

Contingent Convertibles and Bankers' Pay

The Missing Link in India's Financial Regulation

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The compensation practices at large financial institutions are often held as one of the important factors which contributed to the 2007/2008 global financial crisis. Regulators around the world, including India, have therefore moved to enact prescriptions aimed at increasing shareholder oversight of executive pay. Set against this background, the paper makes two novel proposals focusing on the Indian context. First, it nudges the regulators to prescribe creditor-centric compensation rules at banks. The Reserve Bank of India has hitherto focused on pay reforms that will promote incentive alignment between executives and shareholders. This paper argues that such reforms are likely to promote more rather than less risk-taking among bank executives. Second, it argues that the RBI ought to mandate banks to pay a substantial portion of the managerial compensation in contingent capital bonds. The design of these bonds can significantly motivate executives to "think like creditors" and thereby enable avoidance of taxpayer-funded bailouts.

Compensation practices, especially of the large financial institutions, are often held as one of the important factors which contributed to the recent global financial crisis. Employees were too often rewarded for increasing the short-term profit without adequate recognition of the risks and long-term consequences that their activities posed to their organisations. These perverse incentives amplified the risk-taking that threatened the global financial system. Financial regulators around the world, including India, moved to enact prescriptions aimed at increasing shareholder oversight of executive pay.¹

Set against this background, this paper makes two novel proposals focusing on the Indian context. First, it nudges the regulators to prescribe creditor-centric compensation rules at banks and other financial institutions. The Reserve Bank of India (RBI) has hitherto focused on pay reforms that will promote incentive alignment between executives and shareholders in the aftermath of the financial crisis. Such reforms are likely to promote more rather than less risk-taking among bank executives, because the bearer of residual risk in the case of a bank is the taxpayer and the uninsured creditor. On the other hand, a creditor-centric approach to pay reform will ensure "skin in the game" for the bank executives and promote conservative management. Second, for the first time in the Indian context, it argues that the RBI ought to mandate banking institutions to pay a substantial portion of the managerial compensation in contingent capital bonds. Contingent capital bonds are subordinated debt instruments that are either written off or get converted into equity shares conditional on financial health of the bank concerned falling below a particular threshold. The financial health in this case is measured in terms of how much capital a bank retains against the (risk weighted) assets it has created.² This measure, if enacted, would significantly incentivise managers and directors to ensure that the bank takes risks consistent with the interest of the taxpayers and uninsured creditors.

The paper is organised as follows. Section 1 points out the peculiar nature of a deposit-insured financial institution such as a bank. Section 2 discusses the lacunae in the reforms introduced in the aftermath of the financial crisis. Section 3 introduces the concept of contingent capital and the extant market practice in connection with their use in executive compensation. In Section 4 we discuss the structure of currently outstanding contingent capital awards issued by European banks, which

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may exacerbate risk-taking incentives precisely when the bank needs prudent management. We also discuss the design to mitigate those risks. Section 5 argues that contingent capital bonds compare favourably with debt-based compensation (retirement pay and deferred compensation payable to executives). The last section concludes.

1 The Financial Firm

Banks act as intermediaries of short-term deposits to long-term borrowers; the deposits are highly liquid and most are retail and redeemable on demand. On the other hand, the loans that banks advance to their borrowers are highly illiquid investments and fixed in tenure. The intermediation of short-term on-demand funds to long-term fixed tenure investments exposes banks to an "asset-liability risk"—risk that it will be unable to pay back the deposits as they come due, without accelerating (calling back) long-term profitable loans. This is likely to happen, for example, when there is a "run on the bank" when all or a substantial fraction of the depositors demand their deposits back at the same time.

To avoid this, financial sector regulators across jurisdictions have made provisions for deposit insurance *ex ante*. In India, for example, the RBI administers deposit insurance through the Deposit Insurance and Credit Guarantee Corporation (DICGC) that protects deposits to the extent of Rs 1,00,000 in one account. The intuition here is that insuring retail depositors from the loss protects them in the event of bank failure and thus makes the bank less vulnerable to "run on the bank" around the zone of insolvency. Since all banks benefit from the stability that deposit insurance brings about, deposit insurance contributes to mitigation of systemic risk.

