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Bonus plans of mice and men

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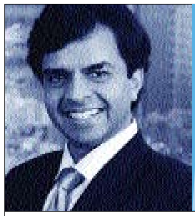

Manoj Thulasidas

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Has the stick been subsumed too much to the carrot?

Our best-laid plans often go awry. We see it all the time at a personal level – accidents (both good and bad), deaths (both of loved ones and rich uncles), births, and lotteries all conspire to reshuffle our priorities and render our plans null and void. In fact, there is nothing like a solid misfortune to get us to put things in perspective. This opportunity may be the proverbial silver lining we are constantly advised to see. What is true at a personal level holds true also at a larger scale. The industry-wide financial meltdown has imparted a philosophical clarity to our profession – a clarity that we might have been too busy to notice, but for the dire straits we are in right now.

This philosophical clarity inspires analyses (and columns, of course) that are at times self-serving and at times soul-searching. We now worry about the moral rectitude behind the insane bonus expectations of yesteryears, for instance. The case in point is Jake DeSantis, the AIG executive vice president who resigned rather publicly on *The New York Times*, and donated his relatively modest bonus of a million dollars to charity. The reasons behind the resignation are interesting, and fodder to this column.

Before I go any further, let me state it outright. I am going to try to shred his arguments the best I can. I am sure I would have sung a totally different tune if they had given me a million dollar bonus. Or if anybody had the temerity

to suggest that I part with my own bonus, paltry as it may seem in comparison. I will keep that possibility beyond the scope of this column, ignoring the moral inconsistency others might maliciously perceive therein. I will talk only about other people's bonuses. After all, we are best in dealing with other people's money. And it is always easier to risk and sacrifice something that doesn't belong to us.

One argument for big bonuses is that the executives work hard for it and earn it fair and square. It is true that some of these executives spend enormous amount of time (up to 10 to 14 hours a day, according to the AIG executive under the spotlight here). But, do long hours and hard work automatically make us "those who deserve the best in life," as Tracy Chapman put it? I have met taxi drivers in Singapore who ply the streets hour after owl-shift hour before they can break even. Apparently the rentals the cabbies have to pay are quite high, and they end up working consistently longer than most executives. Farther beyond our moral horizon, human slum dogs forage garbage dumps for scraps they can eat or sell. Back-breaking labor, I imagine. Long hours, terrible working conditions, and hard-hard work – but no bonus.

But, I am threading on real thin ice when I compare, however obliquely, senior executives to cabbies and slum dogs. They are (the executives, that is) clearly a lot more talented, which brings me to the famous talent argument for bonuses. What is this talent thing? Is it intelligence and articulation? I once met a taxi driver in Bangalore who was fluent in more than a dozen languages as disparate as English and Arabic. I discovered his hidden talent by accident when he cracked up at something my father said to me – a private joke in our vernacular, which I have seldom found a non-native speaker attempt. I couldn't help thinking then – given another place and another time, this cabbie would have been a professor in linguistics or something. Talent may be a necessary condition for success (and bonus), but it certainly is not a sufficient one. Even among slum dogs, we might find ample talent, if the Oscar-winning movie is anything to go by. Although, the protagonist in the movie does make his million dollar bonus, but it was only fiction.

In real life, however, lucky accidents of circumstances play a more critical role than talent in putting us on the right side of the income divide. To me, it seems silly to claim a right to the rewards based on any perception of talent or intelligence. Heck, intelligence itself, however we define it, is nothing but a happy genetic accident.

The next argument in favor of hefty bonuses presents incentives as a means of retaining the aforementioned talent. Looking at the state of affairs of the financial markets, the general public may understandably quip, "What talent?" and wonder why anybody would want to retain it. That implied criticism notwithstanding, talent retention is a good argument. As a friend of mine illustrated it with an example, suppose you have a great restaurant thanks mainly to a superlative chef. Everything is going honky dory. Then, out of the blue, an idiot cook of yours burns down the whole establishment. You, of course, sack the cook's rear end, but would perhaps like to retain the chef on your payroll so that you have a chance of making it big again once the dust settles. True, you don't have a restaurant to run, but you don't want your competitor to get his hands on your ace chef. Good argument. My friend further conceded that once you took public funding, the equation changed. You probably no longer had any say over payables, because the money was not yours. I think the equation changes for another reason as well. When all the restaurants in town are pretty much burned down, where is your precious chef going to go? Perhaps it doesn't take huge bonuses to retain him now.

The last argument for bonus incentives is in terms of profit (and therefore shareholder value) generation. Well, shareholder value in the current financial turmoil has taken such a beating that no sane bank executive would present it as an argument. What is left then is a rather narrow definition of profit. Here it gets tricky. The profits for most financial institutes were abysmal. The argument from the AIG executive is that he and his team had nothing to do with the loss making activities, and they should receive the promised bonus. They distance themselves from the debacle and carve out their tiny niche that didn't contribute to it. Such segmentation, although it sounds like a logical stance, is not quite right. To see its fallacy, let's try a time segmentation. Let's say a trader did extremely well for a few months making huge profits, and messed up during the rest of the year ending up with an overall loss. Now, suppose he argues, "Well, I did well for January, March, and August. Give me my 300% for those months." Nobody is going to buy that argument. I think what applies to time should also apply to space (sorry, business units or asset classes, I mean). If the firm performs poorly, perhaps all bonuses should disappear.

But, this dictum also doesn't work quite right either, for a variety of interesting reasons. First, AIG is a big firm, with business units that operate independently of each other, almost like distinct financial institutions. If I argued that AIG guys should get no bonus because the firm performed abysmally, one could point out that the financial markets as a whole did badly as well. Does it mean that no staff in any of the banks should make any bonus even if their particular bank did okay? And why stop there? The whole economy is doing badly. So, should we even out all performance incentives? Once we start going down that road, we end up on a slippery slope toward socialism. And we all know that that idea didn't pan out so well.

Another point about the current bonus scheme is that it already conceals in it the same time segmentation that I ridiculed above. True, the time segmentation is by the year, rather than by the month. If a trader or an executive does well in one year, he reaps the rewards as huge bonus. If he messes up the next year, sure, he doesn't get any bonus, but he still has his basic salary till the time he is let go. It is like a free call option implied in all high-flying banking jobs.

Such free call options exist in all our time-segmented views of life. If you are a fraudulent, Ponzi-scheme billionaire, all you have to do is to escape detection till you die. The bane of capitalism is that fraud is a sin only when discovered, and until then, you enjoy a rich life. This time element paves the way for another slippery slope towards fraud and corruption. Again, it is something like a call option with unlimited upside and a downside that is somehow floored, both in duration and intensity.

There must be a happy equilibrium between these two slippery slopes – one toward dysfunctional socialism, and the other toward cannibalistic corruption. It looks to me like the whole financial system was precariously perched on a meta-stable equilibrium between these two. It just slipped on to one of the slopes last year, and we are all trying to rope it back on to the perching point. In my romantic fancy, I imagine a happier and more stable equilibrium existed thirty or forty years ago. Was it in the opposing economic ideals of the cold war? Or was it in the welfare state concepts of Europe, where governments firmly controlled the commanding heights of their economies? If so, can we expect China (or India, or Latin America) to bring about a much needed counterweight?

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The author is a scientist from the European Organization for Nuclear Research (CERN), who currently works as a senior quantitative professional at Standard Chartered in Singapore. The views expressed in this column are his own, which have not been influenced by considerations of his employer's business or client relationships. More information about the author and his forthcoming book (*Principles of Quantitative Development*, to be published by John Wiley & Sons Ltd.) can be found at his blog: http//www.Thulasidas.com.