

DEVELOPING “BEST PRACTICES” FOR BANKERS’ PAY IN LINE WITH BASEL III

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Abstract

This paper proposes hybrid capital securities as a significant part of senior bank executive incentive compensation in light of Basel III, a new global regulatory standard on bank capital adequacy and liquidity agreed by the members of the Basel Committee on Banking Supervision. The committee developed Basel III in a response to the deficiencies in financial regulation brought about by the global financial crisis. Basel III strengthens bank capital requirements and introduces new regulatory requirements on bank liquidity and bank leverage. The hybrid bank capital securities we propose for bank executives’ compensation are preferred shares and subordinated debt that the June 2004 Basel II regulatory framework recognised as other admissible forms of capital. The past two decades have witnessed dramatic increase in performance-related pay in the banking industry. Stakeholders such as shareholders, debtholders and regulators criticise traditional cash and equity-based compensation for encouraging bank executives’ excessive risk taking and short-termism, which has resulted in the failure of risk management in high profile banks during the global financial crisis. Paying compensation in the form of hybrid bank capital securities may align the interests of executives with those of stakeholders and help banks regain their reputation for prudence after years of aggressive risk-taking. Additionally, banks are desperately seeking to raise capital in order to bolster balance sheets damaged by the ongoing credit crisis. Tapping their own senior employees with large incentive compensation packages may be a viable additional source of capital that is politically acceptable in times of large-scale bailouts of the financial sector and economically wise as it aligns the interests of the executives with the need for a stable financial system.

Keywords: Basel III, Executive Compensation, Corporate Governance, Global Financial Crisis

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Introduction

The global financial crisis sparked in 2008 highlighted the weakness in risk management developed through the Basel II process. The purpose of Basel II was to create an international standard that banking regulators can use when creating regulations about how much capital banks need to reserve to guard against financial and operational risks. As a key component of bank governance, equity-based compensation usually induces bankers to take excessive risk and create asymmetric rewards and penalties: large bonus for good performance, but no penalties for failure (Bebchuk et al., 2010, Tung, 2010). Because banks are highly leveraged, shareholders are likely to use their control power over executive compensation to encourage a manager’s risk taking behaviour and then shift the risk to regulators and debtholders (Vallascas and

Hagendorff, 2010). Government guaranties of bank deposits further limit debtholders’ incentive to monitor and control management by insulating bank creditors from bank failure (Bolton et al., 2010, Benston et al., 1995). Stock-based incentives, in fact, align the risk preferences of managers with those of shareholders at the expense of debtholders and regulators (John et al., 2010, Jensen and Meckling, 1976).

In response to the 2007–2009 credit crises, financial institutions have started to overhaul their compensation structure. Scholars believe that compensation systems are key components of a bank’s governance and risk management, contributing to bank performance and risk-taking (Barnes et al., 2010). The Basel Committee on Banking Supervision (BCBS) updated its guidelines for capital and banking regulations with the aim to promote a “best practices” approach to risk

management (Bank For International Settlements, 2010). Any revised compensation schemes after the crisis should meet the aim of the FSF Principles for Sound Compensation Practices (2009) in order to curb bankers' appetite for risk taking and align the arrangement of compensation with the regulators' goal of assuring bank safety, prudent risk-taking, effective supervisory oversight and stakeholder engagement. For example, in November 2008, UBS set out a new bonus system that requires its senior bankers to repay part of their bonuses if they underperform in years of losses (Gow, 2008). In the U.K., Lloyds TSB agreed to pay 2008 bonuses over three years starting from 2010 in its subordinated debt or loan notes* (Martin, 2008).

In light of Basel III, we propose hybrid capital securities to be a significant part of the variable incentive compensation for senior bank executives. In other words, banks pay their bankers with their own banks' preferred shares and subordinated debt. The new scheme aims to reward for those who deliver good results over several years without taking unnecessarily high risk. Recipients of hybrid capital securities could not sell their securities before maturity. The maturities of these securities are usually longer than five years and the payoff from holding them is limited by the face value plus coupons. This new bonus scheme could help banks avoid the problems caused by paying cash and stock-based bonuses.

