

# The Good Banker<sup>1</sup>

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## ABSTRACT

What is a good banker? What is the economic value added of banks? The economics literature on financial intermediation focuses on the role of banks as deposit-taking institutions and as delegated monitors of borrowers. But this description barely begins to represent what banks do in a modern economy. Besides commercial lending, large banks are engaged in a number of other activities ranging from cash management, trade credit, swaps and derivatives trading and underwriting of securities. In recent decades banks have increasingly relied on fee income generated from their activities other than lending. The financial crisis, and the concerns about “too-big-to-fail” banks it has exposed, has led to a re-evaluation of bankers’ speculative practices and of the economic benefits of banks’ non-lending activities. Do trading activities undermine sound banking principles and core lending functions? Do they provide economic benefits, or are they simply an undesirable side-product of deregulation? The main argument of this article is that trading activities are an integral and desirable part of modern banking. These activities enhance banks’ traditional lending role, and regulatory attempts to separate lending and non-lending activities are mostly counterproductive. The main cause of bankers’ reckless behavior is rather to be found in out of hand compensation practices, which exacerbate bankers’ pursuit of short-run profit opportunities at the expense of financial stability and their clients’ interests.

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## 1. Introduction

The Libor scandal prompted the new management of Barclays to commission an in-depth review of the bank's corporate culture by an independent commission headed by Anthony Salz. Following extensive internal interviews with hundreds of Barclays' bankers a detailed and insightful review of Barclays' management failings was published in April 2013. It begins with a tactful British understatement: "The public has been encouraged by politicians, regulators and the media to see the banks as having a significant responsibility for the financial crisis and the ensuing economic ills. This has been a cause of the loss of public confidence." [Salz Review, page 4, paragraph 2.5]. To be sure, there has been a constant outpouring of negative commentary on bankers' ethical blindness ever since the failure of *Bear Stearns*, fuelled by a seemingly endless stream of revelations about banks' dubious practices before and during the financial crisis.

We thought we had heard the worst about banks' misconduct, when shady mortgage origination practices—epitomized by predatory lending methods and the rapid growth of 'Ninja'<sup>2</sup> Loans—were reported, or when later the widespread misselling of mortgage-backed securities was uncovered<sup>3</sup>. Alas, over the past five years we have learnt that virtually every major bank has been involved in some form of malfeasance, and that essentially every banking activity has been touched by some scandal, whether it was improperly feeding funds to Bernie Madoff, money laundering, facilitating tax evasion for wealthy private clients, collusion in credit derivatives markets, or the manipulation of LIBOR. What is worse, some banks seemed to continue their bad habits undeterred during the crisis, as the robo-signing of foreclosure notices scandal revealed.

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<sup>2</sup> See for example Agarwal et al. (2012); Ninja stands for "no income, no job and no assets".

<sup>3</sup> See for example Piskorski et al. (2013).

In light of all these revelations it is no wonder that bankers have acquired a bad name and that they have lost the public's trust. But what are the causes of all this misconduct? The answers to this question are important to determine what banking reforms are needed to establish a sounder and more reputable banking industry.

Many commentators have put the blame on financial deregulation, which has allowed banks to gravitate away from their traditional role as lenders and to increasingly engage in speculative trading activities. I will differ with this assessment and argue that the gradual dismantling and eventual repeal of Glass-Steagall separations between commercial and investment banking was a necessary evolution reflecting the changed nature of modern banking. I will argue instead that the causes behind the erosion of bankers' ethical standards and reckless behavior are largely to be found with how bankers were compensated and the culture of impunity that banks' compensation practices gave rise to. Thus, regulatory reforms should be directed more towards reigning in banks' compensation and governance practices than to structural remedies imposing artificial boundaries between different banking activities.

After laying out the two main contending hypotheses in section 2, I will develop at greater length the basic economic and regulatory logic behind the repeal of separations between lending and trading activities before the crisis in sections 3 and 4. I will then turn to a more detailed discussion of compensation practices and the economic logic for controlling bankers' pay in section 5. Finally, section 6 summarizes the main argument and concludes.

## 2. Transactions over Relationships

Two broad explanations for banker misconduct prior to the crisis have been proposed. The first is that banks have increasingly abandoned their traditional commercial banking activities in favor of fee-based transaction services, trading, and speculation. In the process, to borrow the Supreme Court's famous phrasing in its landmark decision *ICI vs. Camp* (1971), bankers have been carried away by their "salesman interest...impair[ing] [their] ability to function as an impartial source of credit."<sup>4</sup> In other words, by moving away from their traditional role of deposit taking and lending to businesses and households, bankers have gradually transformed an activity based on long-term relationships with clients into a short-term trading activity focused on maximizing profits from trading. The Salz Review reaches a similar conclusion and observes that Barclays' "rapid journey, from a primarily domestic retail bank to a global universal bank twenty or so years later, gave rise to cultural and other growth challenges. The result of this growth was that Barclays became complex to manage, tending to develop silos with different values and cultures. Despite some attempts to establish Group-wide values, the culture that emerged tended to favour transactions over relationships, the short term over sustainability, and financial over other business purposes." [Salz, 2013, 2.13]

But the Salz Review also offers another related explanation, one that centers on bankers' compensation practices and banks' bonus culture: "The structuring of pay was typically focused on revenues and not on other aspects of performance. Encouraging the maximisation of short-term revenues carried risks of unsatisfactory behaviour, with significant and adverse reputational consequences for the bank..... Based on our interviews, we could not avoid concluding that pay contributed significantly to a sense among a few that they were somehow unaffected by the ordinary rules. A few investment bankers seemed to lose a sense of proportion and humility." [Salz, 2013, 2.28 and 2.29]

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<sup>4</sup> *Investment Company Institute vs. Camp*, 401 U.S.C. 617 (1971).

