

GraefCrystal.com

The Crystal Report on Executive Compensation



Wall Street Needs an Extreme Pay Makeover

by Graef Crystal

August 10, 2009

Two theories have been shattered in the past months, the one that says Wall Street executives are smart enough to learn new things; and the second that says if you squeeze pay at the top, the top will squeeze pay throughout the organization.

Despite all the negative publicity (and even death threats) received by the CEOs of the major Wall Street firms over pay packages reaching beyond the \$70 million mark, and despite the government's coming in to bail out these firms, we now find them planning a return to the big-bonus culture of yesteryear. Stories abound that Goldman Sachs is accruing billions upon billions in bonus money for payout shortly after the end of 2009.

More thoughtful voices might say to Goldman and other firms: "Why take so much money? Pay yourselves much less." The response: "Are you crazy? If we do that, the money will go to the shareholders. And what did they do to earn it?"

The Way Things Work

When I was the pay consultant to Bear Stearns in the mid 1980s, its then CEO, Alan "Ace" Greenberg, told me how the firm's bonus plan worked: "First, we calculate our profits before paying income taxes and before paying bonuses but after paying all other compensation expenses. Then we take that resulting number and split it down the middle. In most all years, half goes to us in bonuses and half goes to the shareholders."

With minor modifications, I believe the same concept was in operation at the other Wall Street firms, too.

That's a much different way of looking at things, compared to major non-Wall Street firms. The latter identify a group of comparators, measure their pay and then decide how much they

themselves ought to pay. They understand, if only intuitively, that as profits rise, pay also rises, but not as fast.

But the Wall Street firms, if they look at any other companies, were wont to look only at a handful of other New York-based, publicly-traded investment banking firms. They also relied on scraps of lunchtime conversation as to what the heads of private firms, such as the hedge firms, were paying.

The Dealmakers

There's something else you need to know.

Here, let's start with General Electric, or at least the GE I knew from the 1970s and 1980s when I was in my consulting career.

Every GE executive carried a small laminated card in his or her wallet. On one side of the card was the company's pay grades, with their minima and maxima. On the other side was the company's overall bonus funding formula and information on target bonuses and target option awards.

That little card pretty much said it all, and it could be carried in one's wallet without ruining one's suit line.

That sort of organized pay system was anathema from Day One to the Wall Street crowd. Their mantra: "Let's make a deal!" After all, they make deals every day for a living.

What does it matter if I bring you in from the outside at twice the pay of people who will now be your peers, provided you don't say anything about what you're earning? And even if you do say something and I get complaints, I will either raise the pay of the complainants or, if I don't value them very highly, tell them to see if they can replicate their desired pay at some other Wall Street firm that also plays "Let's make a deal".

In other words, we have sheer pay chaos.

When I was the pay consultant to Salomon Brothers in the 1980s, one trader garnered a \$25 million bonus in a single year. His pay was many times the total pay of Salomon's CEO, John Gutfreund.

Maybe Mr. Gutfreund didn't even know about the formula that generated that massive bonus. Or maybe he did know but didn't understand how large the bonus could grow to be. But it's fairly certain in my mind that if Mr. Gutfreund could re-run the film, that trader would not be standing in front of the camera waving a check for \$25 million.

Which brings me to another point. Do these Masters of the Universe, when negotiating a bonus formula, ever run sufficient scenarios to see what amounts might be generated and the profit

figures required to generate them? On the evidence, they did not, and they did not also do that with respect to the exotic securities they designed – securities that would eventually lead to the crash of 2008.

The Andrew Hall Imbrogio

2009's counterpart to the Salomon Brothers trader is Andrew Hall of Citigroup.

Salomon Brothers in the early 1980s went public in an unusual way. It agreed to be acquired by an already-public company, Phillips Brothers, a commodity trading firm. The plan was that there would be two co-CEOs, one, the head of Phillips Brothers and the second, John Gutfreund of Salomon Brothers. The new firm was called Phibro-Salomon. It didn't take very many months for Mr. Gutfreund and his Salomon colleagues to take over the entire company and relegate Phillips Brothers to the status of a subsidiary.

(One of the fabled traders at Phillip Brothers was the later tax fugitive, Marc Rich, whom President Bill Clinton pardoned just before he left office. That pardon dealt a severe blow to the president's reputation.)

Eventually, Salomon was acquired by Citigroup as part of the latter's push to become a financial supermarket. And Phibro came along with the deal.

Now we have Mr. Hall claiming he is owed some \$100 million, based, I assume, on a pre-established bonus formula that was applied to the results of his business unit and not in any way to the results of the overall parent company.

At the same time, we have a devastating report released by New York State Attorney General Andrew Cuomo, which details the billions and billions of bonuses that were paid to other than the very top executives of TARP recipients.

