Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

TRENDMACRO LIVE!

On the New Bank Bonus Restrictions

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Donald Luskin

Unintended consequences buried in the "stimulus" bill are a game-changer to the downside.

We are extremely worried by the implications of the draconian executive bonus restrictions added at the last moment to the so-called "stimulus" bill passed on Friday. We see it as the continuation of the sudden deterioration in the economic policy environment that began on Tuesday with Treasury Secretary Tim Geithner's disastrous presentation of his half-baked Financial Stabilization Program (see "Two Strikes for Tim" February 11, 2009). We have sympathy for the idea that executives whose poor performance drove their firms to require federal assistance should not be lavishly compensated. But the new bonus restrictions actually do little to address that concern -- while at the same time, they punish healthy banks, and unleash unintended consequences that are likely to undermine urgent efforts to shore up credit markets. Reportedly inserted in the bill over strong objections by the White House, the bonus restrictions suggest that the generally centrist Obama administration is unable to rein in the radical populist agenda in Congress. This bodes ominously for other critical economic policy initiatives in the pipeline, especially in the area of mortgage foreclosure relief.

Update to strategic view

US STOCKS, US FINANCIAL STOCKS: We are likely to test the November lows, with financials leading the downside, thanks to the last-minute inclusion of draconian executive compensation limits in the "stimulus" bill. The new rules are an unconscionable bait-and-switch on banks already participating in TARP, and they will likely have dire unintended consequences that will gut critical programs to restart frozen credit markets and support troubled firms. This reveals an out of control radical legislative agenda that has by-passed the more centrist White House, and it points to the risk of more harm as Congress turns next to foreclosure relief.

[see Investment Strategy Dashboard]

WHAT DOES THE NEW LAW DO? The Emergency Economic Stabilization Act (TARP) as enacted on October 14 did little but prohibit most "golden parachute" packages, which is one of the reasons we applauded it as equity-friendly (see "At Last: A Bail-out That's a Bail-out" October 14, 2008). The Treasury's revised rules released February 4 restricted salaries of senior executives of firms receiving "exceptional assistance" (such as AIG, Citibank and Bank of America) to compensation of $500 thousand/year other than restricted stock, with the amount of restricted stock unlimited -- and this only applied on a going-forward basis, not retroactively.

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

- The new law ***prohibits bonuses entirely*** for senior executives and other highly compensated employees of firms accepting TARP money, ***except for restricted stock, with a limit of no greater than one third of total compensation***.
- The number of highly compensated employees other than senior executives affected ***depends on the amount of TARP money involved***. For firms that have taken only small amounts, only the single most highly compensated employee would be affected. For those taking the most, it would apply to all senior executives and the twenty most highly compensated employees.
- The restriction ***applies to any firm that accesses TARP money***, not just those receiving "exceptional assistance."
- The restriction is ***retroactive***, applying to any firm that has accessed TARP money in the past, as well as going forward.
- The Treasury secretary is instructed to ***review bonuses prior to the October 2008 enactment of TARP, and negotiate for "reimbursement"*** of any deemed improper.
- An ***exception is made for bonuses paid under written employment contracts*** executed prior to February 11, 2009.
- Firms are ***permitted to pay TARP investments back at any time***, freeing themselves from the bonus restrictions, without the previous requirement to either wait three years or substitute new private capital.

WHAT'S WRONG WITH THE NEW LAW? The last two items above are significant loopholes, and indeed the even the first item could be skirted by increasing non-bonus compensation. So it could have been worse. Nevertheless, the new law undermines the partnership between the public and private sector, and unleashes important unintended consequences for the stabilization of banks and recovery of credit markets.

Key documents
Stimulus Section B, Title VII **EESA (TARP)** **Financial Stabilization Program** **Treasury comp guidelines** **TALF term sheet**
[Client Resources home]

- The ***restrictions risk a "brain drain"*** just when it's critically important to enlist the talents of the best and the brightest to rebuild troubled banks.
- By ***being retroactive, the bonus restrictions are an unconscionable bait-and-switch*** that penalizes the hundreds of banks that have already accessed TARP funds, most of which are healthy institutions who participated voluntarily.
- It will ***encourage banks to redeem TARP investments*** sooner than they would otherwise, ***sucking much-needed capital out of the banking system*** -- and ***leaving government with warrants, acquired by what amounts to fraud***.
- It will ***discourage market participants from using TALF***, which is partially funded by TARP money, thus ***retarding the recovery of the frozen securitization market***.
- The definition of "most highly compensated" is not specified in the legislative language, so ***potentially all bonuses would effectively be capped*** at the level of the least highly compensated executive nominally affected.
- By applying to individuals based on their compensation, not their actions, the bonus restriction likely ***punishes more those who performed well, and less those who performed poorly***.
- The exemption for executives with existing written employment contracts perversely ***rewards incumbents*** who are most likely to have gotten their firms into trouble, while ***putting the full burden on new executives recruited to help going forward***.
- The loophole for increasing non-bonus compensation ***destroys performance-based incentives***.

