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Wall Street Pay: A Primer

Wall Street will be paying near-record bonuses for 2009 and the public is furious, given Wall Street's role in triggering the recent severe recession. Unfortunately, there is a great deal of misunderstanding surrounding the whole complex topic. This paper attempts to explain the underlying issues comprehensively by giving the facts and the arguments from all sides, as well as expressing a few of the author's own opinions. For the record, I was a Wall Street investment banker for nearly two decades, primarily at J.P. Morgan, ending in 2008. I now work at the Brookings Institution analyzing government policy related to finance.

This primer addresses the following questions:

- Who are we talking about when we refer to Wall Street?
- How does Wall Street compensate its investment bankers?
- Why does Wall Street use this system?
- Why are so many people so upset about the bonus system?
- How does the bonus system affect risk-taking?
- How do banks counteract perverse incentives in the bonus structure?
- How should the profits resulting from the government's aid be split?
- What is Wall Street doing to change the system?
- Did firms with "better" compensation structures perform better?
- What is the government doing?

Who are we talking about when we refer to Wall Street?

The highly paid executives on Wall Street are virtually always investment bankers or the top executives of the firms that employ them. Some of them work for Goldman Sachs, Morgan Stanley, and other traditional investment banks. Increasingly, many others work at the investment banking arms of large commercial banks, including J.P. Morgan (distantly related to Morgan Stanley), Citigroup, and Bank of America (which acquired the old Merrill Lynch to augment its own efforts.)

Investment bankers play many roles, most of which relate to arranging deals ("intermediating") between companies or between companies and investors. Investment bankers arrange mergers and acquisitions of businesses, help firms raise capital by selling stocks and bonds to investors, and assist businesses and investors in trading securities, exchanging currency, buying protection against a rise in interest rates or other financial risks, and similar transactions. Many of these intermediation activities are helped by the bank taking a trading position, such as buying a bond from a seller while looking for an ultimate buyer on the other side of the transaction. Holding inventories of securities to assist these transactions led over time to banks playing a major role in trading for their own speculative gain. (If a bank has traders sitting there anyway, with a good perspective on the market, there is a real financial benefit to using their full trading capacity.) This "proprietary" trading has expanded from a sideline to a major activity of many investment banks.

Investment banks, and the commercial banks with which they are often associated, increasingly also hold large investment positions that are not meant to be traded frequently. Those managing such positions are compensated in a similar manner to traders, but generally operate within tighter risk constraints that may be deliberately reinforced in the bonus process.

How does Wall Street compensate its investment bankers?

Wall Street firms traditionally pay their investment bankers a share of the total revenue garnered by their unit. In aggregate, investment banks usually pay out roughly half of their net revenues as compensation, with some considerable variation between firms and over time. Salespeople selling securities such as stocks and bonds generally receive an explicit commission based on the volume of business generated. Traders, for their part, expect to receive a relatively stable portion of the income they earn for the firm, net of any losses, expenses, and deductions to reflect a cost for the amount of the bank's capital they had put at risk. Mergers and acquisitions and corporate finance advisors also expect to receive a portion of the fees they earn for the bank, although in that area it can be complicated at times to determine how to allocate the credit for bringing in a deal, since multiple key people may have been involved. Subjective judgments are invariably involved in those areas.

One of the balancing acts for each bank is to decide how much the bonuses will be determined by individual or unit performance and how much by the results for the bank as a whole. Determining bonuses completely on individual performance encourages infighting, a "silo mentality," and the taking of risks that can be subtly shifted to other parts of the bank. On the other hand, basing bonuses primarily on the bank's total performance can de-motivate the best performers and push them out to other firms where they will be rewarded more for individual performance, either because a different formula is used or because the firm is small enough that their efforts will have more impact. Wall Street is full of smart, very self-confident people who would rather that their individual performance determines how they are paid. Most banks have settled on an approach that focuses principally on individual performance, but is affected quite significantly by the overall results of the firm.

