What the G20 should do about bankers' bonuses

Debate: **Financial rescue and regulation**, a **Global Crisis Debate**

Posted by: **Tito Boeri (Bocconi University)**, 1 April 2009

"Bankers should stand for the European Parliament". I doubt that parties running in May for seats in Strasburg will take up this proposal of the Jury Team, a group set up to promote independent candidates for public office, "making politics more accessible, politicians more accountable and political institutions more transparent". Not only are bankers nowadays among the least popular job-holders in society, but they proved in many cases to not be at all accountable to shareholders, let alone their stakeholders. Top executives continued to receive high bonuses in spite of huge losses made by their institutions and the negative spillovers on Main Street of the excess debt of their banks. The only thing which is surprising in the popular fury against the excess remunerations of bankers in the midst of the recession is that it materialized rather late in the process. The paradoxes of bankers' pay were already pointed out at the beginning of 2008 (1).

Governments are reacting disorderly to these sentiments of public opinion and with a mixture of shortsightedness and populism. Tax rates of 90 (yes ninety!) per cent are advocated by US Congressmen hitting variable pay of managers of banks bailed out by the State. According to their proponents, these taxes should operate *retroactively*, creating a devastating precedent in the relationship between the State and taxpayers: this principle can in the future justify any breach of rules, as Governments will struggle to reduce the huge public debts that they are accumulating with bank rescues and stimulus packages. Nicholas Sarkozy will issue this coming Wednesday a presidential decree banning bonuses in firms receiving state aid. This means banning performance-related pay for top executives altogether in the country of the Ecole Polytechnique. Indeed, how many firms in France do *not* receive state aid in one way or another? Elsewhere unilateral caps on managerial pay are announced as if they could be actually enforced without international co-ordination in the global competition for talent. Managerial talent in banking, ability in identifying undervalued assets, is so rare in practice!

The forthcoming G20 meeting in London provides an opportunity for Governments to coordinate on a set of rules that would reduce the gap between public opinion and international forums, make bankers more accountable and learn from past mistakes. Finding an agreement along these lines could reduce the disappointment with the likely hot air outcome of the Summit. Here are a set of proposals tackling the bonus issue.

First, all top executives in banks should be invited to voluntarily give up any variable pay related to the 2008 performance of their banks. It will take years to identify personal responsibilities in the financial crisis, but there is little doubt that all bankers, in one way or another, were involved in the crash. It is also clear that the compensation rules were flawed as they induced too much risk taking. Thus, a moratorium on variable pay is warranted while defining new rules. Some bankers already applied this principle, by deciding unilaterally to give up their bonuses. The others should follow this example. Disclosure of top executives pay and social sanctions are the keys to enforce this principle. Governments should abstain from issuing retroactive taxes or bans.

Second, the new rules governing the remuneration of top executives should be decided and voted on at general meetings of the shareholders rather than only at board meetings. This will make top executives' pay at the same time more transparent and allow it to be ruled by those who have been robbed blind and have all to gain from properly designed incentive schemes.

Third, in the case of banks, a close supervision of these bonus schemes should be made by Central Banks. Public supervision is warranted as poorly devised incentive schemes may induce excess risk taking, jeopardizing the stability of the financial system. Central Bank supervision would also make sure that lessons from past mistakes in designing incentive schemes for bankers are duly taken into account. Stock options schemes providing managers with call options with a high strike price induce excess risk taking, as top executives will choose strategies that allow for a significant probability that the stock exceeds the strike price, at the cost of increasing the variance of potential outcomes. The same expected profits can be provided with fewer options at a lower strike price, which reduces the incentives to risk taking. Put options included in bonus schemes, financially sanctioning the manager when the stocks fall below a certain threshold, could also mitigate risk taking. Other details concern the duration of the bonuses and clawback clauses, forcing managers to return past earnings in the case where adverse events materialize. These clauses were clearly absent in the case of AIG managers. All these features should be closely monitored by the independent authorities supervising over bank stability. There is perhaps no other area where the devil is so much in the details.

Fourthly, a case could also be made for internationally coordinating very top income tax brackets. In the last fifteen years, earning inequalities increased everywhere because of the explosion of earnings at the top 1 per cent of the earning distribution. The current wave of social unrest suggests that these huge earnings, sometimes multiplying by a factor of 50,000 average earnings, create problems of cohesion in our societies. Thus, a case can be made for increasing taxes at the very top of the income distribution, treating equally all the different sources of income, provided that these taxes are internationally agreed, and hence are actually enforced in spite of the global competition for talents.

Tito Boeri

Professor of Economics, Bocconi University

(1) Raghuram Rajan, Bankers' pay is deeply flawed, Financial Times, January 8, 2008.

Other Commentaries from Tito Boeri (Bocconi University)