12-5-2013

# Annals of Crony Capitalism: Revisiting the AIG Bailout

Malcom S. Salter

HARVARD UNIVERSITY
Edmond J. Safra Center for Ethics

# Annals of Crony Capitalism:

## Revisiting the AIG Bailout

Malcolm S. Salter

Senior Faculty Associate, Edmond J. Safra Center for Ethics

James J. Hill Professor of Business Administration, *Emeritus*,
Harvard University

Edmond J. Safra Working Papers, No. 32
http://www.ethics.harvard.edu/lab

December 5, 2013

Research in Action
WORKING PAPER

*About this Working Paper Series: In 2010, Lawrence Lessig launched the Edmond J. Safra Research Lab, a major initiative designed to address fundamental problems of ethics in a way that is of practical benefit to institutions of government and society around the world. As its first undertaking, The Edmond J. Safra Research Lab is tackling the problem of Institutional Corruption. On March 15, 2013, this Working Paper series was created to foster critical resistance and reflection on the subject of Institutional Corruption. http://www.ethics.harvard.edu/lab*

*Annals of Crony Capitalism: Revisiting the AIG Bailout*

by Malcolm S. Salter
Edmond J. Safra Research Lab Working Papers, No. 32
Harvard University
124 Mount Auburn Street, Suite 520N, Cambridge, MA 02138

## Abstract

Cronyism may well be an intensifying problem in contemporary American capitalism, but an incorrect identification and labeling of crony capitalism subverts meaningful reform. Five years after considerable financial assistance was provided to the American International Group by the New York Federal Reserve Bank and the U.S. Treasury, the AIG bailout story remains highly controversial as a putative case of capitalism gone bad—crony capitalism at its worst. This paper reviews the record surrounding the AIG bankruptcy and argues that the bailout decision and the subsequent structure of the bailout tell a much different story than the one characterized as "crony capitalism." Based on a close reading of this record, the story I tell is that the lingering controversies over the bailout are not a result of the corrupt behavior of Federal Reserve and Treasury officials. Rather, they are the result of impromptu and highly improvised risk management by government officials who had no clear regulatory authority over failing investment banks and insurance companies—like Bear Stearns, Lehman Brothers, and AIG—and who were conditioned by their professional training and current responsibilities to focus on the worst-case scenarios following the collapse of large financial institutions holding fast-depreciating real estate assets. Operating under severe time constraints and existential anxiety, mistakes and missteps were made by the New York Fed in its unfamiliar role as the chief restructuring officer of AIG. But this is far different story than calculated corruption benefitting large domestic and foreign banks vulnerable to an AIG collapse.

This essay is a cautionary tale about exaggerated (and false) claims of institutional corruption in the public and private sectors. We are currently witnessing a sufficient number of cases of both unlawful and lawful-but-corrupt behavior to motivate a debate about meaningful reforms. Inaccurate characterizations of institutional and individual behavior can only serve to contaminate this important conversation.

Keywords: institutional corruption, crony capitalism, business-government relations, the AIG bailout, decision-making under uncertainty, risk management

# Table of Contents

# I. Why Revisit the AIG Bailout?

How we tell stories matters. If, for example, we tell the AIG bailout story as an example of corruption—of collusion between business and government, of crony capitalism at its worst—we wring our hands about how best to reverse the declining legitimacy of 21$^{st}$-century capitalism. And we write more rules and regulations, offer stiffer punishments for violations, and beg for more attentive oversight.

If, however, we tell the AIG bailout story as an example of risk management by the Federal Reserve Bank and the U.S. Treasury under conditions of existential anxiety about the chances of a global credit market collapse, then our attention shifts to the sources of these anxieties, and the ways in which we can better manage our way through such uncertainties and fears when trying to avoid a potentially calamitous situation.

The implications of the first telling are largely regulatory and legal. The implications of the second telling are largely managerial and psychological.

Five years after considerable financial assistance was provided to the American International Group by the New York Federal Reserve Bank (NYFRB) and the U.S. Treasury, the AIG bailout story remains highly controversial as a case of capitalism-gone-bad. But what is the "true" AIG bailout story? And why is this story still so controversial?

The story being reviewed and retold here is about the rescue of AIG by the U.S. government. It is not a story about the mistakes and missteps of AIG executives leading up to its rescue. It is not a story about the blunders and corruptions of AIG's counterparties in insurance and securities transactions—principally investment banks who faced possible extinction if AIG collapsed. It is not a story about the "worthiness" of any of the financial institutions receiving bailout monies (as difficult as it is to ignore). Rather, the story examined here relates to the decisions and actions of Federal Reserve and Treasury officials, who had limited legal authority over, but full political accountability for, the security and continued functioning of the nation's credit markets.

What this retelling suggests is that the risk management story—with all its warts—is far closer to the truth than the crony capitalism story. Using the metaphor of detective stories, the staging of the AIG bailout may have the superficial look of a crime scene, but what is the crime? Or more literally, the AIG bailout may look like crony capitalism, but what is the evidence of purposeful favoritism?