Another important balance is between paying cash up-front or deferring cash payments over a number of years. When possible, banks prefer to pay much of the bonus money over a period of years and to have the funds invested in the meantime in their own stock. This makes it harder for bankers to leave the firm, since they would usually forfeit the remaining deferred bonuses, and gives them another incentive to look out for the interests of the bank as a whole, since they want the stock to go up. Of course, individual bankers would usually rather receive the cash immediately to use as they wish and to avoid being tied to their current employer in case a better opportunity arises.

Why does Wall Street use this system?

An investment bank can be thought of as an affiliated group of small businesses. The key individuals at most units that perform well could move individually or as a group to another bank and slot right into the existing infrastructure at the new firm. The pages of the *Wall Street Journal* are replete with such switches during the good times and, to a lesser extent, even when times are hard. Top investment bankers usually are very good at one or more of a few fundamental skills: marketing, providing financial or strategic advice, or taking risk positions. All of these activities, particularly the first two, are aided by the establishment of a strong network of personal relationships. These skills and relationships make investment bankers highly mobile. For an advisor or a sales professional, it means that they can usually take many of their clients with them if they move. For a trader, it means that a wide range of people may be aware of their skills.

It is desirable for both sides to find an acceptable compensation approach. Banks need to retain their good employees and the bankers themselves benefit from operating within the confines of a stable firm. The compromise that has been worked out is to have the bank as a whole retain most of the revenue, but to pay out a large, and relatively stable, slice to the bankers. The banks keep a keen eye on the revenue split at their rivals, in order to avoid systematically losing their best people.

Why are so many people so upset about the bonus system?

There are a number of overlapping reasons why people are upset about Wall Street's bonuses. The arguments that are made include:

The bonus system motivates bankers to take excessive risks. Many argue that the potential for large bonuses makes bankers take bigger risks then they should: if it works out, they get paid very well; if it doesn't, they still get their salaries while saddling shareholders with the losses. This is a very important argument that is discussed in the next section. It is clearly at least partially true and the steps that Wall Street and the government are taking to reform compensation approaches are largely driven by this insight.

Banks blew up the world, why should bankers be paid bonuses? We just went through the worst recession since the Great Depression and the investment banks were a key part of the financial system whose meltdown caused the mess. It is difficult for the public to understand what the bankers working at these institutions have done to deserve any bonus at all. This feeling is exacerbated by a general perception of bankers as interchangeable. That judgment leads to a view that: (1) bankers must generally be pretty bad at what they do given what just happened; (2) they are all at fault, and (3) banks should not have to worry about losing employees if some leave due to lower bonuses, since there are many unemployed bankers still out there.

However, these perceptions are largely false. While there are many run of the mill investment bankers who really are virtually interchangeable, the great bulk of the money tends to go to the outstanding investment bankers. These bankers either have special skills or close relationships that allow them to make outsized amounts of money for their firms. Many of them did reasonably well for their banks during the horrible markets of 2008 and even better during the recovering markets of 2009. It was a relatively limited percentage of bankers who lost big money for the firms – most employees continued to do an acceptable job, although not producing the level of profits they would have done in better markets. This situation was masked by the fact that the minority who lost money for their firms often lost them extraordinary amounts in this crisis.

The banks want to carry through on their traditional compact of rewarding performance by paying out a sizeable portion of the revenues that were earned and they are genuinely afraid of losing the best employees to hedge funds or other banks if they do not.

Bankers are overpaid to start with. There are many observers who believe that the world has too many bankers and that paying them less would not only be fairer, but would redirect the best young people towards more socially useful jobs. This may be true. The argument has some appeal even to an ex-banker such as me, although I suspect that the pay cuts I would recommend would not be the slashing attacks favored by the public. Unfortunately, there appears to be no reliable, objective way of effectively determining the right size for any sector of the economy, or the right compensation for its employees, other than through market pricing mechanisms. For example, my personal belief is that entertainers, sports stars, real estate salespeople, and a number of other types of workers are overpaid on average. Unfortunately, I know of no good way to objectively determine what they should be paid.

