Why Are Fannie & Freddie CEOs Paid So Much?

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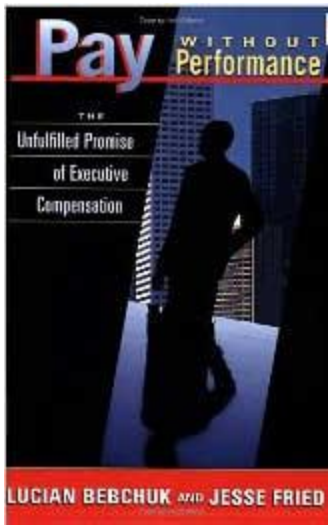
> *"Is it the problem of bad apples, or is it the barrel?"*
>
> Kim Clark, Dean of Harvard Business School, 2003



Run your eye down the following list of salaries and see whether you can spot any anomalies:

President USA $400,000

Secretary of Treasury: $196,700

Chief Justice $217,000

Chair, Federal Reserve: $191,300

CEO, Fannie Mae: $5.5 million

CEO, Freddie Mac: $5.5 million

Then see the following list of bonuses paid to top executives in 2010 and see whether you can spot anything that deserves looking into:

President USA $0

Secretary of Treasury: $0

Chief Justice $0

Chair, Federal Reserve: $0

CEOs, Fannie & Freddie: $12.8 million

According to Chris Isidore at CNNMoney, the top five executives at Fannie Mae received $33.3 million in 2009 and 2010, while the top five at Freddie Mac received $28.1 million. And each company has set pay targets of as much as $17 million for its top managers for 2011. That's a total of $95.4 million, which will essentially be coming from taxpayers.

The salary filings were made by the companies in early 2011, but received relatively little attention until a recent report by Politico.

Following the disclosure of these figures by Politico, the House Financial Services Committee voted 52-4 yesterday to cap salaries for top executives at distressed mortgage giants Fannie Mae

and Freddie Mac to bring the CEO's salaries to less than $220,000. A separate measure to restrict bonuses is being sponsored in the Senate.

Compensation at both corporations has been contentious ever since Daniel Mudd earned more than $12 million while heading Fannie before the meltdown and Richard Syron, Freddie's CEO got almost $20 million in total compensation just before the organization went into conservatorship.

Meanwhile in the Senate, Ed DeMarco, the acting director of the Federal Housing Finance Authority which supervises Fannie and Freddie defended the arrangements. "I need to ensure that the companies have people with the skills needed to manage the credit and interest rate risks of $5 trillion worth of mortgage assets and $1 trillion of annual new business that the American taxpayer is supporting," he wrote in a letter to the senators. DeMarco said at the hearing that it is difficult to attract leadership at firms when there is an uncertain future.

Most analysts now believe that Fannie and Freddie will cost the taxpayer more than $200 billion. It will be the most expensive bailout of the financial crisis — far more costly than bailing out the nation's banks or automakers.

A pervasive practice of excessive compensation

One could look at the Fannie/Freddie salaries as a one-off single decision on excessive pay. That would be a mistake.

In fact, the salaries reflect a pervasive phenomenon of "pay without performance" at the CEO level, and in particularly in the financial sector, as documented in the insightful book by Lucian Bebchuk and Jesse Fried, Pay without Performance: The Unfulfilled Promise of Executive Compensation (Harvard University Press, 2006)

According to Bebchuk and Fried:

"Flawed compensation arrangements have been widespread, persistent, and systemic, and they have stemmed from defects in the underlying governance structure that enable executives to exert considerable influence over their boards… "

"Between 1992 and 2000, the average real (inflation-adjusted) pay of chief executive officers (CEOs) of S&P 500 firms more than quadrupled, climbing from $3.5 million to $14.7 million.'.."

"In 1991, the average large-company CEO received approximately 140 times the pay of an average worker; in 2003, the ratio was about 500:1…"

Dealing with outrage

The book cites public and shareholder "outrage" as a key potential constraint on pay packages. But this has been dealt with by the managerial response of "camouflaging" both the level and performance-insensitivity of executive compensation.

