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Pay as Risk Regulation

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PAY AS RISK REGULATION

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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 guaranties 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[1] and enhanced capital requirements[2]—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 press[5] and appear to have gained some purchase

1. *See* 12 U.S.C. § 1851 (2012); *see also* Press Release, Board of Governors of the Federal Reserve System, Agencies Issue Final Rules Implementing Volcker Rule (Dec. 10, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm.

2. *See, e.g.*, Peter Conti-Brown, *Elective Shareholder Liability*, 64 STAN. L. REV. 409, 425-28 (2012) (describing the Basel agreements and recent calls for higher capital requirements).

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.

4. *See* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010); Wulf A. Kaal, *Contingent Capital in Executive Compensation*, 69 WASH. & LEE L. REV. 1821 (2012); Sallie Krawcheck, *Four Ways to Fix Banks*, HARV. BUS. REV., June 2012, at 107; Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. 1205 (2011); Jeffrey N. Gordon, *Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay* (Columbia Univ. Sch. of Law, Center for Law & Economic Studies, Working Paper No. 373, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1633906; *see also* PATRICK BOLTON, HAMID MEHRAN & JOEL SHAPIRO, FEDERAL RESERVE BANK OF NEW YORK, STAFF REPORT NO. 456, EXECUTIVE COMPENSATION AND RISK TAKING 1 (2010) (suggesting tying bank CEO pay to the bank's credit default swap spread). Much of the theoretical groundwork for the debt compensation proposals was laid prior to the crisis in a paper by Professors Edmans and Liu. *See* Alex Edmans & Qi Liu, *Inside Debt*, 15 REV. FIN. 75 (2011) (first drafted and posted to SSRN in 2005).

5. *See infra* notes 61-62 and accompanying text.

among bank regulators[6] and even bankers themselves.[7] 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 mangers' 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.[8] 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.[9] Although it is commonly assumed that monitoring costs are high for regulators with respect to bank risk,[10] 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

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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/Spamann 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 briefer criticism of the Bebchuk/Spamann proposal).

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

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

9. *See, e.g.*, John E. Core et al., *Executive Equity Compensation and Incentives: A Survey*, FRBNY ECON. POL'Y REV., Apr. 2003, at 27, 32, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=794806 ("Obviously, if shareholders (or the board of directors) could directly observe the firm's opportunities and the executives' actions and know beforehand which actions would maximize shareholder wealth, no incentives (including equity incentives) would be necessary . . . . To motivate the executive to take actions that are in the best interests of the shareholders, compensation risk is imposed on the executive by linking the executive's wealth to firm performance (that is, the second-best contract is used).").

10. *See infra* notes 117-21 and accompanying text.

of regulator ignorance or bank obfuscation.[11] Moreover, and as others have pointed out,[12] 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.[13] 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 other forms of *ex ante* regulation that occur closer to the point of risk-taking. So, in order to be preferable with respect to regulator agency costs, a debt compensation proposal would have to limit regulatory discretion over its implementation. However, the discretion-reducing debt compensation proposals are exactly the ones that are least likely to achieve socially optimal bank manager incentives because there is no reason to think that, say, aping a bank's capital structure sets an efficient, risk-reducing contract. Thus, the effectiveness of debt compensation as a solution to the moral hazard at banks will be at least uncertain prior to adoption.

Nevertheless, it may be that paying with debt would simply be incremental to the array of regulatory tools available. If so, there might be little harm in experimenting with debt compensation incentives, even if they ultimately turn out to be relatively insignificant. However, 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.[14] Even more troublingly, mistakenly 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 guaranties. It goes on to briefly discuss the traditional methods of prudential bank monitoring, many of which appear to have failed in the months and years preceding the

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11. *See infra* notes 123-28 and accompanying text.

12. *E.g.*, Robert P. Bartlett, III, *Making Banks Transparent*, 65 VAND. L. REV. 293 (2012).

13. *See, e.g.*, M. Todd Henderson & Frederick Tung, *Pay for Regulator Performance*, 85 S. CAL. L. REV. 1003, 1015-22 (2012).

14. *See infra* Part II.

recent crisis. Finally, it lays out the collection of proposals for indirect bank regulation through debt compensation that have been generated over the past four years.

Part III calls for some skepticism regarding the ability to produce significant incentive effects by tinkering with bank managers' pay. It describes the new range of incentives facing bank managers, including evidence of a CEO's increasingly fragile grasp on his or her position. The implicit equity performance conditions in the executive's employment arrangement—one must famously keep dancing while the music plays[15]—are apt to counter any risk-dampening effect of debt compensation in the majority of cases.

Part IV offers a separate argument against using a bonding mechanism like debt compensation to fix firm risk-taking. It shows how the conditions necessary for choosing (1) bonding via compensation contract over (2) direct prudential monitoring are not obviously met in the case of governmental regulation of banks. To the extent regulation by pay is preferable to traditional, prudential monitoring, it must be because of high regulator agency costs—that is to say, regulators may not have incentives to forcefully use the information they obtain. However, regulator agency costs are likely to prove as problematic, if not more so, for regulation by pay as they do for traditional prudential regulation.

Part V 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 V 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 they may do so again in this new context, perversely leading to a more relaxed monitoring regime than before.

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.[16] As discussed below,

15. *See* Michiyo Nakamoto & David Wighton, *Citigroup Chief Stays Bullish on Buy-Outs*, FIN. 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.").

16. Among those who share this view, there is some disagreement over what counts as "excessive" risk. *See, e.g.*, Okamoto & Edwards, *supra* note 6, at 204. For instance, Bebchuk and Spamann define it as negative-value "bets" that are nevertheless privately optimal. Bebchuk & Spamann, *supra* note 4, at 255. This may be too strict a definition of "excessive" from the point of view of creditors, who may even object to positive value bets that are particularly volatile.

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.[17] 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.[18] 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.[19]

Although bank managers were exposed to the same sort of incentive shifting as those in 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.[20] More importantly, non-banks are generally subject to cross-monitoring by creditors that often constrains risk-taking.[21] 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.[22] The government, in effect, stands in as the relevant creditor to banks, but government regulators appear to have performed their

17. Simple human error also played a part in the excessive risk-taking that helped cause the recent financial crisis. *See* Ing-Haw Cheng, Harrison Hong, & Jose A. Scheinkman, *Yesterday's Heroes: Compensation and Creative Risk-Taking* (Nat'l Bureau of Econ. Research, Working Paper No. 16176, 2010).