A different angle of attack comes from those who argue that bankers are overpaid because structurally they have too much clout over their own compensation. There seems to be a good argument for this at the level of the CEO and other very senior managers, just as there is with other public corporations. However, it is not clear why this would apply farther down the scale. CEO's of non-financial corporations are routinely paid many multiples of the average executive at their firms, and these multiples have been increasing over time, so it is not clear that financial CEO's pay other bankers too much in order to justify their own arguably excessive compensation.

Bank profits in 2009 have essentially been a gift from Washington. There is little question that if Washington had not intervened to save the financial sector in 2008 and early 2009, the investment banks would have had a much worse year in 2009. Some of them would probably have disappeared, in addition to Lehman and Bear Stearns. This raises a very tricky question – what should be done with the profits from 2009 – which will be addressed further below. There is, of course, a counter-argument that the government also had a major share of the responsibility for the financial crisis. To the extent this is true, it would not necessarily be fair to try to recoup from the banks the full amount of the government's cost of saving the financial sector from problems the government partially caused.

On top of the direct interventions, the Fed's policy of pushing down short-term interest rates and keeping them very low has been extremely helpful in restoring the value of the banks' assets and adding to the profitability of new business, since banks still tend to borrow on a relatively short-term basis and to lend out for longer periods. However, it must be borne in mind that this structural advantage will reverse once the recovery gains enough steam that short-term rates start to rise. That recovery is likely to push longer-term rates higher as well, which will reduce the market value of the loans and bonds that the banks own. The change in the value of a loan or bond is directly related to its maturity -- a one percentage point change in yield on a 10-year bond could move its price by 7% or more, while a similar movement for a 1 year bond would be under 1%. Thus borrowing at close to zero and investing in 10-year Treasury bonds at their current yield of 3.8% may look very good for a year and then turn ugly if government bond rates were to rise to 5.5% by the end of this year, as Morgan Stanley's economists project. This would result in more than an 11% loss in market value, far more than offsetting the first year's 3+% profit. We do not know what will happen with interest rates – Goldman Sach's projections are for considerably lower rates than Morgan Stanley predicts, for example. The point is simply that there is not a "free lunch" here. The structure of interest rates reflects in substantial part expectations about how rates may move over the next year and beyond.

How does the bonus system affect risk taking?

The intent of the bonus system is to motivate bankers to maximize the firm's profits by giving them a significant share of any profits related to their activities. However, the incentives are inherently skewed by the fact that a banker's compensation can only go so low. In purest form, compensation would be floored at zero, while the bank can find itself absorbing losses without limit. In practice, the floor on compensation can be either higher or lower than zero. A portion of compensation, averaging 10-20% of the total for senior bankers, is usually in the form of salary. Some bankers have a significant portion of their bonus guaranteed as well, if they joined their current employer in the preceding year or two and were able to negotiate such a guarantee[1].

On the other side, banks often retain some ability to reduce deferred bonuses from prior years that have not yet vested. To the extent this is the case, a banker can essentially have negative compensation for a particularly bad year if it leads to a large reduction in prior bonuses. In practice, these "clawbacks" have generally only occurred in the rare cases where there was evidence of an illegal activity, such as manipulation of accounting figures.

