FT: **Bankers' pay is deeply flawed**

By Raghuram Rajan

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Summary: Raghuram Rajan says bogus alpha is created by hiding long-tail risks, as with structured products linked to subprime mortgages. A solution would be to hold in escrow a big chunk of bonuses until the full risks play out, meaning only true alpha gets jumbo rewards and reducing the hidden risks in the financial system.

Banks have recently been acknowledging enormous losses, yet those losses are barely reflected in employee compensation. For example, Morgan Stanley announced a $9.4bn charge-off in the fourth quarter and at the same time increased its bonus pool by 18 per cent. The justification was that many employees had a banner year and their compensation should not be held hostage to mistakes that were made in the subprime market. The chief executive, John Mack, however, assumed some responsibility and agreed to take no bonus for 2007 – although he got a $40m payout for 2006.

Even so, most readers would suspect something is not right here. Indeed, compensation practices in the financial sector are deeply flawed and probably contributed to the ongoing crisis.

The typical manager of financial assets generates returns based on the systematic risk he takes – the so-called beta risk – and the value his abilities contribute to the investment process – his so-called alpha. Shareholders in asset management firms, such as commercial banks, investment banks and private equity or insurance companies are unlikely to pay the manager much for returns from beta risk. For example, if the shareholder wants exposure to large traded US stocks she can get the returns associated with that risk simply by investing in the Vanguard S&P 500 index fund, for which she pays a fraction of a per cent in fees. What the shareholder will really pay for is if the manager beats the S&P 500 index regularly, that is, generates excess returns while not taking more risks. Hence they will pay for alpha.

In reality, there are only a few sources of alpha for investment managers. One of them comes from having truly special abilities in identifying undervalued financial assets. Warren Buffett, the US billionaire investor, certainly has it, yet this special ability is, by definition, rare.

A second source of alpha is from what one might call activism. This means using financial resources to create, or obtain control over, real assets and to use that control to change the payout obtained on the financial investment. A venture capitalist who transforms an inventor, a garage and an idea into a fully fledged, profitable and professionally managed corporation creates alpha.

A third source of alpha is financial entrepreneurship or engineering – creating securities or cash flow streams that appeal to particular investors or tastes. As long as the investment manager does not create securities that exploit investor weaknesses or ignorance (and there is unfortunately too much of that), this sort of alpha is also beneficial, but it requires constant innovation.

Alpha is quite hard to generate since most ways of doing so depend on the investment manager possessing unique abilities – to pick stocks, identify weaknesses in management and remedy them, or undertake financial innovation. Such abilities are rare. How then can untalented investment managers justify their pay? Unfortunately, all too often it is by creating fake alpha – appearing to create excess returns but in fact taking on hidden tail risks, which produce a steady positive return most of the time as compensation for a rare, very negative, return.

For example, an investment manager who bought AAA-rated tranches of collateralised debt obligations (CDO) in the past generated a return of 50 to 60 basis points higher than a similar AAA-rated corporate bond. That "excess" return was in fact compensation for the "tail" risk that the CDO would default, a risk that was no doubt perceived as small when the housing market was rollicking along, but which was not zero. If all the manager had disclosed was the high rating of his investment portfolio he would have looked like a genius, making money without additional risk, even more so if he multiplied his "excess" return by leverage. Similarly, the management of Northern Rock followed the old strategy of taking on tail risk, borrowing short and lending long and praying that the unlikely event of a liquidity shortage never materialised. All these strategies essentially earn the manager a premium in normal times for taking on beta risk that materialises only infrequently. These premiums are not alpha, since they are wiped out when the risk materialises.

True alpha can be measured only in the long run and with the benefit of hindsight – in the same way as the acumen of someone writing earthquake insurance can be measured only over a period long enough for earthquakes to have occurred. Compensation structures that reward managers annually for profits, but do not claw these rewards back when losses materialise, encourage the creation of fake alpha. Significant portions of compensation should be held in escrow to be paid only long after the activities that generated that compensation occur.

The managers who blew a big hole in Morgan Stanley's balance sheet probably earned enormous bonuses in the past – Mr Mack certainly did. If Morgan Stanley managed its compensation correctly those bonuses should be clawed back and should be enough to pay those who did well this year without increasing the bonus pool. At the very least, shareholders deserve better explanations. More generally, unless we fix incentives in the financial system we will get more risk than we bargain for. Unless bankers offer these better explanations, their enormous pay, which has been thought of as just reward for performance, will deservedly come under scrutiny.

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