Pay as Risk Regulation

Andrew C.W. Lund

Pace University School of Law

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How do we prevent financial institutions from taking excessive risk when the public fisc serves as creditor? This is one of the central questions left over after the recent financial crisis and, for the past five years, there has been no shortage of proposed answers. Two of the more popular candidates for ex ante regulation—proprietary trading restrictions and enhanced capital requirements—are on their way to being enacted in one form or another, albeit with some controversy over their cost and ultimate efficacy. Meanwhile, a third, more indirect approach has sprouted in the pages of law and finance journals under which bank managers’ compensation packages would be adjusted to include bank debt, thereby altering their risk-taking incentives. This approach has even been put in place at certain non-U.S. financial institutions.

This Article offers a critical appraisal of regulating bank risk-taking through executive pay design. “Risk regulation by pay” is less likely to ameliorate risk-taking than more direct approaches because bank managers with career concerns will continue to face significant incentives to take on high levels of firm risk. Moreover, regulating by pay is an inapt solution where marginal monitoring costs for creditors are relatively low as is the case with bank monitoring. Instead, the case for regulating bank risk through pay redesign must be grounded in a pessimistic view of regulator agency costs in a system of prudential regulation. It is hard, however, to see how compromised regulators faced with broad discretion would be much better at implementing a pay regulation regime. Thus, the most effective version of risk regulation by pay will be afflicted with largely the same implementation problems as traditional, direct risk regulation. Even worse, the very fact of risk regulation by pay, no matter how modestly proposed, makes it more likely that traditional direct monitoring will further atrophy, leaving the government-as-creditor worse off than before.

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I. INTRODUCTION

As the explicit or implicit insurer of banks and other systematically important financial institutions, the federal government has an obvious interest in constraining the risks taken by those firms. That interest may trade off against the benefits of increased liquidity provided by banks’ willingness to take risks. But, at least since the financial crisis made the cost of these guarantees more salient, the question of whether to reduce bank risk has given way to the question of how to reduce bank risk. Some proposals—most notably the Volcker Rule banning proprietary trading and enhanced capital requirements—would alter traditional prudential monitoring mechanisms, resulting in increased direct regulation of banks. Parallel to these, another set of proposals would indirectly regulate bank risk by requiring bank managers’ compensation packages to include some level of unsecured bank debt.

The proposals in the proposals that are the subject of this extended critique were influenced by important differences. This Article groups banks and systemically important non-bank financial institutions together. This is consistent with the approach taken in the proposals that are the subject of this extended critique.

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PAY AS RISK REGULATION

This Article offers a skeptical appraisal of this move to regulate bank risk-taking by altering pay design. Holding all things equal, altered compensation incentives should lead bank managers to take on less risk in order to maximize the value of their portfolio that would then include debt instruments sensitive to such risk. But, to this point, the debt compensation proposals do not fully grapple with the countervailing incentives created by bank executives' career concerns. As the managerial labor market has become tougher on CEOs, advocates of increased debt compensation have a higher hurdle to clear in order to demonstrate that adding some amount of debt will counteract both the incentives provided by managers' existing equity holdings and those arising out of simple career concerns.

Resolving this question largely turns on empirical questions about the managerial labor market discussed below. However, regulating risk-related moral hazard at banks through a compensation contract seems somewhat misspecified even in theory. Bonding through incentive pay is traditionally seen as a second-best solution, primarily useful in cases where a principal's monitoring costs are high. Although it is commonly assumed that monitoring costs are high among bank regulators with respect to bank risk, it is less clear whether those costs are substantially higher than those of bank CEOs upon whose managerial acumen the pay proposals rely. The regulatory experience during the financial crisis was not characterized by particularly high levels of risk.

6. See infra notes 47-57 and accompanying text. To my knowledge, these papers have been subjected to extended criticism only twice. See Kelli A. Alces & Brian D. Galle, The False Promise of Risk-Reducing Incentive Pay: Evidence from Executive Pensions and Deferred Compensation, 38 J. CORP. L. 53 (2012); Karl S. Okamoto & Douglas O. Edwards, Risk Taking, 32 CARDOZO L. REV. 159 (2010); see also Andrew C.W. Lund & Gregg D. Polsky, The Diminishing Returns of Incentive Pay in Executive Compensation Contracts, 87 NOTRE DAME L. REV. 677, 708-11 (2012) (noting that the Tung and Bebchuk/Spaumann proposals are subject to criticism related to a broader argument about the efficacy of incentive pay); infra notes 71-73 and accompanying text (describing Jeff Gordon's criticism of the Bebchuk/Spaumann proposal).

7. See infra notes 47-56 and accompanying text.

8. See infra Part III, for more on those empirical analyses and studies on the effect of inside debt on risk-taking.


10. See infra notes 117-21 and accompanying text.
Moreover, and as others have pointed out, there may be relatively simple ways to effectively lower the costs of monitoring bank risk. Finally, bank managers' monitoring costs may be surprisingly high in modern financial firms.

The more powerful case for regulating risk by pay is grounded, rather, in a pessimistic view of regulator agency costs. Regulators may not have the will to regulate banks as a normal creditor might monitor another firm. Given recent events, it is indeed hard to argue that enforcement incentives are ideal. Regulation by pay solves the problem by relying on managers' self-interest to reduce risk. However, regulation by pay implemented well in advance of any particular bank risk-taking will likely be subject to greater regulator agency costs than current risk-monitoring mechanisms. In fact, most of the debt compensation proposals specifically make this point about substituting indirect regulation into the regulator's toolbox. Moreover, there is reason to worry that debt compensation itself might be little more than an incremental adjustment to the array of regulatory tools available. If so, there is reason to worry that the introduction of debt compensation into the regulatory toolbox might cause regulators to relax prudential monitoring mechanisms. In fact, most of the debt compensation proposals specifically make this point about substituting indirect regulation for direct regulation. Even more troublingly, mis-takenly evaluating debt compensation's effectiveness at deterring risk would be consistent with the historical overestimation of pay-structure's impact on the incentives of corporate managers.

Part II introduces the oft-noted problem of moral hazard in banking given a world of government guarantees. It goes on to describe disastrous events of prudential bank monitoring, many of which appear to have failed in the months and years preceding the crisis. In this world of government guarantees, it goes on to describe disastrous events of prudential bank monitoring, many of which appear to have failed in the months and years preceding the crisis.
PAY AS RISK REGULATION

We refer to the financial crisis of 2008–2009, when many felt regulated banks, who were even subject to positive value effects, were part of the problem. The financial crisis of 2008–2009 exposed the need for a more comprehensive and transparent approach to risk management. The crisis indicated that banks had become too risky, leading to a need for more stringent regulation. In this context, there was a need to rethink the role of pay in incentivizing bank managers.