The Relationship between Corporate Governance and Executive Compensation

The concept of corporate governance is initially pointed out by Adam Smith (1776) based on the work *The Wealth of Nations*. He observes the possible danger connected to the diffusion of stock companies by the lack of incentive for both the owners and managers to manage and control the enterprise efficiently and effectively. Since its conception, Berle and Means' (1932) Principal-Agent model underpins the philosophy of the modern theory of the firm and many models of corporate governance, including that of executive compensation (Ratneser, 2000). Providing incentives to managers of publicly-owned companies is the classic example of the Principal-Agent challenge that assumes that the primary means for shareholders to ensure that managers take optimal actions is to tie managers' pay to the firm's performance (Ratneser, 2000). In effect, this assumption provides incentives for managers to maximise returns to shareholders (Berle and Means, 1932). Pursuing such a linkage aligns the interests of managers with the interests of shareholders. Jensen and Meckling (1976) propose the agency theory that defines the agency relationship as a contract under

which one party (the principal) engages another party (the agent) to perform some service on its behalf. Agency problems arise when the agents (managers) do not necessarily make decisions in the best interest of the principal (shareholders) (Jensen and Meckling, 1976). In order to reduce the divergences of interests between managers and shareholders, two complementary mechanisms – monitoring and incentives – have been designed with the aim to prevent financial damage that can arise due to potential conflicts of interest between managers and shareholders (Jensen and Meckling, 1976, Shleifer and Vishny, 1997). Incentives via executive compensation schemes take a number of different forms such as salaries, bonuses, recruitment incentives, stock options, equity ownership, or pension benefits (Jensen and Meckling, 1976, Fama, 1980, Fama and Jensen, 1983). Agency theory predicts that compensation such as stock options can be the standard solution for inducing risk-seeking behaviour because of their payoff function (Jensen and Meckling, 1976, Smith and Stulz, 1985). The overall purpose of these incentives is to place the managers in a position congruent with the economic interests of the enterprise as a whole.

Theoretically, scholars divide the study of executive compensation into two competing views: the optimal contracting view and the managerial power view (Bebchuk and Weisbach, 2010, Bebchuk and Fried, 2005, Choe et al., 2009, Sun et al., 2010, Bebchuk et al., 2010, Weisbach, 2007). Optimal contracting anticipates that remuneration committees have sufficient incentives to determine executive compensation that optimises on behalf of shareholders (Mirrlees, 1976, Holmstrom, 1979). Structural variables such as board composition and characteristics are insignificant or relevant. In contrast, the managerial power view believes that optimal contracting, originally designed to help remedy agency problems, may have actually become part of the problems because board structure is inefficient due to unresolved agency problems, leading to sub-optimal outcomes (Bebchuk and Fried, 2003). Executives may exert enormous influence over the board of directors to make such pay arrangements in favor of themselves instead of the shareholders. Lee (2006) expresses considerable concern about the contractual terms of compensating top executives, particularly in the form of profit-related bonuses, share options and termination payments which often transpire when company performance has been poor. According to Osterloh and Frey (2005), the performance-pay relation might be a misleading indicator of the compensation arrangements, which are difficult to implement and encourage risk behaviour in a very short-term period. The main academic voice against executive bonuses was raised in the 1930s by John C. Baker, a professor and associate dean at the Harvard Business School (Baker, 1936, Baker, 1939). Baker (1939) reports that

* The UK government has agreed to the Lloyds bank's staff, including low-level workers, receiving about £80 million in 2008 bonuses.

he could find little correlation between executive salaries and corporate earnings (i.e. the lack of evidence that bonuses contributed positively to organisational performance). Baker (1939) argues that there is both the lack of “*guiding principles*” in the field of executive compensation and of “*definite objectives*” in the creation of compensation schemes within large corporations. Similarly, Roberts (1956: 271) also finds that “*executive compensation is related significantly to ... corporate size. Its relationship to the level of profit is superficial and disappears when the influence of size on both compensation and profit is taken into account*”.

