Fed Hits Banks With
Thousands of Firms Affected in Plan Meant to Discourage
Sweeping Pay Limits
Risky Bets; Small-Town Institutions ‘Pay for the Sins’ of Big Players

In a one-two punch at the pay culture of banks and Wall Street firms blamed for the financial crisis, the U.S. government announced plans to aggressively regulate compensation at thou-
sands of lenders and impose steep pay cuts at seven compa-
nies that received billions in federal aid.

While the moves had been antici-

tipated for weeks, Thursday's separate announcements by the Federal Reserve and Treasury Department represent unprece- dented federal intervention in pay decisions traditionally left to boards and shareholders.

The crackdown is likely to in-
fluence how financial firms pay top executives, traders, loan officers and others whose actions could threaten the soundness of the institutions. Compensation experts said it would be hard for companies to escape the new oversight, though individuals could do so by jumping to hedge funds, private-equity funds and other financial firms beyond the reach of the new curbs.

The central bank moved to in-
corporate reviews of compensation into its routine regulatory process, a step that will affect large and small financial firms across the U.S. as well as American subsidiaries of non-U.S. financial companies. Some state regulators said they plan to is-


sue similar requirements for state-regulated banks not cov-
ered by the Fed plan.

"I think it will make an impor-
tant difference" because many banks have been reluctant to change their pay practices unilaterally out of competitive worries, said New York's banking superintendt, Richard Neiman.

As expected, Treasury offi-
cial Kenneth Feinberg said cash salaries paid to the highest-earning executives at seven compa-
nies getting exceptional federal aid will be capped at $500,000, while the group's total pay level, annualized, will be 50% lower than a year before.

Some bankers and outside ex-
perts said Mr. Feinberg was over-
stating the extent of the cuts. Many bankers will continue to enjoy seven-figure pay packages, including one who will receive $9.9 million. Of the 136 employees whose pay Mr. Feinberg reviewed, 29 are on track to collect total 2009 pay of at least $5 million, according to documents released by Mr. Feinberg. His calculations of 50% cuts in total pay for the top 25 at each firm from a year before depend partly on departures of certain highly paid employees.

The rulings will be effective for just November and December.

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The rulings cover the highest-paid 25 employees at each of the seven heavily aided companies: Citigroup Inc., Bank of America Corp., American International Group Inc., General Motors Co., GMAC Inc., Chrysler Group LLC and Chrysler Financial.

Mr. Feinberg said he will have to approve pay for the next chief executive at Bank of America. He already pushed outgoing CEO Kenneth Lewis into giving back $1 million he received so far this year and forgoing the rest of his $1.5 million salary for 2009.

Some critics said that Mr. Feinberg was too soft on the banks and that his main accomplishment—forcing firms to use more stock and less cash when paying employees—didn’t go far enough to rein in compensation. “We’re worried that it’s shifting from one form of compensation to another and still letting people get away with some pretty outrageous things,” said Sarah Anderson, an executive-pay analyst with the left-leaning Institute for Policy Studies in Washington.

While the Fed didn’t propose pay caps, it said it will review compensation policies at “28 large, complex banking organizations,” which it didn’t identify. It will be a “horizontal review” of how each bank compares to the others. The Fed also proposed that pay of traders and other employees be linked to the risks taken to achieve returns. So if two people generate $1 million in revenue each, one who took more chances could be paid less.

Analysts noted that one surefire sign of risk—bets that use a lot of borrowed money—could stay out of style if the Fed uses risk-adjusted returns to assess how employees should get paid.

Morgan Stanley, Credit Suisse Group and some other Wall Street firms already have moved to overhaul pay, including shifting more of it to salary.

Some small-town bankers are resentful of the coming scrutiny by the Fed, blaming manv of the foolish loans and reckless trades that led to the financial crisis on larger institutions. “We’re all having to pay for the sins of the big banks,” said Rusty Cloutier, CEO of MidSouth Bancorp Inc., Lafayette, La.

Since the spring, banks have been fretting over the effect of a provision in the economic-stimulus law that restricts bonuses—historically the lion’s share of top bankers’ compensation—to a fraction of salaries. The worry has been that the combination of this provision, inserted by Sen. Christopher Dodd (D, Conn.), and coming salary curbs by Mr. Feinberg would severely depress overall compensation.

