A Survey of Corporate Risk Management: Too hot to handle? - Managing the managers (part 7 of 9)

Holding shares may make managers risk-adverse

MATTHEW BISHOP ON MARCH 18th 1994, Lorne Weil, the boss of Autotote, a supplier of gambling equipment, struck a deal with Bankers Trust. He promised to give the investment bank any dividends paid during the following five years on some 500,000 Autotote shares he owned - then worth $13.4m - plus any increase in the value of the shares over the period. In return, Bankers Trust would pay him the income from investing $13.4m elsewhere, worth around 1.75% a year, plus any fall in the value of the shares over the five years. Thus, although he technically continued to own the shares in his own company, he was no longer exposed to the risks associated with them. Instead, he was guaranteed a safe (though small) return on his capital.

This, and similar, deals - known as 'equity swaps' - have caused some shareholder activists to worry. Over the past decade, managers have been showered with shares and share options in their firms to provide incentives - so much so that they now own around 10% of the equity of American firms. According to Graef Crystal, an expert on executive pay, that makes any device allowing managers covertly to reduce their equity risk disturbing. Although Mr Weil's motive appeared to be nothing more sinister than to cut his tax bill, it was hard to tell whether the same was true in other cases because there were no clear rules on whether, or when, such equity swaps had to be disclosed. America's Securities and Exchange Commission has since set out fuller disclosure requirements, although these may not have been fully effective. Moreover, big opportunities to reduce exposure may remain on offer outside America.

But managers need not use such direct methods as equity swaps to reduce the risk of holding shares in their own firm. Instead, they could structure the company's hedging strategy so that it reduces the volatility of its share price. They certainly have the motive. Unlike, say, big institutional shareholders such as pension funds, which diversify their risks by holding a large portfolio of shares, many managers have shares only in their own company, which account for a large slice of their personal assets. Managers and shareholders therefore have divergent interests, the owners happy for the firm to be exposed to risk, the bosses not.

On the whole, firms reveal next to nothing about their hedging strategies, so it is hard to tell whether these are used for the benefit of shareholders or managers. One exception is the American gold-mining industry, not least because investors want to be able to choose between firms that offer exposure to the price of gold and those that do not. Investors can easily hedge gold-price risk for themselves by selling gold futures. Yet a new study* by Peter Tufano, of...
Harvard Business School, found that between 1990 and 1993 some 85% of the 50 firms used some sort of gold-price risk-management strategies.

Mr Tufano found no evidence that firms were hedging in order to maximise their value to shareholders. Those companies that were at greatest risk of financial distress did not hedge noticeably more than those with a negligible risk. Nor did firms with larger exploration programmes hedge more. Differences in tax positions shed no light either. However, managers with large shareholdings typically hedged more than those with less equity. And those with substantial share options tended to hedge less (which makes sense, since options can be extremely valuable in good times but worthless when things go badly, which should encourage greater risk-taking). Intriguingly, newer managers tended to hedge more than those in the job for longer.

If this sort of behaviour is common beyond the gold industry, it has some big implications. One is that simply loading managers up with their company's shares does not automatically align the interests with those of shareholders - it may even drive a wedge between them. Another is that boardroom remuneration committees and shareholders need to look closely at the split between shares and options in the boss's pay package.

Virtual hedging

A solution to this problem is suggested** by David Fite, a manager at Bankers Trust, and Paul Pfleiderer, an economist at Stanford. One reason why managers do not like to be exposed to share-price risk is that shares rise and fall for all sorts of reasons outside their control, ranging from exchange-rate movements to the outbreak of war. The answer, suggest Messrs Fite and Pfleiderer, is not to give managers shares but to pay them the return that would have been earned on the shares had the firm hedged those risks that the managers cannot influence. What risks the managers are to bear could be agreed at the start of the year or, in a more sophisticated version, changed during the year at the managers' request. There would be no need for the firm to hedge these risks, though from the shareholders' point of view it might sometimes make sense to do so. It could all be done using the firm's internal accounts, in a sort of 'virtual hedging'.

This would have a valuable spin-off. At present it can be quite hard to judge how well a company's management is doing its job because share prices are affected by events beyond their control. With virtual hedging, managers would be rewarded according to their real performance. There is one big snag, however. Imagine that a firm suffers a huge loss entirely because of events beyond its control, yet its managers are paid according to their performance after virtual hedging, which entitles them to a huge bonus for a job well done. Given present sensitivities about the pay of corporate fat cats, that would be certain to cause a row. Intriguingly, BP, an oil company, has gone some way towards this, allowing the managers of its various business units to 'buy' hedges from the corporate treasury, which then decides whether buying the hedge in the real marketplace would fit in with its overall strategy.

The use of equity as a carrot is but one of many reasons to worry that managers might use derivatives to pursue their personal interests at the expense of shareholders. Many recent derivatives disasters have owed at least something to the juicy bonuses available for good short-term performance. Moreover, as Paul Marsh of the London Business School points out, managers who start off intending only to hedge may be tempted by their own growing experience to start speculating. After a handful of occasions when the market moves in the
direction they expect, they may start thinking of themselves as experts and begin 'actively hedging'. Strikingly, a number of big speculative losses have been run up by people with a relatively good trading record, says Mr Marsh.

Add this managerial dimension to the theoretical and practical complexities of getting the use of derivatives right, and it is clear that shareholders need to keep a close eye on what companies are doing. Unfortunately, at the moment they have no way of finding out.


** 'Should Firms Use Derivatives to Manage Risk?'. By David Fite and Paul Pfleiderer, in 'Risk Management: Problems and Solutions', edited by William Beaver and George Parker. Stanford; 1995

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