Part II suggests that the move to regulating bank risk through pay may turn out to be more than just unhelpful. It may actually displace prudential monitoring to a degree, as admitted by even the most sober proponents. Apart from those admissions, Part II describes how regulators and scholars have often overestimated the level of incentive effects occasioned by tinkering with pay. Given that history, there is reason to think that they may do so again in this new context, perverts regulatory leadership to a more relaxed monitoring regime. When the music stops, in terms of liquidity, things may not be good at all.

II. THE DEBT COMPENSATION PROPOSALS

It is widely believed that banks took on high levels of risk in the lead-up to the financial crisis of 2008–2009, as discussed below.

We refer to the financial crisis of 2008–2009, when many felt regulated banks, who were part of the problem, needed to be more regulated. However, regulatory agency costs are likely to prove as prodigious. It is not enough to think about the costs of the next regulatory action—what agencies cost must be measured. This simple fact, however, is often neglected.

The quintessential example of this neglect is the case of the Office of Financial Management of Banks. In the case of government-mandated regulation of banks, the costs are enormous. The office of Financial Management of Banks is not optional. The Qua, P4. THE TIMES (July 9, 2007), http://www.ft.com/intl/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html#axzz2sZ3TBW8d ("When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing.")

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banks are subject to a particular sort of moral hazard occasioned by the socialization of losses through federal guaranties. Much thought has gone into solving the problem of bank moral hazard, culminating in a series of proposals to adjust bank managers’ pay by adding more bank debt to their portfolio. Those proposals are detailed below, alongside the handful of voices to the contrary that have heretofore been raised.

**A. Bank Moral Hazard and Direct Regulatory Responses**

Bank managers had substantial reasons to prefer excessive risk and volatility during the run-up before 2007. Those managers were appointed by boards answerable to shareholders and, in fact, were significant shareholders themselves by virtue of historical equity compensation arrangements. Whether through labor market discipline, compensation-related bonding, or a combination thereof, managers internalized equity preference for increased risk. Pre-crisis banks, in this regard, were not very different from firms in other industries, with both shifting the preferences of risk-averse managers toward those of risk-seeking, diversified shareholders.

Although bank managers were exposed to the same sort of incentives as those of other industries, banks were uniquely likely to take on higher levels of risk. Non-banks are already less highly levered than banks, lowering the applicable risk baseline. Non-banks are generally subject to cross-monitoring by creditors, but banks are subject to implicit or explicit government guaranties. The government, in effect, stands in as the relevant creditor to banks, but government regulations appear to have performed their protective function, in part, by constraining risk-taking.

**1. Simple human error also played a part in the excessive risk-taking that helped fuel the recent financial crisis.**


—See *Id.*, supra note 6, at 168 ("All banks engage in some form of the ‘carry trade’ that involves borrowing money in order to acquire assets that earn a spread—of the difference between the cost of short term capital and the profit from long term lending. It is generally understood that the carry trade rewards high-risk decisions because leverage amplifies the expected return for any investment.")
monitoring task poorly during the pre-crisis period. The contours of that failure are discussed in greater detail in Part III below, but commentators have observed that the government failed to pump the brakes as bank manager risk preferences were shifted toward those of their shareholders.

Since the crisis, various legislative and regulatory attempts have been made to dampen risk-taking at banks. Consistent with historical prudential monitoring, many of these approaches involve direct oversight of banks' behavior. For instance, the Dodd-Frank Act included a non-specific mandate to ban proprietary trading by banks.25 Recently that mandate has been codified in a final version of the Volcker Rule.26 Elsewhere, regulators and academics are pursuing enhanced capital requirements that would create a cushion in case of failure so as to reduce the risk of bank insolvency.27 Finally and more modestly, some have suggested ways to simply strengthen, without fundamentally changing, the existing bank examiner monitoring regime.28
More indirect routes to reduce risk have also been suggested. The Dodd-Frank Act mandated that financial firms' boards install a risk management committee comprised of independent directors. The committee would theoretically do some of the work of prudent monitoring traditionally performed by regulators.

Alternatively, an enhanced disclosure regime might permit market participants to more effectively price bank risk. Those market participants, primarily subordinated debt holders, might helpfully complement traditional regulation under such a regime.

B. Paying with Debt

The most prominent proposals for indirect regulation, however, seek to shape bank risk-taking by altering bank manager compensation. Under these proposals, bank managers supplied with newly calibrated portfolio incentives would themselves serve as complementary bank monitors. The idea is an extension of the basic incentive pay framework that has come to dominate public company governance over the past three decades.

The goal is to constrain bank managers so that they help overcome managers' natural aversion to risk, by providing them with incentives to perform in a way that reduces the likelihood of systemic failure. The Dodd-Frank Act mandated that banks' capital adequacy ratios be set at a level sufficient to absorb losses from a range of potential market shocks. The idea is that bank managers would be incentivized to make decisions that align with that goal.

The most prominent proposals for indirect regulation, however, seek to shape bank risk-taking by altering bank manager compensation. Under these proposals, bank managers supplied with newly calibrated portfolio incentives would themselves serve as complementary bank monitors. The most prominent proposals for indirect regulation, however, seek to shape bank risk-taking by altering bank manager compensation.
managers' behavior,36 where shareholders do not have the ability or interest to monitor ex ante,37 or where executive decisions affect firm percentage returns rather than dollar returns.38 Determining the effect on firm behavior attributable to this sort of compensation tinkering has proven to be an econometrically difficult trick,39 and there are long-running debates over whether observed compensation structures reflect arm's-length bargaining or managerial power.40 Nevertheless, it is popularly believed that the introduction of heavy levels of performance-based pay caused increased risk-taking economy-wide over recent decades.41

In the light of that success, some commentators turned to managerial pay design in their attempt to adjust (now in a downward direction) risk-taking at banks post-crisis. In fact, even prior to the financial crisis and apart from banking, scholars were beginning to model the use of debt compensation's relation to firm risk-taking. In its most modest form, such an approach might call for a reduction in equity compensation for managers43 and/or longer holding periods for equity stakes.44 More ambitiously, however, some proposals

36. For more on the question of observability, see Bengt Holmström, Moral Hazard and Observability, 10 BELL J. ECON. 74 (1979) (introducing his "informativeness" principle).

37. See Kevin J. Murphy, Executive Compensation, in 3 HANDBOOK OF LABOR ECONOMICS 2485, 2521 (O. Ashenfelter & D. Card eds., 1999) ("In general, increasing shareholder wealth involves investing in positive net present value projects, increasing profits on existing capital, and diverting resources from negative net present value projects. There is a wide array of actions that affect shareholder value, including defining the business strategy, choosing between debt and equity financing, making dividend and repurchase decisions, identifying acquisition and divestiture targets, selecting industries and markets to enter or exit, allocating capital across business units, setting budgets for developing new products and businesses, hiring productive (and firing unproductive) subordinates, and designing, implementing, and maintaining the nexus of implicit and explicit contracts that defines the organization. Expanding the set of potential actions that affect shareholder value diminishes the role for 'informativeness' and increases the benefit of tying pay to the principal's objective rather than to measures of inputs.").


