The incentives of senior bank managers need to be altered in order to make them more risk averse

David Kershaw, **Tom Kirchmaier** *and* **Edmund Schuster** *argue that we need to alter the basic incentive structures of senior managers in systemically important financial institutions. For starters, there should be no bonuses and no performance-related pay of any form.*

Another banking crisis, another predictable regulatory response: more sanctions; stronger enforcement; an inquiry; and yet more disappointment about shareholders' failure to monitor managers and hold them to account. Through this fog of outrage and disappointment we continue to ignore the most basic of economic lessons. Lessons that would help us avoid another sub-prime crisis or Libor scandal. To paraphrase Bill Clinton, "it's about the incentives, stupid".

The incentives of senior bank managers are the primary drivers of bank behaviour and strategy. Senior managers in any bank determine the bank's relationship to risk. Their actions inform fellow members of credit committees and more junior employees about the nature of acceptable risk taking, the types of business the bank should be involved in and the types of behaviour that will please the senior managers. Yet, the basic incentives that structure the behaviour and signals of senior managers in systemically important UK banks are fundamentally wrong.

UK company law clearly instructs managers to promote the interests of shareholders and only shareholders. It also governs the board's relationship with shareholders through a set of shareholder rights that are more powerful than in any other advanced economy. The UK Stewardship Code cajoles institutional shareholders to actively exercise these rights and to behave more like owners. UK pay regulation directs banks to align pay with shareholder preferences. But while company law and pay regulation promotes the primacy of shareholder interests, the interests of shareholders in systemically important banks are at odds with those of the broader society.

As is generally known, equity has option like characteristics that means that it is in the interests of shareholders that their companies take more risk. If the risks pay off shareholders take the gains, if they do not the creditors are left nursing their losses. In the real world of course creditors will not let firms get away with this. That is, we should say, in the non-banking real world. Bank creditors do not discipline banks because they assume they will be bailed out by the state, and the ultimate creditor (the state) does not demand payment for this implicit guarantee. Accordingly, incentive structures that give primacy to shareholder interests – even interests of diversified long-term shareholders – will drive the types of risk taking and associated behaviour that the crisis has revealed to be unacceptable. The term "moral hazard" does not do justice to the nature and extent of this distortion.

Regulation that does not fundamentally alter these incentive structures is incapable of preventing unacceptable and economically inefficient risk-taking. A strategy of first giving primacy to shareholder interests and then trying to mitigate the negative consequences of the pursuit of those interests through minimum capital levels, liquidity ratios and the like is doomed to fail. As we have seen, such rules will be gamed and the spirit of the rules undermined. Regulators do not, and will not, have the resources nor the skill set to play catch-up with the market place. They will always be one step behind and when the public outrage subsides the gaming will resume until the next round of outrage and regulatory tweaking.

We need then to alter the basic incentive structures of senior managers in relation to systemically important financial institutions. If a different incentive structure for senior managers can create a cadre of boring but effective utility banks servicing retail and business customers then the "too big to fail subsidy" for other institutions would be drastically reduced as the failure of a non-systemic bank would not threaten the functioning of the payment system or spill over into the real economy. Only where these conditions are met can the government credibly commit to letting banks fail. Accordingly, we suggest a set of changes that would *only* be applicable to banks determined to be systemically important by the Bank of England.

We propose three changes. First, the corporate objective of a systemically important bank must be changed. The directors should act to promote "the interests of the company" understood as the interests of all bank stakeholders (including shareholders). Shareholder interests would not be granted priority.

Even if bank managers are required to promote the interests of all stakeholders, shareholders' appointment and removal rights are likely to ensure that their interests in practice still come a clear first. The extent to which managers feel that they have room to promote the interests of other stakeholders is a function of the strength of shareholder rights. In the UK these rights are particularly strong. For example, the UK Corporate Governance Code recommends only one-year terms for directors, and they can be removed without cause by a simple majority of the votes cast at a shareholder meeting. Without weaker shareholder rights merely altering the corporate objective would be of limited consequence.

There are many ways in which such rights could be dampened. For example, we could revert to classified boards with three year terms and instead of removal rights being linked to a simple majority of the votes cast the law could instead require a majority of the shares actually issued. Such a proposal runs counter to one of the rote responses to the crisis: that we need more powerful and active shareholders. This is a baffling response equivalent to giving control of the fire brigade to a class which is predisposed to building fires. Of course not all shareholders will actively push managers to exploit the "too big to fail subsidy" but some will. Bank managers of systemically important banks need less exposure to shareholder pressure not more.

Finally, all executive directors and all senior managers who are not also directors and all equivalent managers of all subsidiaries would only receive a salary. No bonuses, no performance-related pay of any form. Pensions would vest only at the statutory retirement age. Salaries would be set by the remuneration committee in the normal way. Lower-level employees could be paid performance-related pay as regulated by the FSA's Remuneration Code. What would be the effects of such a radical step? Most importantly, the primary personal incentives of senior managers would be to keep their job. There would be no bonuses to cushion any fall. This would incentivise senior managers to run the bank in a way which generates profits – to keep shareholders happy enough – whilst minimising the risk of bank failure and bank scandals.

Such managers would be risk averse. They would dispose of excessively risky activities and would not allow innovative risky activities to commence. Over time banks run by managers with these incentives would implement the separation of commercial and investment banking but in a far more effective way than a ban on proprietary trading or the ring-fencing of investment banking activities. This is because it would be implemented by insiders incentivised to take these activities off the bank's balance sheet. Implemented by insiders who know the bank's business and not by regulators who struggle to understand what is and what is not proprietary trading or which side of a ring-fence a particular activity should fall upon.

But wouldn't such an approach to remuneration undermine the generation of value? To a degree, indeed it would; that is the point – the creation of a core of safe UK banks that provide the basic banking function of oiling the wheels of commerce. But wouldn't such a bank be unable to attract talent? No, it would result in the attraction of the *right* talent: conservative and risk-averse managers not creative risk takers. The economy needs those risk takers – but not in systemically important banks.

These incentive solutions are simple and obvious. They would need to be implemented carefully and over time. Why they have not been considered at all is inexplicable.

Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our comments policy before posting.

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