On the other hand, it also induces moral hazard among the shareholders and the management of the bank because deposit insurance in effect shifts residual risk from the shareholders to the taxpayer. This moral hazard creates perverse incentives in the shareholder-management coalition to take exposure to risky assets without adequately accounting for the risks; because the losses that they would sustain in the event the assets (loans) defaulted would be shared between them and the taxpayer, and the profits (in the event there is no default) will exclusively benefit them.

Contrast the pattern discussed above with the incentive structure of the typical non-financial firm. The traditional wisdom for this type of firm is that management and shareholders have diametrically opposite objectives. Diversified shareholders, uncaring of firm-level risk, would want their management (or the controlling shareholder) to invest the firm's resources in risky but positive net present value projects. On the other hand, the managers or controlling shareholders are invested in the firm (through a substantial equity stake or undiversified human capital) and therefore have private incentives to invest the firm's resources in non-risky assets or otherwise reap private benefits of control. Legal institutions and market mechanisms have been devised therefore to align the incentives of shareholder and the management of the firm.

For example, the Securities and Exchange Board of India (SEBI) has mandated in clause 49 of the Listing Agreement that listed companies appoint independent directors on their boards as a condition for offering their shares to the public. Companies routinely pay a portion of executive directors' compensation in equity-based instruments so as to align their objectives with their own. Since the last bearer of risk in a non-financial firm is the shareholder, corporate governance initiatives and market mechanisms are aimed at aligning the interests of the shareholder and the management. By parity, therefore, corporate governance at the financial firms in general and banks in particular, ought to be aimed at aligning the interests of bank executives and the taxpayer/uninsured bondholders—since it is those stakeholders that in effect are the last bearers of the risk in the event of bank failure.

Research on the financial crisis indicates that moral hazard among the shareholders owing to the peculiar nature of the financial firm discussed above could have in fact accentuated the perverse incentives that caused the crisis. Bratton and Wachter (2010) point out that prior to the autumn of 2007, the banks (represented by the subset of bank stocks of the Standard & Poor's 500 (S&P 500)) outperformed the market as a whole, in rough correlation to its ups and downs. The relative weight of the financial sector within the S&P 500 grew from 13% in 1999 to 22.3% in 2006. However, the narrative surrounding the financial crisis revolved around the agency costs³ bank executives imposed on shareholders and other stakeholders. Global regulatory reform in the aftermath of the crisis was premised upon that narrative. For instance, the Dodd-Frank Act enacted in the United States (US) in the aftermath of the crisis, entitled the shareholders to have "say-on-pay."

In India, the RBI has followed the global trend on pay reform and implemented shareholder-centric rules. However, as the next section illustrates, the executive compensation reforms implemented by the RBI are unlikely to deter the risk-seeking incentives of bank shareholders and therefore leave the taxpayer as exposed to losses as she was before the crisis.

2 Pay Reform after the Crisis: High Hopes?

The Financial Stability Board (FSB) issued the Principles of Sound Compensation Practices in 2009 to ensure effective governance of compensation, alignment of compensation with prudent risk-taking, and effective supervisory oversight and stakeholder engagement in compensation. The RBI has implemented the FSB standards through the Guidelines on Compensation of Whole Time Directors (WTDS)/Chief Executive Officers (CEOs)/Risk Officers and Control Function Staff ("Guidelines" hereafter).⁴ The Guidelines prescribe that the compensation structure for the WTDS/CEOs should be divided into fixed pay, variable pay that may be up to 70% of fixed pay and further stipulate deferral of variable pay for a minimum of three years where it is 50% or more of the fixed pay. In addition, they also prescribe *malus*⁵ and clawback for the portion of compensation deferred (in the event of say, earnings restatement after the asset-origination).

An analysis of each of these reform measures is in order before we make the normative claim in this paper.

2.1 Remuneration Committee

As a means to effectively govern compensation of bank managers, the Guidelines mandate that the banks formulate and adopt a comprehensive compensation policy for its employees. The Guidelines further mandate that the board of directors should constitute a Remuneration Committee of the board, with the majority of its directors being non-executive independent directors, to oversee the framing, review and implementation of the said compensation policy.

Note that the directors performing the oversight as part of the Remuneration Committee are beholden to the shareholders as the latter appoint them. As such, it is unlikely that their incentives are aligned with the taxpayers and unsecured creditors as they monitor the remuneration practices of their bank managers (Bebchuk and Spmann 2010). Without prejudice to the aforementioned claim, even the most motivated independent directors are constrained by information asymmetry as they are outside directors retained by the company/bank only part-time; moreover, the independent directors may lack the financial expertise to adequately assess the risk-impact independently of insider-managers. Boards in the US have had majority independent directors since the corporate governance reforms enacted in the aftermath of the Enron scandal.

