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SIFIs regulation and incentives

The role of compensation in SIFI regulation

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We All Share The Right Objectives

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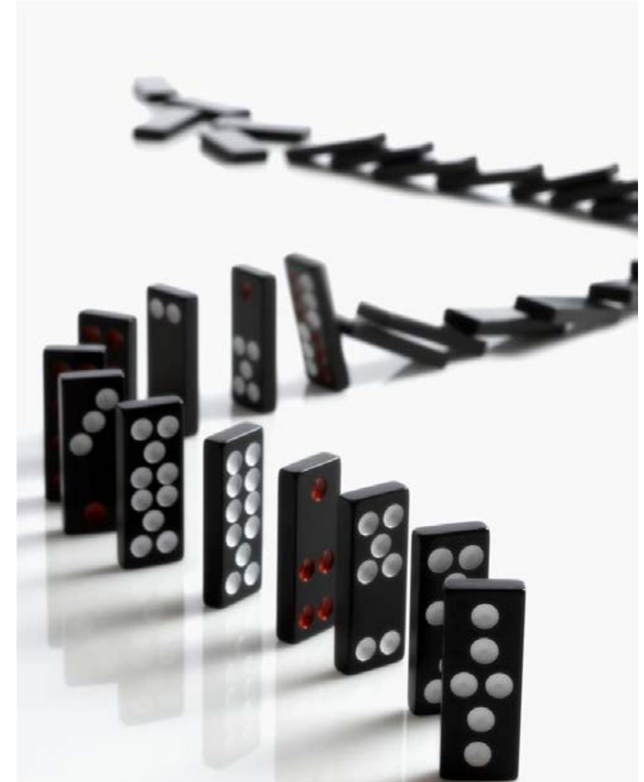
- Making the financial system more robust;
- and better able to serve the wider economy.

- All industries require rules to demarcate the bounds within which firms should compete.
- Banking is no different.

- But which rules best deliver the objectives?



Policy Focus

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- Remuneration of Bankers is the focus of significant regulatory attention in the UK, EU, US and globally.
  - 1-to-1 EU bonus caps;
  - FSB "Principles for Sound Compensation Practices.“
  - Adoption in Basel III of the Capital Conservation Buffer.
  - UK Parliamentary Committee on Banking Standards.
- Concern has focused on both the risk-taking incentives and the size of the aggregate pay bill.
- The pay bill is sometimes in excess of 80% of total shareholder equity, and often in excess of 30% of shareholder equity. (Thanassoulis 2012).

Cap On Total Remuneration In Proportion to Risk Weighted Assets

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- I propose and study effect of a cap on total pay in proportion to (risk weighted) assets

- Variable cap lowers salary costs directly; and
- Cap stops negative externality in labour market, lowering market pay.
- So cap lowers bank costs and hence improves bank resilience.
  - Achieved whilst increasing bank values.
  - Achieved without reduced lending from a Tier 1 increase.
- Encourages diversification by reducing need to focus on limited asset classes.
- A tool for Macroprudential Regulation.
  - Could be used to encourage retail banking.

