Note 5

Kevin Murphy: Compensation Structures and Systemic Risk

- In this short paper, Kevin Murphy, a highly reputable expert on compensation pay, provides some powerful evidence against the claim that common compensation structures led to excessive risk-taking behaviour, and that the schemes were not successful in limiting risk taking.
- The first point in the paper is that despite all the recent political controversies there is ``limited evidence that compensation structures have, in fact, been responsible for excessive risk taking in the financial services industry.'' Indeed, as Murphy rightly points out, the [political] "pressures have emerged even without a definition of "**excessive risk taking**" or how we might distinguish excessive risk from normal risk inherent in all successful business ventures." (p.1) – *This last point is highly important. Without a precise definition of "excessive" or "imprudent" risk taking any claim that compensation schemes were responsible to excessive risk taking, and thus the crisis would be shaky.*
- A second point made in the paper relates to the differences in compensation schemes in financial services and other sectors (e.g. manufacturing sectors). Here is how Murphy puts it: "The primary way that ... [common compensation] structures might encourage excessive risk taking is through asymmetric rewards and penalties; that is, high rewards for superior performance but no real penalties for failure. Financial services firms provide significant penalties for failure in their cash bonus plans by keeping salaries below competitive market levels, so that earning a zero bonus present a penalty. ... But, the facts are that salaries in financial service firms represent a small portion of total compensation and the "bonuses" are not on top of normal salaries, but are rather a fundamental part of competitive compensation. Take away the bonuses, and the banks will have to raise salaries or find other ways to pay, or they will lose their top talent." (p. 2) – *So, contrary to common belief (recall Blinder's short paper), Murphy argues, compensation schemes in financial services are so designed to punish CEOs for their failure. He supports this by looking at the data on banks which received US government help. See Table 1 and 2 in the paper. ...*
- Murphy concludes: "Given the penalties for poor performance inherent in both cash and equity incentive plans, there is nothing inherent in the current structure of compensation in financial services firms that lead to obvious incentives to take excessive risks. To the extent that the firms, indeed, took such risks, we need to look beyond the compensation structure to explain it." (p.6)
- Murphy, thus, points to some other explanations for likely excessive risk taking behaviour, including: "Another way that compensation can lead to risk taking is through inappropriate performance measures. For example, consider mortgage brokers paid for writing loans rather than writing loans that borrowers will actually pay back. In the years leading up to its dramatic collapse and acquisition by JPMorgan Chase at re-sale prices, Washington Mutual rewarded its brokers for writing loans with little or no verification of the borrowers' assets or income, and paid

especially high commissions for selling more-profitable adjustable-rate mortgages. In the end, WaMu got what it paid for, and similar scenarios were being played out at Countrywide Finance, Wachovia, and scores of smaller lenders who collectively were not overly concerned about default risk as long as home prices kept increasing and as long as the lenders could keep packaging and selling their loans to Wall Street. But home prices could not continue to increase when prices were being artificially bid up by borrowers who could not realistically qualify for or repay their loans." (p. 6)