Why Bankers' Pay is the Government's Business

Statement in opposition to the motion: "This house believes that bosses' pay is none of the government's business."

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The Federal Reserve now has in place a policy for supervising executive pay in banks as part of its programme for ensuring the banking system's safety and soundness. Governments around the world have adopted or are considering regulations concerning pay in financial institutions. I have been an early proponent of such government involvement, advocating it in congressional testimony, in "Regulating Bankers' Pay," an article co-authored with Holger Spamann, and in other writings. In contrast to what Mark Calabria argues in his supporting statement for the motion, public officials have good reason to pay close attention to executive pay in banks and to reject assertions that it should be none of the government's business. (By banks I refer throughout to any financial institutions that are deemed to pose systemic risk and are subject to financial regulation for this reason.)

Regulating executive pay in banks is justified by the same moral hazard reasons that underlie the long-standing system of prudential regulation of banks. As governments are now recognising, monitoring and regulating the compensation structures of bank executives can and should be an important instrument in the toolkit of financial regulators.

Because bank failure will impose costs on the government and the economy that shareholders do not internalise, shareholders' interests would be served by more risk-taking than would be in the interest of the government and the economy. This moral hazard problem provides a basis for the extensive body of regulations that restrict the choices of financial firms with respect to investments, lending and capital reserves. It also makes the incentives of the executives making decisions for banks of significant interest to the government.

Shareholders' interest in more risk-taking implies that they could benefit from providing bank executives with incentives to take excessive risks. Executives with such incentives could use their informational advantages and whatever discretion traditional regulations leave them to further increase risks. Given the complexities of modern finance and the limited information and resources of regulators, the traditional regulation of banks' actions and activities is necessarily imperfect. Thus, when executives have incentives to do so, they may be able to take risks beyond what is intended or assumed by the regulators, who may often be one step behind bank executives.

Because shareholders' interests favour incentives for risk-taking that are excessive from a social perspective, substantive regulation of the terms-of-pay arrangements—limiting the use of structures that reward excessive risk-taking—can advance the goals of banking regulation. The regulators' focus should be on the structure of compensation—not the amount—with the aim of discouraging the taking of excessive risks. By doing so, regulators would induce bank executives to work for, not against, the goals of banking regulation.

Interestingly, Mr Calabria seems to recognise that, as long the government provides (explicit or implicit) guarantees to banks' depositors (or other creditors), the government has a stake in bank executives' incentives. He argues, however, that "eliminating these government guarantees should be the preferred approach, rather than creating intrusive regulatory schemes". The government guarantee for bank depositors can be expected to stay for the foreseeable future (and for good reason). Those voting on the motion should take the world as it is, not imagine they are in Mr Calabria's hypothetical no-guarantees world. Furthermore, even in that imaginary world, a banking crisis could well impose large losses on the economy beyond those borne by depositors, and the government would thus still have reasons to seek to limit excessive risk-taking.

The regulation of bankers' pay could nicely supplement and reinforce the traditional, direct regulation of banks' activities. Indeed, if pay arrangements are designed to discourage excessive risk-taking, direct regulation of activities could be less tight than it should otherwise be. Conversely, as long as banks' executive pay arrangements are unconstrained, regulators should be stricter in their monitoring and direct regulation of banks' activities.

At a minimum, when assessing the risks posed by any given bank, regulators should take into account the incentives generated by the bank's pay arrangements. When pay arrangements encourage risk-taking, regulators should monitor the bank more closely and should consider raising its capital requirements.

Before concluding, I would like to comment briefly on several possible objections to government involvement in this area. First, Mr Calabria argues that regulators will be at an informational disadvantage when setting pay arrangements. But placing limits on compensation structures that incentivise risk-taking would be no more demanding in terms of information than regulators' direct intervention in investment, lending and capital decisions. Furthermore, the setting of pay arrangements should not be left to the unconstrained choices of informed players inside banks, because such players do not have incentives to take into account the interests of bondholders, depositors and the government in setting pay.

Opponents may also argue that pay regulation will drive talent away, and that financial firms will lose valuable employees. As I stressed, however, regulation of pay in financial firms should focus on pay structures and should not limit compensation levels. (Prudential regulation may, of course, impose such limits to the extent that compensation levels might result in cash outflows that would leave the bank with insufficient capital.) Thus, to the extent that the use of pay structures that eliminate perverse incentives would be less attractive to some executives, banks would be able to compensate those executives with higher levels of expected pay. Even when such an increase proved necessary, however, providing more efficient incentives would be worthwhile.