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Why Financial Pay Shouldn't be Left to the Market

By Lucian Bebchuk

Although some financial firms are reforming how they pay their employees, governments around the world are seriously considering regulating such firms' compensation structures. The Basel Committee on Banking Supervision has recently come out in favor of such regulations, and the United States House of Representatives has voted to require regulators to set compensation rules.

Perhaps not surprisingly, many financial bosses are up in arms over such moves. They claim that they need the freedom to set compensation packages in order to keep their most talented people – the ones who will revive the world's financial system. So, should governments step back and let financial firms reform themselves?

The answer is clearly no. In the post-crisis financial order, governments must take on the role of monitoring and regulating pay in financial firms; otherwise, the perverse incentives that contributed to the current crisis could easily recur.

It is important to distinguish between two sources of concern about pay in financial firms. One set of concerns arises from the perspective of shareholders. Figures recently released by New York's attorney general, Andrew Cuomo, indicate that nine large financial firms paid their employees aggregate compensation exceeding $600 billion in 2003-2008 – a period in which their aggregate market capitalization substantially declined. Such patterns may raise concerns among shareholders that pay structures are not well designed to serve their interests.

Even if financial firms have governance problems that produce pay decisions deviating from shareholder interests, however, such problems do not necessarily warrant government regulation of those decisions. Such problems are best addressed by rules that focus on improving internal governance processes and strengthening investors' rights, leaving the choices that determine compensation structures to corporate boards and the shareholders who elect them.

But pay in financial firms also raises a second important source of concern: even if compensation structures are designed in the interests of shareholders, they may produce incentives for excessive risk-taking that are *socially* undesirable. As a result, even if corporate governance problems in financial firms are fully addressed, a government role in regulating their compensation structures may still be warranted.

Suppose that most financial firms could be relied upon by regulators to be run in the interest of their shareholders. Would this justify exempting these firms from existing regulations that constrain their decisions with respect to lending, investment, or capital reserves? Clearly not, because shareholders do not bear the full costs of a firm's collapse, and, as the recent crisis demonstrates, the bill for such a downfall must be picked up, at least in part, by taxpayers and the economy. So shareholders' interests might sometimes be served by business decisions that are too "risky," and regulating such decisions is justified – indeed, necessary.

Regulation of pay in financial firms is called for by the same reasons that justify the traditional regulations of the firms' business decisions. The incentives generated by compensation structures determine how firms' managers behave within the boundaries permitted by such traditional, direct regulations. And as traditional regulation of business decisions is bound to be imperfect, regulating compensation structures can be a useful additional tool to control the risks posed by financial firms' behavior. If choices of compensation structures can be expected to affect financial firms' stability, regulating these choices can also be useful for protecting this stability.

Financial firms opposed to pay regulation will likely warn against "micro-managing" compensation, and argue that compensation choices must take into account information about each individual manager that regulators are almost certain to lack. But pay regulation can improve matters without micro-management by setting general standards from which firms may not deviate but that still leave them with significant freedom to account for the individual circumstances of managers.

For example, regulatory standards could require equity-based plans to preclude managers from cashing out awarded shares and options during a certain minimum period after vesting. In such a case, firms could still remain free to choose the number of shares and options awarded to any given manager, as well as to adjust somewhat the length of the post-vesting period during which cashing out would be precluded.

Finally, those opposing pay regulation are certain to warn us about "unintended consequences." But this warning should not carry the day. We have experienced over the last several years the real and costly consequences of a compensation regime that left financial firms free to set their own pay structures. Are we to believe that those consequences are preferable to the unintended consequences of pay regulation?

The effort to avoid the harm of flawed compensation decisions in the future should not be deterred by speculative arguments about unintended consequences. Financial firms should not retain the freedom to create perverse incentives that put all of us at risk.

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