- The fact that the law was included in the "stimulus" bill over the strong objections of the Obama administration implies that ***the relatively centrist White House has lost control of economic policy to the radically populist Congress***, and that ***Tim Geithner has lost the moral authority required*** to influence the debate.
- This ***spooks the markets*** by returning to the bad old days of last fall, with ***government action being a source of risk and instability***, just when it should be acting as a source of assurance and stability.
- This will make it ***impossible for government to convince investors to participate in the "public/private partnership" to rehabilitate troubled assets*** called for last week under Geithner's Financial Stabilization Plan.

IS IT ALREADY DISCOUNTED BY THE MARKET? This is all very bad news for the stock market, especially as it signals the return of the equity-unfriendly approach to bank assistance that decimated the financial sector last September, and triggered the present global credit freeze and recession (see "Death by Rescue" November 17, 2008). It is of sufficient concern to us to have published this report on the Sunday of a three-day weekend so that clients can consider it, but given the how the details of the "stimulus" bill were made public, we can't be sure to what extent the new bonus restrictions have been processed by markets.

A version of it had been promoted by Senators Ron Wyden (D-OR) and Olympia Snowe (R-ME) for a couple weeks, and a week ago Friday it was included as an amendment to the Senate's version of the bill as the price for Republican Snowe's swing-vote. We think most market participants expected the Wyden-Snowe amendment to be stripped out of the House/Senate conference report, and indeed on the most recent Thursday there were reports that it had been. But then on Thursday night a variant version from Senator Chris Dodd (D-CT) was, in fact, included in the report, and it was available on the House web site most of Friday. But the final version, embodied as Title VII of Section B of the American Recovery and Reinvestment Act, was literally the last twelve pages of the 1071-page conference report. So we are prepared to believe that markets were not fully aware of it during Friday's trading session, and we are concerned that as awareness of it and of its implications spread, the reaction will not be good.

IS THERE A BENIGN INTERPRETATION? It's likely the Obama administration will do what it can to repair matters. This morning on "Meet the Press," top White House political advisor David Axelrod hinted along these lines, saying "we're going to have a dialogue with Chairman Dodd and… talk this through." That was a strong hint considering that Axelrod himself probably represents the administration's most anti-business impulses, and reportedly had lost out last week to the more moderate Geithner and Larry Summers when the Financial Stabilization Plan wasn't made more punitive to banks. But what can the White House do? Dodd waves away the key risk that his restrictions will drive away key talent, saying Friday that "The current job market should deter employees from leaving, and if they do, there are many qualified replacements." So with the law already enacted and Dodd unlikely to relent, the only option for the administration is to enforce the law as loosely as possible.

We recall that in the summer of 2002 stocks launched a substantial rally the moment the legislative process of Sarbanes Oxley concluded, apparently a sigh of relief that the risk of a bad law becoming even worse had passed. We'd like to think that such a thing could happen now, with the "stimulus" bill put to bed. But we doubt it, because in this case the risk has not passed -- this time, the legislative process is far from over. Very shortly the Obama administration and the Congress will turn to foreclosure relief, and there is the potential for considerable mischief in that -- especially in the area of mortgage "cramdowns" by bankruptcy judges, which could have profound negative consequences for mortgage-backed securities and the banks who hold them.

BOTTOM LINE: We are likely to test the November lows, with financials leading the downside, thanks to the last-minute inclusion of draconian executive compensation limits in the "stimulus" bill. The new rules are an unconscionable bait-and-switch on banks already participating in TARP, and they will likely have dire unintended consequences that will gut critical programs to restart frozen credit markets and support troubled firms. This reveals an out of control radical legislative agenda that has by-passed the more centrist White House, and it points to the risk of more harm as Congress turns next to foreclosure relief.