39. See Lund & Polsky, supra note 6, at 705 & n.121 (noting that endogeneity poses particularly serious problems for drawing causal inferences from compensation data).


41. See, e.g., KENNETH R. FRENCH ET AL., THE SQUAM LAKE REPORT: FIXING THE FINANCIAL SYSTEM 47 (2010) ("The structure of executive compensation, however, can affect the risk of systemically important financial institutions."); Tung supra note 4, at 1206.

42. See Edmans & Liu, supra note 4; Yair Listokin, Paying for Performance in Bankruptcy: Why CEOs Should be Compensated with Debt, 155 U. PA. L. REV. 777 (2007).

43. See Alces & Galle, supra note 6, at 54 & n.3.

suggest altering the pay structure of bank managers so as to include significant levels of bank debt. This debt would bond managers to the bank’s creditors to one extent or another as opposed to its equityholders.

The inclusion of bank debt in pay packages would be new but not entirely without precedent. Most managers already hold some sort of inside debt. Many are entitled to unfunded future deferred compensation and pension payouts that effectively function as debt claims on the firm.46 In a more mundane sense, future compensation streams are subject to firm credit risk—exactly the sort of debt-like interest that led to the push for enhanced equity pay in the first place. The proposals discussed below are about the same time. Lucian Bebchuk and Holger Spamann, on the one hand, and Fred Tung, on the other, proposed adding debt to bankers’ pay packages in order to ameliorate the moral hazard problem at banks. Bebchuk and Spamann suggested a number of possible structures,47 but the one that has received the most attention is their “pay-by-the-slice approach” that would tie bank manager compensation to the entire set of securities in the bank holding company’s capital structure. Tung’s approach was similar with two notable exceptions that seem to mark improvements. First, Tung would use subordinated bank-level debt as opposed to senior bank holding company debt in order to ameliorate the moral hazard problem.

The Proposals
...ponents within the holding company structure. Second, Tung would not necessarily mimic banks’ capital structures on the ground that individual managers’ risk preferences are likely heterogeneous. Accordingly, there is no reason to assume that mapping capital structure onto pay structure would appropriately align any particular manager’s incentives. Instead, boards should attempt to calibrate an optimal basket of securities for any particular banker’s pay based on specific bank and executive characteristics. This idiosyncrasy limits the ability to directly mandate pay rules or guidelines as would be available under a pay-by-the-slice approach. However, as an external investor the shareholder is not able to directly measure risk or control shareholder risk preferences. Instead, boards may attempt to calibrate appropriate capital structures on the ground that managers within the holding company structure...

56 See Tung, supra note 4, at 11. Importantly, Jordan departs from the Bebchuk-Spamann and Tung departs from assigning their shareholders an ex ante ownership stake in the holding bank.

57 See id. at 1869-72.

48 Id. at 1855-56.

49 Id. at 1849-50.

50 Id. at 1848.

51 Id. at 1848.

52 See Tung, supra note 4, at 1249-50.

53 See Kaal, supra note 4, at 1854.

54 Id. at 1855-59.

55 See id. at 1869-72.

56 See Gordon, supra note 4, at 11. Importantly, Gordon departs from the Bebchuk-Spamann and Tung approaches by assuming that shareholders at systematically important financial institutions may internalize the costs of excess risk-taking to a degree not shareholders and Tung focus on assigning their shareholders an ex ante ownership stake in the holding bank.

In a similar vein, Jordan has recently suggested adding an unsecured convertible debt security to the bank’s capital structure. Unlike banks, Jordan believes that convertible debt would allow the bank to continue paying managers.

47 Jordan assumes that convertible debt would allow banks to continue paying managers. Rather than initially paying via a mix of debt and equity, Jordan suggests that the opposite of convertible debt would be more efficient for shareholders. Jordan’s suggestion is the opposite of the Bebchuk-Spamann approach. See supra.

Jordan also suggests adding a debt-like pay element for bankers. In a sense, however, Jordan’s suggestion is the opposite of that put forth by Bepchuk, Spamann, and Tung. Instead of converting to equity in the event of default, the Jordan convertible would function similarly to the debt to which it is attached. In a similar vein, Jordan has recently suggested adding an unsecured convertible debt security to the bank’s capital structure. Unlike banks, Jordan believes that convertible debt would allow the bank to continue paying managers.
with equity. That equity, however, would be subject to conversion into subordinated debt (with a haircut) upon certain triggers—regulatory downgrades, drops in key accounting metrics, and, perhaps, drops in share prices. This approach clearly provides stronger incentives to avoid excessive risk—at least as insolvency becomes more likely—than Bebchuk and Spamann’s (and certainly Kaal’s) proposal, since a manager’s entire portfolio would be conditionally debt-like.

Finally, Sallie Krawcheck, formerly of Bank of America and Citigroup, penned a Harvard Business Review op-ed in which she joined the call for reconfiguring banker pay to include debt. While noncommittal about the necessary combination of equity and debt in an optimal package, Krawcheck noted that “the most logical endpoint would be a compensation mix that mirrors the bank’s capital structure.” Though the details are not spelled out, her approach is reminiscent of Bebchuk and Spamann’s pay-by-the-slice approach. Coming from a former “insider,” Krawcheck’s article has been celebrated as something of a breakthrough in bank governance. Her compensation solution was positively noted by various press outlets, and a New York Times columnist wrote that the debt compensation proposal was his “favorite” solution in Krawcheck’s article.
Actual implementation of such debt compensation proposals has been sporadic to this point. Some British firms—Royal Bank of Scotland and Lloyds in particular—have included subordinated debt in lieu of cash bonuses. However, these alterations appear to have been driven at least as much by balance sheet considerations as incentive effects. Barclays has also introduced contingent debt-like instruments into pay packages. In the United States, Kenneth Feinberg, serving as Pay Czar for the U.S. Treasury Department, forced AIG to use "Long-term Performance Units" (LTPUs) when compensating executives in 2010. The LTPUs were to be paid in cash on a future date at a value keyed off of both AIG subordinated debentures and common stock, at a four-to-one ratio. Although the Pay Czar sought to use Long-term Performance Units (LTPUs) when compensating executives in 2010, the LTPUs were to be paid in cash on a future date at a value keyed off of both AIG subordinated debentures and common stock, at a four-to-one ratio. Although the Pay Czar sought to use Long-term Performance Units (LTPUs) when compensating executives in 2010, the LTPUs were to be paid in cash on a future date at a value keyed off of both AIG subordinated debentures and common stock, at a four-to-one ratio.
In this example, Tung would substitute a more tailored level of subordinated bank debt in the banker’s pay package.70

