

**Market Update – March 22, 2009 -- AIG**

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## **AIG: What Does This Say About Our Country?**

This week, the country's wrath has come down on AIG. Americans have been furious to find out that our bailout money has gone to pay bonuses to many of the individuals who were responsible for AIG's derivative strategies. Even Fed Chairman Bernanke has said that AIG is the one company that has really made him mad – he was angry that AIG used their balance sheet to support a hedge fund overlay.

In reviewing this week's news about AIG, there are **three key issues** that were raised:

1. the government bailout of AIG resulted in payments to a group of other financial institutions (some of which were foreign);
2. AIG has paid \$165 million of bonuses to the employees of the division that caused the majority of AIG's losses; and
3. The House of Representatives has passed a bill which would tax many of these bonuses at 90%.

After a brief review of some facts, I will address these three issues.

## Background: Key Facts About AIG

1. 80% owned by US (taxpayers)
2. AIG lost \$99.3 billion in 2008
  - a. Q4 loss was \$61.7 billion
  - b. the Financial Products business unit lost \$40.5 billion last year
3. has received \$173.3 billion in taxpayer aid (four bailouts)
  - a. approximately 2/3 (~\$120 billion) of aid has been paid out to trading partners (banks and municipalities)
    - i. \$52 billion from AIG Financial Products Unit
      1. bets on mortgage assets
    - ii. \$43.7 billion to repay banks and brokers
      1. customers of AIG's securities lending business
    - iii. \$24 billion in Fed money that was used to buy mortgage-linked securities that AIG insured
      1. allowed insurance contracts to be terminated
4. \$619 million in bonus / retention payments to employees
  - a. \$165 million of this was paid in the past week
    - i. President Obama said he would do everything possible to recover this.
      1. later he said that legal fight would cost more than recovery
  - b. \$121.5 million to be paid later this month for 2008 incentive bonuses
    - i. 6,400 of 116,000 employees
5. while some people feel that Citi and BAC are starting to improve, AIG just seems to get worse
6. there is still a lot of risk with AIG:
  - a. AIG's derivative exposure is \$1.6 trillion
    - i. was \$2.7 trillion last year
    - ii. credit default swap exposure is \$302 billion
      1. was \$433 billion last year
    - iii. still have \$12 billion of exposure to credit insurance on subprime mortgages

### *One More Scary Thought*

Thomas Gober, a former state insurance examiner who specializes in detecting fraud, believes that AIG's insurance business also has problems. He claims that AIG's 71 subsidiaries are providing reinsurance to each other. He says that if we had a federal insurance regulator who looked at the whole company, they would recognize these problems. I don't know if this is right or wrong. But it's scary to think that "the healthy" part of their business might not be healthy. Some have referred to this as "regulatory arbitrage" where there is not an umbrella regulator.

## **ISSUE #1: The Bailout Money Was Transferred to Other Financial Institutions (Some of Which are Foreign Entities)**

There has been outrage in the popular press concerning the fact that our government's AIG bailout money was simply transferred to banks. It turns out that approximately 2/3 of the \$173.3 billion of bailout money went to banks (some overseas), counterparties and municipalities.

I have several thoughts about this outrage:

1. **We're a nation of morons.** When you bail out an insurance company, who do you think you're rescuing? You're rescuing the people who bought insurance policies. In this case, the insurance buyers were banks, municipalities, etc. This shouldn't have been a surprise to anyone.
2. **Implying that we should not be bailing out foreign counterparties makes no sense.** What should we have done – honor some contracts and not others? We continue to see an alarming amount of protectionist rhetoric. Don't forget that we were the ones who really created these problems. Shocking as it may be, other countries don't love us right now.
3. **This is the meaning of systemic risk.** When you have one financial institution (AIG) that is insuring all other banks and financial institutions, you can't let AIG fail. AIG's failure would have caused large write-downs at many other financial institutions. Once our regulatory oversight failed and allowed AIG to create this risk, the result was that our government had to bail out everyone. In effect, we're seeing the cost of poor regulation.
4. **The real outrage is that AIG compensated these counterparties at 100 cents on the dollar.** If AIG had failed, these counterparties would have been general creditors and they would have hardly recovered anything. Instead of rushing into this bailout, we should have negotiated settlements with these companies.
5. **The financial institutions that dealt with AIG clearly did not assess counterparty risk.** This is a tremendous part of conducting swap transactions. The one company which may have correctly assessed counterparty risk is Goldman Sachs. GS has indicated that they wouldn't have incurred any losses if AIG had failed. The implication is that GS had some sort of short position on AIG and has greatly profited from AIG's troubles and the bailout. (GS won from all sides – their short position paid off and the government bailed out AIG.)
6. **The failure to negotiate settlements with these counterparties may reflect poorly on CEO Liddy.** I'll discuss Liddy in the next section, but he has not done anything to evidence a hard-nosed negotiator. He appears to be more of a custodian. He could have threatened bankruptcy and received a better deal from the counterparties.