## A History of Controversy about Cronyism

Controversy over the bailout was present from its earliest days, starting in September 2008 when many sitting members of Congress, along with other non-interventionists, raised their voices against the initial plan put in place by the New York Federal Reserve Bank, in consultation with the U.S. Treasury.[1] These early critics saw the bailout as an inexcusable breach of market discipline. Complaints about the appropriateness of an AIG bailout were subsequently reinforced by a comprehensive report on the bailout prepared by the Congressional Oversight Panel (COP) and released on June 10, 2010. The bi-partisan COP had been empanelled after the Congress passed the Emergency Economic Stabilization Act of 2008. Its mandate was to "review the current state of financial markets and the regulatory system" and to oversee the implementation of the recently enacted Troubled Asset Relief Program (TARP).[2]

Like most early critics, the COP thought the government had inappropriately put U.S. taxpayers (and TARP monies) on the line for the full cost and full risk of rescuing a failing company. In doing so, the Panel complained that the government had distorted the marketplace by transforming highly risky derivative bets into fully guaranteed payment obligations. The COP also rejected the government's argument that the nation faced the all-or-nothing, "binary choice" of either allowing AIG to fail or rescuing the entire institution. The Panel argued that there were other options for dealing with AIG involving the private sector, even though "orchestrating a private rescue in whole or in part would have been a difficult—perhaps impossible—task." In other words, there were conceptual alternatives to a

---

[1] The Federal Reserve Board also voted in favor of the NYFRB plan. The Treasury played only a consultative role because as of September 2008, it had no authority to provide funds to AIG. The Emergency Economic Stabilization Act of 2008, which authorized the U.S. Secretary of Treasury to spend up to $700 billion to purchase distressed assets like mortgage-backed securities and to supply cash directly to banks, was not enacted until October 3, 2008.

[2] Congressional Oversight Panel, *June Oversight Report: The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy* (DIANE Publishing, 2010) (submitted under Section 125(b)(1) of Title 1 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343). Other oversight bodies examining TARP included the Special Inspector General for TARP (Neil Barofsky) and the Government Accountability Office.

government bailout, difficult as they may have been to implement. In addition, the COP criticized the fact that every counterparty received exactly the same deal during the bailout at taxpayer expense despite their widely differing exposure to an AIG bankruptcy. Finally, the COP criticized the government for failing to address perceived conflicts of interest, even though no actual abuse was discovered: "People from the same small group of law firms, investment banks, and regulators appeared in the AIG saga in many roles, sometimes representing conflicting interests."[3]

Following the COP report in public consciousness were Neil Barofsky's—Inspector General of the $700 billion TARP program from December 2008 through March 2011—relentless public criticisms of Fed and Treasury officials in their management of TARP monies.[4] These criticisms were based on his on-going audits of the TARP program, whose monies found their way into the AIG bailout. Barofsky observed during his tour as Inspector General that the Treasury Department had been "captured by Wall Street's core ideology"[5] and, as a result, the government had showed undue favoritism to Wall Street. For Barofsky, this favoritism was most clearly evident in the failure of the government to negotiate price concessions from megabanks when offering to buy their fast-depreciating mortgaged-backed securities (which represented enormous liabilities to AIG under AIG-issued insurance contracts sold to clients) and to restrict the payout of bonuses to AIG executives in the aftermath of the bailout.

Following Barofsky's public criticisms was Simon Johnson, a former Chief Economist of the International Monetary Fund, who voiced his criticisms of the bailout in an influential and well-received book (written with James Kwak) documenting the increased power and influence of Wall Street on the economic governance of nations.[6] More recently, David Stockman, well known as the Director of the Office of Management and Budget under President Ronald Reagan, has

---

[3] Id.

[4] Barofsky was appointed by President George W. Bush in November 2008 and subsequently confirmed by Congress one month later. Barofsky's job was overseeing TARP and, as chief watchdog, rooting out and prosecuting waste, fraud, and abuse. During his tenure, Barofsky's office issued multiple quarterly reports and over a dozen audits. See Neil Barofsky, *Bailout: An Inside Account of How Washington Abandoned Main Street While Rescuing Wall Street* (Free Press, 2012).

[5] Id., 220.

[6] Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (Pantheon Books, 2010). Johnson is currently a professor at MIT's Sloan School of Management.

attacked the bailout in his recent book bewailing the corruption of American capitalism.[7]

Another notable critic has been Maurice "Hank" Greenberg, the former chairman and CEO of AIG. Greenberg's personal holding company, Starr International, was the largest AIG shareholder prior to the bailout. In 2011 Starr sued the U.S. government for $25 billion on the grounds that the assumption of 80 percent of AIG's stock by the Federal Reserve Bank of New York during the financial crisis (see below) was an unconstitutional seizure of property that violated shareholders' rights to due process and equal protection of the law.[8] The merits of Greenberg's suit, if any, will not be addressed here.