A simple illustration will show why the bonus system can create perverse incentives, despite the intent to link an individual's pay to his or her performance. Let us assume a trader has the ability to enter into a set of transactions that would earn $2 million a year in nine years out of ten, but would lose $30 million in the other 10% of the cases. Clearly, the bank would not want the trader to do these transactions, since it would come out $12 million behind in an average 10 year period. However, the

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[1] Bonus guarantees are sometimes necessary to lure new employees, particularly in good times, because they are moving from a situation where they know how the compensation decisions will be made to a new firm where they could find themselves losing out for political reasons. There is enough subjectivity in awarding bonuses to make this an issue. Of course, bankers will usually try to negotiate such a guarantee even if they are not genuinely concerned about the compensation process. Besides the selfish desire for a minimum, it also reflects recognition of the disruption caused by changing firms, which would otherwise reduce the compensation earned by the employee.

bonus system provides an incentive to do them anyway, if he or she could slip them by management. Let us further assume that the trader has a salary of $150,000 a year (reasonably typical for a senior trader) and effectively receives an additional 30% of any profits. If the transaction in question is profitable for the first four years and then blows up in the fifth, the trader's compensation would be as shown in Table 1.

Table 1: Compensation levels for a hypothetical set of trades

Year	Salary	Profit/(loss) on trade	Trader's share of profits	Total compensation
1	$150,000	$2,000,000	$600,000	$750,000
2	$150,000	$2,000,000	$600,000	$750,000
3	$150,000	$2,000,000	$600,000	$750,000
4	$150,000	$2,000,000	$600,000	$750,000
5	$150,000	-$30,000,000	$0	$150,000
Total	$750,000	($22,000,000)	$2,400,000	$3,150,000

In this extreme case, the trader has done quite well personally while doing significant damage to the firm. The $22 million in this example is not a large loss in the context of a major investment bank, but the overall potential losses from perverse incentives can be much higher. First, the most senior traders are in a position to expose the firm to losses ten or more times this size, while earning commensurately larger levels of compensation. Second, there are many traders in a big bank and their potential losses would add up to much higher levels than shown in this single example. Unfortunately, many of the bets could be correlated, such as through an assumption that housing prices would not fall drastically, so that a large portion of the losses could occur in the same bad year.

How do banks counteract perverse incentives in the bonus structure?

The biggest intellectual debate about Wall Street's bonus system is not whether there are perverse incentives that encourage excessive risk taking, since there clearly are some. Rather the question is whether other aspects of the compensation and management structures reduce the problems sufficiently to justify the continued use of the overall approach. There are many factors that reduce the magnitude of the problem, including:

A large portion of the bonus money is paid to bankers who are not in a position to create excessive risk. Many investment bankers work in areas where this is simply not an issue, barring quite unusual circumstances. They act as marketers, advisors, or providers of technical services to clients and their profitability is fairly clear at the end of each year. In addition, a number of the traders operate on a very short timeframe, holding relatively modest positions overnight, and therefore can be monitored effectively over the course of the year without serious risk of a major loss. The bankers for whom the risk of perverse incentives is high are those who take medium to long-term trading or investment positions, lenders (if one considers them investment bankers rather than commercial bankers), and the senior managers to whom these groups report.

Banks make great efforts to monitor and charge for risk. The big investment banks have quite sophisticated models that attempt to track the level of risk being taken. Trading groups and individual traders are given position limits that they may not exceed, based in large part on the aggregate level of risk indicated by these models. In addition, the outputs of these models are usually translated into charges that are deducted from trading results to reflect the bank's risk, so that a trader who makes $1 million of profit with little risk would be compensated more than one who is equally profitable with more risk. These models can substantially mitigate excessive risk-taking. Unfortunately, the experience of the crisis highlighted a number of flaws common to many models, particularly an over-reliance on past history in forecasting future risks and a failure to adequately include certain aspects of risk, such as the possibility that liquidity in a market might dry up, creating sharp price movements and an inability to get out of bad positions at a reasonable price. These models have generally been revised and further constraints that are not reliant on models are being added in some cases.

In addition to the models themselves, banks have large risk management groups whose personnel are trained to look for all aspects of risk and especially risk in trading positions. Unfortunately, as we now know, these risk managers often proved quite fallible in the crisis, having accepted to some degree aspects of conventional wisdom that caused most people to underestimate the extent of the market risks. Even when they were alarmed, as many were, there was great difficulty in persuading senior managers that they had to cut back on activities that were highly profitable in the short run. Charles Prince, then CEO of Citigroup, is famous for a remark that caught the spirit of many CEO's and managers at the time, to the effect that one had to keep dancing as long as the music was playing. If he, or other CEO's, had sharply curtailed risk taking at the point where it first became excessive in this crisis they would probably have been fired by their shareholders within a year or two for failing to produce the high short-term profits that their competitors were.

