Is Bank Governance Different?

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Corporate Governance and the new Financial Regulation: Complements or Substitutes?
ECGI Brussels 25 October 2010

Outline

1) **Corporate Governance (CG) for Banks & CG for non-financial corporations**
2) **The Board of Directors and other Committees**
3) **Executive Compensation**

I) Corporate Governance for Banks vs. Non-Financial Corporations

- Same legal framework & same fiduciary duties of directors, but…
- Not the same regulatory oversight & not the same expectations from regulators
  - **Balance** 'safety and soundness' and 'shareholder value maximization'
- Limited scope for 'disciplining' takeovers & proxy contests (delay & uncertainty in regulatory approval process)

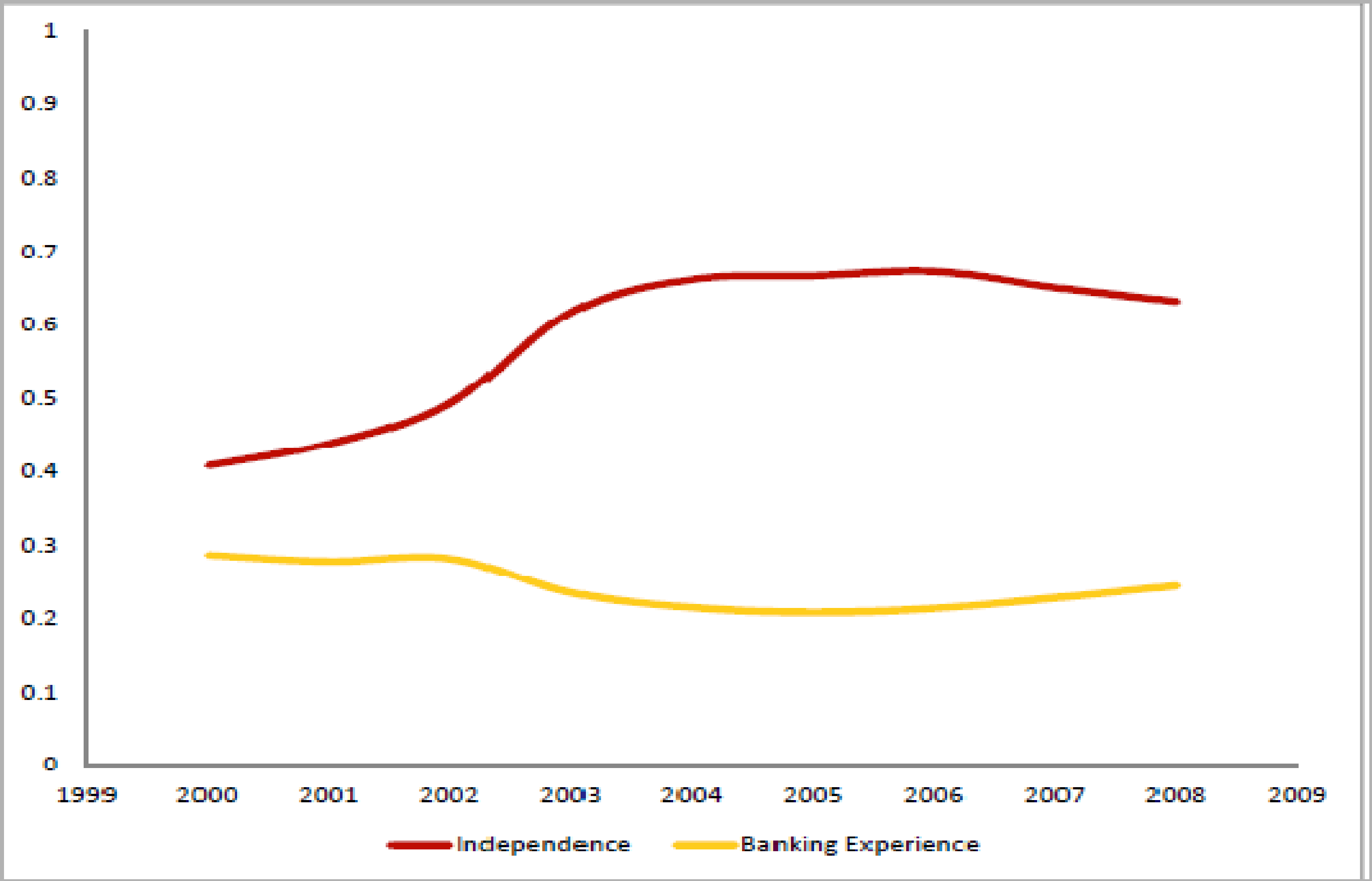
I) Corporate Governance for Banks vs. Non-Financial Corporations