Simon Johnson's and David Stockman's criticisms of the AIG bailout mark a turning point in the national conversation. Prior to their wide-ranging books, many reporters and other commentators took their cues about the AIG bailout from Congressional hearings during the summer and fall of 2008, the June 2010 report of Congressional Oversight, the reports and testimonies delivered by Neil Barofsky, and the more recent report of the President's Financial Crisis Inquiry Commission released in January 2011.[9]

In addition, a small group of journalists had started presenting a broader panorama of AIG's rescue than either the Congressional or Presidential Panels—namely, that the AIG bailout demonstrated not only the incestuous relationship between the most powerful Wall Street firms and the government, but also the fact that the U.S. political system had been subordinated to the financial elite.[10] The

[7] David A. Stockman, *The Great Deformation: The Corruption of Capitalism in America* (Public Affairs, 2013). Stockman served as a Republican U.S. Representative from the state of Michigan (1977-1981) and as the Director of the Office of Management and Budget under President Ronald Reagan (1981-1985).

[8] In March 2005, AIG's board forced Greenberg to resign as chairman and CEO. Greenberg was under the shadow of criminal complaints filed by Eliot Spitzer, then Attorney General for the State of New York, alleging fraudulent accounting, securities fraud, and other violations of insurance and securities law. All criminal charges were eventually dropped, but Greenberg continues to face a reduced number of civil charges brought by the Attorney General's Office in September 2005.

[9] Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (Public Affairs, 2011). This report came to somewhat different conclusions on the causes and management of the financial crisis than the COP report.

[10] Two of the most notable articles making this case are by David Fiderer, "How Paulson's People Colluded With Goldman To Destroy AIG And Get A Backdoor Bailout," HuffPost Blog, January 25, 2010, and William Greider, "Elizabeth Warren Uncovered What the Government Did to 'Rescue' AIG, and It Ain't Pretty," *The Nation*, August 9, 2010. Fiderer was a New York banker for 20 years before turning to journalism. Greider spent 15 years as a *Washington Post* reporter and 17 years as National Affairs Editor at *Rolling Stone.* He has spent many decades covering the nation's central bank and is the author of *Secrets of the Temple: How the*

books of Johnson and Stockman strongly echoed this line of thinking and extended it by arguing that American capitalism—and financial institutions in particular—now held the global economy hostage to private interests, and that this control was, in large part, perpetuated through pernicious "cronyism."[11] They also saw the AIG bailout story as a prime example of ubiquitous "crony capitalism" at work in America today—although neither critic is clear in their books about what they mean by crony capitalism. Here's what I think they mean.

The term "crony capitalism" is typically used to describe an economy where business success (or survival) depends upon close relationships between business people and government officials instead of the free market. In its most common usage, this provocative term conveys a shared point of view—and often collusion—among businesses, their regulators, and even Congress on matters related to regulations, subsidies, special tax breaks, and other forms of business-friendly policies and investments supported by the state. Crony capitalism is of course similar to the phenomenon of regulatory capture, described by Johnson and Neil Barofsky as it relates to the banking industry. Cronyism may also reflect "cultural capture"—the process by which regulation is directed away from the public interest and toward the interest of the regulated industry through such mechanisms of influence as group identification, status, and relationship networks.[12]

An oft-mentioned example of crony capitalism is the "partnership" between Wall Street bankers and elected officials, which led to the financial deregulation in the 1990s that so enriched the finance industry. Through the confluence of campaign contributions, personal connections, and ideology nourished by uncompromising self-interest, the Glass-Steagall Act, which limited commercial banks' activities and

---

*Federal Reserve Runs the Country* (Simon and Schuster, 1987), a book that offers an extended critique of the Federal Reserve system.

[11] Johnson and Stockman have recently been joined in their passionate critique of crony capitalism by Hunter Lewis, co-founder of the global investment firm, Cambridge Associates, and author of *Crony Capitalism in America: 2008-2012* (AC2 Books, 2013). This book is a compendium of brief, hair-raising vignettes of cronyism in the financial and non-financial sectors. His treatment of the AIG bailout is sparse, but not lacking in accusations. For example, he claims that Treasury Secretary Paulson, the former CEO of Goldman Sachs, and New York Fed President Geithner agreed that Goldman Sachs had to be saved, which in some sense is true, but which is stated accusingly with absolutely no attempt to reconstruct the evolution and context of this decision, and the critical differences between AIG's insolvency and that of Lehman Brothers only a few days earlier. Lewis, *Crony Capitalism*, 93.

