Research project

The role of executive remuneration and corporate governance in the banking industry

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**Research motivations and aims**

The last financial crisis highlighted that some bank governance mechanisms failures and executive pay arrangement have contributed to destabilise financial markets (Beltratti and Stulz, 2012; Laeven and Levine, 2009; Ferreira et al., 2012) by encouraging excessive risk-taking incentives. Policymakers worldwide moved forward regulating compensation schemes in banks to eliminate such incentives (Bebchuck et al., 2010).

The financial economics literature underlines that a strong linkage between risk and corporate governance (Jensen and Meckling, 1976) and this link may be stronger for banks (Adams and Mehran, 2003; Mulbert, 2010). In fact, banks benefit greater leverage than other non-financial firms because of the financial intermediation. In this context, agency theory provides a suitable framework because corporate governance mitigates conflicts among different stakeholders (e.g. shareholders vs. debt-holders; shareholders vs. managers) (Jensen and Meckling, 1976). On the one hand, shareholders may mimic an out-of-money call option by investing in riskier assets to benefit from a higher expected return and increase the variability of equity pay-offs to the detriment of their debt-holders (Jensen and Meckling, 1976). On the other hand, managers may pursue their own objectives over those of...

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shareholders. Jensen and Meckling (1976) demonstrated that the incentives of top-level managers with a percentage of ownership of their firm less than 100% may reduce firm value. The prominent literature suggests shareholders may align managers’ incentives to their interests by tying executive compensation to firm performance (Jensen and Murphy, 1990).

Nevertheless, the executive compensations in banks rose overly during the last, while financial institutions were performing poorly. The rise in executive pay levels has been pronounced both in absolute terms and relative ones to non-executive employees (Faulkender et al., 2010) by augmenting inequality problems between executives and other workers. In fact, generous and large-sized stock option schemes may create incentives for managers to behave not in line with long-run bank performance. The academic literature (Bebchuk et al., 2002; Bebchuk and Fried, 2003) suggests that an excessive pay of top-management may be due to weak governance mechanisms, since managers may exert a greater influence on the pay-setting process by extracting rents and protect themselves even in case of bad performance.

The aim of this project is threefold:

1. understanding whether executive compensation schemes may contain incentives for managers to pursue optimal objectives on behalf of shareholders.
2. if not, understanding whether bank board mechanisms may moderate top-executive risk-taking incentives.
3. understanding whether performance incentive features in compensation may lead to manipulation activities (e.g. accounting restatements, timing of disclosure, and earning management).

Related literature

The closest strand of literature this project is related to is the previous literature on executive compensation in banking. Generally, compensation arrangements may shape top-managers’ incentives. In this context, Vega and Delta are two important measures to evaluate such incentives (Core and Guay, 2002). Vega (pay-risk sensitivity) measures the change in the euro (or dollar) value of top manager health for a 0.01-unit change in stock return volatility, while Delta (pay-performance) sensitivity captures the change in the euro (or dollar) value of top-managers’ wealth for a 1% change in stock price. A high-vega compensation scheme including stock option grants should be desirable.
and valuable for managers to take more risk by mitigating potential managerial risk-aversion. Whilst, including a large amount of stock grants in managers’ compensation may reduce conflicts of interests between managers and shareholders by binding managers’ wealth to the firm stock (Jensen and Meckling, 1976). Conversely, Bebchuck et al. (2010) find some evidence that pay-arrangement do not produce necessarily the expected alignment of executives’ interests with long-term aims of shareholders, because top-managers may have some incentives to benefit from large amounts of compensation based on short-term gains (e.g. empire building and shirking explanations). There may be two alternative explanations. First, high-delta compensation may lead managers to pass over positive net-present-value with high levels of risk due to their reinforced risk-aversion. Second, managers having a large equity stake in the firm may opt for riskier projects in order to risk-shift to debt-holders (De Young et al., 2013). This latter argument may be more pronounced in banks as the asset substitution problems are more acute provided that a large portion of debt is in the form of deposits guaranteed by the FDIC in the US and guaranteed by the EDIS in Europe.

