

The Incentive Problem

Why the stir over executive incentive pay is misplaced

By Stephen F. O'Byrne and S. David Young

Many congressmen believe that “perverse incentives” encouraged top managers to take excessive risks and contributed to the financial crisis. They also believe that more regulation of executive compensation should be a key part of any government bailout effort. There is an incentive problem behind the financial crisis, but it's not a top management incentive problem and it won't be mitigated by additional regulation of pay.

An entrepreneur who owns 100 percent of his company has a strong incentive to increase shareholder value, but little incentive to take excessive risks. If he takes too much risk and things go badly, he will be wiped out. It's easy to think that a CEO who owns 5 percent or less of his business has a different incentive. It would seem to make sense for him to bet heavily because 95 percent of the losses fall on public shareholders. But that's the wrong analysis. What matters is what happens to the CEO's wealth. If a bad risk reduces shareholder and CEO wealth by 90 percent, the CEO has no incentive to take that risk.

The best measure of the CEO's incentive to increase shareholder wealth is the ratio of percent change in the CEO's wealth (stock and management option holdings plus the present value of future pay) to changes in shareholder wealth, what is

called “wealth leverage.”

At the end of 2006—when there was still time to take corrective action—Bear Stearns CEO Jimmy Cayne had wealth leverage of 1.0 and Lehman CEO Richard Fuld had wealth leverage of 0.8—higher than the average CEO at 0.65. They were surely aware that reckless decisions would have grave consequences for their own wealth. Cayne had \$900 million in stock and \$70 million in option holdings to lose, while Fuld had \$370 million in stock and \$100 million in option holdings to lose.

Some might think that Cayne and Fuld would have had more concern for the corporate good if they didn't have their huge stock and option holdings. But that ignores the dynamics of executive pay. Without stock and option holdings, a manager's incentive comes from current pay and changes in expected future pay. Current and future pay is very sensitive to company revenue size. For S&P 1500 companies in the finance sector, a doubling in revenue increases top management pay by about 35 percent. That means a manager without stock and option holdings has a strong incentive to pursue short-term revenue growth without regard to shareholder value. This effect is the exact opposite of what Congress is concerned about.

An incentive to pursue revenue

growth without adequate concern for shareholder value is the incentive problem behind the financial crisis, but it was a business unit and trading desk problem. Legislators should read the “Shareholder Report on UBS's Write-Downs” that summarizes the findings of the Swiss bank's investigation into “the principal root causes” leading to its subprime losses. The report concluded that the investment banking division, where the bulk of the subprime losses occurred, “was focused on the maximization of revenue...bonuses were measured against gross revenue after personnel costs, with no formal account taken of the quality or sustainability of those earnings.”

Top management failed in many ways. It tolerated an inadequate risk-management system that relied heavily on bond ratings, and it relied on stock compensation to give business-unit employees an interest in sustainable value. Holding stock in the total corporation is a much weaker incentive for sustainable value than deferred compensation tied to the value of the employee's business unit.

There are plenty of lessons to be learned from the financial crisis about executive compensation, but they are largely lessons about business-unit compensation. Regulation that reduces the CEO's incentive to increase shareholder value is unlikely to help.



Stephen F. O'Byrne (top) is president of Shareholder Value Advisors.

S. David Young is professor of accounting and control at INSEAD.

A copy of the “Shareholder Report on UBS's Write-downs” is available at www.directorship.com/ubs-report.