Executive pay reform unlikely to reduce systemic risk in economy

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Reforms aimed at curbing executive compensation will likely have little effect on reducing systemic risk in the financial system, and they may even have unintended consequences for the freedom to contract, according to a University of Illinois expert in business law and corporate finance.

In a paper published in the *Ohio State Entrepreneurial Business Law Journal*, law professor Christine Hurt argues that giving regulators unprecedented power to prohibit certain types of private compensation under the guise of minimizing systemic risk in the financial system is an unwise move that could ultimately undermine the freedom of contracts.

"Since the financial crisis, both states and the federal government have tried to go in and rewrite existing contracts or put limits on what people can contract for in various areas," said Hurt, a co-director of the Program in Business Law and Policy at Illinois. "We do all sorts of things because we are confident in contracts as enforceable legal documents. Why? Because we believe in contract law, and that courts will uphold contracts. But if it gets to the point where courts can go in and change contracts – well, contracts won't be worth the proverbial paper they're printed on. Ultimately, that could have an impact on everyone whose contractual compensation suddenly seems undeserving, from the executive level to public employees and retirees."

Whether it's executive compensation or public union contracts, just because one side of the contract is disadvantageous to one party doesn't

mean courts or legislators should be able to rewrite it, Hurt says.

"Generally, legislators have had little appetite for interference with private contracting," she said. "But in the wake of the housing crisis, it now seems that various government actors do have some interest, provided the benefits of the new contract favor a sympathetic party. Executive compensation reform would be a good example of an easy target of such contract reform, since people love to turn their scorn to the highly paid."

Although executive compensation has become a lightning rod for legislation, it's actually, in the grand scheme of things, "a very small amount of dollars," Hurt said.

"In the aftermath of the financial crisis, we think that all of these financial firms took on way too much risk and that their actions threatened our economy. But instead of trying to figure out what went wrong, and what prompted them to take on so much risk, legislators have naturally gravitated to executive compensation, which the general public has always thought was way too high. So now we have this new argument for capping executive compensation."

According to Hurt's paper, no theoretical or empirical link exists between how much executives are paid and how much systemic risk their firms cause.

"If you think of AIG and Lehman Brothers, and all the really bad positions they had in mortgage-backed securities, the people who made those trades weren't executives," said Hurt, the Guy Raymond Jones Faculty Scholar at Illinois. "The people who approved those trades weren't executives. So if there is behavior that leads to systemic risk, it's firm-wide by employees – employees who executive compensation reforms are never going to touch.

According to Hurt, if a financial behemoth such as Lehman Brothers was unable to foresee that its compensation program was going to lead to devastating loss, then it's hard to believe that regulators would be able to have better predictive powers than those with the incentive to stop it.

"A decade or two ago, there was a push for incentive-based compensation because we thought if executive pay was tied to a firm's performance, that would ensure we're paying for performance," she said. "So instead of just paying an executive $10 million, we paid them $1 million plus stock options. And that has led to all sorts of creative chaos. Not only are executives allowed to hedge away the downside risks of their stock options, but it also incentivizes them to take risks so the stock price goes up."

Hurt says it's hard to see how Congress comes up with a better solution.

"The last time that we had this debate, the legislature comes up with pay-for-performance," she said. "Well, pay-for-performance may have caused the financial crisis. Critics have been pointing to a lot these firms that we blame for causing the financial crisis – Fannie Mae, Freddie Mac, AIG, Lehman Brothers, Goldman Sachs – and saying, 'See, all of their executive are very well-compensated. Therefore, it must be the money that led these firms into ruin.' Well, these were very large firms, and if they weren't large firms they wouldn't have had an impact on the economy.

"Generally speaking, people at large firms make a lot of money. But there's no logic to saying if they had made a little bit less money, then the financial crisis could have been avoided."

More information: The paper, "Regulating Compensation," is available online.

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