Fed pushes banks to ignore rivals when setting bonuses

Reuters

By Lauren Tara LaCapra

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The Federal Reserve is pushing banks to ignore competitors' performance when awarding bonuses, and focus squarely on their own profitability, according to pay consultants and other people familiar with the matter.

The central bank is hoping to change a deeply ingrained habit on Wall Street: awarding bonuses to senior executives based in part on whether the company's performance lagged or beat rivals.

The Fed fears that these relative performance measures encourage executives to take big risks to keep up with stronger competitors and reward executives even when their banks aren't performing well, the sources said. Regulators also fear that banks may be paying executives large sums at precisely the time when they should be reining in compensation to conserve capital.

The Dodd-Frank financial reform law charged the Fed with implementing new rules about Wall Street pay. At this point, the Fed is just talking to banks, and has not yet issued formal rules or directives.

Lawmakers and regulators hope that changing pay practices will reduce the chance of future financial crises, though some corporate governance experts question whether removing relative performance from the picture will have much impact on risk taking.

The biggest banks, including Bank of America Corp, Citigroup Inc, Goldman Sachs Group Inc, JPMorgan Chase & Co, and Morgan Stanley, consider performance compared to competitors, according to their most recent proxy statements. Spokespeople for those banks declined to comment on discussions with the Fed, citing restrictions and penalties for speaking publicly about confidential matters.

Some who work on compensation plans at big banks argue that when times are good, rewarding relative performance encourages executives to keep hustling, instead of coasting. It also helps retain talent when times are tough, they say.

Firms that advise shareholders on proxy votes, like International Shareholders Services and Glass, Lewis & Co, support using these metrics as well.

Rose Marie Orens, a senior partner who focuses on financial services at the New York-based consulting firm Compensation Advisory Partners, said that the Fed has contacted some of her clients about relative performance issues, as well as other elements of pay.

The Fed has also questioned some banks on whether bonus payments should be capped at only 1.25 times or 1.50 times an initially set target payment - rather than the current industry standard of 2 times, she said.

Roughly half of the 120 largest U.S. companies use relative performance as a benchmark for executive bonuses, Orens said.

Proponents of relative value metrics say that the measures prevent executives from getting bonuses simply because the economy is growing.

"I remain a strong supporter of relative performance over absolute performance," said Lucian Bebchuk, a professor at Harvard Law School who focuses on compensation and corporate governance. Bebchuk advised pay czar Kenneth Feinberg when the latter was charged with keeping bonuses in check at bailed-out banks.

"Absolute performance rewards managers for improvements that are not due to their own performance," he said, adding that "when the sector as a whole does not do well, absolute performance might well fail to reward those executives who do relatively well."

Some academics who study corporate governance note that any formula will have flaws.

"There is no perfect performance measurement plan for a firm," said David Larcker, a professor at Stanford University's Graduate School of Business who focuses on how executive compensation affects corporate performance. "Every one has some downside, risk, or gamesmanship opportunity."

BONUS FOR BEING AVERAGE?

Meeting profitability targets has been tough in recent years as low interest rates, weak demand from customers, and new regulations have crimped revenue. Investors have been pressuring banks to spend less of their revenue on compensation, to boost profits, an argument banks are increasingly listening to.

James Gorman, the CEO of Morgan Stanley, did not get a performance bonus in 2009 - a record year for Wall Street profits - in part because the bank missed its targets for relative total shareholder returns over the period.

Citigroup's board met with big investors after they voted against former Chief Executive Vikram Pandit's pay package last year. Shareholders said they preferred metrics like relative shareholder returns, that provide "a framework for discretion," the bank said in its proxy this month.

Investors want the bank's directors and managers to have the discretion to pay bonuses to senior executives even when times are difficult, the proxy said.

But there are clear downsides to relative pay, too. Companies are notorious for changing their peer groups to make their performance figures look better. A study of S&P 1500 firms' proxy filings by professors at Pennsylvania State University and University of Illinois at Urbana-Champaign found that companies regularly choose underperforming competitors for their peer groups.

When it comes to measures of performance, the Fed is much more concerned about what happens when the economy and markets are doing poorly, said Robert Dicks, who heads Deloitte Consulting LLP's financial services compensation practice.

"The Fed is always concerned about that push to get the last dollar into the pool to pay out bonuses, with a short-term view," said Dicks. "If profits are too low, the bank doesn't have the money to pay out bonuses," he added.

One alternative is to award bonuses based on the bank's profitability adjusted for the risk it took, to discourage executives from taking big risks to eke out small profits.