[12] The concept of cultural capture is developed in an excellent paper by James Kwak, "Cultural Capture and the Financial Crisis" (2013), available at http://www.tobinproject.org/sites/tobinproject.org/files/assets/Kwak Cultural Capture %281.16.13%29.pdf, in Daniel Carpenter and David Moss, eds., *Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (Cambridge University Press, 2013),

affiliates, was repealed. This repeal not only greatly expanded profit opportunities for federally insured commercial banks in high risk/high return investment banking and securities trading; but, according to some critics, it also led directly to the global financial crisis.[13] In the case of financial deregulation, the economy of influences surrounding federal legislators led to a dependent relationship with campaign contributors urging repeal of Glass-Steagall. These dependencies, and many like them, inevitably weakened public trust in Congress. Lawrence Lessig identifies such "inappropriate dependencies" and their consequences as a leading indicator of "institutional corruption."[14]

In the hands of David Stockman, crony capitalism has taken on a more insidiously corrupt meaning—namely, "stealing through the public purse in ways that reward the super-rich." This is precisely what Stockman perceives the bailout of AIG and its credit default swap counterparties to be.[15] He also asserts that crony capitalism has created a class of Wall Street financiers and corporate CEOs who believe the government is there to do "whatever it takes to keep the game going and their stock price moving upward."[16]

## Lingering Allegations of Cronyism

Today, five years after the AIG bailout, critics tend to focus on two allegations that tag the transaction as a leading example of crony capitalism: first, that warding off an AIG bankruptcy was totally unnecessary in the first instance as a bulwark against "contagion" or the serial collapse of other financial institutions playing a central role in the global credit market; and second, that the bailout as eventually structured was a not-so-subtle cover for public subsidies to banks holding large amounts of depreciating securities (such as mortgage-related, collateralized debt obligations or CDOs).

A third issue that also energized criticism of the bailout involved the complicated

http://www.tobinproject.org/books-papers/preventing-capture.

13 See Simon Johnson, "The Quiet Coup," *Atlantic Monthly*, May 2009.

14 Lawrence Lessig, "Institutional Corruptions," Edmond J. Safra Research Lab Working Papers, No. 1 (2013), http://ssrn.com/abstract=2233582; and *Republic, Lost: How Money Corrupts Congress—and a Plan to Stop It* (Twelve, 2011), 16–17.

15 This definition was offered when discussing his book at a dinner hosted by the Edmond J. Safra Center for Ethics, Harvard University, on September 26, 2013.

16 Id.

matter of executive pay at AIG. After the government rescue, senior executives of the holding company and its subsidiaries continued to be compensated at very high levels while they were effectively wards of the state. Large executive bonuses were justified as "retention bonuses" required to keep key executives from defecting to healthier competitors. The board-approved retention plan envisioned paying out $165 million in 2009 and $235 million in 2010.[17] One does not need to be a bailout critic to appreciate how the inevitable disclosure of such payouts would immediately set off a Congressional and public rumpus. As protesters swarmed corporate headquarters and executives' homes, even President Obama was moved to comment publicly on AIG's compensation practices (and expensive retreats for AIG' independent insurance agents): "How do they justify this outrage to the taxpayers who are keeping the company afloat?"[18] Republican Senator Chuck Grassley from Iowa, chairman of the Senate Committee on Finance, was more livid than the President, calling on the AIG executives to either quit or commit suicide.[19]

For all these reasons, critics of the AIG bailout see a story that is just about as pure an example as there is of how cronyism and lack of transparency have corrupted American capitalism.

While the tumultuous events and obscure financial accounting surrounding the AIG bailout still make a definitive assessment of government action in the AIG case difficult, I focus in this paper on the two persistent questions that have not yet been answered to many critics' satisfaction despite considerable analysis by the aforementioned Congressional and Presidential panels:

- Was federal assistance to AIG truly essential for financial system security?
- Was the ultimate form of this assistance—most particularly, the New York Fed's purchase of depreciating mortgage securities at par from AIG's

---

[17] Andrew Ross Sorkin, Too Big To Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System—and Themselves (Penguin, 2009), 162.

[18] Quoted in Sorkin, *Too Big to Fail*, 532.

[19] Barofsky, *Bailout*, 138. Instigating a temporary cap or deferral of bonuses for senior executives, or replacing it with a rich, longer-term plan tracking the appreciation of AIG's stock value in a turnaround, would certainly have been plausible option. As another option, the Treasury as controlling shareholder could probably have forced a renegotiation of employment contracts as a condition of bailout funds. That said, dealing with this incendiary issue was probably an administrative nightmare. The company had approximately 630 compensation plans involving bonuses, retention awards and deferred compensation. The structure and management of these plans were decentralized to various operating units and subsidiaries, and no approval of the plans was required by the holding company. Senior AIG officials no doubt found it difficult to comprehend the scope and cost of all these plans. See Congressional Oversight Panel, *June Oversight Report*, 223.

counterparties in exchange for canceling credit default swaps (CDSs) purchased from AIG to insure these securities[20] —a misuse of public monies that served private interests at the expense of the public interest?

If the answers to these two questions are positive, then the AIG bailout should indeed be branded as a paradigmatic case of crony capitalism, and it should be viewed with the dishonor that goes with this label.

