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Comments on *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices*

Dear Madam/Sir,

Please consider these comments in response to your call. The comments are drawn from research I have conducted with other colleagues at the University of Warwick and the Bank of England. I write in a personal capacity as the Professor of Financial Economics at the University of Warwick.

I have restricted my comments only to the specific areas in which I have substantive points to make.

Comment on #1: "*The board should oversee and senior management should ensure that the firm has in place a compensation system designed to promote ethical behaviour and compliance with laws, regulations, and internal conduct standards.*"

> The pay policies of one financial institution affect those of other institutions as the companies are in competition in the labour market to hire sought-after staff. If one financial institution is willing to offer substantial sums in the hope of attracting bankers, other banks will match. This will collectively raise the amount of money paid to banking professionals in compensation. This compensation bill represents a very large cost to the sector, comparable with the total shareholder equity in the sector. Large aggregate wage bills create financial risk if reducing the pay in times of stress is difficult or slow.
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> This negative externality is explored fully in Thanassoulis (2012). One implication is that financial stability is supported if boards have a responsibility to ensure that the aggregate wage bill is not too large when compared to the risk weighted assets of the bank or financial institution.
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> Further, if wage bills are not prevented from rising then a problem of short-termism in banker behaviour is created when markets consolidate. The banking sector has seen a great deal of consolidation over the last decades. Combined with increasing pay levels, it becomes increasingly expensive for banks to defer sufficient pay to prevent short-termism as such deferred pay is discounted by the employee at above financial market rates (Thanassoulis (2013)). Absent regulation, this creates scope for pay practices which are too lax in terms of risk taking. This insight implies that there is a great deal of pressure on the efficacy of mandatory deferral of pay.

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Comment on #6: "*To effectively accommodate the potentially longer-term nature of misconduct risk, compensation systems should provide for mechanisms to adjust variable compensation, including, for instance, through in-year adjustment, and malus or clawback arrangements, which can reduce the variable compensation after it is awarded or paid.*"

The interests of the Board and the Financial Regulator are not perfectly aligned because of the possibility (either explicit or implicit) of government bailout. This too-big-to-fail problem results in financial institutions targeting a level of risk taking in excess of what is in the surplus maximising interests of the economy or society. Clawback and Malus rules are designed to limit excessive risk taking. Thanassoulis & Tanaka (forthcoming) demonstrate that adjustable pay can be used to neuter the effectiveness of these policies.

Clawback is designed to create a wedge whereby the bank executive only selects a high risk project if it generates a market value sufficiently in excess of that available from an alternative low risk project. The wedge is induced by threatening to claw back some pay from the bank executive with some probability, conditional on the high risk project being chosen. Thus, even if the high risk project would dominate the low risk one for the bank owner, it need not for the bank executive in the presence of a clawback rule. But the Board can counter this effect by having the executive's pay rise sufficiently rapidly in the bank's market capitalisation. The faster this rate of increase, that is the more convex the remuneration scheme, the closer the bank executive's preferences move to the bank owner's despite clawback. Further, as what matters here is the comparison of one project choice to another, the absolute level of pay is not directly relevant. Thus, pay levels can be scaled down whilst increasing pay curvature to ensure that the convex remuneration scheme does not cost the bank any more (in expected terms) than the previous scheme.

A solution in principle is that the regulator adds to the clawback rule a restriction on the curvature of the pay schedule. The pay curvature restriction limits how much shareholders can incentivise management to choose risky projects over safer ones. Thanassoulis & Tanaka (forthcoming) show that, if this is set appropriately, then the excessive risk problem can be solved. However, it may be hard to place such a curvature restriction on pay explicity. If so then regulators should be aware of this loophole and monitor the curvature created by all the remuneration tools, including promotion policy as well as bonus and equity awards.

Thank you for considering these comments.

Yours sincerely,

John Thanassoulis.

References:

Thanassoulis, J and M. Tanaka, forthcoming, Optimal Pay Regulation for Too-Big-To-Fail Banks, *Journal of Financial Intermediation*.

Thanassoulis, J., 2013, Industry Structure, Executive Pay and Short-Termism, *Management Science*, 59, 402-419.

Thanassoulis, J., 2012, The Case For Intervening In Bankers' Pay, *Journal of Finance*, 67, 849-895.

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