PERVERSE COMPENSATION INCENTIVES: ROOT CAUSE OF FINANCIAL CRISIS

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ABSTRACT

The law and public policy of corporation law and securities regulations has generally failed to effectively address the risk-taking incentives that arguably contributed greatly to the financial crisis of 2008. A wide range of laws have generally been considered reasonable candidates to address the matching of business risk with the interests of various constituencies: security-holders, employees, customers, surrounding communities and society. For example, laws have addressed: (1) the tax implications (e.g., deductibility) of risk-taking, (2) disclosure of derivative securities risk (e.g., stock options), (3) the participation of shareholders in setting corporate goals that match the firm's "risk appetite" through proxy disclosure and access to corporate democracy, and (4) the structure of intra-corporate "checks and balances" that are ostensibly needed to adequately manage financial and investment risk. Furthermore, various private relationships, most affected through contract, are also available as mechanisms to identify, evaluate and manage the risks of financial transactions. For example, these have included: (1) compensation committees of corporate boards, generally composed of independent directors, ostensibly provide watchdog monitoring and approval of compensation schemes not directly related to minimize corporate solvency risks, (2) independent assessment mechanisms, deployed to oversee unsystematic risk, including such entities as financial auditors serving in attest roles and ratings agencies that evaluate default risk, and (3) stock resale restrictions that allegedly align the interests of security-holders with the longer-term interests of employees compensated with stock.

In home mortgage business the impact of perverse compensation is most obvious and most harmful to all involved and to the entire mortgage business except those benefit from the compensation schemes. In generating a mortgage loan and reselling it several intermediaries almost all are compensated through commissions which are only paid if the deal goes through. Lets start with generating of the mortgage loan. There is buyer and seller and their realtors. Both realtors are paid commissions if the purchase is completed. The completion of the sale is contingent upon the buyer obtaining the necessary financing. Financing process introduces the mortgage banker which is compensated. Then this loan is bundled and resold in the secondary mortgage market so that the funds can be used to make the next loan and generate more commissions.

Buyers of the mortgage bundles in the secondary market which are investors or financial institutions have little knowledge of the original transaction and the quality of the collaterals for the mortgage bundles. The buyers of the mortgages also do not know the ability of the home buyers to be able to make payments. The risk of these mortgages is now being passed on to the financial institutions and the investors which are very much removed from the original home buying action which generated the collateral. In order to make the risk more acceptable to the buyers of the mortgage bundles a new risk taker for a fee enters into the transaction (an insurance company) to provide guarantees in case of nonpayment. Now the insurance company takes on some of the risk and gets paid for it.

Considering the compensation so far - the buyer's realtor gets paid if the buyers obtains financing and closes the purchase. The seller's listing agent get paid. The mortgage originating banker gets paid commission. The mortgage banks sells the mortgage as part of a bundle and gets paid the markup. Insurance company providing guarantees gets paid and the secondary markets participants buy and sell these instruments and make or loose money in the transactions from this point on.

All the participants' compensations are dependent upon selling as many houses, generation as many mortgage papers and closing as many deals as they can in order to get paid more and more. If the buyers can not make the payments in the future, the people that started the process and generated the paperwork are out of the picture and do not share in the risk taking. Buyer's realtor is paid. Seller's realtor is paid, mortgage banker is paid and since they sold the mortgage with no recourse mortgage banker is paid without taking on any risk. Risk is taken by the final holder of the mortgage bundle and the insurance firm providing the guarantees. It is quite like a legal ponzi scheme involving substantial risk shifting and moral hazard. In our recent experience part of the consequences of this risk shifting ended up costing the taxpayers which had nothing to do with the process.

This paper reviews the failure of these regulatory and contracting mechanisms to align the interests of financial firms and that formed a core of the failed financial firms requiring public financial assistance (e.g., TARP funds) with the compensation incentives these firms gave to their top management, financial engineers and investment managers. In nearly every case examined, firm-specific financial risks created by several key actors, including commercial and investment banks, mortgage lenders and private equity firms, accumulated to create a large scale systemic risk that was largely shifted to security-holders and ultimately was born by the world economy as a whole. Furthermore, this article argues that several key regulatory and contracting mechanisms were circumvented or distorted, any one or combination of which could have prevented the catastrophic losses, business failures and loss of aggregate asset values that underlay the financial crisis of 2008. For example, the financial regulatory bodies, such as the Securities and Exchange Commission (SEC), the Commodity Futures Regulatory Commission (CFTC), various federal banking regulators (FRB, Comptroller, FDIC) and NGO standards setting bodies (FASB) either had limited authority to regulate the most widely deployed derivatives (e.g., credit default swaps), interpreted their missions to assure laissez-faire environments so to incentivize creative financial engineering, or failed to understand the complex systemic risks presented by non-traditional trading strategies and innovative derivative instruments. As the 2008 financial crisis is more rigorously studied and better understood, there are emerging many proposed public policy prescriptions to remedy the financial crisis of 2008. This paper argues that perverse compensation incentives are the root cause of the crisis. As public policy reforms are proposed and debated, the findings of this research will aid in assessing these proposals (e.g., bank pay czar, compensation limits, proxy rule changes, tax modifications, regulatory reviews, trading strategy approvals) and will therefore contribute to the reform debate.