Goldman Sachs' Bonuses: Justified or Not?

by

Brian Leonard

Ethical Issues

Goldman Sachs, one of the most successful investment banks in the world, has traditionally relied on large bonuses to pay its executives. When Goldman Sachs received $10 billion in bailout money in 2008 the bank later disclosed that it was sitting on a fund of $2.6 billion earmarked for executive bonuses. (Griffiths) Today, those same individuals who helped engineer and oversee one of the greatest financial collapses in history continue to receive what many deem excessive salaries and bonuses. These exorbitant payouts are unethical, because they may have contributed to the financial meltdown of 2008 by incentivizing undue risk (Bebchuk) and because Goldman Sachs received billions of dollars in taxpayer ‘bailout money’ to rescue the firm from bankruptcy. (Verret)

Background

Goldman Sachs, like many investment banks on Wall Street use bonuses as its major form of executive compensation. In theory the bonuses Wall Street pays out are incentive-based and awarded as a result of the bank's performance. In this most capitalist of industries the compensation is market driven: if an investment bank wants to attract top-tier talent then it needs to compensate its employees competitively. (Story)

Wall Street compensation is unlike other industries, however. The pressure to pay executives comes from within as much as it does from external (market) forces. (Hodgson) Pressure from highly paid lower-level employees exerts undue influence to pay executives ever-higher sums. As Wall Street's influence has grown over the years so have salaries. According to Moody's, since 1975 workers' pay has increased six-fold. (Story) This trend has amazingly accelerated in recent years, even after the financial meltdown. The base salary at Goldman Sachs for managing directors since 2008 has increased from $300,000 to $500,000, an increase of more than 60%. (Story)

As high as these base salaries are it is important to note that the base salary is not the largest source of executive compensation. The Merrill Lynch proxy in 2004 makes the case for most Wall Street firms when he says, "Under the Merrill Lynch approach, like that of many investment banking/financial services firms, base salaries by design represent a relatively small portion of an executive officer's total compensation." (Hodgson) The compensation sums are staggering, both in their sum total – the Wall Street Journal estimates that pay and benefits of executives of the top 25 publicly traded banks on Wall Street is over $135.5 billion a year (Story) – and in their shear audacity. Performance-based pay is a mantra that can be heard frequently in the hallways of Wall

Street but as Paul Hodgson writes, "The pay performance link is not only broken, it was never forged in the first place." Consider Goldman's chief executive Lloyd Blankfein, who received $67.9 million in bonus monies in 2008 (for FY 2007). This is on top of a substantial base salary of $2 million and does not account for millions more in perks and non-cash compensation, such as private jet access, vacation homes, generous retirement packages, and lavish expense accounts. (Story) This payout was to an executive who, if he did not engineer the byzantine and creative financial products, such as derivatives that brought down Washington Mutual, nearly brought down AIG, and caused financial ruination to thousands of investors, was at the helm of the firm that did. It is this hubris that led President Obama to say, "That is the height of irresponsibility. It is shameful." (Story)

To understand how executive compensation has spiraled it may be instructive to understand how Wall Street firms have evolved. Wall Street was traditionally home to investment banks, institutions that funded Fortune 500 companies and governments. These large firms were partnerships; banks were owned by the executives and subsequently all profits stayed in-house. This promoted a fiscal responsibility because the partners' net worth was at stake. (Dealbook) The incentive was for long-term profit and discouraged short-term rewards. In the 1980's top firms, such as Goldman Sachs, Lehman Brothers and Morgan Stanley switched from private partnerships to publicly held companies, introducing shareholders to the firms. (Story)

Shareholders vote on directors to oversee the company; directors hire managers who operate the bank on a day-to-day basis. However, as a publicly traded company the interests of the shareholders may be at odds with those who work at the bank.

Shareholders look for long-term profitability; executives, especially ones who are compensated with bonuses and perks are more interested in investments that generate short-term profits. David Stockman, former budget director under Ronald Reagan, sees it this way: Wall Street's "unproductive" trading is "extracting billions from the economy with a lot of pointless speculation in stocks, bonds, commodities and derivatives." (Farrell) The difference between the publicly traded investment banks and the formerly privately held partnerships can be summed up by former head of Goldman Sachs Gus Levy, "Yes, we're greedy, but long-term greedy." (Levitt) Levy left Goldman Sachs in 1976; Goldman Sachs went public in 1999.

Nobel laureate economist Paul Krugman explains it this way, "A money manager leverages his clients' money with lots of debt, then invests the bulked-up total in high-yielding but risky assets, such as dubious mortgage-backed securities. For a while (the money manager) will make big profits and receive big bonuses. Then, when the bubble bursts and his investments turn into toxic waste, his investors will lose big — but he'll keep those bonuses." (Krugman)

Ethical Analysis

Utilitarianism Ethics.

