Big Bad Bonuses?

Should Bankers Get Their Bonuses?

Steven N. Kaplan

BANKERS' bonus season has arrived. This year opposition 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 earned less 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, 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 they could three decades ago, bankers and lawyers work on larger deals, and top professional athletes reach larger audiences. Whether fair or moral, their high pay is largely market driven as companies compete for talent.

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 naïve. The best bankers have other options. Star deal makers can go to boutique investment houses and hedge funds or become nonbank money managers. Many already have. A top Citigroup trader, Matthew Carpenter, left in early February for hedge fund Moore Capital, following 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 over time. Some might applaud such a development, but it would weaken the largest financial institutions. The government bailout (and continued subsidization) of some banks does not change banks' need to pay market prices for their talent or risk losing it. The public also is hurt by a less-well-managed banking system (consider the problems pay issues have created for AIG, Fannie Mae, and Freddie Mac).

True, some portion of bank profits this year is a result of government intervention, but the banks paid for that intervention. Most have now repaid the Troubled Asset Relief Program (TARP) money received from the government, and the United States has profited from the "investments." Those who think the return is not enough should criticize the U.S. government for cutting a bad deal rather than the bankers for doing their jobs and making money.

Some banks were effectively forced to take TARP money. They are now being asked to hurt their business and employees (by not paying bonuses) after repaying the government money they did not want or need.

Professional sports provide a good analogy. Say a soccer team has a terrible year because its star goalie had a bad season. But its star forward led the league in scoring. Does this mean the team should not pay the forward generously to ensure he stays with the team? And, if the team has a fantastic season the following year, does that mean players should not be paid because of the bad record the year before? Of course not. Such practices would be detrimental, if not suicidal.

Beyond the bonus furor

Large bonuses were not a primary cause of the financial crisis. Bear Stearns and Lehman Brothers were more aggressive 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 firms. 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, mandates from Congress to provide mortgages to people unable to afford them, flawed ratings from the rating agencies, and up-front incentives for mortgage brokers. Consistent with this, the crisis spread to financial institutions in many countries with very different pay practices.

Instead of fixating on compensation and bonuses, critics should focus on more sensible capital requirements. An effective solution would impose higher and procyclical 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 financial crisis. ■

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Bonuses and the "Doom Cycle"

Simon Johnson

BANKERS' 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 identified 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 management 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 dangerous risk taking. But banks wield substantial political and financial power, and the system has become remarkably complex, so eventually regulators become compromised. The extent of regulatory failure ahead of the current crisis is mind-boggling. Prominent banks, including 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 asset portfolios. The whole banking system built up many trillions of dollars in exposures to 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 date 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 revise. 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, relative to the winnings they would make from gambling, they will be less likely to gamble and are more likely to keep dangerous 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 very 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 Lloyds. 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 financially) on the downside. This requires legislation that recoups past earnings and bonuses from employees of banks that require bailouts. ■

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