Banker's Pay, Incentives and Regulation: a summary

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It is believed that one of the reasons behind the 2008 financial crisis was the excessive risk taken by managers, influenced by the wrong incentives created by their remunerations schemes. Consequently, improving banks' governance models and compensation practices came to the forefront of regulatory reform efforts, in an attempt to align incentives and to ensure long-term sustainability of financial institutions.
The objective of this conference was to shed more light on compensation design and practice in the banking sector and on the role of compensation schemes on bank risk-taking and misconduct. Additionally, it is important to go beyond the identification of the problems and their potential effects on the financial system. It is also necessary to look at the effectiveness and the consequences (intended and unintended) of the regulatory remedies. The papers presented suggested that regulation should be made more flexible and proportionate, focusing on systemic risk.
Several regulatory mechanisms were presented, such as regulating the corporate governance processes, deferment of compensation in order to transform pay-out schedules sensitive to the time horizon of risks, malus and clawback features, and imposing restrictions on pay curvature. The conference highlighted the limitations that a cap to variable remuneration could bring, as well as the higher level of systemic risk induced by engaging in Relative Performance Evaluation.

The first paper presented was "Regulating Bankers' Pay: Systemic Risk, Proportionality and Culture", by Guido Ferrarini. It tries to answer to three different questions. The first question is whether regulation of bankers' pay is justified; the second question is related to the main characteristics of the international and EU regulation of bankers' pay; and the last question is about how the present EU regulation could be improved.
According to the author, there is some evidence that flawed remuneration structures contributed to the failure of many banks and other financial institutions. However, some studies show that banks led by CEOs whose interests were better aligned with those of their shareholders had worse stock returns and a worse return on equity. We should take into consideration that even when senior executives have significant stock ownership in their banks, their short-term incentives induce them to take excessive risks. Setting the structure of pay is a corporate governance function that regulation should not substitute with detailed and rigid provisions. If there are corporate governance failures in the setting of bankers' pay, better to deal with them by lightly regulating the corporate governance processes, as already done under the international principles. Moreover, prudential supervision complements regulation through oversight of remuneration governance and risk management processes concerning the impact of incentives on bank risk-taking.
In terms of international regulation, the Financial Stability Board (FSB) principles[1] break new grounds by requiring financial institutions to align compensation with prudent risk taking. Deferment of compensation, traditionally used as a retention mechanism, should make compensation pay-out schedules sensitive to the time horizon of risks. Another FSB principle claims that a substantial portion of variable compensation (i.e. 40 to 60%) should be payable under deferral arrangements over a period of not less than three years, provided that this period is correctly aligned with the nature of the business, its risks, and the activities of the employee in question. In order to decrease the misalignment between incentives of executives and shareholders, FSB requires malus and clawback mechanisms. FSB principles focus on long-term incentives, widen the powers of supervisors by explicitly making pay at financial institutions subject to prudential supervision, remain at a sufficient level of generality and allow for flexibility in implementation. The EU law shifted from a supervisory approach to a regulatory one on the setting of bankers' pay, adopting detailed and rigid provisions on the structure, governance and disclosure of remuneration. Moreover, CRD IV introduced an unprecedented cap to variable remuneration, which may distort incentives and produce unintended consequences on bank risk-taking. According to Kevin Murphy (2013) the cap will likely

[1] FSB Principles for Sound Compensation Practices, available at http://www.fsb.org/wp-content/uploads/r_0904b.pdf.

increase the level of fixed remuneration, making banks more vulnerable to business cycles and therefore increasing the risk of bank failure.
Finally the author tries to come up with some suggestions on the current regulation. In order to overcome its shortcomings, CRD IV should be made more flexible and proportionate within the limits allowed by the international principles. Regulation should focus on systemic risk, identifying the institutions subject to the most stringent provisions. Finally, governance and supervision of bankers' pay should emphasize the role of culture in the setting and monitoring of remuneration, for incentives are not set in a vacuum but reflect both the culture prevalent in society and that of the individual firm.

The second paper presented was "Only time will tell: A theory of deferred compensation and its regulation", by Florian Homann, Roman Inderst and Marcus Opp. This paper intends to better understand the optimal duration of pay in principal-agent settings, where performance signals arrive over time and the associated increase in informativeness has to be balanced against the agent's liquidity needs. The paper analyzes the effects of recent regulatory interventions in the financial sector, such as minimum deferral periods for bonuses, and shows that moderate interventions can effectively push shareholders to focus more on long-term consequences, while sufficiently long minimum deferral periods unambiguously backfire. One of the main takeaways from this paper is the importance to relate the timing dimension of pay to the variation of the nature of information arrival across industries. For example, it may be hypothesized that firms in R&D intensive industries should design longer duration contracts for their CEOs. The observed duration of pay may reflect an optimal trade-off rather than necessarily a corporate governance failure.