According to Bebchuk and Fried, “Firms have systematically taken steps that make less transparent both the total amount of compensation and the extent to which it is decoupled from managers’ own performance. Managers’ interest in reduced transparency has been served by the design of numerous compensation practices, such as postretirement perks and consulting arrangements, deferred compensation, pension plans, and executive loans.”

The critique of Bebchuk and Fried doesn’t come from fairness or populist perspectives. Their concern is that the compensation arrangements run counter to those of the organization.

A cozy club

Various social and psychological factors—collegiality, team spirit, a natural desire to avoid conflict within the board team, and sometimes friendship and loyalty—have created an environment of escalating executive pay.

This is not just the tightly interlocking directorships where CEO of Company A is director of company B and CEO of company B is director of company A. Even when the directors are not so tightly interlocked, the pool of senior people who sit on boards have a mutual interest in maintaining and advancing CEO pay.

Compensation consultants also play a role in justifying whatever it is the CEO wants to make. After all, who’s going to recommend these consultants to other CEOs?

The “ratcheting up” phenomenon

The vast majority of firms that use peer groups set compensation at or above the fiftieth percentile of the peer group. Such generous benchmarking is likely to boost executive compensation over time even if managerial performance does not improve.

Kim Clark called it “‘the Lake Wobegon effect’ where everybody is above average. And in a lot of companies the way the system works is most CEOs want to be at the 75th percentile of the distribution of compensation…. You get a ratcheting-up effect as that information pervades the market, and we get serious distortions in CEO compensation.”

The golden goodbye

“Gratuitous payments and benefits have taken a number of forms. These include forgiveness of loans, accelerated vesting of options and restricted stock, increases in pension benefits (for example, by “crediting” CEOs with additional years of service), awards of lump-sum cash payments, and promises of consulting contracts that will provide the departing CEO with generous compensation for little or no work.”

Camouflage

What matters in terms of getting the pay deal accepted is whether the pay is *perceived* to be reasonable. Because perceptions are so important, the designers of compensation plans can limit outside criticism and outrage by dressing, packaging, hiding and camouflaging the ongoing rent

extraction. Compensation consultants play a key role in justifying and camouflaging executive pay.

Camouflage has thus become an important aspect of the executive compensation landscape. Compensation plan designers have an incentive to obscure or make more opaque the total value of an executive's compensation package.

As Bebchuk and Fried write, "As disclosure requirements for executive salaries, bonuses, and long-term compensation have become stricter, firms have increasingly turned to post-retirement payments and benefits as ways to compensate managers. These methods enable firms to provide a substantial amount of performance-insensitive value in a less transparent form than, say, salary. Post-retirement value has been provided to executives through four main channels: retirement pensions, deferred compensation, post-retirement perks, and guaranteed consulting fees."

Stealth compensation

Retirement payments hence offer what might be called "stealth compensation."' Indeed, the dollar figures used by the media in reporting compensation levels, and by financial economists in their studies, usually do not include the large value provided to executives through retirement benefits.

Firms cannot use qualified plans to provide executives with pensions that are similar in size to their annual compensation. For this reason, most firms also provide executives with nonqualified "supplemental" executive retirement plans (known as "SERPs").

Qualified pension plans offered to new lower-level employees are usually based on a *defined contribution*. In contrast, SERPs offered to executives are *defined-benefit* plans, which guarantee fixed payments to the executive for life.

SERP plans are designed and marketed specifically as ways to increase compensation "off the radar screen of shareholders." Indeed, it is often difficult even to figure out the total SERP liability of a firm with respect to its executives as a group. A firm must report only one figure: the sum of the liabilities associated with all of its employee pension plans that are "unfunded" or "underfunded".

