How do we deal with rewards for failure while supporting growth?
Transcript

Date: Tuesday, 29 November 2011 - 6:00PM

Location: Barnard's Inn Hall

29 November 2011

Introduction to a Lecture by Matthew Hancock

Professor Ken Costa

It is my very great pleasure tonight to be able to introduce Matthew Hancock MP.

Matthew has many achievements of which he may be justly proud. He has a degree in Politics, Philosophy and Economics from Oxford University and a masters in Economics from Cambridge. He has worked as an economist for the Bank of England and then as a senior economic adviser and Chief of Staff to George Osborne. Last year he was elected as MP for West Suffolk, following which he was elected to the Public Accounts Committee and also the Committee on Standards and Privileges that adjudicates on MPs' conduct. His is rightly tipped as a rising star of the Conservative Party.

However, possibly more important than any of these is the fact that Matthew holds the record for playing the most northerly recorded game of cricket in history, somewhere within the Arctic Circle I believe. Now, cricket is one of those Marmite sports – you either love it or hate it. Matthew is clearly in the 'love it' group, as he not only holds this record but is also joint-secretary of the Lords and Commons Cricket group. But cricket is more than just a sport. It's an idea – an idea that offers me a nice link into the topic under discussion tonight.

If there is one thing people know about cricket, whether they love it or hate it, it is the phrase, "It's just not cricket." It is a short phrase that trips off the tongue very easily, but into that short phrase is packed a myriad of ideas and assumptions that are both highly important and much needed.

As everyone knows, the phrase "It's just not cricket" is shorthand for something like "that kind of behaviour is just wrong: it's dishonourable, it's dishonest, it lacks integrity, it lacks decency." Cricket, like most sports, has many *laws* but the phrase "It's just not cricket" is not a legal one. It is a much softer, subtler, cultural phenomenon. No-one should imagine that this makes it less important. Quite the contrary, in fact: it is precisely those subtler, cultural phenomena that make the game what it is.

Well, the spot fixing scandal this year reminds us – as if we needed reminding – that cricket is not cricket any more. But, if cricket is not cricket any more, then neither is finance and that – dare I say it – is a much more serious problem.

Now, I need to be very clear here. I am not suggesting that finance was ever a spotlessly honourable profession. Nor am I suggesting that we need to return to the City of the Edwardian period, in which 'my word was my bond' was all you ever needed – largely because most people came from a tiny slice of society – Oxbridge and the great public schools.

What I *am* suggesting is that we cannot hope to run a secure, efficient, or sustainable finance sector if we fail to realise that we need *unwritten* laws of conduct – basic human values – just as much as we need written ones, in the form of regulation and legislation. We need the softer, subtler, cultural values – of honour, honesty, integrity, and decency – at least as much as we do effective legislation. We cannot possibly hope to develop a safe, growing and sustainable economy without properly understanding that humans are *moral* beings just as much as they are *financial* ones. Put another way, we are liable to repeat history unless we seek to understand human nature.

I have been working on the St Paul's Initiative to try to connect finance and ethics. There is an important dialogue to be had connecting not only those camped outside St Paul's Cathedral but also the many people working within the market economy who are as concerned by the need to connect the market economy with its underlying moral roots. People ask why we need regulation rather than trying to bring about a change of heart through individual conscience. I am reminded of Martin Luther King. He said "I admit that laws will not change hearts but they will prevent people from being heartless".

All of which this leads me to Matthew and to his important new book, *Masters of Nothing*. Because what *Masters of Nothing* argues is that economic behaviour is underpinned and shaped by human behaviour. It argues that human behaviour is not as rational and logical as we like to imagine. And it insists that unless we understand human nature and behaviour *as it really is* – and not as we like to imagine it to be – we are liable to repeat the severe financial crash of recent years again and again.

"Businesses do not act in a moral vacuum", Matthew writes in his introduction. "Whether legal or not, immoral actions within businesses should not be ignored just because there's a logo on the door." Given that my overarching theme in my role as Gresham Professor of Commerce, and indeed in other lectures I have given recently, is that we badly need to reconnect the ethical with the financial, you will not be surprised to hear that I would add a hearty 'Amen'! to that. The question, of course, is what we can do about it.

