied, holds CRD-IV hostage for more pay restrictions

Ratio of variable:fixed pay capped at 1:1 (Max 2:1 with supermajority vote)

Applies starting in 2014 to world-wide employees of EU-headquartered banks, and EU-based subsidiaries of non-EU banks

The Banking Bonus Culture

History

Bonus culture emerged when investment banks were private partnerships

Low salaries + High variable pay to keep costs variable

Private I-Banks: variable pay in the form of cash bonuses

Public I-Banks: variable pay in the form of bonuses, stock, and options

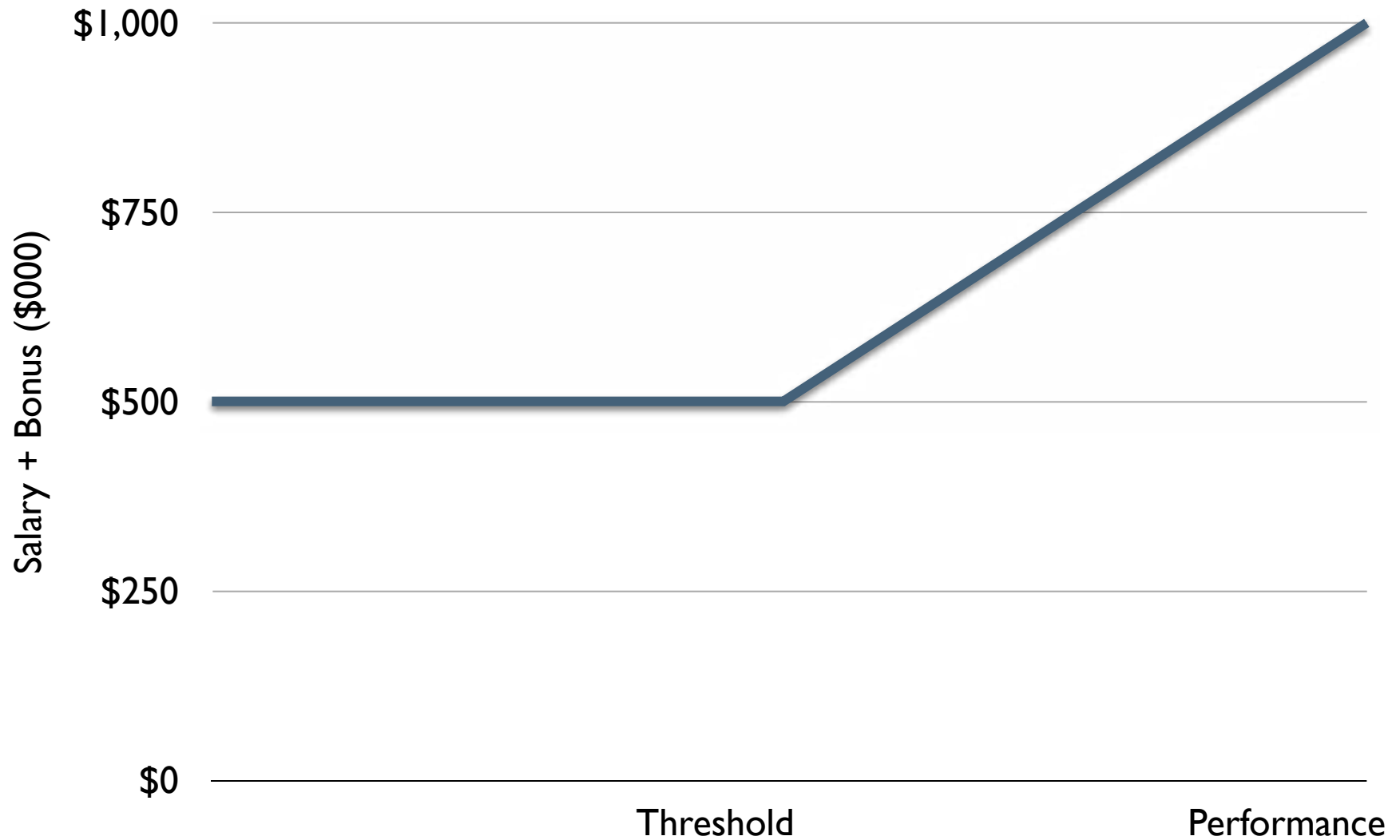
Structure not limited to top executives

Does this culture lead to excessive risk taking?

