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Risk-taking incentives through excess variable compensation: Evidence from European banks

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ABSTRACT

Employing compensation data provided by 63 banks from 16 European countries for the period from 2000 to 2010 this paper empirically investigates the impact of excess variable compensation on bank risk. As a main finding, we provide evidence for a risk-increasing impact of excess variable pay for both executive variable cash-based and variable equity-based compensation. This baseline finding holds under various robustness checks, in particular when controlling for likely reverse causality between bank risk and variable compensation by employing Granger-causality tests and instrumental variable regressions. In addition, results from a large number of sensitivity analyses including board and banking characteristics as well as the financial crisis period and the quality of a country's regulatory framework provide further important implications for banking regulators and politicians in Europe.

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1. Introduction

The global financial crisis from mid-2007 has sparked a new heated discussion among politicians, regulators and academics concerning compensation practices in banking. In particular, many critics demand a strict regulation of bank executives' remuneration since it is suggested that especially incentives from variable compensation packages in banks may have provoked a significant increase in managerial risk-taking and hence, may have been an additional cause of the financial crisis (Bebchuk & Spamann, 2010; Board of Governors of the Federal Reserve System, 2010; Financial Stability Board, 2009).

The noisy debate on managerial compensation in banking is clearly fueled by theoretical predictions suggesting that risk-taking incentives from variable pay packages are expected to be much stronger at banks than at non-financial companies (e.g., Mehran, Morrison, & Shapiro, 2011). The reason is that banks are highly leveraged and, under limited liability, bank managers can shift risk to dispersed and unsophisticated debtholders. In the presence of deposit insurance schemes and implicit governmental bail-out guarantees under the "too-big-to-fail" (TBTF) doctrine, this risk shifting-mechanism becomes even more relevant and can additionally affect taxpayers.

Accordingly, in 2009 the Financial Stability Board (FSB) responded to the G20 Finance-Ministers' and Governors' call for detailed global standards on pay structures, greater disclosure and transparency in banking (Financial Stability Board, 2009). In particular, *FSB Principles for Sound Compensation Practices* focus on (1) a deferral of variable compensation payments in order to reward long-term success rather than short-term risk-taking, (2) the implementation of claw-back provisions that allow recouping variable payments if management decisions fail later on, (3) the payment of bonuses by means of stock options rather than cash and (4) a cap of the proportion of total variable compensation.

As regards the latter principle, in 2013 the European Parliament and Council have decided that annual bonuses for European bank executives must not exceed their annual fixed salary in general. In exceptional cases, the bonus may reach a maximum of twice the salary, provided that 65% of shareholders owning half the shares represented, or 75% of votes if there is no quorum, agree to the increase. In addition, if variable payments exceed annual fixed salaries, then 25% of the entire bonus would be deferred for at least five years in order to encourage bank executives to take a long-term view during their management decisions. Respective regulations are included in the new *European Capital Requirements Directive (CRD IV, 2013)* transforming forthcoming *Basel III-regulations* into

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European banking law. Regulations apply to all bank executives working within the EU as well as employees of European bank subsidiaries abroad. As a consequence, several large European banks have simply increased annual fixed salaries for CEOs in order to bypass the cap of the current total amount of variable compensation. Moreover, it is feared that European banks will lose a competitive edge and that talented bank managers will be forced to move to more attractive financial centers outside Europe.

Against this background, the empirical study at hand sheds a brighter light on the relationship between variable compensation and managerial risk-taking in European banking. Our study complements and extends two previous studies for Europe (Ayadi, Arbak, & DeGroen, 2011; Vallascas & Hagendorff, 2013) in several aspects. First of all, a unique hand-collected data set is employed which includes compensation data provided by the largest 63 European banks from 16 European countries. This is, to best of our knowledge, the largest sample of compensation data from European banks so far. Second, stretching over the period from 2000 to 2010 the panel data set enables us to separately invest the impact of variable compensation on bank risk before and during the financial crisis period. Third, in contrast to previous related studies focusing on Europe (and the USA), the analysis at hand is extended to non-stock listed banks as well as savings banks and cooperative banks and hence, provides further important insights regarding the relationship between variable pay and managerial risk-taking incentives at these banking institutions. Fourth, in contrast to previous studies for Europe we employ a measure of *excess* variable compensation that is determined by other factors beyond bank size, namely managerial talents and quality. And fifth, likely reverse causality between managerial compensation and bank risk is addressed by Granger-causality tests and instrumental variable regressions.

As a core result, we provide empirical evidence of a risk-increasing impact of executive variable compensation with regard to both variable cash-based and variable equity-based payment arrangements. This baseline finding holds under various robustness checks while results from various sensitivity analyses offer further important insights into the compensation-risk-nexus.