As Ferreira et al (2010) point out, independent directors as a percentage of all directors in US banks had in fact increased progressively from 51% in 2000 to 73% in 2008. They observe the same pattern for non-US banks. Board independence therefore does not appear to have prevented bank failures in the US and the United Kingdom (UK) (Becht et al 2011). In fact, there is empirical work pointing to the evidence that banks with more shareholder-friendly boards (meeting “good governance” attributes relating to board independence as defined by Institutional Shareholder Services, a proxy advisory firm), fared distinctly worse during the crisis (Beltratti and Stulz 2009). It is plausible to argue therefore that independent directors have not been very effective in monitoring risk-taking by banks in the years leading up to the financial crisis.

2.2 Deferred Variable Compensation

Another compensation reform mandated by the Guidelines is the deferral of variable pay. Variable pay like bonuses was deemed to contribute to short-termism of commercial and investment bankers that ultimately contributed to the financial crisis. It was thought that deferral would curb short-termism by making sure executives have skin in the game for a specified duration after they acted. However, the minimum deferral period of three years that the Guidelines provide is too diluted. As discussed above, the board and the shareholders are unlikely to have incentives to prescribe deferral periods longer than three years. Therefore, deferral of variable pay (bonus) appears insufficient to reduce the moral hazard that contributed to the crisis.

Other forms of deferred variable compensation intended to incentivise the employee to think long term have their

drawbacks too. One such instrument is restricted stock—which cannot be sold for a specified period or whose sale is contingent on certain conditions. However, imagine a bank at the zone of insolvency that requires recapitalisation in the near term. If the bank management or CEO has a substantial fraction of her wealth locked-in in restricted stock (a kind of deferred variable pay), her incentives would run exactly opposite to recapitalisation as the depressed stock price near the zone of insolvency would mean the CEO’s stake would be substantially diluted if the bank issued more equity. This is not merely academic speculation—Richard Fuld, the then CEO of Lehman Brothers was heavily invested in the firm through equity and equity-linked pay. It is common knowledge that he held out against injecting capital in the firm “at low single digits” that eventually led Lehman Brothers to file for bankruptcy. Restricted stock and other variable deferred pay that align the CEO incentives over the long term thus aggravate the incentive to “hold out” against recapitalisation at precisely the moment the firm requires capital infusion (Gordon 2010).

2.3 Disclosure and Monitoring

Finally, the Guidelines mandate disclosure of pay practices of banks in the financial statements. Although disclosure of compensation is a best practice, theory suggests that diffuse shareholders or debt holders face a collective action dilemma in scrutinising this information. Their individual stake in the firm’s issued equity/debt capital may be too minuscule to make the costs of scrutiny rational since the benefits of their action are diffused among other shareholders. Furthermore, banks bury this information in the annual reports which makes it difficult for regulators to detect problematic pay practices. In sum, therefore, disclosure is unlikely to effectively mitigate the risk-shifting incentives of bank management. Moreover, to the extent that this disclosure is made to the shareholders, the disclosure of pay practices could actually be counterproductive in that shareholders rationally want their managers to take more risks over the long term, in face of deposit insurance.

A related regulatory measure is monitoring. Indeed, the Guidelines prescribe that private banks shall seek RBI approval of their remuneration practices for consistency with the FSB principles.⁶ The Guidelines stipulate that the RBI will monitor if there is appropriate balance between fixed and variable pay, whether adequate deferrals in the variable component are built-in, and whether the cost/income ratio supports the remuneration package consistent with the maintenance of sound capital adequacy ratio. However, as we have already discussed, deferred variable pay can create perverse incentives among the executives to refuse recapitalisation precisely at the time the bank requires it. So, even if the regulators ensure that optimum deferral of variable pay is built into the compensation structure, the same does not guarantee that the bank is less prone to failure in the future.

Finally, in general it is important to acknowledge that regulators are not omniscient and may suffer from cognitive biases, information asymmetry, or act in their selfish interests in preference to the social good. For example, their risk-aversion

may cause them to mandate that a solvent but illiquid bank issue capital it does not need since they bear the costs of apparent regulatory failure alone while the benefits of regulatory supervision are diffused across the financial system. At the other end of the spectrum, even while knowing that a particular bank is failing, regulators may choose to refrain from taking action especially towards the end of their tenure—they may delay disclosure of the failure till the relevant personnel have vacated their position, to avoid the stigma.