Less easily resolved are two sets of somewhat interrelated critiques, one from Jeffrey Gordon,71 and the other from Kelli Alces and Brian Galle.72 Gordon’s argument is made in the context of his already discussed proposal for paying via convertible equity and is relatively brief. Referencing the Bebchuk and Spamann approach, he makes three points. First, paying by the slice will require an initial determination as to what counts in terms of the firm’s capital structure that a banker’s pay package is supposed to mimic.73 Assuming these rules are generalizable, the pay-by-the-slice approach might provide incentives for managers to game capital structure decisions just as they may have gamed ratings agency rules to achieve helpful outcomes for their structured finance products.74 Second, valuation is likely to be difficult for the more exotic bank securities that one often finds in such firm’s capital structures. Many of these securities will not trade in thick markets, and consequently, there may be new pressure placed on accounting measures, potentially giving rise to a separate set of issues.75 Finally, Gordon suggests that even relatively thick debt markets may not reliably reflect bank risk, particularly given the current state of implicit government “too-big-to-fail” guaranties.76

Gordon’s criticisms are essentially practical, revolving around the proposals’ workability. However, there may be reasons to think the proposals are not as difficult to implement as suggested. For instance, Tung’s proposal to simply include an unspecified amount of bank subordinated debt does not rest on an interpretation of a bank holding company’s capital structure and avoids at least the first part of Gordon’s critique. Moreover, the pay-by-the-slice approach would rely on such an interpretation, it is not obvious why an approach that relies on an interpretation of a corporation’s structure to mimic a pay-by-the-slice approach that relies on an interpretation of a bank holding company’s capital structure might be more difficult to implement as suggested. For instance, Tung’s proposal to include an unspecified amount of bank subordinated debt does not rest on an interpretation of a bank holding company’s capital structure and avoids at least the first part of Gordon’s critique. Moreover, the pay-by-the-slice approach might provide incentives for managers to game capital structure decisions just as they may have gamed ratings agency rules to achieve helpful outcomes for their structured finance products. Second, valuation is likely to be difficult for the more exotic bank securities that one often finds in such firm’s capital structures. Many of these securities will not trade in thick markets, and consequently, there may be new pressure placed on accounting measures, potentially giving rise to a separate set of issues. Finally, Gordon suggests that even relatively thick debt markets may not reliably reflect bank risk, particularly given the current state of implicit government “too-big-to-fail” guaranties.

Notes:

70. See id.
71. See Gordon, supra note 4, at 9-10.
72. See Galle, supra note 4, at 9-10.
73. See Gordon, supra notes 4 and accompanying text.
74. See supra note 46 and text accompanying id.
75. See supra note 46 and text accompanying id.
76. See id.
these transaction costs are internalized by firms, though it is hard to see why they would serve as guideposts to inefficient restructurings. 77 Though those fears would appear to require significant mispricing of bank holding company securities in markets in order to present significant arbitrage opportunities, it might also be true that valuation problems would follow the inclusion of exotic debt securities in pay packages, but Gordon himself notes that derivative markets and new accounting conventions would do some of the work, and that those creditors would have different risk preferences as a result. Tung provides evidence that at least the market for subordinated bank debt functions reasonably well. 78 Finally, Gordon himself offers something of a solution to any insensitivity to bank credit risk—commit to excluding debt compensation from any future bailouts. 79 In sum, Gordon raises points that are important and, for Bebchuk and Spamann in particular, difficult to handle, but his argument need not be entirely persuasive to debt compensation's proponents.

Alces and Galle offer a more sustained critique of debt compensation. Their argument is complex but essentially makes three independent claims. 80 First, Alces and Galle posit that any excessive risk-taking observed at banks is largely driven by previous compensation choices, namely the introduction of massive amounts of equity pay into managers' contracts. 81 It would be simpler, they say, to just reduce this type of pay rather than to add a countervailing, risk-reducing incentive through bank debt. 82 Debt compensation's proponents are entitled to respond, however, that there is surprising liquidity in bank debt, and that, at least in the short term, the market would absorb any increase in bank debt issues even if they were issued in order to reduce risk-taking. 83

Moreover, Alces and Galle note that debt compensation must be managed to account for the dynamism of a firm's capital structure. 72 If reorganizations subject bank debt to transaction costs, re-balancing is available subject to transaction costs. 72 As they point out, however, the introduction of new accounting conventions from unexpected sources would make these interventions more substantial to debt compensation's proponents.
and debt-sympathetic debt may have an "equity bias," or "debt bias," but a "debt bias is some-
thing quite different from an "equity bias." 83 The most prominent study concerning the matter showed no significant associa-
tion between pre-crisis equity incentives and firm performance. 84

Second, Alces and Galle puzzle over a conundrum at the heart of the structuring of debt compensation. The new instruments must be "junior" enough to actually make credit risk a significant concern for executives 85 but not too junior so as to chance effectively transforming the security into equity. 86 The potential of bailouts obviously aggravates the former concern, and distinguishing management's debt from subordinated creditors' would seem to be a solution. However, Alces and Galle note that subordinating management's debt more junior than the most junior (yet bailed-out) debt claims would make the claims "too junior to align managers' interests perfectly with any class of creditors": that is, they would be too equity-like. 87 The point here is that even if Alces and Galle viewed their "junior" to "junior" analogy as a solution, the case would be far from ironclad. An "equity bias" in debt compensation need not undermine pre-crisis equity incentives, but it does mean that debt compensation might not solve the problem of moral hazard. In a world of integrated compensation structures, the "equity bias" might not solve the problem of moral hazard, in a world of integrated compensation structures, the "equity bias" might not solve the problem of moral hazard.
Finally and most persuasively, Alces and Galle argue that bank managers will struggle to calibrate their behavior in the face of an increasingly complex decision calculus brought on by the addition of debt compensation.89 Their discussion is rich, but, in short, they suggest that bank managers might behave randomly in response to additional debt incentives, relying on rules of thumb that may not be value-maximizing.90 Alces and Galle anticipate pushback on this point. First, we have no basis for determining the level of pay complexity at which additional complexity becomes useless or even counterproductive.91 Perhaps we have already reached that point with complicated equity pay arrangements, meaning that equity compensation might not be increasing risk-taking the way many people believe it does. Alternatively, we may be far away from the threshold at which the proposals surveyed that new debt instruments from the perspective of the proposals surveyed that new debt instruments from the perspective of the proposals surveyed that new debt instruments from the perspective of the proposals surveyed that new debt instruments from the perspective of the proposals surveyed that new debt instruments from the perspective of the proposals surveyed that new debt instruments from the perspective of the proposals surveyed that new debt instruments from the perspective of the proposals surveyed that new debt instruments.

