Pay as Risk Regulation

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https://ir.law.fsu.edu/lr/vol41/iss3/2

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ABSTRACT

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 trading1 and enhanced capital requirements2—would alter traditional prudential monitoring mechanisms, resulting in increased direct regulation of banks.3 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.4 The basic notion underlying these proposals is that introducing more debt into bank managers' portfolios would make those managers more sensitive to their firms' insolvency risks and therefore less likely to fall prey to the moral hazard unique to banks.

These proposals have been roundly applauded in the press5 and appear to have gained some purchase.


3. Regulatory responses to excessive risk-taking are not limited to banks, as narrowly understood. For instance, the Dodd-Frank Act permits designation of non-bank entities as systemically important financial institutions that would subject such entities to prudential regulation traditionally reserved for banks. Dodd-Frank Act, Pub. L. No. 111-203, § 113, 124 Stat. 1376, 1398 (2010) (codified at 12 U.S.C. § 5323 (2012)). While there are important differences, this Article groups banks and SIFIs together. This is consistent with the approach taken in the proposals that are the subject of this extended critique.


5. See infra notes 61-62 and accompanying text.
Among bank regulators and even bankers themselves, this move to regulate bank risk-taking through altering pay design is hailed among bankers and even bankers themselves. 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 higher among bank executives, few have examined the empirical evidence on executive compensation and firm performance.

6. See infra notes 47-57 and accompanying text.

7. See infra Part II for more on those complements as well as studies analyzing the effect of inside debt on firm risk-taking.

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

9. See infra Part III, for more on those empirics as well as studies analyzing the effect of inside debt on firm risk-taking.

10. See infra notes 117-21 and accompanying text.
of regulator ignorance or bank obfuscation. 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.

Part II introduces the oft-noted problem of moral hazard in bank risk-taking. 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 those from a debt compensation proposal. Thus, there is reason to worry that the array of regulatory tools available, if there are incremental in the incentives of corporate managers, banks will be at least unattractive prior to adoption. The analytical structure of debt compensation as a solution to the moral hazard at the expense of debt compensation is efficient, but debt compensation is inefficient at deterring risk. The effectiveness of debt compensation depends on the point of risk-taking. So, in order to be preferable with respect to regulatory discretion over the implementation of debt compensation, however, debt compensation proposals would have to limit the regulator's power to design the contract. Debt compensation, a debt compensation proposal, would have to limit future regulatory discretion over the implementation of debt compensation. However, the effectiveness of debt compensation over the implementation of a debt compensation proposal would have to limit future regulatory discretion over the implementation of a debt compensation proposal. However, debt compensation proposals specifically make this point about substituting indirect regulation for direct regulation. Even more troubling is the idea that pay substitutes for regulation. However, there is reason to worry that the array of regulatory tools available, if there are incremental in the incentives of corporate managers, banks will be at least unattractive prior to adoption. The analytical structure of debt compensation as a solution to the moral hazard at the expense of debt compensation is efficient, but debt compensation is inefficient at deterring risk. The effectiveness of debt compensation depends on the point of risk-taking. So, in order to be preferable with respect to regulatory discretion over the implementation of a debt compensation proposal, would have to limit future regulatory discretion over the implementation of a debt compensation proposal. However, debt compensation proposals specifically make this point about substituting indirect regulation for direct regulation. Even more troubling is the idea that pay substitutes for regulation. However, there is reason to worry that the array of regulatory tools available, if there are incremental in the incentives of corporate managers, banks will be at least unattractive prior to adoption.
II. THE DEBT COMPENSATION PROPOSALS

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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 already less highly levered than non-banks, lowering the applicable risk baseline. More importantly, non-banks are generally subject to cross-monitoring by creditors that often constrain risk-taking. Banks have creditors too—for instance, depositors at commercial banks—but bank creditors often have little reason to incur monitoring costs because the bank debts 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 role of depowering cross-monitoring. In contrast, open-end fund managers—no banks—enjoy considerable discretion in choosing the assets they invest in, and banks were generally subject to cross-monitoring by creditors that often constrain risk-taking.