3 The Concept of Contingent Capital

One of the mechanisms to address moral hazard is for the bank to issue a long-term deeply subordinated bond that will be called the “contingent capital” instrument. Contingent capital bonds are debt instruments that automatically convert into equity or are written off in the event capital adequacy of the concerned bank (measured as the amount of capital the bank holds against its (risk weighted) assets) breaches a specified critical capital threshold (this may be termed the trigger for conversion). Once written off or converted into equity shares, it thereby increases the amount of equity capital the bank holds and in effect recapitalises it at a time when the bank needs it the most. On the other hand, contingent bonds convert into equity or shore up equity around the zone of insolvency. As such banks and other systemically important financial institutions that have included contingent capital as part of their capital structure mitigate the risk that they cannot issue equity capital near the zone of insolvency.

The design of contingent capital instruments has generated regulatory and policymaker interest in the aftermath of the financial crisis.⁷ As is widely known, taxpayers bailed out many financial institutions including the American Insurance Group, Bear Stearns, and other commercial banks during the financial crisis as these institutions suffered losses on their real estate lending portfolio or credit default swap exposures. Contingent capital in the capital structure has the potential to act as going-concern loss-absorbing capital⁸ thus privatising losses that were socialised in the financial crisis of 2008. Accordingly, banks in Europe including Barclays, Credit Suisse, Lloyds, and Rabobank have issued contingent capital bonds to investors.

3.1 Is Contingent Capital the Panacea?

Conversion Trigger: It is critical that the contingent capital instrument be structured appropriately for it to generate appropriate incentives. Academics and practitioners have focused on the nature of the trigger (at which the debt converts into equity capital) and the effect of conversion (see, for example, Pennacchi et al 2014; Calomiris and Herring 2013; Goldman Sachs Global Markets Institute 2009). As we discuss in the following section, regulators and market practice have preferred accounting-based triggers, pegging the conversion to the capital adequacy ratio. On the other hand though, since accounting triggers are lagging indicators of distress, the counter-view is that triggers ought to be market-driven.

Proponents of market-based triggers argue that since the financial statements of firms are only periodically disclosed and

are historical, there is a risk that the bank capital is depleted to the point of insolvency by the time the conversion is triggered. Therefore, a contingent capital instrument ought to have a forward-looking trigger (for example, market capitalisation—that is, the share price) for the trigger to activate. However, though market-based triggers are more “current,” they are subject to manipulation, especially if the conversion price is prescribed as the market price of equity at the point of trigger rather than fixed upfront. The contingent capital holders can push the already depressed stock price lower by, for example, short selling to get greater amount of stock than otherwise.

Proponents of market-based reform have suggested moving average/volume weighted average as the means to reduce the incentive to manipulate. Such a trigger may specify, for example, that the contingent capital will be converted if the market value of equity declines 10% below its volume weighted average for the last 90 days (Calomiris and Herring 2013). Others have proposed a dual-trigger mechanism based on the decline of bank stock and bank index by a specified percentage to mitigate the risk of manipulation (McDonald 2013).

A detailed discussion of the optimum trigger is beyond the scope of this paper. Since regulators, including the RBI, have espoused the accounting-based triggers⁹ and we propose that bank managers be paid in very aggressive (high) trigger contingent capital instruments (such that they will take the first loss), we will advance this discussion based on the accounting-based triggers.

Conversion Effect: As pointed out earlier, contingent capital instruments could either be designed as contingent convertible bonds—that will convert into equity at the trigger based on a pre-specified formula—or as bonds that will have their principal written off either fully or partly at the breach of the trigger. The former will hurt the shareholders because the conversion has a dilutive impact on stock value; the latter hurts the bondholders and therefore relies on market discipline imposed by contingent bondholders to induce the bank to conserve capital.