The analysis at hand provides important implications for banking regulators and politicians. As we find that the negative impact of excess variable compensation on bank soundness turns out to be stronger if variable pay exceeds fixed salaries, the European Parliament's decision from 2013 to cap executive variable pay is appropriate. However, as our results also reveal a long-term risk-increasing effect of variable compensation at European banks, a deferral of executive variable pay and an implementation of claw-back provisions may be further suitable instruments to maintain financial stability. Moreover, results from various sensitivity tests suggest that diminishing bank shareholder rights and weakening the generosity of single national deposit insurance systems may be further starting points to countervail the managers' incentive to greater risk-taking due to variable compensation packages at European banks.

The remainder of this paper is organized as follows. Section 2 provides a theoretical discussion of risk-taking incentives through executive variable compensation. Subsequently, Section 3 reviews previous related empirical studies for Europe. Section 4 presents the empirical methodology. While data and sources are described in Section 4.1, the empirical model is introduced in Section 4.2. Section 5 presents empirical results and finally, Section 6 summarizes and concludes.

2. Previous related empirical studies for Europe

A large part of research so far has focused on the relationship between CEO compensation and bank performance while the risk-taking effect has been implicitly analyzed (e.g., Gregg, Jewell, & Tonks, 2011). In contrast, a considerably smaller but fast-growing number of empirical studies investigate the direct impact of CEO pay on bank risk-taking (Mehran et al. (2011) provided a comprehensive survey) while a few analyses focus on the compensation-risk relationship with a special emphasis on the recent financial crises (Balachandran, Kogut, & Harnal, 2010; Beltratti & Stulz, 2012; Bhagat & Bolton, 2014; Bosma & Koetter, 2013; Fahlenbrach & Stulz, 2011; Guo, Jalal, & Khaksari, 2015; Srivastav, Armitage, & Hagendorff, 2014). In this context, however, the majority of studies investigate the compensation-risk linkage in the U.S. context while primarily focusing on stock-option based compensation and its impact on aligning interests between bank shareholders and CEOs. In contrast, to the best of our knowledge, only two cross-country related empirical studies analyze the impact of variable compensation on managerial risk-taking using data from European banks.

To begin with, Vallascas and Hagendorff (2013) employed data on cash bonus compensation from a mixed sample of 117 stock-listed banks (thereof 41 European banks) for the period from 2000 to 2008. Their measure of cash compensation includes basic salary, cash bonuses and other forms of cash compensation while bank risk is proxied by the bank's distance to default. The authors provide empirical evidence that an increase in CEO cash bonus payments generally reduces the default risk suggesting that bonus payments are contingent on the bank's solvency and thus, mitigate managerial (excessive) risk-taking. However, further sensitivity analyses reveal that bonus pay induces managerial risk-taking if banks are financially distressed or operate under a weak regulatory framework indicating that banks seek to maximize the value of the financial safety net by shifting risk to weak regulators (and taxpayers).

Ayadi et al. (2011) used compensation data from 53 stock-listed and non-stock listed, systemically important European banks over the period from 1999 to 2009. Bank risk is proxied by the *z*-score and by different market-based risk measures (total, idiosyncratic, systematic and interest-rate risk) during further robustness checks. The compensation measure includes option plans and annual cash bonuses. The authors provide evidence that option plans and annual bonuses do not increase bank risk in general whereas long-term performance bonus plans deteriorate banking stability. Moreover, the analysis reveals a reverse relationship between bank risk and executive compensation, i.e., (i) long-term performance bonus plans are more likely under increasing systematic risk and (ii) distressed banks substitute fixed basic salaries by annual bonus payments.

3. Risk-taking incentives through executive variable compensation

Following the Merton (1973, 1974) framework, bank shareholders hold an implicit contingent claim on the residual value of a bank's total assets. And much as in call options, shareholders' returns increase with the riskiness of the underlying assets since downside risks are borne by the bank's debtholders, regulators and taxpayers. Bank executives, in contrast, have personal wealth portfolios largely undiversified but concentrated in the bank they manage (Murphy, 1999). Therefore, executives are assumed to behave risk averse, protecting their personal wealth probably by passing up high-risk investments which, however, exhibit positive net present values. In order to solve this trade-off and to minimize agency costs, agency-based theories suggest that bank shareholders should design compensation contracts in ways that shareholders' and executives' interests are closely aligned (e.g., Smith & Watts, 1992). In particular, incentives through variable compensation packages could be set that encourage bank executives to adopt more risky but shareholder value-maximizing investment strategies.

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