Lehman Bankruptcy Seen Undeterred by Laws Curbing Compensation

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New U.S. rules on bank pay will do little to curb risk-taking at Wall Street firms, which were largely in compliance with proposed guidelines about deferred compensation before the last financial crisis.

The rules, drafted by regulators at seven agencies and approved for public comment by the Federal Deposit Insurance Corp. on Feb. 7, would require firms to spread at least half of top managers' incentive pay, including stock and options, over three years. Many of the largest U.S. financial firms, such as Lehman Brothers Holdings Inc. and Merrill Lynch & Co., were deferring more than that in the years before Lehman filed for bankruptcy, according to data compiled by Bloomberg.

The Financial Crisis Inquiry Commission said last month that Wall Street pay practices pushed traders and managers to disregard risk. New rules must include longer restrictions on selling shares and require higher levels of stock ownership among top traders and managers in order to be effective in promoting risk awareness, said compensation experts including Harvard Law School professor Lucian Bebchuk.

"The FDIC is being pretty lenient with this formula and allowing a lot of flexibility for these companies," said Paul Sorbera, president of Alliance Consulting, a Wall Street executive search firm. "The firms are already and have been deferring more than that."

Fuld, O'Neal

Lehman Brothers, whose $613 billion bankruptcy in September 2008 triggered a contraction in global credit markets, paid more than 65 percent of each of its top executives' bonuses in restricted stock in 2007, including 89 percent for Chief Executive Officer Richard Fuld, 64. None of the shares could be sold before five years.

Merrill Lynch, which agreed to be bought by Bank of America Corp. in 2008 to avoid collapse, awarded its top executives more than half their compensation from 2004 to 2006 in restricted shares that vested over four years. Former CEO Stanley O'Neal, 59, received his entire $31.3 million bonus in 2004 in such restricted shares.

"There was a lot of accumulated compensation at risk for all of the senior executives," O'Neal said in an interview with the FCIC on Sept. 16, a recording of which was released earlier this month. "The philosophy was that every senior executive should have some significant stake in the company and then some significant stake in the company's performance. These stock awards were pretty significant each year."

Adjusting Awards

One change may come in adjustments of deferred awards. The rules instruct banks to reduce the amounts paid out based on losses that may appear during the deferral period. That provides more downside to executives beyond share-price movements, said Rose Marie Orens, a senior partner at Compensation Advisory Partners LLC in New York. The adjustments may be set by formula or "managerial judgment," the proposal says.

"The part that is different is this whole element of how do you potentially lose or get adjusted because of future losses," Orens said. Previously, "the belief was if the stock went up or the stock went down, that's how you got impacted."

Bank of America, which received $45 billion in bailout funds, deferred at least 59 percent of incentive compensation for its top seven executives from 2004 to 2006, company filings show. The Charlotte, North Carolina-based bank had stricter terms of vesting -- when employees can take ownership over restricted shares and options -- than many of its rivals. None of the shares and options awarded in those years vested before three years, instead of in earlier increments.

Morgan Stanley Bonuses

Morgan Stanley has paid its top executives at least 55 percent of their bonuses in deferred stock since 2003. John Mack, 66, CEO from 2005 to 2009, took all of his incentive pay over that period in restricted shares. The New York-based firm borrowed as much as $100.5 billion from two emergency Federal Reserve programs in 2008 to satisfy liquidity demands, according to data released by the Fed in December.

Some of the banks that emerged from the financial crisis in the strongest position wouldn't have met the new deferral rules before 2007. Goldman Sachs Group Inc., based in New York, paid its top executives more than 50 percent of their 2006 bonuses in cash, according to company filings. CEO Lloyd Blankfein, 56, got $27.2 million of his $53.4 million bonus in cash that year. The company increased the deferred portion of top executives' incentive compensation to more than 60 percent in 2007.

Dimon Pay

JPMorgan Chase & Co., which posted a profit every quarter of the financial crisis, paid its then co-heads of investment banking, Steven Black and Bill Winters, less than 50 percent in deferred pay in 2004 and 2005, according to company filings. Since CEO Jamie Dimon, 54, took over at the end of 2005, top executives have received at least 50 percent in deferred pay.

Dimon got about $17 million in restricted shares and options for 2010, according to a Feb. 17 regulatory filing. Half the shares vest in two years and half in three years. The options become exercisable in equal parts over the next five years. Dimon's cash compensation for the year wasn't disclosed.

Citigroup Inc., which took $45 billion in taxpayer funds to avoid collapse, gave its top executives more than half of their bonuses in cash in 2005, the year the New York-based bank's bond-

trading desk was warned by the Office of the Comptroller of the Currency that it was taking too much risk.

Former Citigroup CEO Sanford "Sandy" Weill, 77, told the FCIC that compensation decisions on Wall Street were driven by executives asking themselves, "Well, this one's doing it, so how can I not do it?" Weill took $29 million of his $43 million bonus in 2003 in cash, giving him among the lowest deferral ratios of any top bank executive in the last seven years.

Cash Bonuses

The proposed multiagency rules would apply only to executive officers of firms with more than $1 billion in assets. At Morgan Stanley, that would cover about 10 people. The proposal would allow banks to pay one-third of the deferred awards after one year and up to two-thirds after two years. The rules don't cap cash bonuses.

The 50 percent and three-year benchmarks may be too stringent for some firms while too lenient for others, said Scott Talbott, senior vice president for government affairs at the Financial Services Roundtable, a Washington group representing large banks such as Bank of America.