7. **It took an inordinate amount of time to learn the identity of the counterparties.** Many believe that this was Treasury Secretary Paulson protecting his former firm, GS. From the original \$85 billion bailout, GS received \$12.9 billion. (On a related note, GS is involved throughout this story: Robert Rubin (GS) pushed deregulation as Clinton's Treasury Secretary. Paulson (GS) pushed AIG's bailout after letting Lehman fail. When Geithner (as NY Fed President) called a meeting to discuss AIG, GS's CEO (Lloyd Blankfein) was the only CEO invited. AIG's replacement CEO (Liddy) was a director at GS.)
  
8. **These counterparties and their CEOs have lost the right to claim that they didn't need their direct government bailout.** The AIG bailout was an indirect bailout of these companies. If a bank was a counterparty to AIG, they received a government bailout. I'm particularly tired of hearing Ken Lewis talk about how BAC didn't need much help. I wish Kenny would tell me how BAC would have done without this AIG bailout. Of course, he's probably busy looking for his next acquisition target.

**ISSUE #2: AIG has paid \$165 million in bonuses in the past week and this is only part of \$619 million of bonuses being paid. Much of this bonus / retention money is being paid to employees in AIG's Financial Products division – the part of the company that caused great losses and systemic risk.**

These bonuses have been on the cover of virtually every newspaper during the past week. There's a sick realization that bailout money is simply being transferred to traders. The question has arisen as to whether these bonuses should have been paid.

*A Few Disturbing Bonus / Retention Facts (from NY Atty Gen'l Andrew Cuomo's Letter to Barney Frank)*

1. After AIG lost \$99.3 in 2008, seven employees received at least \$4 million (one received \$6.4 million).
2. The top ten recipients received \$42 million.
3. The top 22 recipients received \$2 million or more, for a total of \$72 million.
4. The top 73 recipients received \$1 million or more.
5. Eleven of the individuals who received retention bonuses of \$1 million or more are no longer working at AIG, including one who received \$4.6 million.
6. Most bonuses had a provision that required the 2008 bonus to be at least 100% of 2007's bonus.
7. AIG committed to these bonuses in Q1 2008.

As a result of the uproar (and the taxation issue discussed in Issue 3, later in this paper), many employees are going to return their bonus. They must let management know by 5 PM. I will be surprised if any of them don't do this.

In addition, a group of 19 attorneys general is launching an investigation into the bonuses.

There has been much debate as to whether these bonuses should have been honored. Below, I have provided a list of the main arguments.

Arguments in Favor of Paying the Bonuses

- A. **The employees have a contract and our legal system is dependent upon parties honoring contracts.** If we start to create disbelief in the enforcement of contracts, we will have greater problems with long term planning (contracting) and we will always fear that contracts can be revised by the government.
- B. **We need these employees to stay at AIG because they built this bomb and they are the only ones who know how to defuse it.** These are the best people to unwind these positions at the lowest cost.
- C. **These employees are in demand and will leave if they are not compensated at AIG.** This will diminish the viability of AIG and increase the taxpayers' losses.
- D. **CEO Edward Liddy has said that changing these bonuses might make it difficult to attract "the best and the brightest."**
- E. **The majority of these employees did not do anything wrong.**
- F. **Paying the bonuses will avoid a costly lawsuit.** AIG has said that the bonuses must be paid under the Connecticut Wage Act. Under this law, if the bonuses are not paid, AIG could be liable for the legal costs of employees who sue to recover their bonuses as well as penalties equal to two times the bonuses.
- G. **Banks will be unable to raise private capital in the future if investors believe that the government can change the rules.** This will impact the public-private partnership that Geithner plans to use to get the toxic assets off the banks' balance sheets.
- H. **If we don't honor these contracts, the US will continue to lose our moral authority.** We are losing our ability to discourage other countries from repudiating their debt or nationalizing assets. There is really no difference between these acts and what we are doing.

