

Behind the crisis: "The days of big bonuses are over"

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What is behind the global financial crisis? Bad corporate governance, bad incentives, and stock options that led to excessive risk-taking.

Behind the crisis: "The days of big bonuses are over". Incentives are the cornerstone of corporate life, especially when it comes to recruiting executives. However, the corporate governance practices that firms such as Lehman Brothers, Bear Stearns and Goldman Sachs once boasted about are now being called into question - and stoking a huge public backlash.

In the paper "[Current Global Financial Crisis: An Incentive Problem](#)," IESE Prof. Pascual Berrone says the writing is on the wall. It would appear that the corporate incentive schemes designed to boost the performance of managers for the benefit of the company have, in fact, become at best a hindrance and at worst a serious liability to the company.

The paradox of rewarding failure

The dominant system of incentives originates from agency theory, which was popularized in the '70s. Agency theory assumes that "principals" (shareholders), whose primary objective is to maximize the firm's value, delegate tasks to "agents" (managers) whose interests are more self-centered. Based on this logic, contracts were designed to mitigate the opportunism of each agent, between those who hold the property and those who exercise control over it.

Therefore, for managers, outcome-based compensation tools were established, usually focused on issues of pay or prestige. A series of "best practices" emerged based upon

performance, such as offering stock options or bonuses through shares. These measures have become commonplace to the point that they are often applied just because everybody else is doing it.

Yet consider stock options, for example. Executives reap the benefits when the value of the company increases in the markets; however, if the value falls, their wealth does not decrease. This gives rise to a strange paradox: The agent, traditionally considered reluctant towards effort and risk, reacts in these circumstances by risking too much, since he has nothing to lose. According to Berrone, this is probably the main reason why top managers dared to make uncertain investments such as those in mortgage securities.

The same paradox occurs in contract cancellation clauses - the so-called "golden parachutes" - which provide certain benefits for the executive (in capital or shares) in the event that the relationship is terminated (for acquisition, bankruptcy or end of contract). These parachutes are usually justified in the sense that they protect top management from risks that are beyond their control and allow them to concentrate on maximizing benefits for shareholders. But these guaranteed exit packages are sometimes so high that they just seem to encourage failure. Again, do golden parachutes not reward managers in the event of bankruptcy?

Heed the lessons

Berrone emphasizes two important lessons that we should draw from the damage that a wrong system of incentives has wrought.

First, we really know very little about risks. Establishing remuneration strategies that encourage executives to take risks without assessing the consequences is lethal for the long-term survival of companies. Moreover, the existing tools for managing risks do not fully capture the characteristics of risk and uncertainty. Therefore, Berrone proposes a revision of these at the very least. Above all, given the intertwined nature of the modern financial system - where if one entity fails, they all fail - we must find ways to reduce this volatility and avoid future chaos, which might mean elimination of some of these tools.

Second, companies need to heed the angry reaction that these practices have stoked among public opinion and political leaders. Racking up \$440,000 in luxury spa expenses, as AIG executives did, less than a week after the federal government offered an \$85 billion bailout package does not endear sympathy. It's opportunistic, fraudulent and unbridled greed, says Berrone. The international outcry sparked by irresponsible corporate actions makes it impossible to postpone any longer the examination of the current incentive system. As U.K.

Prime Minister Gordon Brown pronounced, "The days of big bonuses are over."

Berrone admits that there is no easy solution to a very inexact science like the design of compensation, as it is so tied to the method of trial and error. However, in light of the deficiencies in the prevailing model, he encourages professionals and academics to join forces in giving it a thorough rethink.

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