Two separate points are made here. The first is that Barclays (and other banks) based bankers' compensation on the wrong performance benchmarks; they lavishly rewarded short-term revenue performance without looking too deeply into how the performance was achieved. Was a banker's sales performance due to misselling, excessive risk taking, or even market manipulation? These questions did not receive much consideration, unwittingly fostering a culture of winning at all costs.

This first point, although systematically ignored even by the most reputable executive pay consultants, is actually in accordance with some of the main contributions of modern agency theory in economics. As the Holmström and Milgrom (1991) multi-task agency theory emphasizes, the obvious risk of offering bankers high-powered incentives to maximize short-term revenue is that they will inevitably respond by neglecting other important tasks that are less well rewarded. And, as Bénabou and Tirole (2012) have recently shown, increased competition for talented bankers can exacerbate this multi-task distortion and give rise to an equilibrium in which a destructive bonus culture can develop inside banks<sup>5</sup>. They consider a multi-task production model, where the output of some tasks is easily measured and rewarded and that of others, which involve some elements of public goods production (such as maintaining the firm's reputation), is not. Agents differ in their productivity, so that firms, who are not able to observe underlying agent productivity types, seek to screen agents based on their observable outputs. Bénabou and Tirole show that under competitive labor markets individual firms can be led to provide excessive incentives to agents on the tasks with easily measured output. Thus competition for talent can give rise to an equilibrium outcome where firms foster a potentially destructive bonus culture, as the less well measured tasks are neglected by agents. They show

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<sup>5</sup> See also Ivan Marinovic and Paul Povel (2012) and Michiel Bijlsma, Jan Boone and Gijsbert Zwart (2012) for related analyses.

that in such a model, welfare can be improved by introducing regulations that put a ceiling on the size of bonuses.

The economics literature on short-termism has also emphasized that rewards for short-term performance can be destructive if they induce behavior that boosts short-term performance at the expense of long-term value (see e.g. Stein 1989). One would think that bank owners and their pay consultants would not be so foolish as to offer such destructive financial incentives to bank managers, traders and executives. But, as Bolton, Scheinkman and Xiong (2006) have argued bank owners themselves, and the financial markets in which they trade their shares, may also have excessively short-run horizons, so much so that they actually are quite happy to encourage bank executives to pursue short-run performance at the expense of long-run value. The key element of their argument is the observation that shareholders often have different opinions and disagree about the fundamental value of a banks' strategy. As a result, bubbles can develop where optimists temporarily drive up stock prices. Shareholders believe they benefit from these bubbles because they hope to be able to exit before the bubble bursts. As a result, they are happy to encourage bank executives to boost short-term performance even at the cost of excessive risk taking, as higher reported short-term earnings tend to fuel the bubble.

The second point in the analysis of the Salz Review on Barclays' pay practices concerns the disproportionate levels of pay of some of the top bankers. The Salz Review indicates that top bankers' remuneration had become so extravagantly high that bankers lost any sense of reality. Top Barclays bankers' lavish pay had the unintended effect of isolating them from their clients and ordinary employees. It fostered hubris and gave rise to a sense of entitlement. The lopsided compensation also boosted their egos, making them overconfident, distorting their perceptions of risk, and muffling their sense of caution. Classical agency theory does not allow for any possible psychological side-effects of outsize pay. This may be an important gap in the economic

theory of incentives that frames compensation practice, especially in view of the abundant anecdotal evidence that people who have the good fortune to rapidly amass wealth can easily become disoriented and squander it, be they successful sportsmen, artists, gamblers, or bankers.

The two broad explanations for the corrosion of bankers' ethical standards and banker misconduct: i) the shift towards a transactions, fee-based, banking model, and ii) the growth of a toxic bonus culture, are not mutually exclusive. Indeed, many commentators have conflated the two explanations. A prominent example is Simon Johnson, who asserted that: "...the culture in big Wall Street banks remains just as bad as ever — traders and executives have no respect for their clients and are mostly looking for ways to behave badly (and get away with it).... Top people at megabanks make a lot of money under existing arrangements. They get the upside from big bets and, when things go badly, they benefit from downside protection provided by the government. This amounts to a non-transparent, unfair and dangerous subsidy system. The Volcker Rule will curtail subsidies and cut bankers' pay.... You should be careful with your investments and be very skeptical of the advice you receive from big banks. Trust community savings banks and credit unions. Trust the FDIC to protect your deposits. Support politicians who want to reform and rein in the power of the big banks." [Simon Johnson on "Making Banks Play Fair" March 19, 2012; BillMoyers.com]

