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by Shumeet Banerji

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Instead of bashing bonuses, let's put in place the incentives we need: linking compensation to risk and capital.

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The world's finance ministers, central bankers, and regulators are currently designing a new set of regulations to prevent banks from bringing the world's economy to its knees again. Nevertheless, the most critical question remains unanswered: Why did the system go out of control in the first place? Most bankers understood that they might face catastrophic institutional failure and enormous loss of personal wealth. Why wasn't that enough to keep them from taking such unprecedented risks?

The implicit response seems to be that they were distracted by their greed. According to this view, these villains exploited the financial system for their own gargantuan end-of-year bonuses, got bailed out, and have every reason to do it again. Given this inherent moral hazard, it's no wonder that so many political leaders in the United States, Europe, and elsewhere are eager to rein in bankers' compensation.

The moral hazard is a real concern. But the plans to limit compensation will not work, because they do not address the core problem: the disconnect among bank capital, risks (borne by both banks and society), and compensation structures (particularly the way traders are paid). If the financial leadership of the Group of 20 (G-20) can follow a "triangle principle" — building a tight regulatory connection among those three factors, making them interdependent at a granular level — they will get closer to mitigating the moral hazard. And they won't have to regulate bonuses directly.

That would be a relief. The proposals being discussed by the G-20 are aggregate, top-down proposals that could make many of the current problems worse, not better. They basically come in three flavors. The first is setting caps on the size of bonuses: for example, capping bonuses as a percentage of base compensation or limiting each bank's overall bonus pool. If legislated (and found constitutional), this would force regulators to make Solomonic judgments about bonus sizes and bank worthiness without the information contained in market signals. And it would motivate good people to move to other sectors or less-regulated entities, such as hedge funds. As George Soros suggests, this may be a good thing, but I doubt it is the intent of the proponents.

We know that the second proposal, deferring bonuses to discourage short-term speculative risk taking, won't work because it did not work before. Almost all the big banks' management teams had their compensation tied to long-term stock performance in 2008. Yet the financial crisis still came. Moreover, deferral will not stop traders from changing jobs; the risk then stays with the original institution while the hiring bank pays the trader the deferral value.

The third proposal, instituting clawbacks (demanding that part of a bonus be returned after the fact in cases of failure), seems attractive, especially to the punitive-minded. But enforcement would be fraught with legal and ethical issues, as the U.S. Congress learned when it tried to retroactively tax bonuses from banks that took bailout funds.

A more general problem illustrated by this discussion on bonuses is the emerging policy preference for disconnected, across-the-board rules on capital, leverage, liquidity, and compensation. For example, one proposal would set in place a maximum leverage ratio: Borrowed funds should not exceed some value, such as 25 times equity. In principle, limiting leverage seems like a good idea, but no aggregate rule can possibly apply to the wide variety of banks, trades, and risk profiles. Such a rule would trump good judgment by skilled risk takers. And US$1 billion worth of investment capital, operating within a regulatory leverage cap, could still be deployed and lost in a million lousy trades.

Instead, banks and regulators would do well to link compensation, risk, and capital at a micro level. The place to start is at the source: the trading desk. Most enormous bonuses have gone to one small subset of bankers — traders. In simplified terms, they 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 traders win big, both they and the bank prosper. But when traders lose, they still get the reward, and the bank — and recently the taxpayers — takes the punishment, particularly when the bank has reserved insufficient capital to protect against this eventuality. There is thus an ill fit between the interests of the traders and those of the bank's shareholders (including the taxpayers for bailed-out institutions). If a bank tries to rein in its star traders, they have likely made so much money in the past that they can simply walk away without concern.

Although my primary purpose in this article is not to address the level of compensation, this is as an obvious issue for boards to consider. A 40 or 50 percent share of profits to traders (at the expense of shareholders and capital buffers to protect taxpayers) is at least worthy of discussion, particularly when those profits depend so crucially on the institutions' capital, infrastructure, customers, and brand, and the state's role as underwriter of last resort. The current system strikes me as inequitable, especially over the business cycle and in light of the implied guarantees from taxpayers of support for institutions in crisis. 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 against hedge funds — and, yes, against inertia by boards and managements in the face of the "war for talent" argument — have entrenched this system. But the system is ripe for change. The solution lies not in aggregate, rules-based regulation, but in a microeconomic reassessment, within each bank, of how the triangle principle should be applied; that is, how to interweave the ways risk is taken, capital is allocated, and people are paid. There are probably several self-regulating and self-correcting mechanisms that banks and regulators could put in place right now. Two simplified examples of the triangle principle illustrate the point.

The first is "paying on the trade." Instead of paying commissions based on a "mark-to-market" estimate of the value of a position, as most banks do now, base these commissions on the actual profit made when a deal is consummated and the position is liquidated. There would be no need to further reserve against the downside because the risk of the deal would be fully internalized. The second is to require each institution to reserve enough capital to account for the downside risk of the asset that has been purchased, including the value of the share of the putative profit that has been paid out in bonuses.

Either of these solutions would tie compensation and capital more directly to the risk and leverage in each contract, rather than setting up crude aggregate standards that don't take into account the characteristics of a particular trade. Instead of shifting the burden of judgment to regulators, this approach would better harmonize individual and institutional incentives. And when bankers have reason to pay attention to the true economics of their deals, rather than to the impact on their bonuses alone, they might find themselves making better deals — and thus reclaiming the reputation they have lost. +

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