Change bank pay now

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Give an artillery commander the wrong target and the result is likely to be collateral damage. Give regiments of global bankers the wrong target and we should not be surprised by a similar outcome. This is what investors and board directors have done. Many bankers lapped it up. The result: considerable western wreckage. Let me explain.

Banks target Return on Equity (RoE). Sell side analysts track it. Many investors have encouraged it. Has the quest for high RoE produced it? No. Have such targets produced attractive shareholder returns? No. Why? Because those concerned did not adjust for risk. Why did some bankers not adjust for risk? Three possibilities: 1) they did not understand the risks they were taking; 2) they understood the risks but prudence was not in their personal interests; or 3) Investors egged them on. Why did investors not adjust for risk? Actually, many did, witness the fact that in the two years preceding the crisis the bank share index sharply underperformed the broader market. Still, the investment community writ large happily held on to such shares. Why did these investors underestimate the risks? Three possibilities: 1) they did not understand the risks banks were taking; 2) they listened to sell side analysts who did not adjust for risk; or 3) they thought they would enjoy the ride while the music was still playing and be smart enough to exit before it stopped. There are other unworthy explanations. Top of the list is that markets assumed that bank debt, bank deposits and in effect banks themselves were guaranteed by government.

What a difference a few years make. The banking share sector has produced much volatility and little return. Measured from the mid-90's the bank sector has underperformed utilities. For the longer term investor, many bank share investments have proved the equivalent of capital contributions to not-for-profit companies employing exceedingly well paid staff. Why? Because now investors are adjusting for risk. For what risks are they adjusting? 1) the risk that bank management do not understand their risks; 2) the risk that governments will not or cannot guarantee banks; 3) the risk that bankers and regulators now understand these risks sufficiently well as to require equity capital in quantities sufficient to support risk-taking.

How should banks best respond? Should they continue to target high RoE? No. Should they abandon raw RoE objectives in favour of better measures of risk adjusted returns? Yes. Will they? Ah, there's the rub. For bank executive pay is currently glued to EPS/ROE-linked targets. These prompt them to maximize non-risk adjusted returns (R) and minimize confidence building capital (E). Have all executive teams acknowledged the inappropriateness of the old targets? No. Have they admitted their inability to achieve them? No. Will bank boards, without prodding, force the issue soon? Maybe, but is that the way to bet?

It is time for shareholders to insist on a proper alignment of bank pay practices with the interests of their owners. Wipe the slate clean of accident prone objectives and substitute new pay proposals which give bankers the incentives to do what many say they were doing but weren't - building shareholder value.

What might those new incentives be? Return on Assets (RoA) is one possibility. Looking at a number of those banks destined for the dust bin shows that in the years preceding the bust, RoA was falling even as RoE was rising.

Return on risk-weighted assets (RoRWA) is second alternative. This measure has the benefit of forcing a focus on risk. What risks are banks taking, in what areas and to what degree? RoRWA should prompt bank boards to ask the questions they have not been asking. But RoRWA is not without its shortcomings. A board that bets the bank on Basel-driven risk weightings is betting that Basel got it right.

What combination of the above might prove best? I confess I don't know. I do know that targeting RoE has contributed to volatility of returns, excessive leverage, reckless risk-taking and systemic instability. It has NOT contributed to the creation of sustained or sustainable shareholder value. As a key motivator for bank behaviour, it has to go.