Each of these critiques of debt compensation is certainly plausible and even persuasive. However, none of them are strong enough, even taken in the aggregate, to require the conclusion that tinkering with bank manager compensation is a bad idea. Parts III and IV attempt to add to the case against regulating banks via pay.

III. COMPETING INCENTIVE STRUCTURES AND THE INEFFECTIVENESS OF DEBT COMPENSATION

Bank managers face pressures and concomitant incentives in an enormous number of domains, making compensation structure just one of a multitude of potential governance effects. To the extent those competing incentive structures are not aligned with the interests of that hypothetical creditor for all intents and purposes.

89. Id. at 79-80.
90. Id. at 77-78.
91. Id. at 79.
92. Id. at 79-80.
93. Alces and Galle do recognize this point, see id. at 82, but contend that increased complexity might be debilitating in addition to merely confusing. Id. ("Using debt instruments may reduce executive sensitivity to all forms of incentives.")
As a solution to change bank desirability, this paper looks to compensation structure. Below, but at the outset it is understandable that those seeking to condition bank behavior will look for bank risk-taking is discussed in Part 1D, conditions where bank managers are viewed to be particularly effective where it is, "the more, the merrier" hypothesis is tested.

Within the corporate governance and finance communities, there has been a move towards greater emphasis on executive compensation as a means to shape bank behavior. For example, as discussed below, compensation may be relatively ineffective in shaping bank behavior. In fact, as

95. See supra notes 18-19 and accompanying text.
96. See supra notes 36-38 and accompanying text.
97. The remainder of this Part assumes that relevant bank shareholders uniformly prefer high levels of firm risk, consistent with the literature for firms generally. See, e.g., Bebchuk & Spamann, supra note 4, at 265; Gordon, supra note 4, at 1206. It is therefore not responsive to Gordon's claim that diversified bank shareholders largely internalize the costs of systemic risk that individual banks might impose. See supra notes 37-38 and accompanying text.
98. See, e.g., William W. Bratton & Michael L. Wachter, The Case Against Shareholder Empowerment, 158 U. Pa. L. Rev. 653, 691-709 (2010); Marcel Kahan & Edward Rock, Embattled CEOs, supra note 4, at 998; see also Paul Rose, Common Agency and the Public Corporation, 63 Vand. L. Rev. 1355, 1356 (2010).
PAY AS RISK REGULATION

management. Proxy advisory firms have increased their influence, generally lowering monitoring costs. Furthermore, boards have become more active at enforcing share price maximization and other shareholder-friendly decision rules at the same time that shareholders have increased their monitoring activities. Nowhere have these changes manifested themselves more than in an increasingly volatile managerial labor market at public companies, including large banks. The managerial labor market's ability to discipline, long viewed with skepticism, has become far more robust. One influential study found that the average tenure of a CEO had shrunk in the years after 1998 to less than six years. This conclusion is consistent with the results of a recent study finding that, as of 2010, the typical CEO of an S&P 500 firm had served for only 6.6 years. In addition, the Wall Street Journal study, see Lublin, supra note 104, similarly found that, of the 28 longest-serving CEOs, 25 had led firms whose share price performance had beaten the overall S&P index over the term of their tenure.
Thus the threat of dismissal exists for all CEOs at firms where below-median industry-adjusted performance is a real possibility. While there may remain a threshold level of underperformance necessary to trigger labor market discipline, it is hard to imagine CEOs with career concerns exploiting any slack. In addition, there is reason to think the labor market should be particularly effective with respect to banks. First, banks and other financial institutions are relatively homogenous, making firms comparable. Second, the homogeneity reduces the value of firm-specific capital, permitting lower cost turnover. If comparisons and transitions are easier at banks, we should expect to see more labor market discipline at financial institutions.

Just as these disciplinary mechanisms reduce the marginal impact of pay structures designed to align managers' interests with equity, they similarly limit the incentive effect of those designed to align managers' interests with creditors. Whatever is done with pay packages, equityholders' interests will continue to drive bank manager discipline in the labor market. Assuming shareholder preference for risk on one hand and compensation incentives tilted heavily toward debt on the other, bank managers will face two conflicting imperatives—reduce risk and increase the value of the debt instruments. The effects of doing so—accumulating risk during the pre-crisis bubble—were surely not only taking about the personal portfolio bubble in other words, accumulating risk during the period when the music stopped. When Citigroup's Chuck Prince noted the need to continue "dancing until the music stopped,"—in other words, accumulating risk during the period when the music stopped—reduce risk and increase the value of the debt instruments, they similarly limit the incentive effect of those designed to align managers' interests with creditors. Whatever is done with pay packages, equityholders' interests will continue to drive bank manager discipline in the labor market. Assuming shareholder preference for risk on one hand and compensation incentives tilted heavily toward debt on the other, bank managers will face two conflicting imperatives—reduce risk and increase the value of the debt instruments. The effects of doing so—accumulating risk during the pre-crisis bubble—were surely not only taking about the personal portfolio bubble in other words, accumulating risk during the period when the music stopped. When Citigroup's Chuck Prince noted the need to continue "dancing until the music stopped,"—in other words, accumulating risk during the period when the music stopped.
The case for debt compensation as a brake on risk-taking actually turns out to be less convincing than the case for equity compensation was as an accelerator for risk-taking. To see this, note the different portfolio incentives created by adding options versus adding debt. The level of debt compensation will have to be extraordinarily high to create a reasonably powerful incentive. Debt's limited upside makes it relatively expensive to use it to counterbalance pressures to maximize share price. Stock options are much cheaper incentive devices (in grant-date value terms) since their asymmetric upside payout might push a hesitant executive to take on outsized levels of risk for a chance at substantially increasing their total compensation. Hence, even moderate levels of inside debt relative to overall wealth may be an issue. Since risk-taking and change in firm behavior based on pay practices have shown that debt and equity market reactions to different pension proposals show that it might have positive effects on behavior of banks run by managers with extremely short labor market horizons and exceptionally high levels of inside debt relative to overall wealth. For managers with moderate or long labor market horizons and/or more varied portfolio holdings, however, we have no right to expect very much from the proposed tweaks to bank manager compensation described above. Nevertheless, there is some evidence marshaled in the debt compensation proposals suggesting that it might have positive effects on firm behavior.
IV. DEBT COMPENSATION VERSUS PRUDENTIAL MONITORING