The Level of Remuneration is a Legitimate Source of Concern

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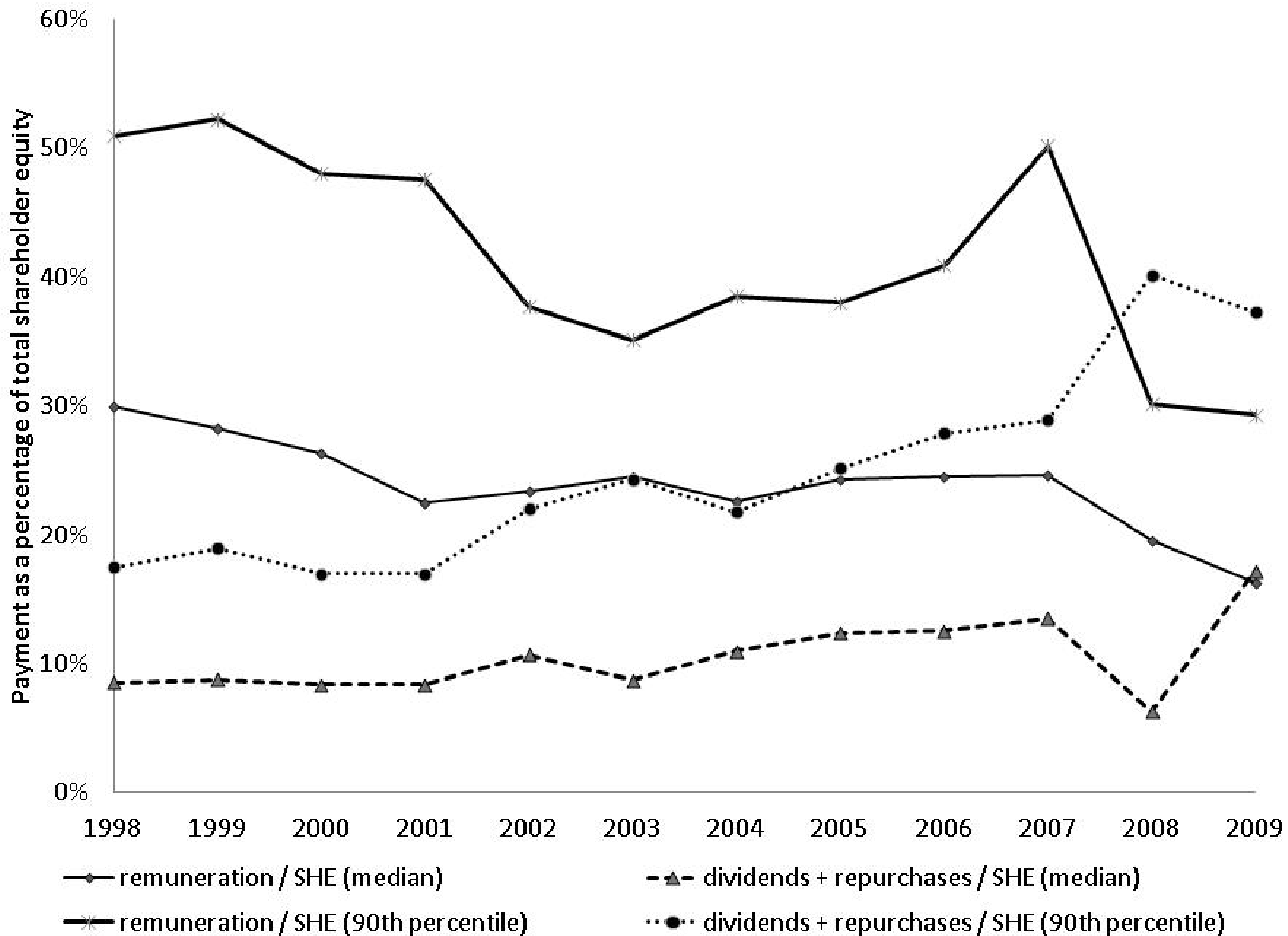
- In 2008/9 the levels of dividends plus share-repurchases combined were argued to be high enough to be restrictive of lending:

    - See, for example, Acharya, Viral V., Irvind Gujral and Hyun Song Shin, 2009, Dividends and Bank Capital in the Financial Crisis of 2007-2009, Available at SSRN: http://ssrn.com/abstract=1362299



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Relevance Of Remuneration To Financial Stability

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- Consider exogenous reduction to aggregate pay bill.
- Express as a proportion of Risk Weighted Assets --- i.e. equivalent Tier 1 increase:

Reduction in aggregate bank remuneration	5%	10%	15%	20%	25%	30%
Average equivalent increase in Tier 1 levels (basis points)	9	19	28	37	47	56

A Targeted Intervention

Gain in Tier 1 from 20% Reduction in Remuneration (20 Most Affected)

