

DEPARTMENT OF ECONOMICS

Dr John Thanassoulis

From July 2011: Manor Road Building, Manor Road, Oxford OX1 3UQ. UK
To July 2011 visiting: Institut d'Économie Industrielle,
Manufacture des Tabacs MF413, 21 Allée de Brienne, Toulouse, 31000, France.
Tel: +44(0)1865 271060 (office) Fax: +44(0)1865 271094



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Ref: Incentive Based Compensation Arrangements

Dear Madam/Sir,

This letter is in response to your invitation for comments on the Proposed Rule on Incentive Based Compensation Arrangements.

One central aim of the Proposed Rule is to prevent compensation at covered financial institutions increasing substantially the risk of those institutions suffering material financial loss.

The level of remuneration paid by financial institutions is a legitimate cause for concern. Just before the financial crisis the total remuneration bill in one year at Merrill Lynch and at Morgan Stanley was running at 50% of their entire stock of shareholder equity. Looking at data on the banks and financial institutions traded on the NYSE over the last 10 years, in about 10% of cases the remuneration bill was worth more than 80% of total shareholder equity. These are large payments which can potentially make the difference between investors having and losing confidence in a financial institution.

The Proposed Rule requires agencies to oversee the structure and level of compensation for numerous individuals across all covered financial institutions in the USA. This is designed to prevent those individuals facing incentives to take on excessive risks. This approach of per person regulation has the following drawbacks:

- The workload on agencies to vet executives' pay individually is huge.
- Per person regulation of variable remuneration will discourage financial institutions from using variable remuneration. Such an outcome would be detrimental as variable remuneration plays an important insurance role: If investment returns are low, then required compensation is reduced – just when the danger of a default event, or a run, is present. A move to increase fixed wages would leave institutions with a large compensation bill even when returns were poor.
- The Proposed Rule makes large strides in improving governance, risk management processes, monitoring and so on. As these measures on governance take effect, it will be less necessary for a regulator to sign off on each individual's pay and so such a regulation will become constricting and potentially outlive its usefulness.

These considerations lead to a simple policy proposal: **implementing a weak cap on the proportion of the balance sheet which a bank or financial institution can use for variable compensation (bonuses)**. Such a policy would have the following advantages:

1. The cap would dampen the competition between the financial institutions for bankers and so act to lower the levels of compensation. This directly contributes to a reduction in the risks that financial institutions face as they can bare the bill for larger investment losses in addition to their compensation bill. This is important given the size of compensation as a proportion of



shareholder equity.

2. The cap is weak in that it is set at a level which is generous enough to allow financial institutions to hire their bankers using variable compensation without having to increase fixed wages. The valuable insurance benefits of variable compensation are thus retained. This is possible as the proposed cap acts primarily to weaken the institutions' ability to drive up compensation for their rivals' bankers. It does this whilst preserving their capacity to employ their own bankers using variable compensation.
3. As the cap is at the balance sheet level, and not at a per person level, policy makers do not need to intervene in the business decision of how much to reward an individual banker. Covered financial institutions are left with discretion over this. Thus agencies are saved a considerable workload.

A cap on the proportion of the balance sheet which can be used for variable compensation can be structured to both lower the risk of financial institutions and increase the value of those same institutions – the only losers would be bankers in that market levels of compensation would be reduced. Such a cap can be implemented by a regulator with authority over only a subset of global financial institutions.

The material in this letter is outlined in further detail in the Oxford University Department of Economics working paper #532.¹ If I can offer any useful elaboration then I am more than happy to. I can be reached via the contact details at the top of this letter.

Yours sincerely,

A handwritten signature in blue ink, reading 'J. Thanassoulis'.

John Thanassoulis.

University Lecturer (tenured) and Official Student (Fellow) of Christ Church
Department of Economics, University of Oxford

¹ Available on my academic website [<http://www.economics.ox.ac.uk/Members/john.thanassoulis/>] or directly from http://www.economics.ox.ac.uk/index.php/papers/details/departments_wp_532/