THE FUTURE OF FINANCE

And the theory that underpins it

9 Why and how should we regulate pay in the financial sector?

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Chapter 9
Why and how should we regulate pay in the financial sector?

Martin Wolf

This chapter investigates whether there is a case for regulation of financial sector pay and, if so, how it should be done. It concludes that regulators should not be concerned with the level of pay. That should be left to tax policy, though there is also a strong case for investigating the degree of competition in the sector and exploring remedies if significant monopolies are discovered. But regulators do have a vital interest in the structure of pay, since shareholders and managers can benefit from gaming the state's role as insurer of last resort of these highly leveraged and so inherently risky businesses. Structural reforms, including much higher capital requirements, would help. But, so long as anything like the present situation prevails, in terms of the structure of the financial industry, it is vital to prevent management of systemically significant institutions from benefiting directly from decisions that make failure likely. The answer is to make decision-makers bear substantial personal liability, in the event of such failures.

> *"Simply stated, the bright new financial system – for all its talented participants, for all its rich rewards – failed the test of the market place."* Paul Volcker.[1]

What, if anything, should be done to regulate the level or structure of remuneration in the financial services industry? This is one of the most contentious questions to have arisen out of the global financial crisis. To answer it, we need to address two further questions. First, what, precisely, is the problem? Second, what might be the solution?

Problems with Financial Sector Remuneration

We live in an era of widening pay inequality in western economies.[2] The extraordinary rewards secured by those in the financial sector have played a substantial part in this growing inequality. Many would argue that such inequality is itself socially damaging, whatever the explanation for it: it undermines the sense of social cohesion, worsens social tensions and undermines equality of opportunity.

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[1] Address to the Economic Club of New York, April 8th 2008.

[2] See, for example, Ian Dew-Becker and Robert Gordon, "Where did the productivity growth go?", National Bureau of Economic Research Working Paper 11842, December 2005, www.nber.org; and Thomas Piketty and Emmanuel Saez, "The evolution of top incomes", National Bureau of Economic Research working paper 11955, January 2006, www.nber.org.

Yet such objections are multiplied in force when, as is the case for the financial sector today, these exceptional incomes appear to be the reward not of either merit or skill, but of rent extraction or "heads-I-win-tails-you-lose" gambling.[3] The fact that states had to rescue the financial sector in 2008, through a combination of aggressive monetary policy and direct fiscal support, and then nursed it back to health, via regulatory forbearance and transfusions of cheap money, makes this sense of injustice stronger still. Contrary to the already notorious statement by Lloyd Blankfein, chairman and chief executive of Goldman Sachs, that his company does "God's work", it is now widely felt that they are instruments of the devil, instead, making their practitioners wealthy beyond the dreams of avarice, while laying waste economies, only to benefit from state-led rescues when threatened with destruction themselves.[4]

Beyond these broader objections to the growth of inequality, in general, and of unjust rewards, in particular, concern is expressed over more specific defects to do with incentives in the financial sector.

The argument here has several steps.

First, financial sector booms and busts create gigantic losses for society, not only via the direct costs of "bail-outs", but still more via the indirect costs of economic instability on the economy.

Second, to the extent, that institutions take synchronized risks, they increase the likelihood and severity of such crises, by creating the conditions in which ultimately ruinous bets are rewarded, at least for a while.

Third, asymmetric information is pervasive. Thus, strategies with zero expected excess returns in the long run may look successful in the short run, either as a matter of luck or because of the nature of the strategy – high probability of small gains with a low probability of huge losses, for example. Such strategies are extremely common: the "carry trade" is such a strategy; so was the strategy of buying AAA-rate collateralized debt obligations, in place of the liabilities of AAA-rated governments. As Raguram Rajan of Chicago University's Booth School of Business has rightly noted: "true alpha can be

[3] On rent extraction, Adair Turner, chairman of the UK's Financial Services Authority, notes: "it seems likely that some and perhaps much of the structuring and trading activity involved in the complex version of securitised credit, was not required to deliver credit intermediation efficiently. Instead, it achieved an economic rent extraction made possible by the opacity of margins, the asymmetry of information and knowledge between end users of financial services and producers, and the structure of principal/agent relationships between investors and companies and between companies and individual employees." See *The Turner Review: a regulatory response to the global banking crisis*, Financial Services Authority, March 2009, http://www.fsa.gov.uk/pubs/other/turner_review.pdf, p.49.

