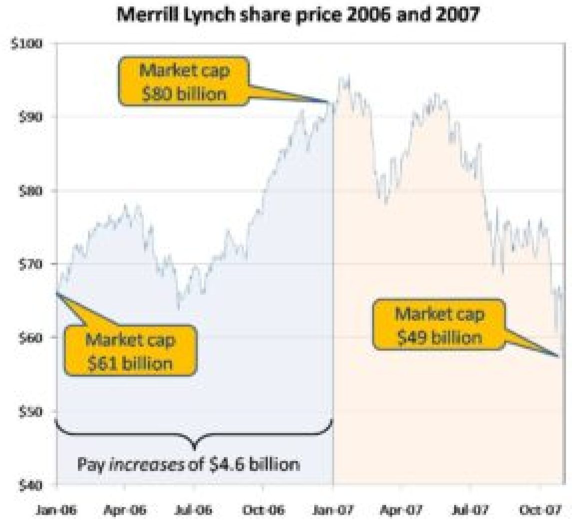
Heads you win, tails I lose – the City explained

written by Clive Bates | 4 November 2007



Imagine your job is taking huge gambles with other people's savings and pensions. Imagine also that the bets are arranged so that you are paid a fortune when things turn out well, but you don't lose anything much when they go wrong. How would you behave…?

I think you might rapidly develop a hog's appetite for wild risk taking. And that is, in essence, what is wrong about the financial markets – the incentives of individual traders and managers are not aligned with the interests of those whose money they manage. The pay system based on big bonuses creates a sharp asymmetry in rewards for success and penalties for loss. There are no *negative bonuses* that penalise big losses. The worst that can happen is a few months gardening and a pay-off that would dwarf most people's regular pay. The institution, its shareholder or investors take the pain – not the trader or manager.

It is this view of ***individual incentives*** that I think has been missing from the commentary on recent turmoil in the financial markets. People are asking why the companies took such risks… just look inside the companies at the personal risks taken by the people making the decisions and it is clear.

The most egregious example of this in recent weeks has been the precipitous fall of Merrill Lynch, and the departure of its top gun, Stan O'Neal. What happened tells us something about how the industry works…

O'Neal's payment for failure. [Mr O'Neal was paid $22 million in 2006], as the company's fortune soared – $14m of that was his bonus. In fact the company put on a nearly $20 billion in shareholder value in 2006 and you might argue that was a good return (see chart / share price data)Much of this value was illusory, as it was stacking up investments in securitised sub-prime mortgages, much of which went very sour indeed in October 2007 – causing an embarrassing $7.9 billion write down in the third quarter results. The market value of the firm has fallen by over $30 billion since the beginning of the year, with who knows what misery still to come as all these dodgy positions unwind. O'Neal had to go, but he will walk with a $160m package. And in the name of a quiet life for all involved (except the shareholders) he has been allowed to retire rather than being given the boot, so his package is $90m more than it otherwise would be [FT report]. So much for the down-side risks….

A negative bonus? In a more reasonable world, there would be symmetry in his reward system – and you might expect him to have a negative bonus, or 'malus'. O'Neal did well in 2006, but so did many at Merrill: from 2005 to 2006, the pay bill increased by $4.6 billion from $12.4 to $17.0 billion, a 37% increase. If we were to pretend this increase was a reward for creating shareholder value (which increased from $61bn to $80bn) we can derive a return to value-creation of 24 cents extra pay for every dollar of extra shareholder value created. But if Merrill Lynch staff had to pay back at the same rate when they have destroyed shareholder value in 2007 so far, there would be a $7.4 billion negative bonus (a 'malus') payable by now. I don't suppose they'll be paying back anything like that much, or anything. [Merrill Lynch 2006 Annual Report]

They're all at it. I don't particularly want to pick on Merrill Lynch. It just illustrates the incentive structure that works in financial markets and it is far from alone: see *Biggest City bonuses ever* [Evening Standard in 2006] and troubles at other investment banks like Citigroup and Barclays. The Northern Rock crisis was driven by a management determined to make aggressive use of a risky business model, placing all their investors at risk. In the end, they were bailed out with £30 billion of public sector loans [BBC]. It's the same basic model – profit from exuberant risk taking while times are good: let others take the pain when it all goes wrong. That's why it's no good asking Northern Rock why they didn't see the credit crunch coming – the *individual managers* (as opposed to the institution) had no incentive to look or to act differently. Quite the opposite.

Could anything be done?
Annoyingly, it is very hard to see how this could be fixed. It would require an incentive structure that was multi-year, transferable between employers, and

stuck with traders and managers even if they left the industry. No manager would accept it, and given the pursuit of talent, no employer would offer it. Any market that required it through regulation would find its institutions moving offshore. It is easier for the fund manager and institution to let the ultimate investor take the pain – as long as all institutions do it together. Which they do. The only sensible approach is *caveat emptor* or 'buyer beware' and distrust of promised big returns.

A Lex comment in the Financial Times puts it rather well:

> *Senior Wall Street executives can enjoy eye-watering pay packages by taking excessive risks during good times – something that only becomes clear when risk management is tested and is found wanting.[…] A radical shift on Wall Street is unlikely. But heads you win, tails I lose is no way to pay anyone.*

Note: Market capitalisation is calculated here as share price at the end of year multiplied by shares outstanding at the end of year as listed in the annual report for 2005 and 2006.