

The Ambachtsheer Letter

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REGULATING COMPENSATION AT FINANCIAL INSTITUTIONS:

ADVICE FOR THE *FINANCIAL STABILITY FORUM*

“You were identified as an expert to be consulted on this issue... and the G-7 Finance Ministers and Central Bank Governors have put everything on overdrive!”

FSF Working Group on Market and Institutional Resilience

Overdrive Indeed!

We received an invitation last month to provide advice to the international *Financial Stability Forum Working Group on Market and Institutional Resilience*. The subject was the regulation of compensation schemes at large financial institutions. The invitation arrived on a Tuesday...and could we please meet to discuss this issue on the following Tuesday. While flattering, this request raised a rather fundamental question: did we really have anything useful to say on this topic? After some reflection, we decided the answer had to be ‘yes’ (after all, the *FSF* had identified us as an expert!) The *AIG* compensation controversy currently playing out in the media provides additional motivation. This *Letter* sets out the advice we shared with members of the *Working Group*.

Before we get to that advice, the extraordinary events that continue unfold ‘on overdrive’ around us deserve a moment of reflection. *Financial Stability Forum* members are meeting as you read this *Letter* to prepare for the G20 Leaders meeting on April 2 in London. Financial stability will be the central theme at this meeting, with compensation schemes at financial institutions just one of a number of major items on a very busy agenda. Other items include bank capital requirements, new regulations for hedge funds, securities and derivatives trading, accounting and audit practices, and the coordination of monetary, fiscal, and trade policies and practices. The complexity and speed of it all makes the head spin.

Four Guiding Principles

Building conviction that we indeed had something useful to say on the compensation question was really not that difficult. After all, we have been studying and consulting on pension fund governance and organization design issues for decades now. Over the course of the last few years, these topics, including the compensation dimension in both pension fund and banking contexts, have been on the agendas of the semi-annual Discussion Forums of the *Rotman International Centre for Pension Management*. Indeed, we have just finished editing two articles on organization structure and incentive compensation that will appear in the Spring 2009 issue of the *Rotman International Journal for Pension Management*, with a mid-May release target.

Articulating some principles to guide our advice seemed like a good first step. We arrived at four:

1. Compensation scheme design should start with a clear statement of the organization’s goals and culture. Whose interests will the organization serve, and how will it ensure this actually happens?
2. Be explicit about the risks the organization faces, how these risks will be measured and managed, and the desired relationship in the organization between risk-taking and incentive compensation.