

## What Should Policymakers Do About Executive Pay?

Many economists and policymakers attribute the 2007-2008 financial crisis, in part, to compensation arrangements that motivated executives and other employees of financial institutions to take excessive risks — risks in pursuit of bigger bonuses and higher values for their stock and stock options. As noted elsewhere in this issue of *Region Focus* (“Checking the Paychecks,” p. 8), this view led Congress to enact a number of provisions in the 2010 Dodd-Frank Act to curb incentive pay. Even before the crisis, there were calls for regulators to do something about executive compensation, which was believed to be driven upward by the influence of management over compliant boards and by a corresponding lack of empowerment on the part of shareholders. What does economics tell us about when federal law should step in to try to shape compensation at private companies?

There is reason to be cautious about the efficacy or necessity of such interventions. Researchers have noted that in the 20 years or so prior to the financial crisis, pay increased substantially even as governance practices were generally evolving to increase shareholder power and as institutional ownership and shareholder activism were growing. In the economic literature, one interpretation of this trend has been that greater competitive pressures on companies, including from globalization, have increased the marginal value of the most capable leaders.

Yet there are real issues presented by executive pay. They are aspects of a more general problem in corporate governance, rooted in the familiar phenomenon of the principal and agent with differing interests — in this case, the separation of corporate ownership (in the hands of shareholders) and control (ultimately in the hands of managers). Will public-company boards and senior management cooperate to devise incentives that lead managers to serve the interests of shareholders, a large group of outsiders, despite the temptations for managers to engage in self-serving practices?

While it is possible for management to act against the interests of shareholders under the noses of an inattentive or overly loyal board, there are multiple sources of market-based discipline: The market for corporate control may lead to the ouster of underperforming or rent-extracting management as well as board members. Chief executives have an incentive to avoid risk to their reputations and future careers. And shareholders who become dissatisfied can readily vote with their feet by selling their shares. Despite some high-profile historical exceptions, these market mechanisms seem to do a reasonably efficient job in general.

One possible policy response is direct regulatory intervention to address managerial abuses. In the context of compensation, the Dodd-Frank Act does give regulators such powers in some circumstances. Critics who perceive a

greater incidence of management abuses do not, however, typically advocate direct government intervention with regard to those abuses. Rather, critics argue mainly for structural measures that will give boards greater power with regard to chief executives, and shareholders greater power with regard to boards. To the extent that such measures must be imposed from above by regulators, there remains the question of why more firms do not embrace them voluntarily, given the benefits that presumably would accrue in capital markets if the measures are believed to lead to better management and less rent-seeking.

Whatever one's view of the ability of market discipline to deter self-serving chief executives, there are cases where this discipline is likely to be impaired by government policy. One such case is when the firm has explicit or implicit backing from the government, as has often been true in the financial services industry. In that circumstance, debtholders may believe that they are protected in the event the institution fails, a belief that reduces the institution's cost of debt. Shareholders, in turn, have an incentive to exploit cheaper debt by increasing leverage — thereby increasing their tolerance for risk. Both debtholders and shareholders will have less concern about excessive risk-taking or rent-seeking on the part of management, and will likely impose less discipline. Thus, even though markets may align the interests of management and shareholders, the existence of a corporate safety net may cause those interests to be aligned in a socially undesirable way.

With regard to compensation, then, the most important task for financial regulators is not to limit the overall level of executive compensation; it is to see that compensation does not vary with the institution's financial results in a way that promotes inappropriate risk-taking that may create losses for the deposit insurance funds and, ultimately, taxpayers. This complex and difficult task is relatively new to financial regulators, but will be less burdensome the greater the influence of market discipline on executive compensation. To foster that discipline means continuing to contain the size and scope of the federal financial safety net. **RF**



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A handwritten signature in black ink, appearing to read 'Jeff M Lacker'.