# Destructive Compensation Practices in Bonus-Driven Financial Firms

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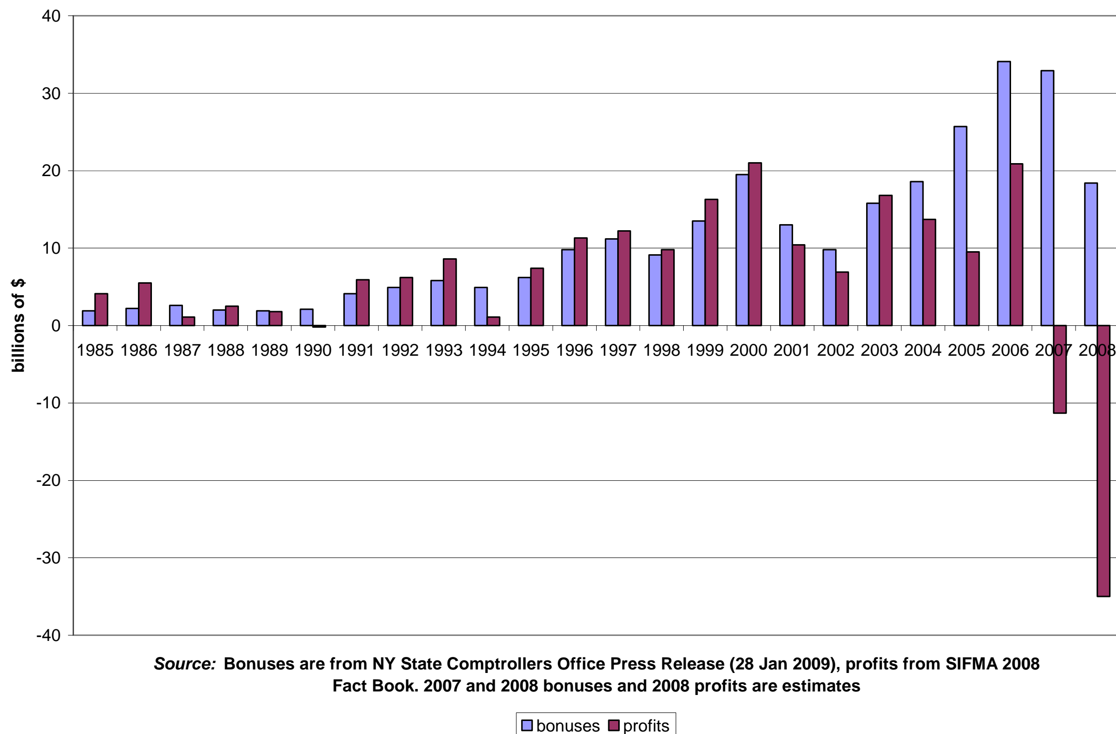
We recently experienced a global financial crisis so severe that only massive rescue operations by governments around the world prevented a total financial market meltdown. A major cause of the crisis was the perverse, bonus-driven compensation structure employed in important financial institutions such as investment banks. This structure provides a rational incentive for key decision makers in these firms, referred to here as 'rainmakers,' to take the excessive risk and employ the excessive leverage in the bubble that helped create the preconditions for the crisis. As Fed Chair Ben Bernanke said recently, "flawed compensation practices at financial institutions contributed to the crisis. … Compensation plans that encourage excessive risk-taking can pose a threat to safety and soundness" (Bernanke 2009). It is unfortunate that this problem only crossed his mind after the crisis broke out.

The graph below demonstrates that rainmaker bonuses are shockingly large, have been rising rapidly over the past decade or more, and remained large even when industry profits collapsed in 2007 and 2008, which accelerated the collapse.