[4] See "I'm doing God's Work. Meet Mr Goldman Sachs". John Arlidge, November 8th 2009, http://www.timesonline.co.uk/tol/news/world/us_and_americas/article6907681.ece .

measured only in the long run and with the benefit of hindsight . . . Compensation structures that reward managers annually for profits, but do not claw these rewards bank when losses materialize, encourage the creation of fake alpha."[5]

Fourth, shareholders, lack the capacity to monitor risks in complex institutions. Worse, in highly leveraged limited liability companies, they also lack the interest to monitor such risks properly, since - as Lucian Bebchuk and Holger Spamann of the Harvard Law School point out, convincingly - they enjoy the upside, while their downside is capped at zero.[6] Thus, "leveraged bank shareholders have an incentive to increase the volatility of bank assets", which enhances their potential gains.

Fifth, not only shareholders, but also creditors, lack the interest to price properly the risks being assumed, since they enjoy a high probability of rescue in the event of failure: this is the operational core of the idea of "too big to fail".

Sixth, managers also have an incentive to bet the bank to the extent that their interests are aligned with those of the shareholders. Since share options are a leveraged play on the gains to shareholders, they make management even more prone to bet the bank than shareholders. Moreover, the fact that managers sometimes lose does not show that they were wrong to take such bets. Yet the evidence even suggests that even the management of failed institutions have been able to cash out substantial winnings before the collapse.[7]

Finally, the combination of asymmetric information with the complexity of such institutions makes it effectively impossible for regulators to monitor the risks being taken.

The problem of remuneration is, therefore, an extreme version of the deep problem in this sector: the misalignment of incentives between the various decision-makers inside the system and ultimate risk-bearers, particularly the taxpayers and the wider public. This is not to say that decision-makers do not also make mistakes induced by over-optimism. But perverse incentives create what I have called "rational carelessness", which makes decision-makers underplay risks or even choose to ignore them altogether.[8] Thus, it is impossible to distinguish between the impacts of perverse incentives and cognitive biases. For this reason, too, it is vital to start our analysis with the challenge of incentives.

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[5] Raghuram Rajan, "Bankers' pay is deeply flawed, *Financial Times*, January 9th 2008.

[6] See Lucien Bebchuk and Holger Spamann, "Regulating Bankers' Pay", Harvard Law and Economics Discussion Paper No. 641, May 2009. See also Martin Wolf "Reform of regulation has to start by altering incentives", *Financial Times*, June 24th 2010.

[7] See Lucian Bebchuk, Alma Cohen and Holger Spamann, "Bankers had cashed in before the music stopped", *Financial Times*, December 7th 2009.

[8] Martin Wolf, "The challenge of halting the financial doomsday machine", Financial Times, 21st April 2010.

Solutions to Financial Sector Remuneration

So what should, or can, be done about these problems with financial sector remuneration.

Inequality, rents and competition

As a general proposition, inequality should be dealt with by general taxation, not by interference in pay levels, least of all interference in pay levels in individual industries. It may be necessary, however, to limit political lobbying and election spending, to ensure that this is possible. Experience has also found that direct government control of pay creates a host of perverse and unintended consequences. But monopoly rent can be attacked, either by competition policy or, where monopoly rent is an inherent feature of a market, by turning the industry into a regulated utility. This may well apply to the activity of market-making, for example.

It would make excellent sense to conduct a rigorous inquiry into the extent of obstacles to competition in the sector, ideally on a global basis. Where lack of competition is found, policymakers can then choose between actions that would enhance competition and moves towards a more regulated industry model. Broadly, it appears plausible that reforms which increase competition, but also shrink the size of the sector, increase capital requirements, lower equity returns and reduce excessive risk-taking should also lower the scale of the rewards available. Indeed, Thomas Philippon of New York University's Stern School of Business and Ariell Resheff of the university of Virginia have recently estimated that rents accounted for between 30 per cent and 50 per cent of the wage differential between the financial sector and other industries.[9] It would seem to follow that a successful attack on those rents would also lower these rewards.