18. *See* Tung, *supra* note 4, at 1206-07.

19. *Id.* at 1214-18.

20. *See, e.g.*, Okamoto & Edwards, *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 positive 'spread'—or the difference between the cost of short term capital and the profit generated by longer term lending. It is generally understood that the carry trade rewards high-risk decisions because leverage amplifies the expected return for any investment." (footnotes omitted)).

21. Tung, *supra* note 4, at 1206.

22. *See id.*

monitoring task poorly during the pre-crisis period.[23] 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.[24]

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]

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23. *See generally* Patricia A. McCoy et al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327 (2009) (detailing the various missteps of regulators during the period leading up to the financial crisis).

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 (noting 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.").

25. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620-31 (2010) (codified at 12 U.S.C. § 1851 (2012)). The statute leaves the contours of the rule to the rulemaking process, which is susceptible to a scathing public choice critique. *See* Kimberly D. Krawiec, *Don't "Screw Joe the Plummer": The Sausage-Making of Financial Reform*, 55 ARIZ. L. REV. 53 (2013). Moreover, a Volcker Rule that is able to usefully reduce bank risk-taking must distinguish between true proprietary trading and difficult-to-cabin alternatives like hedging and market-making. *See* FIN. STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS 16 (2011).

26. 12 U.S.C. § 1851.

27. *See, e.g.*, Conti-Brown, *supra* note 2, at 425-26 (discussing Basel III's increase in bank capital requirements); Anat R. Admati et al., *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Socially Expensive* 57 (Rock Ctr. for Corporate Governance at Stanford Univ., Working Paper No. 161, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2349739 (calling for even higher capital requirements than Basel III).

28. *See, e.g.*, Henderson & Tung, *supra* note 13 (calling for an incentive pay regime for bank examiners); M. Todd Henderson & Frederick Tung, *Reverse Regulatory Arbitrage: An Auction Approach to Regulatory Assignments*, 98 IOWA L. REV. 1895 (2013) (calling for bank examiners to select the firms they will examine); M. Todd Henderson & James C. Spindler, Why Bank Regulation Failed . . . and Will Probably Continue to Fail (2012) (unpublished

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.[29] The committee would theoretically do some of the work of prudential monitoring traditionally performed by regulators.[30] Alternatively, an enhanced disclosure regime might permit market participants to more effectively price bank risk.[31] Those market participants, primarily subordinated debtholders,[32] 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.[33] The idea is an extension of the basic incentive pay framework that has come to dominate public company governance over the past three decades.[34] 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.[35] Performance-based pay serves as a bonding device in situations where it is relatively difficult to observe

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manuscript) (on file with author) (arguing to strengthen the regulatory veto held by bank examiners by expanding precommitment devices of bank examiners); *see also* Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. 63, 81-82 (2012) (collecting examples of "solutions to the problem of systemic risk caused by increasing complexity of financial products and markets").

29. Dodd-Frank Act § 165(h), 124 Stat. at 1429-30 (codified at 12 U.S.C. § 5365(h)). The requirement is for all public bank holding companies and public non-bank financial holding companies supervised by the Federal Reserve with assets of ten billion dollars or greater. *Id.*

30. *See* Kristin N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J.L. REFORM 55, 106-07 (2011). There are substantial arguments against relying on outside directors to shape firm performance in this context. *See, e.g.*, Steven M. Davidoff, Andrew C.W. Lund & Robert Schonlau, *Do Outside Directors Face Labor Market Consequences? A Natural Experiment from the Financial Crisis*, 4 HARV. BUS. L. REV. (forthcoming 2014).

31. *See* Bartlett, *supra* note 12.

32. *Id.* at 305.

33. Whether the managers would be complementary or substitute regulators is discussed *infra* Part IV.

34. For another recent summary of executive-compensation-as-governance over the years, see Alces & Galle, *supra* note 6, at 56-59.

35. *See* Brian J. Hall, *Six Challenges in Designing Equity-Based Pay*, J. APPLIED CORP. FIN., Spring 2003, at 21, 29 ("One of the most commonly alleged benefits of options is that they help overcome managers' natural aversion to risk.").

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.[42] In its most modest form, such an approach might call for a reduction in equity compensation for managers[43] 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.").

38. *See* George P. Baker & Brian J. Hall, *CEO Incentives and Firm Size*, 22 J. LABOR ECON. 767, 778 (2004).

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).

40. *See id.* at 711-15 (summarizing the debate). For a taste of the main points of disagreement, compare LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (suggesting managerial power drives compensation choices), with John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142 (2005) (questioning the Bebchuk and Fried account).

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*

suggest altering the pay structure of bank managers so as to include significant levels of bank debt.[45] 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 bank 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, however, go beyond these existing practices and call for the inclusion of actual or phantom debt securities to be issued by banks or their parent bank holding companies.

1. 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,[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 cancel out potential noise created by non-bank seg-

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Compensation: Focusing and Committing to the Long-Term, 26 YALE J. ON REG. 359, 361 (2009).

45. *See generally* Bebchuk & Spamann, *supra* note 4; Tung, *supra* note 4.

46. *See* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823 (2005); Rangarajan K. Sundaram & David L. Yermack, *Pay Me Later: Inside Debt and Its Role in Managerial Compensation*, 62 J. FIN. 1551 (2007); *but see* Robert J. Jackson, Jr. & Colleen Honigsberg, *The Hidden Nature of Executive Retirement Pay*, 100 VA. L. REV. (forthcoming 2014) (finding that much of executives' inside debt is sensitive to share price fluctuations and, in any event, is payable immediately upon departure from the firm).