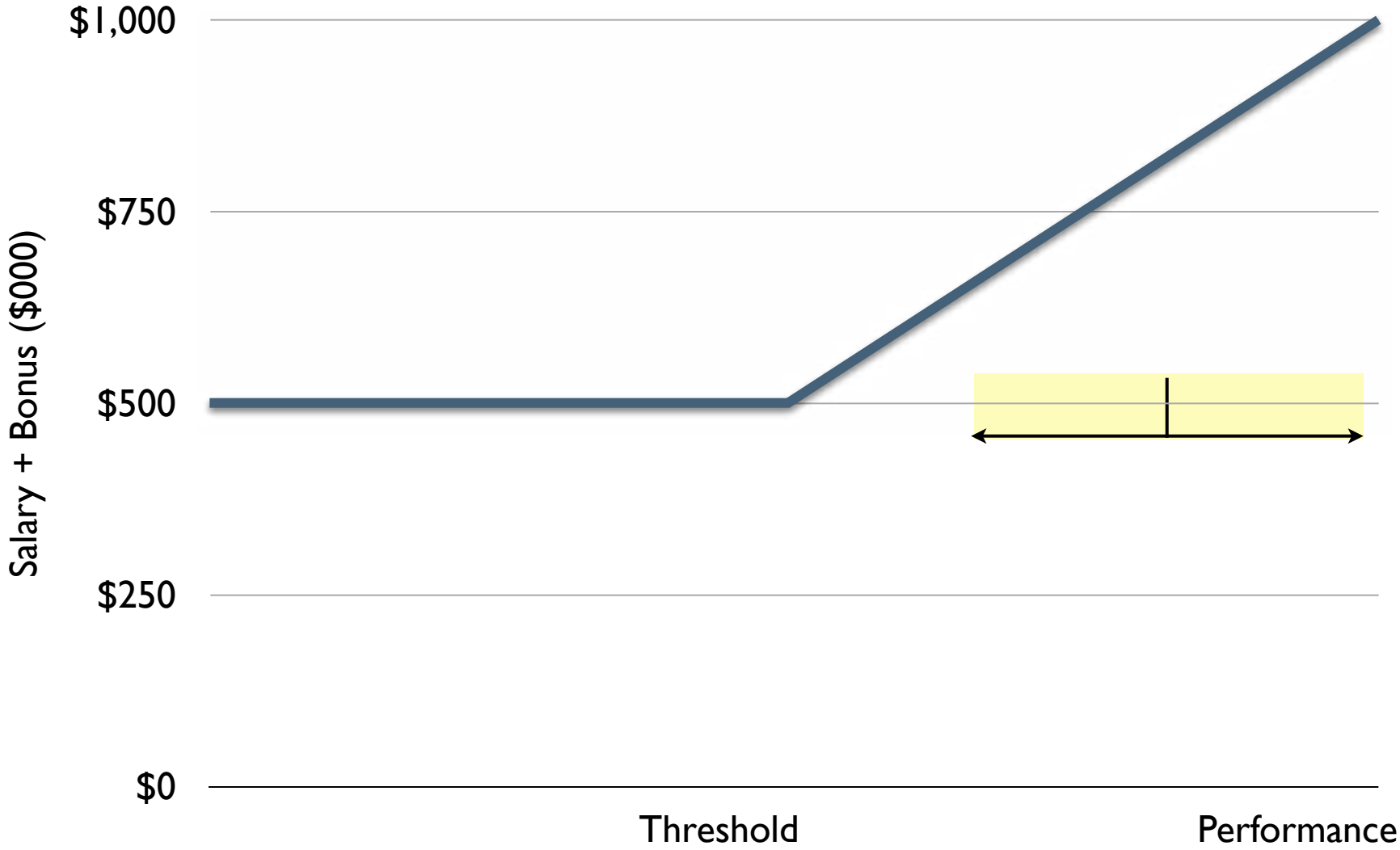
How can we distinguish “excessive risk” from the normal risks inherent in any successful business venture?