"We understand the regulators' approach, and we applaud it," Talbott said. "However, we're not a one-size-fits-all industry, so we have concerns about the government providing these types of specifics."

Andrew Gray, an FDIC spokesman, declined to comment.

Deferral Ratios

Some companies have increased deferral ratios since the crisis. Morgan Stanley said last month that the nine members of its operating committee will have an average of more than 80 percent of their 2010 bonuses deferred. The average amount of all employees' pay deferred was 60 percent, up from 40 percent for 2009, the company said in a Jan. 20 statement.

Goldman Sachs paid 2009 bonuses for its 30 top executives entirely in stock that vested over three years and couldn't be sold for five. JPMorgan, based in New York, gave its top five executives more than 65 percent of their 2009 incentive pay in deferred shares and options.

Still, compensation practices at the six largest U.S. banks have "worsened" since the credit crisis, according to a study commissioned by the Council of Institutional Investors and released in November.

The lenders have simply increased deferral periods rather than make pay dependent on long-term performance measurements, wrote researchers led by Paul Hodgson at the Corporate Library, a corporate-governance research firm in Portland, Maine, that conducted the study. Regulators' encouragement of higher base salaries weakened the link between pay and performance, the study found.

‘Losing It All’

The proposed rules address only incentive compensation, not salaries. Firms including Goldman Sachs, Morgan Stanley and Citigroup have raised salaries for top executives since the financial crisis.

Only 31 percent of financial companies have matched the timing of payouts to the duration of the risk taken by an employee, according to a Deloitte Touche Tohmatsu Ltd. study released last week. About 57 percent of the firms include company stock in their incentive pay, the study found.

“What will change the behavior is the fact that people will realize that what is an accepted behavior in the company is not knocking the ball out of the ballpark and then losing it all the next year,” said Orens. “It isn’t going to come from the comp alone. It never does.”

Aligning Interests

Equity ownership requirements would be more effective at aligning interests than simply deferring awards, said Sanjai Bhagat, a finance professor at the Leeds School of Business at the University of Colorado in Boulder, Colorado.

Regulatory proposals “have these provisions that you have to keep it for a while, but there’s no provision about how much you have to own beyond that -- you could sell it all,” said Alan Johnson, president and founder of New York-based Johnson Associates, which advised Lehman Brothers on its compensation at the end of 2007. “And if you followed the rules, you’d actually own less than people own today.”

Firms including Citigroup, Morgan Stanley and Goldman Sachs have requirements that executive officers hold onto more than 75 percent of the shares they’ve been awarded as compensation in those roles as long as they keep their jobs.

Companies should separate the vesting dates and the dates at which shares can be sold or options exercised, Harvard Law School professors Bebchuk and Jesse Fried proposed in a 2010 paper titled “Paying for Long-Term Performance.” They suggested allowing an executive to sell portions of a stock award over at least six years.

Unloading Limits

Bhagat proposes capping executive cash compensation at $2 million and making managers hold almost all of their stock until at least two years after retirement.

“I hope that in its final rule, or later on, the FDIC will improve the effectiveness of this approach by imposing unloading limits that are defined not just in terms of current equity- based awards but also in terms of executives’ overall portfolio of equity-based incentives,” Bebchuk said in an e-mail.

Stock ownership requirements should also extend to bank staff below those named executive officers in proxy statements, such as the top 200 employees, Johnson said.

Financial institutions have been quicker to link pay to risk management for senior executives than for lower-level employees, according to the Deloitte study. About 56 percent of firms have incorporated risk management into performance measures for top executives, while only 37 percent have done so for business-unit staff, according to the study, which surveyed chief risk officers at 131 firms.

'Greed Unleashed'

Shareholders shouldn't rely on regulators to require appropriate compensation structures, Bhagat said. The Securities and Exchange Commission said last month that investors had the right to weigh in on pay for top executives. The measure will subject compensation plans to non-binding shareholder votes as often as once a year.

"Greed unleashed is what Wall Street is about, and they have lost a handle to the leash, or even the leash, because the shareholders have nothing to say," John Gutfreund, 81, a former chairman and CEO of Salomon Brothers Inc., said in a telephone interview.

Firms need to go beyond clawbacks and longer deferrals to change executives' behavior, Warren Buffett, the 80-year-old billionaire chairman of Berkshire Hathaway Inc., told the FCIC in a May 26, 2010, interview.

"It has to be far more Draconian than that to really change behavior big time," said Buffett, who has about $49 billion of his net worth in shares of Berkshire Hathaway. "You need a person at the top who has all the downside that somebody has that loses their job working at an auto factory."

Buffett also said any CEO who has to tap the government for emergency assistance should "come away with nothing."

'Inappropriate Risks'

The multiagency proposal comes after the Dodd-Frank Act called on regulators to write rules banning any pay structure that "encourages inappropriate risks." The SEC, the Federal Housing Finance Agency and the five agencies that make up the Federal Financial Institutions Examination Council must approve the proposed rule before it can be released for public comment.

A Bloomberg National Poll last year found that more than 70 percent of Americans wanted big bonuses banned for a year at Wall Street firms that took taxpayer money. Another 17 percent supported a 50 percent tax on bonuses exceeding $400,000.

"To some extent, they've undermined the credibility of the free-market system, and I don't think they realize that," Bhagat said. "If they had done well while their shareholders did well, I'd be saying, 'Three cheers.' But they did very well, while their shareholders did badly."