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# Bank bonuses: the people vs Wall Street

As president Barack Obama vowed that America will not repeat the mistakes of the past, huge profits and bonuses signalled that it was business as usual for the bankers

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It was a cold Wednesday morning in Washington DC, and there was a light frost on the ground. As the eight assembled bank chiefs disembarked from the various forms of public transport they had taken, they knew it would be worth it.

Whether it had been the Amtrak high-speed train between New York and Washington, or a commercial flight from Charlotte or San Francisco, private jets had been left on the Tarmac and corporate excess had been replaced by penitence.

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Most of those present on that wintry day in February last year, including Goldman Sachs' Lloyd Blankfein and JP Morgan Chase's Jamie Dimon, were, privately, if not publicly, only too well aware how close the country, and their own institutions, had come to the edge.

And so it was a little surprising that when all eight representatives in the US Congress for the House of Representatives Committee on Financial Services, they were somewhat sheepish. Ken Lewis, former CEO of Bank of America (BoA), told colleagues to find some "humility" before the panel, while Wells Fargo's John Stumpf promised: "We are frugal."

But wind the clock forward exactly 11 months, to last Wednesday, and much has changed. It might have been a cold, wintry day in Washington, but humility had been replaced by hubris.

Although John Mack, chairman of Morgan Stanley, admitted the crisis had been "a powerful wake-up call for this firm", for the other three bankers present – Messrs Dimon, Blankfein and Brian Moynihan, the new chief executive of (BoA) – it appeared to be a matter of business as usual.

For Blankfein, who endured the bulk of the tough questions from Phil Angelides, chairman of the Financial Crisis Inquiry Commission (FCIC), critics said it was as if the past 24 months had never happened. First he blamed ignorance: "We did not know what was going to happen at any minute," he said. And then he blamed others: "It was a failure of risk-management of colossal proportion," he said, in relation to the near-collapse of AIG.

At least two – Dimon and Moynihan – also eschewed their reformed ways and flew to the hearing by private jet.

After a financial crisis which shattered banks, ripped household names from high streets overnight and brought the global economy to the brink of a depression, it is clear that Wall Street's biggest banks have rather swiftly returned to form.

With monies from the Treasury's \$700bn (£431bn) Troubled Assets Relief Programme (TARP) swiftly repaid, profits being made and bumper bonuses on the way, it's as if the past two years were just a bad dream.

"We cannot go back to business as usual," President Barack Obama may have said, as he announced his \$90bn tax on bank profits. But with America's biggest banks set to dole out \$145bn in compensation in the coming weeks, it looks as if Wall Street already has.

As four of America's five biggest banks this week prepare to report what is expected to be a stellar round of annual profits, following hot on the heels of JP Morgan's \$11.7bn profit for 2009, questions are rightly being asked as to why this is happening.

It is, of course, not just a US problem. In Britain, last week's grilling of Stephen Hester, Royal Bank of Scotland chief executive, and Eric Daniels, chief executive of Lloyds Banking Group, by the Treasury Select Committee over the role of bonuses at the banks reminded the public again that bailing them out had cost an awful lot of money.

At the committee hearing, Hester said RBS would pay bonuses in February which would be "the minimum we can get away with", but added that "RBS will be a part-prisoner of the marketplace". Although the bank has not yet decided on how big its bonus pot will be, a figure of approximately £1.5bn is expected. Hester also said: "If you ask my mother and father about my pay, they'd say it was too high."

At the committee meeting, Daniels came under attack from MPs for paying bonuses to senior managers involved in the integration of HBOS last year. Labour MP Nick Ainger said in the hearing: "Do you appreciate that with 15,000 redundancies, which analysts say could reach 23,000 or 24,000, your workforce will be amazed that the board is awarding itself very substantial sums as a result of the merger?" It is also not yet known how big the bonus pool will be at Lloyds.

A spokesman at Barclays said that although no decision had been made on the bonus pool, its size is likely to be influenced by guidelines set down by the Walker Review that is seeking deferred payments and payments in stock. He said senior directors, including the chief executive John Varley and president Bob Diamond, waived their bonuses last year.

An HSBC spokesman said the bonus pool has not been agreed yet, before adding that the bank "has for a long time demonstrated significant restraint when it comes to cash or non-cash compensation".

Given that most commentators would agree it was the financial services sector which was the root cause of the banking crisis, how can it be possible that the very same sector is now riding on the crest of a wave while unemployment in most developed countries continues to grow and sovereign debt weakens.

The answer largely boils down to one word: confidence.

Take Morgan Stanley, for example, which is due to report its full-year figures on Wednesday. Year-to-date, the investment bank has made a net income of \$730m, and is expected to post a profit of \$526m in the last quarter, giving a full-year profit of \$1.26bn. In 2008, it made a profit of \$1.7bn, suggesting a 26pc reduction in the current year. But analysts forecast that total compensation at Morgan Stanley for 2009 will equal \$14bn, some 14pc higher than the \$12.3bn paid out in 2008, even though it is expected to have made less money.

The reason? Compared to 2008, Morgan Stanley has been seen to have a good year – it's that confidence thing again. The uptick in equity markets has made more mergers and acquisitions – a Morgan Stanley sweet-spot – possible, while its debt desks have benefited from the thawing of the credit markets, making strides in both investment-grade and distressed debt. The bank has also profited from the return of the initial public offering (IPO) market, again connected to the strength in equity markets.

But the key driver was its strength in fixed income trading. Morgan Stanley, like many other banks, was able to benefit from the flood of cheap money available, borrowing from the Federal Reserve at or close to 0pc and buying government gilts yielding 4pc.