=>

- Bigger role for BOD and Committees
- Larger size of BOD for BHCs (Adams & Mehran, 2008)
  - **18.2 vs. 12.1**
- Regulation mostly in the form of requirements of 'independence' (% of NEDs)
  - **68.7 vs. 60.6**

II) BOD: Independence vs. Experience

(Ferreira, Kirchmaier and Metzger, 2010)



BOD: Performance & Lack of Experience

Two recent studies:

1. Hau and Thum (2009) for *German Landesbanken*
   - Asset write-downs and losses on average **three times** larger for state-owned banks than privately-owned banks (over crisis period 2007-2008)
   - losses negatively correlated with financial competence of BOD
2. Cuñat and Garicano (2010) for *Spanish Cajas*
   - Financial competence of CEOs negatively correlated with losses

Regulation of Bank BOD: Walker Report (2009) **Recommendations**

Recommendation 1: "Ensure that NEDs have the knowledge and understanding of the business"

Other Recommendations:

- Establish a risk committee separately from audit committee and **elevate** the role & standing of the **CRO**
- *Deferral of incentive pay* as the ***primary*** *risk-adjustment mechanism*
- Remuneration committee should seek advice from risk committee on risk adjustments

III) Compensation and Risk Taking

Modern agency theory of executive pay:

Stock-based compensation aligns CEO and shareholders' **long-term objectives**:

- Stock price an unbiased estimate of fundamentals
- Induces managers to focus on long-run value
- Performance measure that cannot be manipulated easily

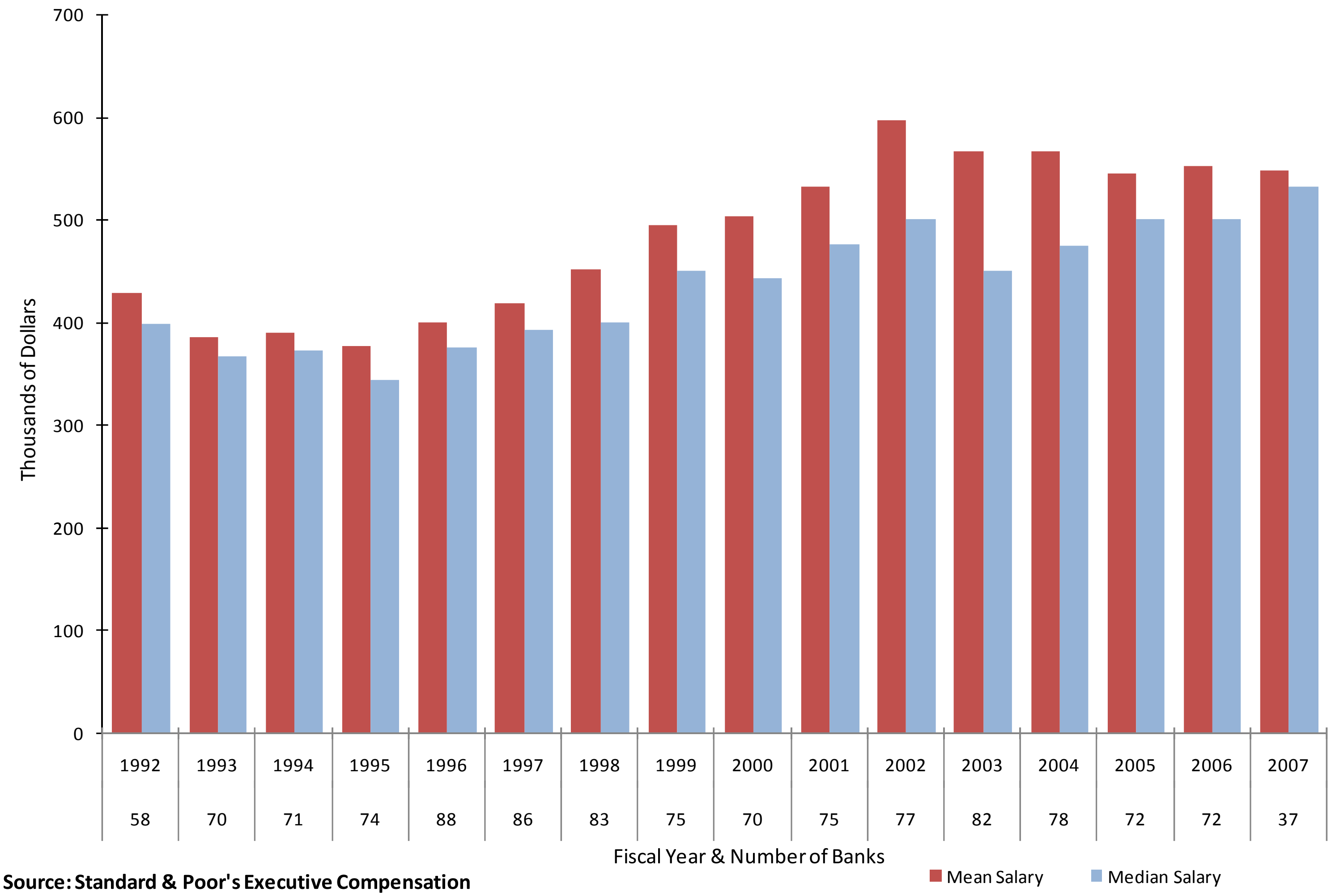
Compensation and Risk Taking (2)