A Review of “Pay for Performance” Compensation Scheme

The past two decades have witnessed the dramatic increase in the performance-related pay in the banking industry. Pay for performance compensation schemes which link executive pay with stock price has been an important feature of executive contracts in Anglo-American systems prevailing in the U.S./U.K. (Murphy, 2003, Benmelech et al., 2010). Agency theory promotes the use of management-shared ownership via stock compensation to ensure that managers make decisions in the best interest of the company (Jensen and Meckling, 1976). Stock compensation has strong association with managerial performance, providing a solution to an agency problem between shareholders and managers. The studies by Murphy (1985), Antle and Smith (1986) and Jensen and Murphy (1990) document the evidence of a statistically significant association between total compensation (cash and share options) and share price performance. For example, Jensen and Murphy (1990) identify that stock options offer the stronger basis for strengthening the performance-pay link than other pay components through the analysis of the pay structure of 1688 executives’ compensation between 1974 and 1986. Murphy (1985) highlights the importance of building a comprehensive pay variable from the analysis of 461 individuals in 72 U.S. firms from 1964 to 1981. According to Hall and Murphy (2003), stock-based compensation, such as restricted stock and stock options, help align managerial and shareholder interests and motivate shareholder wealth creation.

By contract, a large amount of academic debates have drawn attention to the danger of a stock-based compensation structure that might lead to earning manipulation, excessive risk taking and fraudulent schemes (Goldman and Slezak, 2006, Crocker and Slemrod, 2007). Bebchuk and Spamann (2010) argue that stock-based awards, associated with the capital structure of banks, link executives’ compensation to a highly levered bet on the value of banks’ assets. Overly complicated compensation schemes further encourage such profit-oriented behaviour. John and John (1993) argue that stock-based compensation

increased managerial risk appetite and offered executives an opportunity to take excessive risk in order to bolster a company’s share price with short-term maneuvers and gain significant reward without having to bear any downside risks. Sawers *et al.* (2007) have based a study on the behavioral agency model, which predicts that a manager’s wealth in stock-based compensation will influence managerial risk-seeking behaviour. The results suggest that the subjective overvaluation of stock options based on historical rising stock price trends increases risk-bearing behaviour.

Although causes of the financial turmoil are multidimensional, analysts and scholars (Miller, 2008, Bebchuk and Spamann, 2010) have blamed the misaligned compensation arrangements that encouraged management short-termism for the failure of high profile companies such as Bear Sterns, Lehman Brothers, Fannie Mae and Freddie Mac in the U.S. The financial regulators blame those who devised pay-for-performance incentive schemes, which encouraged and rewarded short-term and excessive risk-taking behavior (Miller, 2008). Prior studies on risk taking by financial institutions generally find that risk taking by banks is higher in those with large and diversified blockholders[†] (Laeven and Levine, 2009). Mehran and Rosenberg (2008) associate CEO stock option grants with lower debt and higher capital ratios, but riskier investments. Bebchuk *et al.* (2010) indicate that the top-five executive teams of Bear Sterns and Lehman Brothers cashed out large amounts of performance-based compensation in the form of cash bonus and equity sales during the period 2000-2008. Shareholders are highly concerned with rewards for failure as executives walked away with large pay packets even when the stock market collapsed (Healy, 2009, Goldfarb, 2009).

What are the Hybrid Bank Capital Securities?

The bank hybrid securities that our study examines are *not* the traditional hybrid securities that financial institutions issue on the condition that on conversion time, one hybrid security will convert into one equity share. The hybrid bank capital securities that we propose for bank executives’ compensation are preferred shares and subordinated debt that the Basel II regulatory framework recognises as other forms of admissible capital. Instead of adopting the traditional way of obtaining more capital by issuing ordinary shares, banks were allowed to use hybrid bank capital securities as one alternative of creating regulatory capital.