It appears that the contingent bonds that convert into equity shares are better from a regulatory standpoint than the contingent bonds that are written off. Since shareholders and their appointees control the resources and benefit from the inherent moral hazard in the business of banking, imposing costs on the shareholders through dilution should mitigate the moral hazard and reduce their risk-seeking incentives. On the other hand, write-off contingent capital relies too heavily on bondholder monitoring to ensure that the bank is prudent in risk-taking. Bondholders are outside investors and may suffer from information asymmetry and collective action problems that will dampen their incentives to impose market discipline. In the face of these problems, write-off contingent capital may aggravate the risk-shifting incentive that the shareholder-bank manager coalition already have because a bank that issues write-off contingent capital privatises gains from risk-taking (to shareholders) and shifts the losses to bondholders (Goldman Sachs Global Markets Institute 2009; Coffee 2010).

Contingent capital bonds can also serve as an effective executive remuneration instrument. First, banks that have outstanding contingent capital bonds may use such pay practices as a signalling mechanism to cure the “adverse selection” problem that arises between the investors and issuing banks. Second, designed appropriately, paying executives in these bonds motivates them to think in the interests of uninsured creditors and taxpayers over the long term. So, paying executives in contingent capital is more likely to motivate them to design subsequent issues of contingent capital bonds to the investors appropriately. Finally, even if the contingent capital bonds issued to the executives are triggered, they signal the impending recapitalisation of banks thereby enabling them to capitalise cheaply. As we will see in the following section, these features make contingent capital bonds a far more attractive remuneration tool than paying executives in debt-based instruments.¹⁰

3.2 Market Practice

Paying bank executives in contingent convertible bonds is not just an academic argument; Barclays in the UK¹¹ and banks in Switzerland, including Credit Suisse,¹² have already installed programmes compensating their executives in contingent capital bonds. Both the programmes are identically designed in that the contingent capital awards lapse if the core (equity) tier I capital (this consists of only equity share capital and retained profits)¹³ of the banks concerned falls below a stipulated threshold.

It is debatable whether the design of the awards discussed above is optimal. As the following section will discuss, the design of the contingent capital bonds issued to the executives could be further optimised for aligning their incentives to the interests of taxpayers and unsecured creditors. However, compensation reforms introduced at Barclays and Credit Suisse underline the global shift towards creditor-aligned compensation reform.

4 Designing the Optimum Contingent Capital

Conversion Effect: Imagine the incentives of a Barclays or Credit Suisse executive after the core equity tier I ratio has breached the defined 7% trigger. At that depleted level, it is in the interest of bank creditors and the taxpayers that the bank either recapitalises or pursues prudent credit practices. Note however that, since the awards have lapsed, the bank executives do not retain any skin in the game to adopt prudent practices that will protect the creditors and taxpayers. Indeed, having nothing of their personal wealth to lose and the value of equity being almost zero, they would be highly incentivised to “gamble for resurrection.”¹⁴ There is recent empirical support for the proposition that solvency-linked awards like the ones issued by Barclays and Credit Suisse do not perfectly align executives’ interests with the creditors. This is because creditors typically are concerned about both the event of insolvency and the amounts they will recover in the event of bankruptcy (Edmans 2011).

The ideal design for contingent capital bonds issued to the bank managers should convert the bond into an equity claim on the breach of the trigger. If the trigger is at a high enough point (when the equity capital has some non-zero value), this

design will mean executives still have “something to lose” when capital adequacy has breached a critical threshold. This skin in the game will incentivise the managers to pursue less risk-seeking policies even after capital adequacy has reached critically low levels (Kaal 2012).

Further, the ideal design would have a lock-in restriction so that the executive’s personal wealth remains locked-in in the bank after the conversion to equity. She will have greater exposure to the unsystematic risk related to the bank’s stock promoting risk-aversion. The restriction may be linked to adequate recapitalisation of the bank. Such conditions will motivate the executives to issue capital (or obtain subordinated debt) from the capital markets at the earliest.

Threshold of Trigger: Both Barclays Bank and Credit Suisse have issued contingent capital awards that have the same trigger as would convert/write-off the contingent capital instruments issued to their investors. However, higher triggers for contingent capital bonds granted to the executives can “signal” that the bank needs recapitalisation. For example, if the contingent capital issued to executives converts into equity when the core equity tier I capital reaches 10% (when the outstanding contingent capital has a trigger of 7%), the outstanding bondholders, the shareholders, and the regulators will be warned in advance of the need to recapitalise. Finally, a higher trigger for the conversion of contingent capital issued to the bank managers will be perceived by the contingent capital market investors as more strongly aligning the incentives of the managers to their interests. A higher trigger will therefore mitigate the risk of adverse selection and enable the bank to issue contingent capital at lower cost than otherwise. (UBS has modified its Deferred Contingent Convertible Plan (DCCP) to prescribe a higher trigger for its executive board members; they suffer a loss if UBS’ core equity tier I capital falls below 10%).