Caveats:

- No leverage
- No Stock-options
- No endogenous choice of risk or volatility of earnings
- Risk-Averse Managers & Risk-neutral investors
- No speculative bubbles

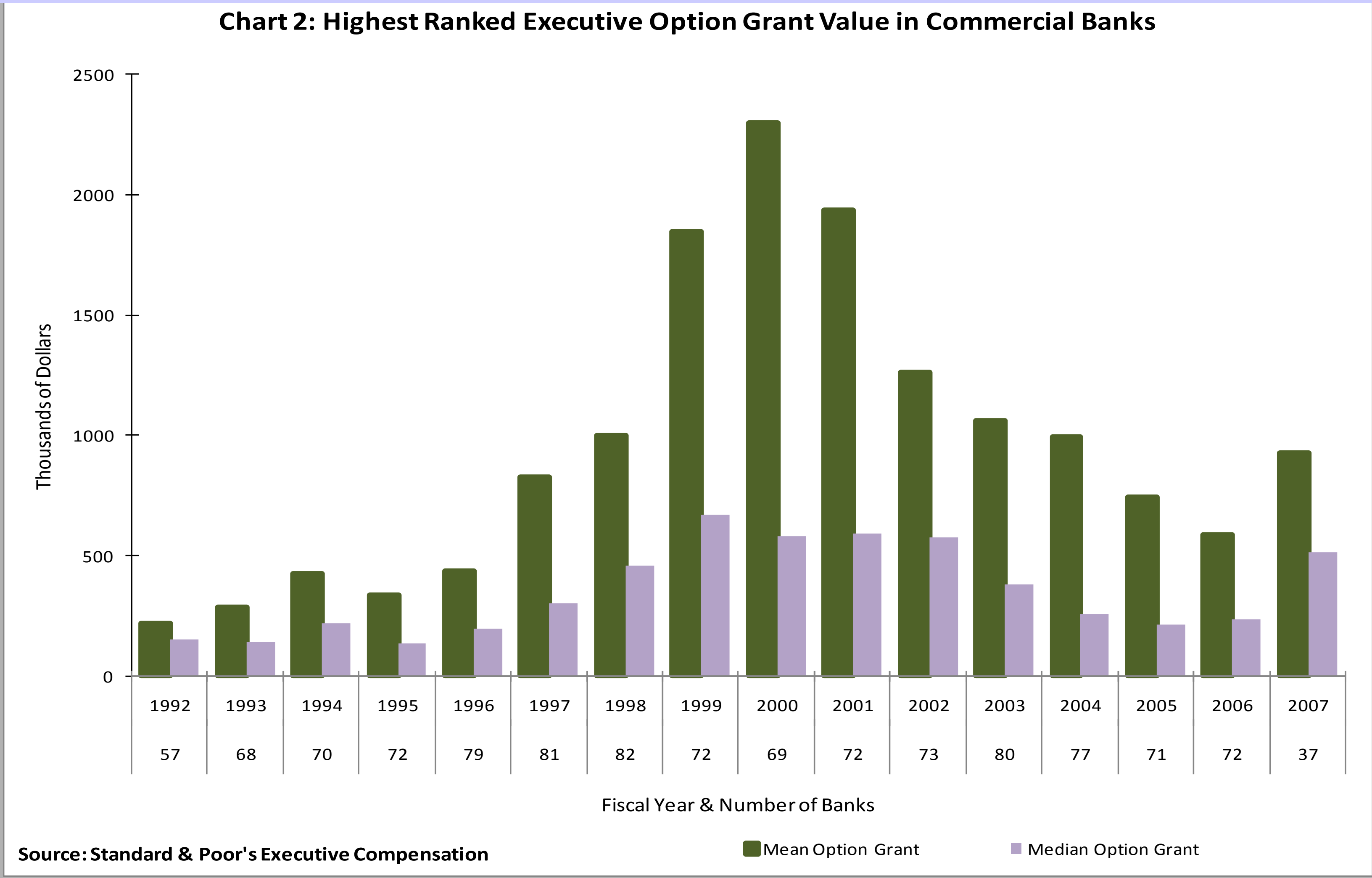
Compensation in Banks: What do we know?

