Should Bankers Get Their Bonuses?

Steven N. Kaplan

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ankers’ bonus season has arrived. This year op- position is stronger than ever given the number of high-paying firms bailed out with taxpayer dollars during the crisis. So why should bankers get their bonuses? Opponents of bonuses make three arguments. First, bankers are overpaid, particularly given the hardships Main Street faces. Second, bonuses are undeserved because many banks would have folded or failed to survive without government intervention. Third, large bonuses encouraged bank executives to take excessive risks, contributing greatly to the financial crisis. The anger is understandable, but none of these arguments stands up to scrutiny.

Bankers are well paid, but their high pay is not unique. Pay has increased markedly over the past 30 years for many—investment bankers, investors (hedge fund, pri- vate equity, and public money managers), top corporate executives, consultants, entertainers, top athletes, and lawyers. Changes in technology, scale, and globalization have allowed these professionals to leverage their skills. Top investors can now manage far more money than was once possible. Conversely, many—investment bankers, investors (hedge fund, private equity, and public money managers), top corporate executives, consultants, entertainers, top athletes, and lawyers. Changes in technology, scale, and globalization have allowed these professionals to leverage their skills. Top investors can now manage far more money than was once possible.

Deserving bankers

Some critics claim bankers would have no alternative if they were not paid as they are, or did not receive the bonuses they do. The critics are naive. The best bankers have other options. Star deal makers can go to boutique investment houses and build businesses that bank money managers. Many already have. A top Citigroup trader, Matthew Carpenter, left in early February for hedge fund Moore Capital, follow- ing in the footsteps of another top trader, Andrew Hall. The greater the reduction in, and restrictions on, pay at large banks, the greater will be the exodus of top talent at large banks, the greater will be the exodus of top talent.

Beyond the bonus furor

Large bonuses were not a primary cause of the financial crisis. Bear Stearns and Lehman Brothers were more ag- gressive than their peers in encouraging employees to defer bonuses or invest them in company stock rather than take cash up front. Stock ownership and bonus deferral did not save those farms. Bank executives lost hundreds of millions of dollars on the stock they owned because of bad decisions they made. Many lost their jobs.

Rather, the crisis was caused by loose monetary policy, a global capital glut, excessively leveraged investment banks, complications from the credit crunch, and moral un- able to afford them, flawed ratings from the rating agencies, and up-front incentives for mortgage brokers. Consistent with this, the crisis spread to financial institu- tions in many countries with very different pay practices. Instead of fixing on compensation and bonuses, crit- ics should focus on more sensible capital requirements. An effective solution would impose higher and procyli- cal equity capital requirements on banks, combined with a requirement to raise contingent long-term debt—debt that converts into equity in a crisis. These debt investors, not the government, would have bailed out the banks. The financial crisis would have been substantially smaller, if it had occurred at all.

The anger toward bankers is understandable, but eliminating or restricting their bonuses will damage the financial sector while doing little to stop any future finan- cial crisis.

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Bonuses and the “Doom Cycle”

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ankers’ bonuses are a high-profile symptom of a much larger and deeper problem—the ability and willingness of the largest players in our financial system to take reckless risks. We have let a “doomsday cycle” take over our economic system. (Andrew Haldane, of the Bank of England, has iden- tified a similar “doom loop.”) This cycle has several distinct stages. At the start, creditors and depositors provide banks with cheap funding. If things go very wrong, they expect central banks and fiscal authorities will bail them out. Banks such as Citigroup and Goldman Sachs—and many others in this past cycle—used the funds to take large risks, providing dividends to shareholders and bonuses to man- agement and staff. Through direct subsidies (such as deposit insurance) and indirect support (such as the prospect of central bank bailouts), we encourage our banking system to ignore large, socially harmful “tail risks”—risks that involve a small chance of calamitous collapse. Banks can walk away and let the state clean up. Some bankers and policymakers even do well during the collapse they helped to create.

Mind-boggling failure

Regulators and supervisors are supposed to prevent this dan- gerous risk taking. But banks wield substantial political and financial power, and the system has become remarkably com- plex, so eventually regulators become compromised. The ex- tent of regulatory failure ahead of the current crisis is mind- boggling. The crisis is seen as a consequence of having Northern Rock in the United Kingdom, Lehman Brothers in the United States, and Deutsche Bank in Germany, convinced regulators that they could hold small amounts of capital against large and risky assets. No one regulator, whole banking system built up $44 trillion of assets and $17 trillion of derivatives. This meant that when one large bank or quasi bank failed, it was able to bring down the whole system.

Given the inability of our political and social systems to handle the hardship that would follow economic collapse, we rely on our central banks to cut interest rates and direct credits to save the loss makers. While the faces change, each central bank and government operates similarly. This time, it was Federal Reserve Board Chairman Ben Bernanke and Treasury Secretary Tim Geithner (president of the New York Federal Reserve Bank in the run-up to the crisis) who oversaw policy as the bubble was inflating—and are now designing our “rescue.”

When the bailout is done, we start all over again. This has been the pattern in many developed countries since the mid-1970s. A decade that coincides with significant macroeconomic and regulatory change, including the end of the Bretton Woods fixed exchange rate systems, reduced capital controls in rich countries, and the beginning of 20 years of regulatory easing.

The real danger is that as this cycle continues, the scale of the problem is getting bigger. If each cycle requires greater and greater public intervention, we will surely eventually collapse.

The best route to creating a safer system includes very large and robust capital requirements, which are legislated and difficult to circumvent or revive. If we triple core capital at major banks to 15 to 25 percent of assets—putting capital- asset ratios back where they were in the United States before the formation of the Federal Reserve in 1913—and err on the side of requiring too much capital for derivatives and other complicated financial structures, we will create a much safer system with less scope for gaming the rules.

Less likely to gamble

Once shareholders have a serious amount of funds at risk, rel- ative to the winnings they would make from gambling, they will be less likely to gamble and are more likely to keep dan- gerous compensation schemes under control. This will make the job of regulators far easier and give our current regulatory system a chance to work.

We also need to ensure that individuals who are part of any failed system expect large losses when their gambles fail and public money is required to bail out the system. Even though many executives at bailed-out institutions lost large amounts of money, they remain wealthy.

Other bankers obviously won big from the crisis. U.K. Chancellor Alistair Darling appointed Win Bischoff, a top executive at Citigroup in the run-up to its spectacular failure, to be chairman of Lloyd’s. Vikram Pandit sold his hedge fund to Citigroup, which then wrote off most of the cost as a loss; nevertheless, Pandit was soon named Citigroup CEO. Jamie Dimon and Lloyd Blankfein, CEOs at JPMorgan Chase & Co. and Goldman Sachs, respectively, are outright winners, even though each of their banks also received federal bailouts and they agreed to limit their bonuses for 2009. Goldman Sachs was lucky to gain access to the Fed’s “discount window,” so averting potential collapse.

We must stop sending the message to our bankers that they can win big on the rise and also survive (or do well finan- cially) on the downside. This requires legislation that recoups past earnings and bonuses from employees of banks that require bailouts.

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