I know Matthew has some intriguing and important answers to that question and, for me, the really exciting thing about them is that they are grounded not only in the desire to understand human nature, but in the recognition that we need a realistic understand, and not one that is satisfied by the myth that we are all narrowly, rational automatons. I look forward greatly to hearing what Matthew has to say…

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How do we Deal with Rewards for Failure
While Supporting Growth?

Matthew Hancock, MP

Introduction

We meet at an uncertain time for the global economy. No-one should underestimate the scale of the crisis, or the scale of measures to combat it. Yet at this time of crisis we must come to the right, not the wrong conclusions about the world we live in, and how to address the problems we face.

I am a loyal friend of capitalism. The free flow of global capital is as powerful a force for good in the 21st Century as the invention of penicillin was in the 19th.

Anyone who doubts the power of capitalism in these dark days for Western Europe should look at the economies of India, China, Indonesia, Brazil, Vietnam and a host of rapidly developing countries, where pro-market reforms have lifted more people out of poverty, ignorance and squalor in the last two decades than any other policy in the history of the world. I am an optimist about the rise of the East. It is an unprecedented opportunity.

But just as this has been happening in the East something was going wrong in the West, in the home of the free market. We have a debt crisis of course, that must be resolved, both here and in Europe. But today I want to look deeper at something different.

One of the most fundamental principles of free market capitalism, the very basis of its moral authority over Socialism, has been ground down.

I'm talking the principle of just rewards: getting out what you put in. The idea that people should be paid according to the value of the work they do.

The debasement of just rewards has undermined the capitalist system and needs to end.

It's been called the 'something for nothing' culture, economists call it rent extraction, I call it rewards for failure.

It turns society against the source of its own prosperity.

It harms the economy.

It's ethically repugnant.

And it needs a solution.

In these difficult times that solution must come in a way that supports not undermines growth. Now is not a time for actions which stifle the creation of jobs.

The idea that Government should pick between 'predators' and 'producers' is absurd.

And state set pay ratios would produce perverse and arbitrary outcomes. Under a pay ratio system the managers of businesses which provide the most jobs would be unfairly penalised.

For example, Tesco, which employs thirteen times as many workers, would likely be hit harder than Goldman Sachs.

I want to talk about how we deal with the very real, very damaging problem of rewards for failure in a way that strengthens the UK as a place to do business.

The Politics of Envy

I think the problem of rewards for failure falls into three parts: it has a social dimension, an economic dimension and an ethical dimension and I will discuss each of these in turn. But first there's one line of argument I want to explicitly reject.

I do not think high pay is always a bad thing in itself. Those that say otherwise are indulging in the politics of envy. No society can call itself free if it imposes a threshold on what people can aspire to. And no economy can afford to be anti-wealth.

Indeed around the City there are literally thousands of small, enterprising, innovative businesses, whose success drives exports and growth, and whose failure would not threaten anyone's' money but their own and their investors'. They too are affected by ill-informed criticism of the City that does not distinguish between the entrepreneurs, and those in charge of the safe stewardship of our largest organisations.

Fortunately respect for wealth creation is deeply embedded in British culture.

Consider the many moving tributes paid by members of the public to Steve Jobs when he died. Jobs died worth an estimated $7 billion dollars, but no one resented him for it because his products have made life immeasurably easier for millions of people.

Then there's *Dragon's Den* and *The Apprentice*. Two of the most consistently popular TV programmes on the BBC. Both explicitly based on the profit motive.

But the fact that the public are supportive of genuine wealth creators is all the more reason to take their concerns about rewards for failure seriously.

Social Arguments
So, of the social, economic and ethical dimensions, let me with an argument about the social impact of rewards for failure.

The tent dwellers at St Paul's should long since have moved on. But in their incoherent complaints they are articulating more aggressively what millions of others feel instinctively whenever a story about executive pay appears in the morning papers.

Take this YouGov poll. 78% of those polled agreed that the growing gap between rich and poor was bad for our society, and 83% agreed that excessive bonuses were one of the root causes of the financial crisis because they fueled irresponsible risk-taking.

Even within the City itself support for business as usual is weak. 63% of financial services workers surveyed by the St Paul's Institute think that FTSE 100 directors are paid too much.

Adam Applegarth took over a successful building society and ended up presiding over the first run on a British bank in over 150 years. He departed with a pay-off of £760,000, £346,000 pension top up and a cut-price staff mortgage.

