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'Flawed' City bonus system takes some flak for crunch

By Sean O'Grady

The Nobel Prize-winning economist Joseph Stiglitz has blamed the "unconscionable" system of generous bonuses paid to investment bankers for exacerbating the global credit crisis.

"The system of compensation almost surely contributed in an important way to the crisis," said Professor Stiglitz, a former chairman of the President's Council of Economic Advisers under Bill Clinton.

"The system was designed to encourage risk taking - but it encouraged excessive risk taking.

In effect, it paid them to gamble. When things turned out well, they walked away with huge bonuses. When things turn out badly - as now - they do not share in the losses."

Despite the turmoil in the markets, bank failures and write-offs amounting to US\$120 billion (\$152 billion), City bonuses will top £6 billion (\$15 billion) this year, though that will be down on the £7.2 billion estimated to have been paid out in 2007, which was itself a reduction on the peak of £8.8 billion in 2006.

This year's bonuses will be the lowest since 2003.

However, the sums involved remain dizzying, with dozens of bankers at Goldman Sachs, for example, awarded bonuses of at least £5 million each at Christmas, with one lucky trader pocketing more than £10 million in cash and shares.

The average bonus at Goldman Sachs last year, one of the more extravagant payers, was £300,000.

Staff are thought to be dreading the possibility that the average this year will be a mere £200,000 - on top of salaries and other emoluments.

Staff numbers, notably at the troubled Bear Stearns, will also be pruned.

Professor Stiglitz said he was not impressed. "Even if they lose their jobs, they walk away with large sums.

"It was predictable that this system would lead to problems."

While rejecting the idea of limiting bonuses, he is keen to link performance to longer-term success: "The solution is not so much to cap the bonuses, but to make sure that they share the losses as well as the gains - for instance, holding the bonuses in escrow for 10 years; if there are losses in the second or third or fourth years, the bonuses would be reduced appropriately."

Reflecting on the collapses at Northern Rock and Bear Stearns and their respective rescues by the British and US governments, Professor Stiglitz added: "It is one thing to gamble with one's own money but these bankers were gambling with other people's money and with the government [taxpayers] backstopping any losses. This is unconscionable."

Nor does he consider the authorities blameless: "The regulators were clearly not doing what they should have been doing; and the regulations themselves have not kept pace with innovations in financial markets.

"Financial markets were very sophisticated in slicing and dicing risk, but they were very bad at assessing risk. They made a large number of elementary mistakes - which should check our confidence in their ability to manage risk.

"There needs to be much better regulation of these new instruments, at least when people are gambling with other people's pension funds."

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