47. Their alternatives include: (1) tying compensation to the value of the bank holding company's common stock and preferred stock issued to the government as part of the 2008 bailouts; (2) the pay-by-the-slice approach adjusted for bailout disbursements; (3) tying compensation "to the aggregate value of the bank [holding company]'s common shares, preferred shares, and bonds at the specified time minus the expected value of future government payments as proxied by the product of (i) the implied probability of default inferred from the price of credit default swaps at the specified time and (ii) the value of the bank's deposits at that time[;]" and (4) tying bonus compensation to "measures such as earnings before any payments made to bondholders." Bebchuk & Spamann, *supra* note 4, at 283-85.

ments within the holding company structure.[48] 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.[49] Instead, boards should attempt to calibrate an optimal basket of securities for any particular banker's pay based on specific bank and executive characteristics.[50] This idiosyncrasy limits the ability to directly mandate pay rules or guidelines as would be available under a pay-by-the-slice approach.[51] However, as an example of its potential workability, Tung suggested that deposit insurance premiums might be tailored to account for any compensation structure adopted by the bank.[52]

In a similar vein, Wulf Kaal has recently suggested adding an unspecified amount of contingent convertible bonds to bank executives' pay packages.[53] This debt would function similarly to the debt described by Bebchuk, Spamann, and Tung, but would convert to equity upon the triggering of some objective threshold of credit deterioration.[54] For signaling purposes, Kaal would set this triggering threshold lower than that used in convertible debt sold to the market.[55]

Jeff Gordon also suggests adding a debt-like pay element for bankers.[56] In a sense, however, Gordon's suggestion is the opposite of Kaal's. Rather than initially paying via a mix of debt and equity securities, Gordon would allow banks to continue paying managers

48. Tung, *supra* note 4, at 1231-35, 1236 & n.165. 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.* at 1231-34.

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 structure. *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 and Tung approaches by assuming that shareholders at systemically important financial institutions may internalize the costs of excessive risk-taking to a degree not otherwise anticipated. This is so, argues Gordon, because institutional shareholders are not able to diversify away systemic risk that excessive bank-specific risk might pose. *Id.* 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 bank managers who are *not* efficiently diversified, having much of their wealth invested in a particular bank's equity securities. *Id.*

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.[57] 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.[58]

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.[59] While noncommittal about the necessary combination of equity and debt in an optimal package, Krawcheck noted that "the most logical end point would be a compensation mix that mirrors the bank's capital structure."[60] 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,[61] and a New York Times columnist wrote that the debt compensation proposal was his "favorite" solution in Krawcheck's article.[62]

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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. Gordon's proposal also solves a potential problem of bank managers with high equity positions failing to recapitalize banks when necessary. *See id.* at 12 (noting that the proposal solves the "Fuld problem," named for Richard Fuld, former CEO of Lehman Brothers).

59. Krawcheck, *supra* note 4, at 108-09. Krawcheck also summarized the main points in an entry for the Huffington Post. *See* Sallie Krawcheck, *How to Make Banks Less Risky*, HUFFINGTON POST (June 13, 2012, 8:00 AM), http://www.huffingtonpost.com/sallie-krawcheck/wall-street-reform-banks_b_1590794.html. Soon after publication, Krawcheck's name was floated as a possible SEC commissioner. *See* Ben Protess & Susanne Craig, *As Official Drops Out, S.E.C. Race Shifts*, DEALBOOK – N.Y. TIMES (Nov. 8, 2012, 2:54 PM), http://dealbook.nytimes.com/2012/11/28/as-miller-drops-out-race-for-s-e-c-chief-shifts/?_r=0.

60. Krawcheck, *supra* note 4, at 109.

61. *See* Shanny Basar, *How to Fix the Banking System*, FIN. NEWS (May 24, 2012), http://www.efinancialnews.com/story/2012-05-24/sallie-krawcheck-fixes-banks; *In the Harvard Business Review, Sallie Krawcheck '87 Calls for Banking Reform*, MOREHEAD-CAIN (June 1, 2012), http://moreheadcain.org/about/ news/sallie_krawcheck_hbr_bank_reform; Alan Kline, *Krawcheck: Banks Have a Governance Problem*, AM. BANKER (May 24, 2012, 1:40 PM), http://www.americanbanker.com/people/sallie-krawcheck-harvard-business-review-1049619-1.html; Adam O'Daniel, *Ex-Bank of America Exec Sallie Krawcheck Shares Advice for Banks*, CHARLOTTE BUS. J. (May 23, 2012, 2:49 PM), http://www.bizjournals.com/charlotte/blog/bank_notes/2012/05/ex-bank-of-america-exec-sallie.html.

62. Joe Nocera, Op-Ed., *The Simplicity Solution*, N.Y. TIMES, May 29, 2012, at A23.

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.[63] 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.[64] 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.[65] 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.[66] Although the Pay Czar has since faded from memory, the Financial Stability Oversight Council retains the mandate under the Dodd-Frank Act to regulate compensation at banks and systemically important financial institutions to reduce excessive risk.[67] 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.[68] Thus, the debt compensation proposals described above may begin to play an even more significant role going forward.

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.[69] Such problems, though, are relatively fixable through tweaking—in

63. *See* George Parker et al., *Lloyds Shares Volatile Despite PM's Support*, FIN. TIMES (Mar. 9, 2009), http://www.ft.com/intl/cms/s/0/3cfa60ca-0c20-11de-b87d-0000779fd2ac.html (Lloyds for 2008 bonuses); Jill Treanor, *RBS Bows to Government Demand to Slash Bonuses*, GUARDIAN (Feb. 17, 2009), http://www.guardian.co.uk/business/2009/feb/17/rbs-bonus-payments (Royal Bank of Scotland for 2008 bonuses).

64. *See* BARCLAYS, DELIVERING ON OUR PROMISES: BARCLAYS PLC ANNUAL REPORT 172-73 (2010), *available at* http://reports.barclays.com/ar10/files/Annual_Report_2010.pdf.

65. AIG, INC., LONG-TERM PERFORMANCE UNITS PLAN (2010), *available at* http://www.sec.gov/Archives/edgar/ data/5272/000095012310054330/y84839exv10w1.htm.

66. *Id.*

67. 12 U.S.C. § 5641(b)(1)-(2) (2012).

68. Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170, 21,199 n.123 (proposed Apr. 14, 2011) (to be codified at scattered parts of 12 C.F.R. and 17 C.F.R. pt. 248).

69. *See supra* notes 49-52 and accompanying text.

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, to the extent that a pay-by-the-slice approach would rely on such an interpretation, it is not obvious why rules of thumb could not be developed. Of course, such rules might

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70. *See supra* note 48 and accompanying text.

71. *See* Gordon, *supra* note 4, at 9-10.

72. *See* Alces & Galle, *supra* note 6, at 65-71. Karl Okamoto and Douglas Edwards also criticize the proposals. *See* Okamoto & Edwards, *supra* note 6, at 182-205. They contend that forced deleveraging in an executive's portfolio may in fact cause those executives to seek out risk in order to at least potentially achieve payouts consistent with the recent past. *Id.* at 192-93. They also argue that given a relatively high investment by the executive in the firm, it does not matter whether the investment comes in the form or debt or equity because high risk presents the unattractive possibility of total loss in either case. *Id.* at 193-96.

73. Gordon, *supra* note 4, at 9-10.

74. *Id.* at 10.

