

Fed aims to rein in bank pay abuses way below top execs

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A few years ago, rank-and-file loan officers were living it up, cruising around Houston in BMWs and Hummers and partying into the wee hours.

"People were earning so much money here that things got really ostentatious," says Matthew Kelly, a former loan officer during the go-go days in Houston. "It was almost as if Wall Street had come to Houston."

Kelly said he could earn \$20,000 a month at the height of the boom. Paid in commissions, many loan officers pushed all the mortgages they could, even if they knew borrowers couldn't pay. Some worked with builders to inflate home values — and their own commissions. They had no incentive to ensure the quality of the loans.

Since taxpayers bailed out the financial system last year, public outrage has focused on the pay packages lavished on Wall Street kingpins — for instance, the \$22 million bonus Lehman Bros. chief Richard Fuld pocketed before his firm collapsed last year.

But much of the rot originated lower on the organizational chart. The Federal Reserve is likely this month to introduce guidelines to curb reckless pay packages in banking. The Fed will look beyond the executive suite and peer deep inside big banks, to the trading floors where individual traders place huge bets and into the cubicles where loan officers are paid for the quantity, not the quality, of mortgages they generate. "Incentive problems may have been more severe a few levels down the management structure than for chief executive officers and other top managers," Scott Alvarez, the Fed's general counsel, told Congress this year. "Poorly designed compensation arrangements for business-line employees, such as mortgage brokers, investment bankers and traders, may create substantial risks."

The Fed's guidance to the banks "will apply not only to the top five or 10 executives but way down into the organization — to traders or anybody whose activities can affect the risk profile of the company," Fed Chairman Ben Bernanke told Congress last week. "We view this as a safety-and-soundness issue."

The Fed's pay rules will apply to the institutions it regulates — 5,030 bank holding companies and more than 800 state banks. If Congress passes a regulatory overhaul this year or next, Fed oversight — and pay rules — could be expanded to all institutions deemed vital to the overall health of the financial system, bank and non-bank alike, according to a Fed official who could not be named because the pay plan hasn't been made public yet.

Closer scrutiny for some

For most of these banks, the new rules probably won't have a big impact. Fed examiners will just look at pay packages as part of their routine examinations into bank operations, the official says.

But 28 unidentified "large, complex banking organizations" will undergo far closer scrutiny. They will be required to submit compensation policies to the central bank. The goal: to come up with pay plans that align risk and reward — and don't enrich employees for making bets that could break the bank, the official says. The Fed will compare the banks' policies, approve the ones that do a good job of making sure employees aren't encouraged to take on excessive risk and nudge the others into making revisions.

"We are not putting out a formula and saying, 'You have to do it this way,' " the official says. "They in a sense get to write their own policies and practices, but they have to write them in such a way as to achieve the aims we set forth in the guidelines. We really do expect the rigor."

Bank pay is coming under assault on a number of fronts. The House in July passed a bill to give shareholders a vote on executive pay and require financial regulators to coordinate efforts to control pay. Financial institutions that took taxpayer money during the height of the crisis from the Troubled Asset Relief Program, or TARP, are subject to pay restrictions from Treasury Department "pay czar" Kenneth Feinberg.

Within the next two weeks, Feinberg will determine the pay packages of the 25 highest-paid employees at each of the seven firms that received the most from TARP — giants such as Citigroup, Bank of America and American International Group. "I have several guiding benchmarks ... which includes ensuring that the compensation structure deters people from taking excessive risk, and also tying compensation to prospective performance," Feinberg said at a recent conference in New York.

Populists outraged at what they see as Wall Street excesses might not be satisfied with the Fed's plan. It is not intended to shrink banker paychecks and bonuses but to ensure that pay plans don't encourage bankers to take undue risks. The guidelines might nudge banks into deferring compensation or taking back bonuses if short-term profits evaporate over time. The "American people don't care if a star baseball player gets paid a lot of money — as long as he earns the money," baseball fan Bernanke told Congress last week. "But the same applies, I think, in the financial sector. They are upset if somebody earns a lot of money, and their company, you know, fails."

TARP's legacy

Bank compensation practices have come under intense scrutiny since taxpayers had to fork over \$700 billion last year to rescue a financial system brought to its knees by bad real estate loans.

The Financial Stability Board, which promotes global regulatory standards, has said that existing compensation policies reward employees for producing short-term profits without recognizing longer-term risks. Two employees who generate the same revenue or profit, for instance, are likely to get similar pay, even if one engages in risky business and the other does not.

The stability board also criticized "golden handshake" deals, in which financial firms recruit superstars from rival firms by guaranteeing bonuses they would have received if they'd stayed

put. Another big problem: Risk-management and human resources officials within banks rarely have the clout to challenge pay policies, the board notes.

Banking pay is unusually generous at the biggest institutions: Wall Street investment banks typically set aside 50% of revenue to pay employees — more than double what other big companies do. Last year, despite being at the center of the financial maelstrom, securities firms based in New York City handed out bonuses totaling \$18.4 billion, according to the state comptroller.

