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January 12, 2010

Wall Street's Rigged Bonuses

Paying executives in stock, a likely proposed remedy at today's hearings on the financial meltdown, is just another way for Wall Street to fix the results.

The show begins today, folks. The Financial Crisis Inquiry Commission begins its hearings, calling the leaders of Goldman Sachs, JPMorgan Chase, Morgan Stanley, and Bank of America on the congressional carpet.

Unfortunately, it's the latest act in an American tragedy—and by now everyone knows the parts they are to play. The bipartisan panel will chide and scold the naughty bankers. The naughty bankers will take their knocks, while explaining why they needed to do what they did, and why it wasn't so bad after all.

Then, after the public flogging ends, the bankers will go home to Wall Street, cash their bonus checks, and set about creating the next big financial crisis. Nothing will change and that is the real tragedy here. The commission is to investigate the causes of the financial meltdown of 2008-2009 and, while it will undoubtedly recommend changes specific to the mortgage crisis that precipitated the big crash, the real cause of the crisis won't even be discussed, let alone resolved.

I predict that the commission will attempt to change behavior without changing the incentives behind that behavior and, in turn, without changing the theory behind the incentives. Trying to get the bankers to change their actions is not unlike admonishing college frat boys to stop trying to bed as many co-eds as possible. For the frat boys, sex is the whole the point. They have a theory about life that goes something like this: The more sex, the better. So badgering them to have less sex is unlikely to have much effect—other than convincing them you are utterly clueless about the things that matter in life. As long as the theory underlying their behavior remains unchanged, so will their behavior. Frat boys will be frat boys. For our frat boys, the incentive is sex. For the bankers, it's money.
Bank executives, like most other corporate execs, are compensated through salary, bonuses, and stock. Of these, salary typically makes up a small percentage. The bulk of

an executive's compensation is tied to the performance of his or her company's stock. Consider Citigroup CEO Vikram Pandit. In 2008, his base salary was $958,333, a mere trifle compared to the value of the stock he received—some $28.8 million, per The New York Times. Kenneth Lewis, the embattled head of Bank of America, received $1.5 million in salary in 2008 but over the years he has amassed more than $47 million in BofA stock.

The idea behind granting executives large amounts of company stock makes sense on the face of it—it is supposed to align the interests of the executives with the interests of their shareholders, to keep the executives from raiding the corporate piggy bank at the expense of their investors. Unfortunately, using stock price as a proxy for company performance is a bankrupt idea. Instead of compensating executives based on the performance of their companies in a real market—real sales, real profits, real returns on investment—we compensate them based on stock performance in an expectations market—a stock market in which prices go up and down based on investors' expectations about how a company will perform in the future.

Compensating an executive for increasing stock price rather than for increasing company profits is like compensating an NFL quarterback for beating the point spread rather than for beating opponents.

In the NFL, the real game is the one played on the field, where one team wins in the end. But in the expectations market—based in Las Vegas rather than on Wall Street—individuals bet based on a point spread rather than an absolute outcome. This Saturday, the Indianapolis Colts are playing the Baltimore Ravens. The point spread favors Indianapolis to win by 6.5 points. If you bet on Baltimore, you are betting that the Ravens will either win the game or, importantly, lose by 6 or fewer points.

So what if players were rewarded based on whether they beat the spread rather than whether they win the game? Well, the Oakland Raiders beat the spread eight times this year, while winning five games. The Indianapolis Colts beat the spread 10 times, while winning 14 games. If compensation were based on performance in the expectations market, we should pay Indianapolis quarterback Peyton Manning and Oakland's revolving door of quarterbacks about the same. But we don't, because one team team, and one quarterback, is much more successful. In football, it's the real game that matters.

Focusing on the real game is a smart approach, because the expectations market can create a pernicious trap. Imagine a football team wins every game it plays. With each successive win, expectations grow. The point spread for upcoming games begins to reflect those raised expectations, making it harder and harder for the team to exceed expectations. In 2007, the New England Patriots won every single regular-season game. By late in the season, the betting line for a game between the Patriots and the New York Jets reached a record 24.5 points. The Pats won the game, 20-10, but didn't beat the spread. No team, no matter how good, can beat the spread every game if expectations keep going up.
Yet shareholders demand that executives continue to beat the spread. So no wonder executives turn to hyping their own stock, shady accounting, and ill-advised short-term

strategies—like issuing and securitizing massive quantities of subprime mortgages—to keep expectations high. They know in their hearts that they can't keep it up, but they keep circling until the music stops. This is the behavior that creates market bubbles and their subsequent crashes. And until the theory behind it—tying executive compensation to stock performance—is demolished, the behavior will continue unabated. The next crash won't be tied to subprime mortgages or Internet stocks, but it will come all the same, despite Washington's finest theatrics.

Roger Martin is dean at the Rotman School of Management at the University of Toronto. He writes extensively on corporate strategy, executive compensation and governance, business design and integrative thinking. His most recent book is The Design of Business: Why Design Thinking is the Next Competitive Advantage *(Harvard Business Press, 2009). Read more on his Web site at* www.rogerlmartin.com.