Arguments Against Paying the Bonuses

- A. **Emotionally, there is something offensive about paying a bonus to employees of a company that would be in bankruptcy but for the fact that they created systemic risk.** If AIG filed for bankruptcy, these bonuses would not have been paid. The employees would have been unsecured creditors.
- B. **We are paying bonuses to people who lost money, destroyed value for shareholders and almost brought down our financial system.**
- C. **We have no problem forcing auto workers to re-negotiate their contracts.** Similarly, we are going to allow judges to change mortgage contracts. Yet, we seem unable to do this with white collar workers.
- D. **These bonuses were designed as a “fraudulent conveyance.”** In bankruptcy, a judge can rescind contracts in which a company tries to convey assets to individuals in order to keep those assets away from creditors.
- E. **All employees have counterparty risk.** If the University of Texas closes or comes upon hard times, I know that I can be terminated. How were these AIG employees able to avoid this counterparty risk?

## Thoughts About the “Contract” Argument

1. **It’s hard to argue with the idea that we need to honor contracts or that we are losing our moral authority.** We take our legal system for granted because we have never known anything different. Creating distrust will have great costs down the road.
2. **It’s hard to estimate whether the loss of confidence in contracts is more significant than the loss of trust in our financial system and our bailouts.** Most likely, people will still be willing to contract. I’m not so sure that they will be willing to support further bailouts.
3. **The Administration had included a TARP provision that exempted pre-existing legal agreements from the bill’s limits on compensation.** There’s a reason they did this – it makes sense in an orderly society. Senator Dodd is being blamed for allowing this provision and may lose his re-election bid. It’s ironic to think that he may be the big Connecticut loser in this deal.
4. **If AIG had been forced into bankruptcy, these employees would have been unsecured creditors and would not have received anything.** This is why it’s difficult to swallow the fact that they are receiving this money.
5. **We’re willing to break contracts with the UAW and we’re ready to change the law concerning mortgage modifications in bankruptcy.** Finding a way to terminate these bonuses is just another step to the breakdown in our legal system.
6. **AIG’s response that these are legal contracts and they can’t be broken is really astounding to me.** I was under the impression that the competitive advantage of insurance companies was their ability to not make payments that they are legally obligated to make. Go figure.
7. **AIG actually negotiated with these employees and the result was that many employees accepted a lower salary in 2009 in exchange for their retention bonus.** Once that was done, it’s hard to accept that these contracts couldn’t be amended.

## Thoughts About the “Important Employee” Arguments

1. **The idea that these traders are so talented that everyone wants them is a myth.** They’ve lost billions of dollars. The reality is that hedge funds want to understand AIG’s trading book so that they can figure out how to profit from it. In effect, these bonuses are hush money. Of course, it’s a sick world when an individual can cause tremendous losses and then hold a gun to their employer’s head, effectively saying, “either pay me a million dollar bonus or I’ll share your secrets with another entity and cause you even greater losses.”
2. **Liddy’s comments that we need to attract and retain “the best and brightest” is offensive.** People who caused these losses are not the best and brightest. We have a warped system where people trading derivatives and causing tremendous losses are considered the best and brightest and they make tremendous multiples of what doctors and scientists earn. As I’ve said before, when people keep repeating something (e.g., we’re the best and brightest and deserve this compensation), people start believing it.
3. **Interestingly, Liddy also called the payments “distasteful” and said that he would have never entered into these agreements.** Which one is it: are the bonuses necessary to keep the best and brightest or are they something AIG should have never entered into?
4. **It might not be that difficult to replace the best and brightest at a lower cost.** Many of the best and brightest from Bear Stearns, Lehman, Merrill Lynch, Fannie Mae, Freddie Mac, Wachovia, Washington Mutual and Countrywide are looking for jobs. Many have relevant experience in losing money, destroying shareholder value and believing that they are still entitled to huge bonuses.
5. **The real problem is that most of us do not fundamentally believe that these employees are worth this much money.** The same goes for the majority of workers in the financial industry. I don’t doubt the intelligence of these people. They really are smart. But a lot of people are smart and we over-value this group’s contribution to our society.
6. **These contracts highlight Wall Street’s tendency to talk about deals to maximize shareholder value while running their own business to enrich employees.**
7. **AIG’s unwillingness to provide names of bonus recipients makes it impossible to determine whether these people are truly necessary to wind down the business.**

