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On Leadership

LEGAL SCHOLAR
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THE QUESTION

AIG-gate: Obama's Leadership Moment?

With Congress now on the verge of taxing away Wall Street bonuses, the mounting outrage over AIG's bonuses and other perceived wrongdoing by bailout recipients threatens to undermine the government's efforts to lure private capital back into the banking system. Is this an opportunity for the new president to show his leadership mettle by opposing the tax and trying to cool the rhetoric, notwithstanding the political risks?

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Pitchfork Populism

Finding a new balance between public regulation and private decision-making is a paramount issue of the time. The crisis in capitalism stems from the systemic failures of business judgment in the financial sector which have caused the credit and solvency crises and led the world to the brink of depression. It is now a commonplace that 30 years of financial deregulation has come to an end.

There is a new consensus on the need for sensible public policy to deal with the causes of private excess and to ensure the safety and soundness of the financial sector going forward -- to reconstruct the basic foundation of the world economy by finding a proper new balance between public and private decision-making. Numerous reports have been published both in Europe and the U.S. on regulatory visions of the way forward. This week the Obama administration will unveil its financial re-regulation proposals (as well as new ideas on how to deal with the "effects" of the melt-down -- the toxic assets which pollute banks' balance sheets).

But, lurking behind the consensus, along all points on the political spectrum, is the concern that regulation has problems too. High among those is recognition that decisions in the public sector can often be driven by irrational politics rather than sensible policy -- by passions

expressing the feelings of the moment, unmoored from sound judgment, which mirror the passions like greed and corruption that have hobbled the private sector.

The AIG bonuses are a microcosm of the problem. The Financial Products Group made terrible mistakes that had enormous, adverse multiplier effects. As financial conditions worsened, any incentive pay should have been carefully tied to positive results. Once those conditions turned into financial disaster and virtual government takeover, AIG and the administration should never have let the bonus money out the door -- their justifications of legality and retention were not credible in the narrow case of the senior employees at the Group. Predictably, the actual payments have fanned flames of public outrage.

But the House bill, imposing a 90 percent tax on all 2009 bonuses for all TARP companies receiving government funds of more than $5 billion is nonsensical as a matter of policy (putting aside questions about constitutionality).

Leadership is about defining problems correctly. If they measure real contribution to an enterprise over time -- real performance with integrity and sound risk management -- phased bonuses are an important incentive, not bad per se. This can be especially important going forward as we seek to repair financial institutions. The blunderbuss House bill has any number of bad impacts: failing to recognize the value of good bonuses; driving people out of financial services; driving companies out of government programs.

Most importantly, the House bill undermines the credibility of public regulation and the importance of sound policy responses to the crisis. It is pitchfork populism -- exactly what thoughtful people fear.

I believe deeply that terrible executive compensation systems were the rocket fuel that drove the financial sector to disastrous excess. And the public is rightly outraged about past pay practices and amounts. But finding the right future balance between government regulation of executive pay to ensure safety and soundness and private sector incentives for sensible innovation and wealth creation is one of the hardest problems at the core of the new re-regulation consensus. Driving talented, blameless people away from regulated entities cannot be the right result.

President Obama (and the Senate) must reject the House bill and go back to the more thoughtful executive compensation proposals he announced a month ago, which invites a sensible, future dialogue between government regulators and affected corporations. Past failures should be handled and explained sensibly case-by-case for individuals responsible for failure, not mishandled as with AIG Financial Products Group leaders. (And, when passions abate, a Dodd amendment to the stimulus bill that arbitrarily limits bonuses also needs to be modified.)

Nothing less than the credibility of public regulation is at stake, with implications far beyond current anger over executive pay as the watershed re-regulation debate begins in earnest.

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