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Why Government Control of Bank Salaries Will Hurt, Not Help, the Economy

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Abstract: *In response to the recent financial crisis, the Obama Administration and the Federal Reserve Board are capping executive salaries and bonuses, and imposing a host of new regulations and mandates—all in the name of reducing risk. If the rule of unintended consequences applies anywhere, it applies here. Government pay rules have been tried before—and have consistently increased the very salaries and special bonuses they intended to curb. Besides, a sense of risk—instead of the certainty of taxpayer bail-outs—is precisely what would rein in some of the reckless corporate practices rightly decried by the government and American citizens. The Heritage Foundation's David Mason explains why the Federal Reserve's newest proposal will fail like all the rest.*

A government "pay czar" now sets salaries at many large American banks.[1] The Obama Administration has proposed legislation to extend similar controls to the entire financial services industry.[2] Apparently impatient with the legislative process, the Federal Reserve Board announced plans to regulate bank pay under existing safety and soundness rules, extending even to low-level employees.[3]

The Financial Stability Board (FSB), an international organization of banking regulators, has issued international standards similar to the U.S. government proposals. Though differing in details, the two bank pay initiatives share the premise that bank compensation policies were a significant factor in the recent financial crisis. Relying on this unproven supposition,

Talking Points

- The Obama Administration's "pay czar" has temporary power to set pay at banks that received TARP bail-out funds.
- The Federal Reserve is now proposing to extend government controls on bankers' pay to every bank in the nation—and to make the controls permanent.
- The Federal Reserve claims the pay rules will limit financial risk, but has never demonstrated any link between executive pay and excessive risk.
- Government-imposed pay limits in the private sector, many tried only recently, have always failed. The Federal Reserve's rules are sure to backfire—increasing, instead of reducing, compensation for many bank executives—and hurting the banking sector as a whole.

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regulators seek to mandate bank pay practices in order to reduce financial risk, most notably by limiting performance-based awards to restricted stock.[4]

Government meddling in private-sector salary decisions is hardly unprecedented. Government pay rules have a long and unmitigated record of failure. The new initiative by the Federal Reserve and the Obama Administration is unlikely to be an exception to this dismal history. The new regulatory proposals are likely to backfire by:

- Increasing, not reducing, aggregate bank pay;
- Spreading, not containing, the bonus culture blamed for financial excess;
- Rewarding below-median performance while limiting higher-performing executives; and
- Robbing banks most in need of strong executives of the most talented leaders.

Some bank executives were overpaid during the financial bubble earlier in this decade. Executives at bailed-out firms, whose alternative was bankruptcy, have no rightful claim to taxpayer subsidies to pay out big bonuses promised during boom years. But punitive polices and over-reaction to past errors will not restore banks to health. Regulators should examine the policy roots of excess compensation and revise policies and subsidies that led to above-market wages in the first place.

The Fed's "Guidance"

On October 22, 2009, the Federal Reserve released its proposed new Guidance on Sound Incentive Compensation Policies to Federal Reserve-member and -regulated banks. The guidance, which is less specific than a formal regulation, requires banks to review all incentive-compensation programs to ensure that they do not encourage excessive risk-taking. Federal Reserve staff will conduct an immediate detailed review of all compensation practices at 28 designated large, complex banking organizations, and will devise specific plans and timetables for improving incentive compensation, risk management, and corporate governance. Incentive-compensation practices at all other banks will be reviewed by bank supervisors as part of regular bank examinations. Both types of reviews are backed up by the possibility of downgrades in a bank's supervisory rating or specific orders to revise certain practices.

While the Federal Reserve's guidance does not specify which compensation practices will be considered unacceptable, it refers to principles, such as deferring (and possibly reclaiming) incentive payments, using longer performance periods, and reducing sensitivity to short-term performance. These principles are consistent with Treasury proposals and actions by the Special Master for Compensation (pay czar) in eliminating stock options in favor of long-term restricted stock. The Federal Reserve guidance refers specifically to FSB Principles for Sound Compensation Practices,[5] which include similar recommendations. Unlike the pay czar's directives, but similar to the FSB principles, the Federal Reserve's guidance affects bank employees at any level at which risk decisions are made (down to the level of individual loan officers or groups).

Did Bank Pay Cause the Financial Crisis?