Senior managers generally have large investments in the stock of their banks. A considerable portion of investment bankers' bonuses are deferred and held in company stock for a number of years. In addition, other incentives, financial and non-financial, are usually provided to encourage such stock ownership. This would not necessarily change the incentives of a trader materially, since his or her profit or loss would be a small portion of the total bank's results. However, it should provide considerable incentive for CEO's and their top lieutenants to watch the risk of their bank's activities. These executives are well aware that top managers lost billions of dollars in the collapses of Bear Stearns and Lehman. These stakes almost certainly act as a considerable disincentive to knowingly taking excessive risks, but provide only a limited protection against ignorance or mistakes of judgment, such as occurred too frequently in the period leading to the crisis.

Future employment and compensation prospects for bankers are affected by their performance. A trader or manager who takes or allows the taking of excessive risk can find themselves without a job and with a stigma attached to them. This is undoubtedly a factor leading to greater conservatism, but its effect was considerably diminished during the boom times. First, most aggressive bets paid off over an extended period of time, fueling over-optimism. Second, other banks and hedge funds often seemed quite willing to pick up people who had failed at their last employer. Perversely, those making large losses were sometimes seen as “players” because of the very size of the positions they were allowed to take. Sometimes new employers seemed to naively assume that the new hires would not make the same mistakes as they had done at their former employers. Doubtless this was aided by the high level of self-promotional ability of many bankers.

All in all, I am personally convinced that there are compelling advantages to the overall use of the bonus system at investment banks. I believe the constraints described in this section, as well as others, reduce the overall harm from perverse incentives enough to warrant continuation, on a modified basis. However, there clearly has to be a great deal of effort focused on incentivizing and monitoring proprietary trading and overall investment activity to ensure that compensation in those areas works as it should. There were very serious incentive problems in those parts of the banks, but it seems a mistake to walk away from a historically successful approach for the whole investment bank because of troubles in one portion of the organization.

Other observers, of course, are more pessimistic about the perverse incentives and would like to see strict limitations on the bonus system more broadly and, in some cases, the abolition or sharp reduction of proprietary trading at the large banks.

How should the profits resulting from the government’s aid be split?

There are several different ways that 2009’s profits could be split, if one accepts that government intervention was responsible for at least a fair portion of those profits.

Let the banks allocate the money as they have always done. This is likely to be the path that the banks actually take, modified somewhat by political pressures. The argument for this approach is that the swing in the profitability of the banks is a necessary recovery after the disaster of 2008 and is a normal consequence of the volatility of financial markets, albeit exaggerated considerably by the dramatic swings of this particular market cycle. Further, the banks want to allocate bonuses to their employees in the time-honored manner that has generally worked well for them. If one believes, as the banks usually do, that the bonus system is broadly beneficial, then it would make sense to continue with the approach.

Reduce bonuses and keep more of the profit to build capital. This position is advocated by many because it appears to do two things that they favor. First, it provides the moral satisfaction and potential societal benefits of reducing the pay of bankers. Second, it helps stabilize the financial system by increasing the capital base of the industry, which might also lead to more lending.

In reality, while the approach would clearly achieve the first objective it would not necessarily have much effect on the second. In financial terms, it would represent a transfer of value from employees to shareholders, since bank profits would be higher by the amount of the foregone compensation. This would raise bank capital levels in the short run. In the longer run, however, the large banks that employ significant numbers of investment bankers are generally capable of attaining their target capital ratios by selling stock if they need more capital or paying out dividends or buying back stock if they decide their capital ratios are too high. Starting out with more capital by reducing 2009 bonuses merely means they have less of a need to sell stock over time or can pay larger dividends, but it will not in itself cause banks to hold more capital in the long run. It is true that there might be some societal benefit for a couple of years to forcing lower compensation and the retention of the extra capital. However, most banking decisions are made based on the capital levels that the banks are targeting for the long term, so the extra capital may not be employed as we would desire, but rather kept in safe investments.