This may well be the case, but it is worth testing whether or not such a telling of the AIG bailout story is accurate. There is a big difference between (a) calculated corruption in the form of generous financial transactions put in place by the U.S. Treasury and the New York Federal Reserve Bank for the benefit of large domestic and foreign banks deemed vulnerable to an AIG collapse and (b) controversial calculations and actions by Treasury and Fed officials working in a state of existential anxiety about how best to manage the risks of a global credit market shutdown.

## The ''Improvised Risk Management'' Story

This paper presents the case for the latter possibility—that the story of both the initial bailout decision and the subsequent structure of the bailout was much different than the label "crony capitalism" suggests. I argue that the lingering controversies over the bailout are not a result of the corrupt behavior of Treasury and Federal Reserve officials, but rather the result of impromptu and highly improvised risk management by government officials—who had no clear regulatory authority over failing investment banks and insurance companies like Bear Stearns, Lehman Brothers, and AIG—and who were conditioned by their professional training and current responsibilities to focus on the worst-case scenarios following the collapse of large financial institutions holding fast-depreciating real estate assets. Many months of mounting evidence and accompanying anxiety over a stock

---

[20] Credit default swaps (CDSs) are a form of insurance on credit securities such as bonds and collateralized debt obligations. They are privately-negotiated bilateral contracts that obligate one party to pay another in the event that a third party cannot pay its obligations. In essence, the purchaser of protection pays the issuer of protection a fee for the term of the contract and receives in return a promise that if certain specified events occur, the purchaser of protection will be made whole—either by cash, in which case the parties agree on a value for the reference obligation, or by physical settlement. If a credit event does not occur during the term of the contract, the issuer will have no obligation to the purchaser and retains the fees paid. See International Swaps and Derivatives Association, "AIG and Credit Default Swaps," November 2009, http://www.isda.org/c_and_a/pdf/ISDA-AIGandCDS.pdf, and *June Oversight Report*, 251.

market in full decline and the vulnerability of the nation's investment banks reinforced the worst-case fears of senior government officials and inevitably shaped their understanding of what was "the right thing to do."

Credit default swaps (CDS) written by AIG covered more than $400 billion in bonds (mostly collateralized debt obligations or CDOs), and the company had nowhere near enough money to cover all the CDS claims that they appeared to owe under these swap contracts. Since AIG sold CDS protection to banks all over the world, an insolvent AIG meant that all those banks would immediately lose their protection. Overnight, banks would have to find replacement coverage at much higher rates because the risks were now higher than when the AIG CDS contracts were purchased. As a result, banks all around the world would be worth less money and would therefore lend less money. Weaker banks might not have sufficient margin to pay the new bond and CDO insurance costs. Under such conditions, these banks would fail, triggering a new round of CDS payouts on all these collapsed banks. This new round of CDS payouts could lead to yet another round of bank failures and a major breakdown in the flow of credit worldwide.[21]

The stock market of course sensed the risks to AIG and its clients who had purchased large amounts of CDS insurance. Just days before Lehman collapsed and the decision to rescue AIG was made, the prices of AIG's shares were off by 60 percent (Lehman's were down 95 percent), and the prices of both Morgan Stanley and Goldman Sachs stocks were in free fall. The credit default swap rates demanded for insuring the credit of the latter two were sky-rocketing. According to Henry Paulson (Treasury Secretary under President Bush and former CEO of Goldman Sachs), "no one in the world—not a rational world, anyway, could have thought Morgan Stanley's business was in anywhere near as bad a shape as [Lehman Brothers]." Paulson sensed the start of a true financial panic.[22]

Paulson was, himself, highly distraught. On Sunday, September 14, 2008—two days before the AIG bailout came together—Paulson called his wife and reported, "I am really scared." He added, "What if the system collapses? Everybody is looking

---

[21] This scenario is nicely developed by Adam Davidson, in "How AIG Fell Apart," Reuters.com, September 18, 2008, http://www.reuters.com/assets/print?aid=USMAR85972720080918.

[22] Henry M. Paulson, Jr., On the Brink: Inside the Race to Stop the Collapse of the Global Financial System (Hachette Business Plus, 2010), 224.

to me, and I don't have the answer."[23] Two days later he reported having bad bouts of dry heaves as a result of total exhaustion and anxiety (it happened six or eight times during the credit crisis).[24]

In this highly charged setting, Treasury and New York Fed officials took a series of unpalatable steps that they viewed as being better than the alternatives: namely, either letting AIG fail like Lehman Brothers, thereby disabling the global credit system and pushing the U.S. deeper into recession; or nationalizing the failing banks and taxing the rest of them in a heavy-handed way to minimize the cost to taxpayers. Given this framing of the alternatives, Fed and Treasury officials opted for a strategy that they hoped would prevent systemic collapse while also avoiding the problems of even more significant government involvement in the finance industry.