Officials close to President Obama argue that the US government's \$2 trillion propping up of the financial system has more than a little to do with all this. Without the extraordinary government intervention of the last 18 months, Morgan Stanley may not have made a profit at all in 2009. That it can afford to pay its bankers so well this year – its compensation:revenue ratio was 64pc at the end of the third quarter, the highest on Wall Street – is, it could be argued, a facet not entirely of its own making.

Little wonder then that President Obama has decided to impose a \$90bn tax on the banking industry. But the Financial Crisis Responsibility Fee (FCRF) is about much more than sending a one-off message. It differs from the UK's banker bonus tax – a one-time fee designed to penalise banks for paying large bonuses – in two key ways.

First, it is spread over 10 years, so banks will continue to have to deal with and account for it and cannot sweep it under the carpet as an exceptional charge. Secondly, it is structured in such a way that certain types of activities are penalised more than others. Collecting customer deposits is welcomed, but the more a bank deals in non-insured deposits, the more it pays.

Combine these two factors, and banks which want to increase the size of their investment banking businesses will be increasingly penalised over time.

But will it be enough to stem bankers' bonuses? Kenneth Feinberg, President Obama's pay czar, admits he believes it will only work as "part of an overall recipe of reform".

Bettina Bender, a partner in employment law at CM Murray, points out, with reference to JP Morgan's \$26.9bn compensation pool, an 18pc increase on 2008, that "the Government measures to limit bonus payments, announced in the US in the wake of the banking crisis, appear to have had no real practical impact".

Professor Anthony Sabino, who teaches law and business at St John's University in New York, agrees: "Wall Street and the City of London are much reviled, and that's their own fault. But is it [the FCRF] a punitive measure? Unless it's one step in a series of stricter reforms and better oversight, then it's going to sit in meaningless isolation."

However, some on Wall Street are sceptical that the FCRF will ever be implemented.

Brian Gardner, banking analyst for Keefe, Bruyette & Woods, is "somewhat sceptical that Congress will pass such a tax" noting that "it is very tough to actually craft this kind of legislation".

Others, including John Berlau, director of the Competitive Enterprise Institute, think the tax is being channelled at the wrong companies, arguing that it is institutions including mortgage finance giants Fannie Mae and Freddie Mac and the automotive industry "that still owe billions upon billions to taxpayers".

For now, the banks themselves are keeping largely quiet on the subject, although JP Morgan Chase's Dimon did say he thinks "using tax policy to punish people is a bad idea".

However, once the results season is through, and 2009's bonuses have been paid, a fierce lobbying effort is expected on Capitol Hill.

But as both Feinberg and Sabino rightly assert, the proposed bank levy is only likely to work as a deterrent if it is backed up by a litany of other measures designed to reshape the way the industry works.

Far more important is actual financial reform, the like of which has been talked about for the last two years – first by Hank Paulson, the former US Treasury Secretary, then by Tim Geithner, the present Secretary – but has yet to see the light of day.

Although the lower chamber, the House of Representatives, passed a version of new financial rules last month – which include the creation of a consumer financial protection agency and a mechanism to deal with companies deemed too big to fail – it did so without Republican support. The House Bill also strengthens the Federal Reserve's hand, giving it responsibilities to monitor systemic risk.

But the Senate, the upper chamber, has its own ideas, with Senator Chris Dodd, who heads the Senate banking committee, trying to get a Bill passed that would somewhat neuter the Fed, and instead create a new super-regulator.

Only once that Bill is passed – a situation made uncertain by Dodd's decision not to stand for re-election later in the year – can the two pieces of legislation be assimilated and agreed upon, not an easy task when Dodd is now pushing for the idea of a consumer protection agency to be dropped.

All the while, other voices are pushing for other reform measures. Be it former Republican Presidential candidate John McCain – who wants to bring back the Glass-Steagall Act, which would effectively break up banking conglomerates like BoA – or Congressman Dennis Kucinich's plan to tax bonuses at 75pc, the raft of other measures only serves to drown out debate over the mainstream reforms, and slow them down.

For Wall Street itself, which has spent an average of \$420m a year for the last nine years lobbying Congress for its own benefit, the delay is no bad thing as it allows activities to carry on as before.

Senior bankers are at pains to point to their own internal reforms, such as Goldman's decision to not allow its 30-strong management committee to receive any part of their bonus in cash, and Morgan Stanley's decision to largely follow suit.

But neither of these measures are expected to reduce the overall amounts paid, and simply make bankers wait for longer until they can cash in their chips.

The only real chance of reform by the banks themselves is if shareholders revolt en masse, and in spite of a number of "say on pay" votes planned for upcoming annual meetings, the outcome is likely to be muted if investors are satisfied with sweetened dividends and in-line earnings per share numbers.

The purpose of the FCIC is to provide answers as to what needs to be reformed, but with its final report due only by mid-December, and based on last week's rather muted performance, the likelihood of its recommendations being included in the current, or indeed any, round of reforms are slim.

Unlike at the end of the last real banking crisis, in the 1930s – when the Senate committee looking into the crisis was disrupted by a circus midget being paid to jump on the lap of John Pierpont (JP) Morgan, and surprising revelations that Morgan himself had not paid any personal taxes for two years – the Commission seems somewhat tame by comparison.

Perhaps if there was a little bit more life and colour, and witnesses of institutions that imploded were actually called, the Commission might capture the public imagination.

Only then will the bold decisions that were taken by the 1930s' committee – decisions which led to the creation of the Securities and Exchange Commission and the imposition of the Glass-Steagall Act – see the light of day.

As it stands, the Commission resembles more of a forgotten sideshow, an after-thought to the main event, while the performers in the big top carry on regardless, night after night, for big bucks.

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