75. *See id.*

76. *See id.*

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 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 surprisingly lit-

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77. *See id.* These restructurings would function as a form of regulatory arbitrage known to be endemic to financial regulation. *See* Iman Anabtawi & Steven L. Schwarcz, *Regulating* Ex Post*: How Law Can Address the Inevitability of Financial Failure*, 92 TEX. L. REV. 75, 77 (2013) ("[I]t is unrealistic to believe that complete *ex ante* regulation could survive the political opposition of the financial services industry.").

78. Tung, *supra* note 4, at 1230-31.

79. It is not clear that this outcome could not be achievable even *ex post* at the time of bailout or even later. *See, e.g.*, Gene Bloch, *Treasury Pressure Leads to AIG Scaling Back Bonuses*, CNN (Mar. 15, 2009, 1:31 AM), http://www.cnn.com/2009/US/03/14/aig.bonuses/index.html?eref=ib_us (noting how AIG reduced post-bailout retention payments to employees after receiving pressure from the Treasury Department).

80. Alces and Galle make other points as well. They argue that debt compensation creates cross-monitoring costs for creditors beyond the class of creditors whose securities are paid to managers. Alces & Galle, *supra* note 6, at 67-68. The basic idea is that creditors that are either senior to or junior to the managers will have different risk preferences as credit risk increases. This is certainly true, but it is not clear why those costs would be greater than the monitoring costs those creditors currently face. Moreover, and as Alces and Galle note, the pay-by-the-slice approach largely obviates this problem. *Id.* at 67-68. Furthermore, Alces and Galle note that debt compensation must be managed to account for the dynamism of a firm's capital structure. *Id.* at 71-72. As they point out, however, rebalancing is available subject to transaction costs. *Id.* Alces and Galle correctly suggest these transaction costs are incrementally harmful to the firm, though it is hard to see why these costs should be particularly large.

81. *See id.* at 57-59, 64.

82. *See id.* at 65-66; *see also* Lund & Polsky, *supra* note 6, at 709 n.138.

tle evidence that equity-laden compensation structures actually produced the sort of risk-taking seen at banks prior to the crisis.[83] 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.[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 claims to 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 certainly true, but its practical import is uncertain. The key is the requirement of something like perfect alignment.[88] In this case, the two debt liquidation preferences—the most junior but potentially bailed out claims and management's ostensibly unprotected claims—would share virtually the same level of seniority. Depending on the magnitude of the debt securities held by the manager, it might be difficult for him to confidently predict his bank's assets in a future insolvent state with enough precision to draw the line between his claims and those of the incrementally more senior creditor. Although the bank manager would not be exactly in the shoes of a hypothesized unprotected junior creditor, he would be pretty close, and one might reasonably expect the manager's decisionmaking to be in-

83. The most prominent study concerning the matter showed no significant association between pre-crisis equity incentives and firm performance. *See* Rüdiger Fahlenbrach & René M. Stulz, *Bank CEO Incentives and the Credit Crisis* (Ohio State Univ. Fisher Coll. of Bus., Working Paper No. 2009-03-013, 2010), *available at* http://www.ssrn.com/abstract=1439859.

84. *See infra* Part III, discussing the strength of the managerial labor market in particular.

85. Alces & Galle, *supra* note 6, at 69.

86. *Id.* at 69-70.

87. *Id.* at 69.

88. *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, allowing room for debt proposals to prove effective. Second, Alces and Galle note that executives might be better positioned to deal with complexity than most, as they are necessarily sophisticated consumers of financial products with greater incentives to understand the consequences of their behavior.[92] 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.[93] Thus, while Alces and Galle may be right that the inclusion of debt securities would overwhelm the cognitive capacity of bank managers, the point need not be fatal to the debt compensation project.

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 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 levers run opposite of new compensation incentives, the latter

89. Alces & Galle, *supra* note 6, at 76-79.

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.").

may be relatively ineffective in shaping firm behavior. In fact, as discussed below, debt-like instruments may be uniquely ill-suited to stand out among contradictory demands on bank managers' decisionmaking.

Within the corporate governance and finance communities, it has been generally understood for decades that compensation structure might complement other disciplinary devices in shaping managers' behavior.[94] This has led to higher levels of equity pay, which, as noted, lines up on the other side of the bank risk-taking problem.[95] Pay structure was thought to be particularly effective where it was relatively difficult to observe managers' behavior and where potential monitors did not have the skill or motivation to do so.[96] That these conditions might not hold for bank risk-taking is discussed in Part IV below, but at the outset it is understandable that those seeking to change bank decisionmaking would look to compensation structure as a solution.[97]

For many reasons, bank CEOs face a different sort of world than the one posited by the original advocates of pay-for-performance. Almost all of these changes have made it harder for the CEO to exert unilateral control over the bank and instead nudge or even force decisions tending toward short-term share price maximization.[98] Institutional shareholders hold a greater share of the public equity market than ever before.[99] Hedge funds and pension funds have taken the lead in a new brand of shareholder activism and have drafted otherwise sleepy monitors like mutual funds to their side in battles with

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94. *See, e.g.*, Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, but How*, HARV. BUS. REV., May–June 1990, at 138, 139-40. For a primer on the theoretical case for incentive pay, see Murphy, *supra* note 37, at 2519-28.

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 255-56; Tung, *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* Gordon, *supra* note 4, at 5-6. It is difficult to tell exactly how sensitive such shareholders are to systemic risk and whether well-diversified shareholders or less-diversified shareholders will prevail at any given firm. In any event, to the extent that shareholders seek to reduce risk at a bank, it is unclear, given the subsequent discussion, why compensation need be one of the governance levers utilized.

98. *See* 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*, 88 TEX. L. REV. 987, 1039-40, 1051 (2010) [hereinafter Kahan & Rock, *Embattled CEOs*]; Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 895-97 (2002).

99. *See* Kahan & Rock, *Embattled CEOs*, *supra* note 98, at 998; *see also* Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355, 1356 (2010).

management.[100] Proxy advisory firms have increased their influence, generally lowering monitoring costs.[101] 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.[102]

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,[103] 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.[104] The increased turnover is not randomly distributed, as getting fired is becoming more and more closely tied to share price performance.[105] The correlation between poor performance and turnover is particularly strong in cases where firm performance falters relative to its peers.[106]

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100. Kahan & Rock, *Embattled CEOs*, *supra* note 98, at 998-1004. For more on the interplay between activist investors and mutual and pension fund voting, see Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013).

