Commentary: Fixing the Financial Crisis Through Compensation Regulation

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US Treasury Secretary Timothy Geithner stirred a hornet's nest this week by announcing that the Obama administration's legislative proposals to regulate compensation at firms in the financial services industry would be introduced in a few weeks. No less imposing a figure than former SEC Chairman Arthur Levitt has denounced this initiative, stating that efforts by the Obama administration to regulate compensation practices are "totally wrongheaded."

I think Sir Arthur underestimates the windmill with which he jousts.

It is not a coincidence that on April 30, 2009, the European Commission released its "Recommendation on Remuneration Policies in the Financial Services Sector." This release followed the Consultation Paper of the United Kingdom's Financial Service Authority (FSA) entitled "Reforming Remuneration Practices in Financial Services." The FSA's report in turn acknowledges the source of its ideas as derived from working groups in the Committee of European Banking Supervisors and the Financial Stability Forum.

The Financial Stability Forum is a particularly interesting partner in the remuneration policies debate. On April 2, 2009, it issued the report of its "Compensation Workstream," essentially a Committee of Regulators, to the G-20 Summit at its meeting in London. As it happens, Mr. Mark S. Carey of the Federal Reserve Board and Mr. Clinton Lively of the Federal Reserve Bank of New York are members of this Committee. Other members include representatives of regulators from Australia, Canada, France, German, Netherlands, Singapore, Switzerland, and the United Kingdom. Oddly, neither China nor any other Asian nation is part of the Financial Stability Forum and presumably not required to impose similar legislation.

For good or ill, all of this collaboration among regulators has led to some remarkably consistent views. It is impossible to read all of this without concluding they are singing from the same hymnbook. This regulatory coherence also means that the Obama administration's legislative proposals are likely to mirror the proposals introduced by the European Commission and the UK's FSA, each of which bear an uncanny resemblance to the report of the Financial Stability Forum.

These reports are loaded with recommendations that, if adopted even in part, will cause massive upheaval in the financial services industry. Here, we can only briefly touch on a few key points.

All of the various reports agree that a global solution is required. None of these regulators is prepared to impose compensation regulations, unless other nations are willing to impose similar regulations. As the Financial Stability Forum argues, major financial institutions compete for talent globally, so change will not be effective unless it is industry-wide and global.

I read this as a statement that European legislators are unwilling to take action, unless the United States is willing to hold their hands and vice versa. Secretary Geithner's legislative proposals, therefore, almost certainly will be consistent with the agreement reached at the Financial Stability Forum.

By "industry-wide," the Forum clearly intends that its proposals will apply to more than just banks. Broker-dealers, large investment funds and insurance companies would be caught in its grasp. On the other hand, the Forum's work would not seem applicable to institutions that are not "systemically significant." That said, large firms will complain to high heaven if smaller firms are permitted to cherry-pick their best employees. If this is to work, it must apply to all firms within an industry.

The report of the Financial Stability Forum proceeds from the premise that the compensation practices of the financial services industry contributed to the current financial crisis. High short-term profits, it argues, led to "generous bonus payments" to employees that failed to take into account the longer-term risks imposed on their employers. These "perverse incentives" amplified risk-taking behavior throughout the industry, which in turn threatened the global financial system. It follows that if "generous bonus payments" amplify the problem of systemic risk, limitations on bonus payments are the solution.

Thus, Secretary Geithner in his Congressional testimony describes compensation reform as part of an effort to achieve safety and soundness. Anyone who has served time as a banking lawyer will readily recognize "safety and soundness" as the Fed's mandate. This terminology suggests that the safety and soundness principle will extend to institutions, such as broker-dealers, insurance companies, investment advisers and the funds they manage that currently are not subject to safety and soundness regulation. Broker-dealers, for example, are used to regulations intended to protect investors from fraudulent and unfair market practices. In the past, investor protection has generally been accomplished without the need to operate with safety and soundness.

Of course, the recommendations of the Financial Stability Forum are not put quite so bluntly. Instead, regulators are urged to require firms to institute compensation policies that will establish a correlation between risk and compensation.

The difficulty is that this has all been tried before. In the late 1990s, various regulators encouraged taking risk into account in determining compensation without much success. The Forum gently suggests that this failure may be attributable to not having tried hard enough.

According to the Forum and the FSA, one way to reduce the incentive for excessive risk-taking is to pay most compensation in the form of salary, leaving only a modest amount to be paid in cash bonuses. The underlying threat is that if no other satisfactory method of taking risk into account can be found, the percentage of compensation that can be paid in the form of cash bonuses will be limited by regulation. Commentators have wimpered that this may not induce the proper amount of devotion to duty by employees.

All of the reports are loaded with suggestions for changing the way compensation is structured. In all of them, non-executive directors and risk management employees are tasked with setting compensation policies, and even determining individual compensation amounts, for the entire firm. As we all know, the loyalty of traders to the head of the desk is attributable in no small measure to the head trader's control over compensation. The head trader's capacity for dominance in such a world would be toothless.

Speaking more broadly, compensation strategies, more than anything else, are the tools through which firms in the financial services industry are managed. In that sense, Arthur Levitt is right to express concern. Wresting control over compensation out of the hands of executive management will alter forever the way firms are run. Indeed, the people who currently manage firms may no longer be up to the task in this new world.

I doubt that many in the industry will support the administration's compensation proposals. It amounts to government intervention on a scale that we have never experienced in this country. It will even be a novelty in most of Western Europe.

It must be acknowledged that when the industry decided to accept taxpayer funds, we became wards of the State. It was a deal done with the Devil, and now we are being asked to pay the price. Government employees work for compensation set by the government.

Whatever our misgivings, this is a global initiative. The train is leaving the station. I am not sure it can be stopped.