The ethical lapses demonstrated by Goldman Sachs leading up to the financial crisis of 2008 are many and significant, including the question of executive compensation. Strict neoclassical economic theories would suggest that external forces should exert no influence in deciding how much employees should be paid at Goldman Sachs. Adam Smith, a pioneer in political economics in his *Wealth of Nations* writes that the sovereign has no business in adjudicating such matters of compensation. (Smith) Then what maxims inform such decisions?

Economist Milton Friedman had long advocated that the only responsibility of business is to maximize profits. He believed that keeping businesses free from regulation results in a free society; so therefore the financial industry, free from burdensome regulations inherently contributed to the betterment of society by keeping it free. (Griffiths) This interesting idea that acts of self-interest (the money managers at investment banks advocating risky investments) were also acts of selflessness because they contributed to a free society is a paradox that is difficult to reconcile. That is because the self-serving acts of money managers, whose actions contributed to the housing bubble also helped cause the implosion of the subprime market and cause the macro financial meltdown.

The greatest happiness for the greatest number of people is the underlying tenet of utilitarianism, and it is hard to deny that for the better part of two decades America, on the whole, enjoyed tremendous prosperity. Utilitarianism would suggest that the economic growth, increased GDP and greater wealth of the 1990's and 2000's were the byproduct of an unfettered market. The aggressive and often questionable lending practices were the engine that drove much of the growth and a generous compensation system was the incentive that was the fuel.

This same utilitarian argument can also be used to demonstrate that Goldman Sachs' actions were unethical. Ultimately, far many more people suffered as a consequence of Goldman's actions than benefitted. During 2008-2009 as the financial world collapsed all around Wall Street the only people who seemed to emerge unscathed, at least financially, were the agents of the meltdown. From a utilitarian perspective the "rights of the few can be sacrificed for the many." (de Waal) As the financial world came crashing down it suddenly inverted the dynamic – the 'many' who enjoyed the success as a result of the work of the few were now on the short end of the stick. Homeowners, small businesses, and very large financial institutions (Washington Mutual, Countrywide, and others) were paying the price from the work of 'the few.'

Large, some thought obscene, bonuses continued to be awarded, however. In 2008 Wall Street investment firms, including Goldman Sachs awarded almost $18 billion in bonuses. This compares to bonuses of $12.1 billion in 2007, which was an increase of 23% from the previous year's bonuses of $9.8 billion in 2006. (Harper) White House "pay czar" Kenneth Feinberg said that nearly 80% of the bonus pay was "unmerited." (Story) There no longer seemed to be a connection between performance and pay. Economist Paul Krugman points out, "The pay system on Wall Street lavishly rewards the appearance of profit, even if that appearance later turns out to have been an illusion." (Krugman) There are no verifiable measures as to what amount of compensation is performance-based, how it is measured, or what the triggers are. (Levitt)

In the years since the financial meltdown the pay and benefits among the top 25 publicly traded banks and security firms continued to increase. Immediately following the meltdown bonuses dropped on Wall Street, due in large part to the depressed stock prices of the publicly traded investment banks but overall compensation increased 6%. (Story) Goldman Sachs estimated paying $17 billion in compensation and benefits to its employees for their work in 2010; a big piece of that will go to their partners. (Leonard) It is estimated that payout in bonus pay among Wall Street banks in 2011 will set a new record. (Story)

Kantian Ethics.

If we impose the Kantian ethical model Goldman Sachs does not fare any better. Kant's categorical imperative asks if we would like to live in a world where everyone behaved the same way? The brokers and partners of Goldman Sachs may have believed that this was the world they *did* live in, that every other financial firm rewarded the type of questionable transactions that Goldman engaged in and they did not care.

If Goldman Sachs had been looking out for their clients' interest it is quite likely that financial disaster could have been averted. Goldman, like most other investment banks used a mathematical formula called Value at Risk (VaR), an extremely complicated model that predicts how much of a client's portfolio is vulnerable. It is a tool, however, and should be one of several factors taken into account. Using VaR solely, which is what Goldman Sachs did, and discounting other relevant risks invites disaster. Additionally, in the summer of 2007 Goldman Sachs experienced 10 straight days of losses and their response was to abandon their VaR model entirely. The bad news was too much to bear publicly so they looked at other financial models that gave a more favorable reading. (Levine)

Additionally, deontology emphasizes that we should respect an individuals' right of free choice and the right to the truth. Goldman's clients did not know that their banker was selling them toxic assets, assets that were promoted for their credit worthiness even though Goldman Sachs knew otherwise. At the same time Goldman Sachs was betting against these same client's stock. It is obvious that Goldman Sachs was acting only in self-interest, and in the short-term at that. Kantian ethics are based on reason. And an obvious conflict of interest, as described above is a dereliction of Goldman Sachs' ethical obligation *i.e. duty* to act in the best interest of their clients. By treating their clients as a means - Goldman Sachs used their clients' vulnerability as a means to their own end - Goldman Sachs violated the categorical imperative.