The third paper presented was "Preaching Water But Drinking Wine? Relative Performance Evaluation in International Banking", by Dragan Ilic, Sonja Pisarov and Peter S. Schmidt. The paper investigates the existence of Relative Performance Evaluation (RPE) in international banking and pays particular attention to banks that claim its use in executive pay. The data range from 2003 until 2014, over 42 non-U.S. banks. RPE implies that compensation contracts should be linked to firm performance in relation to peers with similar characteristics. According to the authors, the global banking industry is an ideal industry to test the usage of RPE for three reasons: a) RPE makes special sense for firms that are exposed to common shocks; b) the banking industry has been shifting from once highly centralized domestic organizations to global organizations[2]; c) the recent financial crisis has drawn increasing attention to corporate governance issues in remuneration policy. If anything, this pressure has prompted banks to make more efficient use of RPE.
In order to infer the usage of RPE, the authors regress the logarithm of total compensation on firm performance, industry and industry/size peer performance, and control variables such as firm size and growth options[3]. Their study tackles the caveat that the soundness of empirical tests on RPE critically hinges on the correct identification of the peer groups, by using the sophisticated industry and industry/size approach of Albuquerque (2009). The analysis also controls for unobservable variation in the level of compensation across years, industries, and countries. When accounting for peer groups, with peer selection based on industry and firm size, they find a negative and statistically significant coefficient on peer performance, which indicates that common shocks are being removed from compensation contracts, providing evidence on the use of RPE in international banking. This evidence becomes stronger and more robust once the focus moves to banks which openly disclose the use of peers in their remuneration practice. Another interesting finding from this paper is the fact that RPE usage is decreasing with growth opportunities. The implementation of RPE in high growth options banks might be too costly due to difficulties in identifying the correct peer group, rendering such banks less likely to use RPE. The paper also concludes that larger banks are more inclined to use RPE in their compensation contracts. In light of the recent financial crisis, high levels of CEO compensation have attracted a lot of attention, and large banks in particular have been under significant monitoring and shareholder pressure. In response to such pressure, large banks are more likely to have become incentivized to be committed to RPE use in determining the level of CEO pay.

[2] In turn, the structure of competition in the industry has adjusted Berger and Smith (2003). Hence, large banks operating on the international level are now dealing with intense competition.
[3] Growth options are defined as market equity plus total assets minus common equity, normalized to total assets.

The fourth and last paper from session 1 was "Ethical standards and cultural assimilation in financial services", by Alan D. Morrison and John Thanassoulis. This paper incorporates ethical considerations in a simple economic model which can analyze the relationship between ethics, culture, and compensation policies. In this model there is a principal who designs compensation contracts for two ethically concerned agents. These agents must decide whether or not to adopt a new business practice which increases the principal's profits, but it may harm customers. The two agents have different levels of information about the new practice. The senior agent has access to a signal of the probability that the practice will harm the customer. The junior agent has no such signal, but is able to observe the senior agent's invocation decision. The junior agent can take account of the senior agent's choice when making his own adoption decision. In the baseline model, it is assumed that the principal maximizes profits, agents account for ethical standards and customers are sophisticated and have perfect information. According to this scenario, firms will always provide ethical services and the principal never uses incentive contracts to corrupt the agents. In contrast, once we consider the principal as an ethically concerned owner-manager, there is a higher incentive to malpractice leading to a reduction in welfare according to a utilitarian perspective. Another extension to the baseline model prevents sophisticated customers from viewing the contracts that the principal signs with the agents and also considers the effect of having unsophisticated customers. In both cases, the principal is not charged for deviating from the surplus-maximizing level of practice invocation and, as a result, the equilibrium features performance bonuses that induce practices that will harm the customer. The last change to the baseline model is the modification in the assumption that all agents act as utility maximizers. Instead, an ethical agent refuses to impose any sort of harm upon another.
This paper shows that partnerships in which senior managers write contracts and have a profit share are not necessarily a good idea, and emphasizes the importance that financial products should be easy for customers to understand, with full disclosure to customers of their financial advisors' commissions. Finally, a cap on bonus payments might result in higher average moral standards amongst retail financial advisors.

The second half of the conference started with the paper "Relative Performance, Banker Compensation, and Systemic Risk", by Rui Albuquerque, Luís Cabral and José Corrêa Guedes. This paper shows that RPE leads managers to choose investments that are correlated across banks, thus increasing the overall level of risk. The model presented features competition between two banks. Each bank is owned by a risk neutral principal and managed by a risk-averse agent. It is assumed that each bank has access to two investment opportunities, one with idiosyncratic risk only and the other with risk that is correlated across banks. Relative performance compensation leads managers to put more weight on investments that are common to the rival bank, as opposed to bank-specific investments subject to idiosyncratic risks. One of the main conclusions from this paper is the fact that shareholders have an incentive to offer RPE as a means to reduce the expected value of CEO compensation required to satisfy the CEO's participation constraint. There are four sources of strategic complementarities: (a) under RPE pay, the more a CEO invests in a correlated project, the more the rival CEO wants to do the same; (b) the more a bank shareholder offers RPE pay, the more the rival bank's shareholder wants to do the same; and (c) the more CEOs invest in correlated projects, the more shareholders want to increase the extent of RPE pay and vice-versa. Finally, (d) leverage adds another incentive to engage in RPE. This situation in turn results in a higher level of systemic risk and an increased likelihood of joint bank failure caused by industry participants investing in correlated assets. The second part of the paper examines how different constraints on bank executive pay affect the equilibrium of the model and thus the resulting level of systemic risk. It shows that the proposed caps on variable pay and on total pay are ineffective in curbing systemic risk as agents circumvent the regulator's constraints.