Briefly speaking, these hybrid bank capital securities are debt-like instruments that exhibit

[†] The owner of a large amount of a company's shares. These owners are often able to influence the company with the voting rights awarded with their holding.

certain characteristics of shares, such as the possibility of interest deferral, deep subordination and very long maturities. We can classify these hybrids into the following three groups: Tier 1 securities,

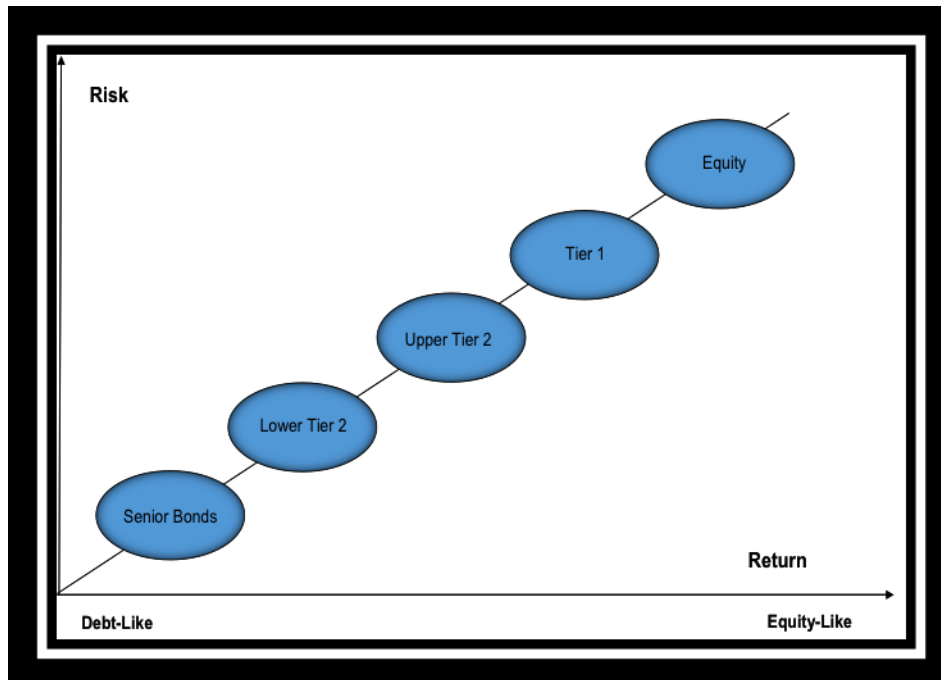
Upper Tier 2 securities and Lower Tier 2 securities in accordance to the risk and return characteristics. **Table 1** highlights some important features of these hybrids.

Table 1. Features of Three Hybrid Bank Capital Securities

Category	Description	Basel II
Core Tier 1		Common stocks and retained earnings
Hybrid bank capital securities	Tier 1 hybrids	<ul style="list-style-type: none"> ○ Deferred coupons non-cumulative ○ No/ very long maturity ○ Call rights for issuer ○ Innovative: the capital instruments with step-ups in the coupon rate ○ Non-innovative: the capital instruments with no step-ups in the coupon rate ○ With high subordination
	Upper Tier 2 hybrids	<ul style="list-style-type: none"> ○ Deferred coupons cumulative ○ No/ very long maturity ○ Call rights for issuer ○ Innovative: the capital instruments with step-ups in the coupon rate ○ Non-innovative: the capital instruments with no step-ups in the coupon rate
	Lower Tier 2 hybrids	<ul style="list-style-type: none"> ○ No coupon can be deferred ○ Very long maturity ○ Call rights for issuer ○ Innovative: the capital instruments with step-ups in the coupon rate ○ Non-innovative: the capital instruments with no step-ups in the coupon rate

