Rich, failed bankers show pay-reform shortcomings

Baltimore Sun
By Jay Hancock
June 6, 2010

There is a seductive myth that the economic destruction of recent years had nothing to do with the limitless pay dangled like a 10,000-pound jelly doughnut before American CEOs.

After all, the argument goes, the annihilation of Bear Stearns and Lehman Brothers hurt top bosses at those companies just as badly as it hurt shareholders and employees. More, if you count value of their stock and options that was wiped out. So how can anybody argue that pay packages made them take risks that killed the companies?

Here's how: These guys tanked their companies and got rich beyond the dreams of gluttony anyway. If you substantially cash out before doomsday, it doesn't really matter what happens afterward.

"The executives were able to obtain large amounts of bonus compensation based on high earnings in the years preceding the financial crisis," write three Harvard Law School professors in a paper to be published this summer. But those Wall Street hotshots, the academics write, "did not have to return any of the bonuses when the earnings subsequently evaporated and turned into massive losses."

Large amounts of bonus compensation. That's one way to put it.

The top five executives at Bear Stearns pulled $1.4 billion out of the company from 2000 through 2008, calculates Harvard's Lucian Bebchuk with two colleagues in a paper being published in the Yale Journal on Regulation. The top five bosses at Lehman Brothers pocketed $1 billion over the same period.

That's not a bad reward for torturing shareholders, inflating the housing bubble and helping pitch the country into the worst financial crisis since the Depression. The Bebchuk paper, "The Wages of Failure," demolishes the notion that Wall Street pay schemes put executives on anybody's side but their own.

An early version of the paper received news coverage a few months ago. But it deserves new attention as Congress moves to pass financial-reform legislation. While some of Bebchuk's concerns about executive pay are reflected in the bills, his best ideas are not.

A key insight: The factors that demolished Bear and Lehman were the same ones that enriched the bosses. They are inseparable. The more subprime loans the banks financed, the higher the fees and supposed capital gains that boosted short-term "profits" on which executive pay was based.

From the executives' point of view, the risk that the loans would blow up in a few years was mitigated by the hundreds of millions they were getting paid and could expect to get in cash bonuses and stock sales while the party lasted. It's almost as if the bigwigs were bribed to put shareholders, bondholders and customers in terrible jeopardy.

For decades, compensation consultants have blabbed about "aligning the interests of management and shareholders." At Bear and Lehman, those interests were aligned the way Glenn Beck aligns with Lady Gaga.

In other papers, Bebchuk recommends change. One unusual idea is tying Wall Street executives' pay to the long-term fate of not just common shareholders but preferred shareholders and bondholders, too. While CEOs work for boards that are elected by shareholders, Wall Street banks are so important to the economy that their chiefs should look out for all investors in the firm, Bebchuk argues.

Another terrific proposal is to make Wall Street bosses pay personal penalties for taxpayer bailouts. The bigger the bailout, the more of their previous pay they would have to give up.

Neither of these is in the pending legislation. The financial reform bill passed by the Senate would let the Federal Reserve and other regulators set rules to ban "excessive" and risky executive compensation at banking companies. The bill passed by the House would make big financial outfits disclose details of incentive-pay schemes to regulators and authorize a study of whether executive pay was linked to risky behavior.

But Bebchuk has already done that study. The Fed is the agency that allowed the housing bubble to happen. You want the Fed as Wall Street's pay overseer?

CEO Dick Fuld pulled $62 million in cash bonuses out of Lehman Brothers from 2000 to 2008 and $461 million in option exercises and stock sales, Bebchuk and his colleagues calculate. Bear Stearns boss Jimmy Cayne got $289 million from options and stock sales and $88 million in cash bonuses.

Yeah, both guys lost hundreds of millions on paper when the stock and options they still held hit the toilet. But they both came out far ahead of the game, wouldn't you say?

Fuld's lawyer didn't respond to an e-mail seeking comment on the Bebchuk findings. Cayne, who told a federal panel last month that he was "shocked beyond belief" by Bear Stearns' failure, didn't respond to a phone message left with the housekeeper at his New Jersey home.

"He's not here," she said. "He's playing golf."