At Citigroup, some executives were relieved Mr. Feinberg’s demands were not tougher. While salaries will be paid more in stock than cash, their total values aren’t expected to shrink in most cases, said people familiar with the matter.

Citigroup executives have been worried that severe curbs could spark an exodus of top traders and bankers. That hasn’t happened. Citigroup has suffered many high-ranking defections, but those executives say their departures didn’t stem from dissatisfaction with pay.

Citigroup said it is “pleased this decision has been issued and we will now work to comply with the plan’s requirements.”

Bank of America officials reached out to those affected by the Feinberg ruling to reassure them pay is “still very healthy,” said a person familiar with the situation. But some remain concerned the firm may face trouble recruiting in its global banking and markets group, run by Thomas Montag—who was identified by people familiar with the matter as the person with the $9.9 million pay package, one of the largest disclosed Thursday by Mr. Feinberg.

—Jon Hilsenrath, Deborah Solomon, Dan Fitzpatrick and Cari Tuna contributed to this article.

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QUESTION OF THE DAY:
Should the government limit executive pay at banks?
Weigh in at WSJ.com/Question
Plan Aims to Curb Dangerous Risks

BY JON HILSENRATH

WASHINGTON—The Federal Reserve’s new compensation rules mark an ambitious attempt by the government to fix a problem banks haven’t been able to manage on their own.

Wall Street and most Main Street banks have been using performance-based pay plans for decades. Poorly designed ones have had disastrous results. Fed officials believe they can push banks to do better, but their plan includes its own risks of unintended consequences.

Fed Chairman Ben Bernanke said pay practices at many banks “led to misaligned incentives and excessive risk taking” that contributed to the financial crisis. The new rules, he said, would ensure that pay is tied to the longer-term performance of banks and doesn’t create “undue risk for the firm or the financial system.”

Several compensation experts said it won’t be easy for Wall Street to evade the rules—something it has proven adept at in the past. For the largest firms, which the Fed worries about most, there will be special scrutiny, an intense review of how their pay practices compare with each other to ensure none encourages undue risk.

Smaller state-chartered banks have a better chance of flying under the radar. One senior regional Fed official said he didn’t think the new pay rules would significantly change the way his supervisors oversaw small and midsize banks in the region.

Some big banks have acknowledged that their compensation plans skewed the incentives of traders and investment bankers during the credit boom.

Executives on bond-origination desks at investment banks, for instance, were often paid for the volume of business they generated, which helped lead to a boom in issuance of mortgage-backed instruments that were riskier than they looked.

But it isn’t easy to avoid creating perverse incentives for financiers. Even bank practices that took into account the amount of risk being taken by employees caused problems during the boom. For instance, traders who were discouraged from taking big chances with bank capital instead turned out to be more dangerous than the ratings implied.

“This could be a disaster if the regulation is totally hamstrung,” said Anil Kashyap, an economics professor at the University of Chicago Graduate School of Business.

The Fed is taking a flexible approach. It won’t dictate pay or specify what kind of compensation plans firms must adopt. Richard Spillenköthen, the former head of Fed bank supervision who now works as a consultant at Deloitte & Touche LLP, says this means fewer hurdles for traders to try to wriggle around.

Instead, the Fed is setting out broad guidelines, such as a demand that firms make pay risk-adjusted, pay out over longer stretches of time and take into account losses employees incur. And the Fed will reserve the right to veto plans it doesn’t like and demand that managers come up with other approaches.

There is a risk that employees unhappy with pay plans at banks might jump to unregulated firms, such as hedge funds or financial institutions operating offshore.

A senior Fed official said he believed the new rules could give banks an advantage by assuring investors that these institutions will be more stable over time. The official added that many Wall Street firms are already moving in this direction in light of the crisis.

If the Fed “is going to be as flexible as they say, the banks will embrace it,” said Yale Tauber, a compensation consultant in New Canaan, Conn. His clients include the compensation committee of Citigroup Inc.’s board.

Fed officials note that the pay proposals are part of a global effort promoted by the Financial Stability Board, an association of finance officials from 20 of the world’s largest economies. The FSB has proposed more explicit rules—such as a demand that 40% to 60% of bank bonuses be deferred over a number of years.

