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Excessive Compensation – An Unintended Consequence

Excessive Wall Street compensation illustrates the law of unintended consequences. To stabilize the global financial system, the Federal Reserve, Treasury, independent agencies and Congress acted to bail out banks and securities firms, guarantee deposits and commercial paper, and allow institutions still standing to convert to bank holding company status, thus opening the Fed window and to flood the world with liquidity lowering interest rates.

Intended consequences occurred. The world's economy did not collapse. Markets eventually unfroze. Risk-taking resumed and, at least, large public companies found credit.

What are the results that were unintended and about which we legitimately lament? The banking system moved closer to an oligopoly creating fewer powerful firms such as Goldman Sachs and JPMorgan. These firms took the Government's largesse and speculated for their own accounts, principally in trading activities. The commercial banks didn't use the Fed window to increase their lending to smaller companies. They reduced risk and raised credit standards, prodded by Congress and regulators.

Goldman and Morgan Stanley, newly converted to bank holding companies, don't lend. They used the Fed's capital and Federal guarantees to buy higher yielding securities, thus arbitraging the Fed. They did almost everything that one would expect of a profit-making business even on Main Street.

Before proposing ways to mitigate the unforeseen, let's face a couple of facts. First, there are no absolute standards for determining compensation, particularly in finance. Having dealt with compensation

as Co-Chairman of a major securities firm, the only matter on which two bankers can agree is what the third should get paid.

Second, Wall Street compensation – relative to value added – is fundamentally inequitable. Society rewards financial manipulators, movie stars and guys who hit three-run homers a lot more than the educators and nurses who contribute to the betterment of our society. A recent story critically reported on college presidents paid more than \$1 million, an amount a utility infielder with a second division club would arbitrate.

Third, the compensation brouhaha is not constructive. Ken Feinberg, the compensation czar, is already temporizing. His decisions seem arbitrary. Vilifying Wall Street may be good politics but it is a distraction from the business of achieving a new regulatory landscape and legitimizes the business community's hunch of an anti-business White House.

Finally, except in TARP where the Government took warrants in the banks so taxpayers could benefit from gains, the Government put no conditions on its programs. There was no requirement for the use of the injections of capital; no pre-negotiated limits on compensation appear; and no formulas for profit sharing.

In retrospect, we understand how this occurred. The Government and the world panicked. The original TARP proposal by Secretary Paulson was written on three pages.

This doesn't mean, however, that we, as taxpayers, are not owed money by these firms beyond the taxes on their engorged pay. Joe Nocera, the *New York Times* columnist, estimated that Goldman has used \$28 billion of Federally guaranteed commercial paper to enhance its profits which, according to the *Wall Street Journal*, benefitted Goldman to the tune of \$754 million.

President Obama and Secretary Geithner might begin to address 2009 compensation by meeting with Goldman, JP Morgan and other appropriate banks and urging them to create a multi-billion dollar

credit facility for small businesses, administered by the SBA. Small business created over 60 per cent of all jobs during the last expansion. Given the fact that Goldman's bonus pool alone is almost \$17 billion, an appropriately sized pool might add considerably to the availability of small business credit.

If the President can't get some accommodation, he and Congress might consider a windfall profits tax for future earnings. A windfall profits tax has been imposed during wars and when industries benefitted unduly from an unusual occurrence. In 1980, Congress passed the Crude Oil Windfall Profit Tax to recoup the revenue earned by oil producers as a result of oil's sharp increase from OPEC's embargo. Profits resulting from use of Government programs might be subject to a surcharge to compensate for the use of the guarantees and capital.

Today's excesses do not derive from an external event. Inadequate Government foresight is a contributing cause. Threat of a windfall tax might be sufficient to spur the banks to reduce pay levels.

These proposals deal with transitory issues. Most of the guaranteed programs hopefully will end. Rewards evidenced by compensation relative to risk, however, are permanently out of balance. If securities traders could lose their capital as well as their income, the public might be less upset about their gains.

Wall Street was not always composed of publicly owned limited liability firms. Prior to 1970, Wall Street firms were private partnerships. Partners' capital supported the firm's operations. Compensation was a private matter among partners, generally tracking ownership. Extraordinary value added could be recognized.

Paul Volcker suggested that bank functions might be divided with one entity involved in traditional lending and relationship oriented business, and the other housing the more risky and impersonal transaction-oriented capital markets activities. Expanding Mr. Volcker's thought further, the idea of leaving lending functions in a limited liability corporation but requiring the capital markets risk-taking

functions, both proprietary and agency, to be owned in partnerships makes sense. Assuming markets reward prudent risks and penalize exuberance, the unlimited liability of the partners might achieve the dual goals of tempering risk and aligning compensation.

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