While the record shows that government decision-makers were well aware of moral hazard issues imbedded in a government rescue of AIG, it also reveals that in attempting to fend off financial panic, Federal Reserve and Treasury officials did not consider it to be either a governing concern or long-term risk factor.[25] For one thing, many of the executives and institutions affected by the financial crisis had already paid a great price in terms of personal wealth destruction. More importantly, the principal concern for the Fed and Treasury was how to put AIG on a "going concern" basis as soon as possible, and how to avoid a breakdown in global credit markets. Once the certain benefits of a bailout (avoiding a breakdown in the global credit markets) came to dominate the uncertain benefits of letting AIG fail (avoiding future moral hazard) in the calculus of government decision-makers, the question became how to execute the bailout at least cost to U.S. taxpayers. It is at this juncture that one might accuse Fed and Treasury officials of favoritism or

---

[23] Id., 215. Paulson wrote in his memoir, "Back in my temporary office on the 13th floor [of the U.S. Department of Treasury building], a jolt of fear suddenly overcame me as I thought of what lay ahead of us. Lehman was as good as dead, and AIG's problems were spiraling out of control. With the U.S. sinking deeper into recession, the failure of a large financial institution would reverberate throughout the country—and far beyond our shores. I could see credit tightening, strapped companies slashing jobs, foreclosures rising ever faster: millions of Americans would lose their livelihoods and their homes. It would take years for us to dig ourselves out from under such a disaster." Id., 214.

[24] Id., 241.

[25] A "moral hazard" is created when people are encouraged to take undue risks without bearing the full consequences of their actions. In this case, the moral hazard created by a government decision to bail out AIG was the message that the government would most likely protect even the most poorly managed financial institutions from collapse in the future. In contrast, a decision to let AIG collapse would have been an

cronyism by paying more than required to AIG creditors (CDS counterparties) in structuring the bailout transaction. But this overpayment, if it was an overpayment, was not material in the eyes of government officials, given the perceived risks of failing to get multiple parties with varying vulnerabilities and disparate interests to go along with a bailout plan in a matter of hours. In this rushed, ambiguous, anxiety-provoking context, charges of crony capitalism do not stand up.

In hindsight, one might argue that Paulson and Timothy Geithner (president of the New York Federal Reserve Bank) made miscalculations and missteps as they tried to cope with unknown risks and their own increasing anxiety. But such a claim, which in several instances is warranted, is hardly evidence of classic cronyism, collusion, and corruption. Indeed, a close reading of the public evidence reveals an alternative narrative of the AIG bailout—a story of highly improvised risk management where it was difficult for Timothy Geithner and Henry Paulson, and their staffs in New York and Washington, to assess the size of the calamity they faced and understand how the calamity's shape was changing.[26] Indeed, not only were the unknowns surrounding AIG's likely collapse enormous, but the unknowns kept changing.

For sure, the New York Fed was insufficiently transparent, as it later admitted, in reporting controversial aspects of the AIG rescue to the SEC, Congress, and the general public.[27] In addition, potential conflicts of interest among the various players were tolerated during the bailout process. But the possibility of

---

unambiguous message to Wall Street banks that they alone were responsible for their financial discipline and future survival.

[26] For example, virtually every senior government official had grossly underestimated the losses from subprime lending and default rates on subprime mortgages during 2007 and 2008. As another example, neither the Federal Reserve nor the Treasury knew for sure the size and business dealings of the shadow banking market (specialized mortgage lenders and other entities) that had grown quickly and out of sight of regulators. This was a critical unknown because the shadow market was very active in the asset-backed commercial paper market, a key source of short-term capital and liquidity for small and large financial players. Along with these unknowns, the gyrating prices of financial stocks and the expanding CDS spreads—indicating the rising cost to insure bonds and real estate assets held by banks against default or downgrade—were adding to general uncertainty and anxiety. What were the expanding spreads signaling? Were they signaling some systematically important collapse? If so, who would collapse first—Bear Stearns? Would the next smallest firm, Lehman Brothers, which was heavily over-weighted in mortgages and real estate assets, follow? Whatever the likely scenario for asset prices, where did the most effective sources of liquidity for banks lie? How could these sources be best tapped?

[27] Proponents of crony capitalism in the AIG case criticize a lack of transparency in AIG's filings with the SEC about (a) the identities of AIG's counterparties, (b) payments financed by the government to AIG counterparties, and (c) the compensation of AIG officials, even though all SEC filings were reviewed and approved by Davis Polk & Wardwell, the New York Fed's lawyers. For bailout critics, the initial lack of precision and detail in public filings during the bailout is evidence of a collective attempt to cover up favoritism and cronyism.

compromised integrity is a long distance from revealed cronyism. Indeed, the largely critical Congressional Oversight Panel—after spending a significant amount of due diligence on this matter—found no evidence that the rescue was orchestrated in order to assist friends and former colleagues of those leading the rescue.[28]

My reading of the record is consistent with that of the COP. In addition, my reading of the 2007-2008 crisis suggests, in the first instance, that federal assistance to AIG was indeed essential to preserve financial system security. I also find little reason to believe that the bailout was purposively designed as a cover for the subsidization of AIG's counterparties (mainly large banks with increasing losses on their holdings of residential mortgage-backed securities), with which principal decision-makers for the government had long-standing personal relationships and, in the case of Treasury Secretary Henry Paulson, a prior financial relationship that created significant personal wealth.

