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Ending bonuses: The simplest way to fix banking

As I write this, EU countries are meeting in Brussels to consider implementing the strictest restrictions on banker pay since the credit crunch. The focus is on capping banker bonuses, and the main reform under consideration is to limit bonus size to 100% of an individual’s annual salary.

Is this cap a good idea? Depends who you ask, and what their priorities are (for example, whether or not the person you ask is a banker who tends to get paid in massive bonuses). If you prioritize the continued existence of (Western?) civilization over most other considerations, however, then the cap is a good idea. Placing restrictions on banker bonuses is the simplest and most direct way to fix the systemic problems that led to the 2008 crisis, and that continue to threaten our societies with the specter of financial meltdown.

Nobody’s suggesting that bankers shouldn’t be well-compensated or rewarded for good performance. But the way in which rewards are allocated has a huge influence on how organisms behave in the pursuit of those rewards. When animals compete for uncertain resources (i.e. resources they aren’t sure they’ll be able to obtain), then the riskiness and aggressiveness of their tactics will be proportional to the value of the resource. Whether you’re a hermit crab, white rat, or chimpanzee, you’ll take larger, more aggressive and more desperate risks in order to obtain an uncertain reward when the value of that reward is greater. Humans are no different, and if we don’t want to motivate people in certain occupations to take very large, aggressive, and desperate risks, then we should not compensate them with very large, uncertain rewards. We should pay them with stable, boring, predictable salaries.

In addressing the behavioral and cultural characteristics of banks that could lead to another financial crisis, it makes sense to focus on bonuses, because incentives created by bonuses are at the heart of so many other problematic behaviors. By this I mean incentives not just to take risks—such as gambling with huge sums of other people’s money—but also to engage in the deceptive practices that some bankers employ to minimize their risks. Practices such as, for example, blatantly deceiving their buyers about the nature and prospects of their financial products, or rigging the Libor rate to the benefit of themselves and the harm of everyone else. Engaging in this kind of callous disregard for everyone who doesn’t happen to be one’s self would be much less tempting if there weren’t such vast, direct, and immediate rewards for getting away with it. Bonuses are those rewards. A nice illustration of this principle has been in the news recently. In 2009 Deutsche Bank awarded an €80 million bonus to Christian Bittar for his contributions to the firm during 2008, the year the crisis hit. The bank had only had time to pay him about €40 million of this amount, however, before deciding in 2011 that it should fire him for his role in manipulating Libor rates prior to and during the crisis.

It's clear that fixing Libor rates is wrong, and destructive to the financial and larger socio-cultural system. But it's also clear that if a system offers an €80 million jackpot to anyone who can get away with cheating (or only €40 million if you get caught), then it contains the seeds of its own destruction.

Some might disagree with me by arguing that reform should emphasize punishment over reward. Instead of focusing on reducing or eliminating bonuses for everyone, why not focus on punishing the guilty? Wouldn't that be fairer? It sounds good, but up to now that system hasn't worked effectively at all. Producing evidence of wrongdoing by specific bank employees, especially high-level managers, is notoriously difficult. Decisions tend to be made by committees, and if the firm is accused of wrongdoing, it often just produces a scapegoat (Bittar is probably an example) in order to wash its hands. That's not to say that bad individual behavior shouldn't be punished, when detectable. But if we can eliminate the incentives that motivate so much of this behavior in the first place, why wouldn't we? That would certainly be a more efficient and preemptive solution.

The most common objection to placing limits on banker pay is that societies who do so will see their bankers defect to more lucrative pastures. This isn't a valid concern. Fields like medicine, science and engineering don't need to rely on giant bonuses to attract the "best" people; why is banking so different? What's more, the main problem we should be trying to solve is staving off a collapse of civilization, not preventing an exodus of bankers. Let the bonus-chasing bankers defect, and make room for ones who are more focused on long-term rewards.