*Source:* **Bonuses are from NY State Comptrollers Office Press Release (28 Jan 2009), profits from SIFMA 2008 Fact Book. 2007 and 2008 bonuses and 2008 profits are estimates**

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Rainmaker bonuses have asymmetric properties that induce aggressive risk-taking. Since boom-period bonuses do not have to be returned when rainmaker recklessness eventually leads to losses for their firms, and since large bonuses continue to be paid even when firms suffer losses in the crisis, it is rational for rainmakers to use unsustainable leverage to invest in excessively risky assets in the bubble. Moral hazard is an important part of this dynamic. When excessive risk-taking causes a financial crisis, monetary and fiscal intervention by the government cushions the crisis, prevents widespread firm failure, and eventually restarts financial market growth. This sustains bonuses even in the crisis, which reinforces rainmaker risk-taking incentives.

Excessive rainmaker risk-taking helps create the rising revenues that are the both the source of and the justification for their giant bonuses. Since values created by rainmakers in the bubble are ephemeral and inevitably evaporate in the bust, rainmaker bonuses are not payments for the creation of long-term value-added. Rather, they are payments for the production of temporary 'false,''fictional' or 'illusory' value.[a] Academic studies by Philippon and Reshef (2009) and by Goldin and Katz (2008) demonstrate that, holding a large number of human capital variables constant, skilled employees in financial firms earn much more than equivalently skilled workers in nonfinancial institutions. Goldin and Katz estimate the rainmaker premium at almost 200 percent. Bonuses are thus a kind of undeserved 'rent' that ultimately comes from the redistribution of income and wealth from the rest of society to the rainmakers.

Top Wall Street employees earn up to 90 percent of their compensation in the form of bonuses. Defenders of bonus systems acknowledge that they escalate compensation in the boom, but argue that when revenues fall, bonuses should fall proportionately, thus protecting shareholder profit. But New York State Attorney General Andrew's recent analysis of Wall Street compensation (as well as the graph above) shows that "compensation for bank employees has become unmoored from the banks' financial performance. Thus, when the banks did well, their employees were paid well. When the banks did poorly, their employees were paid well. And when the banks did very poorly, they were bailed out by taxpayers and their employees were still paid well" (Cuomo 2009). Consider some of his findings. Citigroup and Merrill Lynch suffered massive losses of more than $27 billion each 2008. Yet Citigroup paid out $5.33 billion in bonuses and Merrill paid $3.6 billion in bonuses. Goldman Sachs, JP. Morgan Chase and Morgan Stanley collectively earned only $9.6 billion in 2008, yet they paid bonuses of nearly $18 billion while their stock price tanked.

Major US banks and securities firms are on pace to pay their employees about $140 billion this, a record high. Goldman Sachs is expected to distribute an average bonus of $750,000 this year, grossly unevenly distributed among its 32,000 employees - 15% higher than the previous record bonus in 2006 at the height of the financial bubble. Since Goldman probably would not have survived the crash had governments not injected massive support to financial markets – including $13 billion in government funds channeled to Goldman through AIG, one might consider these bonuses to be state subsidies rather than legitimate free-market earnings.

Crotty (2009) shows that while rainmakers received large bonuses in the boom, and the crash, and the subsequent financial crisis, shareholder value was destroyed in the process. Those who bought stock in

[a] Bubble-induced income is referred to as "illusory value" in a widely noted analysis of the global banking crisis by British regulators. See Financial Services Authority 2009.

the big five independent investment banks after 1996 and held it till early 2009 lost money. For example, if you purchased stock in 1998, you would have lost 77 percent of your initial investment in real terms as a result of risky rainmaker activities. Stock prices rose substantially after early 2009, but only as the result of massive government bailouts financed by taxpayers. In the absence of this intervention, it is likely that most large financial institutions would have failed, destroying all shareholder value.

Rainmaker compensation schemes and their relation to the crisis are analyzed in depth in Crotty (2009). That paper argues that the main source of rainmaker bonuses is the 'false value' they help create in the bubble and that these funds are augmented by oligopolistic market power in key financial market segments.[b]

### The Policy Debate: Many Proposals but Lack of Political Will

The government has used a vast trove of taxpayer money, estimated to be $12 trillion or more in one form or another, to rescue Wall Street from its own excesses. As we have seen, financial firms took advantage of bailout money and the rebound in financial activity it stimulated to pay their rainmakers record bonuses, triggering an intense public backlash that created pressure on the President, Congress and regulatory agencies including the Fed to consider ways to eliminate compensation incentives to excessive risk-taking. Whether much will be accomplished in this regard remains to be seen. There are policies capable of solving the problem. A substantial number of proposals to reform rainmaker compensation systems have widespread support among academics, financial market observers and some government officials. I mention three examples.

First, bonuses should only be paid for actions that increase company profit over the long run – across cycles. At present, rainmakers are paid during the bubble when virtually all trades and deals appear to make money. (They were even paid for creating complex and over-valued financial products like collateralized debt obligations that were never sold to anyone.) When the inevitable crash comes, most of these actions turn out to lose money for the firm and its shareholders, but rainmakers keep their bonuses anyway. As Warren Buffet put it, 'you can't see who is swimming naked until the tide goes out.' To end this destructive practice and induce a long- term horizon and greater concern for risk among rainmakers, bonuses should be held in escrow for five to ten years - or even decades, and reduced or 'clawed back' as ephemeral boom-period gains evaporate. Even Goldman Sachs CEO Lloyd Blankfein stated his support for this policy:

An individual's performance should be evaluated over time so as to avoid excessive risk-taking. To ensure this, all equity awards need to be subject to future delivery and/or deferred exercise. Senior executives should be required to retain most of the equity they receive at least until they retire… (Blankfein 2009)

[b] Crotty 2009 poses two key questions about rainmaker dominated financial firms, and discusses possible answers. Why is excessive rainmaker compensation not restrained by shareholders, boards of directors, top management, the capital markets that fund their firms, or market competition? Why did rainmaker rents remain so large in a period when a substantial proportion of the most qualified graduates of the best schools in the country, and indeed the world, wanted to work for these firms in this era?

Second, though rainmakers put large amounts of internal and borrowed capital at risk in support of their revenue-generating activities in the boom, their contributions to revenue or profit were not reduced by an appropriate risk-adjusted cost of capital before setting their bonuses. The influential Financial Stability Forum (FSF), composed primarily of senior representatives of national financial authorities, noted that "material risk-adjustment of variable compensation grants was not widespread in the industry through 2008" (FSF 2009). Since the risk involved in many rainmaker activities was substantial, and the leverage used in these activities extremely high, bonuses and the incentive to take excessive risk would have been reduced dramatically if an appropriate risk-adjusted cost of capital was used in the bonus calculation. Forcing bonuses to reflect "all types of risk, including liquidity risk, reputation risk, and cost of capital" is one of the FSF's 'sound compensation practices.'

Third, instead of bonuses being set in relation to net revenue as is now generally the case, the total bonus pool should be set in relation to total firm profit before any bonuses are distributed. Total bonuses should be high only in years in which firm profit is high and should be zero in years in which the firm losses money. This would avoid disastrous outcomes such as occurred when Citigroup paid out more money in bonuses in 2008 when it lost $27.6 billion than it did in 2006 when it generated a profit of $21.5 billion. The FSF includes this proposal as another of its sound financial compensation practices: "Compensation systems should link the size of the bonus pool to the overall performance of the firm" (FSF 2009).

## Money Talks: The Inadequacy of Likely Policies

If steps are not taken to end destructive compensation schemes and the other structural problems that contributed to the recent crisis, it will not be because we do not know how, but rather because of the lack of political will in the face of Wall Street's substantial political influence and its implacable resistance to serious regulation. There were early signs that the Obama administration might not be up to the task. The President chose former Treasury Secretary Lawrence Summers as his chief economic advisor even though he played an important role in facilitating the deregulation process that made the recent boom and collapse virtually inevitable. And he selected former president of the New York Federal Reserve Bank Timothy Geithner to be Secretary of the Treasury, even though as president of the New York Fed, he failed to carry out his responsibilities to prevent giant financial holding companies from engaging in excessive risk-taking. He did not even warn the public that they had become dangerously risky. (The same can be said of Fed Chair Bernanke.) The President thus put the task of tightly regulating financial markets in the hands of advisors who spent most of their careers fighting against regulation.

