Reforming the Incentive Structure for Bank Executives

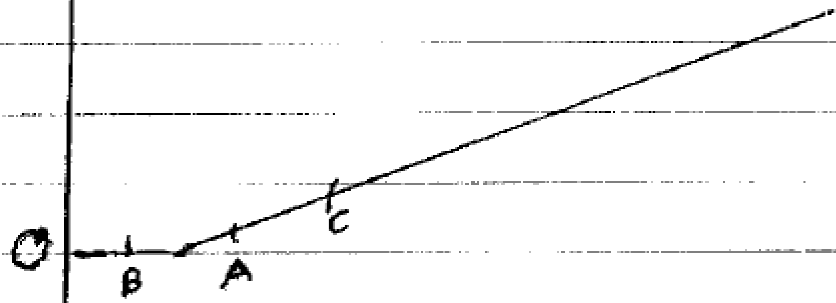
By C.A.E. Goodhart

Limited Liability for Shareholders, including corporate executives, is the greatest source of moral hazard in a capitalist society.

Why Modigliani/Miller and early warnings from uninsured creditors does not work. Difficulty for accountants and supervisors to work in a confrontational fashion.

Some empirical evidence.

What can be done about it?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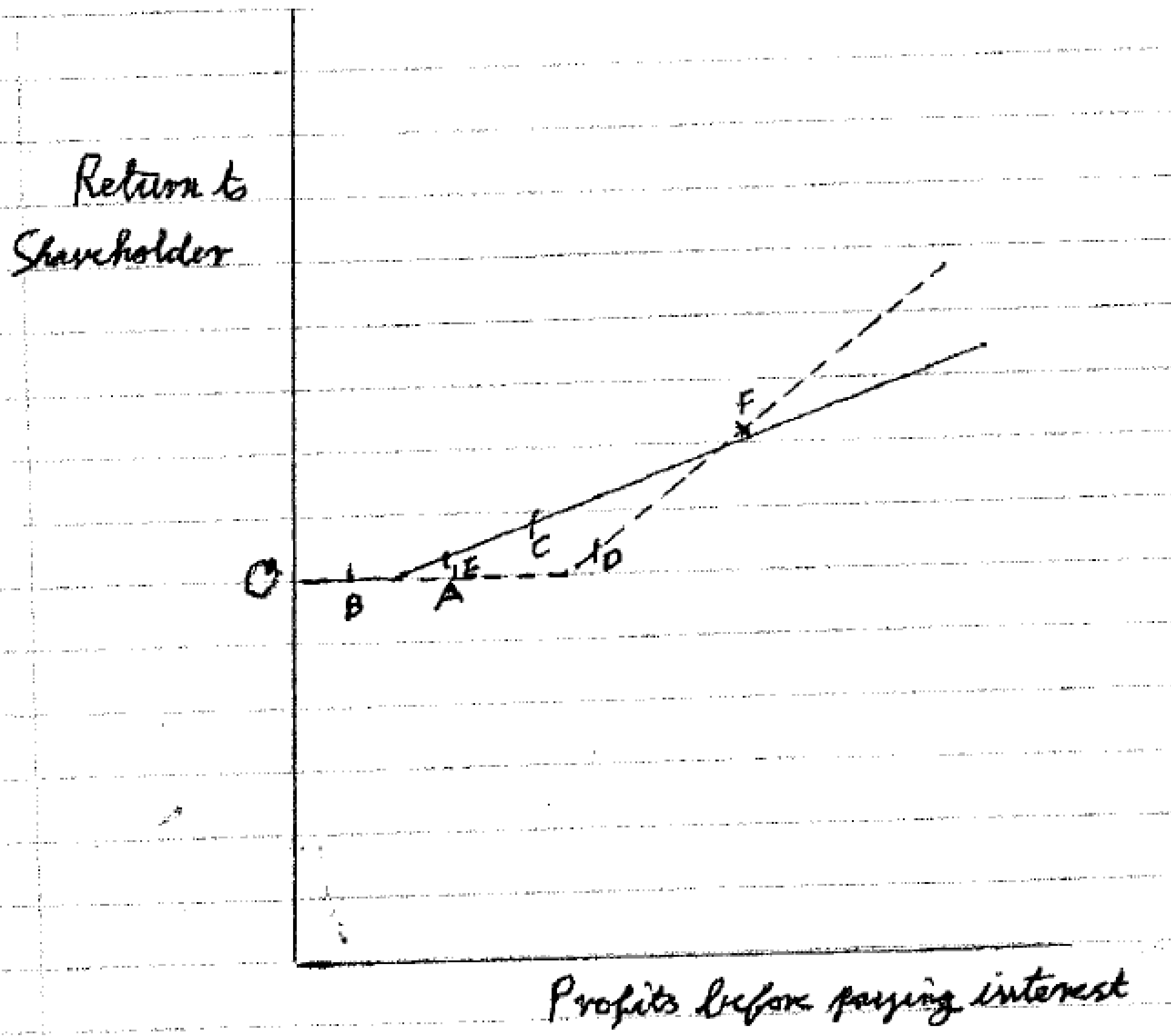
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“Orszag’s task is twofold. To the outside world, he must revitalise a faded franchise facing heightened competition and evolving client demands — and make Lazard’s long-standing, high-minded tagline, “la haute banque d’affaires vis-à-vis the world”, resonate once more.

