

# THE WALL STREET JOURNAL.

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## Bankers Face

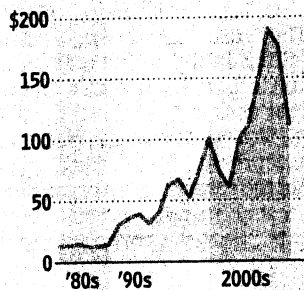
*Fed Plans to Limit How Lenders Can Structure*

# Sweeping Curbs on Pay

*Compensation for Executives, Traders, Loan Officers; 5,000 Firms Affected*

### Rise and Fall

Average Wall Street bonuses, in thousands



Source: New York State Comptroller

BY DAMIAN PALETTA  
AND JON HILSEN RATH

Policies that set the pay for tens of thousands of bank employees nationwide would require approval from the Federal Reserve as part of a far-reaching proposal to rein in risk-taking at financial institutions.

The Fed's plan would, for the first time, inject government regulators deep into compensation decisions traditionally reserved for the banks' corporate boards and executives.

Under the proposal, the Fed could reject any compensation

policies it believes encourage bank employees—from chief executives, to traders, to loan officers—to take too much risk. Bureaucrats wouldn't set the pay of individuals, but would review and, if necessary, amend each bank's salary and bonus policies to make sure they don't create harmful incentives.

A final proposal is still a few weeks from completion and could be revised along the way, according to people familiar with the matter. It requires a vote by the central bank's board, but no congressional approval.

The U.S.'s largest banks, about

25 in number, would get especially close scrutiny. The central bank intends to compare these banks as a group to see if any practices stand out as unusually dangerous to their firms.

The Fed's latest move marks another striking exertion of power by the nation's central bank since the financial crisis struck with ferocity two years ago. It has bailed out firms such as American International Group Inc. and has flooded the financial system with money.

Some congressional critics, especially Republicans, argue the Fed is exerting itself too aggress-

sively, a complaint that will surely be amplified by its move to oversee bank pay practices.

The proposal will likely please congressional Democrats, for whom corporate compensation has become a rallying cry, at a time when the Fed is defending itself from moves by Congress to restrain its independence.

The Fed itself believes it has the legal authority to take such action through its existing supervisory powers, which are designed to oversee a bank's soundness.

Its strategy appears to go further than what some in the industry were expecting, given that it

would apply to many employees, not just top earners. It would go beyond a more generic list of "best practices" that many thought the central bank would craft.

The proposal will likely push banks to use "clawbacks"—provisions to reclaim the pay of staffers who take risks that hurt their firms—in certain pay packages, among other tools, to punish employees for taking excessive risks with their firms' money. The cen-

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tral bank could also demand that more pay be offered through restricted stock or other forms of long-term compensation designed not to reward short-term performance.

The Fed's likely move is a response to a growing critique of pay practices that began building even before the onset of the financial crisis. Previously, regulators generally viewed pay as a matter for firms to determine themselves as they tried to attract top banking talent. Fed officials have since shifted their view.

Pay is now seen as a factor that could make a firm, and more broadly the financial system as a whole, vulnerable to collapse. The financial crisis turned up many examples of how pay can give employees incentives to take risks. One example: loan officers who churned out thousands of low-quality loans in order to claim annual bonuses for themselves.

In a Wednesday speech, Former Fed Chairman Paul A. Volcker noted that one of the causes of the financial crisis "was the ultimately explosive combination of compensation practices that provided enormous incentives to take risks" just as new financial innovations "seemed to offer assurance—falsely, as it has turned out—that those risks had been diffused."

The Fed's planning comes amid an intensifying global debate about the way bank employees are paid ahead of the Group of 20 meeting of world leaders in Pittsburgh next week. U.S. and foreign officials worry that if they don't coordinate their rules, some countries could draw talent away from others.

On Thursday, European Union governments issued a communiqué urging the G-20 to adopt strict rules to restrict bonus payments. Speaking after the meeting of EU leaders in Brussels, French President Nicolas Sarkozy said he would support the idea of linking the size of bonuses at each bank to their level of capital.

The Fed's thinking is the latest in a series of moves by Washington to clamp down on bank compensation. The Treasury earlier this year appointed Kenneth Feinberg to set and review pay for top executives at the largest recipients of federal bailout cash. In July, the House Financial Services Committee approved a bill to give bank regulators the ability to ban "imprudently risky compensation practices" at banks with more than \$1 billion of assets, which means it would apply to roughly 700 banks, a piece of legislation in line with the Fed's likely proposal.

President Barack Obama, Treasury Secretary Timothy Geithner and Fed Chief Ben Bernanke have all criticized executive compensation for having pushed employees to take short-term risks with little regard for the long-term effect on their companies and clients.

Republicans will likely strongly oppose the move and will be joined by industry leaders.

"Given the changes the industry has already done, if the restrictions on income-producers or salespeople are too draconian, it will actually undermine the strength of the institution," said Scott Talbott of the Financial Services Roundtable, a trade group of financial companies.

The Fed regulates more than 5,000 bank holding companies,

which include the nation's largest banks, as well as hundreds of smaller, state-chartered institutions.

Since the financial crisis hit, banks have been tinkering with their compensation systems to make them more palatable to investors and regulators. Citigroup Inc., for example, is shifting pay packages to include more stock and less cash.

At the same time, banks have been boosting the salaries of traders and investment bankers to prevent the recipients' overall compensation from shrinking. Some top banks have been poaching traders, bankers and brokers from rivals by doling out multimillion-dollar signing awards and guaranteeing hefty first-year bonuses, regardless of performance.

The Fed effort is being driven by its newest governor, Daniel

Tarullo, who was named to the central bank's board by Mr. Obama. Mr. Bernanke has also been involved in crafting the proposals.

The Fed board will consider the proposal in the coming weeks. If approved, it will be proposed for public comment. Officials expect to move forward with the plan quickly, said people familiar with their planning.

The policies would apply to banks regulated by the Fed, not savings-and-loans or state banks that are overseen by the Federal Deposit Insurance Corp. The proposal would let regulators determine whether the type of pay—such as bonuses based on the volume of business—creates incentives for behavior that risk the safety and soundness of the bank.

—David Enrich and David Gauthier-Villars contributed to this article.