January 30, 2012 7:26 pm

Forget the big bonuses; a pay squeeze is coming

By Gillian Tett

Say the words "banker pay" to your average voter or politician and these days you will hear an angry hiss. After all, nothing stirs up so much resentment against modern capitalism as the sight of financiers still reaping fat rewards despite failing institutions. On Sunday, the public outrage at Stephen Hester's bonus persuaded the Royal Bank of Scotland chief executive to turn down a pay award (£1m) that would be considered miserly by other bank bosses in the UK and the US.

However, is it possible to imagine a world where banking pay – and banking – is radically slimmed down? Anybody living in countries such as Japan or Sweden would undoubtedly say "yes"; in those economies, foreign financiers' salaries appear bloated. But perhaps a more interesting – and relevant – intellectual exercise is to peer at the US through a long historical lens; to imagine, if you like, a banking pay version of *Back to the Future*.

Take a look, for example, at the work by Thomas Philippon and Ariell Reshef, two US-based economists. They have researched trends in banker pay over the past 150 years and found that, in the early 20th century, financial sector pay relative to the rest of the private sector was roughly at parity (for, crucially, employees with similar levels of education). But then it rose sharply until it hit 1.7 times in 1929, the year of the Wall Street crash.

That echoed a bigger increase in finance: the total cost of financial intermediation (all wages and profits paid to financial firms) had reached 6 per cent in 1930, up from just 2 per cent in 1870, according to separate research that Mr Philippon recently showed to the Federal Reserve Bank of New York.

After the 1929 crash, this trend did not immediately reverse: for several years, financial pay remained high because pay in other parts of the economy fell and some bankers traded cannily during and after the crash. However, in the late 1930s the ratio slumped back towards parity and stayed there for the subsequent three decades; in the years following the second world war, American bankers were paid roughly the same as other professionals. But from the the late 1970s onwards, a new cycle turned: the total cost of financial intermediation jumped to 9 per cent in 2010 from 4 per cent in 1950. The ratio

of financial sector pay to pay in the rest of the private sector hit 1.7 times in 2006 – in a delicious irony, the same level as in 1929.
It is a matter of fierce dispute why banker pay swelled. Financiers are apt to blame it on the increased importance and complexity of finance: in a world of technological change and globalisation, so the argument goes, you need bright, highly skilled bankers. Many economists such as Mr Philippon, however, reject that. He reckons at least half of the pay jump represents “rent seeking” (skimming off fees), not innovation. “The technological development of the past 40 years (with IT in particular) should have disproportionately increased efficiency,” he observes, noting that in companies such as Walmart, “efficiency” has reduced wages.
The crucial question, though, is whether history might repeat itself and produce a big pay swing, as in the post-war years. Right now, it seems hard to imagine; after all, the experience of the past few decades has made it seem almost normal for bankers to be highly paid.
But as this year’s bonus round comes to an end, there are some hints of change. The sector is shrinking: an estimated 60,000 jobs were cut last year. Staff are being paid in stock deferred over a longer time, and pay appears to be falling. Morgan Stanley, for example, has declared plans to cap the amount of bonusthat its staff can receive immediately at $125,000; Goldman Sachs has announced that it is cutting 2011 compensation by 21 per cent; JPMorgan Chase has cut the total pay pool for its investment bankers by 36 per cent year on year. Indeed, the consensus among bank executives in Davos last week was that total compensation for mid- to senior-level employees in 2011 was about 30 per cent lower than 2010 – and perhaps 60 per cent below the 2007 peak. “There is a big change now,” claims one Wall Street CEO.
Now, this decline is still far too small to pacify critics. And it remains tough to calculate the precise squeeze, since banks pay their employees in different ways and – crucially – many financiers are leaving regulated banks for work in shadow banks, where pay is even more opaque.
But, what is clear is that the squeeze almost certainly has further to go, as regulation bites, deleveraging takes hold and western economies ail. It probably will not take the pay ratio to 1950s levels; technology now enables financiers to hop across borders and around rules, skimming fees in opaque ways. But – just as 70 years ago – a cycle has turned; albeit slowly. By 2017, bank pay could look very different from 2007; and modern capitalism will look all the better for it.

The writer is the FT’s US managing editor