Proposals to regulate bank pay by the Federal Reserve, the Obama Administration, and the FSB are premised on the belief that existing pay practices

1. The "Special Master for Compensation" (pay czar) makes employee-specific pay decisions for top executives at seven companies that received extraordinary funding under the Troubled Asset Relief Program (TARP), and sets pay guidelines at other banks that received TARP funds. See TARP Standards for Compensation and Corporate Governance, 31 Code of Federal Regulations § 30.1 *et seq*, (2009).
2. U.S. Department of the Treasury, "Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward: New Independence for Compensation Committees," July 20, 2009, at *http://www.financialstability.gov/docs/regulatoryreform/extended_comp_comm_analysis.pdf* (October 29, 2009).
3. "Proposed Guidance on Sound Incentive Compensation Policies," *Federal Register*, Vol. 74, No. 206 (October 27, 2009), at *http://edocket.access.gpo.gov/2009/pdf/E9-25766.pdf* (October 29, 2009).
4. Restricted stock cannot be sold or redeemed for a specified number of years.
5. Financial Stability Board, "FSF Principles for Sound Compensation Practices," April 2, 2009, at *http://www.financialstabilityboard.org/publications/r_0904b.pdf* (October 30, 2009).

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contributed to risky behavior by banks leading to the market crisis.[6] Bank pay rose with bank profits during the bubble years, but pay critics mistake correlation for cause. While there is considerable academic speculation and dispute about a relationship between executive pay and risk, the speculation is based on mathematical models similar to those used to establish prices for complex financial instruments.[7] Like the pricing models, the pay hypotheses are highly dependent on assumptions that have little to do with how individuals react to incentives in the real world.

Most notably, many pay-incentive models assume that corporate CEOs maximize personal wealth at the expense of shareholders.[8] Incentives matter, but the "corporate greed" explanation is a simplistic caricature. No serious observer believes that Sanford Weill built Citigroup or that Ken Lewis built Bank of America simply to extract excess rents from corporate shareholders. Making public-policy decisions based on such simplistic assumptions is just as risky and myopic as using similarly simple assumptions to establish prices for complex financial products.

Real-world evidence, on the other hand, shows no discernable link between the pay structures that regulators now criticize and risky bank investment decisions:

- The amount of stock-option compensation, the factor most often cited as potentially risk-inducing, had no bearing on bank performance during the financial crisis.[9] If stock options induced executives to take more risks, banks with option-heavy compensation packages would have fared worse in the crisis. A comprehensive pay study by the compensation-consulting firm Watson Wyatt shows that stock options did not encourage excessive risk-taking by executives.[10]
- Banks headed by CEOs who owned large amounts of stock, a factor that supposedly better aligns the interests of the CEO and shareholders, fared no better during the financial crisis than banks whose CEOs owned fewer shares. In fact, the higher the value of a CEO's holdings of a bank's shares, the worse the bank performed during the crisis.[11]
- Executives at banks that failed or stumbled lost massive amounts of personal wealth,[12] averaging $95 million for financial industry CEOs in 2008 alone.[13]

6. See, for instance, Press release, Board of Governors of the Federal Reserve System, October 22, 2009, at *http://www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm* (October 30, 2009); Damian Palette and John Hilsenrath, "Bankers Face Sweeping Curbs on Pay," *The Wall Street Journal*, September 18, 2009 (quoting former Fed Chairman and Obama Advisor Paul Volker), at *http://online.wsj.com/article/SB125324292666522101.html* (November 2, 2009); and "White House's Summers Says Must Fix Compensation," Reuters, September 18, 2009, at *http://www.reuters.com/article/GCA-Economy/idUSTRE58H5D020090918* (November 2, 2009).
7. See, for instance, Ella Mae Matsumura and Jae Yong Shin, "Corporate Governance Reform and CEO Compensation: Intended and Unintended Consequences," *Journal of Business Ethics*, May 26, 2005, at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=707742* (October 30, 2009), and Lucian A. Bebchuk and Yaniv Grinstein, "The Growth of Executive Pay," *Oxford Review of Economic Policy*, Vol. 21 (2005), pp. 283–303, at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=648682* (October 30, 2009).
8. See discussion of "rent seeking" scholarship in Thomas A. DiPrete, Greg Eirich, and Matthew Pittinsky, "Compensation Benchmarking, Leapfrogs, and the Surge in Executive Pay," self-published, December 11, 2008, at *http://www.stanford.edu/group/scspi/pdfs/rc28/conference_2008/p109.pdf* (October 30, 2009).
9. Rüdiger Fahlenbrach and Rene M. Stulz, "Bank CEO Incentives and the Credit Crisis," Social Science Research Network Working Paper Series, July 27, 2009, at *http://ssrn.com/abstract=1439859* (October 30, 2009).
10. Watson Wyatt, "Going Beyond Conventional Wisdom: Designing Executive Pay to Balance Risk and Performance," June 2009, at *http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=21310* (October 30, 2009).
11. Fahlenbrach and Stulz, "Bank CEO Incentives and the Credit Crisis," p. 3.
12. Fahlenbrach and Stulz, "Bank CEO Incentives and the Credit Crisis," and Alan Reynolds, "What to Do About Executive Compensation," *The Washington Times*, October 12, 2008, at *http://www.cato.org/pub_display.php?pub_id=9712* (October 30, 2009).

