Learning from Ken Feinberg

Reuters Blog
By James Saft
March 25, 2010

Sometimes it's what doesn't happen that is most illuminating.

When Pay Czar Kenneth Feinberg first slashed executive compensation at U.S. firms that benefited most from a government bailout the cry was that this would hurt these weakened firms when they could least afford it, as the best and brightest would leave for better money elsewhere, where the free market still ruled.

Well, the door didn't hit them on their way out, but mostly because they stayed rooted to their desk chairs.
Feinberg evaluated the compensation of 104 top executives at affected companies in 2009, reducing pay for most to levels far below financial industry norms and their own former earnings.

Yet here we are in 2010 and about 85 percent are still working for the same firms, still toiling for the kinds of wages that may well make them wish they'd gone into the law rather than finance. Remember all those articles in glossy magazines about how impossible it is to make it in New York City on $500,000 a year?

"The argument that we hear all the time; that if we don't pay more this key official will leave, he will go to a foreign competitor," Feinberg told CNBC television.

"I've always been dubious about that argument and I think the statistics bear out the fact that most officials stay at those companies."

Feinberg announced this week that he has told AIG, General Motors Co, GMAC Inc, Chrysler Group LLC and Chrysler Financial Corp to cut cash compensation for 119 top executives by a third in 2010 and total pay by 15 percent. Bank of America and Citigroup have repaid taxpayer funds and are now subject to diminished supervision by Feinberg, whose brief is to determine if pay at bailout firms is "in the public interest."

Feinberg also announced he will examine pay in late 2008 and early 2009 at all 419 companies which got bailout money via the Troubled Asset Relief Program.

Even if you think, as I do, that the mechanisms intended to protect the interests of shareholders in setting executive compensation are broken, the idea of a government Pay Czar is untenable, even risible. The U.S. bailed out its banks and automakers and had to do something to address the obvious inequity of seeing some of that money line the pockets of executives at the mismanaged firms. His power is more moral than actual, and will diminish quickly as the visceral memory of the acute phase of the crisis fades.

TIME FOR BOARDS TO ACT

In showing that one of the main arguments used to back ever-expanding executive pay — a market that will snap up the under compensated — may be flawed, Feinberg has done us all a great favor.

The great thing about Feinberg's little experiment is that it is massively scalable and doesn't require government intervention. All Feinberg has done is test a false market. If I were on the compensation committee of a corporate board and I looked at that 85 percent figure, I might just feel compelled to give it a go at my own company. Heck, I might even feel I was obliged to.

Executive compensation at U.S. corporations has grown massively in comparison to overall wages. That's not a problem because it denotes inequality, it is a problem because it indicates that the same market forces that determine most wages are somehow not operating in the same way when the elevator gets to the top floor. One of those markets is false, and I am betting that it is the one tightly controlled by a self-interested group of executives, board members and compensation consultants.

This is a problem, in other words, of shareholders' rights.

Lucian Bebchuk of Harvard Law School has argued that relations between top executives and boards are not truly arm's length. There are simply too many ways for management to reward boards for overpaying them. A given board member has much to fear by taking on a highly paid chief executive and little reason to believe he will be rewarded or defended by shareholders if he does. Institutional shareholders have ranged from ineffective to comatose.

All of this makes a case for breaking down the barriers that protect executives and boards from shareholder influence — staggered board elections and takeover defense measures to name just two.

Feinberg, in an admittedly extreme set of circumstances and as the representative of government power, has cut through those defenses with a single stroke, and in so doing, has demonstrated the lie that market forces have driven compensation.

What is needed now is not one big Feinberg working for the government, but thousands of little Feinbergs working for shareholders.

(Editing by James Dalgleish)

(At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.)