The public will have 30 days to comment on the proposed rules before they become official. Even as the comment period proceeds, the Fed is moving ahead with the review of pay practices at big banks.

—Joann S. Lublin contributed
BY DEBORAH SOLOMON

WASHINGTON—At the heart of Kenneth Feinberg's job as the Treasury's special master for compensation has been a series of tense paradoxes.

Among those, as he saw them: Reining in pay while ensuring that key employees stay, and curbing excessive risk-taking yet keeping firms viable. More broadly, he said in an interview, no matter how big an axe he might take to Wall Street pay, he felt the ultimate numbers were sure to stun most Americans.

"The toughest problem I confronted was the chasm between the perceptions of Wall Street and the perception of Main Street. Different planets," said Mr. Feinberg of his task of crafting pay limits for seven firms receiving large sums of government aid. "No matter what decision I make, Wall Street will be unhappy...and there will be many people who will be unhappy that I didn't go far enough."

And so he came up with a sweeping plan that will lop an average of 50% off total compensation, yet still allow 30 employees at Bank of America Corp. and Citigroup Inc. to walk away with multimillion-dollar packages, including one totaling $9.9 million.

Mr. Feinberg said he determined early on that his decisions would likely satisfy no one. Along the way, he clashed with the companies over proposed cuts to cash salaries, disagreed with the Treasury over the waiting period before employees could access their stock and even reversed his own decisions. At times, he said, he warned firms that high paychecks would invite criticism and inflame populist rage against the companies.

Several weeks ago, Mr. Feinberg told Bank of America that it could pay some of its top 25 employees cash salaries between $800,000 and $900,000, according to government and company officials. But as the decision sank in, the numbers began to look too high to Mr. Feinberg. He worried the paychecks would seem too generous, particularly when so many Americans were out of work. He went back to Bank of America and told the firm that employees could make no more than $600,000, a decision that stunned bank executives.

Companies offered reams of data designed to show that employees were worth much more than Mr. Feinberg thought, he said. He was deluged, he said, "with data on the marketplace, data on competition, data on what others make, data that warns me that if I don't pay X, you will lose people who will go to European banks or Asia or Chinese banks. That America will suffer. That it is short-sighted."

To some extent, the hard sell worked. Mr. Feinberg said the comparable data influenced his decisions, convincing him in some cases to pay more than he might otherwise have decided.

One example was American International Group Inc., the insurer whose payout of retention bonuses in March sparked the furor that ultimately led the White House to create a pay czar. Mr. Feinberg pushed AIG officials to honor a previous commitment to return $45 million of those retention payments.

But some AIG employees balked, saying the money was contractually obligated and that returning the payments and accepting a salary cut in 2009 were simply too much. They threatened to leave the firm if the contracts weren't honored, according to people familiar with the situation.

Mr. Feinberg ultimately agreed to allow the payments to three employees. After talking with officials at the Federal Reserve and the Treasury, Mr. Feinberg reached that conclusion "due to the unique circumstances currently found to exist at AIG, and the need to retain the services of these three employees who are deemed to be particularly critical to AIG's long-term financial success," according to his determination.

To compensate, Mr. Feinberg deducted some of the retention payment from the employees' 2009 salaries, but they wound up as a result of the overall compensation actually increase, the only time that happened in the review.

For the most part, Mr. Feinberg operated as a free agent, with little oversight from the Treasury and no contact with the White House. Treasury officials said they wanted to let Mr. Feinberg make his own decisions but offered thoughts and suggestions along the way.

At one point, they disagreed about how long employees should have to wait before accessing stock grants that were being given in lieu of cash. Mr. Feinberg initially wanted a shorter period, while Treasury officials argued most of the stock should remain off-limits until the government was repaid. They ultimately agreed on a four-year period, with a third of the stock accessible after two.

One of the biggest eye-openers for Mr. Feinberg was the disparity between pay at the seven firms he oversees. When the compensation packages first crossed his desk this summer, he said he was surprised by how much compensation at Citi- group, Bank of America and American International Group exceeded pay at firms such as General Motors Co. and Chrysler LLC.

Mr. Feinberg decided to take a much bigger swipe at compensation at the two banks and AIG, believing they relied too heavily on cash. Total 2009 cash compensation at GM, for instance, was cut 17.9% from 2008 compared with 96.4% at Citigroup.

