Playing paymaster

Mint
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An economist walks into a bar, goes a joke, and is asked: What are the two fundamental things about economics? One is that incentives matter. Two, there is no such thing as a free lunch. Economists may bicker about everything else, but incentives are “one thing” they can’t ignore. Let’s hope the Reserve Bank of India (RBI) doesn’t ignore it either.

This “one thing” is key to making headway in the global debate over executive pay at banks—with large bonuses, the West’s masters of the universe had their eye on short-term greed instead of long-term need—a debate RBI weighed in on last week with its first ever draft guidelines for compensation at private and foreign banks. If incentives do matter, financial regulators must stay aware of two points.

First, regulators should know they can’t entirely leave the job of monitoring pay to bank shareholders. The old regulatory principle of letting managers’ incentives align with those of shareholders needn’t hold true here. That’s because, for commercial banks that are important for the financial system, shareholders’ incentives are already skewed. Harvard Law School’s Lucian Bebchuk has argued that shareholders know the government will bear the downside risk: They could well be goading managers to take on more risk.

That’s why regulators should keep a close watch, as RBI is doing. We don’t know how it has intervened in compensation matters before, but it’s good that the central bank is finally offering a coherent policy.

But, second, regulators should also know how to keep a close watch. Instead of spending too much time focusing on specific levels of pay, we think they should focus on the general structure of incentives. Here, it’s unclear where RBI stands.

Though it seems interested in overall pay structures, RBI has now suggested that annual increases in fixed pay shouldn’t be more than 10-15%. It also recommends that banks offer bonuses specifically through stock options, which aren’t cashed in immediately. These diktats are troubling, not least because they remind us of a socialist India with wage controls.

In today’s India that’s anyway suffering from a shortage of professional talent, hard caps on salary raises will only drive competent managers to other firms. And we don’t know how India, where cash is still king, will adapt to a sudden proliferation of stock options. The US has seen cases of options backdating, where options are possibly fraudulently issued at a later date, to get a favourable price.

That’s why incentives matter. India’s regulators should keep this in mind while finalizing these guidelines, lest the joke be on them.