On the other hand, the most concrete example of allegedly risk-inducing pay—commissions to brokers who originated sub-prime mortgages—has nothing to do with the executive bonuses that are the focus of public outrage and academic attention. Sub-prime mortgages were in demand before 2006 due to miscalculation of the risk–reward relationship, not due to a deliberately risky bet. If commission-based compensation had been banned, banks would have found other ways to motivate employees to originate sub-prime loans.[14]

Relying on simplistic economic models, mechanistic assumptions, and academic theories—the same toxic mix that created the financial bubble—regulators have decided that bank pay systems, rather than poor regulations or bad judgments, were a major cause of the financial crisis. These theories fly in the face of actual evidence about the relationships between executive pay and bank performance. By embracing the latest compensation fad, regulators are preparing to repeat the obvious mistakes of very recent history.

Regulators are relying on simplistic economic models, mechanistic assumptions, and academic theories—the same toxic mix that created the financial bubble.

Remarkably, the Federal Reserve's recent compensation guidance repeatedly asserts the pay-risk linkage but fails to provide any basis for the claim. The guidance cites no studies, refers to no experts, and includes no examples of supposedly risk-inducing pay practices. There may be empirical or theoretical support for Federal Reserve proposals, but the Fed's announcement fails to provide evidence or argument that the practices it seeks to control bear any relationship to excess risk in banks. Even if the Fed is correct, a discussion of the basis for its conclusion is critical to judgments about what types of incentive compensation contribute to unreasonable risk.[15]

Three Strikes for Government Pay Rules

Corporate-pay critics argue as if dictatorial CEOs set their own pay through captive boards of directors.[16] If that caricature ever was accurate, it no longer is today. Today, 99 percent of compensation committee members in American corporations are independent or outside directors.[17] New York Stock Exchange and NASDAQ rules require listed companies to have wholly independent compensation committees. Securities and Exchange Commission (SEC) rules strongly encourage the practice for other companies and effectively regulate the standards these committees use to set pay.

Government wage and price controls have a four-millennium record of failure.[18] Three recent efforts to limit executive pay backfired, producing unintended consequences—including pay *increases*—and helped create the bonus culture that critics now decry.

13. Press release, "CEO Financial Fortunes Drop Sharply, Watson Wyatt Proxy Analysis Finds," Watson Wyatt, May 13, 2009, at *http://www.watsonwyatt.com/news/press.asp?ID=21197* (November 2, 2009).
14. Many subprime mortgages were originated by independent brokers rather than bank employees, whose pay would be subject to regulation. Some banks did offer extraordinary incentives to brokers originating subprime loans, advertised cash-out loans as "like money falling from the sky" and urged brokers to "get going, approvals are waiting" on subprime loans. See Joe Nocera, "Subprime and the Banks: Guilty as Charged," *The New York Times*, October 14, 2009, at *http://executivesuite.blogs.nytimes.com/2009/10/14/subprime-and-the-banks-guilty-as-charged/* (October 30, 2009), and accompanying documents (Chase B&C Lending) at *http://graphics8.nytimes.com/images/blogs/executivesuite/ChaseFlyer.pdf* (October 30, 2009).
15. "Proposed Guidance on Sound Incentive Compensation Policies."
16. David Owen, "The Pay Problem," *The New Yorker*, October 12, 2009, at *http://www.newyorker.com/reporting/2009/10/12/091012fa_fact_owen* (October 30, 2009).
17. Nikos Vafeas, "Further Evidence on Compensation Committee Composition as a Determinant of CEO Compensation," *Financial Management*, Vol. 32 (2003), pp. 53–70.
18. Robert L. Schuettinger and Eamonn F. Butler, *Forty Centuries of Wage and Price Controls* (Washington, D.C.: The Heritage Foundation, 1979).