Chart 1: Highest Ranked Executive Salary in Commercial Banks

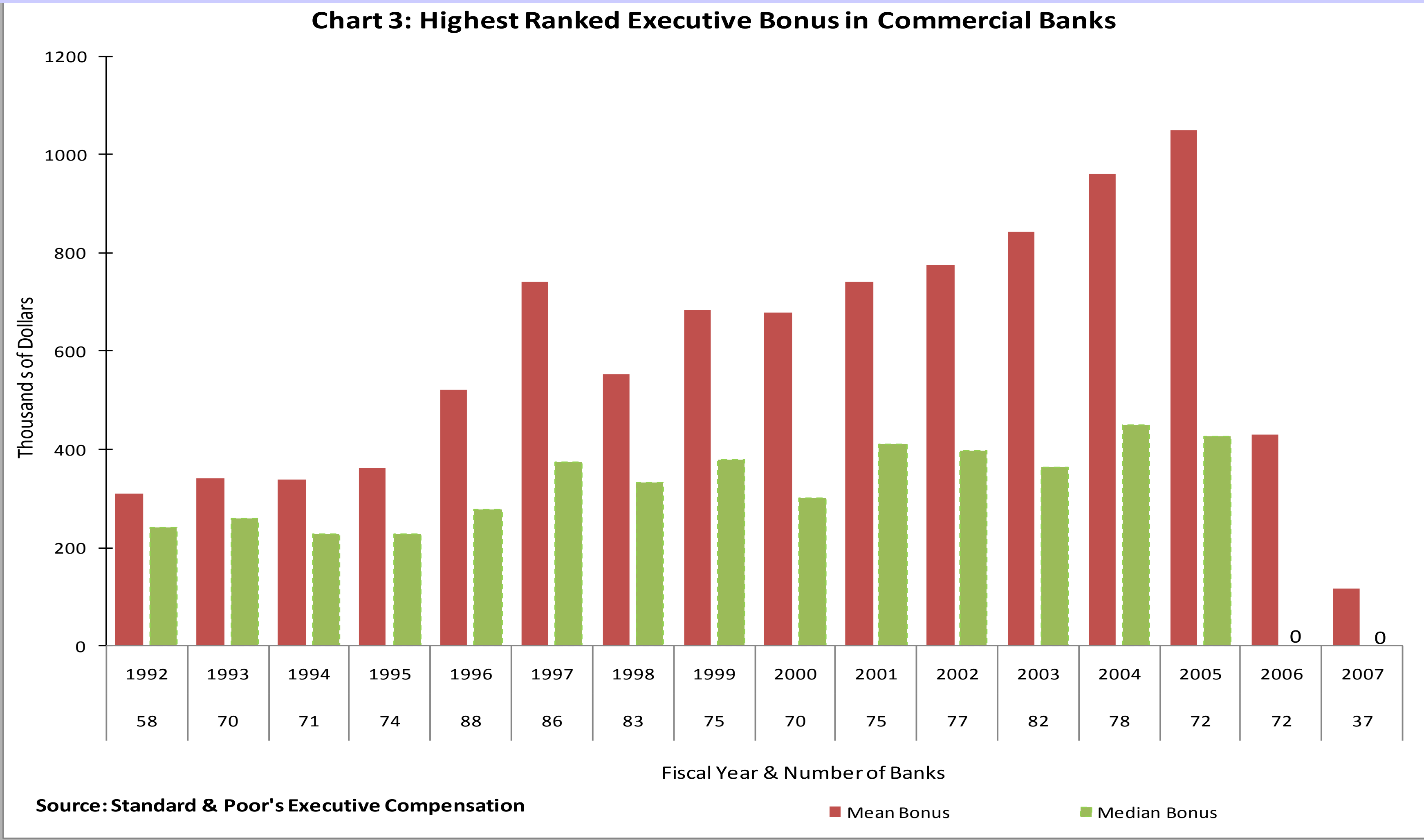


Source: Standard & Poor's Executive Compensation

Compensation in Banks: What do we know?



Compensation in Banks: What do we know?



