CHAPTER 3

RISK TAKING BY BANKS: THE ROLE OF GOVERNANCE AND EXECUTIVE PAY

Summary

There is broad consensus that excessive risk taking by banks contributed to the global financial crisis. Equally important were lapses in the regulatory framework that failed to prevent such risk taking. Reforms are under way to further strengthen the regulatory framework, realign incentives, and foster prudent behavior by bankers. These reforms aim to enhance capital and liquidity buffers and influence the incentives that induce bankers to take excessive risk. Regarding the latter, measures are being introduced to enhance risk governance and to ensure that pay practices fully reflect the risks that bankers take.

To be effective and avoid unintended consequences, such reforms must be based on a thorough understanding of what drives risk taking in banks. This chapter aims to contribute to that understanding through an empirical investigation that relates various measures of bank performance and risks to bank characteristics of governance, risk management, pay practices, and ownership structures.

The results show that banks with board members who are independent of bank management tend to take less risk. The level of executive compensation in banks is not consistently related to their risk taking. More pay that is related to longer-term job performance is associated with less risk. Moreover, banks that have large institutional ownership tend to take less risk. As expected, periods of severe financial stress alter some of these effects because incentives change when a bank gets closer to default.

With these results in hand, the chapter recommends policy measures, some of which are part of the current policy debate but have so far not been empirically validated. Measures include more appropriate alignment of bank executives' compensation with risk (including the risk exposure of bank creditors), deferment of some compensation, and providing for clawbacks. Bank boards should be independent of management and should establish risk committees. Supervisors should ensure that board oversight of risk taking in banks is effective. Consideration should be given to including debt holders in addition to shareholders on bank boards. Finally, transparency is critical to accountability and the effectiveness of market discipline.

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