Strike One: Golden Parachutes. A wave of hostile corporate takeovers in the early 1980s generated publicity about a then-rare compensation arrangement known as a change-in-control agreement, or "golden parachute." Reacting to a few ousted executives who received large severance payments, Congress imposed an excise tax on payments above a stated threshold. By 1988, the previously rare agreements were in place in 41 percent of large U.S. companies, rising to 57 percent in 1996, and 70 percent in 2000.[19] Rather than reducing golden parachutes, regulation increased their number by legitimizing the concept and establishing an implicit standard of triple annual pay.[20]

Strike Two: The Million-Dollar Pay Cap. One element of Bill Clinton's 1992 "It's the Economy, Stupid," campaign was a proposal to limit corporate pay. Soon after Clinton was elected, a sympathetic Congress capped the corporate tax deduction for compensation at $1 million per employee, but exempted performance-based pay from the cap.[21]

In a classic tale of unintended consequences, executive pay soared. CEO salaries previously below $1 million increased, with the government cap now an implicit salary *floor*.[22] Due to the tax mandate, executive pay also shifted decisively toward performance-based measures. Stock options, the most common form of incentive pay, rose from 30 percent of executive pay in 1992 to nearly 70 percent in 2000.[23] When stock prices boomed in the 1990s and again in the middle of this decade, executive pay skyrocketed. This poorly designed plan to limit corporate pay and tie pay to performance triggered the stock-option boom that is a major element of the current pay flap.

Strike Three: Disclosing and Explaining Rules, and the Lake Wobegon Effect. In 1992, the SEC issued enhanced disclosure rules for executive compensation encouraging the use of "peer group" comparisons, or benchmarking, in setting pay.[24] As a result, at least 95 percent of corporations now use some form of benchmarking.[25]

Peer-group benchmarking assesses pay by comparison to similar firms.[26] Unsurprisingly, when corporations compare themselves to competitors, they seek to be above average.[27] Rating a top executive "average" is an insult. Which corporate board wants "average" performance? The phenomenon of everyone believing himself "above average" is known as the "Lake Wobegon Effect."[28]

19. Michael C. Jenson, Kevin J. Murphy, and Eric G. Wruck, "Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them," Social Science Research Network Working Paper Series, July 14, 2004, pp. 28–29, at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=561305* (October 30, 2009).
20. *Ibid.*
21. 26 United States Code § 162(m), and "How Bill Clinton Helped Boost CEO Pay," *Business Week*, November 27, 2006, at *http://www.businessweek.com/magazine/content/06_48/b4011079.htm* (October 30, 2009).
22. James S. Wallace and Kenneth R. Ferris, "IRC Section 162(m) and the Law of Unintended Consequences," Social Science Research Network Working Paper Series, November 2006, at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=942667* (October 30, 2009).
23. *Ibid.*, p. 6.
24. See, for instance, "Executive Compensation and Disclosure," Securities Act Release No. 7009, August 6, 1993, at *http://content.lawyerlinks.com/default.htm#http://content.lawyerlinks.com/library/sec/sec_releases/33-7009.htm* (November 2, 2009). A discussion of benchmarking is explicitly required under the 2006 SEC compensation rule revisions.
25. Watson Wyatt, "Proxy CD&A Disclosures in 2008 Improving, but Analysis often Lacking," June 2008, at *http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=19245* (October 30, 2009); John M. Bizjak, Michael L. Lemmon, and Lalitha Naveen, "Has the Use of Peer Groups Contributed to Higher Pay and Less Efficient Compensation?" Social Science Research Network Working Paper Series, March 2007, at *http://ssrn.com/abstract=252544* (October 30, 2009).
26. See, for instance, James W. Bannister and Harry A. Newman, "Analysis of Corporate Disclosures on Relative Performance Evaluation," *Accounting Horizons*, Vol. 17 (2003).
27. Bizjak, Lemmon, and Naveen, "Has the Use of Peer Groups Contributed to Higher Pay and Less Efficient Compensation?" p. 2.

