

# Destructive Compensation Practices in Bonus-Driven Financial Firms

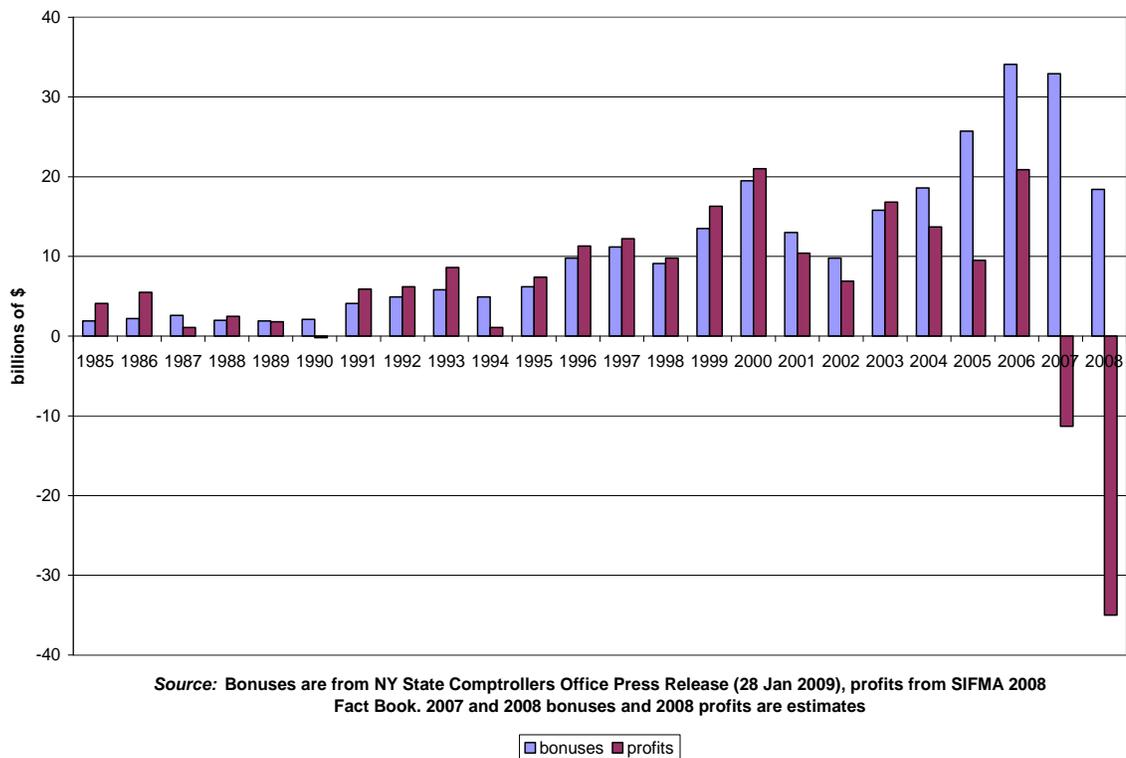
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A major cause of the recent global financial crisis was the perverse, bonus-driven compensation structure employed in important financial institutions such as investment banks. This structure provides a rational incentive for key decision makers in 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 (See [Crotty, 2009](#)).

This graph 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.

Wall Street bonuses and Pre-tax profits for all US Security Dealers



The Administration and the Fed have recently expressed their intention to take the compensation problem seriously. 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.

## The Policy Debate

There are policies capable of eliminating compensation incentives to risk-taking that have widespread support among academics, financial market observers and some government officials.

- First, bonuses should only be paid for actions that increase company profit over the long run – across cycles. 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.
- Second, bonuses should be calculated using the appropriate risk-adjusted cost of capital. Rainmakers put large amounts of internal and borrowed capital at risk in support of their revenue generating activities in the boom. Forcing bonuses to reflect risk would have dramatically reduced bonuses and the incentive to take excessive risk.
- 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 loses money.

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.

## Reference

Crotty, James (2009). “The Bonus-Driven ‘Rainmaker’ Financial Firm: How These Firms Enrich Top Employees, Destroy Shareholder Value and Create Systemic Financial Instability,” Political Economy Research Institute website, October.