The second literature that this project is related to is the prior literature on how corporate governance mechanisms affect firm’s corporate outcomes. Previous studies focus on board structure (Pathan and Faff, 2013); personal characteristics (e.g. age, gender, education, and ethnicity education) of board members and executive teams (Adams and Ferreira, 2009; Berger et al., 2014; Faccio et al., 2016, Sila et al., 2016), ownership structure and control (Caprio et al., 2007, Barry et al., 2011), stock ownership by executives and board members (Laevens and Levine, 2009: Vallsacas and Hangerdoff, 2011; Onali et al., 2016) stock ownership by institutions (Iannotta et al. 2007; Larcker et al., 2007).

The third literature this project is related to is the literature on the factors affecting earnings management activities. The possibility to manage earnings may occur because reported income may include cash flows and changes in the firm valuation that are not reflected in the current cash flows (Bergstresser and Philippon, 2006). Researchers in accounting literature have identified many factors that may influence earnings management activities: firm characteristics (Watts and Zimmerman, 1990; DeFond and Park, 1997; Penman and Zhang, 2002; Doyle et al., 2007a), financial reporting practices (Moses, 1987; Altmuro et al, 2005; McVay, 2006), board characteristics (Klein, 2002; Doyle et al., 2007a), ownership structure (Bergstresser and Philippon, 2006; Larcker et al., 2007).
The selected candidate of this research project will be required to bridge the three aforementioned literature in a novel way in order to accomplish the aims specified in the previous section.

**Research expected outputs**

At the end of the project, the selected candidate is supposed to generate at least one academic article that is suitable for an international research journal in the field of the economics of financial intermediation. Examples of potential targets are: *Journal of Financial & Quantitative Analysis*, *Journal of Financial Intermediation*, and *Journal of Banking & Finance*.

**Research Plan**

The first part of the research project consists of reviewing the prominent literature and the definition of research gaps and contributions. Some relevant outcomes and connections can be established to wealth concentration issues, explored into Yunus Social Business Centre.

The second part of the project is composed by the data collection, the data management, and the first explorative analysis. Merge activities are required to set up a novel dataset using accounting data, corporate governance information, and internal data provided by Union dataset.

The third part of the project is mainly oriented to develop the first draft of the research outputs. Particularly, it is composed by the second data analysis, reporting the results, and the development of the first draft.

The latter will be presented to ad-hoc seminars and leading and international conferences in order to stimulate the research debate and favour useful feedbacks for research improvements. Manuscripts will be submitted to conference and journals.

The last part of the project is aimed at correcting statistical and theoretical (i.e. R&R) issues before the accomplishment of the final output.
### Funding and Training opportunities

The selected candidate will have the opportunity to debate with leading public and private research centres interested in investigating the performance incentive of top-managers in banking. The leading partners are represented by:

- University of Bocconi (Milan, Italy)
- University of Nottingham (Nottingham, the United Kingdom)
- First CISL (Union dataset provided by research Centre in Milan)
- YSBC (Unibo, Glasgow, St. Gallo)
- YSBC University of Glasgow

The candidate will select considering econometric skills applied to dynamic panel data, score matching, and propensity score methodologies. Training will be provided with a visiting period to Glasgow Yunus Social Business Centre, to establish connection to Ysbc in Forlì and to explore the wealth/compenstion concentration topic related to top managers in banking and financial industries.
References


Selected tutor publication 2013-2017

1. Torluccio, Giuseppe; Tomaselli, Angelo; Andi, Duqi, Is relationship lending still a mixed blessing? A review of advantages and disadvantages for lenders and borrowers, «JOURNAL OF ECONOMIC SURVEYS», 2017,

2. Onali, Enrico; Galiakhmetova, Ramilya; Molyneux, Philip; Torluccio, Giuseppe, CEO power, government monitoring, and bank dividends, «JOURNAL OF FINANCIAL INTERMEDIATION», 2016, 27, pp. 89 - 117


Previous Department Grant assigned to prof Giuseppe Torluccio

Angelo Tomaselli Department grant 14 / 24 mons

Publication before 30 month of the end of Grant - Class A – Anvur

Torluccio, Giuseppe; Tomaselli, Angelo; Andi, Duqi, *Is relationship lending still a mixed blessing? A review of advantages and disadvantages for lenders and borrowers*, «JOURNAL OF ECONOMIC SURVEYS», 2017

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Bologna, May 2nd 2018

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