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**Comment: Range of Methodologies for Risk and Performance Alignment of Remuneration**

Dear Madam/Sir,

The attempt to adjust banking remuneration for risks taken relies crucially on the methodologies employed in measuring and identifying risk. The US and European financial crisis of 2008 has underlined the woeful inadequacy of the risk measurement approaches and models employed by even the most sophisticated financial players. This has been recognised by a number of regulators.

It is insufficient for regulators to proceed with the attempt to adjust banking remuneration for risks taken, without prior identification of the right methodology that can correctly measure such risks, especially of the type that brought down many financial institutions and banks in the US and Europe in 2008.

The consultative document states that "For many activities, bad-tail risk (low frequency, high impact risk) is difficult to measure ex ante" (p. 13). This is not correct. It is also inappropriate to deal with this problem by recommending deferral of remuneration. Deferral would not change incentive structures sufficiently to avoid the type of risky behaviour that has caused the financial crisis: bankers would know that they would not get a bonus if they brought down the bank, but they would bet on this event happening sometime later, affecting perhaps a bonus further in the future. As banking crises tend to happen with gaps of several years, bankers would still benefit by hoping that the banking system will hold up while they receive their deferred bonuses.

The solution is to identify the underlying causes of the financial crisis correctly and measure the appropriate risk adequately. I have summarised some of my research on this topic in some of my publications (e.g. Werner, 2005; Werner, 1997) and an earlier submission to the BCBS (<http://www.bis.org/publ/bcbs165/universityofsou.pdf>).

Concerning the measurement of the appropriate risk, and the attempt to adjust banker remuneration accordingly, my findings imply, among others:

- Bonuses should not be awarded at all to bankers that create undue systemic risk by extending credit (and thereby create new money supply) to borrowers

who will use the money for transactions that do not contribute to GDP (these are mainly financial or 'speculative' transactions). The economic justification is that the bankers rely on the public privilege of money creation for their 'success' and hence have to take public welfare into consideration.

- Bonuses should only be awarded to bankers that contribute actively towards financial stability, economic growth and a value-added oriented income distribution by extending credit (and thereby creating new money supply) to borrowers who will use the money for productive transactions that contribute to real GDP by creating new goods and services.
- Bonuses should be structured to reward bankers who take time to analyse small-scale loan applications; there should be no positive proportionality at all to the size of any deal. Alternatives might include proportionality to the time required (which is often much larger in the case of small firm loan applications) and inverse proportionality to deal size.

I would be happy to comment in greater detail, should the Committee consider any of these observations to be of relevance at all.

Yours sincerely,

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## **Bibliography**

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