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The bonus pool, mark to market and free cash flow: producer surplus and its vesting in the financial markets

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Abstract

Regulatory proposals that seek to limit or govern finance industry bonuses in the interests of systemic stability need to be grounded in the financial economics of producer surplus and its distribution. In this respect, existing treatments of economic agency in justifying large bonus awards are content to accept accounting Profit and Loss (P&L) numbers as a basis for the managerial bonus pool. We argue that managerial bonuses and shareholder dividends should be treated more symmetrically, and constrained by free cash flow criteria that capture producer surplus created by genuine managerial ability. Priority rules should apply, such that fair market value is a compensation for shareholder risk bearing and not a source of managerial surplus. The use of free cash flow conversion ratios neutralises the free option problem that has become a social irritant in public bailouts.

Keywords:

banking regulation

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performance pay

real option

JEL Classification:

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M52

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Notes

¹ In 2006 the top 250 managers at UBS earned an average bonus of USD 1m; see <http://news.hereisthecity.com/news/business> news/6493.cntns. Even after the crunch, the 2008–09 bonus pool for Salomons was a reported USD 4.6 billion (BBC News, 16 July 2009); as of 30 September 2009 Goldman Sachs had set aside \$16.7bn to cover pay and bonuses for 2009, an average payout of \$700,000 per worker, and a further \$3 billion for the first 3 months in 2010 (Times, 18 April). JP Morgan is reportedly also awash (Guardian, 14 October 2009). Bailed out UK banks are claiming force majeure; if they do not pay large bonuses, staff will migrate.

² It is common knowledge that the finance industry is at the forefront not only of executive pay but also of pay further down the line. Kaplan and Rauh ([2010](#)) is a comparative empirical study.

³ The dislocation between firm value and manager rewards has been graphic over the period 2006–09. Firm (share) value has not yet fully recovered. But managers have had huge bonus rewards for two of those years with no penalty for the interim loss of value; the free option aspect.

⁴ The word ‘carry’ is often used in the industry to refer to the cumulative premiums paid up to the current point. The ‘carry return’ would then be the current premium.

⁵ In some contexts regulatory capital might also be required, the required rate of return on which should be charged against the fair market premium income from the swap. Historically this was not done and the further issue arises as to just what the appropriate rate would be, even within tier one capital e.g. equity versus preferred shares costs of capital, or some weighted average cost.

⁶ A recent example is the huge profit (relative to capitalisation) reported for the month of June in the year 2008–09 by the Reserve Bank of New Zealand. Much of this was due to MtM gains, e.g. for its bond portfolio. This – and doubtless a bit of arm wrestling – appears to have encouraged it to pay a dividend of \$630m to its shareholder, the NZ Government. The senior executives decided to forego a salary rise for the coming year, though no information was released on bonuses, past or future.

⁷ Rajan et al. (2007) is a good source, as are investment bank publications such as the JP Morgan/Risk JPM Guide to Credit Derivatives, or the Merrill Lynch Credit Derivatives Handbook, Vols 1 and 2. More general treatments of credit pricing include Duffie and Singleton ([2003](#)), Bomfim ([2005](#)) and Loeffler and Posch ([2007](#)).

⁸ To be sure, shareholders can gain from MtM via expectations of future free cash flow reflected in the value of their shares. More perceptive shareholders can realize such gains by selling the shares, leaving the new owner with the risk of adverse MtM.

⁹ An AITE Group study is available at <http://www.aitegroup.com/Reports/ReportDetail.aspx?recordItemID=531>.

¹⁰ Some issues arise with reliance on the Sharpe ratio, given that very good market timing ability can result in perverse ratios (Dybvig and Ross, [1985](#); Bowden, [2005](#)); also whether the Sharpe ratio concerned is really zero capital in nature, i.e. pure enhancement as in Bowden ([2003](#)). However, the study is consistent with our own experience of the market.

- ¹¹ Although training costs are arguably not of significance in the case of senior people, who operate off standardized trading and information platforms (Bloomberg, Reuters) and control systems (Sungard or similar).
- ¹² It was alleged in the trial of Société Generale trader Jerome Kerviel that his superiors were well aware of what was going on. Société Generale denied Kerviel's allegations; however, it ‘admitted lax controls while it focused on building up its investment banking business into a derivatives powerhouse’ (Financial Times, 5 October 2010). Market experts doubt Kerviel was able to pull off the fraud alone (Times, 27 January 2008). However, none of the senior managers took responsibility for the case.
- ¹³ There may be others. Madura and Wiant ([1995](#)) note an incentive for bank insiders to trade on inside information following recent MtM style revaluations of the bank.
- ¹⁴ Back in the 80's it was quite common for high profile traders and dealers to earn more than the CEO. The Australian bank Westpac was an example: one of its New York fixed interest traders was reported in the press as earning three to four times the CEO. Times have evidently changed.

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