Altering Incentives in the Financial Industry

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Much like Richard Posner, Martin Wolf is not a very big fan of Obama's proposed restructuring of the financial regulatory structure. But rather than focus on the fallibility of regulators as Posner does, Wolf focuses on the incentives at the heart of the financial system:

> Lucian Bebchuk and Holger Spamann of the Harvard Law School make the big point in an excellent recent paper.* Its focus is on the incentives affecting management. These are hugely important. Still more important, however, is why a limited liability bank, run in the interests of shareholders, is so risky.
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> In a highly leveraged limited liability business, shareholders will rationally take excessive risks, since they enjoy all the upside but their downside is capped: they cannot lose more than their equity stake, however much the bank loses. In contemporary banks, leverage of 30 to one is normal. Higher leverage is not rare. As the authors argue, “leveraged bank shareholders have an incentive to increase the volatility of bank assets”. ...
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> Profs Bebchuk and Spamann add that four features of the modern financial system make the situation even worse: first, the capital of banks is itself partly funded by debt; second, the role of bank holding companies may further increase the incentives of shareholders to underplay risk; third, managers are rewarded for aligning their interests with those of shareholders; and, fourth, some of the ways managers are rewarded – options, for example – are themselves a geared play on rewards to shareholders. So managers have an even bigger economic interest in “going for broke” or “betting the bank” than shareholders. As the paper notes, the fact that some managers lost a great deal of money does not demonstrate they were foolish to make these bets, since their upside was so huge. ...
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> Such a crisis is not only the result of a rational response to incentives. Folly and ignorance play a part. Nor do I believe that bubbles and crises can be eliminated from capitalism. Yet it is hard to believe that the risks being run by huge institutions had nothing to do with incentives. The unpleasant truth is that, today, the incentive to behave in this risky way is, if anything, even bigger than it was before the crisis.
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> Regulatory reform cannot end with incentives. But it has to start from incentives. A business that is too big to fail cannot be run in the interests of shareholders, since it is no longer part of the market. Either it must be possible to close it down or it has to be run in a different way. It is as simple – and brutal – as that.

The classic criticism of CEOs is that their personal incentives are not aligned with the desires of shareholders. Wolf is arguing that the exact opposite is true: CEOs take massive risks because their principals demand it from them. However, this risk-taking creates systemic risk, and the events of the past year have showed that if firms are "too big to fail" they will not be allowed to fail.

This sounds a lot like moral hazard, but in truth that is only partly accurate. Shareholders do have plenty at stake, but their potential losses are bound at zero while their potential gains have no upper bound. Simply allowing them to go out of business is not enough of an incentive to prevent risk-taking, since risk-taking is rational in this environment.

Wolf's last paragraph is unsatisfying, however. It may not be easy to see which firms are systemically important ex ante. Even relatively small firms can spread a lot of risk through counterparty obligations. But even if we could tell, how would we break them up? How would we "run them in a different way"?

We can't, says Brad DeLong, unless we publicly display managers of failed firms in the stocks:

> Managers and traders are, however, where I would focus most of my attention. I believe we need compensation reform: compensation schemes that make it a complete personal catastrophe for the CEO and all other employees if their bank fails. If managers and traders are, personally, wiped out--reduced in assets to their last two cars and their last four-bedroom house--if any financial institution they worked for goes bankrupt anytime in the next two years, then we have a chance of creating sufficient caution. Otherwise, I don't see how we do it.

Who in their right mind would work in finance under those conditions? No, that is not the answer. Individuals and firms should be allowed to take risks without fear of punitive reprisals if it is in their rational self-interest. We cannot, and should not, attempt to change the nature of man. What we should do is find a way to link outcomes to actions in a way that minimizes externalities. But so far, that solution has proven elusive.