Source: Compiled by Authors

Figure 1. Risk and Return of Hybrid Bank Capital Securities



Source: Compiled by Authors

Figure 1 below is a stylised representation of the risk-return relationship of the various hybrid bank capital securities. In general, investors in hybrids bear a number of risks which are not present in senior

bonds, such as the risk of a cancelled or deferred coupon payment, and risk of extension[‡]. Tier 1

[‡] Risk of extension: If an issuer, whose credit quality deteriorates, decides not to call a security at the call date,

securities are more **equity-like** than Upper Tier 2 and Lower Tier 2 securities as they subordinate to all other kinds of instruments, except ordinary shares. For Tier 1 securities, deferred coupons are non-cumulative, i.e. the financial institution will not pay them in the future (BIS, 2004)).

Investors in Upper Tier 2 hybrid bank capital securities bear similar risks as Tier 1, but coupons are **cumulative** (i.e. the financial institution will pay the deferred coupons in the future). Lower Tier 2 securities are more like **senior bonds**, insofar as they rule out coupon payment deferral or cancellation. However, they are more volatile than senior bonds during their term to maturity due to their subordination to senior bonds in the case of insolvency.

Basel II and Bank Hybrid Capital Securities

In the original 1988 version of the Basel Accord (Basel I), only two elements were eligible to make up core capital: equity capital and reserves (Basel Committee 1988). Only undisclosed reserves, revaluation of reserves, general provisions and hybrid debt/ capital instruments and subordinated term debt could comprise supplementary capital. At first, the Basel Accord (Basel Committee, 1988) viewed hybrid capital instruments as part of supplementary capital. In the October 1998 “*Instruments Eligible for Inclusion in Tier 1 Capital*” press release, the BCBS admitted the inclusion of hybrid instruments as part of core capital, provided that financial institutions fulfilled certain conditions. The Basel Committee on Banking Supervision (Bank For International Settlements, 1998) foresaw the issuance of “innovative” capital instruments, with step-ups in the coupon rate at the call date and for the purpose of generating core regulatory capital at a lower cost. The BCBS placed a 15 percent cap on these innovative securities as core capital. Moreover, the BCBS allowed banks to issue additional “*non-innovative*” capital securities that had a call date and often included a switch from fixed rate to floating rate at that day, but did not involve a coupon step-up.

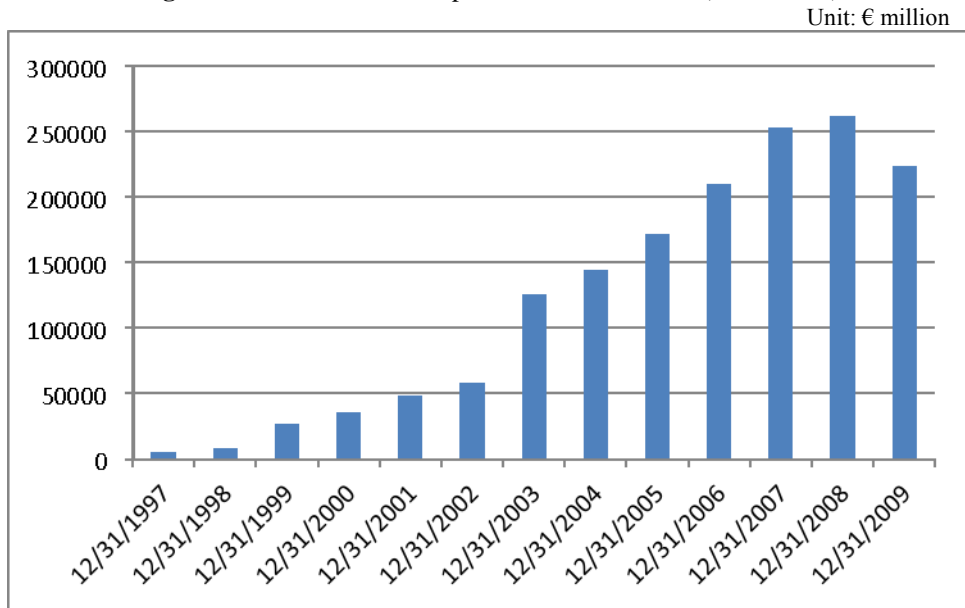
This change was one of the main drivers of the increased issuance of hybrid capital securities by financial institutions. In *Figure 2*, we show that the face value of hybrid bank capital securities outstanding in the euro zone grew 25-fold between 1998 and 2008. The market for hybrid securities expanded rapidly because the market perceived them as a timely solution to the demands of both issuing institutions and investors. There are three major growth drivers in the European market for hybrid bank capital securities: 1) the aforementioned Basel regulatory framework; 2) the adoption of easy-to-

