Their Gamble, Everyone's Money

The New York Times
August 8, 2009

Many Americans are understandably furious about the colossal bonuses making a comeback at JPMorgan Chase and Goldman Sachs while millions of people around the world are still suffering because of Wall Street's recklessness.

Despite that anger, the objective of government efforts to regulate compensation should not be to punish bankers or cap the money they make. Instead, they must focus on changing a perverse incentive system that too often rewards bankers for taking irresponsible bets — bets we all pay for when they go disastrously wrong.

So far Congress has made little progress. A House bill approved in July offers shareholders a nonbinding vote on the pay of bank executives, which is nice. So is its requirement that directors on compensation committees be independent. But the House punted on the most needed reform. The bill merely instructed the Securities and Exchange Commission and other regulators to come up with new compensation rules within nine months.

The Senate is expected to consider executive compensation after the summer recess only as part of a broad package of regulatory reform that is already meeting stiff resistance from Wall Street.

If regulators are going to have to do what Congress won't, there are a several things they should remember. Pay structures should not be left up to banks' boards. Regulators must establish and enforce them. Any new rules on pay should serve the same purpose as regulating banks' capital levels or the kind of loans they can make: protecting the financial system and the economy.

Crafting specific rules to align bankers' remuneration with both their performance and the risks they take will not be simple to engineer.

They might include claw-back provisions to recoup bonuses. They could require parceling pay over a period of years, to encourage bankers to make investments that would not tank the day after they were paid. They could require bankers to give up pay if the government had to come to the rescue.

The rules that regulators set must be specific enough that bankers could not elude them by simply getting a good accountant and changing a few definitions. Yet they must be flexible enough that they could be adjusted by regulators if circumstances so demanded.

Lucian Bebchuk and Holger Spamann, experts in securities law at Harvard Law School, suggested that bankers' pay could be linked to other prudential rules, like capital requirements. For instance, if bankers' pay was designed to rise when the value of the assets did but not to fall commensurately when the assets went sour, they might be tempted to take on more risk than they should. If regulators determined that was the case, they might require banks to set aside more capital, just as they must when they make risky loans.

The point of the exercise is to instill caution among bankers' ranks. They must know they will share in the losses if that investment that looked so hot the day they made it ultimately costs the bank billions.