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Using deferred compensation to strengthen the ethics of financial regulation

Edward J. Kane *

Department of Finance, Boston College, 330A Fulton Hall, Chestnut Hill, MA 02467, USA

Abstract

Defects in the corporate governance of government-owned enterprises tempt opportunistic officials to breach duties of public stewardship. Corporate-governance theory suggests that incentive-based deferred compensation could intensify the force that common-law duties actually exert on regulatory managers. In principle, a forfeitable fund of deferred compensation could be combined with provisions for measuring, verifying, and rewarding multiperiod performance to make top regulators accountable for maximizing the long-run net social benefits their enterprise produces. Because government deposit-insurance enterprises are purveyors of credit enhancements for which private substitute and reinsurance markets exist, their performance could be measured accurately enough to make employment contracts for deposit-insurance CEOs a promising place to experiment with this kind of accountability reform.

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Regulation and ethics are terms of art. Regulation consists of setting rules (in Latin, *regula*) and enforcing them. Enforcement entails monitoring and compelling regulatee conformance. External enforcement is sometimes characterized as supervision and may be assigned to parties whose interests differ substantially from those of the rule-makers. It is convenient to define "ethics" of regulation etymologically as occupational standards of performance that are imbedded in the customary ways of doing things that one may observe today in the community of actual supervisors

* Corresponding author. Tel.: +1-617-552-3986; fax: +1-617-552-0431.
E-mail address: edward.kane@bc.edu (E.J. Kane).

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and regulators (cf. Jackall, 1988). These practical standards tell us how to expect conflicts of interest inherent in particular regulatory duties to be resolved.

In modern societies, a financial institution is an organization that produces funds-management, informational, and transactional products for a base of customers with whom it seeks to maintain a repeat-business relationship. Back-office elements of this business may be characterized as an information and dealmaking factory. Each deal obligates the counterparties to exchange a mix of information, cash, and service flows today and at specified future dates. To reliably value their side of potential deals, financial institutions gather, verify, and process information about the investment projects and creditworthiness of their counterparties. Through their capital structure and contracting instruments, institutions transmit accounting and other kinds of information about how existing deals allocate risk across their firm's explicit and implicit stakeholders.

The proximate goal of any financial regulator is to constrain the behavior of client financial institutions. Regulatory constraints supplement subtler limits that are set by social norms and by competitors in the markets in which institutions compete.

To set bounds on the behavior of a financial firm requires regulatory officials to focus on its information flows and dealmaking activity. To establish even limited control over a universe of individual regulatees, financial regulators have to establish protocols for disclosure, truth-telling, promise-making, promise-keeping, and conciliation.

Particularly because of externalities associated with financial institutions' role in a country's payments system, most societies assign government financial regulators three major tasks:

1. to limit risks of fraud, discrimination and contract non-performance in financial transactions;
2. to operate a safety net designed to virtually eliminate risks of fire-sale losses associated with financial-institution insolvencies and unjustified customer runs; and
3. to operate the fraud controls and safety net honorably and at minimum opportunity cost to taxpayers.

These services offer benefits in confidence and convenience to regulated firms and to their customers. Minimizing the opportunity costs of producing regulatory benefits entails marginal-cost pricing for all services performed specifically for particular constituencies, balancing increases in uncompensated current expenditures on enforcement, and compliance against the decreases such expenditures might induce in the projected costs of future financial messes and crises. The optimal balance may be defined as the equilibrium tradeoff that would obtain if it were possible to align the incentives of regulators perfectly with those of taxpayers.

In choosing and operating a framework of rules and bureaucratic enforcement, the CEO of any regulatory enterprise faces three potential incentive conflicts. First, society usually assigns more than one mission to each regulatory enterprise. These separate missions may and sometimes do conflict with one another, allowing regulators to choose which ones to prioritize (Wall and Eisenbeis, 1999). Second, parties