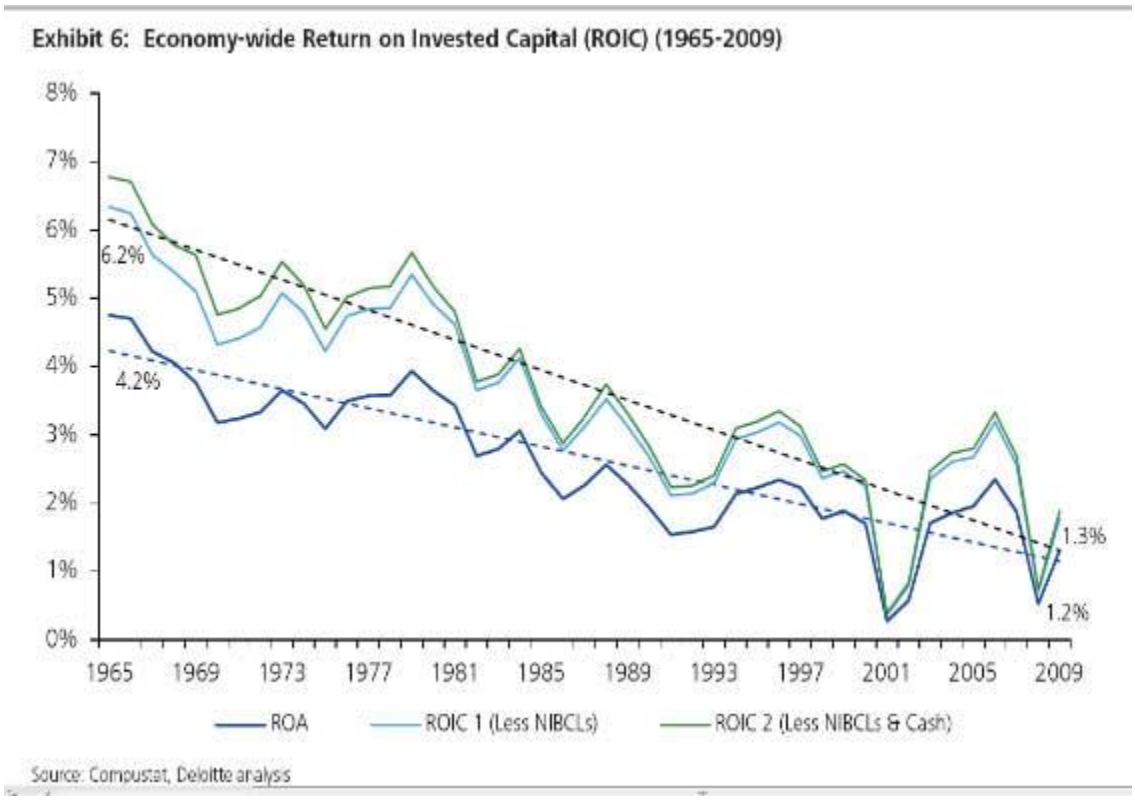
In 2010, GE's liability is a staggering $4.4 billion in 2010, up from $1.1 billion in 2000: in the same period, GE's share price fell by some 60 percent.

Kim Clark, Dean of Harvard Business School, asked in 2003: "Is it the problem of bad apples, or is it the barrel?" Bebchuk and Fried's book clearly shows that it is the barrel.