Fraction of Executive Pay Payable in Contingent Capital: The fraction of executive pay that ought to be paid in executive compensation for the “right” incentives to be generated in the executives is an empirical question. Nonetheless, a review of market practice indicates paying executives approximately 25% of their total annual compensation in contingent convertible instruments could be a good point of departure. For example, Antony Jenkins, the incumbent Executive Director and CEO at Barclays Plc retained approximately 28% of his annual compensation for 2013 in contingent capital award.¹⁵ Across the Atlantic, Sergio Ermotti, Group CEO (and member of the executive board) of UBS received approximately 21.5% of his total compensation for 2013 in DCCP.¹⁶

Voluntary versus Mandatory: Risk-seeking constituencies like shareholders have no incentive to induce risk-aversion in their executives through issue of high trigger convertible contingent capital. Directors are after all the fiduciaries of shareholders on the board; so they are similarly unlikely to take initiative in this regard. Finally, executives managing the bank “to the street” are unlikely advocates for remunerating

themselves through high trigger convertible contingent capital. Accordingly, it appears that regulators should mandate the adoption of such design through regulatory fiat. The RBI should amend the Guidelines to provide for remunerating a considerable fraction of managerial pay at private sector banks through convertible contingent capital instruments.

Finally, we note that mandatory introduction of high trigger convertible contingent capital as remunerative tools is likely to optimise subsequent issues of contingent capital to the investors to the extent managerial personnel including the CEO choose the design thereof. Since high trigger contingent capital will induce the managers to align themselves to the bond holders and be less risk-seeking than otherwise, such managers may be more likely to issue contingent capital with terms dilutive of the shareholder, as part of the bank's capital structure.

5 Debt versus Contingent Capital Bonds

It has been long recognised that compensating the bank managers in debt will align their actions towards reducing riskiness of the assets that the bank creates (Jensen and Meckling 1976). (Paying executives in debt instruments is usually achieved by deferring a portion of their compensation presently due for certain duration; for example, pension is a form of debt compensation.) Empirical research also supports the proposition that compensating actors in debt-based instruments makes them less risk-seeking than otherwise. Cassell et al (2012), for example, find that CEO debt holdings (pensions and deferred compensation) correlate to lower levels of risk-seeking behavior. The authors find a negative association between CEO debt holdings and the volatility of future stock price returns, financial leverage and a positive association between CEO inside debt holdings and the extent of diversification (Cassell et al 2012). Consistent with these findings, scholars have proposed that executives be paid a

portion of their compensation in subordinated bonds that the bank issues to investors (Tung 2011).

However, debt is not without its disadvantages. We discuss the principal issues below. On the other hand, contingent capital bonds have the design features that can improve upon these drawbacks and therefore either replace or augment debt instruments in the executive compensation mix.

5.1 Magnitude and Duration

First, a large amount of inside debt has to aggregate for it to "push" the bank manager to risk-averse behaviour. The bank manager will rationally discount the utility of inside debt if only a minor fraction of her yearly pay is paid in inside debt.

Duration of debt is another drawback. For debt to induce alignment with the creditors and taxpayers, the duration of the deferral ought to be long term such that the executives would still have their personal wealth at risk as the bank reaches the zone of insolvency. The more closely the duration of this debt approximates perpetuity, the more skin in the game for the executives near insolvency. As a corollary, regulatory prescriptions ought to mandate longer term, not short-term deferrals. However, the Guidelines prescribe a minimum deferral period of merely three years. In other words, the bonus held back as debt is paid out in a period of three years following its accrual leaving the executives without any skin in the game over the long term. Thus, their risk-seeking incentives are unlikely to be altered even in presence of "inside debt."

Further, some forms of debt (gratuity pay and provident fund) are paid out to the executives immediately on their retirement. It is the risk of default on the debt they owe the bank that will motivate the executives "to think like creditors." To the extent the executive retains discretion to determine the timing of her retirement, "inside debt" enjoys a de facto "seniority" to other

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debt on the balance sheet. As such, the executive is immune from the risk of default. Thus, to summarise, inside debt is insufficient to motivate the executives to think in the interests of creditors and taxpayers because they face no risk of default on the inside debt that they owe from the bank concerned.