We can all agree that there something deeply wrong about this – the deep disconnect between the actual business outcome and the level of 'compensation' received.

And we can also agree that if executive pay disproportionately outstrips corporate performance - however you measure it - year on year, then shareholders are behaving very strangely indeed.

And this has practical political consequences. In the YouGov poll 68% were in favour of a financial transactions tax on the grounds that it would curb the culture of outrageous bonuses in the City, despite the fact that we know it would be hugely damaging and hardly anything would change if imposed here or in the EU alone.

But are the public right to perceive a problem? The statistics support them.

Pay rises are disproportionately accruing to those at the very top. Last year FTSE 100 directors' earnings rose by a median of 16%, compared to a private sector average of 2.6%

Crucially, top earnings are outstripping long term corporate performance. Across the FTSE 350 total boardroom earnings have increased by 108% over the last ten years. Bonuses in particular have shot up by 187%. Yet over the same period year-end share price has declined by 71%, while profit by half.

The effect of all this is that free market capitalism is widely seen to be rigged in favour of an unprincipled minority at the top.

Bankers' bonuses rose sharply in 2009, after the crash. They may now be coming down, but the damage has been done to a social perception. Despite the many changes brought to the rules of the City, a perception of business as usual prevails.

Those of us who recognize the power of capitalism must face these concerns.

But how do we restore public trust in capitalism?

One of the first things we can do is address the charge that corporate boards are a disconnected elite by making them more representative.

Having looked at a lot of evidence I am firmly convinced that there is a systematic bias against the inclusion of women at top corporate level. At present only 14% of FTSE 100 directors are women, this falls to 9% across the FTSE 250.

Yet the research suggests that having a diversity of women on boards not only increases overall board effectiveness, but actually enhances the profitability of a company.

In one study by McKinsey it was found that 89 listed companies with the highest levels of gender diversity had operating returns worth double the average.

Economics Arguments

So the figures confirm the public's concern that top pay has too often outstripped performance. The question then becomes what to do.

When you put the question of excessive pay to top earners their response is nearly always the same.

"Global businesses have to pay competitively in order to attract the best talent from around the world." This is the answer I got from Bob Diamond when I put the question to him recently.

It's an answer often heard in the City.

But you don't hear the argument run quite like that anywhere else.

blIn most areas of business a competitive labour market puts downward, not upward, pressure on pay.

Does the 'remorseless logic' of globalised competition run in a totally different direction depending on the pay bracket of the labour in question?

If the best talent 'from around the world' really was being mobilised then we would expect top earnings to fall as they were competed downward. After all, surely brilliant individuals from India and China would be willing to work for less than their Western counterparts.

In fact we know they would.

The CEO of the world's biggest bank by market capitalisation, Hong Kong based ICBC, earns only $235,000 a year. The CEOs of the Bank of China and CCB, earn $229,000 each. Yet these men have proven highly capable of running organisations just as big as their British counterparts for a fraction of the price.

Would talent leave the industry? I doubt as much as fearmongers suggest. Ask a highly paid finance executive if they would do the same job for less, and they usually struggle to avoid a smile. At the Treasury Select Committee, Bob Diamond couldn't' bring himself to deny he'd do the job for nothing.

So why is pay competed down at junior levels, but competed up at senior levels? Why do shareholders, keen to grip costs elsewhere in the business, tolerate cost inflation to such a degree in this one area of senior executive pay?

Let's look to the incentives on management. Managers' and shareholders' incentives are aligned when it comes to junior pay. Both want to hire the best they can for the minimum cost. But for senior executive pay, the incentive on management is misaligned. Of course good managers of large banks consider far more than just their pay scales when thinking of a business decision. But at base their personal incentive, in the narrow sense, is that they want to pay more.

So aligning the incentives of management and shareholders would be a good start – and as an economic policy, it's hard to argue against.

For what are the economic consequences of high executive pay?

Excessive pay has also been shown to undermine financial stability.

At a time of high volatility in financial markets you might think responsible boards would be doing everything they could to strengthen a bank's balance sheet. Yet since the crash of 2008 bonuses have steadily been on the rise again, even as instability gathers pace. Rather than using profits to shore up levels of capital and liquidity, banks have focused exclusively on reducing lending to the rest of the economy while continuing to pay whopping bonuses.