Unsurprisingly, the predominant effect of benchmarking is to pull executives who earn below-average pay up to the average or above. Between 1992, when SEC rules were revised, and 2005, CEOs who earned salaries below the median of their peer group received $1.3 million per year *higher* pay increases than their counterparts with above-median pay.[29] This peer group effect has about three times more influence over changes in pay than does corporate performance.[30]

Limiting successful and highly performing individuals promotes mediocrity.

The effect of government "disclose and explain" regulations is to boost, not limit, pressure for executive pay increases. Publicity may limit a few top performers, but top performers can justify top pay. The more prevalent effect is to drag the corporate median, and particularly those below the median, ever higher—a kind of "no executive left behind" for the Fortune 500. Like most bureaucratic schemes, benchmarking rewards those at the bottom and middle, regardless of performance. Limiting successful and highly performing individuals promotes mediocrity.

Why Government Pay Rules Fail

Compensation decisions are based on a complex mixture of business, competitive, legal, and psychological factors. Government pay rules fail because they emphasize isolated factors, throwing pay systems out of balance. If regulators instead try to fine-tune rules, they wrap the private sector in red tape. Even government rules that are merely suggestive (such as SEC benchmarking guidance) imply legal force. Several specific government errors have been demonstrated in recently failed pay rules.

Legitimizing Effect. Some government rules limit a disfavored practice, such as excessive salaries or golden parachutes. But caps imply disapproval for anything below them, so government limits created an expectation in which the highest cap became standard compensation.

Underestimating Incentives. Government incentives are powerful medicine. Firms often react to incentives more readily than policymakers anticipate. Tying pay to corporate performance created a boom in options beginning in the 1990s, which created a powerful link between compensation and stock prices.[31] The same experts who over-emphasized performance measures are now ready to over-correct by requiring pay systems to reward risk avoidance. The result will likely be another government-induced over-emphasis, this time on the downside of the risk–return curve.

Non-linear Reactions and Feedback Effects. Corporate pay systems are complex. Insurance giant AIG had 620 bonus programs worth $455 million covering 51,500 employees (averaging only $9,000 per covered employee). In addition, AIG had more than 5,000 employees covered by 13 different retention plans and a similar number of employees receiving deferred compensation. After reviewing these programs, the TARP Inspector General concluded that Treasury Department officials simply did not understand AIG's pay structure when they bailed out the company last year.[32] Now, in a classic over-reaction to understandable outrage at six-figure bonuses at a single AIG subunit, regu-

28. See, for instance, remarks of Alan L. Beller, "Remarks Before Conference of the NASPP, the Corporate Counsel and the Corporate Executive," October 20, 2004, at *http://www.sec.gov/news/speech/spch102004alb.htm* (October 30, 2009); Scott Schaefer and Rachel M. Hayes, "CEO Pay and the Lake Wobegon Effect," *Journal of Financial Economics*, December 11, 2008, at *http://ssrn.com/abstract=966332* (October 30, 2009); and "Illusory Superiority: The Lake Wobegon Effect," Wikipedia, at *http://en.wikipedia.org/wiki/Lake_Wobegon#The_Lake_Wobegon_effect* (October 30, 2009).
29. Bizjak, Lemmon, and Naveen, "Has the Use of Peer Groups Contributed to Higher Pay and Less Efficient Compensation?"
30. *Ibid.*, pp. 2, 14.
31. Financial Stability Board, "FSF Principles for Sound Compensation Practices," April 2, 2009.
32. Gregg D. Killoren, "Treasury Did Not Understand AIG's Complex Pay Structure: SIGTARP," CCH Financial Crisis News Center, October 14, 2009, at *http://www.financialcrisisupdate.com/2009/10/treasury-did-not-understand-aigs-complex-pay-structure-sigtarp.html#more* (October 30, 2009).

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lators want to control every bonus plan covering every employee at every financial institution.

It is impossible to change a single factor in a complex system and reliably predict the result. Input changes react with existing conditions in unpredictable ways or become magnified by feedback loops to produce results out of scale or even out of the direction intended. The difficulty in measuring initial incentives is magnified by the likelihood that those incentives will cascade or interact in unexpected ways with non-regulated features of compensation systems.