101. *See* Kahan & Rock, *Embattled CEOs*, *supra* note 98, at 1005-07. For an example of the way in which proxy advisory firms wield influence over governance questions, see Andrew C.W. Lund, *Say on Pay's Bundling Problems*, 99 KY. L.J. 119, 121, 126-27 (2010).

102. *See* Lund & Polsky, *supra* note 6, at 693-94.

103. *See, e.g.*, Core et al., *supra* note 9, at 30 & 45 n.2 (ignoring, for incentive purposes, the threat of termination but noting that "[t]his assumption likely does not hold for CEOs with large turnover probabilities"). Research performed at the end of the last century largely confirmed this view. *See* Murphy, *supra* note 37, at 2547 (finding a 7.9% probability of departure for young CEOs at average-performing firms increasing only to an 8.5% probability if the young CEO's firm realizes returns 30% below industry average); Kevin J. Murphy & Ján Zábojník, Managerial Capital and the Market for CEOs 28-30 (Apr. 2007) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984376 (finding that "departure probabilities for CEOs realizing returns 30% below the industry average were increased by 0.4% in the 1970s, 0.7% in the 1980s, and 0.4% in the 1990s" and concluding "that the turnover-performance relation . . . has fallen since the 1980s").

104. Steven N. Kaplan & Bernadette A. Minton, How Has CEO Turnover Changed? 2 (Aug. 2008) (unpublished manuscript), *available at* http://faculty.chicagobooth.edu/steven.kaplan/research/km.pdf. 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. Joann S. Lublin, *CEO Tenure, Stock Gains Often Go Hand-in-Hand*, WALL ST. J. (July 6, 2010, 12:01 AM), http://online.wsj.com/news/articles/SB10001424052748703900004575325172681419254. In addition, the Wall Street Journal study found that (excluding founders) only twenty-eight CEOs of the 500 S&P firms had served for more than fifteen years, suggesting that the archetypal entrenched CEO has become a myth. *Id.*

105. *See* Dirk Jenter & Fadi Kanaan, *CEO Turnover and Relative Performance Evaluation* 20-24 (Nat'l Bureau of Econ. Research, Working Paper No. 12068, 2006), *available at* http://www.nber.org/papers/w12068.pdf (finding turnover strongly correlated with stock returns consisting of firm-specific performance and industry-wide performance). The Wall Street Journal study, *see* Lublin, *supra* note 104, similarly found that, of the twenty-eight longest-serving CEOs, twenty-five had led firms whose share price performance had beaten the overall S&P index over the term of their tenure.

106. Jenter & Kanaan, *supra* note 105, at 20-24.

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 homogeneity reduces the value of firm-specific capital, permitting lower cost turnover.[111] 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 the 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, or increase risk and save their jobs. When Citigroup's Chuck Prince noted the need to continue "dancing until the music stopped"[112]—in other words, accumulating risk during the pre-crisis bubble—he was surely not only talking about the personal portfolio effects of doing so.

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107. *See id.* For more on this data and its implications, see Lund & Polsky, *supra* note 6, at 702-03.

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 via takeover (but not internal forced departures) for CEOs with low share holdings. 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 (perhaps demonstrating a survival effect, managerial power, or both). *See* John C. Coates IV & Reinier Kraakman, *CEO Tenure, Performance and Turnover in S&P 500 Companies* 15-17 (Eur. Corporate Governance Inst., Finance Working Paper No. 191/2007, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=925532.

109. Lund & Polsky, *supra* note 6, at 703.

110. Renée Adams & Hamid Mehran, *Is Corporate Governance Different for Bank Holding Companies?*, 9 FRBNY ECON. POL'Y REV., Apr. 2003, at 123, 125 & 137 n.13.

111. *Id.*

112. *See* Nakamoto & Wighton, *supra* note 15.

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. With inside debt's fixed payout, however, the magnitude of inside debt holdings would have to be much larger to cause a manager to eschew normal career concerns in order to protect the debt portfolio's value.

Nevertheless, there is some evidence marshaled in the debt compensation proposals suggesting that it might have positive effects on firm risk-taking. For instance, some studies have found a correlation between large CEO pensions and less risk-taking.[113] Along the same lines, studies have shown that debt and equity markets react to disclosure of CEO debt holdings, implying that those markets predict a change in firm behavior based on pay practices.[114] As Alces and Galle note, however, endogeneity may be an issue, since risk-taking and pay design may be driven by CEO choices or firm culture.[115] The endogeneity explanation seems at the very least plausible given the apparent weaknesses of debt compensation described above.[116]

This is all to say that paying with debt might have some effect on the behavior of banks run by managers with extremely short labor market horizons and exceptionally high levels of inside debt relative to their 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.

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113. *E.g.*, Sundaram & Yermack, *supra* note 46, at 1554-55; *see also* Frederick Tung & Xue Wang, Bank CEOs, Inside Debt Compensation, and the Global Financial Crisis 3-4 (Boston Univ. Sch. of Law, Working Paper No. 11-49, 2012) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1570161; *but see* Jackson & Honigsberg, *supra* note 46 (linking CEO pension value to share price).

114. *E.g.*, Chenyang Wei & David Yermack, *Investor Reactions to CEOs' Inside Debt Incentives*, 24 REV. FIN. STUD. 3813 (2011).

115. *See* Alces & Galle, *supra* note 6, at 83; *see also* Lund & Polsky, *supra* note 6, at 682-83.

116. In fact, Tung and Wang *raise* the endogeneity point explicitly, Tung & Wang, *supra* note 113, at 25, and conclude they cannot "make strong causal inferences from the data." *Id.* at 27.

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 prudential bank monitoring. However, those costs attend to all *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-

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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 is discussed in greater detail below.

119. *See supra* notes 36-38 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 CEOs' actions or use other governance mechanisms to indirectly reduce agency conflicts, strong performance-based incentives will be less necessary.").

ing high levels of monitoring resources, thereby obviating much of the need for performance-based pay.[122] Because performance-based pay devices are most beneficial as monitoring costs increase, the appropriateness of debt compensation for bank risk-taking necessarily turns on the magnitude of those monitoring costs.