It is important, however, to make a clear distinction between these two explanations, for they lead to very different assessments of how banking needs to be reformed. Echoing Robert Shiller (2013), who in his discussion of collateralized mortgage obligations (CMOs), wisely warns that: "[we] have to understand human behavior and human ethical standards, to know that the financial system that produced the CMOs and other derivatives was not inherently evil, that it had sound concepts that might sometimes be derailed, that [we] *should not adopt a Manichean view of business that sees the financial community in black and white* [emphasis added]", I shall argue that the

transformation of banking away from its traditional role of relationship lender to small and medium sized firms is a natural and efficient evolution, responding to technological changes and changing needs for financial services in the economy, but that compensation of bankers has gotten out of hand to the point that it has corroded bankers' ethical standards of conduct.

### **3. What is a Good Banker?**

For many the idealized image of the good banker is James Stewart playing the role of George Bailey, the selfless manager of a small bank, in Frank Capra's classic *It's a Wonderful Life* (1946). It is an image that is appealing both for the noble character of the main protagonist and the nostalgic depiction of relationship banking in a small-town savings and loan bank. Recently, Joe Nocera (2011) conjured up this very image in singling out Robert G. Wilmers, the CEO of M&T Bank as the personification of a good banker. In Wilmers' own words: "Most bankers are very involved in their communities... banks exist for people to keep their liquid income, and also to finance trade and commerce." And Nocera adds: "what particularly galled [Wilmers] — trading derivatives and other securities [that] really had nothing to do with the underlying purpose of banking. He told me that he thought the Glass-Steagall Act — the Depression-era law that separated commercial and investment banks — should never have been abolished and that derivatives need to be brought under government control." [Joe Nocera, "The Good Banker", *New York Times*, May 30, 2011]

This is a widespread sentiment. Many believe that the origins of the crisis of 2007-09 can be found in the passage of the Gramm–Leach–Bliley Act of 1999, which essentially repealed Glass-Steagall and allowed for the expansion by commercial banks into investment banking. While the Dodd-Frank Act of 2010 partially reverses some of the Gramm–Leach–Bliley provisions with



the *Volcker rule* prohibiting proprietary trading by banks, this is only seen as a modest step in the right direction, and many continue to call for the return to a complete separation of commercial and investment banking, as vividly illustrated by the “21<sup>st</sup> Century Glass-Steagall” bill introduced in the Senate on July 11, 2013 by Senators Warren, McCain, Cantwell and King.

The opposition to the universal banking model, which combines commercial banking, investment banking, and insurance activities, comprises different constituencies invoking different reasons for returning to a Glass-Steagall form of separation. At a general philosophical level there has long been an ethical condemnation of speculative activities (at least since Aristotle) and several major religions condemn financial speculation (see e.g. Sen, 1991). Interestingly, Robert Shiller (2013) has recently reaffirmed this condemnation by arguing that: “Speculation *is* selfish in the sense that successful speculators do not share information freely. They buy and sell on behalf of their own account instead of revealing information and generously providing the information to all of society.” Shiller’s argument in effect is that a good banker is motivated by altruism and to the extent that speculation involves the selfish exploitation of counterparties’ ignorance it cannot be part of the job description of a good banker.

This is a deep insight that goes to the heart of some of the concerns voiced in the Salz Review about bankers’ lost trust, and to the apprehension expressed by the Supreme Court in *ICI vs. Camp* about the subtle hazards in mixing lending and securities trading activities in the same bank. In *ICI vs. Camp* the Supreme Court had to determine whether First National City Bank’s creation and promotion of a collective investment fund (functionally similar to a mutual fund) constituted an infringement of the Glass-Steagall separation between commercial and investment banking. Although the Court recognized that the collective investment fund posed no immediate systemic risk it nevertheless decided that this was a violation of the law, on the grounds that the

extension of commercial banks' activities into the fund industry could give rise to *subtle hazards* that the legislators sought to avoid.

In a penetrating analysis of the history of enforcement of the Glass-Steagall Act and the gradual dismantling of the legal barriers separating investment and commercial banking activities in the decades following *ICI vs. Camp*, Langevoort (1986) shows that while the Supreme Court may have been prescient in pinpointing the subtle hazards of mixing traditional lending with securities trading activities, and the risks that “the promotional needs of investment banking might lead commercial banks to lend their reputation for prudence and restraint to the enterprise of selling particular stocks and securities”<sup>6</sup>, the evolution of financial markets, technological change, and the changing financial needs of households and corporations left no choice to the courts but to gradually dismantle the restrictions imposed on commercial banks by the Glass-Steagall Act.