Then there is that second theory – that if you squeeze the top, the top will then squeeze everyone else. That's the theory that underpins the TARP legislation. But if that theory were true, then Mr. Hall would now be standing in his compensation underwear right alongside Citigroup's CEO, Vikram Pandit.

In one meeting I had with John Gutfreund, he referred to his subordinates as "mercenaries", meaning that they would kill your mother for a quarter and theirs for a dollar.

It was this fear of losing good people to other Wall Street predators that led companies to cut deals that, though they might be terrible for the long-term, at least kept the talent in place.

Recommendations

So what should be done about all this? I have a number of thoughts.

First, I have no problem with business unit incentive plans, at least in concept. At the moment, the Washington bureaucrats and congresspersons seem to see business unit incentives as a prime cause of the crash of 2008. I think they are wrong.

Phibro is a good example here. So far as I can see, it is in a business that is way outside the Citigroup mainstream. So paying an incentive to Andrew Hall based on the performance of tellers would seem to be sheer idiocy.

That said, I think that every bonus-eligible employee should have at least some fraction of their bonus opportunity predicated on overall enterprise results – 100 percent for the CEO and senior staff, less than that for people running business units.

Why do I say that? Sure, there is a need for teamwork, but that may or may not be a serious reason in a particular case. The serious reason is that if the corporation takes a hit, the aggregate amount spent on bonuses begins to drop automatically. Though it won't likely drop to zero, the drop ought to be sufficient to induce Attorney General Cuomo to start investigating something other than pay.

Second, I think we need to introduce the concept of a negative bonus, which, to my way of thinking, is something different than a clawback.

A clawback, the way I define one, involves the recapture of past bonus monies as a result of incorrect accounting during earlier periods or accounting that failed to establish sufficient reserves.

A negative bonus plan says: "If you're going to get a \$100 million bonus in the good times, then to give you simply no bonus in the bad times won't hack it. We want you to suffer just as you prospered earlier."

Using Mr. Hall as an example, that could be accomplished by paying him, say, only one-third of his \$100 million right away. The remaining two thirds would be put into an escrow account, to be debited over the next two years if Mr. Hall's unit delivered performance lower than its bonus threshold level.

If the executive decided to quit, then any bonus monies still in reserve would automatically be forfeited. Although retention is not the primary goal here, it is a useful adjunct when it comes to dealing with mercenaries.

Back in the 1980s, I tried, unsuccessfully, to introduce a negative bonus plan to an investment banking client of mine. Senior executives had substantial deferred compensation accounts at the

time. My plan was centered on a “target” return on equity, which I recall was 15 percent. Interest on the deferred compensation monies would be determined by subtracting 15 percentage points from the actual return on equity and then doubling the remainder.

For example, assume the company earned a return on equity of 25 percent. First, the 15 percent target level was subtracting from the 25 percent actual level to produce a remainder of 10 percent. The remainder was then doubled, and senior executives that year earned 20 percent on their deferred compensation.

But if the company earned only a 15 percent return on equity, there would be no interest at all that year. And if it earned 5 percent, then deferred compensation accounts would be hit with a 20 percent reduction.

This bank’s executive committee loved the upside of my new plan, in large part because the company was already earning well above a 15 percent return on equity. But they couldn’t stomach the idea of a negative rate of interest. So they bought the upside and capped the downside at the then T-bill rate of interest.

I pointed out the asymmetry of that approach – great rewards in the good times and at least some rewards in the bad times – and asked: “What are the shareholders going to say about this plan?”

One of the members of the executive committee replied: “Screw the shareholders. If they don’t like it, they can apply for jobs, and then they can get in this plan, too!”

Third, whatever bonus plan is offered to a business unit executive needs to be “stress tested”, to use the currently popular parlance. By that, I mean that thousands of scenarios need to be run so that the people approving the bonus plan understand how much can be earned and under what circumstances.

Fourth, I believe that board compensation committees, which already ride herd over top executive compensation, should be required to approve business unit incentive plans where the maximum individual payout could possibly be higher than \$X, e.g., higher than \$2 million.

Fifth, the board compensation committee’s consultant should be required periodically – perhaps as often as annually – to review all outstanding business unit bonus plans and then present the results of that review to the committee, including the consultant’s recommendations as to amendment or discontinuance of any of the plans.

Finally, although those little laminated cards, a la General Electric, will never catch fire on Wall Street, the current system of chaotic compensation could use at least some further structuring. This, too, could be handled by board compensation committees, advised by their compensation consultants.

None of these recommendations is all that dramatic, except perhaps the concept of a negative bonus. But in combination, they ought to move the ball a bit further towards the goalposts of rational investment banking pay.

2009 marks Graef Crystal's 50th anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay.