Submission on the Productivity Commission Draft Report on Executive Remuneration in Australia

Introduction

The Productivity Commission Draft report on Executive Remuneration in Australia has much to commend it. It shows an intricate understanding of the key questions of agency theory, and makes good suggestions on this front. However in the end, the report misses the mark. It does so because it does not consider deeply enough the implications of limited liability legislation. For while the report correctly identifies the central importance of limited liability to companies and executive pay, it does not identify the most crucial links between limited liability, executive pay and corporate risk taking. For this reason, it does not go far enough in outlining solutions - the sickness is not fully diagnosed, and so the medicine fails to be fully effective.
Let me take the key points in turn.

1. What are the weaknesses of limited liability legislation?

The report does well to single out the importance of limited liability and the great gains that limited liability has brought us. The ability to raise large amounts of capital and spread risk have certainly been worth the introduction of limited liability legislation, commencing in England around the 1850s, and spreading from there. The report rightly acknowledges this. However, the report fails to analyse all the weaknesses of limited liability legislation. It focuses disproportionately on the principal-agent problem, and neglects the greater problem - the problem that limited liability protections encourage excessive risk-taking. This point can be seen most clearly through option pricing theory. In practice today, limited liability legislation limits the losses of shareholders to the amount of their initial investment (shares do not trade with negative value). This provides all shareholders with a put option, where they have the option (as a group) to sell their whole company to creditors for the value of the company's assets. In this way, shareholders can avoid fully paying their creditors in the event of insolvency. Option pricing theory tells us about the value of this option: options are worth more if the volatility of the underlying instrument increases. What this means is that shareholders have a financial reward when their company takes more risk, because this extra risk increases the value of the option they possess - the option granted to them courtesy of limited liability legislation.

This means that shareholders gain financially when their companies increase their risk profile. It is a state of affairs which has existed ever since limited liability legislation was first introduced. However, in recent years the incentive for executives to take ever increasing risk has grown. As discussed in detail by the Draft Report, executives have been increasingly paid in stock, in order to reduce agency costs. This means the payoffs to executives resemble more closely the payoffs to shareholders, including exposure to the implicit option granted through limited liability legislation. What this does is to dramatically increase the executives' incentive to take risk, and to take excessive risk. Hence the growth in gearing that we have seen (the growth in gearing is especially pronounced if one compares today's levels of gearing with the levels existing before limited liability legislation passed). For debt is the easiest way for executives to increase risk.

Now some will argue that this extra risk and extra debt is not a problem, since nobody suffers. For everyone gets what they want - the shareholders want the executives to take more risk, since the shareholders are also exposed to the increase in the value which comes with risk, and the creditors lend with their eyes open - they carefully scrutinize companies before lending to them, so they are not the losers.
But arguing this way ignores at least one key problem: creditors themselves have the same incentives to take excessive risks which I have been discussing. For lenders these days are usually companies protected by limited liability, run by executives paid in stock, who therefore gain by taking excessive risk. So what happens is that excessive risk is taken both by non-financial firms and by financial firms. Thus risk can continue to build across the corporate sector, because all the shareholders and executives benefit from extra risk by virtue of the option given to them through limited liability legislation. The disaster of the recent global recession was built on the back of such repeated leveraging. The problem has been more severe in America, but it is still a problem in Australia. The outworking of the problem in general is that we have considerably more defaults and bankruptcies and bank failures than we would have if we had the same firms with the same capital bases but without limited liability legislation. This problem is becoming more pronounced because executives are paid more in stock and options than they used to be, leveraging their personal wealth to the amount of risk they bring into the businesses they are running.

I am not opposed to limited liability legislation. I believe the gains we have made with limited liability legislation still vastly outstrip the problems which have come through excessive risk taking. However, as the numbers of defaults increase, and as the average level of gearing in companies increases, and as governments globally feel forced to bail out banks (or guarantee their deposits), this is becoming a more contestable point. The benefits of limited liability should now rightly come under scrutiny. A great failure of this Productivity Commission report is that it has not considered deeply how much we have lost as a nation (or as a globe) through the excessive risk-taking encouraged by the combination of limited liability legislation and high levels of executive stock-based pay.