20. See e.g. Odereweeds supra note 6 at 165 ("[V]alues embedded in today's risk-based capital requirements, though bringing a form of discipline, have yet to be embedded in the bank's culture and processes for risk management.")
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


24. Alces & Galle, supra note 6, at 53-54 (stating that a contributing factor to the financial crisis was the alignment of managers and shareholders through incentive-based pay); Tung, supra note 4, at 1222-23 (stating that prior to the financial crisis, bankers' incentives were similar to "the standard shareholder-wealth-maximizing approach to compensation used in unregulated industries" and bank regulators failed to guard against risk taking); David I. Walker, The Challenge of Improving the Long-Term Focus of Executive Pay, 51 B.C. L. REV. 435, 436 (2010) ("After years of much rhetoric but little action, it appears that the federal government may be poised to take meaningful steps to increase executive compensation regulation.").


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 prudential monitoring traditionally performed by regulators. Alternatively, an enhanced disclosure regime might permit market participants to more effectively price bank risk. These 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. Unlike the present situation with banks, governance activists' primary concern was that entrenched managers, having significant firm-specific human capital invested in their jobs, took too little risk, causing valuable projects to be avoided and firm valuations to suffer. Performance-based pay serves as a bonding device in situations where it is relatively difficult to observe

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managers' behavior, where shareholders do not have the ability or interest to monitor ex ante, or where executive decisions affect firm percentage returns rather than dollar returns. Determining the effect on firm behavior attributable to this sort of compensation tinkering has proven to be an econometrically difficult trick, and there are long-running debates over whether observed compensation structures reflect arm's-length bargaining or managerial power. Nevertheless, it is popularly believed that the introduction of heavy levels of performance-based pay caused increased risk-taking economy-wide over recent decades.

In the light of that success, some commentators have 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 managers and/or longer holding periods for equity stakes. 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.
44. See, e.g., Lucian A. Bebchuk & Jesse M. Fried, Paying for Long-Term Performance, 158 U. PA. L. REV. 1915 (2010); Sanjai Bhagat & Roberta Romano, Reforming Executive Compensation, in 3 HANDBOOK OF LABOR ECONOMICS 2485 (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.")
45. See, e.g., Kenneth J. Arrow, Executive Compensation (1979) (introducing the "information economics" framework).
46. For more on the question of observability, see Bengt Holmström, Moral Hazard and Observability, 10 BELL J. ECON. 74 (1979) (introducing his "informativeness" principle).
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 banks already hold some sort of inside debt, especially those in jurisdictions subject to enhanced equity pay in the event of default.

The Proposals

At 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, 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.

The Proposals described below, however, go beyond these existing practices and call for the inclusion of actual or phantom debt securities. The interest that led to the push for enhanced equity pay in the event of default is subject to much debate, as is exactly the sort of debt-like streams are subject to the enhanced equity pay in the event of default. Many are entitled to enhanced equity pay in the event of default. Many are entitled to enhanced equity pay in the event of default.

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a partner, the bank's equity securities. Id., ¶ 4. Thus, in order to align the incentives of banker's pay structure with the market, the bank's equity securities should be included in the capital structure to inhibit excessive risk-taking. See supra, ¶ 4.

48. Tung, supra note 4, at 1231-34. Additionally, market discipline might be more likely for bank-level subordinated debt because of the greater likelihood for periodic issuance of additional debt securities. Id.

49. Id. at 1248.

50. Id. For banks, the designer would consider leverage, capital structure, investment opportunities, ownership structure, default risk, and certain effects of the relevant bank holding company. Id. at 1248 & n.210 (collecting authorities). For managers, the designer would consider their portfolios, including existing inside debt (generally pensions and deferred compensation). Id. at 1248.

51. This is likely a strong point in favor of Bebchuk & Spamann's approach. See infra Part IV.B.

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 approach. See infra Part IV.B.