Fixing incentives

So far as possible, the problems identified above need to be fixed by changing incentives – radically so, if necessary. The alternative – effective supervision – is substantially less plausible and is, in any case, only a second line of defence against irresponsible risk-taking. So how might this be done?

Broadly speaking, there seem to exist two strategies. The first is to restructure the financial industry in such a way that the risk-taking parts – sometimes called the "casino" – will never need public bail-outs, in which case one could leave the monitoring of pay structures to shareholders, themselves monitored by creditors fully aware of the risks they are running. The second strategy is to assume that the public sector will always be the

[9] Thomas Philippon and Ariell Resheff, "Wages and Human Capital in the U.S. Financial Industry: 1909-2000", National Bureau of Economic Research Working Paper 14644, January 2009, www.nber.org.

risk-taker-of-last-resort, and so intervene in the structure, but not the level, of pay, to ensure that the interests of the public are reflected in those incentives.

On the first of these two approaches, the relevant question is whether restructuring of this kind would be both feasible and effective. One possibility would be narrow banking, as recommended by John Kay.[10] But the rest of the system would then have to be credibly free from government insurance, in the sense that all participants would know that they would live and die by the market. The second, even more radical alternative would be "limited purpose banking", which is recommended by Laurence Kotlikoff of Boston University, in which intermediaries would be prevented from taking risk on their own books, unless they had unlimited liability.[11] Instead, any changes in the valuation of assets would be passed through at once to investors, as mutual funds or unit trust do today. Financial assets would then be marked to market at all times. Thus, under Mr Kay's proposal, the credit system, as we know it, would be set free, though separated from deposit-taking, while, in that of professor Kotlikoff, it would effectively disappear.

I am skeptical about the effectiveness of these two structural alternatives. I believe it is impossible for governments to make a credible pledge to let the credit system as a whole implode in a crisis. But if this commitment were not credible, there would surely be excessive risk-taking, which would, in turn, make crises highly probable. Thereupon, governments would almost certainly prove the truth of the beliefs of those taking the risks. For this reason, narrow banking alone would be insufficient to make the system more stable.

Limited purpose banking looks more hopeful, though it is extremely radical: the financial system, as we know it, would cease to exist: we would no longer have traditional term transformation. The big question, however, is whether the government would stand aside when asset prices collapsed. It is used to doing so when equity prices collapse. But the US authorities did not dare to stand aside when the money market funds were imperilled by massive withdrawals during the financial crisis of 2009. Instead the Federal Reserve intervened. True, it is possible that this would not happen if the vulnerability of the banking system to cascading asset prices were eliminated.

In any case, there is little likelihood of either of these radical structural alternatives being adopted. This then leaves us with the aim of changing incentives within a system that continues to enjoy a substantial degree of implicit and explicit insurance by the state. So how might one change the incentives affecting such institutions?

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[10] "Narrow Banking: the Reform of Banking Regulation", 2009, http://www.johnkay.com/2009/09/15/narrow-banking/.

[11] Laurence J. Kotlikoff, *Jimmy Stewart is Dead: Ending the World's Ongoing Financial Plague with Limited Purpose Banking* (London: John Wiley & Son, 2010).

The first step would be to force financial institutions to become either full partnerships or, more plausibly, to increase their equity capital and possess large cushions of contingent capital (perhaps a combined total of as much as 20-30 per cent of assets).[12] The advantage of greater equity capital (or near equivalents) is that it would greatly reduce the likelihood of any need for a government rescue, though it could not eliminate it. Moreover, with much greater equity, the asymmetry of shareholder incentives would also be reduced, since the owners of the firm would have far more to lose.

Nevertheless, so long as there were outside shareholders, the latter would still have only a limited ability to monitor the activities of management and employees. Moreover, if the social interest in containing risk-taking in financial institutions continued to exist, as it surely would, the regulator would have a legitimate interest in the structure of incentives even if shareholders could monitor their employees. This is, indeed, already widely accepted. So the question is not whether there should be intervention in the structures of remuneration, but rather what the principles of such reformed structures should be. Let us list the broad considerations that should apply, before turning to some details.