This is exactly why Bank of England's Financial Policy Committee recently warned the banks that bonus payouts *must* reflect any reduction in profits.

There is also evidence suggesting that excessive pay fuelled the creation of unnecessary financial products which have gone on to destabilize the financial system.

When a new financial innovation is introduced outsiders will pay a high premium for the specialist knowledge needed to take advantage of it. This effect becomes gets more extreme during a period of low volatility, as investors scour financial markets looking for anything that will deliver 'yield'.

The practice of securitization – where thousands of loans are bundled up and sold on – directly contributed to the rise of the soaring bankers' bonus. Once upon a time retail banks would provide loans and gradually make back their profits as the loan was repaid. Reward occurred over time, and was based on concrete outcomes. But in the securitized world pay has come to be determined by expectations, instead of outcomes. The loans are made, bundled up together and sold on at a fee. The profit the salesperson makes is based on the estimated value of the loan.

But this is a bit like Toyota guessing how many cars they'll sell over the next ten years and booking the profits today. The result of this system is that bankers can make huge instant profits in one go, even though the products they're selling may turn out to be worthless in the future. But because they get paid on the day they sell there is very little personal risk for those who trade in the assets.

The misalignment of incentives has another impact, thanks to the strong link between the size of an institution and the size of the CEO's compensation. This is because shareholders have traditionally reasoned that the larger the company, the greater the opportunity the chief executive has to add value.

So the management almost always have a strong personal incentive to ensure that a takeover deal goes ahead.

But this can create a conflict of interest as not all mergers add value for shareholders, and some may involve a huge transfer of risk to the bidding company. The interests of principal and agent are therefore at odds.

For example, by the time of the final sign off of many large deals, almost everyone in the room has a personal interest in the deal going through.

Company law requires shareholders to take independent advice on takeovers. But supposedly independent advisers often have their own incentives for ensuring the deal goes ahead. Of course directors have a statutory duty to promote the interests of shareholder. But these duties, though written in legislation, rarely provoke a challenge. This isn't much of a surprise when we consider the behavior of large groups – especially large groups without gender diversity.

Once they get bigger than three people, groups tend to challenge less, and instead bind together. Those who speak against the group tend to be ostracized and lampooned. We saw it over and again with those who predicted the great debt boom would end in tears. And it's true when climbing mountains too: groups of four or more tend to meet more accidents as no-one wants to be the first to pipe up and say the weather is closing in.

Of course if directors fail to challenge, shareholders have the right to challenge too. In practice, they very rarely vote down the management. Their specific votes on pay, which are advisory and have been ignored, should be made binding. But alone this will not be enough. As while management has an asymmetry of incentives, shareholders suffer from an asymmetry of information.

How can we tackle these asymmetries of information and incentives?

In other areas of public life where the public interest is involved we have institutions which ensure that both sides of the argument are heard. In the House of Commons we have an official opposition to challenge government, with a leader paid a cabinet minister's salary and given a research budget. Professional or employment tribunals provide a voice for each side of the argument. In criminal law, public prosecutors make the case and others try to undermine it.

For this reason Nadhim Zahawi and I have proposed the creation of a Public Protagonist, who would have access to corporate books, and present an independent case, as they see it, on pay, or takeovers, to shareholders.

Where there is doubt about the real economic value of a deal their task would be able to present the case the board didn't want their shareholders to hear, in terms they could understand.

Shareholders would be under no obligation to heed the Protagonist's advice but the managerial monopoly on the salient facts would be broken, and a culture of challenge would be introduced.

Of course it wasn't always like this. In an older City of bowler hats and merchant banks – a City regulated by the eyebrow of Governor of the Bank of England - the forerunners of modern investment banks were partnerships. This meant the interests of shareholders were directly aligned with that of the management. Both received the same returns on their capital, but the partners knew they could lose their wealth and their life's work if they mismanaged the firm.

Yet when the merchant banks were demutualised, either through listing or takeover, the returns continued to go to management, not the new owners.

But because it was now a return on labour instead of capital the management no longer faced the same risks as shareholders. At worst they could lose their job – and even that risk could be hedged by the negotiation of golden parachute clauses in their contracts.

