Congress, Debt and the Largest Poker Game in History: Part III; Compensation

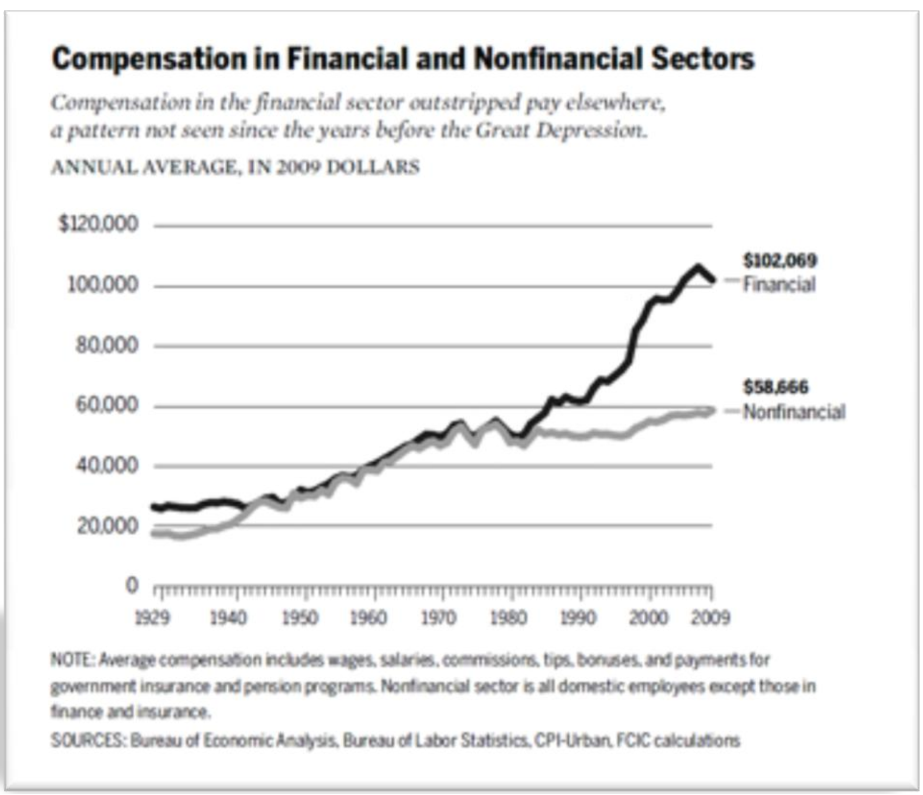
August 30, 2011

What is the ultimate goal of any company, business or organization? Some might say to develop a new product; some might say to help people, save the environment, increase home ownership and the wealth of the nation.

However the reality is somewhat different. Although these might be goals of the company based on their products, their ultimate goal is to make money. The more money the company makes, the more money they (management) will make. This is especially true for companies that are public (offer stocks) with an added bonus; the more money the company makes, the more money people will want to invest in the company, and an even greater amount of money they (management) will make.

No one can deny a company, an investor or an individual the ability to obtain the most value for their services. Whether that is a product, work performed or return on an investment. We are all trying to make money. The issue became, what was more vital to the financial sector during the 1980’s all the way through 2008 leading up to the financial meltdown? Was it the product that the banks were selling? Was it the customers that they were servicing? Was it the investors that had believed in them? Or was it the benefit of their personal compensation?

You could argue it was a bit of both, but if we look at a little of the past, it almost seems hard to imagine personal compensation didn’t have a major role to play.



If we look at the chart above[1], from 1929-the 1940s financial institution compensation was slightly higher than the compensation for nonfinancial sectors. From the 1940s until around 1981 the compensation stayed the same. From 1981 until 2009 there became a huge spike in the difference between the financial sector compensation and the nonfinancial sector compensation. Why is this important?