As Langevoort (1986) explains: “[the] view of banks [underlying Glass-Steagall] as something of public trustees or a public utility, [was] perhaps justified given the regulation-induced monopolistic conditions in the post-1933 banking marketplace,... [but] One doubts that many sophisticated people today see the banker as anything but a businessperson under pressure to sell products and generate profits - not a likely source of “disinterested investment advice” unless that service is paid for. Camp's reference to the “conservative traditions of commercial banking,” in contrast to the promotional emphasis of the securities industry, rings hollow if consumers treat the financial services products offered by the two industries as in fact fungible. The monopoly rents that once could be appropriated by the industry have in many respects disappeared in the face of vigorous competition, and with them the normative basis for

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<sup>6</sup> 401 U.S.C. at 632.

expecting any compensating sense of public responsibility.” [Langevoort, 1986, pages 700 and 703-04]

Indeed, the history of banking of the past fifty years is one of increased competition from the financial services industry, which gradually undermined the traditional, local, undiversified commercial banking model. Whether on the depositor side or on the borrower side, commercial banks increasingly faced competition from close substitutes offered by non-bank entities. When bank depositors moved more and more of their savings into higher-return money market mutual funds, which simultaneously attracted a larger and larger fraction of corporate issuers away from banks, Congress had little choice but to significantly relax the interest rate ceiling restrictions imposed on commercial banks under regulation Q in the early 1980s.

A further relaxation of the commercial banking regulatory straitjacket followed when commercial banks were allowed to offer discount brokerage services and individual retirement accounts (IRAs) to their depositor clients. While the Supreme Court had adhered to a strict interpretation of Glass-Steagall in the early 1970s in *ICI vs. Camp*, both it and the lower courts gradually retreated from this fundamentalist interpretation in the 1980s and ruled that the provision of these services was not incompatible with Glass-Steagall. Further erosion of the strict separation between securities markets and commercial banking was brought about when securities firms in the mutual funds business were allowed to also offer FDIC-insured checking accounts to their clients, when banks were permitted to privately place commercial paper for their corporate clients, and finally when securities affiliates of bank holding companies were allowed to underwrite stock and bond issues.

In sum, the erosion of the strict separation of lending and trading activities in the 1980s and 1990s took both the form of commercial banks extending their footprint into among others the

mutual fund business, and investment banks offering traditional commercial banking services such as checking accounts. From the perspective of their corporate and retail clients the distinction between commercial and investment banking activities became increasingly blurred: what is the difference for a corporate borrower between a commercial paper issue held by a money market mutual fund and a short-term loan extended by a commercial bank? Moreover, the separation between the two banking sectors imposed increasingly onerous artificial barriers preventing the offering of complementary services, such as commercial loans together with hedging, trade credit, and cash management services. Most importantly, the Glass-Steagall separation between commercial and investment banking introduced a form of destabilizing competition between the two sectors, artificially favoring the less tightly regulated sector. The pressure to deregulate largely came from the sector at risk of losing ground and of becoming unviable. Thus, when the competitive distortions from Glass-Steagall became evident, the courts responded by relaxing the most distortionary restrictions in the law in an effort to restore a level playing field.

The passage of the Gramm-Leach-Bliley Act of 1999 is thus mostly a response by Congress to a *fait accompli* and an affirmation of the new reality of financial markets. Indeed, viewed from a global perspective, commercial banking in the U.S. was arguably lagging behind leading European, Japanese and Canadian commercial banking industries, which were much more concentrated and diversified. It is remarkable, for example, that one year prior to the passage of the Gramm-Leach-Bliley Act, Deutsche Bank completed a merger with Bankers' Trust, thus allowing the leading German universal bank to expand on a huge scale into the derivatives and swaps business, the fastest growing and most profitable segment of the financial industry.

Of course, the fundamental economic causes for the repeal of Glass-Steagall—technological changes, financial innovation, the global integration of financial markets, the growing

competitive pressure from the non-banking sector—do not magically erase the subtle hazards that the Supreme Court pointed to in *ICI vs. Camp*. As is amply evident from the stream of revelations about banks' wrongdoing over the past five years, subtle hazards in universal banks were real and widespread. Arguably however, the bankers' "salesman interest", that the Supreme Court was intent on suppressing, was stoked more by the relentless stock market pressures to meet return-on-equity targets, and by the increasingly high-powered financial performance incentives given to bankers.

What is more, a narrative of the crisis that finds its main origin in financial deregulation and the repeal of Glass-Steagall is at best highly incomplete. After all, the first institutions to fail were entirely specialized banks, whether they were savings & loans institutions dedicated to the origination and distribution of residential mortgages, such as *New Century Financial* (which failed in April 2007), or pure investment banks, such as *Bear Stearns* (which collapsed in March 2008) and *Lehman Brothers* (which filed for bankruptcy on September 15<sup>th</sup> 2008).

Perhaps the main revelation of the financial crisis was the fundamental fragility of the specialized investment banking model inherited from Glass-Steagall. As formidable competitors as sophisticated securities firms could be in a bull market, the crisis has also starkly revealed that stand-alone investment banks are much more vulnerable to runs, given the very short-term nature of their wholesale funding, the absence of anything analogous to deposit insurance to buttress their funding, and the lack of access to the Central Bank backstop. Indeed, a remarkable outcome of the financial crisis is that virtually no significant investment bank without a bank holding company license remains; and with *Morgan Stanley* and *Goldman Sachs* only two stand-alone large investment banks are left standing.