understand rating standards by the rating agencies; and 3) and the introduction of the Euro (Yu and Luu, 2009).

Basel II, the revised framework agreed on by the BCBS in 2004, made amendments to the capital adequacy rules for financial institutions, but it maintained the 15% limit for innovative Tier 1 securities (Bank For International Settlements, 2004). The Basel committee conceded individual governments some flexibility with regard to non-innovative Tier 1 securities (Bank For International Settlements, 2004). Therefore, the limits for non-innovative Tier 1 hybrids vary across different jurisdictions, with some countries allowing hybrid debt to form up to 50% of all Tier 1 capital, whilst other jurisdictions allow significantly less. *Table 2* shows a summary of national regulations. For example, Austrian banks can issue both innovative and non-innovative hybrid bank capital securities totaling up to 50% of net Tier 1 capital. Since innovative hybrid bank securities are limited to 15%, Austrian banks can issue up to 35% of their hybrid capacity in the form of non-innovative securities if they want to maximise the hybrid component of the capital mix.

the investor is subject to extension risk. Often, a step-up occurs at the call-date, which may not be sufficient to compensate investors for the deteriorating credit risks.

Figure 2. Euro Financial Corporate Index Sub-Debt (Face Value)



Source: Compiled by authors (data collected from Global Index System)

Table 2. Hybrid Limits as a Proportion of Total Tier 1

	Supervisory Limit on Innovative Tier 1	Supervisory Limit on Hybrids Excluding Non-cumulative Preference Shares	Limit on Tier 1 Bank Hybrids under National Company Law
Non-additive limits			
Austria	15%	30%	50%
Belgium	15%	33%	33%
Denmark	15%	15%	Not recognised
France	15%	25%	No issuance so far
Germany	15%	50%	Not recognised
Greece	15%	30%	No limit (Issuance unusual)
Ireland	15%	50%	No limit
Italy	15%	15%	50%
Netherlands	15%	50%	50%
Norway	15%	15%	No issuance
Portugal	20%	20%	50% (Issuance unusual)
Spain	15%	30%	30%
Sweden	15%	15%	No limit
U.K.	15%	15%	50%

Source: CEBS (European Banking Authority, 2007)

Why Should Bank Executives' Compensation Comprise Hybrid Bank Capital Securities?

Moral hazard problems exist, particularly in the monitoring of managerial risk-taking behaviour in the banking industry because the corporate governance in banks differs from that of a generic company (Mülbart, 2010, Vallascas and Hagendorff, 2010). Bank shareholders benefit from high leverage, and thus encourage management to take excessive risk via the control of executive compensation. The cash and equity-based compensation exaggerates the management risk appetite due to the rewards that

management bases on short-term performance (Vallascas and Hagendorff, 2010). Since some long-term compensation incentive risks are not incorporated in the traditional compensation scheme, we suggest that banks' stakeholders and regulators should push for a change in remuneration practices. In particular, we argue that hybrid bank capital securities should pay a substantial part of senior bank executives' incentive compensation. Our rationale is that the face value and all coupon payments during the maturity will restrict the payoff from holding these hybrid bank capital securities (Yu and Luu, 2009).