1. Collective Action Problems, Information Quality, and Expertise

In most respects, the marginal monitoring costs for prudential regulators are relatively low. The federal government faces no serious collective action problem because it is explicitly the creditor to all banks for federally insured deposits and implicitly the creditor for many bondholders and counterparties at too-big-to-fail banks.[123] Furthermore, the government should have relatively low marginal costs for gathering additional information going forward.[124] For a long time, national banks, state banks, bank holding companies and other FDIC-insured institutions have been subject to review by bank examiners employed by one regulatory body or another.[125] Since Dodd-Frank's enactment, the FSOC may require similar examinations of systemically important non-bank financial firms by the Federal Reserve.[126] These bank examiners are on site at banks on a regular basis reviewing bank assets and operations.[127] Todd Henderson and Fred Tung, for instance, report that the equivalent of twenty examiners were monitoring Washington Mutual for over 200 days annually during the 2003–2008 period.[128] During such periods, bank examiners have access to all aspects of the bank's operations. Additionally, none of the *post mortems* from the financial crisis suggest that bank managers systematically misled regulators by withholding information from them.[129]

Further, there may be relatively easy ways to enhance information gathering by regulators. Robert Bartlett, discussing the con-

122. *See, e.g.*, Adam J. Levitin, Response, *The Problematic Case for Incentive Compensation in Bankruptcy*, 156 U. PA. L. REV. PENNUMBRA 88, 94-96 (2007); Robert K. Rasmussen, Response, *On the Scope of Managerial Discretion in Chapter 11*, 156 U. PA. L. REV. PENNUMBRA 77, 77-78 (2007).

123. Individual regulators may face collective action problems as a part of a team, but this is a type of regulator agency cost discussed *infra* Part IV.A.2.

124. To be sure, the initial installation of bank examiners imposes serious costs. However, the existence of bank examiners is part of the baseline from which the debt compensation proposals spring, and as such, those costs are not appropriately counted in this context.

125. Henderson & Tung, *supra* note 13, at 1016-21.

126. 12 U.S.C. § 5323 (2012).

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.[130] Bartlett points out that the granularity missing from such disclosure might pose problems,[131] 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.[132] 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.[133] 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.[134] Moreover, as discussed above, there is no reason to think that new disclosure mandates could not be produced to further level the playing field between managers and regulators.[135]

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. Along these lines, 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 trading decisions to take advantage of flaws in the Value at Risk ("VaR") credit model.[136] The supervisors of these

130. Bartlett, *supra* note 12, at 369-82.

131. *Id.* at 377-79.

132. *See, e.g.*, Henry T.C. Hu, Review Essay, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1463 (1993) (reviewing PETER L. BERNSTEIN, CAPITAL IDEAS: THE IMPROBABLE ORIGINS OF MODERN WALL STREET (1992)).

133. *See id.*

134. *See* Henderson & Tung, *supra* note 13, at 1015.

135. *See* Bartlett, *supra* note 12, 369-82 (suggesting a disclosure regime to increase transparency).

136. *See* Steven L. Schwarcz, *Conflicts and Financial Collapse: The Problem of Secondary-Management Agency Costs*, 26 YALE J. ON REG. 457, 460-61 (2009) (observing that VaR

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 either surmountable or equally experienced by bank managers, debt compensation proposals are bound to be less effective.

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's effectiveness discussed in Part III would tend to dominate.[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.[143] The most draconian version of

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did not account for events with a de minimis chance of occurring even if the cost to the firm in the rare negative case would be catastrophic).

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 compensation costs on firms because the debt is unlikely to engender much of a risk premium required by managers. *See infra* note 175 and accompanying text.

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.

142. Gordon, *supra* note 4, at 13.

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.[144] 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.[145] 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?[146] 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.[147] Generally, regulators have been loath to force firms to compensate executives in particular ways or at particular levels.[148] 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

144. *See* 12 U.S.C. § 5221 (2012) (mandating compensation restrictions on recipients of bailout funds).

145. Tung, *supra* note 4, at 1249-50.

146. Tung notes the problem. *See id.* at 1250 ("Relying on regulators to incorporate banker pay arrangements into their discretionary regulatory strategies carries certain risks, of course[,] . . . [including] the standard regulatory agency conflicts . . . .").

147. For reaction to the government's implementation of TARP see, for example, Eric C. Anderson, *The TARP Travesty*, HUFFINGTON POST (Dec. 10, 2009, 2:33 PM), http://www.huffingtonpost.com/eric-c-anderson/the-tarp-travesty_b_387504.html; *Bank of America's TARP Repayment: Ken's Last Act*, ECONOMIST (Dec. 3, 2009), http://www.economist.com/node/15020046; Rick Newman, *Why Goldman Sachs Should Repay Its TARP Money*, U.S. NEWS & WORLD REP. (Mar. 24, 2009), http://money.usnews.com/money/blogs/flowchart/2009/03/24/why-goldman-sachs-should-return-its-tarp-money. For reaction to the government's implementation of § 162(m) of the Internal Revenue Code, see, for example, JAMES M. BICKLEY, CONG. RES. SERV., EMPLOYEE STOCK OPTIONS: TAX TREATMENT AND TAX ISSUES 9-10 (2012), *available at* http://www.fas.org/sgp/crs/misc/RL31458.pdf; Nancy L. Rose & Catherine Wolfram, *Regulating Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation*, 20 J. LAB. ECON. S138 (2002); Norman R. Augustine, Op-Ed., *Raise the Price of Fame*, N.Y. TIMES, June 16, 2005, at A27, *available at* http://www.nytimes.com/2005/06/16/opinion/16augustine.html?r=0; Editorial, *Chairman Frank*, N.Y. SUN, Jan. 5, 2007, at 6, *available at* http://www.nysun.com/editorials/chairman-frank/46160.

148. *See, e.g.*, Andrew C.W. Lund, *Tax's Triviality as a Pay-Reforming Device*, 57 VILL. L. REV. 571, 585-86 (2012); David I. Walker, *A Tax Response to the Executive Pay Problem*, 93 B.U. L. REV. 325, 376-84 (2013).

attention, regulators might reasonably be expected to be more lax in their oversight of bank behavior.[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.[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

149. Anabtawi & Schwarcz, *supra* note 77, at 96-97 ("*Ex ante*—before a crisis emerges—proponents of enhanced financial oversight confront a formidable asymmetry in political power between the financial industry and the general public. Special interests oppose meaningful constraints on risk taking, and the general public has neither the means nor the interest to compete with them. Only in the wake of a severe economic downturn does public discontent tend to translate into regulatory reform." (footnotes omitted)). On the other hand, the particular salience of executive compensation may conceivably steel regulators' will or cow bank managers. *See* Joe Nocera, *Pay Cuts, but Little Headway on Larger Goals*, N.Y. TIMES, Oct. 23, 2009, at B1, *available at* http://www.nytimes.com/2009/10/23/business/23nocera.html (discussing that Kenneth Feinberg "tried hard to balance the desire among angry taxpayers to see pay curbed at the companies [the government] had to save last year"); *see also* David Ellis, *Wall Street Fat Cats Fear the Pay Czar*, CNNMONEY (Oct. 20, 2009, 2:58 PM), http://money.cnn.com/2009/10/20/news/companies/feinberg_compensation/index.htm (noting that Kenneth Feinberg "suggested" that "outgoing Bank of America CEO Ken Lewis . . . not accept a salary or bonus for 2009"); Eamon Javers, *Feinberg Touts His Special Mastery*, POLITICO (Oct. 23, 2009, 4:51 AM), http://www.politico.com/news/stories/1009/28635.html (stating that Feinberg "rejected the initial proposals of every single company involved [in the executive compensation process]").

