Unholy Trinity: Bailout Guarantees, Fixed Wages, and Capital Regulation

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Abstract:

This paper shows that a separation of ownership and control together with fixed wage manager remuneration allows banks to better exploit implicit government bailout guarantees. If a bank is managed by an owner-manager (i.e., manager with pure equity compensation) the optimal capital structure trades off the benefits derived from a higher leverage (i.e., a higher value of government guarantees) and its costs (i.e., inefficiencies from risk-shifting). This leads to a moderate leverage level and a riskier than the social optimum asset risk choice.

By separating ownership and control and setting up an "initially" risk-curbing compensation scheme (i.e., a combination of equity and fixed wage), the bank can eliminate the costs from risk-shifting, which allows for a higher leverage level. Ultimately, this can increase the riskiness of the asset risk choice compared to a pure equity manager remuneration, depending on the tightness of the capital regulation in place. These findings yield important implications for the regulation of banker pay.