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by Shumeet Banerji

As Wall Street and the major European banks — led by the newly notorious Goldman Sachs — report record quarterly results and record bonus accruals, the public and policymakers have grown increasingly frustrated. Their outrage stems from incredulity. How could institutions saved by the taxpayer 18 short months ago possibly be paying out staggering bonuses now, to the very people who caused the crisis? Moreover, how did these institutions come to make so much money in the first place? In parallel to this outrage is the growing realization that a globally coordinated approach to bank regulation is unlikely. As a result, governments and regulators will be restricted in their ability to address some of the core issues because of jurisdictional arbitrage, and may be viewed as taking insufficient action to "do something about the banks."

Meanwhile, still unanswered is the most critical question: Why did the system go out of control in the first place? Most bankers surely understood that taking such unprecedented risks might result in catastrophic institutional failure and enormous loss of personal wealth. Why wasn't that enough to keep them from taking the course they did? If global policymakers better understood the answer to that question, they would be able to take much more effective measures.

The real answers to these questions have less to do with villainy or lax supervision than with inherent moral hazard. Addressing this hazard would be the right reason for political leaders and the boards of banks in the U.S., Europe, and elsewhere to be interested in bankers' compensation. Today, the urgent question that remains unanswered is whether the proposals that are moving ahead will address moral hazard adequately and thus prevent another systemic crisis.

Taken collectively, in spite of many valid objections, by and large the suite of proposals emerging from the Financial Stability Board, the International Monetary Fund (IMF), the Institute of International Finance, and other supervisory organizations around liquidity, leverage, capital, and even taxation would move us forward toward a regime with more stability. An endemic problem is the policy preference for across-the-board rules, applied at a minimum to "systemically important institutions" irrespective of institutional risk profiles. Aggregate rules are right on average, and wrong in particular cases, every time. Two institutions with balance sheets of similar sizes — one a big fixed-income trader and the other a trade facilitator — will have profoundly different risk profiles and deserve very different controls. Moreover, even among institutions with similar business mixes, the evidence is overwhelming that some of the small handful of systemically important

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institutions were much better risk managers than others. There is therefore a strong case for a more nuanced approach, as proposed by Adair Turner of the Financial Services Authority, for examining the risk behavior of each institution and regulating it accordingly.

The fundamental problem with these approaches, however, is that the measures are inadequate on their own. This is because they implicitly assume that banks are unitary entities that respond to the incentives supplied by the regulator. They do not address the reality of large, decentralized, multi-line global banking institutions, which is that no administrative checking mechanism can effectively supervise such a complex institution. Instead, any successful regime must address both the aggregate institutional requirements and the microeconomics of risk taking when faced with asymmetric information *within* the institution. The only way that regulators — and, more important, boards and managements — can exercise supervision over such complex institutions is to address the core problem: the disconnect between capital reserving and particular risks borne by banks and compensation structures (especially those of traders), and the lack of alignment of these mechanisms with the institution's interests. This is the sense in which the proposals do not adequately address moral hazard.

To the extent that microeconomic proposals have been put forward, many could make the current problems worse, not better. These proposals come in three flavors. The first is limiting the size of bonuses (as Germany's financial stabilization fund, SoFFin, has done for the managements of banks that took state aid), or taxing them when they are above an established threshold (as in the U.K. chancellor's and the IMF's plans). This raises the problem of knowing at what size bonuses become immorally large, requiring regulators and legislators who have judgment far superior to that of ordinary mortals. Furthermore, those who promote the taxation of bonuses seem to base their claims to legitimacy on intellectually questionable premises: Because these gains are "ill gotten," taxing them will not distort an economically useful activity.

We know that the second proposal, deferring bonuses to discourage short-term speculative risk taking, won't work because it did not work before. In 2008, almost all the big banks' management teams had their compensation tied to long-term stock performance. Moreover, systemic crises appear every eight to 10 years, and no deferral proposal extends to that horizon. So as long as a trader is lucky with timing, he or she will be long gone before the full systemic effects of the relevant trades come to fruition. Finally, we are already seeing the deferrals being factored in to signing bonuses for star traders — the deferral migrates, but the risk stays with the original institution.

The third proposal, clawback provisions, seems attractive, especially to the punitive-minded. Many banks have already adopted variants of these, but enforcement is likely to be fraught with legal and ethical issues. Skeptics suspect that this is precisely why they have been adopted so quickly.