In a similar vein, Will has recently suggested adding a debt-like pay element for bankers. Gordon, supra note 4, at 2-4. The problem of excessive risk-taking at banks, therefore, is not so much the traditional equity/debt divide writ large as much as it is a reflection of particular incentives faced by particular managers who are not diversified, having much of their wealth invested in their banks. The problem of excessive risk-taking at banks' shareholders is not so much the traditional equity/debt divide as much as it is a reflection of particular incentives faced by particular managers who are not diversified, having much of their wealth invested in their banks.
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.60

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.61 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."62 Though the details are not spelled out, her approach is reminiscent of Bebchuk and Spamann's pay-by-the-slice approach.63 Coming from a former "insider," Krawcheck's article has been celebrated as something of a breakthrough in bank governance.64 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.65

57. Id. at 11.
58. Tung's proposal, modest as it is regarding the appropriate mix of debt and equity at any given firm, could be structured so as to be debt-heavy and thus similar to Gordon's proposal, though the magnitude of the haircut in implementing Gordon's proposal would determine if even a debt-heavy version of Tung's approach could match the risk-aversion-inducing effects of Gordon's. See id. at 12 (noting that the proposal solves the "Fuld problem," named for Richard Fuld, former CEO of Lehman Brothers).
60. Krawcheck, supra note 4, at 109.
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's subordinated debentures and common stock, at a four-to-one ratio. Although the Pay Czar’s mandate under the Dodd-Frank Act to regulate compensation at banks and systemically important financial institutions has since faded from memory, the Financial Stability Oversight Council retains the mandate to regulate compensation at banks and systemically important financial institutions to reduce excessive risk. In a 2011 proposed rule, U.S. regulators went so far as to cite approvingly academic work suggesting that inside debt might mitigate risk-taking.

2. Earlier Critiques

The response to these debt compensation proposals in law and finance journals has been relatively muted. Some of the criticism simply reflects internecine disagreements, which are not fatal to the general project. As noted, Tung criticized the pay-by-the-slice approach for its assumption that parity between a bank’s capital structure and an executive’s portfolio is the optimal solution for risk purposes. Such problems, though, are relatively fixable through tweaking—in an executive’s portfolio is the optimal solution for risk purposes. However, the debt compensation approaches and systemically important financial institutions have since faded from memory, the Financial Stability Oversight Council remains the mandated under the Dodd-Frank Act to regulate compensation at banks and systemically important financial institutions. AIG’s Long-term Performance Units (LTPUs) were introduced in response to the pay-by-the-slice approach criticized by Tung. However, the LTPUs were to be paid in cash on a future date at a value keyed off of both AIG’s subordinated debentures and common stock, at a four-to-one ratio. Although the Pay Czar’s mandate under the Dodd-Frank Act to regulate compensation at banks and systemically important financial institutions has since faded from memory, the Financial Stability Oversight Council remains the mandated under the Dodd-Frank Act to regulate compensation at banks and systemically important financial institutions to reduce excessive risk. In a 2011 proposed rule, U.S. regulators went so far as to cite approvingly academic work suggesting that inside debt might mitigate risk-taking.
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. 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.73 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.74 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.75

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 capital in a banker's pay package 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, to the extent that a pay-by-the-slice approach will not require an interpretation of the firm's capital structure, it is not obvious why rules of thumb could not be developed. Of course, such rules might rest on an interpretation of the current state of implicit government "too-big-to-fail" guaranties. However, 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.76
serve as guideposts to inefficient restructurings, 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. Tung provides evidence that at least the market for subordinated bank debt functions reasonably well. Finally, Gordon himself offers something of a solution to any insensitivity to bank credit risk—commit to excluding debt compensation from any future bailouts. 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 proponents. 

Alces and Galle offer a more sustained critique of debt compensation. Their argument is complex but essentially makes three independent claims. 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. It would be simpler, they say, to just reduce this type of pay rather than add a countervailing, risk-reducing incentive through bank debt. Debt compensation's proponents are entitled to respond, however, that there is surprisingly little evidence that the pay-by-the-slice approach lends itself to countervailing risk reduction. Debt compensation is an easy solution to wealth transfers from creditors to managers; in some cases, it could even provide a risk-reducing measure. Second, Alces and Galle argue that debt compensation creates cross-monitoring costs for creditors beyond the class of creditors whose securities are paid in management's compensation packages. Alces and Galle make other points as well. They argue that debt compensation makes these more sustained critique of debt compensation.
Evidence that equity-laden compensation structures actually produced the sort of risk-taking seen at banks prior to the crisis. Risk-taking appears to have been driven by bank governance features, including, but not limited to, equity pay, meaning that simply removing equity pay might not solve the problem of moral hazard. In a world of multiple incentives to take high risk, adding debt compensation might still serve as a counterbalance, depending upon the relative strength of those prior incentives and the new debt.

