Paying for long-term performance: restructuring bankers' pay for risk regulation

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Summary

The purpose of this paper is to propose hybrid capital securities as a new approach to compensation for senior bank executives and risk-takers instead of cash or equity-based compensation currently adopted by the industry. The global financial turmoil indicated that misaligned pay-for-performance compensation arrangements encouraged management short-termism and rewarded excessive risk-taking behaviour in Anglo-Saxon system. Rather than regulating specific instruments and processes, we believe that it is much more efficient to overhaul the compensation scheme to align it with risk management and governance. This empirical paper investigates the European hybrid market by employing data from the Merrill Lynch Global Index System from 2000 to 2010. Our paper contributes to both literature and practices by designing a structured scheme to tie the executive's interests to long-term performance of the bank, the goal of regulators and the economy at large which consequently reduce the probability of future bank failures.

Abstract

Introduction

The study of executive compensation has attracted great interests from academics, businesses, regulators as well as the general public over the past several years, especially in the wake of the global financial crisis sparked in 2007. Although causes of the financial turmoil are multidimensional, misaligned compensation arrangements that encouraged management short-termism have been blamed for the failure of high profile companies such as Bear Sterns, Lehman Brothers, Fannie Mae and Freddie Mac in the U.S. The financial regulators blame those who devised pay-for-performance incentive schemes, which encouraged and rewarded short-term and excessive risk-taking behaviour (Miller 2008). Bebchuk et al. (2010) indicate that the top-five executive teams of Bear Sterns and Lehman Brothers cashed out large amounts of performance-based compensation in the form of cash bonus and equity sales during 2000-2008. Shareholders are highly concerned with rewards for failure as executives walked away with large pay packets even when the stock market collapsed.

Pay for performance compensation scheme which links executive pay with stock price has been an important feature of executive contracts in Anglo-Saxon system prevailing in the U.S./U.K. (Murphy 2003; Benmelech, Kandel et al. 2010). Agency theory promotes the use of management shared ownership via equity compensation to ensure managers make decisions in the best interest of the company. Despite the argument that equity compensation has shown strong association with managerial performance, providing a solution to an agency problem between shareholders and managers, a large amount of academic debates have drawn attention to the danger of equity based compensation structure that might lead to earning manipulation, excessive risk taking and fraudulent schemes (Goldman and Slezak 2006; Crocker and Slemrod 2007). Bebchuk and Spamann (2010) argue that equity-based awards, associated with the capital structure of banks, link executives' compensation to a highly levered bet on the value of banks' assets. Such behaviour is further encouraged by the overly complicated compensation schemes, which enable executives to benefit from excessive risk taking, while limit downside risk to a minimum.

Our paper does not put its concentration on whether cash or equity-based compensation amplifies the agency problem. Instead, the primary aim of the paper is to identify an alternative compensation scheme, which is believed to be best structured to tie the executive's interests to long-term performance of the company and its shareholders. We propose that hybrid capital securities should be a significant part of the variable incentive compensation of senior bank executives and risk-takers. Recipients of hybrid capital securities should not be allowed to sell their securities before maturity. In this regard, the scheme contributes to reducing incentives towards excessive risk taking, helping to align the incentives of bank executives with the goals of bank regulators and the economy at large and thus reducing the probability of future bank failures.

Pay-For-Performance Compensation and Global Financial Crisis

In light of the financial crisis that started in 2007, it is widely accepted that bank regulation has been ineffective in managing systemic risk and preserving financial stability. The crisis emerged because of the failure of both investors and rating agencies to recognise the complexity and financial risk that had built up in the financial system through the development of asset-backed securities (ABS) and collateralised debt obligation (CDOs). The public debate on regulation has revolved around some basic questions. Was the regulatory system fundamentally flawed? How could changes in regulation prevent future crises? Were regulators themselves asleep on the job? The current financial crisis provides evidence on the limited ability of financial regulators to manage systemic risk. The causes are multidimensional. Firstly, the complexity of the financial derivative instruments, which were developed to profit from the real estate market in the U.S., has gone beyond the capacity of regulators to evaluate. Secondly, we note the impunity with which those institutions and individuals who breached the regulatory framework were able to behave and extricate themselves. The question is whether key decision-makers in large financial conglomerates who originate and acquire these derivative products would change their approach if they will not be easily escaped adverse consequences. We believe that, rather than regulating specific instruments and processes, it is much more efficient to overhaul the compensation practices that we believe significantly contributed to the crises. The compensation schemes in the financial industry have been viewed as largely unrelated to risk management and risk governance. One of the consequences was that high short-term profits led to generous bonus payments to bank employees without adequate regard to the longer-term risks they imposed on their firms. Any revised compensation packages after the crisis of 2007 should meet the aim of The FSF Principles for Sound Compensation Practices (2009) to ensure effective governance of compensation, arrangement of compensation in relation to prudent risk-taking and effective supervisory oversight, and stakeholder engagement in compensation.