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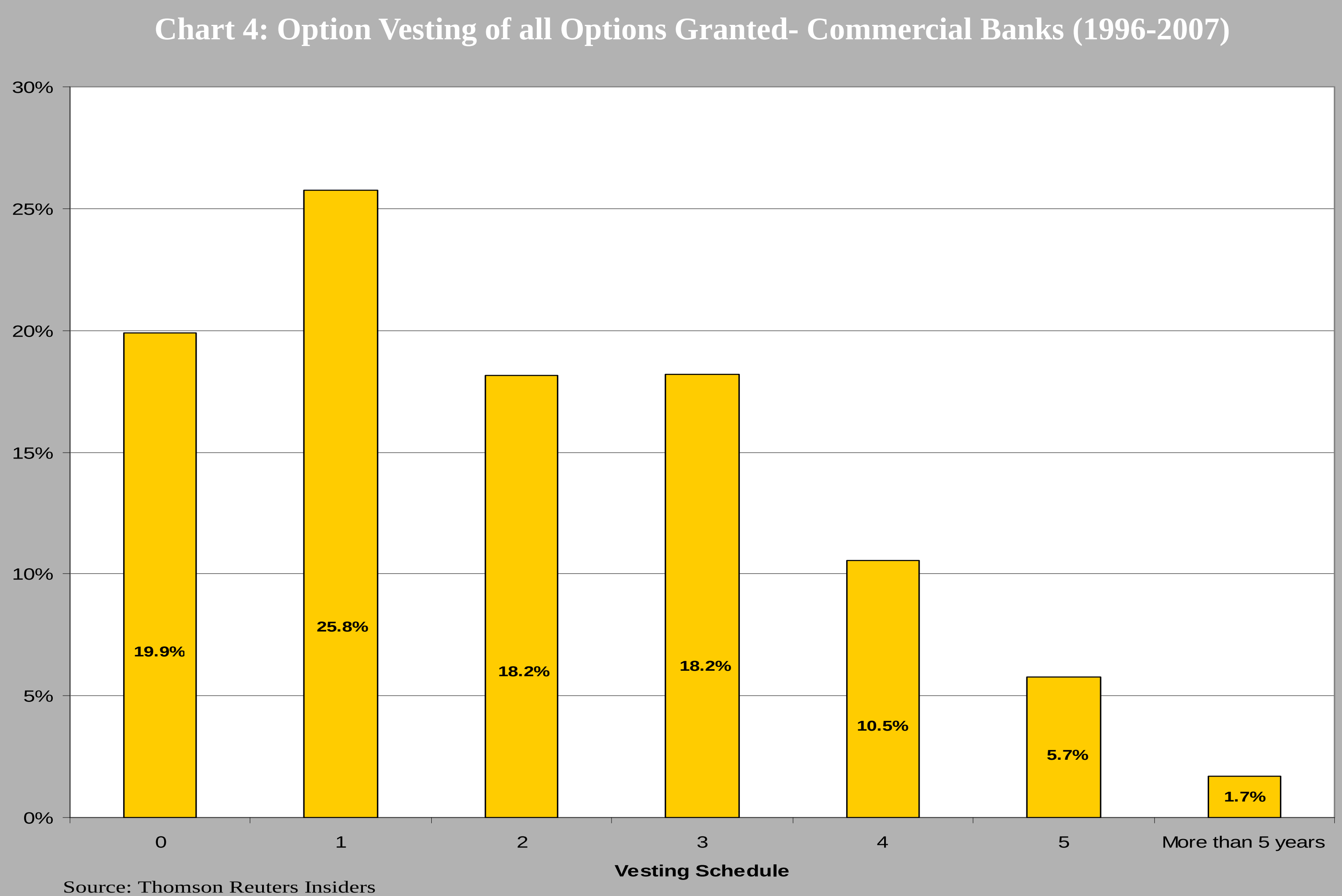