Contingent convertible bonds are structured to account for both these disadvantages of debt. First, contingent convertible bonds are long duration instruments having a tenure of not less than 10 years. Thus, they more closely approximate the duration unsecured creditors (taxpayers) of the bank are exposed to. Paying executives in these bonds therefore more closely aligns the executives' interests to the unsecured creditors (taxpayers). Second, these bonds could be issued to the executives as coupon-carrying grants unlike pensions or deferred compensation which is held back. Therefore the magnitude of debt due to the executives could be higher without the opportunity cost they incur on inside debt if such debt is issued pursuant to contingent capital bonds. Finally, the appropriately designed contingent capital bond converts into equity on the breach of the trigger as discussed above. Unlike debt, conversion to equity exposes the executive to default risk in the event of insolvency.

Thus, paying executives in contingent convertible bonds appears to be more advantageous than paying them in debt as they are more motivated to think in the interests of uninsured creditors and taxpayers in face of default risk.

6 Conclusions

It is important to recognise that the financial firm (or the bank as a convenient metaphor) has distinct corporate governance requirements given it operates where the residual risk-holder is in fact the taxpayer; this is all the more so, if the bank/financial firm is systemically important. The crisis highlighted the aforementioned distinction. Accordingly, to the extent regulators are resorting to direct regulation of bank managerial pay, they should devise instruments that align the managers to non-shareholder constituencies. Convertible contingent capital is one such instrument. Moreover, the market practice of marquee global banks in Europe has provided lessons for the RBI in the design of their contingent capital.

The search for a silver bullet as a cure to the enduring tension between systemic risk and moral hazard may indeed be never-ending; however, optimally designed contingent capital in remuneration and capital structure may just be as close as it gets.

NOTES

- 1 See "Guidelines on Compensation of Whole Time Directors/Chief Executive Officers/Risk takers and Control Function Staff, etc," DBOD No BC 72/29.67.001/2011-2012, 13 January 2012.
- 2 See Section 3 for a detailed discussion of the instrument.
- 3 See Jensen and Meckling 1976 explaining agency costs as arising whenever one or more principals engage another person to perform some service on their behalf that involves delegating some decision making authority to the agent such that, "if both parties are utility maximizers, there is a good reason to believe that the agent will not always act in the best interests of the principal."
- 4 See note 1.
- 5 A requirement for the employer to make "negative awards" if the performance of the business is overstated or the employee is found to be in breach of his contract.
- 6 Section 35 B of the Banking Regulation Act, 1948 empowers the RBI in this respect.
- 7 The concept of contingent capital is not a novel solution. Ideas concerning reversible debt have existed in academia since the early 1990s (see Doherty and Harrington 1995).
- 8 Squam Lake Group, "Aligning Incentives at Systemically Important Financial Institutions," March 2013; See also Bank for International Settlements (2013); Section 165 (b) (1), Dodd-Frank Wall Street Reform and Consumer Protection Act (authorising the Federal Reserve to adopt a contingent capital standard); Basel III has defined capital comprising Tier I Capital as "Going Concern Capital" and Tier II Capital as "Gone Concern Capital." The former would consist of Common equity (i.e., common shares and retained earnings) and additional tier 1 capital while the latter would help ensure that depositors and senior creditors can be repaid if the institution fails.
- 9 See Annexure 16 in RBI (2013).
- 10 See Section 5.
- 11 See Barclays PLC Annual Report 2013, p 111.
- 12 See Credit Suisse Annual Report 2013, p 185.
- 13 See <http://lexicon.ft.com/Term?term=core-tier-one-capital> for a clear explanation of the term.

- 14 The scenario might be thought of as the last minute of a Football game with one team trailing 0-1. At that point, having nothing to lose, the trailing team's goalie has every incentive to "swing for the opposite goal posts" leaving his goal post unprotected. Just as the trailing team and its goalie, the management with a lapsed award (when the capital is lowest) has nothing to lose and has the maximum incentive to "gamble for resurrection."
- 15 See Barclays PLC Annual Report (2013) pp 111, 124 (disclosing annual compensation for Antony Jenkins and the amount retained as contingent capital award as of December 2013).
- 16 See UBS Annual Report 2013, p 316.

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