Aside from pay regulations’ diminished effect in a new managerial labor market, bank risk-taking may not be an obvious candidate for preferring indirect regulation to more direct prudential monitoring. Direct monitoring already exists through bank examiners and a substantial regulatory regime, meaning that marginal implementation costs of better direct monitoring are much smaller than they might be otherwise. Informational asymmetries, commonly named as the downfall of prudential monitoring, may be somewhat surmountable. \(^{117}\) Regulatory agency costs—the lack of monitoring will on the part of individual regulators—are real and problematic in the context of ex-ante bank regulation that grants broad discretion to regulators, including a debt compensation regime. \(^{118}\)

A. The Costs of Prudential Monitoring

Optimizing bank risk through pay design makes sense when monitoring costs are high. In such situations, it is more efficient for the monitor (here, the government-as-creditor) to condition payments to the agent (here, bank managers) on some sort of performance measure than to incur those high costs of monitoring its behavior (here, risk-taking). \(^{119}\) This basic insight supports, for instance, the use of equity pay in an optimal contract between dispersed shareholders and managers of large, public companies. Those dispersed shareholders are unlikely to monitor if the costs are even marginally high because of well-known collective action problems. \(^{120}\) Worse yet, the costs to public company shareholders of monitoring project selection are high because of the open-ended nature of the equity contract and a lack of expertise.

On the contrary, where marginal monitoring costs are low, performance-based pay is less necessary. \(^{121}\) For instance, in the case of firms in bankruptcy, creditor groups are already committed to invest.

117. See infra notes 149, 177-78, 180 and accompanying text.

118. The problems with relying solely on ex-ante bank regulation are discussed in Anabtawi & Schwarcz, supra note 77, at 93-102. The authors discuss the unavoidability of accidents, problems of regulatory capture, and over-deterrence of risk-taking. The second of these problems was discussed in an earlier section of this note. The authors discuss the appropriability of monitoring and diagnostic information that accompanies monitoring. The costs to public company shareholders of monitoring project selection are high because of the open-ended nature of the equity contract and a lack of expertise.

119. See supra notes 28-50 and accompanying text.

120. See, e.g., STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 201-03 (2002).

121. John E. Core & Wayne R. Guay, Is CEO Pay Too High and Are Incentives Too Low? A Wealth-Based Contracting Framework, ACAD. MGMT. PERSP., Feb. 2010, at 5, 12 ("To the extent that boards and shareholders can either directly monitor CEO’s actions or include bank regulation that grants broad discretion to regulators, including a debt compensation regime, strong pay-performance linkages will be necessary.")
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1. Collective Action Problems, Information Quality, and Expertise

Further, there may be relatively easy ways to enhance inter-

motion of regulation by regulators. Robert Bartlett, discussing the con-

motion from them, 129 the

resources, See generally Henderson & Tung, supra note 13, at 1016-21.

For an overview of the role played by bank examiners, see generally Henderson & Tung, supra note 13, at 1016-21.

In most respects, the marginal monitoring costs of prudential

As a type of regulator agency cost discussed infra Part IV.A.2.

122. See, e.g., Adam J. Levitin, Response, The Problematic Case for Incentive Compen-

sation in Bankruptcy, 156 U. PA. L. REV. PENNUMBRA 88, 94-96 (2007); Robert K. Rasmus-


123. Taking a cue from regulator agency costs discussed infra Part IV.A.2.

124. To be sure, the initial installation of bank examiners imposes serious costs. How-

ever, the existence of bank examiners is part of the baseline from which the debt compen-

sation proposals spring, and as such, these costs are not appropriately counted in this con-

text. For a discussion of the role played by bank examiners, see generally Henderson & Tung, supra note 13, at 1016-21.


127. For an overview of the role played by bank examiners, see generally Henderson & Tung, supra note 13, at 1016-21.

128. Id. at 1017.

129. See, e.g., id. at 1021-26.
text of increasing market-based monitoring of bank risk, suggests that disclosures adapted for easier credit modeling could be crafted for transmission to the relevant monitor. Bartlett points out that the granularity missing from such disclosure might pose problems, but bank regulators would have the ability, post-disclosure, to delve into the details of a bank’s operations in ways that ordinary market participants would not. Furthermore, confidentiality concerns are much less serious in cases of monitoring by regulators than they are in cases of market-based monitoring.

Traditional critiques of prudential monitoring have also alluded to the lack of expertise on the part of regulators. The idea is that even if raw information about bank positions is made available to regulators, bank examiners and their supervisors are hopelessly overmatched by better-informed bank managers. Of course, we might expect bank managers to understand their firm’s risk more than bank examiners, but the degree of that difference is unclear. Henderson and Tung, for example, conclude their review of post-crisis summaries of bank failures by noting that bank examiners were generally aware of the problems at distressed institutions well before they became public and did not suffer a failure to understand what was happening. Moreover, as discussed above, there is no reason to believe that new disclosure mandates could not be produced to level the playing field between managers and regulators, though the difficulty of achieving that result should not be underestimated.

In cases of market-based monitoring, much less seems to be required of prudential supervisors than they are required to do. Market-based disclosures would not, in principle, contain the detailed information about the details of a bank’s operations that traditional prudential disclosures contain. But bank regulators would have the ability, post-disclosure, to delve into the granularity missing from such disclosures much more easily. For transmission to the relevant monitor, Bartlett suggests that disclosures adapted for easier credit modeling could be crafted.
middle-level managers relied on VaR models to evaluate their performance without fully understanding what was missing from the model. To the extent that such information or expertise problems are surmountable or equally experienced by bank managers, debt compensation proposals are unlikely to improve significantly higher.

2. Regulator Agency Costs

The failure of prudential monitoring is apt to be a story of the lack of monitoring will. Henderson and Tung make this point explicitly in their recent work. That recognition led them to suggest tinkering with regulator pay to encourage more forceful bank monitoring. Alternatively, one could imagine relaxing the civil service protections afforded to bank regulators to give them greater career-oriented incentives to intervene. More to the point, comparing direct regulation (prudential monitoring) and indirect regulation (debt compensation) turns out to be a difficult empirical question reducible to the respective discounts imposed on the former for regulator agency costs and the latter for bank managers’ insensitivity to pay structure. This question might be less thorny, however. If regulator agency costs would be roughly equivalent in a debt compensation regime, it ceases to be preferable to prudential monitoring on any count as even weak concerns about debt compensation’s potential to disrupt the compensation status quo would tend to dominate. That is, debt compensation proposals are unconvincing unless they are at least better at dealing with regulator agency costs than traditional prudential monitoring.

B. Regulator Agency Costs and Debt Compensation

Other than Jeffrey Gordon’s proposal, which suggests that shareholders might voluntarily adopt risk-reducing compensation structures, all of the other debt compensation proposals heretofore discussed implicitly or explicitly rely on regulatory intervention to disrupt a default. The most straightforward version of this view is that the most disagreeable version of debt compensation proposals are unconvincing unless they are at least better at dealing with regulator agency costs than traditional prudential monitoring and economic incentives under the latter for bank managers to use more sophisticated techniques to manipulate the risk of their bank.

