Pay regulation is not the best way to address moral hazard

Financial Times
From Prof Luigi Zingales
August 17, 2009

Sir, Lucian Bebchuk has strongly endorsed the House of Representatives' decision to regulate the pay structure of the entire financial sector ("Regulate financial pay to reduce risk-taking", August 4). Financial institutions are special, argues Prof Bebchuk, because they impose costs on taxpayers that they do not internalise. This specialness warrants a broader role for the government in setting chief executive officers' pay in financial institutions.

I agree with his premise, but his conclusion is a non-sequitur. First, his reasoning assumes that pay regulation is the best way to address the moral hazard problem created by the too-big-to-fail policy. In fact, it is not even clear that it can help fix it. When shareholders have strong incentives to gamble at taxpayers' expense, they can easily bypass pay restrictions by providing managers with career incentives or stock awards to induce them to gamble more.

But even if pay restrictions could attenuate the moral hazard problem, are we sure that the government's regulation would help? As Prof Bebchuk admits, politicians are more interested in setting limits to the total amount of compensation, rather than in designing the optimal form of compensation. Politicians will naturally seek demagogic restrictions on total pay that will make them look good in the eyes of angry voters, but will not attenuate moral hazard.

Last but not least, Prof Bebchuk's reasoning assumes that poorly designed CEO compensations were the cause of the current financial crisis, while a recent paper by Rudiger Fahlenbrach and Rene M. Stulz show that there is no correlation between the two.

Banks' specialness does warrant a role for the government: not in setting pay but in imposing effective capital requirements that eliminate the value of the free option provided by the too-big-to-fail policy.

Is such a goal attainable? From the technical point of view, it is very simple. It is sufficient to have a regulation that forces shareholders to issue more equity or lose their stock when this free option starts to be near the money.

As Oliver Hart and I explained in a recent paper, this can be easily achieved by giving a regulator the power to intervene every time the credit default swap on the debt of a financial institution becomes too high (ie, the debt is at risk).

Any other regulation is not only useless but also counterproductive because it detracts political support in favour of the ultimate objective.

Luigi Zingales,
Booth School of Business,
University of Chicago, US