A better approach would be for banks and regulators to link compensation, risk, and capital at both the institutional and micro levels. The place to start is at the source: the trading desk. Most of the enormous bonuses have gone to a small subset of bankers —

traders, whose activities were the most significant driver of the financial crisis. Although much public anger is directed at banks' executives, they are not generally the recipients of the largest packages. In simplified terms, traders are paid as much as 50 percent of the net present value of their position each year, even though the results are played out over time. When they win big, both they and the bank prosper. But when traders lose, they still get the reward, and the bank — and in some cases, the taxpayer — takes the punishment, particularly when the bank has reserved insufficient capital to protect against this eventuality. There is thus a mismatch between the traders' interests and those of the bank's shareholders and the taxpayers who are the underwriters of the state's implicit guarantee of these institutions.

The solution lies not in aggregate, rules-based regulations but in a reassessment, within each bank, of how the "triangle" principle should be applied; that is, how to interweave the ways risk is taken, people are paid, and capital is allocated, and hence the share of profits that goes to insurance, to compensation, and to shareholders' accounts. Instead of shifting the burden of judgment to Solomonic regulators, this approach would better harmonize individual and institutional incentives. When bankers have reason to pay attention to the true economics of their trades, they will make better trades. By aligning incentives for traders with the long-term stability of the institution, the interests of long-term investors and the system at large are also likely to be better looked after.

The first set of issues a microeconomic approach must address is how to structure traders' compensation in a way that better ensures institutional, and therefore systemic, interests. The most direct path would be to have the traders' interests mimic those of the institution. In the current compensation model (which remains largely untouched), traders are paid a share of their net asset position at some interval (usually annually) based on the mark-to-market valuation of that position in the context of a value-at-risk model. Two aspects of this model are striking. First, traders are paid on accounting profits, particularly troublesome in the light of long-tail contracts. Second, the assets are treated the same regardless of their underlying riskiness.

On the first aspect, an immediate improvement would be to pay on realized cash profits (on the P&L). A trader would be paid on the net position as it unwinds year after year rather than on the accounting net present value (NPV). On the second aspect, an obvious improvement would be to use risk-weighted assets, rather than assets alone, as the unit of analysis. None of this would prevent a trader from maintaining a shadow account over the long term in the form of a "personal balance sheet," preferably including his or her own capital in the mix. And if the institution were unwilling to align the tenor and two-way symmetry of compensation contracts with traders, the regulator could compel it to hold more capital for situations in which a greater share of the NPV of riskier positions is paid out in compensation.

The other important set of issues has to do with the level of compensation and the share of profits going to traders; both have risen dramatically in the last two decades. The outrage over the level of compensation paid to traders is largely misplaced. Nevertheless, the questions stirring in public debate are important and in the long run dangerous for banks. Trading has increasingly come to be characterized as a skill business, not unlike Formula One driving or championship tennis. But there is at least some truth to the notion that the trading business is dependent on central bank policies and the capacity for technology to present infinitesimal arbitrage opportunities across the world — which, when aggregated over very large leveraged balance sheets, create massive profits that individuals, certainly, and even lesser institutions cannot duplicate. A growing undercurrent suggests that in fact these are not terribly useful economic activities, and thus can be taxed, with complete justification, at onerous rates. The counterargument — that taxation will depress shareholder returns and curtail lending — is true only if the share of profits paid as compensation remains constant.

This seems an obvious issue for boards to consider. A 40 or 50 percent share of profits to traders at the expense of shareholders — and the capital buffers needed to protect taxpayers — must be worth discussing, particularly when those profits depend so crucially on both the institutions' capital, infrastructure, customers, and brand, and the state's role as underwriter of last resort. The current system appears inequitable, especially over the business cycle and in light of the unfunded guarantees from the state. Parenthetically, this system also reinforces money — not values, strategy, culture, or the quality of the institution — as the only reason to work at a bank.

Competitive pressures to retain star traders, especially when hedge funds are bidding for their services, and inertia by boards and managements in the face of the war-for-talent argument have entrenched this system. It is ripe for change. And although the government tax proposals at hand may have a soothing effect on outraged citizens and may enrich the Treasury, they will have no effect on curbing bonuses, or preventing the next systemic crisis, unless there is global coordination of the response. Real change will come only when both boards and regulators realize that they have an identical goal — ensuring institutional longevity to ensure systemic stability — and that reform is therefore in everybody's interest. +

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