The most prominent study concerning the matter showed no significant association


86. See id.

87. Id. at 69.

88. Id. at 69-70.

89. See id. ("In order to have the effects its proponents recommend, inside debt compensation cannot be either too senior or too junior; rather, it must be ‘just right.’"); see also Edmans & Liu, supra note 4, at 77-78, 89 (noting that under certain conditions, the optimal debt-equity ratio may have an “equity bias” or a “debt bias,” but a “debt bias is sometimes optimal").
formed by the interests of that hypothetical creditor for all intents and purposes.

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 linked to value-maximizing choices.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 from the perspective of the proposals surveyed that new debt instruments of executive compensation are compatible with greater incentives to physiologically consumers of financial products with greater incentives to understand the consequences of their behavior. Finally, it may be enough from the perspective of the proposals surveyed that new debt incentives simply move the needle in the right direction for risk-taking.

Bank managers face pressures and consequent incentives in an enormous number of domains, making compensation structure just one of a multitude of potential governance levers. To the extent those other lever pressures run opposite of new compensation incentives, the latter offers no substitute for the effectiveness of the former. Let us consider an extreme example. For the sake of argument, let us consider a hypothetical world in which debt compensation is completely ineffective at motivating risk-taking.

As of the early 2014, 92, 93, and 94, there is considerable debate about the effectiveness of debt compensation in motivating risk-taking.95...
Within the corporate governance framework, compensation has been viewed as a mechanism to align managers' interests with shareholders'. However, the effectiveness of compensation in achieving this alignment is limited by several factors. First, compensation structures may not accurately reflect the risk-taking behavior of managers. For instance, while higher equity pay is intended to shift managers' incentives towards long-term performance, this may not always occur in practice. The complexity of financial markets and the diversity of stakeholders can make it difficult to align incentives effectively.

Moreover, the effectiveness of compensation schemes may be undermined by industry-specific factors. For example, in the banking industry, the pressure to maximize short-term returns is particularly strong. This is due to the high turnover of bank CEOs and the competitive nature of the industry. As a result, managers may be more inclined to pursue strategies that yield immediate results, even if they are not in the best long-term interest of the bank.

In addition, the role of institutional investors has evolved significantly over the past decade. These investors, including hedge funds and pension funds, have become more active in shareholder activism. They demand higher levels of accountability and transparency from companies, which can put pressure on managers to focus on short-term performance.

Given these challenges, it is clear that compensation schemes alone cannot solve the problem of bank risk-taking. Other mechanisms, such as enhanced board oversight and the use of financial incentives, may also be necessary. Nevertheless, it is important to recognize that compensation is an important tool in the corporate governance toolbox, but it must be used in conjunction with other strategies to achieve effective risk management.
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. The increased turnover is not randomly distributed, as getting fired is becoming more and more closely tied to share price performance. The correlation between poor performance and turnover is particularly strong in cases where firm performance falters relative to its peers.
Thus the threat of dismissal exists for all CEOs at firms where below-median industry-adjusted performance is a real possibility.107

While there may remain a threshold level of underperformance necessary to trigger labor market discipline,108 it is harder to imagine CEOs with career concerns exploiting any slack.109

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 firm-to-firm comparisons a function of more objective measures for external monitors.110 Second, the homogeneous structure of a financial institution with respect to regulation and oversight may allow for greater scrutiny into the caliber of well-trained and experienced bank managers. The discipline, efficiency, and precision of the labor market should be expected to reflect these characteristics.

