

The “Short-bolting” of the Financial System: Dangerous Compensation Schemes and Questions For Directors

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In the early days of the financial crisis, the Financial Times published an article *Gone by the Board* (June 26, 2008). In this full page article, authors Francesco Guerrera and Peter Thal Larson wrote at length about why the Directors of the big banks failed to spot the credit risks that resulted in the asset-backed securities crisis. They discussed the responsibility of the Directors on matters of risk, but they also observed that exercising that responsibility in the now complex banking system and derivatives markets is almost beyond reasonable expectations for a Director.

However, the credit risk is not all the Directors missed. It is now clear that many compensation schemes have been dangerously misaligned with safety and soundness and, at least in part, motivated the compromising behaviors of the mortgage brokers, lending officers and derivative traders that led inevitably to the current crisis. The underlying problems with these compensation schemes are much easier to understand than the risks of complex securities. Directors should be expected to understand and make judgments regarding the systemic risks inherent in compensation schemes.

Consider first an analogy. Many years ago, mining engineers determined that rock explosions (the major cause of mine collapse in hard rock mining) could be prevented by forcing bolts into the walls and ceiling of the mine cavity to replace the pressure of the rock that had been removed from the cavity. The mining engineers learned to calculate how many bolts and how long these bolts needed to be in order for the mine to remain safe and sound. It was a labour-intensive process to drill and install these bolts, but it was well worthwhile as it substantially reduced the risk of mine collapse.

Management then discovered that if the labourers installing these bolts were incented “by the bolt”, they tended to work a little harder, resulting in improved productivity. However, human behaviour being what it is, some labourers soon realized that a little compromise on the length of the bolts would increase take-home pay and would go unnoticed by management. Of course, the workers did not, or chose not to believe such compromise would affect safety.

However, inch by inch this practice of “short-bolting” led inevitably to mine collapse amid a false sense of security. Mining disasters revealed the fallacy of financial incentives that could encourage unsafe practices, practices that inevitably could result in disaster.

The role of misaligned incentives in the collapse of the asset-backed commercial paper market is now clear. Beginning with subprime mortgages, brokers and lending officers inch by inch



compromised the quality of the loans. Inclined to "grow the book", they were tempted to bend standards or compromise on compliance. These portfolios were then packaged and sold and repackaged and resold, each time with the apparent security of being "asset-backed", while the true quality of the assets was hidden, like short bolts. At each hand-off, someone earned a volume or spread-based incentive, and no one was inclined to look carefully at the bolts.

The mining industry had two options to deal with the practice of short-bolting. They could either increase inspections and penalties to a level that would ensure that the bolts were meeting the specifications, or they could remove the incentive to compromise. They chose the latter and it has proven to be a simple, safe, sound, economical and sustainable solution.

Today, mining company Directors would likely and rightfully be held legally accountable for a mine collapse if they knowingly tolerated an incentive system that would so predictably result in compromises in safety. The Directors do not have to be mining engineers to understand the systemic risks imposed by such incentive schemes.

Such is now the case in financial institutions. It is arguably too much to expect a Director to understand the layers of risk in today's complex credit products and their derivatives. They are forced to rely on review of the risk management systems and procedures of the bank. However, any Director can understand how incentives can affect human behavior and create systemic risk. With hindsight on the recent collapse, Directors can and should probe for risks created by misaligned incentives in compensation schemes.

The lessons apply to all Directors, not just Directors of financial institutions. Compensation practices have typically been aligned with industry norms, instead of with strategy. Pay-for-performance is often upside focused, relying on measures of volume versus value, with no measures or recourse for risk. Yet, the systemic risk inherent in misaligned incentives has seldom been examined by Directors.

For a start, here are five easy questions for Directors to ask about incentive schemes:

- 1 Have the critical roles for which incentives could pose risks or need to be aligned with strategy been identified?**
- 2 Where practical, are such incentive schemes linked to risk-adjusted returns, with suitably delayed payout timeframes and recourse?**
- 3 For key roles, is compliance to safe standards and alignment with strategy adequately monitored?**
- 4 Are the monitors/supervisors inclined to safeguard compliance (rather than systemically linked to subordinates' performance)?**
- 5 Taken together, are the incentives aligned with the strategy as well as the safety and soundness of the institution?**

Most of the failed financial institutions would have answered "no" to most, if not all, of these five questions.

The risk management issues revealed by this crisis need to be addressed. The Director has a role in ensuring that adequate risk management processes are in place, of course, but cannot be expected to understand the inherent risks of complex products, such as derivative securities, any more than they could be expected to know the length of the bolts required in the mine.

However, there can and should be a greater focus by boards on the financial incentives up and down the business that may be misaligned with strategy or creating systemic risk. Indeed, given the hard-learned lessons of this costly financial crisis, it would now be irresponsible to tolerate incentive systems so misaligned with safety and soundness, just as it was in the mine.

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