## Thoughts About Political Issues

1. **This entire incident serves as evidence that the government is not competent to run a business.** The time to renegotiate these bonuses was **BEFORE** the bailout. If AIG had gone bankrupt, the bonus contracts would have been worthless. The government forced CEO Robert Willunstad to step down; we could certainly have forced these contracts to be rescinded.
2. **Is this what we want the Administration to be focused on right now?** The Administration has led the charge against these bonuses. Is this getting us closer to or further from a solution? Do you want the Administration spending time on a \$165 million issue when we have a multi-TRILLION dollar problem going on? This would be like me pondering bankruptcy and spending a week trying to recover \$1 that I was overcharged in a restaurant.
3. **The Administration has lost the opportunity to appear as the reasoned thinkers in this chaos.** They would have been much better off saying, “these bonuses are outrageous and people should be shamed into waiving their right to these bonuses; but, we’re a nation of laws and we made a mistake in not negotiating these contracts away from these scoundrels. We will not lower ourselves to their level and disrespect our legal system.” Instead, the Administration reacted emotionally and have lessened their authority.
4. **Maybe it was the Administration’s goal to turn the heat up on AIG.** People have stopped talking about the stimulus package and TARP. I think that this is shortsighted, but it’s a possibility.
5. **It is going to be virtually impossible to get further bailout funding from Congress.** If you believe that, then you believe that this AIG bonus issue has created tremendous risk for the world’s economy.
6. **We’re seeing what happens when the government rushes in to do a bailout.** There’s too much to understand in a short time period. (Ask Ken Lewis about doing an acquisition in just two days.)
7. **Congress called in the wrong people to testify.** They should have called in Hank Greenberg (long time CEO of AIG) – who I’m absolutely sick of. He’s Mr. “Everything Fell Apart After I Left.” There’s no responsibility for the actions he took, pushing AIG into the credit default swap market. Congress should have called in AIG’s directors. They should have called in the people who were responsible for writing these bonus contracts. Then, Congress could have called in any AIG employee who did not waive his / her right to their bonus and inquired as to why they feel that they are entitled to these payments.

8. **The Justice Department could have launched an investigation into the participants of this bonus plan.** This would have received less attention than the approach we've used and may have been healthier in the long term (although the threat of criminal prosecution is extremely heavy handed).
9. **The big winner in this incident is NY Attorney General Andrew Cuomo.** He has brought many of the problems to light and has been supplying information to the federal government. He's the new Eliot Spitzer (without the prostitutes).
10. **Geithner is one of the big losers in this incident.** Last Sunday, he said that lawyers informed him that he couldn't stop the payments. The next day, the President told him to do everything he could to block these payments. He's in (arguably) one of the most important jobs in the world right now, and the Administration is helping him to look like a buffoon.

**In Geithner's defense, his department is understaffed and he has a tremendous amount going on:** he's working on the toxic assets (in the banks), reviving securitized lending, developing a new regulatory system, creating a mortgage bailout program, overseeing the auto industry, etc. Regardless, unless something changes, he could be pushed out in the not-so-distant future.

11. **One of the reasons that Geithner was selected for the Treasury position was consistency – he had been NY Fed President and had been involved in a lot of deals that had been taking place.** Now, people are blaming him for being involved in the original AIG bailouts. It may be that his earlier involvement is going to hurt him.

### **Thoughts on Edward M. Liddy**

I'm sick of hearing that Edward M. Liddy (AIG's CEO) didn't cause the problems; he just stepped in to take over. Back when I was a prosecutor, I saw two types of defense attorneys, scummy ones and scummier ones. No, actually I saw defense attorneys who vigorously defended their clients and others who tried to separate themselves from their clients. Those who vigorously defended their clients were the ones that I respected.

All Liddy cares about is being seen as a white knight. This week, Liddy wrote in The Washington Post, "**When I answered the call for help** and joined AIG in September 2008..." He also said, "so, **of our own initiative, we suspended our federal lobbying activities and halted corporate political contributions.** We also restricted executive compensation. In all, total 2008 compensation for the top 47 executives is 56% lower than their total 2007 compensation. **My annual salary is \$1. My only stake is my reputation.**" Wow! You stopped AIG's federal lobbying...in other words, you stopped using the government's money to influence the government. Your nobility overwhelms me.

Liddy is being paid \$1 per year. I think he's being overpaid.

## **A Few Random Thoughts on the Bonuses**

1. **The bonus issue is further evidence that we live in a country of morons and the media and politicians know it.** People don't understand the bailouts or the events that caused our financial crisis. But anyone can understand that some bonuses are being paid to people who caused problems. We latch on to this issue because it's simple.
2. **This \$165 million is .1% of our AIG bailout.** We have a ton more at risk than this amount. It just makes us mad that some people are being wrong enriched.
3. **The nation's love affair with stocks and increased participation in the stock market results in people caring much more about this type of incident.**
4. **At least we didn't hear the absurd comment that the bonuses were paid with "non-bailout funds."** Of course, maybe thought leader Erin Burnett could explain her "two piles of money" theory to us. She's on CNBC and can read a teleprompter, so she must be smart...
5. **On Saturday, there were people who rode a bus to go to AIG employees' homes to protest. If you thought this was a good idea, you have serious issues.** Would you have said something to these people if you were alone? When you get to the house, may you could also yell at their kids while you're there.