And inside the bank, he just has to get Lazard’s notoriously jaded troops on board.

If he can pull it off, the reward will be considerable. Under a board-devised pay plan, stock worth at least $86mn will vest on top of Orszag’s standard annual salary and bonus if Lazard’s share price climbs from the low $30s at his appointment to $69 by 2030 — equivalent to more than $3bn in aggregate equity value creation.”

From *The Financial Times*, ‘Peter Orszag wants to reimagine Lazard. Will his bankers let him?, by S. Indap and J. Franklin, New York, June 4, 2024.

“The American worker’s average annual wage in 2023 was only $65,470, according to the Bureau of Labor Statistics. At that wage, it would take 445 years to earn as much as the middle-of-the-road chief executive on this list.”

“The median pay for chief executives of S&P 500 companies rose 63 percent from 2010 through 2023, based on data provided by ISS-Corporate. At the same time, the S&P 500 returned 462 percent, including dividends, according to FactSet.”

From ‘The sky is barely the limit for chief executives’ pay’, by J. Sommer, *The New York Times International Edition*, June 10, 2024.

Why does Modigliani/Miller not work?

1) Tax advantage of debt.
2) Informational advantage of management.
3) Run if others run; not otherwise.
4) Bail-outs for bank creditors / Credit Suisse.
5) Who watches the watchers?

