Is Bank Governance Different?

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

**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

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Compensation in Banks: What do we know?

Chart 2: Highest Ranked Executive Option Grant Value in Commercial Banks

Source: Standard & Poor's Executive Compensation

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Compensation in Banks: What do we know?

Chart 3: Highest Ranked Executive Bonus in Commercial Banks

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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

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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
- Regression is for sub-sub-periods 1992-94 & 98-2000
- Log (average compensation) against log (market cap.) & sub-industry dummies (Primary dealers, Insurers)
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**

<table>
<thead>
<tr>
<th>OLS Coefficient on Residual Executive Compensation</th>
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<tr>
<td><strong>LHS</strong></td>
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<td></td>
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<tr>
<td>CRSP VW Beta</td>
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<tr>
<td>N=137</td>
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<tr>
<td>0.0365***</td>
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<td>[0.0135]</td>
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<td>0.9773***</td>
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<td>Exposure to ABX</td>
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<td>[0.0533]</td>
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<td>(0.1094)</td>
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<td>N=108</td>
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**Risk-taking and Governance**: standard governance measures are not correlated with risk-taking

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<tr>
<th>LHS</th>
<th>Gov. Variable</th>
<th>Early Period</th>
<th>Late Period</th>
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<td><strong>CRSP VW Beta</strong></td>
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<td>% Outside</td>
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<td><strong>Return Volatility</strong></td>
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<td><strong>Cumulative Excess Returns</strong></td>
<td>G-Index</td>
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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)

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

- 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.