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The Impact of Income Disparity on Financial Regulation

By Steven L. Schwarcz March 7, 2014

The following post is based on an article by Professor Steven Schwarcz of Duke Law School entitled Intrinsic Imbalance: The Impact of Income Disparity on Financial Regulation, *which documents and examines the consequences of the extraordinary two-to-one income disparity between members of the financial industry and their regulators.*

Scholars have long observed the existence of an information asymmetry between regulators and industry due to delays in obtaining information. I argue, in contrast, that the two-to-one income disparity between members of the financial industry and their regulators creates an additional, and very different, information asymmetry: one based not on obtaining but on processing information.

My article first shows the existence of that extraordinary income disparity. It is generally recognized that there is some income disparity between government regulators and private-sector employees in regulated industries. U.S. Bureau of Labor Statistics surveys indicate, for example, that federal government pay is around 25 percent lower than private-sector pay for similar jobs. A much larger income disparity exists, however, between financial regulators and private-sector employees of the financial industry.

This disparity can be demonstrated by comparing the incomes of representative financial industry workers and government regulators. Taking into account salaries and bonuses, a two-to-one (approximately) private-sector compensation advantage is mirrored in all of the available data, except at the top compensation levels where the private sector's compensation advantage spirals even higher. Thus, although federal government pay is around 25 percent lower than private-sector pay for similar jobs generally, it appears to be more than 50 percent lower than private-sector pay for similar financial jobs.

Next, I argue that this huge income disparity makes it difficult for regulatory agencies to hire competitively compared to industry. The SEC's staffing crisis, for example, is shown to result primarily from an inability to compensate SEC employees adequately.

Other things being equal, it should not be surprising that people choosing between employment offers will select the offer paying twice as much as alternatives. But are other things truly equal? To answer that question, I examine the relevant frameworks by which to assess human economic decisionmaking in choosing employment. The more general framework is rational choice theory ("RCT"), which assumes that rational people will pursue the greatest net benefits. Although RCT studies show that choice can involve differences in work-place values, degrees of risk aversion, reward preferences, and personality types, the extent to which these differences outweigh income differentials is inconclusive.

Public sector motivation ("PSM")—the predisposition to respond to motives grounded primarily or uniquely in public institutions and organizations—is the other relevant framework by which to assess decisionmaking when choosing between public-sector and private-sector jobs. PSM posits that some individuals will choose to earn less money in the public sector in order to work for the public good. The reliability of PSM is not, however, free from doubt. Although some studies find that highly educated and more experienced workers are far more likely to choose the public sector, offsetting lower wages with rewards arising from the characteristics of their jobs, other studies find no differences in the relative value of money between public-sector and private-sector employees and that compensation is a decisive factor even for workers with high PSM.

Moreover, PSM's ability to overcome the two-to-one income disparity is highly questionable in the context of persons interested in finance. Among other things, those persons, *by reason of that very interest*, would be expected to inherently favor higher financial incomes. Empirical evidence indeed indicates that the most well trained financial employees self-select into higher paying positions.

I then argue that the difficulty of regulatory agencies to hire competitively compared to the financial industry creates an information asymmetry between

financial regulators and members of the financial industry. Although the general problem of asymmetric information has been debated at length by scholars, this article's focus—on information asymmetry resulting from differences in intellect and abilities between regulators and the regulated—is new. Scholars studying information asymmetries between regulators and the regulated have focused in the past almost exclusively on information acquisition and product-development lag time. That focus is limited to regulators *obtaining* information. It therefore only indirectly concerns differences in intellect and abilities; because industry first develops the products to be regulated, even the brightest and most able regulators would be disadvantaged and subject to lag time.

In contrast, my article focuses on significant differences in intellect and abilities, which go to the ability of financial regulators to *process the information, once obtained*. There are at least three levels of complexity in financial markets: complexities of the assets underlying investment securities traded in financial markets and of the means of originating those assets; complexities of those investment securities themselves; and complexities of those financial markets, which operate as systems. An understanding of these levels of complexity sometimes challenges experts at even the most sophisticated financial firms. Administrative agencies that lack that expertise will be even more challenged to understand these levels of complexity.

Next, I analyze the regulatory consequences of the information asymmetry to administrative rulemaking, monitoring, and enforcement. The better regulators understand financial innovations, the better they can promulgate rules to curb harmful innovations. Absent a clear understanding, regulators might not only fail to promulgate adequate rules; they also might misinterpret the innovations and promulgate rules that are harmful.