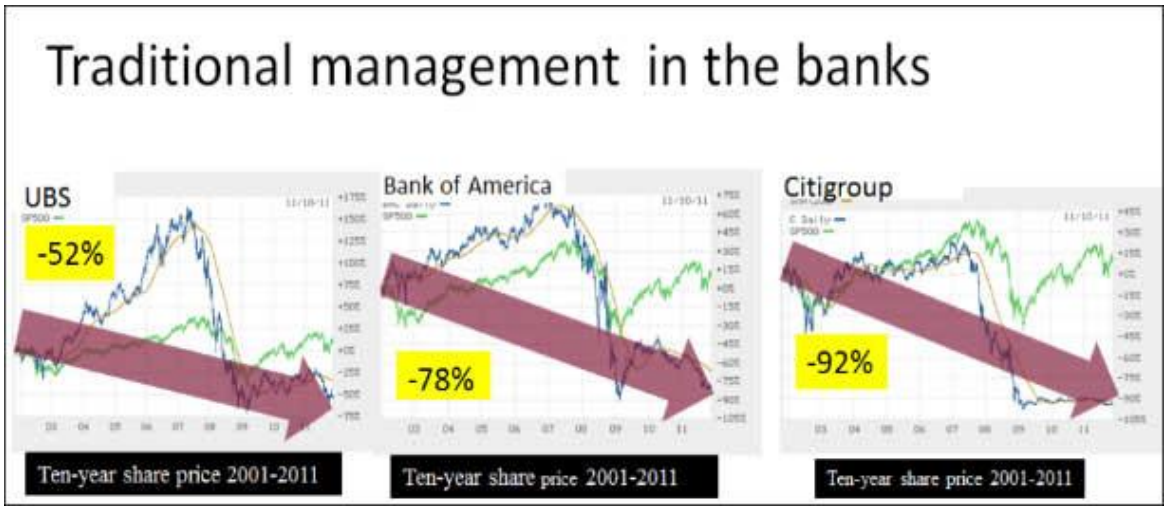
What has been presented for many years as "shareholder capitalism" is in reality "managerial capitalism". The principal beneficiaries of this approach to management are the managers.

What is the basis for these financial rewards?

These extraordinary levels of compensation don't appear to be based on long-term performance, if you look at the rate of return on assets or rate of return on invested capital for 20,000 US firms from 1965 to 2010:



Nor in the case of financial institutions is it based on benefits for the shareholders, if you look at the ten-year share price of banks like UBS [UBS], Citi [C] or Bank of America [BAC].



"For a long time, economists and policymakers have accepted the financial industry's appraisal of its own worth," writes John Cassidy in the New Yorker, "ignoring the market failures and other pathologies that plague it. Even after all that has happened, there is a tendency in Congress and the White House to defer to Wall Street because what happens there, befuddling as it may be to outsiders, is essential to the country's prosperity." Maybe it is time to question the financial sector's evaluation of their own worth?

As we saw in the discussion yesterday of Dan Ariely's work on the science of cheating, "stretching the rules" is likely to become rampant when "everyone in our in-group is doing it." That's what we have with CEO compensation in general, and financial sector compensation in particular: a pervasive case of in-group behavior.

"Consider that we trust military and homeland security personnel with our lives, yet we don't give them lavish bonuses," writes Nassim Nicholas Taleb, a professor of risk engineering at New York University Polytechnic Institute, a former trader and the author of *The Black Swan*. "They get promotions and the honor of a job well done if they succeed, and the severe disincentive of shame if they fail. For bankers, it is the opposite: a bonus if they make short-term profits and a bailout if they go bust. The question of talent is a red herring: Having worked with both groups, I can tell you that military and security people are not only more careful about safety, but also have far greater technical skill, than bankers."

There is a need for compensation to be based, not on the managers' own assessment of their own competence and worth, but rather on what they are doing for the principal stakeholders and the economy. In the case of organizations like Fannie and Freddie, that means in the first instance the taxpayers and their representatives in Congress. In the case of private sector organizations like GE or the banks, it means in the first instance their customers: are they delighting their customers?

Is change possible?

Is change possible? "Not long ago, it seemed fanciful that public smoking would be restricted and tobacco companies would sponsor public service ads that discourage smoking," wrote Deepak Chopra and David Simon in 2004. "But this shift in awareness occurred when a critical mass of people decided they would no longer tolerate a behavior that harmed many while benefited a few."

The idea that CEO compensation, particularly in the financial sector, needs to be brought in line with the actual worth to the economy is an obvious but still radical idea. Like all great obvious, radical ideas, in the first instance it will be rejected. Then it will be ridiculed. Finally it will be self-evident and no one will be able to remember why anyone ever thought otherwise.