Literature Review

The concept of corporate governance is initially pointed out by Adam Smith (1776) based on the work *The Wealth of Nations*. He observes the possible danger connected to the diffusion of stock companies by the lack of incentive for both the owners and managers to manage and control the enterprise efficiently and effectively. Jensen and Meckling (1976) propose the agency theory that defines the agency relationship as a contract under which one party (the principal) engages another party (the agent) to perform some service on their behalf. Agency problem arises when the agents (managers) do not necessarily make decisions in the best interest of the principal (shareholders) (Jensen and Meckling 1976). In order to reduce the divergences of interests between managers and shareholders, two complementary mechanisms -- monitoring and incentives have been designed with the aim to prevent financial damage that can arise due to potential conflicts of interest between managers and shareholders (Jensen and Meckling 1976; Shleifer and Vishny 1997). Incentives via executive compensation schemes take a number of different forms such as salaries, bonuses, recruitment incentives, stock options, equity ownership, or pension benefits (Jensen and Meckling 1976; Fama 1980; Fama and Jensen 1983). Agency theory predicts that compensation such as stock options can be the standard solution for inducing risk-seeking behaviour because of their payoff function (Jensen and Meckling 1976; Smith and Stulz 1985). The overall purpose of these incentives is to place the managers in a position congruent with the economic interests of the enterprise as a whole.

Theoretically, the study of executive compensation can be divided into two competing views: optimal contracting view and managerial power view (Bebchuk and Fried 2005; Weisbach 2007; Choe, Tian et al. 2009; Bebchuk, Cohen et al. 2010; Bebchuk and Weisbach 2010; Sun, Zhao et al. 2010). Optimal contracting anticipates that remuneration committees have sufficient incentives to determine executive compensation that optimizes on behalf of shareholders (Mirrlees 1976; Holmstrom 1979) Structural variables such as board composition and characteristics are insignificant or relevant. In contract, managerial power view believes that optimal contracting originally designed to help remedy agency problems may have actually become part of the problems because board structure is inefficient due to unresolved agency problems, leading to sub-optimal outcomes (Bebchuk and Fried 2003). It is believed that executives may exert enormous influence over the board of director to make such pay arrangement in favour of themselves instead of the shareholders. There has been considerable concern about the contractual terms associated with the compensation of top executives, in particular, in the form of profit-related bonus, share options and termination payments when contract are ended (often when the performance of the company has been poor) (Lee 2006). According to Frey and Osterloh (2005), the performance-pay relation might be a misleading indicator of the compensation arrangements, which are difficult to implement and encourage risk behaviour in very short-term period.

The empirical evidence on the relationship between pay and performance is mixed. In most empirical studies, various variables such as firm size, sales growth, CEO duality and ownership structure have been taken to study the performance-pay relation. The studies by Murphy (1985), Antle and Smith (1986), Jensen and Murphy (1990) document the evidence of a statistically significant association between total compensation (cash and share options) and share price performance. For example, Jensen and Murphy (1990) identify that stock options offer the stronger basis for strengthening the performance-pay link than other pay components by analyzing the pay structure of 1688 executives' compensation between 1974 and 1986. Murphy (1985) highlights the importance of building a comprehensive pay variable from the analysis of 461 individuals in 72 US firms during 1964-1981. According to Hall and Murphy (2003), stock-based compensation, such as restricted stock and stock options, help align managerial and shareholder interests and motivate shareholder wealth creation. By contrast, scholars such as Gregg et al (1993) and Conyon and Gregg (1994) find a decreasing relationship between share price performance and executive pay. However, these studies fail to incorporate share options into the pay variable. It is argued that share options did little to address agency problem but offered executives an opportunity to take excessive risk in order bolster company's share price with short-term maneuvers and gain significant reward without having to bear any downside risks. A study by Sawers et al. (2007) is based on the behavioural agency model, which predicts that managerial risk-seeking behaviour will be influenced by the manager's wealth in stock-based compensation. The results suggest that the subjective overvaluation of stock options based on historical rising stock price trends increases risk-bearing behaviour.

Development Plan

The paper will be further developed to incorporate the literature review of the uniqueness of the compensation arrangements in banking industry due to the fact that banks are highly leveraged, equity-based incentive pay is prevailing and creditors in the form of insured depositors by government do not have incentives to monitor banks' risk taking behaviour. The main characteristics of hybrid bank capital securities will then be analysed and followed by the investigation of European hybrid market by employing hybrid data from the Merrill Lynch Global Index System from 2000 to 2010. We outline the evolution of the European market for hybrid bank capital securities and discuss the reasons for its remarkable growth. Furthermore, we will investigate investors' experience with these securities before and after the Great Credit Crisis. The risk-return trade-off relationships from 2000 to 2010 will be estimated. According to our empirical analyses, we will put forward and lay out the rationale for our proposal of including subordinated bank debt in executive compensation packages.

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