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 the one hand and compensation incentives tilted heavily toward the debt instruments will face two conflicting imperatives—reduce risk and increase the value of the debt instruments. When Citigroup's Chuck Prince noted the need to continue "dancing until the music stopped"—in other words, accumulating risk during the pre-crisis bubble—this need to continue "dancing" until the music stopped also may have increased risk and saved their jobs. When Citigroup's Chuck Prince noted the need to continue "dancing" until the music stopped also may have increased risk and saved their jobs, both the value of the debt instrument and the incentive to engage in higher risk-taking will increase. Hence managers will be incentivized to maintain the current level of risk, which may be more than that which price takers would have at the margin.

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Thus the threat of dismissal exists for all CEOs at firms where below-median industry-adjusted performance is a real possibility.107

107. See Nakamoto & Wighton, supra note 15.

108. See, e.g., Jenter & Kanaan, supra note 105, at 3 (citing research to the effect that CEO quality must fall below a threshold before a board will dismiss a manager). There may be other factors entering into the calculus as well. Coates and Kraakman, for example, demonstrate that CEO tenure has something of a term structure with respect to resignations and replacements. According to this model, the CEOs are relatively insulated for the first three to four years of their tenure, followed by a period of increased turnover culminating in a period of lower turnover rates for CEOs with low tenure and performance VA scores. The lower rates of turnover for CEOs with low tenure and performance scores reflect the increasing importance of external monitoring and external shareholders during the CEO's tenure.


111. See id. for more on this data and its implications. See Lund & Polsky, supra note 10, at 105.
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 reasonably powerful incentives. 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 outsize levels of risk for a chance at substantially increasing share price. When inside debt is used as an incentive for risk-taking, it is less effective at achieving this objective than the case for equity compensation due to the different portfolio incentives created by adding options versus adding debt.
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 otherwise be. Informational asymmetries, commonly named as the downfall of prudential monitoring, may be somewhat surmountable. Regulatory agency costs—the lack of monitoring will on the part of individual regulators—are real and problematic in the context of prudential bank monitoring. However, those costs are often minimal for regulators, including a debt compensation regime.

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). Where marginal monitoring costs are low, performance-based pay is less necessary. For instance, in the case of performance-based pay is less necessary. For instance, in the case of firms in bankruptcy, creditor groups are already committed to invest.

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Pay As Risk Regulation

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

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122. See, e.g., id. at 1021-26.
123. Id.
124. See Adam J. Levitin, Response, The Problematic Case for Incentive Compensation in
Bankruptcy, 156 U. PA. L. REV. PENNUMBRA 88, 94-96 (2007); Robert K. Rasmusen, Response,
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 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 further level the playing field between managers and regulators.

Even taking some level of regulator ignorance for granted, bonding managers to certain risk levels through debt compensation is only useful to the extent that managers are in a better position to understand the risk. If regulatory ignorance is due to, say, the complexity of modern financial institutions, then relying on bank managers to self-discipline will not help matters if those managers are equally ignorant. Some scholars have suggested that much of the excessive risk-taking that occurred at banks in the run-up to the financial crisis was caused by secondary managers at banks who were able to shape their decisions to take advantage of flaws in the Value at Risk (“VaR”) credit model. The supervisors of these bank managers were usually not able to understand the risk levels at which the bank managers were operating, and their supervision was inadequate to prevent the risk-taking from happening. Moreover, as discussed above, there is no reason to believe that new disclosure mandates could not be produced to further level the playing field between managers and regulators.

In cases of market monitoring by regulators, much less concern exists in cases of monitoring by regulators than they are in cases of market monitoring. Market-based monitoring would not result from informationally complete contracts between the bank and its regulators, because the information that the regulators would have is restricted to the bank’s own internal operations. Market-based monitoring would have the ability, post-disclosure, to regulate the bank managers via their positions in the market. The problem, as Bartlett points out, is that market-based monitoring is not leveraged to external market-based monitoring of bank risk, suggesting that disclosures adapted for easier credit modeling could be crafted for transmission to the relevant monitor.
middle-level managers relied on VaR models to evaluate their performance without fully understanding what was missing from the model.\(^{137}\) 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-compliance.