Difficulty Correcting Errors. In a privately managed system, unintended consequences are identified and addressed relatively quickly. Regulators are insulated from the consequences of their decisions and public policy is difficult to change, so policy mistakes often remain in place long after their ill effects are apparent. Private-sector compensation practices are reviewed and adjusted periodically. The SEC did not change its compensation disclosure rules between 1992 and 2006, and failed even then to address the "Lake Wobegon" problem of which one of its own senior officials complained in 2004.[33] A private company that failed to revise compensation policy for 14 years and ignored a senior executive's public warning would likely be cited by the SEC for an oversight failure.

Lack of Flexibility. Government regulation will further homogenize pay practices, exacerbating negative effects of government-favored mechanisms, and ensuring that everyone in the industry will make the same mistake. The herd effect of government mandates greatly aggravates the negative consequences of any policy errors. Left to their own devices, private companies are more likely to experiment, with competition leading to the most successful pay practices.

Pay Rules Cannot Address the Most Significant Performance Problems. Pay cuts are negative motivators. An underperforming executive whose salary is reduced will become a disgruntled, underperforming executive. Unlike in bureaucracies, in the private sector, poor performers are often replaced—just ask the former CEOs of Bank of America, Citibank, and Merrill Lynch. To the extent that government pay rules are intended to penalize poor performance, they will not be useful. Since the government is not normally in a position to discharge underperforming executives,[34] government pay rules do not address the most serious performance issues.

This Time is No Different

Apparently based on academic theories that stock volatility might benefit executives (by making options more valuable), the Obama Administration–Federal Reserve pay plan mandates that bank executives receive incentive pay largely in long-term restricted stock. The Watson Wyatt study showed that increasing the time period over which pay is received had no effect on corporate risk.[35] On the other hand, larger annual incentives, now in regulatory disfavor, tend to reduce corporate risk.[36]

Even scholars who believe government pay rules are needed agree that the government's latest fad, restricted stock, is the wrong mechanism for reducing risk. Prominent pay critic Lucian Bebchuk argues that pay systems should target total firm value, including preferred stock and bonds as well as common stock.[37] Common stock, Bebchuk argues, is too volatile a measure of corporate performance compared to more stable preferred stock and bonds.[38]

33. Beller, "Remarks Before Conference of the NASPP."
34. The controversy over the Obama Administration's meddling in auto makers' personnel issues, acting, in essence, as the major stockholder, is both an exception to and a cautionary tale regarding this principle.
35. Watson Wyatt, "Going Beyond Conventional Wisdom: Designing Executive Pay to Balance Risk and Performance," June 2, 2009, at *http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=21310* (October 30, 2009).
36. *Ibid.*
37. Lucian A. Bebchuk and Holger Spamann, "Regulating Bankers' Pay," *Georgetown Law Journal*, forthcoming, at *http://ssrn.com/abstract=1410072* (October 30, 2009).
38. *Ibid.*

The Predictable Undesirable Effects of the Bonus-Limit Plan. While the largest danger of the Federal Reserve pay plan may lie in its unforeseeable results, several likely negative effects are apparent from the outset:

- The bonus-limit plan will spread a "bonus culture," now limited to major New York-based banks, by setting an implicit, government-approved level for bonuses.
- Cross-firm comparisons will pressure firms paying below-median salaries to boost pay, while doing little to curb pay increases at firms with above-average performance. Banks that pay less than their peers will increase pay, and median pay will rise.
- Pay will rise to offset the risk related to potential "claw-backs,"[39] offsets, or delays in stock vesting. To remain competitive with non-regulated employers, banks will increase current compensation to offset the loss or risk.
- Regulated banking will be less attractive to the highest-performing employees to the extent that top salaries are cut. The best-qualified executives will be attracted to hedge funds or other private capital arrangements.[40]
- Regulations will create winners and losers among firms, most likely hindering weaker banks and comparatively helping stronger ones.

Reverse Robin Hood. Regulation is rarely neutral in effect on firms. Regulation can entrench firms by erecting entry barriers or favoring existing business models. Proposed pay regulations threaten to further entrench large banks and to further weaken marginal institutions.

The Financial Stability Board wants to prohibit "poorly capitalized" banks from paying large bonuses.[41] But a poorly capitalized bank is, by definition, in trouble due to loan or other business losses. While managers who presided over losses should not be rewarded, troubled banks are likely to need—and seek—new management.[42] Persuading qualified managers to leave healthy institutions in an effort to resuscitate poorly performing rivals will require exceeding the salary paid by the healthy rival. Often the most sensible compensation arrangement would include a large bonus for a successful effort.