However, in the wake of the crisis the banking industry is now more integrated and concentrated than ever before. A new category of banks has emerged, the global systemically important financial institutions (SIFIs), with its attendant *too-big-to-fail* problem. The importance of these banks to the economy inevitably transforms their status, as the Salz Review lucidly recognizes: “The implicit and explicit government support of banks and the systemic risks they pose to financial stability make them semi-public institutions.” [Salz Review, 2013: 2.5] To be sure, because of their semi-public status SIFIs should not be allowed to be guided only by bankers’ “salesman interest”. In effect, their status as SIFIs puts them in the same position as the “public trustees or public utilities” implicitly envisaged by Glass-Steagall for community banks in the 1930s, albeit on a much bigger scale. If SIFIs are allowed to reap the full benefits of scale and scope a bank can ever hope to reach, they must also shoulder greater responsibility for safeguarding the health of the economy and the entire financial system.

The alternative course for SIFIs advocated by many is to break them up or shrink them down to size (see e.g. Tarullo, 2012). An important lesson from the history of bank regulation post-Glass-Steagall, however, is that a regulatory approach that seeks to strictly divide the financial system into separate parts, based on somewhat arbitrary distinctions between different financial activities, may not be sustainable and will introduce an artificial destabilizing competition between the separated parts of the system. If savers see no clear difference between a bank checking account and a money market mutual fund, if they overlook the fact that one contract is insured against investment losses but not the other, then inevitably the regulated, but more costly, commercial banking sector will be vulnerable to unfair competition from the more lightly regulated securities industry. And if corporations can obtain credit in the form of cheaper commercial paper issues or wholesale funding, then the viability of traditional commercial banks could be threatened. Every time two similar services or products are offered that receive different regulatory treatment, the forces of arbitrage will push out the product that is hampered

by more burdensome regulations, whether this is a product offered by the securities industry or by banks.

This lesson has not been fully absorbed, as is witnessed by the Liikanen and Vickers “ring-fencing” rules in respectively the E.U. and the U.K. or the Volcker rule in the U.S. under Dodd-Frank. Even if one assumes that the Volcker rule can be enforced as intended, its ultimate effect may not be the wished-for risk-reduction for banks, as Whitehead (2011) among others has argued. At the very least, the outcome of the Volcker rule will be that proprietary trading will be displaced to the hedge fund sector. But banks won’t necessarily be shielded from the added risk exposure taken on by hedge funds, as in reality hedge fund and G-SIFI banking activities are closely interwoven.

Just as with *Bear Stearns*, *Lehman Brothers*, or even *AIG*, the danger is that risks will accumulate in less supervised and less regulated sectors with which, however, the more regulated banking sector will be closely interconnected. Similarly, the ring-fencing of traditional commercial banking activities under the Vickers and Liikanen rules, presents the risk that the safer, but perhaps less profitable, local commercial lending activities will shrink in size relative to the more risky and more profitable global securities trading activities. At the same time, the commercial banking affiliates could still be exposed indirectly to the risks taken on by the much larger investment banking affiliates. Should a large U.K. investment bank affiliate fail, this could have contagious repercussions for the U.K. financial sector and economy similar to those following the failure of *Lehman Brothers*, rendering the whole ring-fencing effort pointless.

Shrinking SIFIs down to size, while stopping short of interfering directly in the organization of their business, may be less problematic. However, to determine the appropriate size of a systemically important bank requires a detailed grasp of its business model and a careful

evaluation of the source of its returns to scale and scope. Measuring bank returns to scale is an even more perilous exercise than for non-financial firms. In particular, the estimated size of returns to scale can vary dramatically depending on how financial and human capital is measured, and on whether the measured producer surplus does or does not include bankers' (abnormal) compensation, as Anderson and Joeveer (2013) have shown. Moreover, limiting the size of G-SIFIs may not necessarily reduce systemic risk: if the smaller G-SIFIs have similar balance sheets then an aggregate shock to a particular asset class can result in similar destabilizing fire-sale externalities as when a large horizontally integrated G-SIFI holds the same positions, as Greenwood, Landier and Thesmar (2011) have shown.

#### **4. The Future of Banking**

What is the source of returns to scale and scope of large systemically important financial institutions? What economic value added do these banks contribute to the economy? How SIFIs should be regulated and whether they should be barred from investment banking activities or proprietary trading depends in large part on the answer to these questions. Unfortunately, there is little existing research in finance and economics on bank returns to scale and scope we can rely on. First of all, only a tiny fraction of the academic research literature on banking is devoted to universal banks (see Drucker and Puri, 2007 for a recent survey). Second, the literature on universal banks mostly focuses on the narrow issue of the costs and benefits of combining underwriting services and lending activities in the same institution. Indeed, most of the theoretical literature on universal banks is cast around the following tradeoff: the informational returns to scope from combining both activities (the information acquired through lending makes for better underwriting) are limited by conflicts of interest (for example, as suggested in *ICI vs. Camp*, the temptation to help a weak issuer raise funds through a bond or equity issue in order to repay an outstanding loan).



