Geithner's Plan on Pay Falls Short

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By Joe Nocera
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It was another one of those Timothy Geithner moments.

On Wednesday, the Treasury secretary held a roundtable discussion with a group of about 20 government officials and outside experts; the subject was executive compensation. Kenneth R. Feinberg, the Treasury Department's new "comp czar," was there, as was Mary Schapiro, the new chairman of the Securities and Exchange Commission; Daniel K. Tarullo, the newest Federal Reserve governor; and Lucien Bebchuk, the Harvard Law School professor who has turned his academic interest in executive compensation into a crusade.

It was, I heard later, a terrific meeting — a spirited, high-level give-and-take about what the government could do to better align the interests of shareholders with that of top executives, to ensure pay was linked to performance and to rid the system of the kind of compensation incentives that caused so much excessive risk-taking and helped bring about the financial crisis.

"The discussion was surprisingly substantive," said Nell Minow, the co-founder of the Corporate Library. "Geithner was very engaged in the discussion and genuinely interested in what everyone had to say."

When the meeting ended, the doors were flung open and the media was invited in. Looking sternly into the cameras, Mr. Geithner read a statement in which he described executive compensation as a "contributing factor" to the crisis. Then he outlined a series of tough-sounding principles, including a "re-examination" of such egregious practices as golden parachutes, a need to align compensation practices with "sound risk management" and the importance of having compensation plans that "properly measure and reward performance."

But then, as he so often does, he proceeded to follow these tough words with actual proposals that were less than inspiring. The only legislation his department planned to propose — indeed, the only legislation he deemed necessary — were bills that called for compensation committees to be made up of independent directors, along with "say-on-pay" legislation, which would give shareholders the right to vote on a company's pay plan. That vote, however, would not be binding.

"Finally," he said, "I want to be clear on what we are not doing. We are not capping pay. We are not setting forth precise prescriptions for how companies should set compensation, which can often be counterproductive. Instead, we will continue to work to develop standards that reward innovation and prudent risk-taking, without creating misaligned incentives."

Later that afternoon, I called Ira Kay, who heads the executive compensation practice at Watson Wyatt & Company, to ask him what he thought of the government's proposals. "I was relieved," said Mr. Kay. I'll bet he was.

Until the financial crisis, most people, myself included, did not make distinctions between different kinds of companies when it came to executive compensation. It was just one big problem, revolving primarily around the idea that there was something fundamentally wrong about executives taking home giant, multimillion dollar pay packages for mediocre performance or even outright failure — something, alas, that happens with annoying regularity in corporate America.

But if the near collapse of the financial system has taught us anything, it is that there should be a distinction. On the one hand, there are companies whose executives can make awful mistakes, even driving their corporations into bankruptcy, but whose actions have little or no effect on the rest of us. Most companies fall under this category.

And then there are those handful of companies — the too-big-to-fail banks and other large financial institutions that pose systemic risk — whose failure can wreak devastating havoc on the economy. For these latter companies, getting compensation right isn't just a matter of fairness or improved corporate governance. It turns out to be critically important if we are to prevent a repeat of the calamity that has befallen us. But as difficult as it has been to overhaul executive compensation overall, it is going to be even more difficult to take the tougher measures that need to be taken with the banking system.

Let's look first at the broader issue. In truth, for the first time in my memory, I think there is a decent chance that the compensation games will come to an end — though it won't be by doing anything so radical as trying to cap pay, something that simply doesn't work. (Mr. Geithner was right about that.)

Instead, it will be because boards have come under renewed pressure, thanks to the financial crisis, to control executive pay. It is also because, with the Democrats in charge, the issue is high on the agenda. (On Thursday, the House Financial Services Committee held a hearing on executive compensation.) Mr. Geithner's two proposals will most likely breeze into law — and will certainly make a difference on the margins.

Most important, though, it is because the re-energized S.E.C., under Ms. Schapiro, is preparing a handful of new rules that will force companies to do a great deal more to spell out their compensation rationales, while making it easier for shareholders to express their displeasure if they feel boards have been too generous. In particular, the S.E.C. has begun laying the groundwork for a rule that will make it easier for shareholders to nominate directors — something that is tremendously difficult right now. Ms. Minow is among those who believe that the ability to replace incumbent directors is likely to have the biggest effect in reforming executive pay.

That's the good news. The bad news is that for the banks, these measures won't be enough. Banks, as we all now know, are different. Their deposits are insured by the government. When they run into problems, they have access to the Federal Reserve's discount window. The government has a keen interest in the "safety and soundness" of banks, which is why they are so heavily regulated. Even in good times, taxpayers are at risk if a bank's management makes too many risky bets. In bad times, excessive risk-taking by bankers can bring down an economy.

With the big banks, there is always a degree of moral hazard because they simply can't be allowed to fail the way other companies can. Market discipline — or better corporate governance — just isn't enough; even when a bank's management is aligned with shareholders, they aren't necessarily aligned with taxpayers. So it falls on the government to find ways to change the compensation incentives that encouraged the kind of crazy risk-taking that got us into so much trouble.

That is why, in his statement, Mr. Geithner stressed the importance of coming up with a compensation system that accounted for risk — he was speaking directly to the need to change the compensation system at banks. But none of his proposed solutions dealt with that problem. Neither he, nor anyone else in government, has yet figured out what to do about it.

Most of the ideas so far have been aimed at forcing bankers to have their bonuses paid in restricted stock that they could not cash in for years — until it was clear that the profits they had generated were not illusory. But to my mind, the problem really goes much deeper than that.

For one thing, the culture of bankers and traders, unlike at most nonbanks, rests on an "eat what you kill" mentality. That is why so many executives at, say, Merrill Lynch, felt justified in demanding big bonuses despite the firm's huge losses. After all, they had made money on their trades — so why should they be punished because others had lost money for the firm?

For another thing, compensation at banks needs to be changed not just at the top, but also deep in the ranks, at the level of individual trader — or, indeed, anybody else who can put the firm's capital at risk. This also makes it more difficult, because you can't fix the problem with better corporate governance at the top. The changes have to be more systemic than that.

There is a third problem: once banks and investment banks were allowed to tear down walls between them, banking became a greedy profession. Look at all those banks panting to give back their bailout billions — in large part because they don't want to have to deal with the executive compensation restrictions. And unlike other companies, where people glow with pride at the introduction of a new product, the key moment in the life of a banker is when he finds out what his bonus is for the year. None of this will be easy to change.

In his statement, Mr. Geithner stressed that the Federal Reserve was working on this problem as part of its job supervising banks. I got the strong sense this week that the Fed now views bank compensation as something it will begin to look at much more closely — and will eventually start regulating. The foolish and counterproductive distinction between banks that still have bailout money (which have onerous compensation rules) and those that gave it back (and thus have no rules) will go away, as it should. All banks pose risks to taxpayers, whether they still have bailout money or not. And all banks should have the same set of compensation rules.

There is another potential source of new ideas, though: Mr. Feinberg. A large part of his new job will be to determine the compensation for the most highly paid executives at the seven companies, including General Motors, Citigroup and American International Group, that have received the most government aid. But another part of his task, he told me this week, is to devise

a compensation structure for all management ranks of those companies, not just the biggest earners.

Mr. Feinberg is, above all else, a practical man who likes solving problems, and he seemed to relish this latter aspect of his new role. “If this job has any long-term impact,” he said, “maybe we can come up with something that can serve as a model.”

Surely somebody needs to — and soon.