Should we pay European bankers (also) with (bail-inable) debt?

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Bank failure and remuneration

Name: Richard S. Fuld

Nickname(s): Gorilla; Dick

Occupation: Lehman Brothers CEO (1993-2008)

Award and nominations: n. 1 in the "*Worst American CEOs of All Time* list"; ranked in "*25 People to Blame for the Financial Crisis*"

Remuneration in 2007: 22 million dollars

Total remuneration while CEO: approximately half a billion dollars

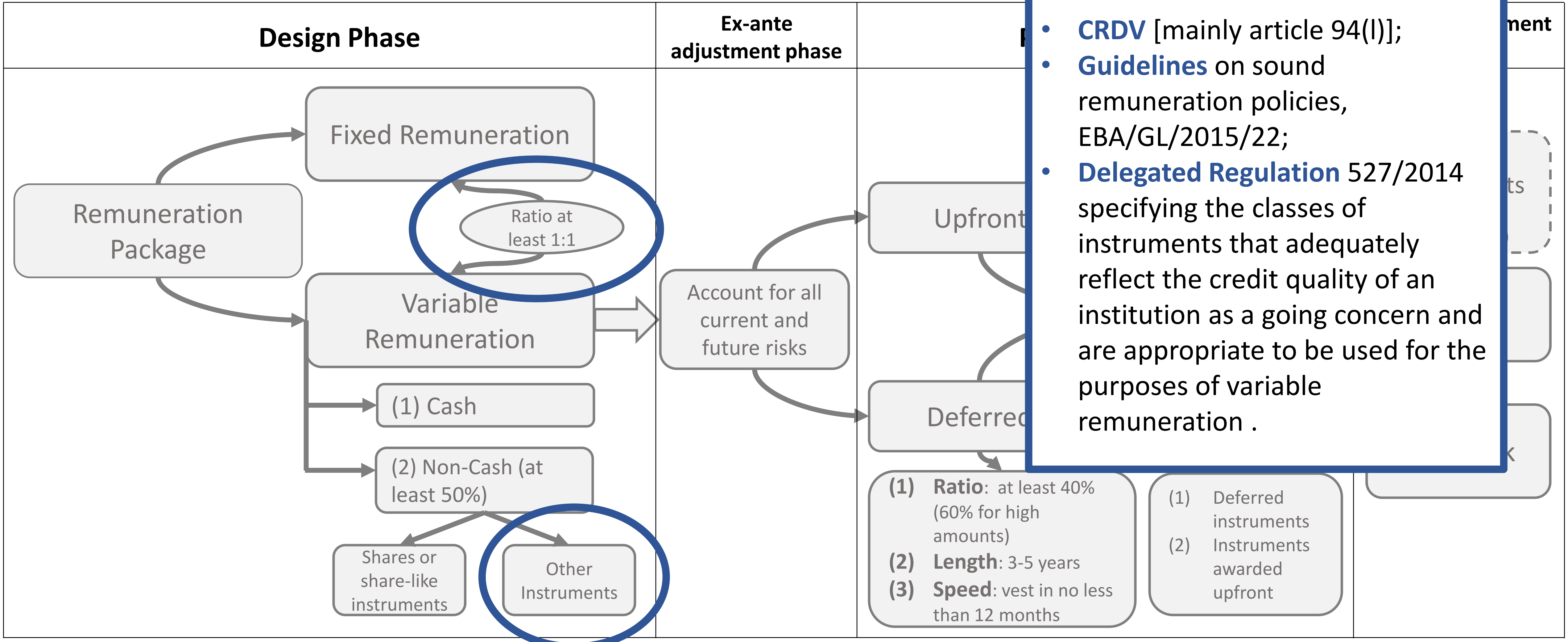
RQ: How to efficiently and effectively reform remuneration regulation?

- *Can it account for specialties of bank governance?*
- *Can it enhance bank resolvability?*

What remuneration is about?

