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It May Be Outrageous, but Wall Street Pay Didn't Cause This Crisis

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Barney Frank, chairman of the House Financial Services Committee, is sponsoring a bill to rein in what he calls "imprudently risky compensation" on Wall Street.

By FLOYD NORRIS
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There is a lot about Wall Street pay to make the rest of us livid, or at least jealous. And now Congress seems poised to act on it.

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The House of Representatives is expected to pass on Friday a bill to empower regulators to change what the bill's sponsor, Barney Frank, calls "imprudently risky compensation practices" on Wall Street.

Other companies will have to face regular shareholder votes on pay, although the votes will be nonbinding, and board compensation committees will have to jump through more hoops.

The big winners will be compensation consultants, for whom there are likely to be more

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I doubt all of this will hurt very much, unlike the last Congressional stab at doing something about excessive executive pay, passed when Jimmy Carter was president. That led to soaring pay and some of the abuses that now outrage people.

But neither will it do much good.

It is galling to see executives making tens of millions of dollars for running companies that have to be bailed out by taxpayers, but there is little evidence that big pay — or the incentives connected to it — caused the financial train wreck that sent the world into recession.

To the contrary, there is plenty of evidence that no one who counted — traders, chief executives or regulators — understood the risks that were being taken.

A new study shows that banks run by chief executives with a lot of stock were, if anything, likely to do worse than other banks in the crisis.

"Bank C.E.O. incentives cannot be blamed for the credit crisis or for the performance of banks during the crisis," states the study, by René Stulz, an Ohio State University finance professor, and Rüdiger Fahlenbrach of the Swiss Federal Institute of Technology.

"A plausible explanation for these findings is that C.E.O.'s focused on the interests of their shareholders in the build-up to the crisis and took actions that they believed the market would welcome," Mr. Stulz said.

The chief executives were wrong, of course. Most lost tens of millions of dollars in equity value but sold few shares before the crisis hit.

Whatever else they lacked, they had plenty of incentive to keep their banks from failing.

But those incentives did not matter when they should have. Bankers and regulators believed in the "Great Moderation," a term popularized by Ben Bernanke, then a member and now the chairman of the Federal Reserve Board, in a 2004 speech.

Thanks in part to "improvements in monetary policy," Mr. Bernanke said, without excessive modesty, there had been "a reduction in the extent of economic uncertainty confronting households and firms." Recessions, he added, "have become less frequent and less severe."

Bankers were not the only ones who concluded that the chances of a very bad outcome were exceedingly low. As year after year went by with nothing very bad happening, they saw no reason not to borrow more and more money to place what they deemed to be safe bets.

It may be worth noting that, of the 98 financial companies studied by Professors Stulz and Fahlenbrach, the one with the most valuable holdings of stock and options in his company at the end of 2006 was Richard Fuld of Lehman Brothers. His holdings, now worthless, were valued at $1 billion.

I had lunch with Mr. Fuld in early 2008, after the financial crisis was under way and less than eight months before Lehman failed. The conversation was off the record, but I am sure he had no inkling of the how great were the risks Lehman faced as a leader in the mortgage securitization business.

He was later raked over the coals in Congressional hearings about his huge compensation. That most of it was in stock and options that he never cashed in seemed to be something most legislators could not comprehend.

As Congress moves to do something about executive pay, it is worth asking what would

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have happened if Mr. Fuld had somehow realized in 2005 that the mortgage business was a time bomb and had gotten Lehman out of it. Within a year, its profits would have sagged and its share price collapsed. Mr. Fuld would have been labeled a dunce, and might have lost his job. The same can be said of Jimmy Cayne of Bear Stearns and Stan O'Neal of Merrill Lynch, the two runners-up in the richest bank C.E.O. sweepstakes of 2006.

President Obama has proposed legislation to deal with many aspects of the financial crisis, and it is no surprise that this bill is the one that seems to be having the easiest road to passage, even though every Republican voted against it in the House Financial Services Committee. The banks probably realize it won't make much difference and are doing their most intensive lobbying elsewhere.

I asked Professor Stulz what he thought of the bill. "It is hard to believe that regulators will be better at devising compensation plans with proper incentives," he said. "Properly designed capital requirements are a much more efficient approach to regulate the risk of financial institutions than fiddling with compensation."

Indeed, much of the financial "innovation" of recent years consisted of bankers coming up with ways to evade capital requirements. The regulators are now trying to deal with that, but their efforts are handicapped by bankers warning that they will maker fewer loans if capital rules are tightened.

That said, the bill could help some. The Sarbanes-Oxley law, passed in 2002, does seem to have resulted in board audit committees taking their jobs much more seriously. It would be good if the same happened at compensation committees. Perhaps it will do some good to tie compensation to long-term results, or to force executives to hold stock rather than sell it quickly when options vest.

Still, as Alan Blinder, the Princeton economist and former vice chairman of the Fed, wrote recently in The Wall Street Journal: "The executives, lawyers and accountants who design compensation systems are imaginative, skilled and definitely not disinterested. Congress and government bureaucrats won't beat them at this game."

The last time Congress took action in response to populist outrage at executive pay, it changed tax laws to bar salaries of more than $1 million from being deducted as corporate expenses. Payments based on performance could still be deducted.

The result was not what Congress intended. At large companies, $1 million soon became a floor, not a ceiling, for the boss's salary. Bonus and stock option plans proliferated to take advantage of the "performance-based" loophole. Eventually, we got to the oxymoron of "guaranteed bonuses."

Since most of their promised compensation was in the form of bonuses, Wall Streeters could not understand why people thought they should not be paid just because their firms had to be bailed out. A promise is a promise, they said.

We can hope that this bill will have fewer unintended consequences. But even if Mr. Frank, the chairman of the House Financial Services Committee, is right to call it "the first step towards comprehensive financial regulatory reform," there will have to be much larger steps taken to reach that goal.

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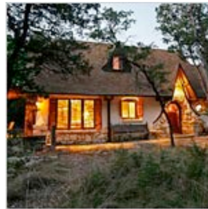

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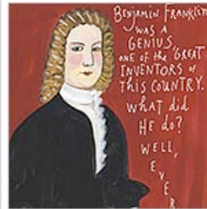

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