Healthy firms, on the other hand, have less need to offer above-average compensation or guarantees. The Federal Reserve proposal helps wealthy institutions, while handicapping smaller or marginal banks. Thus, bonus limits likely will contribute to concentration in the banking industry; some observers believe that a structure of fewer and larger banks contributes to the fragility of the financial system.[43]

The reverse Robin Hood effect is not mere theory. The most profitable U.S. bank, Goldman Sachs, supports bonus limits, though it may pay more than $20 billion in bonuses to its employees this year.[44] Troubled competitors Citibank and Bank of America, on the other hand, are deprived of larger bonuses as an important recruiting tool.[45]

More generally, regulatory compensation standards will be subject to lobbying, manipulation, and rent-seeking. Banks seeking to give, or employees seeking to obtain, higher pay will perform for the political-regulatory system rather than competing in the marketplace.

39. A "claw-back" is a mechanism by which an employer can take back pay previously earned by an executive.
40. Kevin Crowley, "G-20 Pay Plans Risk Losing Top Employees, Bankers Say," Bloomberg.com, September 8, 2009, at *http://www.bloomberg.com/apps/news?pid=20601087&sid=aWjMXU1Mbk4Q* (October 30, 2009).
41. Financial Stability Board, "FSB Principles for Sound Compensation Practices: Implementation Standards," September 25, 2009, at *http://www.financialstabilityboard.org/publications/r_090925c.pdf* (November 2, 2009).
42. For instance, former Citibank CEO Charles Price and former Bear Stearns CEO James Cayne resigned after their banks lost money in 2007; two successive chairmen of Merrill Lynch, Stan O'Neil and John Thain, resigned or were ousted due to that firm's losses. See Nicola Brooks, "CEO Salaries, U.S. Banks and Emerging Markets," Moneyweb, January 16, 2008, at *http://www.moneyweb.co.za/mw/view/mw/en/page87?oid=185502&sn=Detail* (October 30, 2009). Bank of America chairman Kenneth Lewis resigned due to his bank's troubles.
43. Michael McKee and Scott Lanman, "Greenspan Says U.S. Should Consider Breaking Up Large Banks," Bloomberg.com, October 15, 2009, at *http://www.bloomberg.com/apps/news?pid=20601087&sid=aJ8HPmNUfchg* (November 2, 2009).

The Next Crisis. It is hard to predict all the effects of a government-mandated "restricted stock" fad. One effect could be to reduce employee mobility, which has been a keystone of personal success and healthy inter-firm competition for talented employees. Regulators have no data on likely effects because no one has ever emphasized "risk-limiting" features to the degree proposed. The modeling software is the same technology that mispriced assets during the recent bubble. Like previous pay mandates the new proposals are likely to produce an over-reaction, leading to a new crisis—and calls for even greater regulation.

Is Private-Sector Pay the Government's Problem?

There is widespread agreement that excess leverage was a significant factor in the financial bubble.[46] Existing government pay rules mandate tying executive pay to corporate performance, creating, in effect, leveraged executive pay at profitable firms—when corporate performance increases a little, executive pay increases much more. Consequently, when profits and stock prices of financial firms boomed during the financial bubble, executive pay skyrocketed. Now that the bubble has burst, public anger and regulatory attention has focused on the pay rather than the policies that led to the financial bubble.[47] Compensation reaped during the bubble by some financial executives was unjustified. But policymakers should learn from recent compensation policy mistakes and avoid mandates that are likely to create new imbalances in private-sector pay. Just as a wise approach to financial regulatory reform will consider policy mistakes along with private-sector excesses, compensation reform requires careful attention to existing policy incentives.

Now that the financial bubble has burst, public anger and regulatory attention focuses on pay rather than the policies that led to the bubble.

