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# Will Executive Incentives Keep the "Bailout" from Working?

The infusion of hundreds of billions of dollars of taxpayer funds into the domestic financial system has created a fundamental change in the ownership structure of most banks. By establishing the US government as the largest single shareholder in many of the TARP-participating banks, there is a divergence in shareholder objectives. The government as an investor has provided cheap, patient capital in the form of preferred stock that only requires a 5% annual dividend and no price appreciation. The Government has invested in these banks with the intention that these investments would stabilize the financial industry and get credit flowing again to the broader economy. It wants financial recovery, job creation and economic growth. However, historic financial industry practices and the incentive arrangements offered to executives at these institutions may be working directly against the government's public objectives.

The traditional investor objectives of maximizing economic value through growth in earnings and increased rate of return on capital employed, and the incentives that reward these results, are the heart of the conflict. When faced with difficult economic times such as we are currently seeing, the natural reaction (as motivated by these incentive plans) is to avoid the loss of capital, cut off lenders that don't meet high credit standards and generally batten down the hatches. It is no surprise that bankers are acting consistent with their objectives and their financial interests.

## Alternative Approach

If the "bailout" is to succeed, we need to find some way to reconcile these divergent interests. It wouldn't make sense to change the incentives for the bank as a whole; The Government's investment is big, but it is only 10-20% of the total equity in these banks. The other shareholder's interests must be respected as well. But to clarify objectives and maintain accountability for results within the institutions, one possibility is to build a new organization within the banks that is focused on the needs of this new, unique shareholder. This "Rescue Bank" can be a separate legal corporation or an autonomous division, but it needs special staffing, leadership, and incentives that are attuned to the unique goals of its shareholder. It is likely that the strongest economic impact will come from the small to medium sized businesses that have historically been the engine of job creation. A large number of these are suffering from overextension, shortage of capital and customers that cannot buy their products due to lack of financing. These accounts could be transferred to the Rescue Bank, along with appropriate loss reserves that will create a level playing field. Then the Rescue Bank could help these companies by utilizing flexible credit standards, refinancing, pools of investment capital and inexpensive financing facilities for their customers.

The Rescue Bank would need to be staffed by seasoned commercial bankers that have been through economic downturns and who are experienced in lending to troubled companies and by investment bankers that can help restructure balance sheets and provide creative secured lending. The management group would comprise leaders that see beyond the bank's balance sheet to its obligation of providing access to capital and general financial liquidity to the public.

## Aligned Incentives

We know from experience that employee and management incentives do motivate the behavior that is asked for. But if plans are built around net income and financial returns, we will not get the kind of actions that this situation or this shareholder requires. Instead, a very significant portion of the staff's annual compensation should be tied to such metrics as: client revenue growth; job creation or saves; GDP growth within the market area; business startups; and public approval.

We don't want these bankers to totally ignore the concept of profits, after all the Government money does need to be repaid. Long-term incentives could be designed to balance the annual goals by investing a slice of the parent's capital along with the government's money (e.g., $1 for every $5 of TARP dollars). This "common stock" would be credited with any Recovery Bank financial returns in excess of the 5% required on the preferred stock. Grants of book value phantom shares (with conversion rights to the parent common stock) that vest when the TARP money is repaid would provide a powerful leverage to get this troubled economy up and running again. If the Rescue Bank's annual return on total equity only reaches 7%, these awards would grow by 17% that year – plus any kick from the recovery the parent's stock price.

Incentives do work. If we create the right ones for this situation, we as a country can more quickly work our way out of this difficult financial situation.

- Paul McConnell

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