A Dirty Job No One Should Do

A lawyer's self-serving defense of Wall Street pay doesn't add up.

BY JOHN MILLER

> **Wall Street Lawyer: Don't Blame Pay**
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> Steve Eckhaus just wanted to get some deals done. He has negotiated hundreds of high-profile pay packages, some of which were met with scorn and scrutiny in Washington and beyond.
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> "I hate to say it, but I have friends who blame me for the financial crisis," says Mr. Eckhaus, who estimates he has negotiated well over $5 billion in banker pay over the years, including several $100 million pay deals.
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> "It was understandable why there was anger," says Mr. Eckhaus, but "the crisis was not caused by Wall Street fat cats." In general, he said his clients are "pure as the driven snow" and doing work that supports the economy and justifies their pay.
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> "There's nothing helpful or healing in the midst of a financial crisis to talk about Wall Street 'fat cats,' " added Mr. Eckhaus. "To blame Wall Street for the financial meltdown is absurd."
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> —Steve Eder, "Wall Street Lawyer: Don't Blame Pay," *Wall Street Journal*, February 5, 2011

Pure as the driven snow? How about as dirty as what remains of the Northeast's snow piles, covered with filth a month after record storms? Eckhaus and his fat-cat clients richly deserve the scorn that even his friends have heaped upon them. The pay packages Eckhaus negotiated are obscene. They cushioned financial fat cats from the often-disastrous consequences of their actions. And Eckhaus's protestations notwithstanding, the finance industry's compensation structures lie at the heart of the financial crisis. Banking execs and other key decision-makers all along the mortgage securitization process were induced to take excessive risks because of the way they were compensated.

Let's start with the first link in the process—the people who made the mortgage loans to homebuyers. It's standard practice to pay mortgage brokers based on the volume of loans they originate, not the performance or quality of those loans. And since the banks and mortgage companies who employ the brokers bundled up the loans and sold them off as mortgage-backed securities, they too had little interest in the quality of the loans.

The fees garnered by the financial-services industry from home mortgage lending and mortgage securitization were enormous, as much as $2 trillion in the six years from 2003 to 2008, according to estimates by economist James Crotty. That figure includes the fees paid to mortgage brokers as well as the fees collected by investment bankers who packaged the loans into securities, the fees paid to the ratings agencies who gave the securities their seal of approval, and the fees paid to yet others who serviced the securities. Those massive sums were paid out for short-term success even when the decisions those sums rewarded resulted in long-term losses or failures, a point Securities and Exchange Commission chair Mary Schapiro confirmed for the Financial Crisis Inquiry Commission, the ten-member panel appointed by Congress to examine the causes of the financial crisis.

That the compensation system has "no rhyme or reason" is the conclusion Andrew Cuomo, then attorney general of New York, reached in his 2009 report on compensation practices in the U.S. banking system. The record of Bank of America, for Cuomo, shows just how little compensation had to do with bank performance. In 2006, as the bank raked in profits during the housing bubble, it paid out $18 billion in compensation. In 2008, after the bubble had burst, Bank of America continued to make compensation payments at the $18 billion level—even as its net income plummeted from $14 billion to $4 billion. That fall Bank of America took over Merrill Lynch, which had just brought a new investment banking chief on board—Mr. Eckhaus's client Tom Montag—by guaranteeing him a $39.4 million bonus.

Those giant bonuses paid out to Wall Street high rollers provoked the ire of many, especially when they came from financial firms that received TARP (Troubled Asset Relief Program) bailout funds from the federal government, as was the case

with Mr. Montag's millions. The Cuomo report pays special attention to the bonuses paid out by the original TARP recipients. For two of the nine, Citigroup and Merrill Lynch, the disconnect between the banks' earnings and executive bonuses was especially alarming. Together, these two corporations in 2008 lost $54 billion, paid out nearly $9 billion in bonuses, and then received TARP bailouts totaling $55 billion. At Merrill Lynch, 700 employees received bonuses in excess of $1 million in 2008. The top four recipients alone received a total of $121 million. Merrill's reported losses for 2007 and 2008, as Crotty points out, were enough to wipe out 11 years of earnings previously reported by the company.

The Cuomo report rails against this "heads I win, tails you lose" bonus culture. As Cuomo put it, when banks did well, executives and traders were showered with bonuses. When the banks lost money, taxpayers bailed them out, and bonuses and overall compensation remained sky-high.

The consequences of such a perverse compensation system are disastrous, as Crotty explains:

> It becomes rational for top financial firm operatives to take excessive risk in the bubble even if they understand that their decisions are likely to cause a crash in the intermediate future. Since they do not have to return their bubble-year bonuses when the inevitable crisis occurs and since they continue to receive substantial bonuses even in the crisis, they have a powerful incentive to pursue high-risk, high-leverage strategies.

So go ahead and blame Wall Street for the crisis. Not to would indeed be absurd. The bonuses Eckhaus's clients and others took home were the most deformed element of a compensation system that enabled the risk-taking that pushed the financial industry into crisis. Those bonus babies deserve your scorn. Throwing them out with their dirty bathwater, the whole compensation system, is the first step toward curbing the destructive behavior they helped to perpetuate. D&S

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SOURCES: Steve Eder, "Wall Street Lawyer: Don't Blame Pay," Wall Street Journal, February 5, 2011; James Crotty, "The Bonus-Driven 'Rainmaker' Financial Firm," Political Economy Research Institute Working Paper 209, revised August 2010 (www.peri.umass.edu/236/hash/468a9ba021/publication/386/); Andrew Cuomo, No Rhyme Or Reason: The Heads I Win, Tails You Lose Bank Bonus Culture, State of New York, 2009 (www.scribd.com/doc/17849813/Andrew-Cuomos-Bonus-Report); The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, January 2011 (www.fcic.gov/report).