As plausible as such a conflict of interest sounds, there appears to be no evidence so far of such abuse of securities investor-clients by universal banks. And this is not for lack of research, as a significant fraction of the empirical studies on universal banking are devoted to this question. The evidence from these studies is that securities issues underwritten by universal banks, who have a lending relationship with the issuer have lower yields (or less underpricing) and also lower fees, which is difficult to reconcile with a the view that these underwriters are conflicted. Drucker and Puri (2007) summarize the findings of this empirical research as follows: “Overall, the empirical evidence shows that using relationship banks as underwriters improves the pricing of issues and lowers fees, and both prior lending relationships and lending around the time of a security issuance increase the probability that an underwriter will be selected as underwriter.” In fact, the combined findings of this research are so strong in their eyes that Drucker and Puri are led to ask the rhetorical question: “Given these facts, is it possible for [stand-alone] investment banks to remain viable underwriters?” [Drucker and Puri, 2007, section 4.3, first paragraph]

Even a cursory read of the annual reports of JPMorgan Chase (2012) and Citigroup (2012) immediately reveals how oversimplified existing economic models of universal banks are. It is easy to see from these reports that there is much more to universal banking than deposit taking and lending combined with securities underwriting. In a nutshell, the business model of global universal banks on the corporate and investment banking side is to provide bundled financial services to the world’s largest non-financial companies and to meet the special financial needs of these corporations. For example, firms that operate in multiple countries rely on JPMorgan Chase and Citigroup and a handful of other global banks for a number of financial services, which include cash, foreign exchange, and payroll management, payments & settlement, trade credit, and other transaction services. But the role of global banks can go much further and also cover customized hedging and insurance services built around the analysis of large datasets,

along with the more traditional lending and funding functions. It is instructive to consider for example the list of services mentioned by the Corporate and Investment banking division of JPMorgan Chase in its annual report of 2012 under the heading *Evolution of Product Set Usage among Clients*. These include: “Advisory; Equity Capital Markets; Debt Capital Markets; Lending; Rates, Credit, Foreign Exchange, Securitized Products; Equities, Futures & Options; Commodities; Cash Management; Liquidity; Trade; Depositary Receipts; Custody.”

Large banks also reap substantial economies of scale by delivering many of these services through sophisticated electronic platforms: “We have 20,000 programmers, application developers and information technology employees who tirelessly keep our 31 data centers, 56,000 servers, 22,000 databases, 325,000 physical desktops, virtual desktops and laptops, and global networks up and running. We spend over \$8 billion on systems and technology every year.” [JPMorgan Chase annual report, 2012, page 22] The fixed costs of setting up and running these IT platforms are so high that these technologies are basically out of reach for medium sized banks and all but a small number of large non-financial corporations. This is why global banks like JPMorgan Chase are able to offer significant value added by bundling financial services with lending. The total value of these services is what attracts large firms to global banks, as the evidence in Parthasarathy (2007) confirms. As much as one-stop banking may remain an elusive concept on the retail banking side, it is a model that appears to be working on the corporate banking side (at least for the largest corporations), as the study by Parthasarathy (2007) suggests. Blue chip firms, the study shows, tend to get all their financial services from the same bank, while smaller firms value more the local networks and knowledge of regional banks.

A major challenge for SIFIs, however, is to be able to successfully integrate the retail banking side, a critical source of liquidity, with the thriving corporate banking side, which relies on the delivery of cost-effective liquidity and lending services to corporations. The value added from

the one-stop universal banking model, however, seems to be harder to deliver on the retail side, where public trust in bankers is of greater importance and has been eroded the most. Retail customers must have confidence that the services and products they are being offered by their bank are not peddled to them because of the high commissions and fees attached to them. This is where banking scandals and banker misbehavior has damaged the universal banking model the most. This is where reining in the toxic bonus culture that has led bankers astray matters the most, and where regaining the public's trust will pay off the most.

## **5. Bank Governance and the Regulation of Bankers' Pay**

How can banks regain the public's trust? The answer to a large extent lies in governance and pay reform. As far reaching as the regulatory response to the crisis of 2007-09 has been—ranging from more stringent capital requirements, limits on proprietary trading, the creation of a new systemic risk regulator charged with supervising (bank and non-bank) SIFIs, tighter regulations and the creation of a special resolution procedure for SIFIs, new regulations for derivatives and swaps, registration of hedge funds and tighter “skin-in-the-game” rules for securitization—it is still remarkable how little attention has been devoted to governance and pay reform.

This is unfortunate, given that bankers' high-powered performance-based pay has in all likelihood overly stimulated their “salesman interest” in the run-up to the crisis. As Cheng, Hong and Scheinkman (2010) have shown, it is striking that most of the worst performers in the crisis were financial institutions that also offered the most high-powered financial incentives to their executives. The list of companies for which residual CEO compensation (that is, the component of compensation not driven by firm size and industry) varied the most with the underlying risk exposure of the financial institution (as measured by for example the institution's daily equity beta) speaks for itself: it includes AIG, Lehman Brothers, Bear Stearns, Merrill

Lynch, Morgan Stanley, Bank of America, Citigroup and Goldman Sachs (see their Figure 2). A related analysis by Balachandran, Kogut and Harnal (2010) looking at how risk of default varied with the extent of stock-based compensation of bank executives, also finds that risk of default was higher at the banks offering higher equity-based pay.

