Alternatives to Sarkozy's pay caps

The Deal
By Sara Behunek
August 27, 2009

French President Nicolas Sarkozy's iron-fisted proposals to curb outsized financial sector bonuses, including a potential pay cap and/or heavily taxing bonuses, is not expected to go over well when he pitches them at the G-20 meeting in September.

But there are other, more reasoned approaches that the G-20 leaders would likely give a warmer reception.

The Wall Street Journal's Simon Nixon champions forcing banks to hold more capital against trading books, an initiative he says the entire G-20 should adopt. Nixon writes:

After all, it is traders who take home the really big bucks based on risks taken using balance sheets implicitly backed by taxpayers. Policy makers should force up the cost of capital for trading desks. That would cut into risk-adjusted trading profits and, when coupled with existing changes to remuneration policy, stifle megabonuses and force desks to temper wilder activities.

Higher capital requirements are on the way, Nixon maintains, though it is unclear how high they will go. A review by the Bank for International Settlements could mean the capital charge on certain trading assets rising three times or more, he writes.

As explained by Reuters columnist Peter Thal Larsen, "higher capital requirements will make [trading businesses] less profitable for banks in the future" and in theory should lead to smaller bonuses. Larsen also contends that bonuses will naturally shrink "if, as is widely expected, future returns in banking are lower than during the boom."

However, this might only solve a part of the problem. Deterring traders from taking on excess risk doesn't mean executives at the highest levels of the organization would be similarly dissuaded. What's more, this approach still bases bonuses on the flawed metrics that tie executives' bonuses to highly levered bets on the value of banks' capital.

Instead of basing executives' payoffs only on equity, or levered equity, compensation could be based on the value of a broader array of securities, as suggested by Harvard Law professor and compensation expert Lucian Bebchuk.

In a research paper (posted after the jump), Bebchuck and Ph.D. candidate Holger Spamann write:

Instead of tying executives' compensation to the value of a specified percentage of the common shares, executives' compensation could be tied to the value of a specified percentage of the value of the common shares and the preferred shares.

More generally, executives' payoffs could be tied to an even broader basket of securities than common shares and preferred shares. In particular, executives' payoffs could be tied to a set percentage of the aggregate value of common shares, preferred shares, and all outstanding bonds.

Because such compensation structure would expose executives to a broader fraction of the negative consequences of risks taken, it will reduce their incentives to take excessive risks.

So, now that the floor is open, does anyone else have a suggestion? - Sara Behunek

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