In March, insurer AIG paid \$165 million in bonuses to 400 employees of the unit responsible for the massive losses that required a \$180 billion bailout. Merrill Lynch lost \$15 billion in the fourth quarter, its worst ever, but paid \$3.6 billion in bonuses; 696 Merrill Lynch executives pocketed bonuses of \$1 million or more, New York Attorney General Andrew Cuomo says.

"It's incumbent on financial services firms, given what's happened, to scrutinize and review their compensation programs," says Hye-Won Choi, head of corporate governance at TIAA-CREF, a \$374 billion pension plan for teachers and health care professionals. "These firms are now public companies, taking money from public shareholders. So I'd tell them: 'It's your responsibility to tell us why the 50% number continues to be appropriate.'"

Despite the firestorm of criticism, Ohio State University researchers Rudiger Fahlenbrach and Rene Stulz say big CEO paydays aren't responsible for the financial meltdown. In a paper released in July, they argue that financial industry CEOs, paid mostly in stock, didn't enjoy big gains while their shareholders absorbed losses. The CEOs lost big, too: a median loss of nearly \$5.1 million in their stockholdings from 2006 to 2008.

But Lucian Bebchuk and Holger Spamann of Harvard Law School say that paying CEOs in stock gives them an incentive to take big risks: If the gamble works, "gains on the upside are unlimited." If it fails, the government, which guarantees deposits, often absorbs the worst of the losses.

In addition to scrutinizing the pay of senior managers, the Fed will look closely at two other types of bank employees, the official says. Receiving the most new attention will be individual employees — typically traders — who can expose the bank to vast losses. Think of rogue traders Nick Leeson, who single-handedly brought down Barings, Great Britain's oldest bank, in 1995, or Jerome Kerviel, who cost France's Société Générale \$7 billion before he was stopped in January 2008.

The Fed will also monitor groups of individuals — such as mortgage lenders like Kelly and his co-workers — who can't do much damage by themselves but who collectively can expose a bank to big losses if they have wrong incentives.

Some ideas for reducing warped incentives, cited by the Financial Stability Board: doing away with guaranteed bonuses; putting bonuses in an escrow account that diminishes or disappears if the loans, investments or deals the employees made fall short of expectations or lose money;

giving the board of directors, not management, more say over compensation policies throughout the bank.

Some shareholders don't like so much government interference in corporations. Connecticut Treasurer Denise Nappier, who oversees \$21.5 billion in state retirement funds, says, "Government's role should mostly be limited to ensuring that shareholders of the company can hold boards of directors responsible for pay practices."

Other critics say the Fed is the wrong agency for the job. It's already busy running monetary policy, managing interest rates to contain inflation while keeping the economy growing. And it let the housing bubble inflate, setting the stage for the crisis.

"It's a huge mistake for the Fed to be involved in this," says Stuart Greenbaum, professor at the Olin Business School at Washington University in St. Louis. "Getting engaged in this kind of activity endangers its independence. It will be lobbied to death by all these guys" trying to shield their bonuses.

"The same Federal Reserve that allowed banks to take risky investments is now entrusted to reform compensation?" asks Charles Elson, director of the Weinberg Center for Corporate Governance at the University of Delaware. "If someone gets you lost in the woods, would that be the right person to get you out of the woods?"

Others say the job is just too hard. "There are thousands of loan officers, each selling different kinds of loans," says Jeff Visithpanich at compensation consultants Johnson Associates. "To determine risk for each job profile and get that granular is insane. How will the Fed define risk?"

Greenbaum figures that regulators will be outmatched by bankers maneuvering to protect their pay. "I don't think they're very well-positioned to do it," he says. "You have a bunch of people making \$150,000 a year opining on people making \$5 million. Tell me, how does that work?"

The Financial Stability Board concluded that regulators must step in because banks won't reform compensation policies on their own: Banks fear that if they move first, rivals might swipe their best employees.

Change needed

Even bankers believe the status quo needs changing: 98% of the banks surveyed by the International Institute of Finance believe that warped pay practices contributed to the financial crisis. In its 2009 proxy statement, banking giant Citigroup endorsed a shareholder proposal that would require senior Citi executives to retain their stock holdings for two years after they leave the company. Without such a rule, Citi warned, top executives could "walk away without facing the consequences of actions aimed at generating short-term financial results." The proxy pointedly noted that former CEO Charles Prince had been allowed immediate access to more than \$28 million in stock when he was forced out in 2007.

Rep. Barney Frank, D-Mass., chairman of the House Financial Services Committee, says, "Bankers are smart enough not to have a public fight" over pay.

For many, the damage is done. The non-bank firm where Kelly worked, Aegis Funding, is out of business, sunk by the bad loans that gave its employees such fat commissions. He's seeking a new career: "I don't want to be part of a manipulative business, where loan officers don't have any responsibility to their customer."