How can pay lead to risk taking?

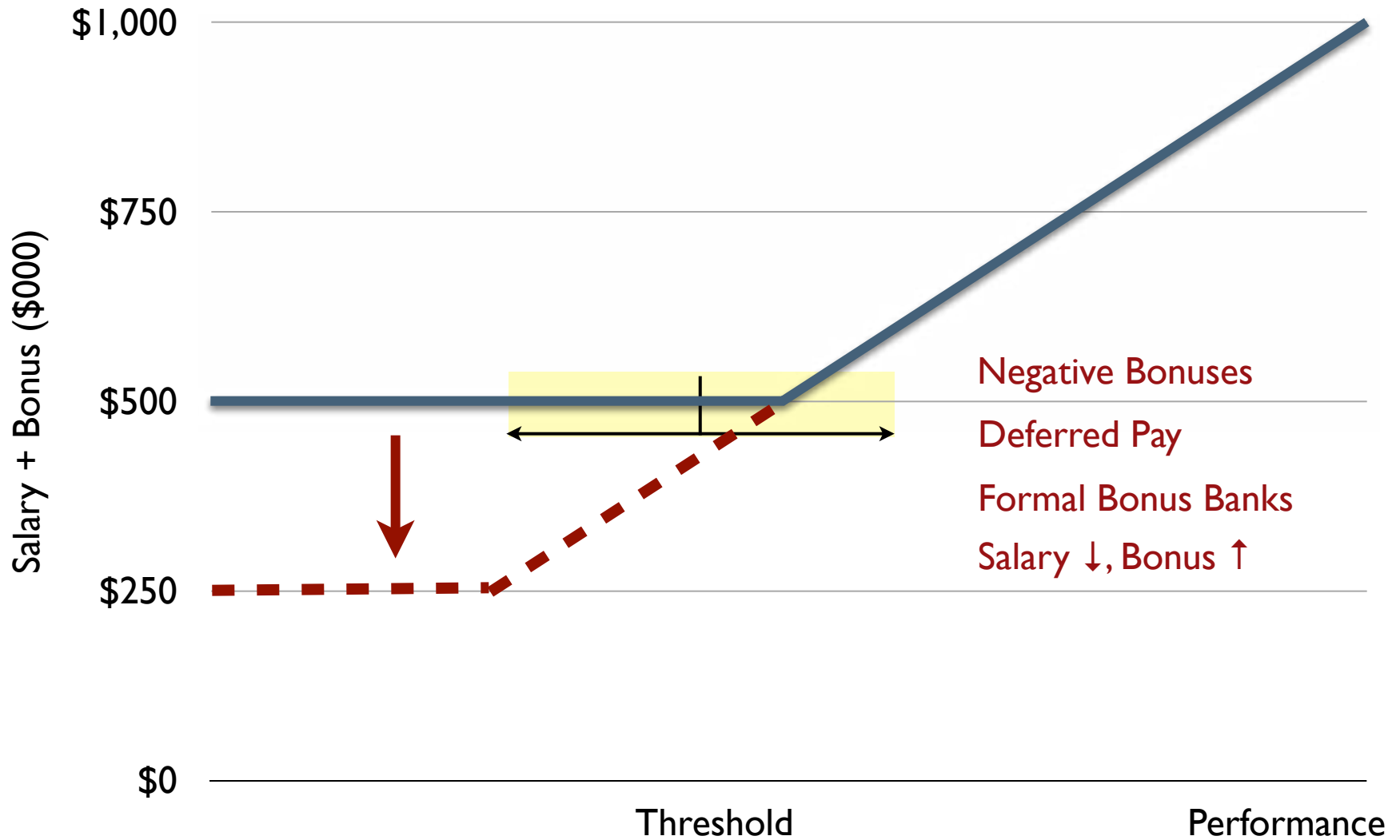
Pay and Risk Taking



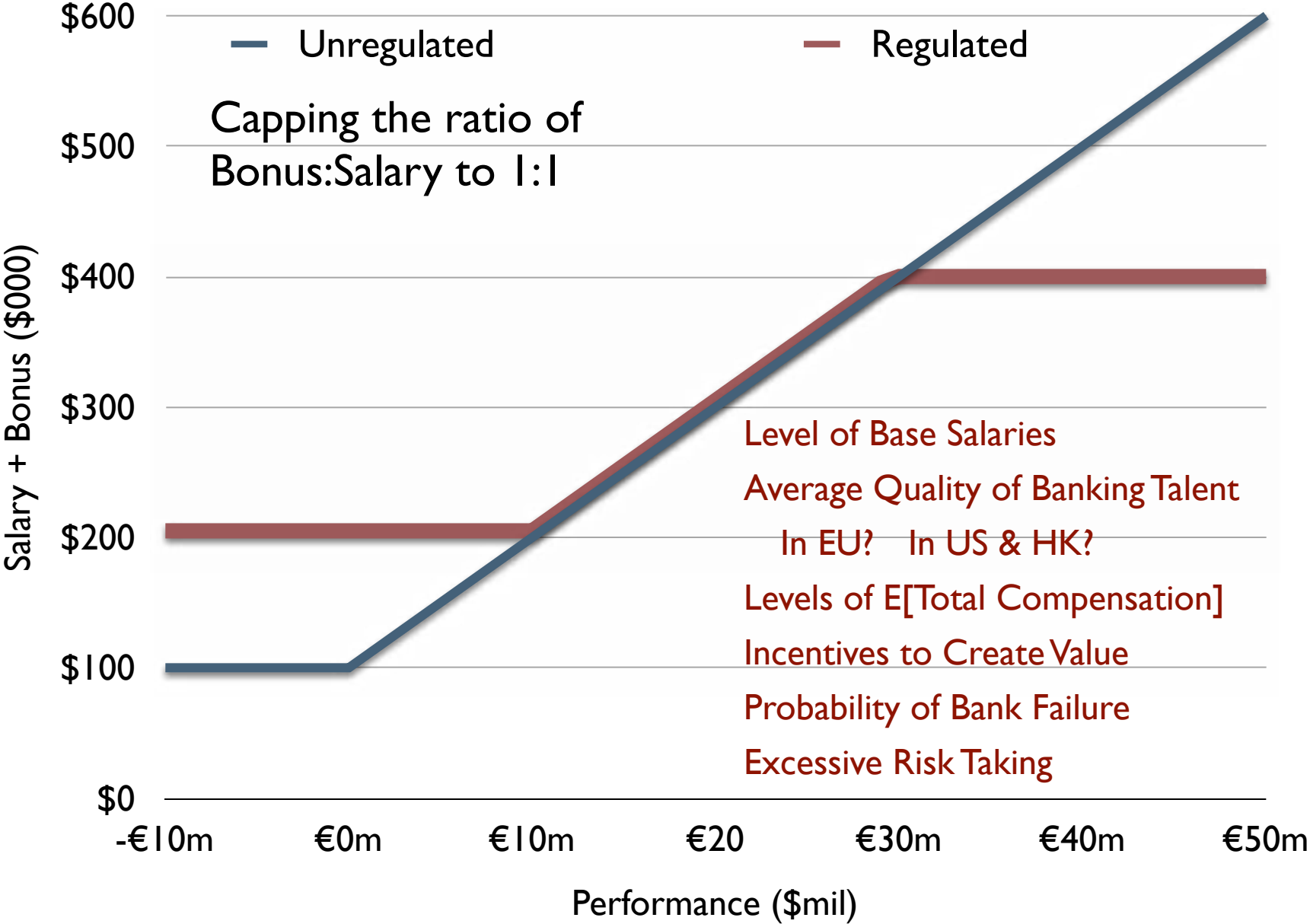
Pay and Risk Taking



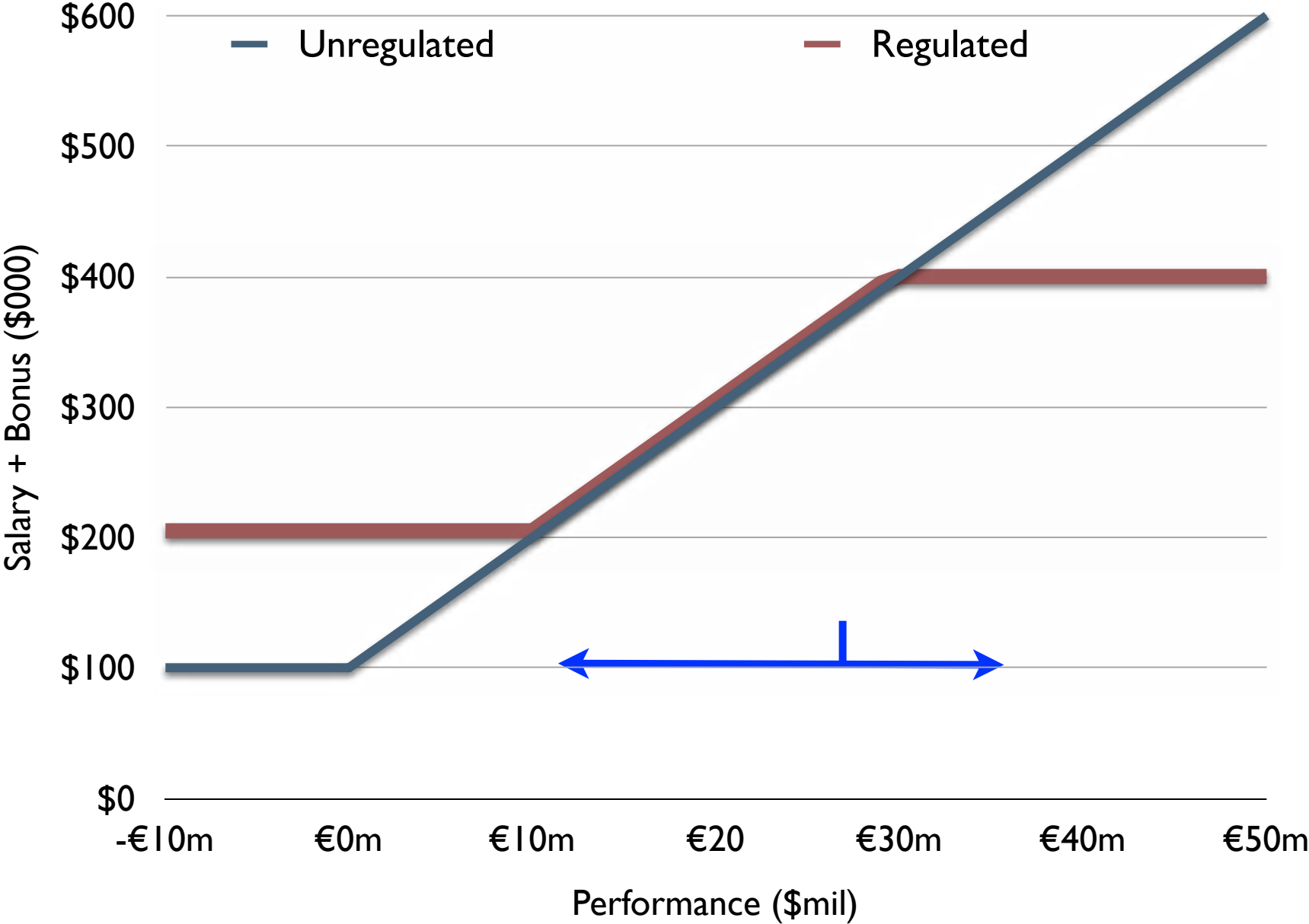
Reducing Convexities



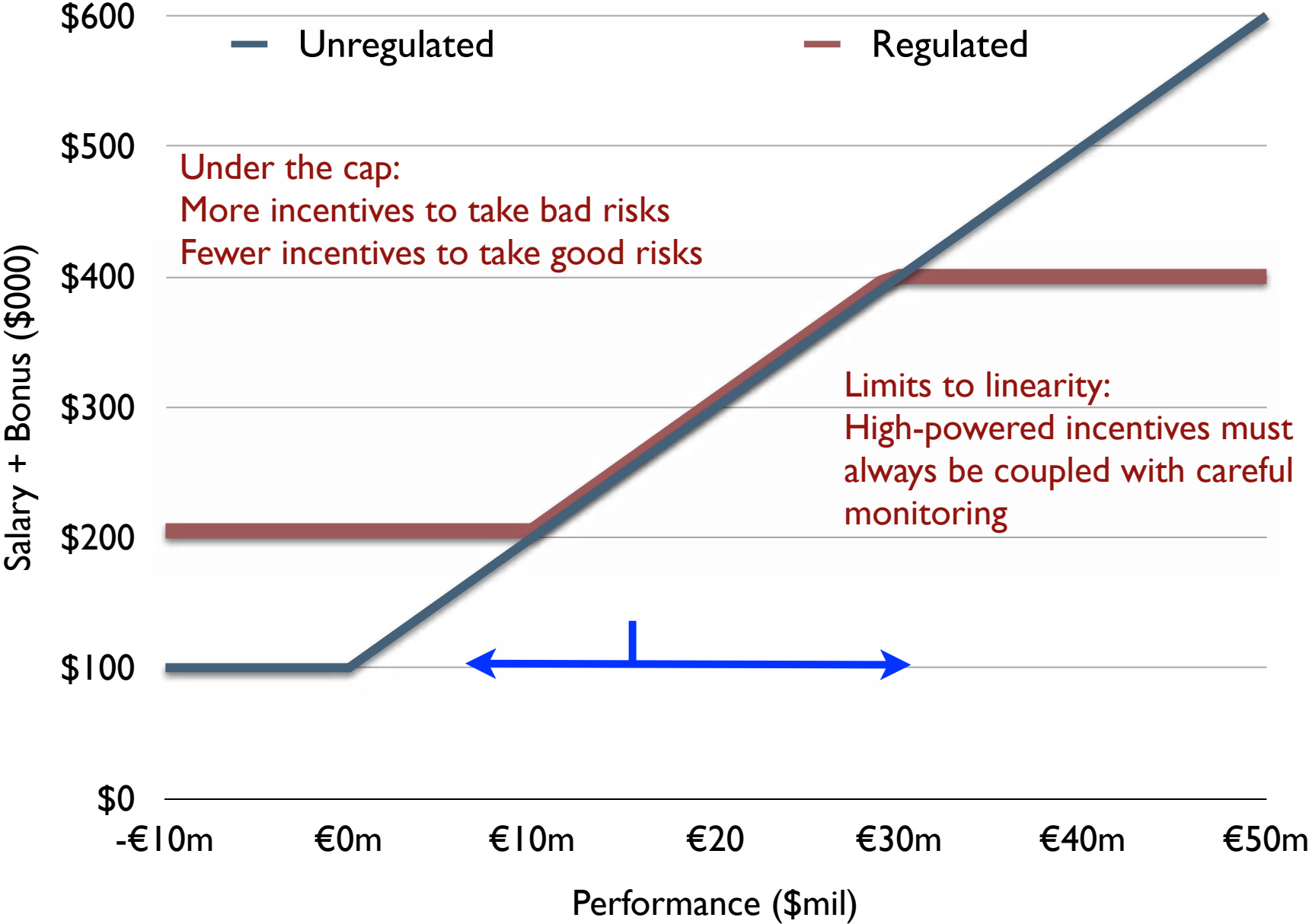
EU Banking Bonuses



EU Banking Bonuses



EU Banking Bonuses



Assessment

The attack on banking bonuses has occurred:

- without a definition of excessive risk taking (or how we might distinguish “excessive” from “normal risk)
- without any evidence that compensation structures materially contributed to the financial or Euro crisis

Alternative Hypothesis

- Regulations on banking bonuses are an opportunistic attempt by politicians to punish an unpopular sector with unusually high levels of compensation
- The regulations do little, or nothing, to mitigate “excessive risk taking” and will destroy value
- Best viewed as part of the ongoing (and value-destroying) general attack on wealth

If you see something, do something!