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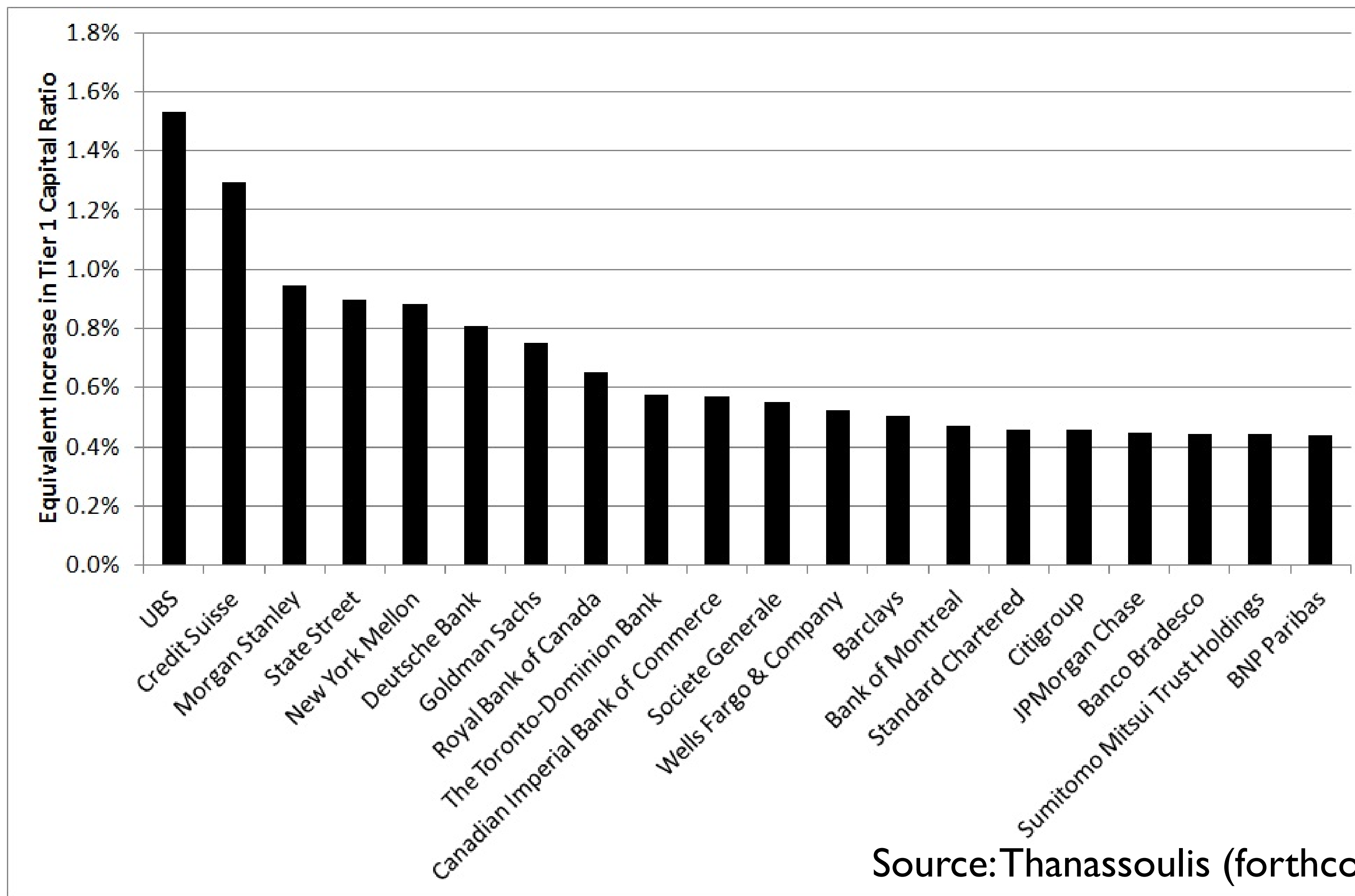

Source: Thanassoulis (forthcoming). Bloomberg data for 2009.

The Competitive Externality

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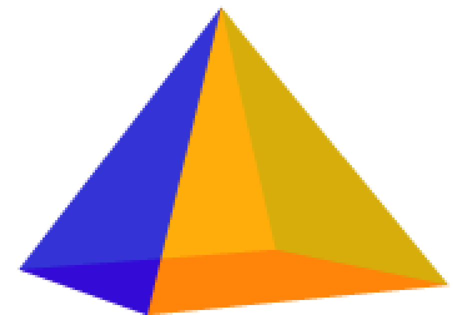
- The market rate is determined by the amount the marginal bidder is willing to pay.
- A banker's pay is determined by how much a rival bank is willing to bid for him.
- In bidding for bankers they don't ultimately hire, the losing bank is:
  - Pushing up pay for the hiring bank.
- This pushes up risk for the hiring bank.
  - Larger costs.

The Market

- The market is like a pyramid.
- At the bottom of the pyramid are those searching for an executive to run a small pot of resources.
  - Or to work for a less attractive bank.
- These would like to hire better – they drive up the pay of the better bankers.
- The same effect works all the way up the pyramid.
- Hence institutions looking for executives to run large resources must pay even more.



How To Lean Against This Externality

- Cap on remuneration in proportion to Risk Weighted Assets.
- Affects marginal bidder more than affects employing bank.
  - Marginal bidder has to be more aggressive. Cap stops this.
- Lowers remuneration ***levels***.
- Allows banks to still use bonuses
  - Marginal not fixed costs.
- Hence employing bank's value is raised.
  - Same banker, hired for less.
  - Bank more robust to bad asset realisations.

Pay Cap Corrects Labour Market Externality

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- Now bank willing to pay less to poach even better bankers (as more value from equilibrium banker).
- Reduction in externality propagates through market.
  - Lowers market rates of pay.
- *Macroprudential*: no single bank can do this alone.

Pay Cap Corrects Labour Market Externality: Notes

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- Potential concern of departure of workers from finance - (Philippon and Reshef (2012)) pay premium of 50% to 250%; long way before a serious concern.
- Salary caps have been used in US sports. But different to proposal here:
  - Sports salary caps same across all teams; here cap linked to size of assets.
    - Link to size makes cap target negative externality.
    - Link to size avoids distortion in allocation of talented bankers to banks.
- Widespread consolidation in banking sector already documented. (e.g. Bank of International Settlements 2001). Model captures one reason why:
- Grow balance sheet to allow more talented bankers to be hired.
- Pay cap here does not necessarily strengthen merger incentives.

