

Risk based rewards in the Financial Sector

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The Special Case the Financial Institutions

- Opaque, financial information
- diverse stakeholders
- difficult to monitor
- Highly leveraged
- Inherent structural mismatch
- Significant systemic importance,
- The existence of the public safety net
- Endemic tradeoff of risk in the nature of financial intermediation

Motivation & Behaviour in a Risk Reward Framework

- The Age old principal & agent problem
- early work of Jensen suggests
 - *motivating humans through incentives which include money.*
 - *However when the compensation of the principal and the agent is not aligned excessive risk taking can occur*
- self-interest may be consistent with altruistic motives but this is insufficient to control and motivate the behaviour of agents



Endemic risk takers

- in light of the GFC it becomes clear that financial institutions need to move to a culture of accountability in terms of risk taking & sharing
- In the past accountability implicit in integrity and altruism of employment contracts and social accountability
- The GFC & significant problem loans such as Enron, WorldCom and HIH has shown us the altruism and integrity do not make all agents perfect agents
- Conversely individuals appetite for risk varies considerably and individuals may be irrational

Incomplete Incentive Compensation Contracts

- Poorly aligned incentives causing the taking of undesirable and irresponsible risks,
- perverse incentives encouraging excessive risk-taking for short-term gain,
- Business leaders taking an excessive risk in the quest to achieve next quarters profits
- A embedded culture of myopic short termism

The earnings myopia syndrome

- Short termism exists in
 - The investor preferences and is
 - embedded in the managers response behavior – a prisoners dilemma that is
 - Current earnings signal future, firms inflate current earnings to signal future prospects, investors discount current earnings accordingly but no firm can credibly defect from the game.*
 - The generation of irrational risk taking



Issues

- Cultural
- Risk Determination
- Contractual

Issues: Cultural

- Need to design & influence the FI culture of risk taking behaviour
- Directors clear policy of an acceptable level of risk and long run performance targets.
- For a number of FI's this is a cultural shift in the organization as well as loan policy, investment policy and trading policies.

Issues: Determination

- A matching of the organizational structure with the risk reward framework
- Risk control and culpability or ability to influence risk levels
- Management acceptance of responsibility of risk taking behavior

Issues: Contractual

- A complex long run state contingent compensation framework that rewards risk behaviour matched with the long-run interest of the stakeholders
- Compensation elements
 - Salary and bonus
 - Pension
 - Deferred compensation
 - Stock options