$$\text{Hybrid Valuation} = \frac{C_1}{(1+r)^1} + \frac{C_2}{(1+r)^2} + \frac{C_3}{(1+r)^3} \dots + \frac{C_n + F}{(1+r)^N}$$

Where:

The maturity of this hybrid will last for N years

C: Coupon payments of these bank hybrids

F: Face value of these bank hybrids (In the U.K., face value=£100)

R: Required rate of return

According to the hybrid valuation equation, we can observe that the financial institutions have already fixed the future cash flows which Bank CEOs will receive through the whole maturity at the same time when they pay these bank hybrids as their bonus at Year 0 (Yu and Luu, 2009). No matter how much risk a banker undertakes later on (in the following N years), the maximum bonus rewarded to these bank CEOs will be limited to these fixed cash flows generated from coupon payments and face value. We believe that this design will discourage these bank CEOs to take excessive risks.

Unlike common stock and stock options, which are currently popular forms of incentive compensation for executives (Bebchuk et al., 2010), hybrid bank capital securities would limit the upside from driving bank profits even higher since the maximum future cash flows are fixed. However, this new bonus system still exposes bank managers to the downside risk of insolvency. We can use the aforementioned equation to explain our proposal. If a bank goes bankrupt before the maturity, its CEOs will lose several coupon payments and face value which they originally expect to receive at the end of maturity. Yu and Luu (2009) and Tung (2010) argue that paying bankers with their own banks' public subordinated debt securities will give bankers direct personal incentives to avoid excessive risk because market pricing of these securities is sensitive to downside risk at the bank. In return, this may contribute to a more prudent management of financial institutions in the future.

The emphasis on the share price has led some bank executives to take greater risks than they otherwise would have to achieve a higher reported return on equity in a short term, as exemplified by Mehran and Rosenberg's (2008) findings. The proposed new bonus scheme may overcome this drawback if the recipients of these hybrid bank capital securities cannot sell the securities before the issuer repays them. This occurs when the financial institution calls the hybrid bank capital securities or at final maturity (Yu and Luu, 2009). Maturity of these hybrid bank capital securities are usually longer than 5 years, so the new remuneration system would see rewards for those who deliver good results for longer terms.

In addition, we propose that banks should publish the purchases and sales of an institution's own hybrid bank capital securities by its senior executives, as is already the case with equity purchases and sales by company directors. The signal that executives send by buying their own institutions' hybrid bank capital securities could help investors and other stakeholders gain greater confidence in the solvency of a bank. Unusual sales of hybrid capital securities by executives may have the opposite effect, but would also provide useful information and help market participants identify well in advance deteriorating financial institutions.

Basel III

The nationalisation of Northern Rock in the U.K. wiped out some Tier 1 securities, whilst others continued to receive coupon payments (Davies, 2009). In the case of Bradford & Bingley, all Tier 1 issues became worthless (Unmack, 2009). As the lack of international consistency in the treatment of hybrids became apparent, the European Commission (according to the BCBS 164) recently harmonised the rules of capital definition for all EC banks (Bank For International Settlements, 2004). It includes limits on hybrids, with predominant core capital of a minimum of 50% and a possibility of having hybrids up to 35% of total capital before any bank holding deductions.

In January 2011, the Basel Committee outlined the new rules for hybrids in the context of Basel III (Bank For International Settlements, 2011). The Committee requires consistency of the regulatory capital after the end of the transition period (the end of 2012) with the following instruments (Bank For International Settlements, 2011):

- No change for Core Tier 1 which still includes common stocks and retained earnings;
- New terms for Tier 1 hybrids: no maturity, non-cumulative deferred coupons, no step-up, conversion after breach of objective trigger, and write off / conversion on decision of regulator; and
- New features for Tier 2: no step-up, long maturity, no distinction between Lower Tier 2 and Upper Tier 2, write-off/conversion on decision of regulator.