150. *See* Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 546 (2000) ("Scholars have expended considerable energy in particular on structuring and disciplining the exercise of discretion in order to limit agencies' freedom 'to do as they please.' " (quoting Peter H. Schuck, *Delegation and Democracy: Comments on David Schoenbrod*, 20 CARDOZO L. REV. 775, 777 (1999))); Mark Seidenfeld, *Bending the Rules: Flexible Regulation and Constraints on Agency Discretion*, 51 ADMIN. L. REV. 429, 436-37 (1999) ("It is hard to argue against empowering regulators with greater flexibility to better serve the purposes underlying regulation. Problems arise, however, when different individuals characterize the purposes of a regulatory scheme."); Adam S. Zimmerman, *Distributing Justice*, 86 N.Y.U. L. REV. 500, 557 (2011) ("After all, agencies need discretion to determine when to enforce their own regulations.").

difficult to revise in the face of changed circumstances."[151] For Tung, a range of bank-specific and manager-specific factors will cause optimal packages to diverge across cases.[152] This tracks the point well-understood in the finance 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. 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 representing a basket of the firm's securities, including common stock, preferred stock, and bonds.[154] Nothing in Bebchuk and Spamann's proposal *requires* that the basket of securities in the manager's pay structure mimic the capital structure of the bank (or bank holding company).[155] In fact, in a preliminary version of their article, Bebchuk and Spamann seemed to concede, *pace* Tung, that "[o]ptimal 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.[156] 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,[157] and they at least appear not to have disavowed that characterization.[158]

The noteworthy characteristic of such an approach is that it *is* likely to lower regulator agency costs. There would be a compensation "rule" to be applied mechanically. This "rule" would leave little

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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).

153. *E.g.*, John Core & Wayne Guay, *The Use of Equity Grants to Manage Optimal Equity Incentive Levels*, 28 J. ACCT. & ECON. 151, 152 (1999).

154. Bebchuk & Spamann, *supra* note 4, at 283-85. The authors recognize the distortive 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.

156. Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay* 45 (Harvard John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 641, 2009).

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 aping 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 mix that mirrors the bank's capital structure.").

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 imagine how a simple "pay by the slice" approach would appropriately structure optimal risk-taking incentives at many firms,[162] even assuming a high level of sensitivity on the part of bank managers.[163] Managers' existing portfolio holdings will vary considerably, particularly so at the moment of pay regulation's implementation, but also for any internal hires who accumulated debt (such as deferred compensation or a pension) or equity (shares or stock options) holdings at an earlier career stage. Moreover, managers' background levels of wealth, career horizons, and risk aversion are bound to be heterogeneous, making a capital-structure-mimicking approach rough justice at best.[164]

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 fall

159. Gordon, *supra* note 4, at 9-10. The Internal Revenue Code may also pose problems as more exotic instruments are used. *See* 26 U.S.C. § 409A (2012) (requiring certain types of nonqualified deferred compensation to be included in gross income).

160. Gordon, *supra* note 4, at 10.

161. *See* Tung, *supra* note 4, at 1245.

162. *See id.* ("Because bank managers' individual situations will vary in ways that are not correlated with their BHCs' capital structures, there is no conceptual basis for assuming that executive pay in the form of a representative slice of the BHC's securities will offer appropriate incentives to internalize risk at the banking subsidiary.").

163. For reasons to think that pay incentives might be drowned out anyway, see *supra* Part III (competing labor market incentives), and *supra* notes 80-93 and accompanying text (describing Alces and Galle's behavioral psychology claim).

164. For more on the intensely idiosyncratic nature of optimal compensation design, see Lund & Polsky, *supra* note 6, at 711-15.

away.[165] To be sure, questions would remain concerning the effect of particular capital levels and their relationship to liquidity in the economy,[166] among other things. But the heterogeneity of optimal capital requirements across firms would become less important as monitoring and compliance costs were discounted.[167] Similarly, if regulators are permitted to adopt a rough version of the Volcker Rule so as to prevent potential regulatory capture, the arguments against such a rule become more limited.[168]

Granting all of that, one-size-fits-all compensation structures might impose a different level of social costs than one-size-fits-all prudential monitoring rules. Regulation by pay with low regulatory discretion, like other pricing mechanisms, may prove information-forcing and therefore preferable to command-style direct regulation. It is at this point that the arguments about debt compensation's ineffectiveness discussed in Part III reappear, however.

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 increasing the level of bank debt held by managers might cause. In fact, Tung,[169] along with Bebchuk and Spamann,[170] make this very point near the end of their proposals.[171]

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165. For more on the critiques of capital requirement rigidity, see Admati et al., *supra* note 27; *see also infra* note 176.

166. Skander J. Van den Heuvel, *The Welfare Cost of Bank Capital Requirements*, 55 J. MONETARY ECON. 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.").

167. *See id.*

168. *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 customer service, market liquidity, and other beneficial functions performed by many banking entities. . . . Balancing these competing concerns and implementing workable and enforceable definitions of permitted and prohibited activity falls to the five federal agencies charged with Volcker Rule implementation." (footnote omitted)).

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

170. *See* Bebchuk & Spamann, *supra* note 4, at 285 ("However, that executives may have other sources of incentives to take excessive risks to benefit common shareholders hardly implies that it would be undesirable to place limits on the extent to which pay arrangements provide executives with such incentives; such limits would at least move us in the right direction.").

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

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.[172] 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.[173] Moreover, there is a well-developed view that equity-heavy packages, particularly when options did not have to be expensed, were misperceived by boards as being cheap forms of compensation.[174]

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.[175]

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 salary and perks, which may cause managers to charge a risk premium for the substitution. Should either of these assumptions fail, debt compensation proposals would become more problematic.

