

Real Time Economics

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Guest Contribution: Back to the Good Times on Wall Street

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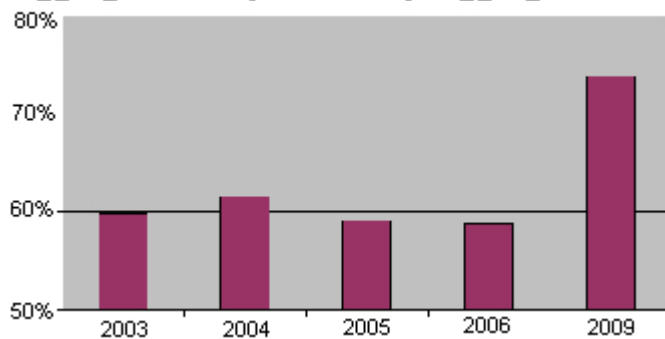
New York State Attorney General Andrew Cuomo released yesterday a report on compensation and income at nine major banks during 2003-2009. An assessment of these figures raises serious concerns from the perspective of both investors and taxpayers.

The Cuomo report focuses on nine large financial institutions that received substantial TARP support from the government. Below we focus on the compensation decisions these firms made during the first half of 2009. Assuming that these decisions are a sign of things to come, the firms' post-crisis pay policies appear to be, in the aggregate, even more lucrative to the firms' employees than precrisis policies.

From shareholders' perspective, it is useful to examine what may be labeled "Earnings before Compensation ("EBC"), which are equal to the sum of net income and compensation expenses. A financial firm's ECB in any given year represents the total pie to be divided between the two groups crucial for the firm's existence and operations — the firm's employees and the shareholders providing the firm's capital. Firms' compensation decisions determine what fraction of ECB goes to employees rather than left in firms' coffers (or distributed as dividends) to shareholders.

During the first half of 2009, with the exception of State Street, the banks in the group have enjoyed substantial ECB levels. The bar graph below displays the fraction of the banks' aggregate EBC levels paid out as compensation to employees during the precrisis years as well as during the first half of 2009.

Aggregate Compensation / Aggregate EBC



As the bar graph shows, during each of the years 2003-2006, this fraction was in the 52%-62% range. In contrast, during the first half of 2009, this fraction was about 74%. To the extent that employees were not under-compensated during 2003-2006, investors have a reason to wonder: might financial firms be letting employees eat part of the investors' lunch?

Defenders of firms' compensation decisions argue that firms are paying what is necessary to retain able employees and to prevent the flight of talent. The aggregate figures of pay and compensation can also be useful in considering this argument.

In 2006, aggregate ECB for the banks in the group equaled (in 2009 dollars) \$244 billion and the banks' total compensation expenses were \$143 billion. By contrast, assuming that ECB and compensation in the second half of 2009 will be the same as in the first half, the firms will pay an aggregate \$156 billion even though they will generate an aggregate EBC of only \$211. Assuming that the behavior of these firms is representative of the financial sector, investors might wonder why financial firms need in the aggregate to spend more on compensation even though they generate less value.

We now turn from the perspective of investors to that of the government (two perspectives that somewhat overlap as the government owns shares in some of these banks). We believe that government policy toward compensation in banks should focus on the incentives produced by pay structures, not on compensation amounts. But the above compensation figures should be of interest to public officials for two reasons.

First, during the financial crisis, taxpayers have expended substantial resources to shore up the firms' capital, with the firms covered by the report receiving a total of \$165 billions in TARP funding. The compensation amounts taken by employees out of the firms — \$156 billion in 2009 alone assuming the second half of the year is the same as the first — are sufficiently large to have a meaningful impact on the firms' capital.

Second, during the past two decades, compensation in finance has increased relative to other parts of the economy, and the financial sector has attracted an ever-increasing share of the country's best and

brightest. Following the financial crisis, there is widespread recognition that, in the post-crisis world, finance should command a smaller share of these best and brightest. To the extent that relative pay in the financial sector remains at or above its lofty precrisis levels, the desirable adjustment in the allocation of talent will be impeded or delayed.

Assessing the compensation figures for the first half of 2009 indicates that the good days of compensation are clearly rolling again. Investors and taxpayers should closely watch how these figures evolve during the remainder of 2009 and beyond.

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