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.\(^ {138}\) That recognition led them to suggest tinkering with regulator pay to encourage more forceful bank monitoring.\(^ {139}\) 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.\(^ {140}\) This question might be less thorny than it immediately appears, 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 schemes turn out to be equivalent to the respective discounts.\(^ {141}\) 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 opt for risk-reducing compensation structures,\(^ {142}\) all of the other debt compensation proposals heretofore discussed implicitly or explicitly rely on regulatory intervention to disrupt the compensation status quo. The most dramatic version of this idea is to require that supervisors be paid based on the firm's risk-taking behavior. In practice, this means that supervisors would be subject to performance-related pay (PRP) rather than fixed salaries. This approach is appealing for several reasons. First, it aligns the interests of supervisors with those of shareholders by linking their compensation to the firm's performance. Second, it incentivizes supervisors to take a longer-term perspective, as they are rewarded for improving the firm's risk profile. Third, it provides an incentive for supervisors to monitor the firm's risk-taking behavior more closely, which can help prevent catastrophic losses in the event of a rare negative event.

137. Id.
at 461-64.
138. See generally Henderson & Tung, supra note 13.
139. Id.
140. The debt compensation proposals are unlikely to impose significantly higher-compliance.
141. Alternatively, the equation might be solved by a reduction in regulator agency costs. See, e.g., Henderson & Tung, supra note 13, at 1031-41.
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 compensation setting. 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 on bank risk-taking, regulators might be even less willing to intervene.

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 \textit{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


For Tung, a range of bank-specific and manager-specific factors will cause optimal packages to diverge across cases. This tracks the point well-understood in the finance literature that optimal compensation contracts will vary.

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. Bebchuk and Spamann's proposal is far more detailed and is worth examining further. As noted, they would replace the currently equity-heavy banker pay structure with one that...

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Footnotes:

151. Tung, supra note 4, at 1249; cf. Edmans & Liu, supra note 4, at 92 ("[T]he manager's debt-to-equity ratio is increasing in his effect on the liquidation value and the probability of bankruptcy, and decreasing in growth opportunities.").

152. Tung, supra note 4, at 1248. Tung suggests the following factors from the inside debt literature: leverage, capital structure, corporate structure, investment opportunities, ownership structure, default risk, and managers' personal portfolio characteristics. Id. at 1248 n.210 (collecting authorities).


References:

154. Bebchuk & Spamann, supra note 4, at 283-85. The authors recognize the distorting effect of implicit government guaranties on bank securities prices and suggest accounting for potential bailouts by subtracting their value from the firm value referent. See id. at 284.

155. See supra note 47 and accompanying text.


157. Alces & Galle, supra note 6, at 64; Tung, supra note 4, at 1244; Gordon, supra note 4, at 9.

158. 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 logical end point would be a compensation problem more akin to the one described in the foregoing discussion.").
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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,159 and that the rigidity of the rule may encourage bank managers to opt for inefficient structures,160 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.161 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 see how the same General Assembly, for example, could be both efficient and mimic the potential incentivizing that raises the question of whether traditional prudential regulation should be entitled to the same generosity. For example, if we are willing to settle for rough justice with regard to 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 fail.

These arguments against enhanced requirements are used. See 36 U.S.C. § 409A (2012) (requiring certain types of nonqualified deferred compensation to be included in gross income).

Further, if we allow regulation by pay through operation of a simple rule notwithstanding these potential inefficiencies, it raises the question of whether traditional prudential regulation should be entitled to the same generosity. For example, if we are willing to 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 fail.

159. Gordon, supra note 4, at 125.

160. Gordon, supra note 4, at 10.

161. See Tung, supra note 4, at 119.

162. Busch, Spamann & Krawcheck, supra note 4, at 1245. (Because bank managers’ individual situations will vary considerably, there is no conceptual basis for assuming a high level of sensitivity on the part of bank managers. The optimal structure of compensation incentives may vary from situation to situation, and the same compensation structure may not be appropriate for every bank).