Assets Valued on a Risk Weighted Basis

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- Banker will be tempted to alter the investment profile s/he targets if doing so allows more to be paid under the cap whilst preserving returns net of risk.
- Not possible if weights proportional to expected returns of the assets.
  - Implies (CAPM) weights proportional to asset's systematic risk.
- Parallels optimal risk weights in capital adequacy regulation (Rochet (1992)).
  - Basel risk weights a convenient (but not perfect) approximation.

Asset Allocation Responses To Pay Cap

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- Absent regulation, bankers want to run more assets and grow pay.
  - Implies banks raise asset allocations to areas where they wish to hire the best bankers.
- Remuneration cap weakens this excessive concentration effect.
- To understand suppose cap is gradually removed:
- Cap affected marginal bidder most – so more intense bidding from bank underweight in that class.
- To continue to employ best banker must match aggressive bidding.
  - Lowers profits from asset class, and raises default event risk.
  - Profitability enhanced by moving assets to target class (pay becomes a lower proportion of assets).
- So pay cap reduces pressure for banks to excessively focus on core areas.

Pay Regulation For Macroprudential Objectives

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- Cap on remuneration need not apply to all business lines:
  - e.g. could apply to wholesale banking but not retail banking.
- So pay regulation can be used to re-target banks' activities;
  - If regulator considered equilibrium asset allocation unsatisfactory (c.f. UK Funding for Lending).
- Also banks in competition with other Financial Institutions (e.g. hedge funds), outside regulatory net.
  - Not a problem – can be used to further enhance the efficacy of pay-caps as a macroprudential tool.

Asymmetrically Applied Pay Regulation

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If pay cap applying only to wholesale banker remuneration is made more severe, all banks increase their asset allocation to retail banking.

Parallels diversification intuition:

- Wholesale pay bonus caps kick-start asset re-allocation.
  - Inhibits bank r bidding up wholesale banker bonuses.
- Bank w now faces less aggressive bidder. So benefits from increased diversification.
  - Moves money, at margin, to retail.
- No pay cap on retail implies new second round effect:
  - Bank w more aggressive bidder for best-retail banker.
- So r consolidates assets in retail.

Pay Regulation and Partial Regulatory Coverage

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- If the bank is subject to a sufficiently stringent cap on remuneration for the wholesale banking book then the bank will re-allocate more assets to retail banking and reduce the size of the wholesale banking book.
- Bank r can secure bankers – but pay cap regulation means, in wholesale banking, not the very best ones.
- So returns available from wholesale banking fall slightly.
- Bank therefore chooses to divert some funds to retail banking and secure greater diversification benefits.
- By adjusting cap through the cycle, the regulator can manipulate the assets used for retail banking.
- Microprudential intervention applied generally delivers macroprudential goal.

Conclusion

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- Variable cap in proportion to Risk Weighted Assets lowers bank risk and raises bank values.
- Impacts marginal bidder most and so lowers market rates of pay.
- Targeted intervention: A 20% reduction in the remuneration bill would equate to extra Tier 1 of 150 basis points for most affected banks.
- Cap encourages institutions to diversify more and so adds further to robustness.
- Cap forms a Macroprudential tool.
- Appropriate risk weights mitigate bankers' incentives to abuse assets for pay.

Conclusion on Bank Level Pay Cap

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- Consider cap on total bank remuneration summed over all wholesale bankers proportional to banks' risk-weighted wholesale banking assets.
- Cap applied at the (easier to implement) bank level will likely be implemented by senior management as a top down rule.
  - Numbers of employees involved make micro-managing deviations from a general rule impractical.
- Hence cap at bank level tackles externality at individual banker level.

Conclusion on Bank Level Pay Cap

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- Numbers of Employees Targeted By Intervention On Top 20% Of Earners:

	20% of employees in 2009
UBS	13,047
Credit Suisse	9,520
Morgan Stanley	12,278
Deutsche Bank	15,411
Goldman Sachs	6,500
Citigroup	53,060

A Targeted Intervention

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- A variable cap on total remuneration for finance executives in the wholesale sector flexed in proportion to wholesale Risk Weighted Assets.

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References

- The material in this talk is drawn from:
  - The Case For Intervening In Bankers' Pay, 2012, *Journal of Finance*, 67, 849-895.
  - Bank Pay Caps, Bank Risk, and Macroprudential Regulation, forthcoming, Journal of Banking and Finance.
  - Safety in Numbers, *Financial World*, May 2013, 20-21.