Note 11

The Special Case of Banks: A Possible Solution

A Possible Solution: To prevent imprudent risk taking, the incentives of the CEO must be aligned to those of the creditors in highly leveraged institutions such as banks.

1. The level of leverage in financial intermediaries such as banks is usually high. Banks have low equity (e.g., 5%) but an exceptionally high debt level (95%). This could exacerbate perverse incentives because in the case of failure shareholders would lose very little (5% of the bank's assets) compared to creditors (95% of the bank's assets). In case of success, shareholders gain greatly more than creditors. In highly levered banks, risky projects have limited downside but unlimited upside potential. Bebchuk and Sapmann (2010) emphasize that bank executives share in gains that flow to common shareholders but are insulated from losses that the realization of risks could impose on bondholders, depositors and taxpayers, hence giving executives the incentives to discount the downside of risky strategies.

2. The problem is exacerbated by deposit insurance and implicit bailouts for firms that are "too big to fail." Deposit insurance and implicit bailout can encourage excessively risky investment projects.

3. In the relatively recent literature, to reduce perverse incentives for imprudent risk taking, it has been suggested that for highly levered firms such as banks, the CEO's compensation ought to be so structured as to maximize the entire value of the firm – both equity and debt values – and not the equity value alone (Bolton, Mehran and Shapiro, 2010). Similarly, Macy and O'Hara (2003, p.92) argue that "the scope of the duties and obligations of corporate officers and directors should be expanded in special cases of banks. Specifically, directors and officers of banks should be charged with the heightened duty to ensure the safety and soundness of these enterprises. Their duties should not run exclusively to shareholder ... and to include creditors." This implies that compensation in highly leveraged firms should be linked to firm risk as a whole so that the interests of the creditors are accounted for and that the bank can comfortably make obligatory payments to the creditors.

4. One way to link compensation to firm risk that has been received considerable attention recently is through deferred compensation and pension, alternatively called inside debt (Edmans and Liu, 2010; Wei and Yermack, 2010). Note 12 will elaborate on this proposal.

References:

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