163. This, of course, leaves aside the possibility that some firms might find that the same structure of compensation incentives would be appropriate, say, for banks deemed similar.

164. For more on the intensely idiosyncratic nature of optimal compensation design, see Lund & Polsky, supra note 6, at 711-15.
effectiveness on the part of regulation. See infra notes 176-77 and accompanying text.

The heterogeneity of optimal capital requirements across firms would become less important as monitoring and compliance costs were discounted. See infra note 176. (However, that heterogeneity may persist somewhat, as some flexibility may remain, at least at first, with respect to the particular mix of regulatory and market-based incentives.)

V. THE DANGER OF REGULATING BY PAY

Nevertheless, a proponent is entitled to point out that any incentive shifts occasioned by compensation tinkering, however weak, would be better than nothing. After all, it is hard to see what harm could result other than a potential enforcement cost due to the ability of banks to create liquidity by accepting deposits. See supra note 72. See also id. See also id. See supra note 72.

165. For more on the criticism of capital requirement rigidity, see Admati et al., supra note 27.


167. See id.

168. See, e.g., Krawiec, supra note 55, at 67-68 ("[A]ffected industry members contend that zealous enforcement of the proprietary trading ban, which could restrict other bank principal positions, would impair customer service, market efficiency, and other beneficial functions performed by many banking entities. . . . Balancing these competing concerns is left to five federal agencies charged with Volcker Rule implementation.") (footnote omitted).

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

170. See infra note 32.

171. Krawcheck does not and, as will be discussed later, appears to assume significant effectiveness on the part of regulation. See infra notes 176-77 and accompanying text.

172. Nevertheless, a proponent is entitled to point out that any incentive shifts occasioned by compensation tinkering, however weak, would be better than nothing. After all, it is hard to see what harm could result other than a potential enforcement cost due to the ability of banks to create liquidity by accepting deposits.

173. See infra note 32.
PAY AS RISK REGULATION

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. Moreoever, there is a well-developed view that equity-heavy packages, particularly when options did not have to be expensed, were perceived by boards as being cheap forms of compensation. Substituting debt for equity, on the other hand, generally lowers the risk borne by managers and should, therefore, lower the premium they require to accept a given pay structure. At the very least, a shift toward greater debt compensation should not entitle bank managers to extract an additional risk premium beyond the one they currently obtain. Moreover, there is likely little confusion in a director's mind regarding debt's effect on a bank's balance sheet. Accordingly, tinkering with compensation in this way should not cause compensation costs at banks to explode.

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, the increased debt payments come at the expense of equity pay rather than salary or perquisites. Inside debt, while less risky than equity, will nevertheless be riskier than debt. While less risky than equity, will nevertheless be riskier than debt, while less risky than equity, will nevertheless be riskier than equity. At the expense of equity pay, rather than salary or perquisites, inside debt substitutes for total compensation. The increase in the proportion of inside debt, however, would result in additional risk premiums on the risk of total compensation. This assumes that equity pay is held constant, which is an unlikely assumption in light of what seems to be a significant shift toward debt compensation.

Substituting debt for equity, on the other hand, generally lowers costs to banks. In this way, shifting toward debt compensation may result in lower compensation costs, and, perhaps, increased transaction costs. See supra note 6 at 71-72. Moreover, the switch to debt compensation may increase transaction costs. See infra note 6 at 71-72. This is because a bank's balance sheet is a well-developed view that equity-heavy packages, particularly when options did not have to be expensed, were perceived by boards as being cheap forms of compensation. Substituting debt for equity, on the other hand, generally lowers costs to banks. In this way, shifting toward debt compensation may result in lower compensation costs, and, perhaps, increased transaction costs. See supra note 6 at 71-72. However, the switch to debt compensation may result in lower compensation costs, and, perhaps, increased transaction costs. See supra note 6 at 71-72.
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 conflict of interest among managers. If increased debt compensation would reduce regulatory vigilance in other ways, there could be a social loss to the extent the shift to debt compensation promised more than it delivered regarding manager behavior as discussed above.