Taxpayers justifiably expect the government to keep a close eye on pay at firms that were bailed out with taxpayer subsidies. Whether the government is capable of doing so is an unanswered question.[48]

For non-subsidized companies, the case for government pay rules is unclear. The government justifies its proposed pay regulations by claiming the regulations will protect corporate shareholders and the economy. In a well-functioning market, firms that pay executives above their market worth eventually suffer. If executives are able to continuously extract what appear to be above-market returns, classical economics suggests that hidden rents are a likely cause. The Federal Reserve's pay guidance points to hidden subsidies in the form of deposit insurance and the "too big to fail" economic policy in order to justify government pay controls. The Fed reasons that these policies enable financial

44. "Goldman Sachs, which set aside $11.3 billion in the first half of the year toward bonuses for its employees but has also spoken out against excessive pay at firms that lost money, said excessive risk-taking should not be rewarded. 'We think it entirely appropriate that people are rewarded for performance, but compensation should correlate directly with the performance of the firm,' said Goldman Sachs spokesman Lucas van Praag.'" Alister Bull, "Fed Eyes New Bank Pay Rules to Fight Risk," Reuters, September 19, 2009, at *http://www.reuters.com/article/businessNews/idUSWEN373720090919* (November 2, 2009).

45. Ian Katz and Christine Harper, "Banker-Pay Limits May Hurt Citigroup, Bank of America," Bloomberg.com, September 29, 2009, at *http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a.wN5_AqS07Q* (October 30, 2009).

46. See, for instance, Ben Bernanke, "Lessons of the Financial Crisis for Banking Supervision," Speech to the Federal Reserve Bank of Chicago Conference on Bank Structure and Competition, May 7, 2009, at *http://www.federalreserve.gov/newsevents/speech/bernanke20090507a.htm* (October 30, 2009), and J. D. Foster, "Understanding the Great Global Contagion and Recession," Heritage Foundation *Backgrounder* No. 2331, October 22, 2009, at *http://www.heritage.org/Research/Economy/bg2331.cfm*.

47. John Taylor, *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis* (Stanford, Calif.: Hoover Institution Press, 2009).

48. "Pay Rules Complicate GM CFO Search," Reuters, October 17, 2009, at *http://www.reuters.com/article/businessNews/idUSTRE59G1UN20091017?feedType=RSS&feedName=businessNews* (October 30, 2009).

firms to pursue higher risk (and higher reward) business strategies while forcing taxpayers to bear the risk of failure.

A salary guarantee with a bankrupt firm is worth nothing. Thus, government bail-outs (actual and implied) eliminate the pay consequences of failure. Taxpayers are justifiably outraged about outsized bonuses paid by bailed-out firms. The solution however, is not to bail out firms and limit bonuses, but to stop bail-outs. If executives at financial firms understand that the personal price of corporate insolvency is the loss of a job, including unpaid compensation claims, executive attention might be more firmly fixed on avoiding insolvency.

Similarly, appropriate pricing of deposit insurance will prevent firms from extracting non-market rents in the form of extraordinary profits and salaries.

Regulators should avoid over-correcting. Instead of a risk-reduction mandate to offset the effects of the government's own risk-enhancing policies, regulators should back out of the corporate pay thicket and render any necessary compensation policies market-neutral. Policymakers should:

- Apply the same tax, regulatory and accounting rules to all forms of compensation (salary and stock, for instance);
- Avoid dictating compensation time frames. In some positions monthly performance, and therefore monthly bonuses, are critical. The government's current preference for a longer time horizon should not be foisted on every firm and employee;
- Eliminate the "Lake Wobegon Effect" by reducing, not increasing, the emphasis on cross-firm peer-group comparisons in salary setting;
- Reject compensation caps;
- Avoid conflicting regulatory incentives; they should not encourage risk-taking with subsidies and guarantees while simultaneously attempting to limit risk with compensation limits; and
- Recognize that singularly focused mandates imposed on complex systems are unlikely to produce predictable or desired effects.

Conclusion

The Federal Reserve and the Obama Administration are regulating financial-sector pay to discourage risk-taking and reduce over-payment of executives.

Policymakers should consider the trail of failure and unintended consequences left by previous efforts to regulate corporate pay. Limiting "golden parachute" payments caused them to soar in number. The executive salary cap led to an explosion in executive pay. Government exhortations to tie pay to peer groups boosted the compensation of lower-paid executives and caused overall executive pay to spiral.

Regulators cannot achieve desired results by attempting to fine-tune company policies. Regulators must recognize that past regulatory failures helped create the problems they face today. Rather than rushing to embrace the latest compensation fad and adding new layers of rules to private-sector compensation decisions, policymakers must acknowledge the limitations and unpredictable reactions of complex compensation systems to regulatory incentives.

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