First, the regulator, representing the public interest, is interested in the soundness of the institutions under its supervision, not in maximizing expected returns to shareholders. At a minimum, therefore, it wants the interests of decision-makers to be aligned with those financing the balance sheet as a whole, not just with those of the shareholders, who finance an extremely limited part of the balance sheet.

Second, the regulator wants to ensure that, under no circumstances, can employees of the firms benefit from risk-taking behaviour that risks the safety of the balance sheet as a whole – that is to say, makes bankruptcy a likely outcome.

Third, in carrying out this objective, the regulator must make it clear that it is the responsibility of management and senior staff (namely, those charged with oversight of risk-management in the firm) to protect its balance sheet, in the public interest.

Fourth, the regulator should also make clear that these decision-makers exercise a public trust, for whose competent execution they will be held personally liable.

Finally, in ensuring such liability, sufficient time must pass between the making of decisions and the judgement on whether decision-makers have fulfilled their trust appropriately.

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[12] In practice, it would be impossible to raise the capital required by large financial institutions from a partnership. That was why the limited liability company was invented, in the first place. It seems particularly important for large financial institutions.

Thus, the fundamental ideas are that the decision-makers in the firm exercise a public trust, which is to protect the balance sheet as a whole, for whose discharge they are to be held personally liable over a long enough period to make the judgement on their actions feasible.

How might these ideas be made effective, in practice?

The Squam Lake Report, authored by a distinguished group of American economists, makes the following recommendation: "Systemically important financial institutions should withhold a significant share of each senior manager's total annual compensation for several years. The withheld compensation should not take the form of stock or stock options. Rather, each holdback should be for a fixed dollar amount and employees would forfeit their holdback is their firm goes bankrupt or receives extraordinary assistance"[13] Effectively, this would mean that management would bear substantial personal liability, in the event of a failure. As the authors rightly note, pay in deferred stock or in stock options fail to align the interests of the managers with the safety of the balance sheet as a whole, but only with the portion financed by equity. As they also note, under such payment schemes, "managers and stockholders both capture the upside when things go well, and transfer at least some of the losses to taxpayers when things go badly. Stock options give managers even more incentive to take risk. Thus, compensation that is deferred to satisfy this regulatory obligation should be for a fixed monetary amount."[14] Then, in the event of failure or government rescue (excluding access to lender-of-last-resort facilities at the central bank), the sums would be forfeit, unless some value were left over after all other creditors were made whole. It would be crucial that such obligations could not be expunged by leaving the firm, but would be in place for a significant and fixed period of time.

On similar lines, Neil Record, writing in the Financial Times, argues that "Bankers who wish to receive a bonus above a threshold (say £50,000, or twice average earnings) would become personally liable for the amount of the bonus for a period, perhaps 10 years. They would sit between equity holders and other creditors of the bank - and so would be called upon should any bank find that its equity capital is wiped out by losses. In practice, this would mean their liability would be triggered by a government or other (private sector) rescue. If there turned out to be no rescue, then they would be liable to the liquidator. If there were a rescue, the rescuer would pay over support monies, and then reclaim them from the limited-liability bankers. The bankers would be released from this liability over time, but of course with every new bonus payment they would incur a new liability. By this mechanism, all senior bankers would have a rolling portfolio of liabilities to the extent of the cash they had taken out of the bank in bonuses. . . . I would also suggest that bankers' liability should not be an insurable risk; bankers would be

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[13] *The Squam Lake Report: Fixing the Financial System* (Princeton and Oxford: Princeton University Press, 2010), pp.81-82.

[14] *Ibid*., p.82.

prevented by law from insuring their exposure (just as one cannot insure against criminal penalties)."[15]

The details of such proposals are to be worked out. But the nature of the regulatory requirements seems quite clear.

First, regulators should establish the principle of personal liability of the decision-makers in the firms.

Second, they should also establish principles on which the relevant key decision-makers would be identified.

Third, regulators should publish the criteria for determining such personal liability.