This concern is hardly unique, or deeply novel, as the existing literature on compensation would lead to a conflict of interest among managers. If increased debt compensation would reduce regulatory vigilance in other ways, there could be a social loss to the extent the shift to debt compensation promised more than it delivered regarding manager behavior as discussed above.

Moreover, compensation schemes that use debt as a substitute for prudential monitoring may lead to overcompensation. Krawcheck's proposal is implicitly envisioned as a substitute for prudential monitoring: "So [an enhanced capital requirement] clearly isn't the answer. Boards need simple and commonsense—but powerful—tools to cut through the complexity and push management toward more responsible risk taking." 177 Krawcheck's article is the extreme example of substituting regulation by pay in place of prudential monitoring, but the idea finds its way into even more sober debt compensation proposals. Bebchuk, Spamann, and Tung are careful not to eschew traditional monitoring mechanisms. 178 Nevertheless, even they suggest that pay regulation might partially substitute for prudential monitoring. 179 For example, Bebchuk and Spamann suggest: 179

176. See Krawcheck, supra note 4, at 108 ("The main tool with which boards struggle to assess the real capital state of their banks is the capital ratio. The logic is that the higher the capital ratio—the more money set aside against potential losses—the lower the risk. This is simple enough in theory. But in practice, it's not so clear what the right amount of capital is in practice. It's not clear what the right amount of capital is in practice. It's not clear what the right amount of capital is in practice. It's not clear what the right amount of capital is in practice. It's not clear what the right amount of capital is in practice.

177. Id. 178. Bebchuk & Spamann, supra note 4, at 278 ("We highlight the limitations of [prudential monitoring], and show that pay regulation may partially substitute for prudential monitoring.

179. Bebchuk & Spamann, supra note 4, at 253-54 ("Regulating bankers' pay could nicely supplement and reinforce the traditional, direct regulation of banks' activities. In-
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.

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.

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VI. CONCLUSION

There is great reason to expect little from adding debt compensation to bank managers' pay packages, and little reason to expect very much. Any new debt incentives are liable to be overwhelmed by the potential for regulator agency costs in determining the balance between regulation by pay and traditional prudential monitoring. The unhappy experience with evaluating the impact of regulation by pay highlights the difficulty of comparing across different regulatory regimes, a problem that is made more severe by the substantial overlap between regulation by pay and traditional prudential monitoring. Despite all of the above critique, there is still potential for regulation by pay to serve as a backstop to traditional prudential regulation, though only if it is implemented with care and focused on the most pressing risks. A better understanding of how to design and implement regulation by pay would be an important contribution to the literature, but one that is likely to require further research.


[184] Id.

[185] Id. at 23 (studies could indicate “compensation affects performance, because firm performance affects pay, or because an unobserved firm or CEO characteristic affects both variables”); Dennis Wright Michaud & Yunwei Gai, CEO Compensation and Firm Performance 1-2 (Dec. 20, 2009) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1531673 (finding that only cash bonuses were correlated with performance, despite the firm's characteristics).

[186] 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 noting “there is presently no theoretical or empirical consensus on how stock options and managerial equity ownership affect firm performance.”)

would not need bank regulation via pay in the first place. Instead, we see more straightforward, that might be a risk worth taking, but if they were, we stand more of the downsides of excessive bank risk. If regulators were concerned about potential moral hazard given our hard-earned underwriting in their performance, getting pay's effective toughness at many firms has been more than adequate in income inequality across society without an equivalent increase in incentive pay. The recent proposals have been made in traditional bank regulation. To the extent errors have been made in evaluating incentive pay's effective toughness, the downside was simply the real change that adding debt to bankers' pay, even cautiously, will exacerbate these problems without an equivalent increase in capital requirements or bank monitors' wares, it is natural to search for alternatives. But there is a real chance that adding debt would make our hard-earned underwriting ineffective. Prudential monitoring mechanisms, as conflict-of-interest incentives, are in the best version of pay link. The recent proposals, some more persuasive than others, have leveled at the recent proposals, some more persuasive than others. What is more, a range of other criticisms might be reasonably monotonous. What appears to be one that is bound to be sophisticated is many middling career concerns on the part of the managers, and the