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Bank executives should face greater liability for losses [1]

Written by **Blog Editor** [2] | Friday 21 September 2012

We released a report today, *Market-based bank regulation: Creating incentives that promote responsible banking* [3], which argues that a market-based alternative to orthodox bank regulation should be adopted to promote responsible decision-making behaviour by banks. The paper looks at the historical example of 19th Century American banks, where executives and shareholders faced liability for twice the value of their shareholdings. This double liability shareholding system led to lower failure rates and incentivised bank executives to limit excessive risk-taking. The author, Mikko Arevuo, argues that a variant of the system should be introduced today to discourage risky behaviour.

The report suggests two market-based solutions, both of which could make bank managers more responsible for losses. These are:

? Creating a special class of employee shares that become convertible to common shares at the prevailing market value after 5 years, at a rate of one employee share to one common share. Should the bank fail before the strike date, bank executives would be held responsible for the losses up to the value of their shares on the date they were received.
? Alternatively, attaching a restriction to executive bonus payments that make them subject to a ?claw-back? clause for a pre-defined period of time, up to 10 years.

For these proposals to be fair, they should be targeted only at those executives who have the power and authority to make decisions that have a material impact on the bank?s risk profile. As a result there would be greater managerial oversight over the risk-seeking activities of employees.

A move to these market ?based solutions would re-align incentives to promote sound executive decision-making. This would be preferable to our current traditional capital adequacy based banking regulation, which has been unable to cope with the risk seeking behaviour of bankers and the moral hazard that is embedded in the modern banking system. The implicit promise of bailouts for failing banks holds taxpayers to ransom to cover losses incurred as a result of poor managerial decisions. Many of the current regulations have sought to restrict certain banking activities and set limits to executive compensation levels, which is unlikely to anticipate the causes of the next banking crisis.

Instead Market-based regulation would increase incentives for bankers to think seriously about the risk-return implications of their business decisions. This will be good for the financial services industry and would reduce the need for excessive micro-management and regulation of banking activities, while making executives at least partially liable for the costs that bank failures and losses impose on society.

Mikko Arevuo, author of the report, adds: ?Public anger at the behaviour of banks and bank executives is fully understandable. Taxpayers and voters, quite rightly, demand that something is done about irresponsible risk-taking and poor managerial judgment by executives. However, the political default position of more regulation is a blunt instrument. It will result in higher costs that banks will eventually try to pass on to their customers. Moreover, an overly complex regulatory framework may result in the creation of risks that no one had predicted in advance, as banks try to find ways around the new regulations. Finally, regulation is often a poor tool in changing human behaviour. My paper was written to provoke debate about the role of regulation in changing managerial behavior. I believe that effective regulation should focus on incentivizing managers to behave in the interest of their firms? key stakeholders, rather than focus on the institution level capital adequacy-based frameworks."

The report was covered in the Daily Telegraph [4] and Money Marketing [5] today.

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