137. Id. at 461-64.
138. See generally Henderson & Tung, supra note 13.
139. Id. at 461-64.
140. The debt compensation proposals are unlikely to improve significantly higher

2. Regulator Agency Costs

dept compensation proposals are unconvincing unless they are at least better at dealing with regulator agency costs than traditional prudential monitoring and economic incentives under the latter for bank managers to use more sophisticated techniques to manipulate the risk of their bank.

141. Alternatively, the equation might be solved by a reduction in regulator agency costs that appear.

143. E.g., Bebchuk & Spamann, supra note 4, at 278-79; Tung, supra note 4, at 1247.
regulatory intervention might involve direct involvement of regulators in structuring bank manager pay packages as seen post-crisis in the work of the Pay Czar. A more limited version would, for example, call for softer third-party intervention by altering deposit insurance premiums to account for more or less risk-friendly pay structures. Obviously, a number of approaches that fall between these poles are available. In all cases, however, regulatory action will likely be required to set up a scheme for evaluating and enforcing pay norms.

The debt compensation proposals leave largely unaddressed this question: Why should we expect regulators to be more aggressive in forcing risk-reducing pay practices onto bank managers than they would be in their traditional role of monitoring bank risk-taking? There is at least some reason to think that the problem of regulatory forbearance and/or capture might be more acute in the context of pay-setting than in other discretionary regulatory decisions. Stories abound of extraordinary industry pushback against regulatory incursions into pay-setting. Generally, regulators have been loath to force firms to compensate executives in particular ways or at particular levels. Moreover, at the time when debt compensation approaches would have to be adopted, regulators might have little reason to think that any particular bank is actually taking on high levels of risk. Faced with no emergency to focus their

attention, regulators might reasonably be expected to be more lax in their oversight of bank behavior.\textsuperscript{149} The case that regulation by pay might be less susceptible to regulator agency costs is likely to depend instead on the specificity and rigidity of the pay regulation ultimately adopted. That is, the magnitude of any regulator agency cost problem is in significant part a function of the discretion left to the regulators when they mandate pay.\textsuperscript{150} As implementation of any particular debt compensation becomes more complicated, regulatory discretion must increase. That increase, in turn, will permit regulator agency costs to multiply, reducing any benefits achieved by the debt compensation proposals and permitting the same pathologies observed in the prudential monitoring context.

What might the debt compensation proposals look like in practice? Proponents are split on the question of ex ante specificity. Tung would require little: “Because of each bank’s unique situation and the fine judgments required to optimize compensation arrangements, strict regulatory mandates seem inadvisable. Generalized mandates are likely to offer a poor fit for many banks, and mandates may be

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  \item enforced only if there is an audit after the fact, which may be too late to prevent the harm.
  \item ineffective because of the different ways in which banks structure their compensation arrangements.
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the financial literature that optimal compensation contracts will vary.153

Others appear more open to simplifying matters. Bebchuk and Spamann’s proposal, along with Krawcheck’s, seem to point in this direction, although it is less clear that they do so in order to minimize regulator agency costs.157,158

The noteworthy characteristic of such an approach is that it is likely to lower regulatory agency costs. There would be a “rule” to be applied mechanically. This “rule” would be a compensation "slice of the capital structure" approach, not as a slice of the firm’s capital structure, but rather a slice of the firm’s capital structure, mimicking the firm’s capital structure. The benefit is that it would be easier to administer, and the costs would likely be lower.

Bebchuk and Spamann’s proposal requires that the basket of securities in the manager’s pay structure mimic the firm’s capital structure. In a preliminary version of their article, Bebchuk and Spamann seemed to concede, pace Tung, that “optimal setting of executive pay arrangements requires substantial information,” which makes most sense if the basket approach they advocate permits something more complicated than mere replication of the firm’s capital structure. Nevertheless, the few responses to Bebchuk and Spamann’s proposal that have been written have characterized it as a “slice of the capital structure” approach, and they at least appear not to have disavowed that characterization.

Krawcheck’s advocacy of this approach is more explicit. Krawcheck, supra note 4, at 109 (“Any shift in this direction would have an impact, but the most critical and troublesome regulations are related to bank holding companies’ equity capital requirements.”).
PAY AS RISK REGULATION

room for shirking by regulators and would seem to make forbearance harder to come by for banks and managers. It is true that there might be complicated questions about characterizing or replicating certain securities in the capital structure, and that the rigidity of the rule may encourage bank managers to opt for inefficient structures, but with some trial and error, mimicry may be readily achievable. What we gain by thinking in these terms is a plausible case in which regulating via pay dominates traditional bank monitoring by significantly reducing regulator agency costs.

Two concerns immediately arise, however. First, as already noted, one-size-fits-all guidelines will often be imperfectly calibrated in any given case. The question of discretion trades off efficient tailoring of compensation contracts against regulator agency costs. Taking the Bebchuk, Spamann, and Krawcheck approach, for example, it is hard to imagine how a simple "pay by the slice" approach would appropriately structure optimal risk-taking incentives at many firms, even assuming a high level of sensitivity on the part of bank managers. Further, making a capital-structure-mimicking approach too justice-conscious, making a capital-structure-mimicking approach too justice-conscious, would make it impossible to tailor the pay structure to the needs of each individual manager. Moreover, managers' background levels of wealth, career horizons, and risk aversion are bound to be heterogeneous. Even if we are willing to settle for rough justice, it is not clear that traditional prudential requirements should be abandoned in favor of a more prescriptive approach. For example, if we settle for rough justice regarding capital adequacy and accept that the rules might be suboptimal as applied to many firms, some of the arguments against enhanced requirements under Basel III begin to fall.
effectiveness on the part of regulatory pay incentives. See infra notes 176-77 and accompanying text.

117. Krawcheck does not and, as will be discussed later, appears to assume significant
the effect of the Volcker Rule.

118. See below for a discussion of the particular capital levies and their relationship to liquidity in the

119. FLORIDA STATE UNIVERSITY LAW REVIEW

120. See infra note 4.

121. \[298, 299 (2008) \] ("[C]apital adequacy regulation can impose an important
cost because it reduces the ability of banks to create liquidity by accepting deposits.")

122. See id.

123. See, e.g., Krawiec, supra note 25, at 67-68 ("Affected industry members contend
that zealous enforcement of the proprietary trading ban, which could restrict other bank
principal positions, would impair commerce, siphon off trades, and other beneficial
functions performed by many banking entities. . . . Balancing these competing concerns
and maintaining an appropriate level of bank capital is a complex and multifaceted
problem."").