Let us think back to the key moments in deregulation of the banking industry[2]:

1978, Marquette vs. First of Omaha – Supreme Court allows banks to export the usury laws of their home state nationwide and sets off a competitive wave of deregulation, resulting in the complete elimination of usury rate ceilings in South Dakota and Delaware, among others.

1980, Depository Institutions Deregulation and Monetary Control Act – Legislation increases deposit insurance from $40,000 to $100,000, authorizes new authority to thrift institutions, and calls for the complete phase-out of interest rate ceilings on deposit accounts.

1982, Garn-St. Germain Depository Institutions Act – Bill deregulates thrifts almost entirely, allowing commercial lending and providing for a new account to compete with money market mutual funds. This was a Reagan administration initiative that passed with strong bi-partisan support.

1987, FSLIC Insolvency – GAO declares the deposit insurance fund of the savings and loan industry to be insolvent as a result of mounting institutional failures.

1989, Financial Institutions Reform and Recovery Act – Act abolishes the Federal Home Loan Bank Board and FSLIC, transferring them to OTS and the FDIC, respectively. The plan also creates the Resolution Trust Corporation to resolve failed thrifts.

1994, Riegle-Neal Interstate Banking and Branching Efficiency Act – This bill eliminated previous restrictions on interstate banking and branching. It passed with broad bipartisan support.

1996, Fed Reinterprets Glass-Steagall – Federal Reserve reinterprets the Glass-Steagall Act several times, eventually allowing bank holding companies to earn up to 25 percent of their revenues in investment banking.

1998, Citicorp-Travelers Merger – Citigroup, Inc. merges a commercial bank with an insurance company that owns an investment bank to form the world's largest financial services company.

1999, Gramm-Leach-Bliley Act – With support from Fed Chairman Greenspan, Treasury Secretary Rubin and his successor Lawrence Summers, the bill repeals the Glass-Steagall Act completely.

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[1] Commission, . F. C. I. C. (2013). *The fInancIal crIsIs InquIry report, fInal report of the natIonal commIssIon on the causes of the fInancIal and economIc crIsIs In the unIted states*. Public Affairs. Pg. 62

[2] Sherman, Matthew, "A Short History of Financial Deregulation in the United States," Center for Economic and Policy Research, July, 2009. http://www.openthegovernment.org/sites/default/files/otg/dereg-timeline-2009-07.pdf.

2000, Commodity Futures Modernization Act – Passed with support from the Clinton Administration, including Treasury Secretary Lawrence Summers, and bi-partisan support in Congress. The bill prevented the Commodity Futures Trading Commission from regulating most over-the-counter derivative contracts, including credit default swaps.

2004, Voluntary Regulation – The SEC proposes a system of voluntary regulation under the Consolidated Supervised Entities program, allowing investment banks to hold less capital in reserve and increase leverage.

Let's draw a conclusion from the data in the chart, and the deregulation of the financial industry.

As deregulation was enacted, and the financial sectors were allowed to expand their services and their products with little to no regulation, profits increased and with that so did compensation. How much did compensation increase? $43,403 on average.

Some might say that doesn't seem like much, and if the financial sector is providing a product that helps move our economy forward and provide people with the capability to increase their purchasing power whether that is for a first or second home, a new car or that big screen T.V. they always wanted, why does this matter. What is the big deal?

The big deal was when "investment banks went public in the 1980's and 1990s, the close relationship between bankers' decisions and their compensation broke down. They were now trading with shareholders' money. Talented traders and managers once tethered to their firms were now free agents who could play companies against each other for more money."[3] You may stop and say wait a minute that sounds like the free market at work and if the free market value of their services is deemed to be "more valuable" then why shouldn't their compensation increase?

Well investment and commercial banks "began providing aggressive incentives, often tied to the price of their shares and often with accelerated payouts."[4]There are two things to think about here; 1. What is our goal in working for an institution? 2. What is the institutions goal? Again the ultimate answer is to make money.

Again, some will say that is the free market, and the free market is what drives a good economy. And that may be true, but when the free market can be manipulated because of little or no regulation providing protection for either an investor or an individual the free market can be a nasty machine that can wreak havoc on an economy. Let us take a look at the example of the mortgage industry.