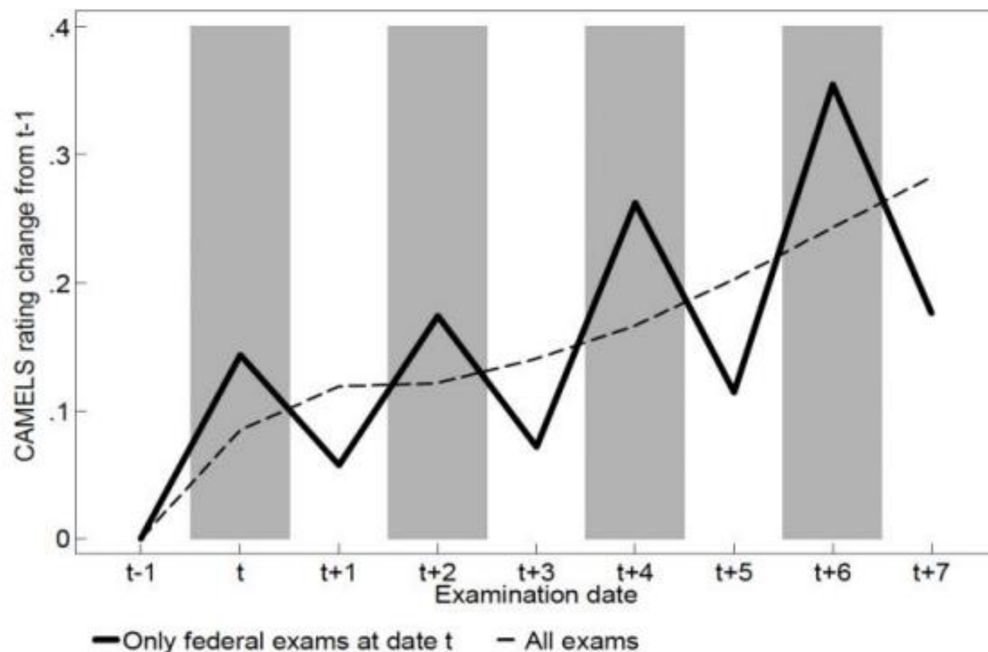

Figure 4.3. What About Regulatory Enforcement? Based on our analysis, banks such as SVB (and First Republic), which are regulated under dual regulators in rotation, face potentially inconsistent enforcement of regulation. This figure plots the average cumulative CAMELS rating change from the level prior to each exam to the level at the exam (shown as the first rotation) and afterwards (the second to the eighth rotation). The solid line shows the average cumulative CAMELS evolution for all examinations in the sample. The dashed line, instead, shows the average cumulative CAMELS evolution conditional on the first exam being conducted by a federal agency. Because the examiner rotates at each exam, federal exams occur at odd rotations (highlighted as the grey bars), while state rotations occur at even rotations.

Source: Agarwal et al. 2014.

Some empirical evidence:-

1) Goodhart and Lastra, ‘Equity Finance: Matching Liability to Power’, *Journal of Financial Regulation,* Volume 6, Issue 1, 20 March 2020, pp 1-40.
2) Goodhart and Postel-Vinay, ‘The City of Glasgow Bank failure and the case for liability reform’, Centre for Economic Policy Research, DP18799, 1 February 2024, and Economic History Working Papers No. 367, London School of Economics, February 2024.
3) Anderson, et al., ‘CEO Ownership, Risk Management, and the Bank Runs at Unlimited Liability Banks During the 1890s’, Federal Deposit Insurance Corporation Working Paper 2024-03, April 2024.

Conclusion of paper three above:-
“Our findings support the notion that higher presidential liabilities contribute to the stability of the banking system by encouraging banks to target lower default risk. Our study suggests that regulatory policies on bank executives can influence risk management practices and reduce the default risk of banks.”

What can be done about it?

a) Require more equity: Admati/Hellwig?
b) Claw back?
c) Remove limited liability for executives?
d) Make all bonuses payable in bonds?
e) Change appointment mechanism.
f) Any others?

‘Davis Polk Discusses RECOUP Act’s Clawbacks of Failed-Bank Executives’ Compensation’, by R.D. Guynn, M.E. Tahyar, K.T. Lin, L. Gocaj and A. Tynes, CLS Blue Sky Blog.

> “In a recent opinion piece in the Washington Post, former FDIC Chair Sheila Bair and leading British bank historian Charles Goodhart argued in favor of the executive compensation clawback provision in the proposed RECOUP Act,”

> “The FDIC already has the authority to recoup compensation from senior executives of insured banks for losses caused by their gross negligence.”

> “Unlimited liability was never the norm for bank shareholders or executives in the United States.”

“The risk that the FDIC could construe the clawback provision in the RECOUP Act to have a strict liability standard of care subject to Chevron deference will certainly deter many able and responsible people from serving as bank executives. This deterrence would be particularly likely and undesirable when the banking regulators are encouraging troubled banks to replace certain bank executives with more capable people who could save the bank from failing.”

“At a minimum, Congress should amend the clawback provision in the RECOUP Act to specify a standard of care consistent with U.S. historical precedent, meaning negligence or gross negligence, not strict liability.”