Reduce bonuses and pay the difference to the government. If Congress were to conclude that banks got too good a deal from the rescues, there are various ways in which it could extract revenue from the banks. (Interestingly, the Emergency Economic Stabilization Act (EESA) which authorized the TARP calls for the Administration to come back with a plan to recoup any costs from the financial industry over time.) One way to do this would be to tax the bonuses of investment bankers, following in the footsteps of the British government, which recently announced a large temporary tax on all banking bonuses above 25,000 British pounds (about $40,000). The British are charging the banks directly, in hopes that this will encourage them to hold down the bonuses for this year. (It's also a handy way of raising taxes without annoying the general voting population.) The French are also likely to take action in this regard.

To me, this seems an odd way to respond if the real issue is that the government believes banks got too good a deal from the aid. If banks do respond by slashing bonuses in the short-run, it will be the shareholders who win, not the public. Although I am loath to propose it because it has other disadvantages, a windfall profits tax would be a more logical response to this complaint. Such a tax might achieve the same political end as well, since it is not clear that voters would care that much about bonuses if the banks were paying large sums to the government for the support taxpayers provided. (Of course, the British government may be so confident that banks will still pay their usual bonuses that it perceives this as a kind of windfall profits tax in reality.)

The advantages of a windfall profits tax are that it would remedy a perceived unfairness to the public and raise substantial revenue. The disadvantages are that it would weaken a banking system that is still somewhat unstable and that it raises a host of its own fairness issues. For example, would the tax be based on the amount of aid received? If so, it is essentially a unilateral rewriting of the contractual terms and would hit the weakest big banks hard. Or would all of the banks be deemed to have benefited from the overall stabilization? In that case it would arguably be unfair to the strongest and most conservative banks which benefited least from the support. How would one determine the portion of the profits that are "excess" or would one simply put an extra tax on all bank profits? Would the government reduce the tax level to reflect its own errors? (Many observers have cited alleged errors such as the confusing way in which the government rescued Bear Stearns but then let Lehman go under. The larger argument has also been made that the government significantly inflated the housing bubble that caused so many of the losses.) On top of this, there would be concerns about the precedent of the government deciding what profits are due to government actions.

My own view is that a windfall profits tax causes more problems than it would be worth, but at least it would actually address the concern about whether the public had a fair deal from its support of the banks.

Reduce bonuses and pass the savings on to customers. If there were a long-term reduction in the portion of revenues paid as compensation, this would initially increase the profitability of banks but would likely be competed away over time as some banks reduced the price of loans and other services in order to attract more business. Economic theory is clear that pricing of services in a competitive market eventually moves to the level where suppliers of capital earn a return commensurate to their risk, without outsize profits. Although the banking industry is more concentrated than it used to be, it is still quite unconcentrated compared to most American industries, and therefore there is a competitive market for most bank services.

However, this only works if there is the expectation of a long-term change. A short-term reduction of bonuses for 2009 would not spur this kind of competitive response, since prices of services are set on a forward looking basis, which would take account of a return to traditional compensation patterns after 2009 or perhaps after 2010.

What is Wall Street doing to change the system?

Most people on Wall Street would argue that the basic compensation system is effective and was not the major cause of the crisis. Nonetheless, they would also agree that there need to be improvements in how traders are compensated and a general movement towards having a higher percentage of bonuses be deferred and deferred for a longer period on average.

