Money makes the WORLD go round

Professor JONATHAN WILLIAMS explores the web of incentives created by executive remuneration contracts which goes some way to explain the risk-taking behaviour of bank executives in the past.

It seems the issue of bankers' pay is never far from the front pages these days. It is five years since the greatest banking crisis since the 1930s hit the global economy and, in the UK, political debate remains centred on the extent of the economic recovery and what should be done to the banks that many blame for causing the crisis.

While company executives have been paid significantly more since the mid-1990s, the pay of bank executives grew even faster to produce a widening differential between what Americans would term Main Street and Wall Street. What's more, the structure of executive remuneration changed. Executive pay comprises salary, bonus, and equity-based components. Over time, the fixed component of pay, salary, has fallen as a proportion of total compensation because banks increasingly have used variable pay components to reward executives. Indeed, bonus payments to CEOs and executive directors of UK banks more than doubled between 2003 and 2006. Although it could be argued that it is rational for shareholders to tie variable rates of executive pay to bank performance, many commentators are acknowledging the role of compensation contracts in creating a set of inappropriate incentives that induced excessive risk-taking behaviour and contributing to the development of the crisis. Put simply, contracts tied executive remuneration to short-term bank performance, enhanced by excessive risk-taking, rather than aligning executives' interests with long-term bank performance.

Adam Smith once famously remarked that employee managers expend less effort in running a firm compared to owner managers.

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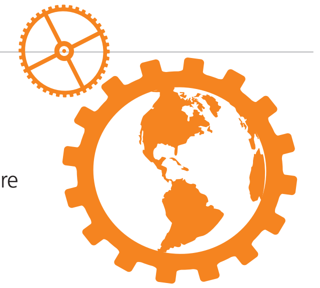
Essentially, Smith was describing the classic agency problem which results from the separation of ownership and control. Agents (executives) can expropriate principals (shareholders) by using their abilities to secure private benefits or to pursue their own objectives as opposed to maximising the value of a company. Referring to "own objectives", it is relatively straightforward to envisage empire building, shirking behaviour, acceptance of perks, taking too little or too much risk in order to enhance control, or simply making poor production and investment decisions as "agency goods". Consuming agency goods is a primary source of bank inefficiency.

Theoretically speaking, "optimal contracting" is the dominant view for setting pay. A compensation contract is "optimal" if it maximises shareholder value or minimises agency costs. Controlling agency costs demands effective monitoring by principals. Under optimal conditions, greater monitoring by principals increases the effort expended by agents who demand higher remuneration in return. An alternative view, the managerial power perspective, claims executives are more powerful than shareholders and influence the setting of their pay. Whereas exercise of managerial power might realise improvements in bank performance, if executives do not consider compensation to be sufficient then performance could worsen. Corporate boards include independent or non-executive directors who could counsel against excessive pay but does not account for the possibility of pre-existing networked relationships between executives and non-executives, which could extend to dictating nominations to compensation committees or exerting influence through interlocking boards. However, the ability of executives to affect compensation is offset when institutional shareholders hold large ownership claims.

At the core of the agency model of executive compensation is the idea that shareholders design contracts to incentivise executives to maximise company value. This assumption might not hold. Shareholders could opt to maximise their own wealth and compensation contracts could instead incentivise executives to take more risk. Consequently, the incentive structure could inadvertently and adversely affect default risk, market efficiency and efforts to improve corporate governance. Why would shareholders carry more risk than executives? The answer is because shareholders more probably hold a diversified portfolio of investments whereas executives are risk-averse since they cannot diversify employment risk.

The classic agency problem contends that executives can make decisions which serve to increase their entrenchment, making it difficult for shareholders to replace them. Entrenched executives typically demand more substantial compensation. Entrenchment lets executives dictate corporate strategy according to their skill-sets, which could lead to poor decision-making and worsening performance. Whereas compensation contracts try to remedy the weak incentives problem by increasing (decreasing) the proportion of variable (fixed) income components, higher variable pay is associated with a greater willingness for risk-taking.

The "empire building" hypothesis suggests entrenched executives enhance control and power through expansion and diversification at the expense of company value. Empire building produces a sub-optimal outcome when a lack of effective monitoring by shareholders lets executives pursue self-interest. What's more, compensation contracts can perversely encourage executives to consume agency goods. Executives could implement a growth strategy to earn higher compensation for running a bigger bank because executives gain through equity-linked pay. Other important incentives pertain to prestige, power and business reputation. Formerly, executive perquisites or perks were considered (almost) purely as a vehicle for executives to misappropriate company resources. Nevertheless, banks wishing to retain existing executives and hire new talent seem willing to assume higher agency costs in the form of perks. Of course, perks may enable executives to perform their roles more effectively, which infers perks do not always signal managerial excess and could enhance productivity and performance.



As shareholders gain awareness of relative bank performance, they will try to influence the decision-making of bank executives – particularly when performance is poor – by re-exerting their preferences and objectives by revising executives' compensation contracts. This view reflects the fact that banks now set executive compensation based on concerns other than simply maximising shareholder value. Increasingly, banking firms and regulators are interested in setting executive compensation contracts which better incentivise executives to make decisions more consistent with long-term bank performance including market share, sales growth, profit gains and improvements in operational efficiency.

Without question, the structure and size of executive compensation are vital factors in determining executive behaviour and decision-making.