



Greed



J.A. Bikker

Variable remuneration in banki

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For bank employees, variable remuneration is a big deal – even more so in the case of investment banks, most especially those in the USA, which focus on the investment and trade in financial products. Top executives and traders take the lion's share, while bonuses for sales staff are much more modest. Elsewhere in society the role of variable pay is fairly limited: top executives and salespeople do receive bonuses, but in the main these are dwarfed by what the banks are forking out.

Most employees earn almost totally fixed incomes. Even where productivity may be traced to individuals, the employer takes the profit realised by successful workers and bears the burden generated by less successful ones. The real reward for good performers is spread out over the long term in the shape of salary hikes and promotions. The self-employed do of course benefit from their own success, but here the agency problem is absent because all roles are played by the same actor.

Top-level traders and salespeople at banks receive their large benefits because their contributions to the bank's profits are directly visible. Apparently the uber-bright and figure-wise are able to realise successes others cannot even dream of. They are able to demand high rewards from their employer, because in the current market they could make the same kind of money elsewhere. Hiring and trai-

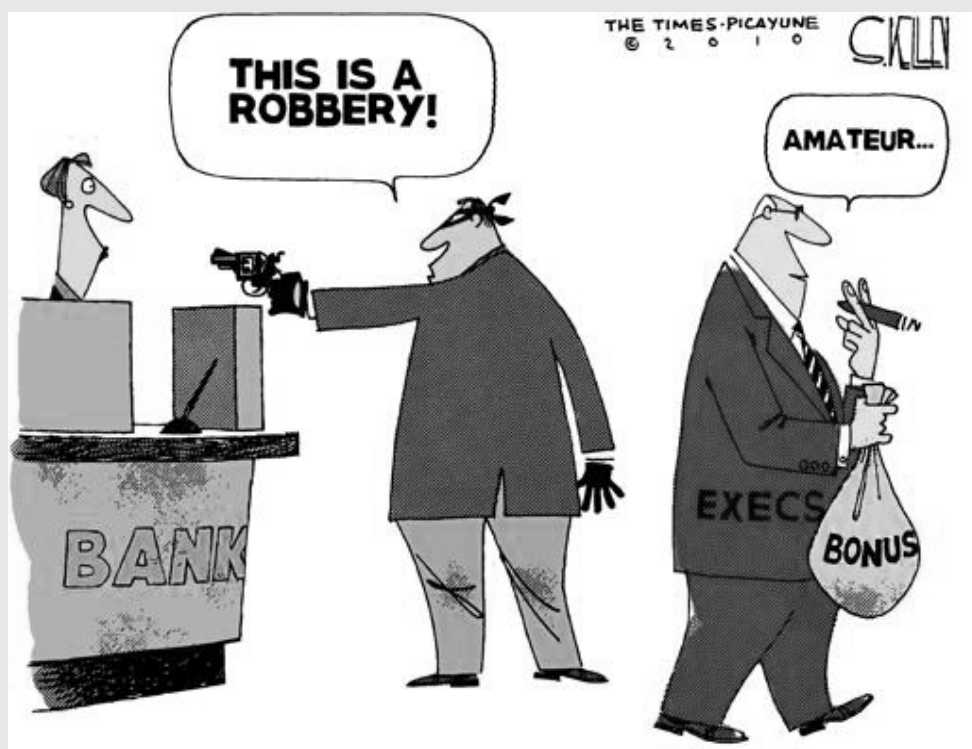
Banking: bonus or malus?

...ning new people is no antidote. It's much like the markets for football players, singers or movie stars: certain talents are apparently rare and readily marketable. Managerial wizards, too, are often able to land high bonuses. By contrast, the equally rare talents of top-level academics are – alas! – in less brisk demand. Nor do researchers at Philips earn seven-digit incomes. Successful inventions are good for a modest premium at best. The market value of their talent is not as high, perhaps because a researcher may spend decades striving for that one big breakthrough, or because he or she can succeed only working in a team. For commercial success you must be able to both show and exploit your talent time and again.



