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AIG Employees – Taking the Rap

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It has been interesting to watch the AIG bonus issue play out from a political perspective. It has become apparent to me that many in the media are not interested in reporting the story truthfully but in twisting it to meet their rating needs. Much as the Boy Scout helping the old lady across the street is never the lead story but a homicide is, media finances dictate the way a story is presented. Once a story has been presented in this way and populist support has jumped on the bandwagon, politicians fight with each other to ride the lead horse no matter how immaterial the bonuses are relative to the overall bailout.

Bonus means different things to different people. Most earn bonuses at the end of the calendar year for positive results at their company. Others receive a bonus for a specific project, again to recognize a positive accomplishment. Retention bonuses are paid to keep employees when the employer knows there are other opportunities available and a specific need exists where that employee is needed until at least a certain date. Often times, when a company announces layoffs they will pay a retention bonus to specific employees if they have reporting duties to complete or other such tasks. At AIG my understanding is that the employees were paid $1 in regular wages and encouraged to stay through retention bonuses. If these bonuses are withdrawn or taxed away then these employees, who had nothing to do with the AIG problems in credit default swaps (CDS), will have worked for free. People who are complaining about these bonuses should put themselves in their shoes. Would you work for free? I wouldn't. I'm told these highly paid professionals are eagerly sought after by hedge funds and other entities. They will not stay unemployed for long. The public should be encouraging them to stay at AIG and help pay back the public loans, not drive them away.

Another issue is the retroactive consideration of punitive tax law and breaking of contracts. This would set a horrible precedent and discourage highly paid workers from participating. Jonathan Clements wrote a great article in the WSJ that, since he now works at Citi setting up a consumer based website, his incentive to earn above a certain amount in any calendar year was about zero.

More on AIG

It looks more and more like AIG was "saved", at least temporarily, so that certain firms would receive their CDS payments. When contracts with Goldman Sachs, and perhaps others, mature it will be interesting to see if the government then allows them to go through bankruptcy. Why have these payments been paid at 100 cents on the dollar? Where is the counterparty risk that these contracts are supposed to have? Are any of the counterparties refusing to accept the money? I bet not.

Mark to Market Accounting

When will people realize that the accounting method does not drive value? As a solvency metric it should be incorporated in capital requirements but not be used to determine annual income. An untold story is that the US previously utilized MTM accounting. Why hasn't anyone written that up so we can make our own decisions?

Principle-based approaches are procyclical, adding more capital when times are bad. Prior exposure based (or rules based) approaches generally offset the risk by reducing capital, for example when mortality is high.

Systemic Regulator

Can this idea really work? I can't visualize a politician who will not allow this regulator to become the protector of his/her domain, much as OFHEO did with Fannie Mae and Freddie Mac. Lobbying dollars will end up ruling, with perceived government guarantees for a wide range of financial entities. Is this a step toward a true meltdown of the US financial system as everyone and everything is guaranteed?

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