Later on this culture was brought into the retail banks. And it introduced incentives for risk-taking that were radically at odds with the interests of shareholders and depositors.

We have to re-learn the lesson that aligning the interests of principals and agents is the only way to have a healthy capitalism.

The simplest way to do this would be to make current advisory votes on pay into binding votes but alone that won't be enough.

There also needs to be a new culture of radical transparency, with published pay bands for all senior staff. If the owners of a business are fairly to assess how much their employees are worth they need to know what they and others are spending on them in the first place.

The system of bonus clawbacks also needs to extended. The FSA require the most senior staff at regulated firms to hold back a 'significant' proportion of their remuneration package for at least three years. But given that the average lifespan of FTSE 100 CEO is only 3 and a half years this is a weak deterrent. Management, like shareholders, need to be in a position where they have something quite significant to lose if a firm blows up.

By the same token we need to ensure that the management really do have skin in the game – a meaningful proportion of their livelihood needs to be bound up with the fortunes of the company. Stock options are a poor substitute because they provide no downside. If the share price rises the executive can cash in. If it falls he's under no obligation to buy.

The psychology literature has also identified what's known as the 'house money effect' in relation to CEO stock options. In casinos across the world it's well observed that high rollers fail to quit while they're ahead because they don't think of their recent winnings as 'theirs'. Where the sense of a personal stake is weak we become much less loss averse.

I believe the way forward is to pay senior employees in instruments which lose nominal value if the firm runs into trouble. In other words they should be paid in debt.

Cocos - bonds that automatically convert into stock during a time of financial stress – are an important step. Credit Suisse already have moved in that direction. If a bank ran into trouble employees holding cocos would experience the same fall in share price as the shareholders, while contributing to the capital levels.

In the world of securitization there is an especially strong case for replacing sales fees with debt. Traders in collateralized loans have no incentive to ensure that their products are worth what the market claims because they are paid sales fees upfront. But if their income stream was derived from the loan itself they would have a very good reason to perform the necessary due diligence.

These are initial suggestions and by no means the final word. They are aimed to tackle the real micro-economic problems, and so support a strong and competitive business culture.

<u>Ethical Arguments</u>
Finally, there is a strong ethical dimension to the argument about fair pay, not least because socially defined boundaries of what's acceptable are one of the most powerful determinants of human behaviour.

We know that markets which lack a strong ethical framework become corrupt and impoverished.

Just as a functioning market requires buyers and sellers, capital and labour, it also needs trust, decency, mutual respect and fair play. Regulation is important but it is no substitute for improved culture.

We also know from the financial crisis that the unbridled pursuit of rational self-interest is ultimately self-defeating because we are *not* rational.

So where did it come from, this strange idea that business 'ought' to be amoral, that anyone entering a boardroom had to leave their conscience outside?

Why did we come to believe that if something is good for the board it must be good for the entire economy?

And what happened to the pride and dignity of a good job done well?

In 1970 Milton Friedman famously wrote that the only social responsibility of business is to make as much money as possible. To gung-ho libertarians this provided the perfect justification for unrestricted plundering, irrespective of the consequences for society or the rest of the economy.

But in their excitement the neglected to finish Friedman's sentence, which reads like this:

'It is the social responsibility of business to make as much money as possible, while conforming to the basic rules of society, both those embodied in law and those embodied in ethical custom.'

Far from being a manifesto for corporate greed, Friedman's essay is a moral defence of property rights and the principle of shareholder sovereignty, within a culture of ethical behaviour.

According to Friedman the only entity with the moral authority to spend other people's money in ways which prejudice their individual interests is government itself. Govt is only allowed to suspend the principle of private property because it has a democratic mandate.

Spending shareholders' money in ways which fail to maximise shareholder value is a violation of fiduciary duty. Ethical custom – as Friedman called it – is crucial to the framework of a free market.

So rewards for failure subverts the very principle of private property itself. Yet the libertarian right's response is to do away with regulation altogether.

And the socialist response to a moral problem is to crush it with government bureaucracy, even at the expense of growth.

This is why confronting the problem of rewards for failure is so urgent. If we allow the current fear and mistrust of business leaders to fester then the arguments of the anti-enterprise begin to gain traction. Instead it falls to us to restore the free market system that this country invented, in the way that works for billions of people around the world.