The second paper presented on the second session of the conference was "Bank Risk-taking and Misconduct", by Ieva Sakalauskaite. The main objective of this paper is improving the current understanding of the motivations to misconduct. While the costs of misconduct in banks can be substantial, the drivers behind it are not well understood. Empirical analysis on the causes of bank conduct failures have been limited due to lack of data on such events, focusing mostly on the outcomes of disciplinary actions. The data was taken from the information on both regulatory actions and private lawsuits against major financial institutions that have resulted in disciplinary costs higher than one million USD. The paper examines how changes in the business cycle, bank characteristics and pay structures affect different types of unlawful activities and which factors amplify the cyclicality of misconduct. According to the data, there is evidence that some classes of misconduct might be pro-cyclical and the effects are exacerbated by

compensation schemes. Furthermore, it can be observed that increases in bank leverage are associated with more underwriting fraud. The relationship between leverage and misconduct intensity is stronger in banks with more aggressive compensation structures. Despite the data limitations, this provides some support to the recent regulatory changes, and suggests that bank supervision intensity should be stronger when GDP growth is higher. In order to explain the dynamics of bank misconduct observed in the data, the paper builds a theoretical model which incorporates both agency conflicts within banks and changes in shareholder preferences over the cycle. It suggests that when bank shareholders do not have sufficient tools to prevent misconduct effectively, frequent detection by regulators might be more effective in preventing conduct failures than changes in incentive schemes, as the latter can result in profitable investment opportunities being foregone. On the other hand, when detection is not sufficient to prevent misconduct and financial penalties are limited by bank capacity to pay, misconduct can be preferred by bank shareholders and induce excessive risk-taking.

The third paper presented was "Risk Choices and Compensation Design", by Mark Carey and Bo Sun. The goal of this paper is to evaluate theoretically the feasibility of omitting risk from compensation functions in a world with bad-tail risk as well as ordinary risk, using the types of compensation functions observed in early 2010. Most such functions compensated employees with a mixture of stock, cash and options. The paper investigates the ability of pay functions that resemble stock and options to incentivize managers to exert effort while avoiding bad-tail risk. One of the innovations in this work is the introduction of collars in compensation design and the benefits that they bring along. The three main contributions from the paper are the following: a) pay functions similar to options are more effective in deterring tail risk than those similar to stock for a wide variety of project choice sets; b) the authors' findings support regulators' argument that bank compensation functions should include risk arguments; c) stock-like pay functions are more often effective if the ex post penalty imposed on the manager when bad-tail realizations occur is sufficiently large.
According to the paper, traditional compensation contracts are unlikely to be effective, given the managers limited liability. Contracts that feature deferral of payout of a substantial share of compensation, with the firm being able to use malus and clawback features to recapture deferred compensation after bad realizations, appear more likely to be effective.

The last paper presented on the conference was "Optimal Pay Regulation for Too-Big-To-Fail Banks", by John Thanassoulis and Misa Tanaka. This paper examines the optimal design of pay regulation for banks that are too-big-to-fail (TBTF), using a principal-agent framework. In the presence of explicit deposit insurance and the implicit possibility of government bailouts (the TBTF effect), a bank's shareholders have the incentive to design pay contracts to encourage executives to take excessive risks at the expense of the taxpayers. In order to correct the TBTF distortion, the authors propose two solutions: the first is to impose malus and clawback to ensure that the bank executives suffer a financial penalty when the bank fails, and the second is linking the bank executive's pay to the interest rate on debt, whereby pay is reduced when the interest rate is high. However, pay regulation could be undermined fairly easily if bank owners can make pay both increasing and convex in the bank's equity value in order to reward risk-taking. The pay schedule can be made convex most obviously through a schedule of equity-linked bonus payments and via stock options, but also through promotions which reward risk-takers by increasing their base pay. According to the paper, convex pay could be used to circumvent a range of pay regulations, including malus and clawback, and regulations linking pay to the interest rate on debt. Convex pay can also limit the effectiveness of bonus caps. In theory, the regulator could close this "loophole" by imposing restrictions on pay curvature. In order to impose these restrictions, the regulator needs to observe the full pay schedule and has to be able to control the instruments used to generate the pay curvature. Restricting some methods of achieving pay convexity, such as schedules of bonus payouts and stock options, may be practicable. However, other methods of generating curvature, such as via a promotion policy designed to favor risk takers, might be difficult to regulate in practice. Without closing these loopholes, pay regulations are unlikely to be effective in achieving their stated aims of mitigating excessive risk-taking.