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Bonus Guarantees Can Fuel Risky Moves

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Financial firms seeking to attract and retain talent are reported to be making a substantial use of guaranteed bonuses, and the French Economy Minister recently called for limits on guaranteed bonuses. While many now focus on how using guaranteed bonuses affects the level of pay, it is important to recognize their effect on incentives. Guaranteed bonuses create perverse incentives to take excessive risks, and they consequently could well be worse for incentives than straight salary.

Introducing a guarantee into a bonus plan eliminates some downside risk but leaves the bonus compensation sensitive to performance on the upside. At first glance, a bonus plan with such a guarantee seems superior in terms of incentives to a fixed payment that isn't sensitive to performance on either the upside or the downside. A closer inspection, however, reveals that the incentives produced by such a plan could well be counter-productive.

Consider a bank that sets annual compensation for an executive running a trading unit that is expected to generate between zero and \$100 million in profit at the end of the year. Suppose that the bank was initially considering a fixed salary of \$1 million and a bonus plan rewarding the executive with \$1 million for each \$10 million of profit – a plan that, depending on the unit's performance, would provide the executive with an amount between \$0 and \$10 million. And assume also that, concerned about losing the executive to competitors, the bank decides to guarantee the executive's getting a bonus of at least \$5 million and thus a total compensation of at least \$6 million.

The introduction of a \$5 million floor for the bonus would insulate the trader from the downside risk of low profit levels: the trader would get the same bonus amount of \$5 million whether the unit's profits are zero or \$50 million. But the bonus plan would still give the trader an incentive to seek a high profit level: the trader's bonus would increase by \$5 million if the profit is \$100 million rather than \$50 million.

Thus, compared with an average performance of \$50 million in profits, the compensation structure under consideration would produce an extra \$5 million in the event of stellar performance but not reduce compensation in the event of poor performance. As a result, the executive's interest will be served by taking a bet that would increase the odds of a \$100 million profit even if the bet would produce an even higher increase in the odds of no profit.

Indeed, taking as given that it's necessary to provide the executive with a \$6 million floor on compensation, a \$1 million salary together with a guaranteed \$5 million bonus would produce worse risk-taking incentives than a salary of \$6 million coupled with a bonus plan that would reward the executive

with \$500,000 for each \$10 million of the unit's profits. Although this bonus plan would also reward the executive with an extra \$5 million in the event profits reach \$100 million , it would make the bonus compensation sensitive both on the upside and the downside. As a result, this bonus plan won't distort risk-taking choices: the executive would take a risk only if doing so would increase the odds of a good outcome by more than it would raise the odds of a bad outcome.

The above discussion has implications that go beyond the question of guaranteed bonuses. It's now well recognized that bonus plans based on short-term results which may turn out to be illusory can produce excessive risk-taking, and that plans should therefore be structured to account for the time horizon of risks. But even though tying bonus plans to long-term results is desirable, it isn't sufficient to avoid excessive incentives to take risks. Bonus plans tied to long-term results can still produce such incentives if they reward executives for the upside produced by their choices but insulate them from a significant part of the downside.

Bonus plans that provide executives with such insulation from downsides – either by establishing a guaranteed floor or otherwise – can seriously backfire. Firms setting bonus plans, and regulators monitoring compensation structures, would do well to recognize and pay close attention to this problem.