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Regulate financial pay to reduce risk-taking

By Lucian Bebchuk

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A bill requiring federal regulators to draw up rules for compensation structures in the financial sector was passed by the US House of Representatives on Friday and will be taken up by the US Senate. Such pay regulations, which authorities around the world are considering, will meet stiff resistance from financial institutions. Yet the case in their favour is compelling.

While the need to reform pay arrangements is now widely accepted, many believe that such reforms should be left to corporate boards and that government intervention should be limited to ensuring the adequacy of corporate governance processes. The Basel committee on Banking Supervision has urged boards to be closely involved in pay-setting; and the bill passed on Friday mandates “say on pay” shareholder votes and bolsters the independence of compensation committees. Would improvements in governance obviate the need for regulating pay structures? Not at all.

Outside the financial sector, government intervention should indeed be limited to improving internal governance, leaving choices over pay structures to shareholders and the directors elected by them. But financial institutions are special, and their special circumstances warrant a broader role for government.

Regulation of pay in financial institutions is justified by the very same moral hazard concerns that provide the basis for existing regulation of the sector. Because the failure of such companies imposes costs on taxpayers that shareholders do not internalise, shareholders’ interests are served by more risk-taking than is socially desirable. For this reason, financial institutions have long been constrained by a substantial body of rules that restrict private choices with respect to loans, investments and capital reserves.

Shareholders’ interest in more risk-taking implies that they could benefit from providing executives with excessive incentives in this direction. Executives with such incentives can use their informational advantages, and whatever discretion they have been left by existing regulations, to increase risks. Regulation of pay structures is a way to counter this. It would make the executives of financial companies work for, not against, the goals of financial regulation.

Opponents of such regulation will argue that the government does not have a legitimate interest in telling shareholders how to spend their money. But it does. Given the government's interest in financial companies' stability, intervention in pay structures is as legitimate as the traditional forms of financial regulation.

Opponents may also argue that regulators are at an informational disadvantage when assessing pay arrangements. Yet more informed players inside financial companies lack incentives to internalise the interests of depositors and taxpayers when setting pay structures. Furthermore, limiting structures that incentivise risk-taking is not more demanding in terms of information than regulators' traditional intervention in investment, lending and capital decisions.

In addition, opponents may argue that pay regulation will drive talent away. But the proposed rules would apply to pay structures and not total compensation, which financial institutions would be free to set at the levels necessary to retain employees.

The regulation of pay structures is considered against the background of news that compensation in the financial sector is returning to the lofty levels of before the crisis. It is thus worth stressing that, while the regulations under consideration would address concerns about incentives, they would not, nor are they intended to, address concerns about overall compensation amounts. Their goal is to promote the safety and soundness of the financial system, not to address shareholder concerns about excessive levels of pay. In the US, such concerns would be best addressed by supplementing the mandated "say on pay" votes with a substantial strengthening of shareholder rights.

Regulating compensation structures should become a critical instrument in financial regulators' toolkits. It would help prevent in the future the excessive risk-taking that contributed to the current crisis.

The writer is a professor of law, economics and finance and director of the programme on corporate governance at Harvard Law School. This article builds on his testimony before the financial services committee of the US Congress and his white paper, co-authored with Holger Spamann, on Regulating Bankers' Pay