Of Banks and Bonuses

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Earlier this month, when Goldman Sachs reported record quarterly profits — and prepared to pay juicy bonuses — it was widely, and correctly, noted that the firm was leading the way back to a future in which outsized pay for short-term gains could once again foster excessive risk taking.

Sure enough, last week, Morgan Stanley explained its quarterly loss by saying that some of its traders were still "gun shy" after last year's near-death experience in the financial markets, but that the firm now planned to increase its risk taking. To try to stay competitive with Goldman and other banks, Morgan Stanley has also allocated a big chunk of its net revenue for compensation.

This from a couple of firms that 1) probably wouldn't even be around today were it not for ongoing government rescues of the financial system and 2) by dint of being too big to fail, now enjoy an implicit guarantee of future bailouts if their bets go wrong. The financial system may be stabilizing for now, but the danger to taxpayers if markets were to buckle again is at least as great as ever.

Financial regulatory reform is supposed to control that danger. For example, both the Obama administration's proposal and ideas from Congressional committees sensibly call for banks to hold more capital with which to absorb losses. A wise variation on that basic notion is that the bigger the bank, the higher the capital requirement should be. Insurance premiums paid to the government could also increase along with a bank's size. Such provisions would create incentives for banks to limit their size and in so doing, reduce the risk they pose to the system.

The problem is that the bonus-driven risk culture is reasserting itself now, while comprehensive reform will probably take until next year, if it occurs at all. A solution is for Congress to handle bankers' compensation as a stand-alone issue, as the House Financial Services Committee has said it is ready to do. There is no question about the need to end the perverse incentives that helped to set off the financial crisis. There is ample, and justified, anger among Americans about outsized pay — often to the very same bankers who profited from the bubble — to warrant fast-tracking the issue.

Among the needed pay reforms are rules to tie executive payouts to long-term results, like prohibitions against cashing out equity-based compensation until many years after options or shares have vested. Bonuses need to be delayed to ensure that the profits on which they are based do not prove transitory. An insightful reform recommended by Lucian Bebchuk, a Harvard Law professor and director of the law school's Program on Corporate Governance, would require that executive compensation be tied not only to the company's stock performance, but also to the long-term value of the firm's other securities, like bonds. That would encourage executives to be more conservative about using borrowed money to juice returns to capital, because it would expose them to the losses that leverage can exert on all the firm's investors.

Reforming the way bankers and traders are paid needs to be part of a newly regulated financial system. But it needn't and shouldn't wait for comprehensive reform to see the light of day.