Consistent with this, Goldman Sachs has announced that its top 30 executives, who form its Management Committee, will have all of their bonus money for 2009 deferred for 5 years and effectively held in the form of Goldman stock. There will also be a method to claw back some or all of the deferred bonus money in cases where the employee engaged in materially improper risk analysis or failed sufficiently to raise concerns about risks. Goldman has indicated that this standard will go well beyond malfeasance or illegal manipulation of accounting numbers.

It is unlikely that even Goldman will maintain a policy of 100% bonus deferral in the long run, but it is clear that banks are moving towards the deferral of greater percentages of bonuses and longer deferral periods for that money. (It should be noted that a substantial amount of deferral is already part of how virtually all investment banks operate, including all the major firms.)

There is a side-effect of changes of this nature which has not received much attention in public policy circles. It is highly likely that the banks will take advantage of these changes to try to lock their employees into staying with the firm. Traditionally, deferred bonuses have been forfeit when employees leave for another firm, even though this is not an inherent aspect of deferral. Expanding deferral in time and amount would make this forfeiture issue more important. It will probably be beneficial to the financial system by lowering employee turnover and may allow banks to slowly reduce compensation levels without facing a major exodus. However, forming a real conclusion would require looking at the benefits of mobility, such as the ability of small investment banks to start up and provide better customer service and the efficiency of having employees move to the firms where they can provide the greatest value.

There is also a more specific, but very important, compensation issue with traders. Traders are among the few people in an investment bank who can expose the firm to large risks that carry multi-year exposures. As described earlier, there is a real potential for perverse incentives to encourage excessive risk-taking by these traders.

Wall Street is still wrestling with the issue of compensating traders. There are no easy answers. You cannot just hold off on compensating the trader until the transaction is unwound. Some of these positions may be held for many years and traders may well move on to another firm or retire in the meantime. Once they have moved on, it is unknown whether they would have sold the position out before a later collapse in prices. The traders would face the risk that the bank would make valuation decisions that would reduce the bonus of departed traders. Unfortunately, the most potentially profitable positions are often illiquid, so it is not possible to price them with accuracy at any given time, otherwise you could just value everything as of the date the trader leaves and readjust compensation on that basis.

Did firms with "better" compensation structures perform better?

Given this movement towards "better" structures, it is interesting to inquire as to whether the firms that had compensation structures closest to the new approach did better than those with higher levels of cash compensation. Unfortunately, the answer appears to be "no." Bear Stearns and Lehman were known for having compensation structures with high levels of deferral and a full 5-year vesting period, rather than the 2-3 years that many Wall Street firms used. In the case of Bear Stearns, it is even said that the CEO used to call people up who were planning to sell the stock after the vesting period to inquire as to whether they had money problems or had lost faith in Bear. Whether these phone calls occurred frequently or not, the story was very well known and doubtless influenced the activities of executives who knew the importance of top managers in deciding their future. Partially as a result, close to a third of the stock of Bear Stearns was owned by employees at the time that it sank. Lehman had a similar corporate culture, although not as extreme.

This is not to suggest that changes like those Goldman is making are counterproductive. There is every reason to believe that compensation changes of this nature will help focus employees on risk and on helping the firm as a whole. It is possible that the compensation approaches at Bear Stearns were in place partly because of a conscious or unconscious understanding that the firm had a "cowboy" culture that was too prone to taking risk. If so, these larger cultural problems may have overwhelmed the risk mitigation benefits of the compensation approach.

What is the government doing?

In general, the Administration and regulators have focused on pushing for compensation structures to be adjusted to avoid encouraging excessive risk. They have not attempted to limit the amount of compensation, except to the extent that sheer size encourages excessive risk-taking.

For example, the Fed has issued proposed guidance on sound incentive compensation policies, formally putting the guidance out for comments on October 27, 2009, with a comment period that ended a month later. A modified version of this guidance will presumably be issued as a formal rule early this year. The proposed guidance requires that banking organizations have compensation structures that are consistent with three key principles that are fleshed out to some extent in the larger document:

- "Provide employees incentives that do not encourage excessive risk-taking beyond the organization's ability to effectively identify and manage risks"

- "Be compatible with effective controls and risk management"

- "Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors."