Translation: Support banks, Bonus, Inveterate

Where economists worry about the



perverse incentives imparted by huge bonuses, public opinion tends to balk at the resulting income inequality. And while that in itself does not concern economists, they do question the efficacy of the bonuses. Not that the scientific literature is unanimous about the use of variable remuneration. Obviously, rewards encourage production, or in the case of piece rates, enforce it. Less obvious is whether high bonuses do, in fact, stimulate an equal improvement in performance. According to Maslow's famous pyramid of personal needs, once the basic necessities of food, housing and safety have been met, our needs shift, via love, to recognition and approval by others, personal growth and self-actualisation. For the top dogs in banking, this sequence probably no longer holds: they have been spoilt by lucre and are li-

kely to remain so. What has economists worried, is the perverse incentive that variable pay gives to bank managers and workers, because it tends to shift their focus towards the short-term achievement and to foster an enjoy-now-worry-later attitude. Also, it makes them more risk-prone, because higher-risk investments tend to bring higher returns. Nassim Taleb, investor and author of two books on life in the fast lane of investment banking, illustrates this effect with investments that bring in just a little extra yield almost every year, while carrying a tiny chance of tremendous loss, for example Russian bonds that yield slightly more interest because of the higher risk involved. The loss if things turn sour (as during the Russian crisis of 1999) completely wipes out the profit of decades. The investor is sacked, but retains his bonuses earned over the fat years while the bank is left to sustain the loss. A more current example would be Greek (or other PIGS countries') government bonds: you earn a few percentage points extra interest against the small chance of losing the principal. (During the writing of this article, the credit spread of Greece exploded, indicating that this small probability of a default may not be inconceivable). This is typical of the entire financial market: a marginal probability of huge losses, offset by a little extra yield. Taleb explains that we humans have an irrational way of dealing with chance and tend to underestimate losses that carry a low probability. If we already underestimate risks unintentionally, how much more so if we get rewarded right away for short-term successes without any fear of



Translation: I have stipulated two annual salaries in case I fail my banking examination

penalty for possible future losses? Even worse, of course, is that bonuses may incite non-integer behaviour – e.g. cheating customers – as in the run-up of the credit crisis seems to have been the case with Goldman Sachs, where traders sold wrapped up subprime mortgage loans to their clients and at the same time did bet on the decline of their value. When banks pay bonuses, they get in greedy grabbers.

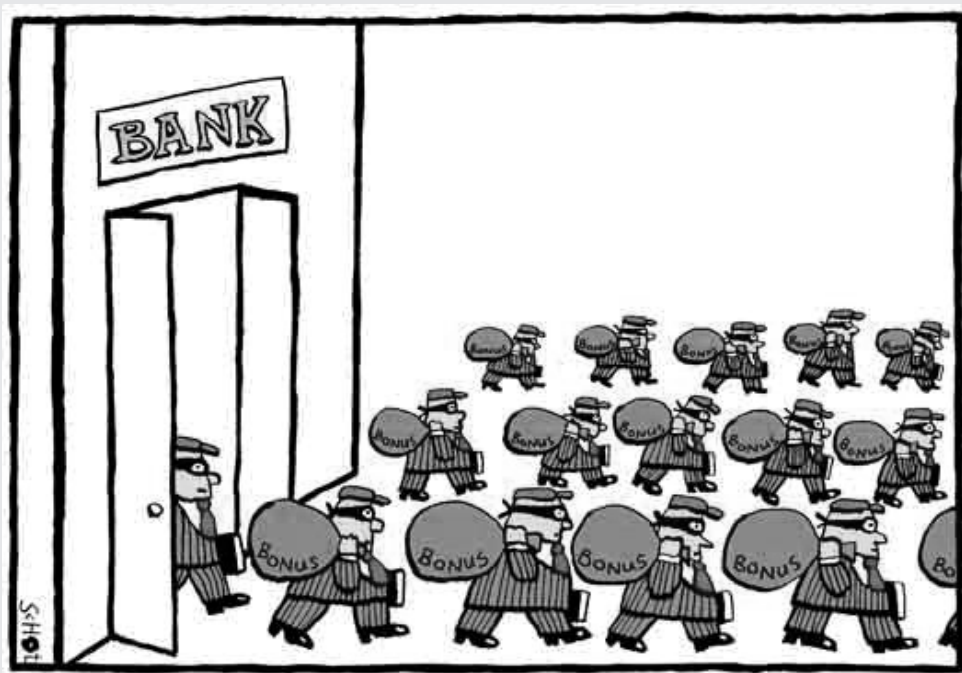
One suggested solution has been to spread out bonuses across a number of years and to cut rewards when losses are made (see, for instance, ‘Compensation Principles and Standards Assessment Methodology’, Basel Committee, www.bis.org). It would be better to adjust returns on investment (and the related bonuses) for inherent risk. However, that is easier said