Both Obama and Geithner have indicated that they feel uncomfortable interfering with the compensation practices of private firms. In September 2009 the President said that we needed "a change in Wall Street compensation so long-term performance rather than short-term profit is rewarded." But he added: "this has been a country where, as a general proposition, we don't go around saying, 'You can't pay people whatever the market will bear in the private sector.'" He also said that "shareholders are the 'best check' on pay practices, and government shouldn't dictate standards when firms avoid taking taxpayer funding." President Obama then posed a question that sheds light on his mind-set on this issue: "Why is it that we're going to cap executive compensation for Wall Street bankers, but not Silicon Val-

ley entrepreneurs or NFL football players?" It is hard to believe that he does not understand that when NFL compensation is too high, the only problem is that ticket prices rise, whereas when financial market compensation practices induce excessive risk-taking, this can trigger a global financial market collapse that can force the government to spend virtually unlimited amounts of public money to fulfill its lender of last resort responsibility. Geithner also has been cautious on the issue. In testimony before the House Financial Services Committee in March 2009, he said that the Administration was indeed worried about financial market compensation practices. But "Geithner made it clear that he did not envision a system that placed the equivalent of government salary regulators inside corporate boardrooms." He added: "The government should not be setting detailed or prescribing detailed regulations to govern amounts of compensation and their distribution" (Cleveland Plain Dealer 2009).

The Administration and the Fed have recently expressed their intention to take the compensation problem seriously. It may be that they will do so. However, their proposals to date are either: too weak to resolve the problem; too vague to allow a thoughtful assessment of their possible effectiveness; or merely temporary and applicable only to firms that have unpaid TARP loans. Consider examples of each problem in order.

First, the President supports legislation that would allow shareholders to hold a nonbinding vote on the compensation practices of their firms and require that Directors' compensation committees be independent from top management. These proposals are clearly inadequate to their task. In addition to fact that the shareholder vote is nonbinding, when stock prices are rising rapidly in a boom, neither stockholders nor Directors are likely to oppose current compensation practices. Second, on October 22, 2009 the Fed issued "proposed guidelines that would require banking organizations to review their compensation practices to ensure that they do not encourage risk-taking…" (Board of Governors 2009). However, the Fed has not yet told us what rules and regulations, if any, will be imposed on bank compensation practices, it merely says that too-big-to-fail banks will be required to "review" their own guidelines while Fed supervisors monitor compliance with these guidelines (Bernanke 2009) Third, in October 2009 the President's "special paymaster" Kenneth Feinberg announced plans to reform pay packages for the twenty five most highly paid employees in the seven firms that still have TARP funds (Feinberg 2009). He said his plan will reduce average compensation by half. Bonuses must be paid in stock that can be only be sold in one-third installments starting in 2011, or earlier if the TARP funds are repaid. This is an improvement over current practice, though it has serious limitations. For example, exceptions can be made "when necessary to retain talent and protect taxpayer interest," a loophole so big you could drive gigantic bonuses through it. Moreover, since financial bubbles normally last more than three years, the holding period set by Feinberg is not long enough to adequately restrain risk-taking. Most important, these restrictions only apply to firms that have not paid back their TARP money.

Thus the odds seem quite low that the government will adopt policies that strongly decrease rainmaker compensation incentives to take excessive risk in financial expansions. This makes it imperative for individuals and organizations that understand the dangers that current financial markets institutions and practices pose to our economy and society to redouble their efforts to pressure the government to stand up to Wall Street and act decisively to eliminate perverse compensation schemes.

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