The corporate virtue of bankers

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Senior bankers make a lot of money and take a lot of risk. This combination strikes most commentators and politicians as revealing sad failures of personal morality and corporate governance, failures that must be rectified by the regulation of bankers' pay. They are confused.

The principle challenge of corporate governance is to align the managers' interests with the owners'. A simple way is to make managers owners too, by paying their bonuses in company shares. Yet this is an imperfect solution, because it fails to give managers the same "risk appetites" as other shareholders.

Few of a company's shareholders are investors in that company alone; most hold a diversified portfolio of stocks. Provided these stocks are not perfectly correlated, the volatility of the portfolio's value is lower than the average of each stock's volatility. When held in such a portfolio, the optimal volatility of each individual stock is higher than it would be if held on its own.

The risks of company managers, by contrast, are concentrated in the firm they work for. Not only are they partly paid in its shares but, if the company fails, they lose their incomes. A company's managers are therefore more risk averse than its owners, even when their bonuses are paid in shares.

This fact helps to explain the high salaries, huge bonuses, "golden parachutes" and other elements of "fat cat" compensation that outrage the popular press. They are designed to relieve corporate executives of their natural caution and bring their risk appetites up to the level of the other shareholders'. Contrary to popular opinion, it is low paid and risk-averse bank managers that would represent a failure of corporate governance.

But surely, some will protest, the financial crisis shows that bankers took too much risk. It does not. Shareholders of a limited liability company enjoy an asymmetric exposure to its performance. If it does well, there is no limit to how much their equity can appreciate. If the company fails, however, the most they can lose is what their shares cost to buy. This means that shareholders benefit from risk.

A simplified example will make this clear. Imagine you are a shareholder of a firm with a leverage ratio of 10:1. If the assets devalue by 10 per cent, you lose all your equity. However, if their value increases by 10 per cent, you double your money. If the probability of each outcome is 0.5, your equity is worth 1 (=2x0.5+0x0.5). Suppose the firm now increases its risk by taking its leverage to 50:1. If the assets increase in value by 10 per cent, then your equity is worth 6. If the assets decline in value by 10 per cent, then your equity is again worth nothing. The expected value of your equity is now 3. The extra risk has made you better off.

Why then do companies not increase their risk *ad infinitum*? The answer is that they are prevented from doing so by their creditors. Because a firm's creditors do not participate in its profits, they gain nothing from its extra risk taking. On the contrary, the more risk the firm takes, the less likely its creditors will be repaid and, hence, the greater the "risk premium" they will charge for their lending. It is the increasing cost of borrowing that constrains corporate leverage and other risk taking.

This market mechanism breaks down, however, when the corporates concerned are banks, because lending to banks is made (almost) risk free by government guarantees. These guarantees are explicit in the case of "retail deposits" and unstated but dependable in the case of "wholesale" bank creditors.

Since 1988, 28 of the world's largest 100 financial institutions have failed. This equates to a 1.3 per cent annual probability of default. Nevertheless, the top 100 banks have enjoyed an average credit rating of A+, which corresponds to a 0.05 per cent annual probability of default. This apparent anomaly is easily explained by the fact that in only two of these 28 cases of bank failure did the national government allow creditors to suffer losses.

By eliminating the normal "risk premium" on bank debt, government guarantees subsidize bank risk-taking. A bank that took so little risk that it was no more likely to default than the government could borrow at the same low rate of interest even without the guarantee. Its managers would effectively be rejecting the government's offer of a subsidy. By contrast, the greater the risks taken by a bank, the greater the subsidy it extracts from the government guarantee.

If the virtue of senior bankers' is still not clear, imagine two tobacco companies, Holy Weed and Noxious Weed, both eligible for government subsidies of tobacco production. Whereas the CEO of Noxious Weed accepts the subsidy, Holy Weed's CEO rejects it. Who has been irresponsible?

Perhaps the CEO of Holy Weed has performed a public service, but that is irrelevant. He is not a public servant. He is responsible not for public welfare but for the welfare of his firm's shareholders. Rejecting a subsidy would be a dereliction of that duty, since it would drive down the value of Holy Weed shares.

Similarly, a senior bank manager who refused to take government subsidized risks would be derelict in his duty to his shareholders. It should surprise no one that banks whose senior executives had the greatest shareholdings also took the greatest risks. The bankers who "brought the economy to its knees" were only doing their job.