I was first asked to write some words in favour of bankers’ bonuses. But having gone into print on the ‘pro’ side, I felt impelled to put forward the ‘anti’ as well. Here are both sides; make up your own mind which side you’re on.

THE CASE FOR

There is no logical reason why investment bankers should get substantial bonuses and engineers not. Then again, there is no logical reason why investment bankers should be paid more than engineers at all. Or indeed, why engineers should be paid more than, say, nurses. Nobody really knows who should get what. Back in the 13th Century the philosopher St Thomas Aquinas tackled this, looking to determine the ‘just price’ for any piece of work. He failed, and it would be presumptuous of me to assume that I can do any better.

Nevertheless, although I can’t justify it, I can explain why they are paid in this way. In every industry, pay is set according to the ‘market’; the norms of our jobs in relation to our peers. Banking has developed such a market. So, the questions to ask are:

• Why did this happen?
• What would happen if we tried to change it?

Profits depend on individuals

The nature of investment banking means that profits are volatile, and depend very much on the activities and talents of individuals. There is considerable scope for an individual to make the bank a lot of money by performing well. Or indeed, to lose it by messing up. In such circumstances, many people argue that a bonus will motivate better performance.

A big pot is available for bonuses

When times are good, investment banking is a very profitable business, so there’s a big pot available for bonuses. It may be that money motivates individuals, or that may be totally fallacious, but if the money is there, the argument is that it’s probably worth spreading it around generously, just in case that was what was driving the profits.

There’s a lot of it around

The third reason why large bonuses are available in banking relates to the nature of the business. Their stock in trade is money; they are (metaphorically) surrounded by it. Many years ago, when I worked in a Spam factory, I was allowed to buy Spam cheaply, as a ‘perk’ of the job. By the same token, bankers might argue that they deserve some of their product too! And working with large sums of money each day means that one becomes insensitive to small sums, which is why the bonuses are so big.

So, that is why we are where we are. Let’s turn now to what might happen if we were to try to change the system. It would not be pleasant.
Not just for some bankers
We cannot change pay for just some bankers – just in the UK, or only in certain banks - any more than we can change the traffic rules so that blue or red cars have to drive on the right!
A few years ago I did research into executive pay, interviewing the great and the good to determine why they got paid what they did. One City CEO explained it very simply. He said that if ‘they’ were to halve the pay of all the CEOs in the City, then no-one would bat an eyelid. But it would have to be all the CEOs. If even one individual retained his high compensation, then the others would demand parity.

Base salaries would increase
If somehow one did persuade all bankers to do without their bonuses, it is likely that their base salaries would increase. As I said, there’s no logical reason why bankers get paid the sums they do. But the fact is that they do, and they have developed lifestyles based on this. If bonuses were to disappear, it would constitute a change in terms of employment, making it likely that base pay would have to rise to compensate. And that high base pay would be required every year; even in years when they made losses. Surely in a business where profit is so volatile, it makes sense to have compensation linked to results?

Some individuals would leave
Another reason for retaining the bonus is that some individuals would leave if it were removed. Not all, obviously. Not every banker is immensely talented, and not every banker could find another well-paid job. But if sufficient of the good ones found employment elsewhere, that could decimate the industry. And with only 90% of the banking industry left, the UK would no longer be a world leader. Which, despite what you may think, does matter.

THE CASE AGAINST
You might have noticed that we’re in a bit of a financial mess. Caused, in part, by the past irresponsibility of financial institutions. Yet they tell us that their time for remorse is over, and we should be happy for them to receive large bonuses again. Unfortunately, that makes little sense in motivational or financial terms, and to many people is quite offensive from a moral perspective.

Rewarding Poor Performance
The trouble with paying bonuses to bankers at the moment is that their achievement is rather less than exceptional. Bonuses should only be paid – to anyone, in any industry - if their effect is either to reward exceptional achievement or to motivate appropriate behaviour for the future. And the evidence is that bonuses do not motivate the right things, anyway.

Bonuses don’t work
Bonuses don’t work. Oh, they work very nicely to incentivise low-interest, repetitive tasks. But there is research evidence to suggest that they don’t produce the desired results for more complex activities. Indeed, experiments have shown that individuals who are ‘motivated’ by the prospect of financial reward actually do worse at complex cognitive tasks than those without the benefit of an incentive. And top-level banking is a complex cognitive task, in which risk management is fundamental. Given that one reason for the collapse of the financial system was that its participants had misunderstood or wilfully ignored the level of risk inherent in the plethora of financial instruments they were creating, reconstituting the same reward system that contributed to this failure may not be the most intelligent move.
Implicit government underwriting
Leaving aside risk, there are other financial arguments against bonuses. One impact of the crisis is that we are more aware that the banks make their profits in part due to their implicit underwriting by the government. When the banks failed, the taxpayer stepped in to bail them out; indeed, we now own several of them, and the others benefited from an asset-protection scheme. They get the upside, we bear the downside. This does not fully show up in their accounts: the profits they report include no costs for the implicit guarantee, because no such charges are made. Thus profits, and profit-related bonuses, are overstated.

Debt hived off into a ‘bad bank’
Furthermore, one cause of the increased profits is a reduction in impairment charges (bad debts). One reason impairment charges are down is because much of the toxic debt was hived off into a ‘bad bank’ so they could carry on trading with clean balance sheets. This was necessary, but it is perhaps unreasonable to reward it.

Pushing total pay higher
When the crash hit, large bonuses could not be paid. But individuals in the industry had lifestyles dependent on receiving significant sums. And although much has been said to disparage bankers and banking, this is a valuable industry that we all need, and these individuals do have the relevant expertise, and had to be retained. Accordingly, there was a significant increase in the general level of their base salaries, which doubled in some instances. If we now revert to the previous bonus regime, those additional sums being paid on top of the increased salary levels will potentially push total pay even higher.

People are suffering
Even if the profits were real, many of us feel uncomfortable about paying large bonuses to bankers in the current economic climate. People are suffering. Not necessarily me. Nor, I hope, you. But there are a lot of people, in this country and around the world, whose lives are significantly worse because of a recession driven by a crisis caused by irresponsible banking. I accept that most individual bankers were not personally and directly responsible for the financial crash. But they did personally and directly benefit from the lakes of money lapping around financial services before the crash, when their companies were misreading risk and reporting huge profits. And there’s something uncomfortable about hearing ‘well, that was last year’s problem; we’re making money now so we deserve a bonus’. In the same way that banks are, quite reasonably, utilising their previous huge losses to minimise this year’s tax liabilities, bankers should take account of previous huge losses in setting this year’s bonuses, and reduce them significantly. That would, at the very least, be the polite thing to do.

And Finally
So I rest my case, both cases. I’ll leave you with this quote:
*The test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function.*

(F. Scott Fitzgerald, “The Crack-Up”)

1. The case ‘for’ was first put forward in my article for E + T magazine March 2010.