than done. Traders know more about the risks of their complex products, whereas risk management is the responsibility of higher management, who also stand to benefit from short-term returns and risks. After all, they earn bonuses as well, and successes are good for their personal reputation and subsequent career moves. Then there are shareholders who hope to make a quick buck by selling their shares again after a rapid price rise – think of activist shareholders and buyout funds. In short, there is a great deal of resistance to be overcome before the bonus culture of quick successes and high risk-taking can be eliminated.

A more viable strategy would be to spread out both returns and bonuses across a period that is certain to include

both fat and lean years. Another possibility is the claw-back of bonuses when bad times come round. This will solve only part of Taleb’s problem, but it’s a step in the right direction. A similar first step has been introduced for mortgage and insurance intermediaries, who these days receive their full commissions only if a sale proves a lasting success.

The root of all evil is the lust for money (1 Timothy 6:9). It’s not the money itself that does all the harm, or the bonuses even, but greed. It’s the way people react to bonuses. Jeroen Smit, in his book *The perfect prey on the decline and fall of ABN Amro*, suggests that towards the turn of the century, the firm’s executives strived to run a quality bank that worked in the interests of its clients. This also offered the best possible foundation for long-term client relationships and thus for continuity. Somewhat later, the focus shifted from serving clients’ interests to creating shareholder value. High bonuses were introduced for trading room personnel, and it was thought that senior management should be cut a piece of the same pie. Those who added shareholder value had to be rewarded. At least, according to the cited book. To be sure, this shift away from ‘doing a good job’ towards ‘earning good money’ also occurred elsewhere in society. In many cases, making a lot of money was translated into taking a lot of risk. Bank clients, too, disregarded risks – as many have acknowledged – when for a quarter per cent extra they moved all their savings to Icesave. Greed blinded many of us.



Several authorities have undertaken to curb the runaway bonuses: the G-20, the EU, the supervisors. The emphasis of their efforts has been on the promotion of long-term assessments: spreading the payment of bonuses across several years, awarding bonuses only for long-term successes, inclusion of payback clauses. Supervisors will see to it that banks' bonus systems do not promote risk-taking and thus do not undermine banks' stability. DNB has issued principles for controlled remuneration policies, jointly with the AFM, which it later elaborated into a set of good practices.

Yet banks on the whole are reluctant to introduce restrictions. Bank that had to reduce bonuses because of the government support they received, did their utmost to pay back the rescue capital quickly to have

their hands free. Meanwhile the media has been reporting that bonuses for the year 2009 did skyrocket again. Large parts of investment banks' profits are spent on bonuses instead of dividends. Of course this is especially true of the USA with its heavy emphasis on investment bank activities. In Europe, and the Netherlands in particular, bonuses have been far lower, not counting severance payments. High tax rates on bonuses, as in France and the UK, or extra taxes for banks (USA) are unable to control the bonus tsunami. But as hard as it is to act against bonuses and reckless risk-taking, curbing the underlying evil of greed is far more difficult. ☹

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Notes

- 1 Jaap Bikker also works as a senior researcher at the Supervisory Policy Division of De Nederlandsche Bank (Dutch Central Bank), j.a.bikker@dnb.nl. The author, who wrote this article in a personal capacity, wishes to thank Leo Kranenburg and Claudia Zapp. The illustrations' sources are cartoonbox.slate.com/stevekelley/2010/01/15/ (Figure 1), www.tomjanssen.net/index.html (Figure 2), basvanderschot.com/index.php?page=home (respectively: *economie*) (Figures 3-5) en cartoonbox.slate.com/stevesack/2010/01/14/ (Figure 6).

