The Seattle Times

Friday, October 23, 2009 - Page updated at 06:01 PM

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Fed plan to police bank pay unlikely to curb risk

By STEVENSON JACOBS
AP Business Writer

It's the boldest idea yet to rein in Wall Street recklessness: Put the Federal Reserve in charge of policing not just the nation's banks, but also how much their employees are paid.

But can it work?

Some experts say the plan might help correct a pay system that has long rewarded those who make the sort of high-risk bets that triggered the financial crisis. Others see it as merely a short-term fix that wilil have little effect on making banks act more prudently.

The biggest concern is that as long as the government stands ready to rescue troubled banking giants, there's little to discourage traders from making potentially calamitous gambles on stocks, bonds and exotic financial products.

"Outsized pay that is a result of taking lots of risk is a problem," said Bill Fleckstein, a Seattle-based hedge fund manager. "But the real problem is the fact that these institutions have a setup where it's heads they win, tails the taxpayer loses."

Signs suggest that system still exists today. Only a year after the financial crisis peaked, the biggest banks are already making billions again placing risky bets with help from cheap government loans and other federal subsidies.

If those bets were to go bad, the loss to taxpayers could be immense. That's led some critics to call on the government to ban big commercial banks from trading risky securities - or shrink them so their collapse wouldn't jeopardize the economy.

The Obama administration and the Federal Reserve have resisted such calls, opting instead to seek the authority to take over and wind down large banks that get into serious trouble.

On Thursday, the Fed took a different tack, detailing plans to address the outsized compensation and risk-taking blamed for fueling the worst financial crisis since the Great Depression.

Under the plan, the central bank wouldn't set compensation, but it would review pay polices - and veto those found to encourage excessive risk-taking by executives, traders or loan officers. Even banks that didn't benefit from the taxpayer-financed bailout would be subject to the Fed's compensation oversight.

The Fed plan would require the 28 biggest banks - including Goldman Sachs Group Inc., Citigroup Inc., Bank of America Corp. and Wells Fargo & Co. - to submit compensation plans for review. Thousands of smaller banks would also face supervision.

It's the latest in a string of proposals by the administration, Congress and banking regulators to crack down on the problem.

Simon Johnson, a former chief economist with the International Monetary Fund, said the plan might reduce excessive

risk-taking at banks under the Fed's watch - but not at firms beyond the Fed's authority, including hedge funds and other securities firms that trade billions of dollars in complex securities and whose collapse could hurt the economy.

"This is a good start, but it's not enough," said Johnson, now a professor at the Massachusetts Institute of Technology's Sloan School of Management.

The Fed's plan was unveiled the same day that the Treasury's "pay czar," Kenneth Feinberg, announced plans to slash pay at seven big firms that haven't repaid their government bailout money.

Those companies must to cut their top executives' average total compensation - salary and bonuses - in half, starting in November. Under the plan, cash salaries for the top 25 highest-paid executives will be limited in most cases to $500,000 and, in most cases, perks will be capped at $25,000.

Speaking Friday, Feinberg said he will now turn to designing compensation structures for 75 additional high-paid employees at the companies that received extraordinary bailouts: Bank of America, American International Group Inc., Citigroup, General Motors, GMAC, Chrysler and Chrysler Financial.

For the executives ranking 26 through 100 in pay, Feinberg will set up a general plan to govern their pay, rather than specific terms.

Feinberg also has the authority to claw back compensation at any firm that received money from the $700 billion bailout program and still hasn't paid it back. But he said he's reluctant to do that.

The government's involvement in determining Wall Street pay has raised concerns that top performers could flee to companies or industries with less restrictive pay rules.

At some of the seven firms under Feinberg's authority, more than half of the 25 top earners had already left. They include 14 at Bank of America and 13 at American International Group. But Feinberg said he will set pay for their replacements at the beginning of next year.

Other analysts said the Fed, meanwhile, would find it hard to define exactly what constitutes excessive risk-taking. Banks and regulators themselves missed the warning signs before the housing bubble popped last year.

"What is excessive risk and who knows?" said David Yermack, finance professor at the Stern School of Business at New York University.

From a logistical standpoint, he called the Fed's proposal to gauge the level of risk-taking at thousands of banks "ridiculous."

"You would need thousands of experts, and to think you can identify which traders are taking on too much risk may be impossible," he said.

Even the Treasury's pay czar acknowledged the difficulty of determining when a risk is excessive.

"I'm not sure what is risk," he said. "I'm certainly not sure what is excessive risk."

AP Economics Writers Christopher S. Rugaber and Jeannine Aversa contributed to this report from Washington.

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