### **ISSUE #3: The House of Representatives has passed a bill which would impose a 90% tax on the AIG bonuses.**

More specifically, the House's bill would impose a 90% surtax on bonuses granted to employees with household income of more than \$250,000 at companies that received at least \$5 billion from the government's financial rescue program. The measure passed by a 328-93 vote. The tax would be retroactive to December 31, 2008. The Senate is comparing a somewhat similar bill.

This bill is consistent with growing American sentiment to impose greater taxes on the wealthy. A Gallup poll showed that 51% of Americans believe that we should impose heavier taxes on the wealthy. This number was 49% in 2007 and 45% in 1998.

Currently, this bill would affect:

Citigroup  
JP Morgan Chase  
Wells Fargo  
Bank of America  
Goldman Sachs  
Merrill Lynch  
Morgan Stanley  
PNC Financial Services  
US Bancorp  
AIG  
General Motors  
GMAC

Some thoughts about this:

1. **This sounds very similar to passing a law making an earlier "legal act" illegal.** While taxation is not a criminal issue, the rationale is the same: when the government can change the rules in order to send unpopular citizens to jail or to impose a financial penalty on an unpopular group, we no longer live in a society in which we can trust the laws or plan ahead.
2. **Institutions could avoid this tax by repaying the government.** Several banks have either applied to make early repayment or are considering this. The problem is that early repayment could result in banks that are undercapitalized. In effect, the result is a less stable banking system.
3. **These new rules are going to make it more difficult to implement the public-private partnership that is being considered in order to get toxic assets off of banks' balance sheets.** Hedge funds and private equity firms are already scared of participating in these deals. There is a feeling that if the investors earn returns that are too high, the government will try to clawback these profits. Many funds have already withdrawn their applications for

other reasons (confusion about the contracts, fear that participation would result in increased regulation, etc.).

4. **The speed with which this bill has been written and passed is alarming.** It's hard to believe that this bill is well thought out or has considered unintended consequences. What do you believe was more important: thoughtful consideration or speed? (The only consequence that lawmakers are considering is that it will look bad during the next election if they stood in the way of the lynch mob.) This bill reeks of anger and populism. There's a saying that bad facts result in bad laws – and that's what we have here.
5. **As an example of the crappiness of this bill, consider this example.** The bonus is taxable if your AGI is above \$250K. Imagine two married couples. The two men work at AIG and make \$150K in salary and \$90K in bonus. One has a wife that stays home with the kids and does not have outside income. They will not pay any tax on the bonus. The second husband has a wife that works. She makes \$100K. His entire bonus will be taxed at 90%. Does this make sense?
6. **This bill may continue to destabilize our financial system and our markets.** Our markets need confidence that our banks will stabilize and recover. There is no way that any rational employee would stay at one of the firms that can't pay bonuses. Towards the end of the week, the bailout firms were down close to 14%, while the non-bailout firms had hardly dropped. Clearly, the market believes that the new bill has made the bailout firms less valuable than comparable firms.
7. **The government may have reduced the chance that we will recover money from the banks we bailed out.** If we see talent leave these firms, the ability of these firms to stay in business may be called into question.
8. **Ironically, the Merrill Lynch bonuses, which started the bonus backlash, would not be taxed under the House bill.** They were paid before December 31, 2008.

My view on this taxation issue...these bonuses anger me. As discussed in the previous discussion of Issue #2 (in this paper), many of these individuals were responsible for some of the system's financial distress. They put AIG at risk and AIG put the system at risk. They certainly don't deserve a bonus for this.

I personally believe that virtually all of them will return their bonus. They will not want to testify and they will be scared of future problems as well as the taxation. Congress can say that they won. BUT, regardless of what happens, this bill was a big mistake. We continue to behave like a third world country that does not have the protection of a stable legal system.

One of the things that you have to accept in life is that sometimes you are in a lose-lose situation (Jenny refers to this as marriage). I'll give you a small example...one time I received a small tax bill from the state of NY. I don't remember the amount, but it was probably somewhere around \$20. The state was wrong, but it would have taken me a significant amount of time to write a letter explaining their mistake. I took out my checkbook, wrote the check and moved on. (Of course, the fact that I'm still telling this story is evidence of my bitterness...)

Similarly, think of buying a crappy car and then being gouged at the dealership to repair it – that's not fair. Right now, we're in a situation that's not fair – some people are being wrongly enriched at our expense. But, at the end of the day, destroying the stability of our legal system is not the answer. We have to accept that part of life is that sometimes you just get screwed. Get over it and move on. Most importantly, don't let it happen again.