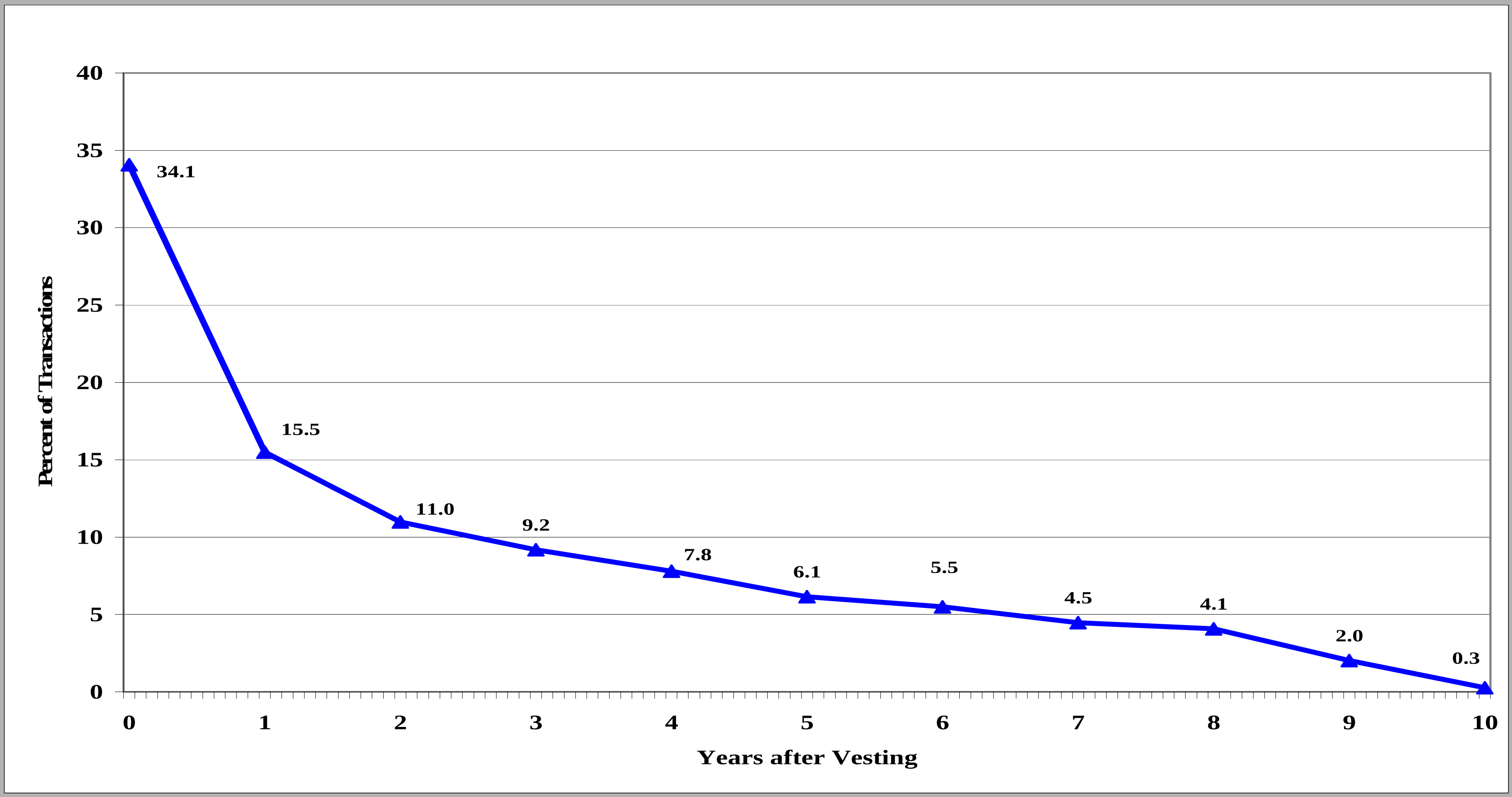
Stock option grants are characterized by **short vesting**