Table 3 summarises these changes:

Table 3. Bank Hybrid Securities under Basel III

Category	Basel II	Basel III	
Core Tier 1	Common stocks and retained earnings	The same as Basel II	
Hybrid bank capital securities	Tier 1 hybrids	<ul style="list-style-type: none"> ○ Deferred coupons non-cumulative ○ No maturity ○ No step-up ○ Conversion after breach of objective trigger ○ Conversion on decision of regulator ○ Write-off 	
	Upper Tier 2 hybrids	No distinction between Upper Tier 2 and Lower Tier 2 hybrids	<ul style="list-style-type: none"> ○ Long maturity ○ No coupon deferral ○ No step-up ○ Conversion on decision of regulator ○ Write-off
	Lower Tier 2 hybrids		

Source: Compiled by Authors

The most important innovation is that, in the case of Tier 1 hybrids, conversion into equity will occur once a fixed objective trigger has been reached, although the Committee has yet to define the trigger. The exact trigger will probably not become clear until the Basel guidelines become national law. Furthermore, the Committee should not include step-ups in the Tier 1 hybrid’s new terms. Currently, the new Tier 1 hybrids are popular in the market. Contingent Convertible instruments, or “CoCos”, it is unclear whether already issued CoCos meet the criteria of Basel III. For Tier 2 hybrids, the new Basel III document allows these Tier 2 hybrids to have a long maturity and in order to include them in equity capital, a company or any of its subsidiaries cannot hold or own its Tier 2 hybrids §.

After reviewing the new regulatory framework of Basel III on hybrids (Bank For International Settlements, 2011), we believe that both the new Tier 1 and Tier 2 securities are suitable as a significant portion of bank executives’ compensation pay. Although there is a mandatory conversion of the new Tier 1 securities into equities when the trigger is breached, this conversion arguably occurs when the bank is in a situation of some financial distress and share prices are likely to be depressed (Bank For International Settlements, 2011). Executives would not unduly benefit from attempting to raise share prices through risky strategies, as may be the case if their compensation is primarily made up of common stock and options.

The global financial crisis provided an initiative to reform bankers’ pay coincided with a decades-long tread of banking deregulation (Yu and Luu, 2009, Tung, 2010). We propose that the only way towards “best practices” is to design a new approach to executive compensation which incorporates new bank

regulations on capital requirements and market discipline into the pay-for-performance design. In addition, aligning the interests of management with those of shareholders via equity-based compensation, hybrid securities encourage the use of debt-like instruments that take debtholders and regulators’ interests into consideration.

Conclusion

This paper provides an overview of the initiatives of reforming bankers’ compensation in light of recent corporate governance failures in banks and the risk management under Basel III (Bank For International Settlements, 2011). Paying compensation in the form of hybrid bank capital securities may help banks regain their reputation for prudence after years of aggressive risk-taking. We position that the asymmetric payoff of these securities to the holders makes them particularly suitable as part of executive compensation packages. Moreover, banks are desperately seeking to raise capital in order to bolster balance sheets damaged by the ongoing credit crisis (Bank For International Settlements, 2011). Basel III especially expects banks to meet the requirements by 2019. For banks to tap into their own senior employees with large incentive compensation packages may be a viable additional source of capital that is politically acceptable in times of large-scale financial sector bailouts and is economically wise as it aligns executive interests with the need for a stable financial system. Given the important role of banks in the economy, the public and the market have a high degree of sensitivity to any difficulties potentially arising from any corporate governance failures in banks (Bank For International Settlements, 2010). Studying a new form of compensation might contribute to the bank’s sound governance, stability of the international financial system and the reaction

§ After January 1, 2013, there will be only Basel III compliant issuance.

to the public anger over 'rewards for failure'. Thus, risk management in corporate governance is of great relevance both to the individual bank and to the economy as a whole.

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