Mr. Feinberg said the assignment was "very, very difficult."

"I don't think he'll be ready for canonization, but anybody who's got any brains at all knows that this is a very tough situation," said former Republican Sen. Chuck Hagel, a longtime friend of Mr. Feinberg.

In the end, Mr. Feinberg said he weighed "the fact that these seven companies are in part owned by the U.S. and that the U.S. government is a creditor and has a right and an expectation as to how to influence compensation decisions."}

"As the government's lead negotiator in the task force again in 2010, Mr. Feinberg demurred: "It's taken a toll," he said.
In the annals of what used to be known as American capitalism, yesterday will go down as a sorry day: The Treasury and Federal Reserve announced wage controls on private American companies. So once again our politicians are blaming bankers, rather than addressing the incentives the politicians themselves created for bankers to take excessive risks.

President Obama cheered the pay reductions as “an important step forward” and urged Congress to “continue moving forward on financial reform to help prevent the crisis we saw last fall from happening again.” The pay curbs are intended to feed the official political narrative that the bankers caused the entire crisis, and that cutting their future pay will prevent the next one. Only a politician could really believe this, or at least pretend to.

We certainly have no sympathy for bankers who’ve been bailed out, and the most defensible of yesterday’s pay curbs are those announced by Treasury “pay czar” Ken Feinberg. He was handed the task of determining compensation for 175 executives at seven companies that are still using money from the Troubled Asset Relief Program: Citigroup, AIG, Bank of America, General Motors, Chrysler, GMAC and Chrysler Financial. These companies—and executives—owe their survival to political intervention, and the price of such taxpayer help is inevitably some populist retribution.

Mr. Feinberg thus has the impossible job of navigating between Congress’s desire for revenge and the incentives needed to motivate business success at companies that still need to repay taxpayers. His strategy seems to be to slash cash compensation to $500,000 or less for most of the affected workers, while the bulk of their compensation will come in the form of stock tied to future corporate performance. This seems reasonable enough in principle. But the danger is that these pay limits will drive the most talented people at these firms to other companies without such onerous pay limits.

Far more dangerous is yesterday’s announcement that the Fed plans to impose new pay guidelines on all of the banks it regulates. While the Fed imposed no pay cap, and it was at pains to say it didn’t want to impose a “one size fits all” standard, the implication is that any large single-year payouts will be frowned upon by regulators. The Fed wants what it refers to as more “balanced” pay standards, which in practice is likely to mean smaller bonuses up front and longer time frames to see if “risks” pay off over several years.

The irony is that judgments about what constitutes “excessive risk” at banks will presumably be made by the same Fed regulators who let Citigroup put hundreds of billions in SIVs off its balance sheet. That certainly looks “excessive” now, though apparently it didn’t amid the credit mania. The point is that Fed officials aren’t likely to have a clue what kind of risks warrant tighter compensation rules. And these new guidelines may also drive the best and brightest out of the banks and into less regulated institutions.

Paul Volcker must be smiling at that one. Like Bank of England Governor Mervyn King (see below), the former Fed Chairman argued in Obama circles that a better way to regulate banks is to separate the riskiest trading activities from those that accept taxpayer guaranteed deposits. That reform would have moved the riskiest proprietary trading out of taxpayer-protected institutions. But the White House and Treasury deemed this too politically difficult, so instead they are now regulating the pay of bankers as an alternative way to diminish those risks. Good luck.

Meanwhile, the Administration still hasn’t done anything to change the incentives for excessive risk-taking that are embedded in its own “too big to fail” doctrine. As long as bankers and their creditors believe they have a federal safety net, they will have a cheaper cost of capital that will encourage them to take greater risks. New pay rules will quickly be worked around or through.

As Mr. King put it this week, “The sheer creative imagination of the financial sector to think up new ways of taking risk will in the end, I believe, force us to confront the ‘too important to fail’ question. The belief that appropriate regulation can ensure that speculative activities do not result in failures is a delusion.” The same can be said for pay curbs.

The most profound mistake in these rules is the terrible precedent they set for wage controls across the economy. The Obama Administration will say that banks are a special case, and that is true. But once politicians feel free to regulate executive pay for one industry, it is no great leap to do it for everyone. Our guess is that these pay rules will prove to be both ineffective and destructive—a perfect Washington combination.