Fourth, the liability should be for a substantial portion of total remuneration, whether paid as bonuses or salary, with the portion rising together with the seniority of the decision maker at the time he or she received the remuneration. For the chief executive, that portion should be close to 100 per cent.

Fifth, the liability would be a cash amount, indexed to inflation.

Sixth, the period over which such liability would continue should be substantial – preferably, at least ten years after receipt of the remuneration. This would be long enough to establish the viability of many (if not all) strategies. Thus, there would be a rolling responsibility.

Seventh, stock awards would be permitted, but stock options would be precluded for such decision-makers. The sale of stock would be prevented if it lowered the net worth of decision-makers (active or retired) below their liabilities.

Eighth, the liability would be uninsurable.

Ninth, regulators would also have a say in the remuneration structures of the non-key decision makers in the firm. The principle of claw-back of remuneration, in the event of failure, would be part of such discussion. In the event of failure, all stock options should be cancelled, for all employees.

Tenth, senior executives of failed financial firms would be barred from subsequent employment in the industry for a substantial period of time.

[15] Neil Record, "How to make the bankers share the losses", *Financial Times*, January 7th 2010.

Evidently, such reforms would be far better implemented if they applied across borders. But, if necessary, countries should go their own way, since they have a vital national interest in ensuring the safety of the balance sheets of their own firms. Regulators would then have to agree the principle of remuneration for senior executives in all systemically significant national financial businesses.

Conclusion

The question of pay is unavoidably fraught. It concerns not just the financial sector, but the wider economy and, indeed, its political and social stability. It is plausible, in fact, that the liberalization of the financial sector has had substantial direct and indirect impact on the widening inequality of private sector pay in many countries over the past three decades. It is also plausible that remuneration is one factor, among others, that led financial firms to take a risk-seeking approach to the exploitation of their balance sheets, with ultimately disastrous results.

On both aspects, therefore, there is a case for policy action. So far as the economy, as a whole, is concerned, the obvious policy instrument is taxation, since direct controls on pay are likely to have unintended adverse consequences. But, in the case of finance, it also makes sense to undertake a rigorous assessment of competition. Should there be severe competition issues, policy-makers should consider remedies: either competition should be enhanced or regulation be introduced, as in any other monopolistic industry. Market-making is an obvious area for such treatment.

Beyond this, the structure – rather than the level – of pay in the financial sector must be regarded as a matter of public interest, since taxpayers are the risk-takers of last resort. The fundamental problem is that, in the case of the financial industry, with its highly leveraged balance sheets, limited liability creates perverse incentives for both shareholders and management. These are not fully offset by the creditors, partly because the latter rightly believe that they enjoy the benefits of explicit and implicit taxpayer insurance. These perverse incentives encourage rational carelessness, with intermittently catastrophic results.

So what is to be done? The regulators have a duty to correct the perverse incentives at work. Higher capital requirements would help. But it would not be enough. Massive structural change in the financial system might also help. But it is unlikely to occur. Thus, it is also important to motivate management to protect the balance sheet as a whole and not just identify their interests with those of shareholders, since maximization of expected shareholder returns can leave huge tail risks with taxpayers.

For this reason, regulators should insist in a change in the structure of incentives, to discourage executives with responsibility for risk-management from "gaming the state". Since outside supervision is likely to fail, the best way to achieve this result is to make management liable in the event of bankruptcy or state rescue. This can be achieved by forcing a substantial part of remuneration to be held back for an extended period, probably 10 years, and then lost, in the event of failure. In this case, the management of failed institutions would lose much of their accumulated wealth. In addition, stock options, with their perverse, one-sided incentives should be eliminated for all employees of systemically significant financial institutions and all variable pay should be subject to claw-back in the light of subsequent performance.

Aligning the interests of those who work in the financial sector with those of creditors, including the creditor of last resort – the state – would not solve every problem in the industry. But it is the best way to realign incentives. The crucial step is to abandon the idea that shareholder interests alone count. They do not. In the case of financial institutions, there is a wider public interest in actions that minimize the chances of bankruptcy. Making decision-makers substantially liable in the event of failure of the business under their control is also a vital part of the solution.

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