- Non-financial firms
  - Reward strategy to handle separation of ownership and control
  - Link between pay and performance
  - Fixed and variable components of remuneration
    - Cash
    - Shares and share-linked instruments
    - Pension schemes
  - Incentivize to undertake all and only positive NPV projects [but contracts are incomplete!]
- Bank Governance is special
  - Highly-leveraged institutions → too much risk
  - Moral Hazard & Systemic externalities
    - Ex-ante approach; Portfolio approach; Early recapitalization incentives (Fuld Problem)

Incumbent EU Regulation (1)



Relevant Sources

- **CRDV** [mainly article 94(l)];
- **Guidelines** on sound remuneration policies, EBA/GL/2015/22;
- **Delegated Regulation** 527/2014 specifying the classes of instruments that adequately reflect the credit quality of an institution as a going concern and are appropriate to be used for the purposes of variable remuneration .

Remuneration through debt: rationale and practice

- "Remuneration through inside debt would eliminate to a large part (perhaps all) of the agency costs of debt" (Jensen and Meckling, 1976)
- Debt has been used through pension schemes (overlooked until recently)
  - Inside debt in both financial and non-financial firms (Edmans and Liu, 2006): Reduce risk-shifting incentives; Makes managers sensitive to liquidation value; Mix of debt and equity with an equity bias (value maximizing strategy)
- The UBS Experience
  - Deferred Contingent Capital Plan (DCCP): 37,5% of variable compensation awarded in AT1 instruments;
  - Principal amount wiped out to zero if CET1/RWAs<10%
  - 2 billions USD DCCP awarded from 2012 and 2017.

Reforming EU remuneration regulation (1)

- Modification to incumbent regulation:
  - Remove regulatory cap + Minimize the use of cash bonuses
- Include bail-inable debt in variable remuneration **(substitute)**
  - Better account for bank governance specialty + pay for performance
- Fine-tune remuneration through debt with the rest of pay regulation **(complement)**
  - Optimal pool of tools: AT1, T2, non-capital eligible (mandate to oversee); ad hoc issuance → 104 CRD
  - Deferral & Retention policies: tailored solutions (mandate to oversee) → 104 CRD

Reforming EU remuneration regulation (2)

- Fine-tune remuneration through debt with the resolution framework
  - Increase political viability of resolution
  - Combine with new powers on MREL breach (BBRD2);
  - Importance of structural subordination
- Implementation strategies
  1. Elicit unbiased preferences
     - Limited modification to primary law [art 94(1)] and revised delegated regulation → void structural regulation + incentives to use debt (nudge)
  2. Mandate remuneration through debt
     - Deep revision of art. 94(l) mandating the inclusion of bail-inable debt in remuneration packages → different structural regulation better grounded on economic theory

Conclusion

- Remunerating bankers (also) through bail-inable debt
  1. improves the link between pay and performance;
  2. marginally improves the situation when it comes to complexity and calibration;
  3. fine-tunes pay regulation with the specificities of bank governance
  4. generates further positive spillovers and virtuous synergies with banks' resolvability and the resolution framework.
- Shed light in the relation between bank governance and regulation
  - Regulation of bank governance
  - Governance regulation as a medium between regulatory goals and banks' incentives

Thank you

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Backup (1)

Bank A			
Asset		**Liabilities**	
Risky loans	90	Deposits	90
Cash	10	Bail-inable d.	5
		Equity	5

Project			
Cost		**10**	
P(S)	0,1	V_S	90
P(D)	0,9	V_D	0
NPV	-1	Project shall not be undertaken	

Risk-shifting Incentives			
	Success	Failure	E(V)
E(V) of equity	85	0	8,5
E(V) of bail-inable debt	5	0	0,5

Shareholders will undertake the project since the value of equity increases in expected terms → ***Inefficient!***

Backup (2)

Scenario 1: the decision maker holds 2 in equity			
	Success	Failure	E(V)
E(V) for the decision maker	32	0	3,2
Comment: the welfare of the decision maker increases in expected terms. The project will be undertaken and the risk will be shifted to bail-inable creditors.			

Scenario 2: the decision maker holds 1,1 in equity and 0,9 in bail-inale debt			
	Success	Failure	E(V)
E(V) for the decision maker (equity part)	17,6	0	1,76
E(V) for the decision maker (debt part)	0,9	0	0,09
Comment: the welfare of the decision maker decreases in expected terms **(1,85 < 2).** The project will not be undertaken → **Efficient solution**			