Despite outrage, AIG bonus fiasco could happen again

Reuters
By Pedro Nicolaci da Costa
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WASHINGTON - To many Americans, it's a matter of common sense: traders who failed so spectacularly at their jobs that they nearly brought down the global economy should be fired, not rewarded with handsome bonuses.

Yet AIG, the fallen insurer, paid out an additional $100 million this month, much of it to the very financial products division whose rampant risk-taking took the firm to the brink. And there's another $75 million coming.

So far, the government has yet to enact concrete steps to prevent it from happening all over again.

Regulators still lack the authority to wind down large financial firms, and the private sector continues to use compensation contracts that preclude renegotiation when performance sours.

Treasury Secretary Timothy Geithner has called on Congress to pass a tax on financial institutions, which he says could be used to help recoup the money.

But experts say this approach ignores a key lesson from the crisis: the need to ensure that contracts for executive pay are written in such a way that encourages prudent behavior and accountability, not unabashed risk-taking.

"All pay plans should require checks and balances, including the use of 'circuit breakers' which prohibit any payments when the company is in a financial crisis or similar problem situation -- i.e. AIG and most of Wall Street," said Paul Dorf, a managing director at consulting firm Compensation Resources.

Many analysts say such restrictions, sometimes known as clawbacks, should extend well beyond finance, pointing to scandals at firms like Enron and Worldcom.

Geithner, and pay czar Kenneth Feinberg, say that while lamentable, the AIG payments must legally be honored. President Barack Obama has argued that high executive pay is a natural outcome of the "free market."

This explanation doesn't sit well with many Americans, who are upset at what they see as an unfair system that rewards incompetence.

And then there is the staggering price tag: the AIG bailout, which gave the government a 79.9 percent stake in the firm, cost some $182 billion -- enough to employ more than 12 million minimum wage workers for a full year.

"I just don't think it's right," said Tom Harpenau, president of a meat company in Iowa. "In any business, if you own 51 percent or more, you make the rules."

While executive pay tends to be far higher in the United States than in other rich nations, European governments have taken a tougher stance. Britain has announced a 50 percent levy on large bank bonuses and France appears to be moving in a similar direction.

Clawbacks, With Teeth

In AIG's case, remuneration contracts were written in a way that largely blocks any sort of legal dispute after the fact.

That does not mean, however, that the policymakers who drafted the bailouts, including top officials at the Treasury and the Federal Reserve, could not have done more to prevent AIG's top brass from getting paid.

Geithner, who was then head of the New York Federal Reserve Bank, played an important role in the negotiations and has come under fire for a decision to pay out AIG's creditors in full when it came time to settle its dangerously complex credit derivative contracts. Geithner has maintained he played no role in the decision on creditor payments.

Legal and compensation experts say top government officials, including then-Treasury Secretary Henry Paulson, also the former head of Goldman Sachs, could have attached more strings to bailout cash from the Treasury's $700 billion financial rescue fund.

"The legislation actually made it easier to pay these bonuses out," said Miriam Cherry, a law professor and compensation expert at University of the Pacific's McGeorge School of Law in Sacramento, California.

The Treasury could at least have stalled the payments by forcing the executives to sue for their bonuses in court, said Cherry, the law professor.

"They could have made the executives do the work. They could have made the executives have to sue to get those bonuses," she said. "They didn't negotiate that and that's problematic. They thought it would fall under the radar screen."

Not even contracts that include clawbacks are foolproof. For them to be effective, regulators must ensure that they are not only widely used but also adequately constructed.

"Many financial firms have already announced they will be using clawbacks going forward, but unfortunately they have not given outsiders the ability to assess whether the clawbacks are effective or merely cosmetic," said Lucian Bebchuk, a professor at Harvard Law School and a leading expert on the subject of compensation. "The devil is in the details."

The best way to make sure pay is commensurate with effort is to draft contracts that truly reward long-term contributions.

"Incentives are more effective than bonuses, since the former requires identification of expectations -- what are the goals to be achieved, what activities and actions are prohibited," said Compensation Resources' Dorf.

(Reporting by Pedro Nicolaci da Costa; Editing by Dan Grebler)