

Banking Risk: Time to Separate CEO Compensation From Shareholders' Interests

When CEO pay is aligned with shareholders' interests, bank executives may be incentivized to take on too much risk, say IESE's Christian Eufinger and Andrej Gill. This is not a corporate governance failure, but a problem stemming from government guarantees — one with a proposed solution.



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Top lesson from the 2008-9 financial crisis: Banks take on too much risk. And everyone knows the government, at great taxpayer expense, will bail certain banks out if things get too bad — for the sake of social good.

Government guarantees help keep the banking system healthy, but they also mean that shareholders of distressed banks potentially have a lot more to win than lose when they make risky bets. And if bank CEOs' compensation is aligned with shareholders' interests, via stock options or other types of variable pay, they too have distorted risk incentives.

This state of affairs is not a corporate governance failure, but a problem stemming from those government guarantees, say [Christian Eufinger](#) and Andrej Gill, the authors of "Incentive-Based Capital Requirements," which proposes a new regulatory approach.

In brief, Eufinger and Gill propose separating management's incentives from shareholders'. More specifically, they suggest that banks implement a more conservative compensation structure for managers, with higher fixed payments and lower variable payments (because of the latter's tendency to incentivize risk-taking). And that with more conservative compensation structure, banks should be able to access more debt.

Basically, it's a new take on capital requirements, based on managers' pay instead of assets.

Usually, regulators focus on banks' current assets and the risk levels of those assets in capital requirements. However, the most recent financial crisis revealed that measuring asset risk is a difficult and error-prone process. The new proposal is simpler.

Next Steps: How to Make it Work

Incentive-based capital requirements, as a policy, must be transparent and flexible in order to work. By ensuring bank managers are invested in their bank not defaulting — their wage depends on it — Eufinger and Gill argue that their policy is more effective than trying to directly impose risk-mitigating initiatives, like banning insured debt altogether. And by changing the bank's capital requirements whenever managers' pay structure changes, there is a high level of flexibility.

By motivating bank management to take responsible, low-risk investment decisions, this new approach to bank regulation could promote success for both financial institutions and society as a whole.

Methodology, Very Briefly

The authors' model builds on previous studies to examine risk-shifting incentives when managers' incentives are decoupled from shareholders'. They consider an economy with three dates, three risk-neutral parties (shareholders, creditors, and bank managers), and two

investment possibilities (risky and safe), assuming that the government will step in if the bank fails.

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