Large portion of options exercised shortly after they vest

Chart 5: Time Until Exercise - Commercial Bank Vested in the Money Options (7,254 Transactions)



Source: Thomson Reuters Insiders

Compensation and Risk Taking (3)

- Shareholders incentives to rein in risk-taking (*i.e. leverage*) depend on:
  - **observability** of risk choice,
  - **verifiability** of incentive contract,
  - **deposit insurance**,
  - debtholders' (**mis)-perceptions of risk**

Cheng, Hong and Scheinkman (2009)

- **Does CEO compensation lead to excess risk-taking?**
- **Panel** of finance cos. from 1992 to 2008
- **Residual compensation:** regress total compensation on **firm size** and **sub-industry classification**
- **Two sub-periods:** 1992-2000 and 2000-2008
- Regression is for sub-sub-periods 1992-94 & 98-2000
- Log (average compensation) against log (market cap.) & sub-industry dummies (Primary dealers, Insurers)

Cheng, Hong and Scheinkman (2009)

- Sub-periods 95-2000 & 2001-08 are used to compute **risk-measures (beta, return volatility, tail cumulative return performance)**
- **Regress these risk-measures on lagged residual compensation**
- **RESULTS:**

1. Residual pay in the two cross sections is **highly correlated** (0.61)
2. Firms with **high residual compensation**: **Bear Stearns, Lehman, Citicorp., Countrywide, AIG**

Cheng, Hong and Scheinkman (2009)

Residual comp. highly correlated with subsequent risk-taking

OLS Coefficient on Residual Executive Compensation

LHS	Early Period	Late Period
CRSP VW Beta	0.2079*** [0.0502] (0.1048) N=137	0.1717*** [0.0503] (0.1122) N=139
Return Volatility	0.0365*** [0.0135] (0.0764) N=137	0.1037** [0.0454] (0.0688) N=139
Cumulative Excess Returns	0.9773** [0.4161] (0.0685) N=147	-0.3205*** [0.1019] (0.0693) N=151
Exposure to ABX		0.1429*** [0.0533] (0.1094) N=108

Cheng, Hong and Scheinkman (2009)

Risk-taking and **Governance** : standard governance measures are not correlated with risk-taking

LHS	Gov. Variable	Early Period	Late Period
CRSP VW Beta	G-Index	0.0044	0.0072
		[0.0125]	[0.0101]
	E-Index	-0.0246	0.0159
		[0.0243]	[0.0213]
	% Outside Directors		0.1818
			[0.2087]
	Board Size		-0.0012
			[0.0081]
Return Volatility	G-Index	-0.0024	-0.0011
		[0.0024]	[0.0085]
	E-Index	-0.0125**	-0.0143
		[0.0058]	[0.0168]
	% Outside Directors		0.0753
			[0.1904]
	Board Size		-0.0068
			[0.0061]
Cumulative Excess Returns	G-Index	-0.0610	0.0099
		[0.0706]	[0.0312]
	E-Index	0.0393	0.0573
		[0.1591]	[0.0571]
	% Outside Directors		-0.2608
			[0.3662]
	Board Size		0.0165
			[0.0153]

Cheng, Hong and Scheinkman (2009)

MAIN CONCLUSIONS:

- Important heterogeneity in risk-taking
- Correlated with compensation
- **“Say on Pay”** may not be effective

Bolton, Mehran, and Shapiro (2009)

- **We propose:**
- Tying CEO compensation to a measure of default risk (**CDS spread**)

$$Compensation = \bar{w} + s_E P_E + s_D(\bar{P} - P_{CDS})$$

- **Empirical evidence**: using a SEC regulation on increasing compensation transparency in 2007, we show that the market (CDS spread) believes tying compensation to debt-like compensation (deferred compensation and pension) leads to lower risk

Bolton, Mehran, and Shapiro (2009)

- **Optimal *versus* Equilibrium CDS-based compensation**
- Would shareholders use CDS prices to influence a CEO's choice?
  - **Renegotiation**: shareholders may have incentives to undo contract once bonds have been issued
  - **Deposit Insurance**
  - **Naive Bondholders**

Bolton, Mehran, and Shapiro (2009)

- Risk taking increases when it is less observable and there is more leverage
- Shareholders may not have the incentive to correct for risk taking due to: renegotiation, deposit insurance, and naive bondholders
- Basing compensation on CDS spreads can decrease risk taking
- Empirical evidence seems to suggest this will work