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 \(\rightarrow\) 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.

### Design Phase

- **Remuneration Package**
  - Fixed Remuneration
    - Ratio at least 1:1
  - Variable Remuneration
    - (1) Cash
    - (2) Non-Cash (at least 50%)
      - Shares or share-like instruments
      - Other Instruments

### Ex-ante adjustment phase

- **Upfront**
- **Deferred**
  - (1) Ratio: at least 40% (60% for high amounts)
  - (2) Length: 3-5 years
  - (3) Speed: vest in no less than 12 months

- **Retention Policy** (only for the part paid in instruments)

- **Malus**
  - Ratio: at least 40% (60% for high amounts)

### Pay out phase

- **Ex-post adjustment phase**

- **Clawback**
- **Implicit adjustments** (price movements)

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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 $\rightarrow$ 104 CRD
  • Deferral & Retention policies: tailored solutions (mandate to oversee) $\rightarrow$ 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 $\rightarrow$ 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 $\rightarrow$ different structural regulation better grounded on economic theory

29.10.2019
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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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## Bank A

<table>
<thead>
<tr>
<th>Asset</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risky loans</td>
<td>90</td>
</tr>
<tr>
<td>Deposits</td>
<td>90</td>
</tr>
<tr>
<td>Cash</td>
<td>10</td>
</tr>
<tr>
<td>Bail-able debt</td>
<td>5</td>
</tr>
<tr>
<td>Equity</td>
<td>5</td>
</tr>
</tbody>
</table>

## Project

<table>
<thead>
<tr>
<th>Cost</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>P(S)</td>
<td>0,1</td>
</tr>
<tr>
<td>V_S</td>
<td>90</td>
</tr>
<tr>
<td>P(D)</td>
<td>0,9</td>
</tr>
<tr>
<td>V_D</td>
<td>0</td>
</tr>
<tr>
<td>NPV</td>
<td>-1</td>
</tr>
</tbody>
</table>

The project shall not be undertaken.

## Risk-shifting Incentives

<table>
<thead>
<tr>
<th></th>
<th>Success</th>
<th>Failure</th>
<th>E(V)</th>
</tr>
</thead>
<tbody>
<tr>
<td>E(V) of equity</td>
<td>85</td>
<td>0</td>
<td>8,5</td>
</tr>
<tr>
<td>E(V) of bail-able debt</td>
<td>5</td>
<td>0</td>
<td>0,5</td>
</tr>
</tbody>
</table>

Shareholders will undertake the project since the value of equity increases in expected terms → **Inefficient!**
### Scenario 1: the decision maker holds 2 in equity

<table>
<thead>
<tr>
<th></th>
<th>Success</th>
<th>Failure</th>
<th>E(V)</th>
</tr>
</thead>
<tbody>
<tr>
<td>E(V) for the decision maker</td>
<td>32</td>
<td>0</td>
<td>3,2</td>
</tr>
</tbody>
</table>

**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-inable debt

<table>
<thead>
<tr>
<th></th>
<th>Success</th>
<th>Failure</th>
<th>E(V)</th>
</tr>
</thead>
<tbody>
<tr>
<td>E(V) for the decision maker (equity part)</td>
<td>17,6</td>
<td>0</td>
<td>1,76</td>
</tr>
<tr>
<td>E(V) for the decision maker (debt part)</td>
<td>0,9</td>
<td>0</td>
<td>0,09</td>
</tr>
</tbody>
</table>

**Comment**: the welfare of the decision maker decreases in expected terms \((1,85 < 2)\). The project will not be undertaken → **Efficient solution**