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How to Pay a Banker

By Lucian Bebchuk

The United States' Federal Reserve Board recently adopted a policy under which bank supervisors, the guardians of the financial system's safety and soundness, would review the compensation structures of bank executives. Authorities elsewhere are considering or adopting similar programs. But what structures should regulators seek to encourage?

It is now widely accepted that it is important to reward bankers for long-term results. Rewarding bankers for short-term results, even when those results are subsequently reversed, produces incentives to take excessive risks.

But tying executive payoffs to long-term results does not provide a complete answer to the challenge facing firms and regulators. The question still remains: long-term results for whom?

Equity-based awards, coupled with the highly leveraged capital structure of banks, tie executives' compensation to a leveraged bet on the value of banks' assets. As Holger Spamann and I show in our research, executive payoffs should be tied to the long-term value delivered not only to shareholders, but also to other contributors to banks' capital. As it is, bank executives expect to share in any gains that might flow to common shareholders, but they are insulated from the consequences that losses, produced by their choices, could impose on preferred shareholders, bondholders, depositors, or the government as a guarantor of deposits.

Insulating executives from losses to stakeholders other than shareholders can be expected to encourage them to make investments and take on obligations that increase the likelihood and severity of losses that exceed the shareholders' capital. In addition, such insulation discourages the raising of additional capital, inducing executives to run banks with a capital level that provides an inadequate cushion for bondholders and depositors. The more thinly capitalized banks are, the more severe these distortions – and the larger the expected costs rising from insulating executives from potential losses to non-shareholder stakeholders.

How could pay arrangements be redesigned to address these problems?

To the extent that executive compensation is tied to the value of specified securities, such pay could be tied to a broader basket of securities, not only common shares.

Thus, rather than tying executive pay to a specified percentage of the value of the bank's common shares, compensation could be tied to a specified percentage of the aggregate value of the bank's common shares, preferred shares, and all the outstanding bonds issued by the bank. Because such a compensation structure would expose executives to a broader share of the negative consequences of risks taken, it would reduce their incentives to take excessive risks.

Nevertheless, while such a compensation structure would lead executives to internalize the interests of preferred shareholders and bondholders, thereby improving incentives, it would be insufficient to induce executives to internalize fully the interests of the government as the guarantor of deposits. To do so, executive payoffs could be made dependent on changes in the

value of the banks' credit-default swaps, which reflect the probability that the bank will not have sufficient capital to meet its full obligations.

In addition, bonus compensation should be redesigned. In the past, bank executives' bonuses were often based on accounting measures that are of interest primarily to common shareholders, such as return on equity or earnings per common share. In the future, banks should consider basing bonus compensation on broader measures, such as earnings before any payments made to bondholders.

Recognizing the value of tying executive payoffs to the effects of executives' choices on non-shareholders highlights the important role of bank regulators in this area. The common shareholders in financial firms do not have an incentive to induce executives to take into account the losses that risks can impose on preferred shareholders, bondholders, depositors, and taxpayers. Consequently, governance improvements that make directors more focused on shareholder interests cannot be relied on to tie executive payoffs to the interests of shareholders and non-shareholders alike. Regulatory encouragement may be helpful, perhaps even necessary.

Getting executives to internalize perfectly the expected losses that their choices might impose on contributors of capital other than shareholders is complex. But moving in this direction, even if imperfectly, would mean real progress. Motivating financial executives to focus on the effects of their choices on all those contributing capital to the bank would significantly improve their risk-taking incentives. It thus would also contribute to making our financial systems safer.

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