In the past if you needed a mortgage you would go to your local commercial bank and if you had the right credit, a good job and 20% of the down payment, the bank would invest in you, and

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[3] Commission, . F. C. I. C. (2013). *The fInancIal crIsIs InquIry report, fInal report of the natIonal commIssIon on the causes of the fInancIal and economIc crIsIs In the unIted states*. Public Affairs. Pg. 62

[4] Commission, . F. C. I. C. (2013). *The fInancIal crIsIs InquIry report, fInal report of the natIonal commIssIon on the causes of the fInancIal and economIc crIsIs In the unIted states*. Public Affairs. Pg. 62

give you a 30 year fixed rate mortgage to allow you to purchase a home. It seems to be a fairly simple system, which gives the bank a small but safe return on their investment (the interest paid by the borrower) at little or no cost to the investors (those who used commercial banks to "house" their money in checking or savings accounts). The system was working, but it was not generating enough home ownership (a statistic politicians love to utilize to increase their votes) and it was not generating enough profits (what a company's ultimate goal is).

Now remember the deregulation of the financial sector took place in the 1980s. With that in mind let's take a quick flashback to before this happened.

"Until 1970, the New York Stock Exchange, a private self-regulatory organization, required members to operate as partnerships. Peter J. Solomon, a former Lehman Brothers partner, testified before the FCIC that this profoundly affected the investment bank's culture. Before the change, he and the other partners had sat in a single room at headquarters, not to socialize but to "overhear, interact, and monitor" each other. They were all on the hook together. "Since they were personally liable as partners, they took risk very seriously," Solomon said."[5]

Wait a minute, before deregulation, companies took a closer look at the risk their investments potentially could have because these companies were private, and they acted as partners together. But this stifles the free market and that is bad for the economy; right? Maybe. Back before deregulation, the financial sector paid well, but you didn't receive a "large" compensation until you retired. This meant that the financial success and stability of the company was tied to your pay. However, once the financial sector went public, compensation was no longer tied to the financial success of the company; it was tied to the stock prices. If you wanted to make more money, you needed to have a "better" product for the consumers to increase "profits" to increase the number of investors, which in turn would increase the value of your stock. Higher stock prices, more money in compensation.

Again though, how did this affect you, and the overall stability of the economy?

"Though base salaries differed relatively little across sectors, banking and finance paid much higher bonuses and awarded more stock. And brokers and dealers did by far the best, averaging more than $7 million in compensation."[6]

If we think back to our example of mortgages, and the safety measures commercial banks used to asses risk, could that still be applied to a publically traded company where compensation was tied to stock prices? The answer is no, and this is where creativity, manipulation, and lack of regulation allowed products and services to create a real estate bubble (inflated home values, increased home ownership and the move away from the 30 year fixed mortgage).

Why would these institutions dare to risk their stability of their company through higher risk? Higher risk leads to higher reward; and when you are playing with someone else's money (in

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[6] Commission, . F. C. I. C. (2013). *The fInancIal crIsIs InquIry report, fInal report of the natIonal commIssIon on the causes of the fInancIal and economIc crIsIs In the unIted states*. Public Affairs. Pg. 63

many cases your pension funds or 401ks, and overseas investors), are you really worried? Do you see past today, tomorrow, the end of the year's $7 million dollar bonus? Probably not.

The free market is necessary, and the ability of that free market to "generate" the costs or value of services rendered is important to our economy. However, with so many financial institutions tied to each other, and so many people stretched thinner than they should be financially, could it be possible that regulations should be put in place to protect the People from the potential greed and "misuse" of the free market for personal gains?

If the ultimate goal of everyone is to make money, what would it take to stop companies from taking advantage of others to get there? Regulation.

Leverage + Off-Balance Sheets + Securitization = Profits

Profits = Higher Compensation

- A Silence DoGood