Equally striking are the findings of Ellul and Yerramilli (2012). Their study directly measures banks' risk controls and seeks to determine how effective these controls were in limiting risk taking and losses during the crisis. They construct Risk Management Indices (RMI), which take into account dimensions of bank risk management such as the presence of a Chief Risk Officer (CRO) and his/her seniority, the ratio of CRO to CEO pay, whether the CRO reports directly to the board, the banking experience of independent directors on the risk committee, etc. Their first finding is that risk management varies considerably across banks. About half the banks had a CRO reporting directly to the board, or a CRO with a senior management position, and only one in five CROs was among the highest paid executives. Their second finding is that the importance of the CRO position in the bank—what they refer to as “CRO centrality”—is the key component of the RMI. Third, they find that banks with more risk controls (higher RMI) took fewer risks and suffered fewer losses during the crisis. These studies and others (see Becht, Bolton, Röell, 2011, for a selective review of this research) provide more systematic evidence consistent with the conclusions of the Salz Review (2013) for Barclays establishing a link between senior bankers' lavish compensation and their willingness to take unconsidered risks.

Bankers have not always been so abundantly compensated. According to Philippon and Reshef (2012), who track average compensation across industries over the past 100 years in the United States, pay levels in the financial and non-financial sectors for jobs requiring similar education backgrounds have been roughly in line from the great depression to the 1990s. However, in the quarter century preceding the crisis of 2007-09 pay rises in the financial sector have increasingly

outpaced those in other sectors, with bankers earning a 50% premium by 2006 and bank executives earning a 250% premium, after controlling for firm size and job tenure. This rise in relative banker pay may well reflect a remarkable relative growth bankers' productivity over the past thirty years. But the fact that most of the increase in pay has occurred in the shadow finance sector also suggests an alternative explanation, which has more to do with bankers' greater ability to extract informational rents by cream-skimming the most valuable investments away from the uninformed investor public (see Bolton, Santos and Scheinkman, 2012). Indeed, it is revealing that one of the most bitterly fought regulatory battles in the aftermath of the financial crisis of 2007-09 has been and still is over the regulation of trading activities of swaps, derivatives, and other instruments in unregulated over the counter (OTC) markets, where banks are generating an increasingly large share of their earnings<sup>7</sup>.

If disproportionately high remuneration fosters a culture of entitlement, if high-powered incentives for bankers give rise to push-back by traders against the constraints and risk-limits imposed by lower-paid and less senior risk officers, and if as a result of these pressures banks end up taking excessive risks or skirting the law, then a natural regulatory response would seem to be to reign in pay and to bolster the authority of risk managers. Indeed, European legislators have recently taken steps to control banker pay. However, the idea that regulators should intervene and control executive pay remains largely a taboo in the US.

The ambiguities around unrestricted market-based pay for bankers and traders at systemically important financial institutions have been sharply brought to light in the context of the rescue of AIG and the negotiations between Treasury and Congress around TARP. Banker compensation quickly became an important issue for Congress, and one closely followed in the media and by

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<sup>7</sup> See Kara Scannell, "Big Companies Go to Washington to Fight Regulations on Fancy Derivatives," *The Wall Street Journal*, July 10th, 2009 and Gillian Tett, "Calls for radical rethink of derivatives body," *Financial Times*, 26th of August, 2010.

public opinion. When TARP was proposed to Congress a key issue that was debated is whether there would be conditions on pay of executives and traders at institutions receiving TARP funding. The brief exchange between Hank Paulson and Barney Frank on this question recounted in Kaiser (2013) superbly summarizes both sides of this issue. To justify the lack of any pay conditionality in the initial TARP proposal by Treasury to Congress, Paulson simply said that: “If you put in a compensation requirement...I cannot say that [TARP] will work.” To which, Barney Frank replied: “If there are no compensation requirements, I cannot say that [TARP] will pass.” [Robert G. Kaiser, 2013, page 11]

Ever since the first negotiations around TARP, the regulation of banker compensation has been a contentious political issue. A particularly controversial decision was to allow AIGFP, the AIG entity responsible for building a systemically risky net credit default swap (CDS) short position of nearly half a trillion dollars, to pay retention bonuses of up to \$165 million to its traders as part of the \$85 billion bailout deal from the Fed. The main argument against intervention to reign in pay is, of course, that compensation should be left to market forces, and that artificial limits on pay will simply prevent banks from attracting or retaining top talent. It is based on such logic that it was deemed more efficient to pay the market rate to retain AIGFP managers with the necessary skills to unwind AIG’s huge CDS position in an orderly way. But this free-market logic was swept aside by the general moral outrage sparked by the revelations of these bonuses. Was it morally justified to reward those directly responsible for the financial crisis in such a way? Very few thought so.