The onus would be on bank managements and boards of directors to ensure that these principles are followed. Bank examiners at the Fed would then review the compensation policies as part of their normal bank examination process. They would highlight any deficiencies and could require various actions if they believed the deficiencies were important enough to affect the safety and soundness of the bank.

The Fed will also require 28 "large complex banking organizations"-- effectively the key banks in the country -- to provide extensive information on compensation policies. This data will be used by the Fed to compile a "horizontal survey" that will let them identify best practices, as well as individual banks that are outliers with one or more practices that appear unsound.

Some observers were disappointed that the Fed did not propose harsher and more specific compensation rules, perhaps including limits on total compensation. The Fed directly acknowledged some of these ideas by specifically suggesting that people comment on a few points, including a suggestion that senior executives at the big banks must have at least 60% of bonuses deferred and that at least 50% of any deferred payments be in the form of company stock or an instrument linked to the stock price.

The Fed's proposed guidance implicitly rejected the idea of mandating highly specific compensation rules (with the possible exception of the two deferral percentages just discussed) by repeatedly pointing out the need for compensation rules to be appropriate for the specific circumstances of a bank or a particular type of employee. For example, the guidance states "[f]or most banking organizations, the use of a single formulaic approach to making employee compensation arrangements appropriately risksensitive is likely to provide at least some employees with incentives to take excessive risks." Other parts of the guidance discuss the relative benefits of directly risk-adjusting performance in a quantitative manner versus deferring bonus payments until the results of a given year's actions become clearer, noting some circumstances in which the former would be better than the latter and other circumstances where the opposite is true. The guidance also discusses important differences between compensation practices for senior executives compared to those whose actions have less effect on the firm as a whole.

It is possible that the Fed's rules will become significantly more specific in the future, as it gathers the information from the horizontal survey, receives more feedback from various parties, and has some time to see how different practices affect risk-taking in the future. However, its rules are not likely to satisfy those observers who simply do not trust the management of the banks and feel that they need to be curbed by very specific limits. Certainly nothing in the Fed's proposed guidance or the statements of its key personnel has suggested that the Fed would be inclined to place absolute limits on the level of compensation, a popular idea among many who do not trust, or sometimes even value, bankers.

Congress is currently actively considering major legislation to reform the regulatory system for financial institutions and markets. The bills in the House and Senate generally create rules roughly in line with the Fed's proposed guidance, although the bills are generally even less specific and leave the responsibility to the regulators to determine the detailed rules. There are three areas in which the bill that has passed the House adds some additional specific requirements. First, shareholders will be given a non-binding vote each year on executive pay, allowing them to express their approval or disapproval of what the board of directors and management have decided. Second, any mergers and acquisitions activity that triggers "golden parachute" payments must be accompanied by a non-binding shareholder vote on the payments to each individual. Finally, publicly listed financial institutions are required to have a more clearly independent compensation committee of the board of directors. The Senate bill is in an earlier stage of development, but appears broadly similar on points related to executive compensation.

In addition, early in 2009 Congress required that the seven firms that received exceptional assistance over and above the level of support provided in the first two rounds of the TARP should have pay levels monitored and constrained by a Special Master. Kenneth Feinberg ended up in this role and he has restricted the amount and type of compensation at those firms that fell under his jurisdiction. He generally forced those firms to pay lower levels of compensation than they had proposed and to make more of the payments in the form of deferred stock in the companies. Not surprisingly, many of the individuals at those firms who would have been subject to his purview - because of their high rank or compensation levels - chose to leave for greener pastures in order to avoid the limitations. This is the downside of enforcing tougher pay rules on those firms in which the taxpayers have the greatest stake – there is a tendency for the better executives to leave. The best executives are the ones most likely to find attractive offers elsewhere and therefore the departures disproportionately represent a "brain drain" rather than a normal movement of personnel from firm to firm.