For example, Goldman Sachs was buying risky, mortgage-related securities issued by Washington Mutual (WaMu), a longtime client. Even though Goldman had determined that the mortgage market was likely to fail, and in a big way, it continued to sell the WaMu securities to its investors, while promoting the investments as solid. As it was promoting and selling WaMu's soon to be worthless securities Goldman Sachs was betting against Washington Mutual's securities, a practice called 'shorting.' (Morgenson) Kerry Killinger, CEO of Washington Mutual suspected Goldman Sachs of underhanded dealings; in an email Killinger remarked that Goldman Sachs "…was shorting big time." (Morgenson) However, Killinger suspected Goldman was shorting other clients, not WaMu. In another email, which emerged after Washington Mutual collapsed Killinger wrote, "I don't trust Goldy on this. They are smart, but this is swimming with the sharks."

One of many problems was the complexity of the financial products being sold by Goldman Sachs. Derivatives, mortgage-backed securities (MBS), asset-backed securities (ABS), collateralized mortgage obligations (CMO), collateralized debt obligation (CDO) and a whole alphabet soup of intricate and complicated securities were promoted and sold that were understood by only a very few people. As evidenced above, the CEO of one of the largest commercial banks (WaMu) didn't fully understand the dealings that his bank had with Goldman Sachs. But as Goldman CEO Blankfein is quick to say in Goldman's defense, their clients are very sophisticated investors; “We deal with the most demanding and, in some cases, cynical clients.” (Morgenson)

Needless to say, Goldman Sachs was not looking out for the best interests of their clients. The firm’s “15th principle” urges Goldman employees to embrace conflicts with clients; this would include conflicts of interest. (Morgenson) A pay bonus pay structure that rewarded short-term gain for executives and brokers, at the expense of all else is a gross violation of Kantian ethics.

Conclusion

Bonuses tied to performance seem to be appropriate incentives for professionals in the financial sector. However, there seems to be no justification for the high remuneration that is commonplace on Wall Street in general and Goldman Sachs specifically. There seems to be no ethical justification for the exorbitant bonuses that continue to be part of the Goldman Sachs culture.

REFERENCES

Bebchuk, LA. Cohen, A. Spamman, H. (2010) "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008" *Yale Journal on Regulation* 27.2: 257-+. Print.

De Waal, L. *"What will Kant's ethical views be on the AIG bonuses?"* Blog entry. Accessed 17 Oct. 2011 from http://184-106-235-187.static.cloud-ips.com/q/what-will-kants-ethical-views-be-on-the-aig-bonuses.html

Farrel, P. (2010) "GOP Destroyed Economy." MarketWatch. Web. Accessed 23 Oct. 2011. http://www.marketwatch.com/story/reagan-insider-gop-destroyed-us-economy-2010-08-10

Griffiths, J. (2009) **"**Public Ethics Case Study: The Corporate Social Responsibility Of Goldman Sachs" *International Public Policy Review* VOL. 5, NO. 1 – Oct. 2009

Harper, C. (2007) "Goldman's Bonus Pool Jumps 23% to Record $12 Billion" Bloomberg. Web. Accessed 28 Oct. 2011 http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aUHCJ33.KB.Q&refer=us

Hodgson, P (May/June 2004). "The Wall Street Example: Bringing Excessive Executive Compensation into Line." *Ivey Business Journal Online*, 1+

Krugman, P. (2008) "Madoff Economy." *New York Times*. 19 Dec. 2008. Web. 29 Oct. 2011

Leonard, B. (2010) "Goldman Sachs Directors Bled The Bank Dry, Shareholder Says" *Courthouse News Service*. Web. Accessed 26 Oct. 2011 http://www.courthousenews.com/2010/01/07/23425.htm

Levine, A (2009) "The Global Recession and Jewish Law." *American Economist*. Volume: 53. Issue: 1. Page Number: 6+

Levitt, J (2005) "Corporate Culture and the Problem of Executive Compensation." *Journal of Corporation Law*. Volume: 30. Issue: 4.: 749+.

Morgenson, G., Story, L. "Clients Worried About Goldman's Dueling Goals" *New York Times*. 18 March 2010. Web. Accessed 27 Oct. 2011.

New York Times. Dealbook**.** (2008) "A Partnership Solution for Investment Banks?" Web. Accessed 21 Oct. 2011 http://dealbook.nytimes.com/2008/08/20/a-partnership-solution-for-investment-banks/

Smith, A. *An Inquiry into the Nature and Causes of the Wealth of Nations*. Edwin Cannan, ed. 1904. Library of Economics and Liberty. Web. Accessed 11 Nov. 2011 http://www.econlib.org/library/Smith/smWN.html

Story, L. (2011) "Executive Pay." *New York Times*. 30 March 2011. Web. Accessed 26 Oct. 2011

Verret, J (2010). Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice. *Yale Journal on Regulation*, *Volume: 27. Issue: 2*, 283+.