124. Tung, supra note 4, at 1250-51.

125. See infra note 177.

126. For more on the criticism of capital requirement rigidity, see Admati et al., supra

127. Nevertheless, a proponent is entitled to point out that any incentive shifts occa-

128. point near the end of their proposals.

129. Tung, supra note 4, along with Bebchuk and Spamann, makes this very

130. In the Volcker Rule.

131. Nevertheless, as discussed in Part III, the arguments about debt compensation’s

132. It is at this point that the arguments from the direct regulation, forgoing any incentive shifts occasioned by compensation’s impact on pay, which is where bank

133. The other pricing mechanisms, my view remain important.

134. Such a rule becomes more limiting.

135. So to prevent potential regulatory capture, the arguments against

136. Similarly, if capital requirements across firms would become less important as

137. To be sure, questions would remain concerning the effect of
A. Compensation Costs

This modest formulation is actually more supportable in the case of shifting toward debt compensation than it was when pay shifted toward levels of equity beginning in the 1980s. Absent incentive effects, it is well-understood that substituting fixed pay for equity is an inefficient way to compensate managers, primarily because the riskiness of equity pay inclines managers to require a premium beyond their reservation wage in order to bear the new risk. Moreover, there is a well-developed view that substituting debt for equity is a cheaper solution because debt is less risky than equity, which reduces the premium required. Moreover, in a world of static total compensation, the increased debt payments come at the expense of equity pay rather than salary or perquisites, insidiously shifting the burden of increased risk upon managers. Accordingly, tinkering with compensation in this way should not cause compensation costs at banks to explode. However, two caveats to this happy state of affairs are in order, however. First, this assumes that a shift to increase the proportion of inside debt is not effected by simply adding incremental debt onto existing pay packages, as might be the case under circumstances of significant managerial power. Second, this also assumes that, even in a world of static total compensation, increased debt payments come at the expense of equity pay rather than perquisites, insidiously shifting the burden of increased risk upon managers. Accordingly, tinkering with compensation in this way should not cause compensation costs at banks to explode.

172 See supra note 4 and accompanying text.
B. Perceived Substitution Effects

In any event, the move to debt compensation might cause other problems. For instance, such a shift could lead to a concomitant relaxation of prudential monitoring by regulators. If increased debt compensation would reduce regulatory vigilance in other ways, there could be a social loss in the form of the failure to regulate the con- 

B. Perceived Substitution Effects

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When bank regulators ensure or at least verify that compensation structures do not provide strong incentives to take risks, banks can be given more discretion to make choices. We do not believe that regulating executives’ incentives alone would be sufficient to ensure the soundness of financial institutions and would not obviate the need for substantial direct regulation of banks’ actions.

But, we do believe that, with experience, banking regulators may sometimes be able to reduce traditional regulation of the menu of actions when bank executives’ incentives are more in line with the regulation’s goals.

The qualifications in that prescription—regulators’ ability to “ensure” or “verify” the impact of compensation structures and an incremental approach based on “experience” going forward—are surely appropriate. However, whether they offer much comfort is another question. Note that the relative weights to place on regulation by pay and more traditional tools are to be determined by regulators, the same regulators whose poor performance is driving the regulation-via-pay project in the first place. If regulatory agency costs are significant, it is hard to imagine why anyone should expect regulators to strike the optimal balance among these various tools. If their natural inclination tends to toward forbearance as the premise underlying the project suggests, new levels of debt compensation might grease the skids toward that result.

What is more, evaluation of compensation incentive-shifting ability is notoriously difficult. Many studies have purported to demonstrate a link between compensation-based incentives and firm performance. Why is it so notoriously difficult? Why many studies have purported to demonstrate a link between compensation-based incentives and firm performance?

When is more evaluation of compensation incentive-shifting ability possible? When is more evaluation of compensation incentive-shifting ability possible?

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formance. Yet the majority of those studies covered earlier periods when the vigorous alternative mechanisms described above were not
performing as well.183 See, e.g., Carola Frydman & Dirk Jenter, CEO Compensation 23:25 (Rock Ctr. for Corp.
studies).

More importantly, it is near impossible to infer causation in those studies. Compensation structure is as likely to be an endogenous output, given a firm's characteris-
tics, as it is to be an exogenous input.184 Even those who otherwise approve of a robust incentive-pay
regime sound a cautious note with regard to the evidence of its actual effects.185 However, despite all of this qualification, there is no doubt that the vast
majority of law and finance scholars, to say nothing of other corporate governance activists, subscribe to some version of the view that compensation structure materially
moves firm performance. It seems safe to presume that a similar faith is likely to be overwhelmed by

VI. CONCLUSION

There is great reason to expect little from adding debt incentives to the pay packages of bank managers and little reason to expect
direct tension with the reformers' goals. Adverting to regulation by pay, then, is apt to do more than serve

183. See Carola Frydman & Dirk Jenter, CEO Compensation 23:25 (Rock Ctr. for Corp.
studies).

184. Id. at 23 (studies could indicate "compensation affects performance, because firm
performance affects pay, or because an unobserved firm or CEO characteristic affects both
performance and that CEO compensation was endogenous, while pay was not correlated with
performance).

185. See Murphy, supra note 37, at 2539 ("Unfortunately, although there is a plethora
of evidence on dysfunctional consequences of poorly designed pay programs, there is
surprisingly little direct evidence that higher pay-performance sensitivities lead to higher
stock-price performance."); Core et al., supra note 9, at 34 (describing conflicting studies
regarding the relationship between equity compensation and firm performance while not-
ning "[t]here is presently no theoretical or empirical consensus on how stock options and
managerial equity ownership affect firm performance").

182. See Carola Frydman & Dirk Jenter, CEO Compensation 23:25 (Rock Ctr. for Corp.
studies).
would not need bank regulation via pay in the first place. The
more vigilant, that might be a risk worth taking, but if they were, we
standing of the downsides of excessive bank risk. If regulators were
regularly able to more thoroughly define our hard-earned under-
regulatory concern is more troubling given our current state and the
early in their performance. Getting pay’s effects wrong in the bank
increase in income inequality across society without an equivalent
excessive compensation costs at individual firms and perhaps some
measuring incentive pay’s effects before, the downside was simply
traditional bank regulation. To the extent errors have been made in
beneath in capital requirements or bank monitors’ wanes, it is natural
to demand in capital requirements or bank monitors’ wanes, it is natural
to search for alternatives. But there is a real chance that adding debt
approvingly ineffective prudential monitoring mechanisms. As con-
 Still, there is something to be said for experimenting in light of
likely to be more persuasive than others. Proposed at the recent proposals, some more persuasive than others.
more, a range of other criticisms might be reasonably
monitoring appears to be one that is bound to be suboptimal at many
best version of pay linking vis-a-vis prudential prudential bank
ever middling career concerns on the part of the managers. And, the

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