Of these two conclusions, the second one remains the most controversial to this day. This is because the eventual **form** of the bailout, which unfolded in multiple transactions from September 2008 to March 2009 in response to an inadequate initial bailout package and changing conditions at the company and in the capital markets, raises nagging questions of fairness.

The confounding issue here is that AIG's customers (counterparties in credit default swap contracts designed to insure their holdings of mortgage-backed securities) received what looks to be very generous treatment from the government during the bailout. Much of the venom of bailout critics has focused on the

---

[28] At the same time, it is clear that the same small group of law firms, investment banks, and regulators tended to appear in the AIG saga in many roles, sometimes representing conflicting interests. To quote from the conclusion of the COP report, "The rescue of AIG illustrates the tangled nature of relationships on Wall Street. People from the same small group of law firms, investment banks, and regulators appear in the AIG saga (and many other aspects of the financial crisis) in many roles, and sometimes representing different and conflicting interests. The lawyers who represented banks trying to put together a rescue package for AIG became the lawyers to FRBNY, shifting sides in a matter of minutes. Those same banks appear first as advisors, then potential rescuers, then as counterparties to several different kinds of agreements with AIG, and ultimately as the direct and indirect beneficiaries of the government rescue. Many of the regulators and government officials (in both Administrations) are former employees of the entities they oversee or that benefited from the rescue. . . . These links have led to many allegations that the rescue was orchestrated in order to assist friends and former colleagues of those leading the rescue. Although Panel staff has spent significant time reviewing hundreds of thousands of pages of documents from the time of the rescue, to date they have found no evidence of any such concerted effort. It is nonetheless indisputable that the friends and former colleagues of those who directed the AIG rescue are among the many beneficiaries of the rescue." Congressional Oversight Panel, *June Oversight Report*, 234. Morgan Stanley and Goldman Sachs were prominent among the larger group of advisors retained by the New York Fed in the AIG situation.

government's negotiations with AIG's CDS counterparties—and particularly Goldman Sachs where the Treasury Secretary and many of his staff had spent their entire business careers—which resulted in the purchase of mortgage-backed securities insured by AIG at par value when the market prices of these securities were falling. This negotiation—or lack of it—is presented as a perfect example of corrupt "crony capitalism" at work. Despite this apparent largesse, there is nothing in my reading and analysis of the record to suggest an intentional government campaign to use public monies and credit facilities to unfairly protect the private interests of trading banks deemed vulnerable to an AIG collapse.

I take this position fully realizing how tempting it is to assume the worst about crony capitalism in the AIG bailout when Timothy Geithner and Henry Paulson were in the saddle. After all, Paulson was the former chairman and CEO of Goldman Sachs, the largest counterparty beneficiary of AIG's bailout.[29] His staff at Treasury included many former Goldman Sachs veterans—for example, Robert Steel, Steve Shafran, Neel Kashkari, Dan Jester, and Ken Wilson; Geithner's chief of staff was an ex-Goldman executive; and Geithner's board of directors include many of Wall Street's most influential players.

But these outwardly incriminating facts do not seem to fit with either the decision context of the AIG rescue or the career paths, public service aspirations, conflict of interest controls, and risks of public humiliation for high-ranking Treasury and Federal Reserve Bank officials. Paulson, for example, started his career in government before being recruited to Goldman Sachs. While this career pattern conforms with many "revolving door" patterns involving public officials, Paulson's initial point of departure and subsequent professional and personal life devoted to environmentalism and other social causes suggest legitimate service aspirations, at the very least. Residual loyalties to Goldman Sachs could certainly have persisted, if even unconsciously, but why would Paulson have ever taken steps that would have put his personal reputation for integrity and savvy at risk at such a late date in his career? Yes, good people sometimes do stupid things inadvertently, particularly when they cannot recognize individual or institutional conflicts of

[29] The bank collected over $7 billion from AIG in the year preceding the bailout and another $12.9 billion when the government, as part of the federal rescue of AIG, covered in full the money AIG owed Goldman Sachs on insured securities. Gretchen Morgenson and Louise Story, "Testy Conflict with Goldman Helped Push A.I.G. to Edge," *New York Times*, February 6, 2010.

interests. But failing to recognize or be warned of conflicts of interests in matters of state, as a highly visible Cabinet officer and the nation's most senior financial executive, is highly unlikely.