Economists generally shy away from ethical arguments to justify interventions to regulate pay. It is not their comparative advantage. They prefer to rest their reasoning on efficiency grounds, that is, on welfare efficiency grounds. Thus, intervention to regulate pay is justified for economists if market forces are shown to lead to distortionary pay practices such as those

highlighted by Bénabou and Tirole (2012) and Bolton, Scheinkman and Xiong (2006). Similarly, intervention is justified if market forces result in investment or occupational misallocations due to the extraction of informational rents by bankers, as shown in Bolton, Santos and Scheinkman (2012).

As well-grounded as these economic arguments are, it is still worth pointing out that they all abstract from the basic reality that pay of government employees, regulators, and officials is not determined by market forces. It is well known that government officials are generally paid significantly less than their private sector counterparts (for jobs requiring similar education backgrounds). Differences in job security can explain part of the pay difference, but fundamentally this pay difference rests on the notion that working for the government is a public service, and unlike for private sector jobs compensation of public servants cannot be solely driven by “salesman interests”. Of course, the lower pay in the public sector does mean that government is not always able to attract and retain top talent. Still, public service is valued by many very talented people who want to make a difference. A particularly striking, but admittedly extreme, example of pay disparity is that of Ben Bernanke. The Federal Reserve was recently described by Warren Buffett as “the greatest hedge fund in history”. Picking up on this comment the Wall Street Journal further observed: “If it were really a hedge fund, Ben Bernanke would be the worst-paid manager in history. A typical “two-and-20” hedge-fund payday structure on the Fed’s \$3 trillion in assets and “profit” paid to the Treasury would equal fees of \$78 billion. Mr. Bernanke’s actual remuneration: \$199,700.” [From the Wall Street Journal, September 23, 2013 *Overheard* column].

If pay restraint in the public sector is accepted on the notion that public service must be shielded from “salesman interests”, then one might argue by extension that, some form of pay restraint is called for at SIFIs, which already are in effect “semi-public institutions” as the Salz Review

(2013) describes. Or put slightly differently, if the economic viability of SIFIs rests in part on an implicit or explicit government backstop, then shouldn't the government be entitled to scrutinize and regulate pay practices at SIFIs? It is after all somewhat paradoxical to limit pay at the Fed acting as a lender of last resort, while allowing for unrestrained compensation at the institutions that are the main beneficiaries of cheap public liquidity.

Part of the reticence in pursuing a more forceful policy regulating compensation at SIFIs is that it is not obvious a priori how best to approach the problem. The European Union's move to ban banker bonuses in excess of fixed salary in April 2013 struck many as a rather crude and heavy-handed intervention. Switzerland chose a different approach, giving greater power to shareholders to approve CEO pay packages, and altogether banning golden parachutes. The U.K. business secretary Vince Cable has proposed extending personal liability for bank directors in the event of a large loss or collapse of the bank<sup>8</sup>. Others have advocated putting a limit on the level of pay based on a multiple of the lowest wage paid to a bank's employee (say, fifty or one hundred?). The difficulty of course with this latter intervention is that any multiple that is chosen could be seen as arbitrary. Still, the difficulty in determining a reasonable cap on executive pay at SIFIs is not a sufficient argument for giving up entirely. Perhaps, the regulation of pay is approached more straightforwardly by focusing more on the structure than the level of pay? Thus for example, if stock-based compensation induces excess risk-taking by bankers and puts taxpayers at risk, it makes sense to introduce structural requirements such as extending performance-based pay to include exposure to the bank's own CDS spread so as to penalize risk-shifting, as Bolton, Mehran and Shapiro (2010) among others have proposed. Such structural pay requirements alone, along with corporate governance rules specifically designed for SIFIs, such as giving more authority to the chief risk officer as Ellul and Yerramilli (2012) have advocated,

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<sup>8</sup> David Oakley and Helen Warrel, "UK to crack down on negligent directors", Financial Times July 14, 2013



are likely to go a long way in reigning in bankers' "salesman interests" and in fostering good banker behavior.

## **6. Conclusion**

A good banker should not be driven excessively by "salesman interests". A good banker is a responsible steward, seeking to enhance the long-run sustainability of the bank, and internalizing the systemic risks the bank might inflict upon the financial system. A good banker is not necessarily someone who favors deposit-taking and lending activities over trading and the provision of other fee-based financial services. We have argued that a modern bank can bring greater value added by integrating lending with other complementary financial services. This is especially the case for the global systemically important banks that are able to generate significant returns to scale and scope by offering one-stop access to a whole range of banking services to large corporations with multiple financial needs. But given that many of these services are fee-based they can sharpen bankers' "salesman interests", particularly if these activities are strongly incentivized. In addition, the value added systemically important banks are able to generate rests in a crucial way on a government backstop. In this respect systemically important banks are more like "semi-public institutions" than full-fledged private entities. For all these reasons, bankers' compensation at systemically important banks needs to be kept in check. In sum, a good banker is a steward that is not overly incentivized or overpaid.

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