A further question is raised at this juncture to which I will now turn: How should we define *excessive* risk taking?
My answer to the question goes as follows: Excessive risk taking is risk taking which serves oneself at the expense of the common good. Here we come inevitably to a discussion which stretches beyond the realms of finance theory - a question of the purpose of work. It has been a significant mistake in the academic world to separate the discipline of finance from disciplines like philosophy and theology. That should be clear at this point. For now this discussion must consider the purpose of work, 'the good', the 'common good' and such like. Today's finance lecturers usually avoid such a discussion, but it cannot be avoided.
My contention is that the purpose of work is to serve the common good. Let me apply this to executives, albeit briefly. Executives can act in ways that serve the financial interests of their shareholders while serving the common good, or they can act in ways that serve the financial interests of their shareholders at the expense of the common good (or they can do both, at different times and in different ways). In the former case, executives are doing good work, in the latter case they are not. Examples of the latter include cases when executives collude with competitors on

pricing, or when they bribe governments to win business, or when they delay payment of creditors beyond what is reasonable. None of these practices represent good work. None of them are work performed in accordance with the way work ought to be done. These are all examples where the government can rightly step in by means of legislation to limit actions which are contrary to the common good.
My point is that now is the time to legislate against grossly excessive risk taking, for it is now clearly doing damage to the common good.

Someone might ask at this point, what is the basis for arguing that the purpose of work is to serve of the common good? My answer is a biblical one: The basis is that Jesus, the Son of Man came not to be served, but to serve, and give his life as a ransom for many. This defining act of love is sufficient to show us the purpose of our work - to serve others. Of course, here we stray far beyond where most finance lecturers are comfortable! Partly for that reason, I do not propose to linger here. Let us press on to the next question:

2. What is the solution to this problem?

I can identify at least two explanations why executives have been taking excessive risk. The first explanation is greed: we are all fallen humans, whose greed can be seen in different ways. Executives just have greater outlets for their greed. The second explanation is that the limited liability legislation works in combination with executive stock-based pay to provide a potent outlet for that greed.
The solution to the first problem lies in the steady transformation of peoples' hearts through the preaching of the free forgiveness won in the death of Jesus Christ. I won't dwell on this point since it is heavily contested. But even this great and costly solution will not see anyone completely overcome selfishness and greed until Jesus' return.
We must therefore focus on the second source of the problem: the problem is that the combination of legislation (limited liability) and modern customs (paying executives in stock) produce a large incentive for executives to take excessive risk.
One point should be made clearly here: since excessive risk-taking is encouraged partially by legislation, the problem can be partially rectified by legislation.
I recommend consideration be given to creating legislation in the following direction: that either criminal law or tort law (or both) be legislated which proscribes the following behaviour: 'grossly unreasonable risk-taking, in service of oneself, at expense to the common good, leading to default on debts, and leading to an undermining of public confidence in the protections afforded by limited liability'. The lawyers can take over here and turn this into something workable. This is rough and needs work. But this is the kind of legislation now needed not just in Australia but throughout the Western world. For injustice is occurring that should be remedied at law. The whole world has been victim of an injustice in the form of the global recession. The perpetrators were those businessmen who took grossly unreasonable self-serving risk at the expense of the common good. We need to be careful about this, for it is a subjective thing to determine when risk-taking is unreasonable and when it is taken to the detriment of the common good. Hence I would only want to see convictions of someone committing this offence in particularly egregious cases.

In conclusion, the Draft Report on Executive Remuneration in Australia says a lot that is good. Its discussion of the agency problem is excellent, and its solutions on that score seem wise. However, it has missed the broader picture. The big failure is the

lack of substantial discussion as to how the rules of limited liability are interacting with stock-based executive salary to produce excessive risk-taking which works against the common good.

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