A lack of full understanding of financial innovations and products may also have monitoring consequences—that regulators will be unable to effectively monitor financial innovations and products. I do not claim that reducing the income disparity between regulators and industry could eliminate information-based market failures. Not only regulators but also industry participants—including rating agencies, monoline insurance companies, and even the most sophisticated and largest institutional investors—either missed or did not adequately take into account early warning signs of the recent financial crisis. Nonetheless, reducing the income disparity should at least help to reduce the information asymmetry and its consequences.

Finally, because of the sheer number of regulatory personnel needed to pursue enforcement actions, enforcement—more than rulemaking and monitoring—turns as much on the quantity as the quality of regulators. The more staffing an agency has, the easier it will be for the agency to bring enforcement actions. And much public enforcement is done informally by regulators, which requires highly skilled staffers.

Thus, I conclude that the two-to-one income disparity between the financial industry and its regulators creates an information asymmetry that can cause regulatory failures in rulemaking, monitoring, and enforcement; and those failures, in turn, can help to explain why financial regulation is so often inadequate. I next consider how the information asymmetry could be mitigated.

The most direct way to mitigate the information asymmetry would be to reduce the income disparity. That could be done by increasing regulators' compensation, or by limiting financial industry compensation. The ability of government to increase regulators' compensation is, of course, highly subject to political considerations. Some scholars even argue that attracting more able workers into the public sector, by increasing income, would be inefficient because, they contend, the return on talent is always higher in the private sector. That may or may not generally be true, but it is unlikely to be true for financial regulation so long as regulators suffer from an information asymmetry that can prevent them from effectively monitoring and regulating financial innovations that might create systemic externalities.

It therefore ought to be efficient to increase regulators' compensation as needed to reduce that information asymmetry. Although not a controlled experiment, I examine the experience of Singapore, which pays its government financial regulators incomes that match or exceed that of comparable private-sector workers. The International Monetary Fund believes that this pay parity has enabled Singapore to become a highly successful regional financial center.

Whether the Singaporean attempt at income parity could be viable in other countries, including the United States, is unclear. Even given the political will to achieve that parity, the financial industry would be motivated—and so long as finance is highly profitable, it should be expected to be able—to match and exceed any public-sector raises that drew away significant talent. Singapore's success to the contrary may be bound up with a regulatory economy-of-scale or other country-specific explanation.

As a variant on increasing regulators' compensation, I also examine paying regulators based on their performance. Some scholars, for example, partly blame the lack of performance-based incentive for the failure of bank examiners to act aggressively to prevent excessive risk during the recent financial crisis. Performance-based pay for regulators is an interesting idea, but whether it would work in practice is highly fact dependent.

A further way to mitigate the income disparity and, hence, the information asymmetry might be to legally limit compensation in the financial industry. A populist movement towards limiting financial industry compensation has gained momentum in recent years, reacting (among other things) to huge bonuses paid to senior financial executives while shareholders of their firms faced losses. But even if politically viable, limiting financial industry compensation might have unintended and perverse consequences. Moreover, any such limits might not extend to restrictions beyond the highest paid executives, who are not the ones for whom the income disparity creates the most troublesome information asymmetry.

I also examine other measures that don't address the income disparity per se but nonetheless might help to reduce the information asymmetry or its consequences, such as increasing the non-monetary attraction of public-sector regulatory jobs or reducing the information asymmetry by blunt force (for

example, by standardizing financial products, by increasing specialization among regulators, and by paying third-party experts to try to reduce the asymmetry). I show, however, that these approaches are likely to be inefficient and could backfire.

Finally, I suggest another possible response: to accept the reality of the income disparity, and hence the resulting information asymmetry, and to regulate in a way that mitigates its consequences. The main consequence of the information asymmetry is that financial regulation will always be insufficient to prevent financial failures. This prompts a two-pronged regulatory response that UCLA Professor Iman Anabtawi and I have elsewhere proposed, based on chaos theory: to supplement traditional ex ante (preventative) financial regulation with ex post (ameliorative) regulation whenever financial failures are inevitable. In other words, regulatory responses must not only attempt to reduce those failures but also must work to mitigate their consequences when they inevitably occur.

Written for Columbia Law School's symposium on "Administrative Law and Financial Regulation," Schwarcz's article is slated to be published in Law and Contemporary Problems as part of a special issue (issue 1 of volume 78) devoted to the symposium.