Remuneration and Risk-taking in Financial Institutions

Elizabeth Sheedy, PhD

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MACQUARIE UNIVERSITY | APPLIED FINANCE CENTRE

Remuneration:

Politics, Regulation and Economics

Remuneration:

- Clawbacks at Lloyds and HSBC
- Dodd-Frank
- EU: CRD III

Remuneration:

- A new world for bankers?
- Or will the old ways return when the crisis blows over?

Remuneration:

Research: Does remuneration influence risk-taking?

It’s complicated…

- How to measure risk and performance?
- Is high risk always ‘bad’?
- Endogeneity?
- Interaction with risk controls, regulation and culture?
- Exact structure of remuneration vs total?
- Risks misunderstood? Cognitive biases?

What's the role of shareholders?

- 'Say on Pay' theory
- Equity as a call on assets?
- Moral hazard?
- Short-term focus?
- Are they actively encouraging risk-taking?

Academic Research on Remuneration

Cheng, Hong and Scheinkman (2010) "Yesterday's Heroes: Compensation and Creative Risk-taking" NBER 16176

Find correlation between total remuneration of Top 5 and risk-taking

What’s the role of shareholders?

- Are they actively encouraging risk-taking? YES
- High salaries and bonuses are a risk premium to compensate staff?

Consider Bear Stearns and Lehman

In 2008 the CEO of Lehman incurred (paper) losses of $931 million on his shareholdings while the CEO of Bear Stearns lost over $900 million.

Cash bonuses 2000-2007

Bear Stearns		Lehman	
CEO	Execs 2-5	CEO	Execs 2-5
$87.5m	$239m	$61.6m	$102.4m

Proceeds sale of equity 2000-2007

Bear Stearns		Lehman	
CEO	Execs 2-5	CEO	Execs 2-5
$289m	$817m	$471m	$389m

Accumulating vast wealth leads to risk tolerance.

Remuneration most problematic when...

- Total remuneration is high over long period of time
- There are options and cash bonuses involved (vs shares)
- Shareholders have short-term focus
- Weak regulatory environment
- Weak risk culture/controls

What do we mean by strong risk culture?

- Focus on shareholder interests not necessarily appropriate
- Traditional corporate governance measures focus on shareholder rights

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What is risk culture?

"The norms and traditions of behaviour of individuals and of groups within an organisation that determine the way in which they identify, understand, discuss and act upon the risks the organisation confronts and the risks it takes." IIF 2009

IIF recommendations on risk governance

- Dedicated risk committee with strong experience and skills
- Independent CRO with status/power
- Adequate ***resources*** for risk management function
- Clearly defined risk appetite
- Effective dialogue about risk at all levels (questioning)
- Deep understanding of risk profile
- Clear understanding of individual responsibilities in risk management structure

Academic Research on Risk Controls

Ellul and Yerramilli (2010) “Stronger Risk Controls, Lower Risk: Evidence from US Bank Holding Companies” NBER 16178

How to measure effectiveness of risk governance?

- Remuneration of the Chief Risk Officer (vs CEO)?
- Banking experience of independent Directors?
- Frequency of Risk Committee meetings?

Ellul and Yerramilli study finds that banks with stronger risk governance have lower enterprise-wide risk, **even after controlling for remuneration** policy.

Risk management

Power/status?

Resources?

Education and experience?

Risk education

- Master of Applied Finance
- Compulsory unit on Financial Risk Management
- Many advanced risk electives

www.mafc.mq.edu.au

Financial Stability Board

- Produced Principles for Compensation in April 2009
- International body
- Endorsed by G20, Basel Committee
- Governance, Structure, Disclosure, Supervision

Financial Stability Board

- **Remuneration must be aligned with prudent risk-taking.**
- Symmetry (deferrals and clawbacks)
- Adjusting performance for risk
- Equity vs cash
- No guaranteed bonuses

Financial Stability Board: Progress

- Late 2011 survey by IIF and Oliver Wyman
- Significant progress has been made in implementation of principles
- More work to be done e.g. risk-adjustment, clawbacks, material risk-takers.
- But is this just a side-show?

Basel Regulations

- Basel 2.5 from 31 Dec 2011(market risk)
- Basel 3 is just around the corner
- National regulators will review bank compensation policies

Increased capital requirements!

$$\text{ROE} = \frac{\textit{Earnings}}{\textit{Capital}}$$

Capital Conservation Buffer

Can remuneration practices of the past be sustained? Probably not.

Conclusion

- Remuneration policy has affected risk-taking (driven by some shareholders).
- Permanent reduction in remuneration at regulated entities. Will this help?
- Risk controls are an effective counter-measure if adequately resourced.
- Macquarie will continue to research and educate in financial risk management.