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172. *See supra* note 34 and accompanying text.

173. Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3, 16 (2002) ("[T]he economic cost to shareholders of granting options often far exceeds the value that employee-recipients place on the option.").

174. *See, e.g.*, Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847 (2002).

175. *See* Edmans & Liu, *supra* note 4, at 77 ("Even in situations where bonuses can attenuate risk-shifting, inside debt can be a cheaper solution since its sensitivity to liquidation values renders it a more powerful instrument."). However, the switch to debt compensation may increase transaction costs. *See* Alces & Galle, *supra* note 6, at 71-72. This, along with concerns about regulator agency costs, may counsel in favor of a rough, pay-by-the-slice approach.

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 to the extent the shift to debt compensation promised more than it delivered regarding manager behavior as discussed above.

This concern is hardly fanciful in regard to Krawcheck's proposal. Prior to suggesting a pay-by-the-slice approach (as well as a new dividend policy and a reduction in the role of net interest income in performance evaluation), Krawcheck claims that traditional prudential monitoring via capital requirements is problematic.[176] Her debt compensation proposal is explicitly envisioned as a *substitute* for that sort of 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 behavior in the direction of 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:

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176. *See* Krawcheck, *supra* note 4, at 108 ("The main tool with which boards and regulators have managed risk at banks in recent decades is the capital ratio. The logic is that the higher the capital ratio—that is, the more money set aside against potential losses—the lower the risk. This is simple enough in theory but wildly complicated and confusing in practice. It's not at all clear what the right amount of capital is; in fact, it's not even clear how capital should be measured. At any given board meeting, bank directors will hear about GAAP capital, capital as measured under the current Basel regime (international standards set by bank regulators), capital as measured under the coming Basel regime, and the bank's own view of the right amount of capital, often called economic capital. Within these categories are various subcategories, including Tier 1 capital, tangible capital, and total capital. These capital measures often fail to keep up with market events. Also, the calculations can be shaped by banks' own assessments of risk, regulators' assessments of banks' risk models, and ratings from rating agencies—all of which are subject to underlying biases, to put it mildly.").

177. *Id.*

178. Bebchuk & Spamann, *supra* note 4, at 278 ("We highlight the limitations of [prudential monitoring], and show that it can be usefully *complemented* by regulating the incentives of those making the choices from the menu." (emphasis added)); Tung, *supra* note 4, at 1209 ("Requiring bankers to hold their own banks' debt would not substitute for traditional external regulation but would offer an important supplement to the existing regulatory toolkit for constraining bank risk taking.").

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-

> [W]hen 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.*[180]

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[181]—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 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.[182] Many studies have purported to demonstrate a link between compensation-based incentives and firm per-

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deed, if pay arrangements are designed to discourage excessive risk-taking, direct regulation of activities *could be less tight than it should otherwise be*." (emphasis added)); Tung, *supra* note 4, at 1247 ("For example, better prudential incentives in executive pay arrangements *may justify . . . less stringent capital requirements, or less burdensome reporting requirements or on-site examinations for a given bank*." (emphasis added)). Tung makes the point even more explicitly in a subsequent paper. Tung & Wang, *supra* note 113, at 4 ("Not only may banking regulation offer a substitute for corporate governance, as some believe; we offer the first evidence that governance—in the form of bank CEO compensation structure—may *substitute for banking regulation*, as a number of commentators have recently proposed." (emphasis added)).

180. Bebchuk & Spamann, *supra* note 4, at 286 (emphasis added).

181. Tung also suggests that the exact contours of pay regulation and its substitution for prudential monitoring "will need to be worked out through practical experience." Tung, *supra* note 4, at 1251.

182. Igor Filatotchev & Deborah Allcock, *Corporate Governance and Executive Remuneration: A Contingency Framework*, ACAD. MGMT. PERSP., Feb. 2010, at 20, 21 ("Despite considerable research effort, the empirical findings on these causal linkages [between compensation-based incentives and firm performance] have been mixed and inconclusive. For example, empirical studies and meta-analyses of the effects of executive equity-related incentives on financial performance have failed to identify consistently significant effects.").

formance.[183] Yet the majority of those studies covered earlier periods when the vigorous alternative mechanisms described above were not nearly as strong. We have little evidence of the leverage that pay tweaking provides in today's corporate governance environment. 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 characteristics, 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 might be shown by regulators when evaluating the efficacy of any new debt compensation incentives.

Adverting to regulation by pay, then, is apt to do more than serve as a belts-and-suspenders addition to the regulatory arsenal. Given (1) the potential for regulator agency costs in determining the balance between regulation by pay and traditional prudential monitoring, and (2) the unhappy experience with evaluating the impact of pay design on incentives, there is a good possibility that the inclusion of regulation by pay will actually lower overall regulation of banks, in direct tension with the reformers' goals.

VI. CONCLUSION

There is great reason to expect little from adding debt compensation to the pay packages of bank managers and little reason to expect very much. Any new debt incentives are liable to be overwhelmed by

183. *See* Carola Frydman & Dirk Jenter, *CEO Compensation* 23-25 (Rock Ctr. for Corporate Governance at Stanford Univ., Working Paper No. 77, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1582232 (offering a sample of such 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 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 improved firm performances and that even that relationship is vulnerable to endogeneity concerns, i.e., compensation "was simultaneously determined 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 noting "[t]here is presently no theoretical or empirical consensus on how stock options and managerial equity ownership affect firm performance").

even middling career concerns on the part of the managers. And, the best version of pay tinkering vis-à-vis traditional prudential bank monitoring appears to be one that is bound to be suboptimal at many firms. What is more, a range of other criticisms might be reasonably leveled at the recent proposals, some more persuasive than others.

Still, there is something to be said for experimentation in light of apparently ineffective prudential monitoring mechanisms. As confidence in capital requirements or bank monitors wanes, it is natural to search for alternatives. But there is a real chance that adding debt to bankers' pay, even cautiously, will exacerbate those problems with traditional bank regulation. To the extent errors have been made in evaluating incentive pay's effects before, the downside was simply excessive compensation costs at individual firms and perhaps some increase in income inequality across society without an equivalent gain in firm performance. Getting pay's effects wrong in the bank regulatory context is more troubling, given our hard-earned understanding of the downsides of excessive bank risk. If regulators were more vigilant, that might be a risk worth taking, but if they were, we would not need bank regulation via pay in the first place.