Similarly, Geithner's career reveals legitimate public service and public policy aspirations. His upbringing and education were deeply rooted in international affairs and language (he graduated from high school in Bangkok and attended Peking University in 1981 and Beijing Normal University in 1982 while completing his undergraduate degree at Dartmouth College). After three years working for Kissinger Associates, he joined the International Affairs division of the U.S. Treasury and rose to Under Secretary for International Affairs. After a brief stint as a Senior Fellow at the Council for Foreign Relations, he served three years at the International Monetary Fund as the director of its Policy Development and Review Department prior to his appointment as president of the New York Fed in 2003. While Geithner undoubtedly forged close working relationships with leaders of U.S. and international financial institutions during his time at Treasury and the IMF, there is no evidence of any prejudicial bias towards banks that I am aware of, and certainty no taint from the "revolving door." The only credible case for Geithner's favoritism to banks could be the prospect of future employment in one of the financial institutions he oversaw as FRBNY president. This, we now know, did not happen.[30]

## Telling the AIG Bailout Story

No telling of the AIG bailout can begin without a description of the multi-step transaction that unfolded over many months in a largely incremental fashion. Strangely enough, many facts of this highly technical transaction are neither acknowledged nor fully understood by public commentators and bailout critics. In addition, few folks realize that by the end of 2012, four years after the bailout was initiated, the Treasury reported an overall positive return of $22.6 billion on the $182.3 billion committed by the government to stabilize AIG during the financial crisis.[31] I summarize some of the fundamental details of the bailout in Section II

[30] On November 16, 2013, it was announced that Timothy Geithner would join the little-known, but widely respected leveraged buyout firm, Warburg-Pincus. Buyout firms are not supervised by either the Federal Reserve of the U.S. Treasury.

[31] Bailout critics have two problems with the Treasury's accounting. First, they like to argue that this positive

below.

Once I lay out the basic facts of the bailout transaction and its subsequent implementation, I turn in Section III and IV to the two questions noted above: Was the bailout truly necessary in the first instance? Or put slightly differently, would an AIG bankruptcy actually have led to “deadly contagion” in the form of cataclysmic financial failures of large, systemically important banks? And was the form of the eventual bailout an appropriate way of utilizing public monies to improve the prospects of private interests?

For the first set of questions to be answered satisfactorily, we can start by examining the testimonies before Congress made by key decision-makers in the AIG bailout, and then assessing them in light of analyses performed by the two aforementioned Congressionally-commissioned reports addressing the financial crisis and AIG bailout. Special attention needs to be paid to the systemic and firm-specific risks of an AIG collapse and, in particular, the so-called risks of “contagion” where an AIG collapse triggers the serial collapse of other financial institutions. I supplement evidence presented in various Congressional studies and testimonies with my own analysis of the potential effects of bankruptcy on the balance sheets of two of AIG’s most important CDS counterparties.

Next, the claim of cronyism surrounding the New York Fed’s purchase of mortgage-related debt securities insured by AIG’s CDS contracts at their par value (in exchange for the cancelation of these contracts) needs to be addressed. Of particular interest is the question of why Timothy Geithner, who was still head of FBNYC in September 2008, supported the strategy of paying AIG counterparties the full value (par) of the insured securities (mainly collateral debt obligations when (a) CDOs had fallen so significantly in value, (b) other mortgage-bond insurers had been able to strike deals on similar contracts at reduced prices, and (c) prior to the bailout, AIG had reportedly been negotiating in an attempt to get its counterparties

---

return was largely the result of the Federal Reserve artificially stimulating a sharp recovery in the stock market and the price of AIG’s shares held by the Treasury through its easy money policies. While it is true that this monetary policy had an ameliorative effect on the stock market (and the profits of financial institutions borrowing money at close to zero cost), it defies logic and practical politics to claim that this was the purpose of such easy money policies. Such monetary policy was of course aimed at stimulating investment and job growth. Second, bailout critics argue that the post-bailout performance of AIG, whose equity was held by the government, should not be surprising because it had been given a “free good” in the form of low cost credit and capital. If these returns were inevitable (they weren’t!), then the relevant calculus, critics claim, is not the return to the government but opportunity costs. But what were these opportunity costs, and how can they be valued?

(bank customers) to accept as little as 60 cents on the dollar. Also of interest is the role of Secretary Paulson, if any, in influencing the design of a bailout plan that would "save Goldman" from further distress or collapse.

As I have already noted, AIG's payments to its CDS counterparties—funded by government-extended credit—appear to bailout critics to be no less than a gift to Wall Street, and Goldman Sachs in particular. Indeed, the report prepared by the House Committee on Oversight and Government Reform refers to these payments as a "backdoor bailout of AIG counterparties."[32] In this sense, the committee report echoed the finding of Neil Barofsky, the special inspector general for TARP, that the Fed "refused to use its considerable leverage" to negotiate better terms. Barofsky's finding was later roundly criticized by the New York Fed.

Barofsky's finding may have had its roots in a report commissioned by the New York Fed and prepared by the BlackRock asset management firm in 2008, which came to light at hearings held two years later in January 2010 by the aforementioned House Committee on Oversight and Government Reform. The BlackRock report aroused Committee interest by demonstrating on the basis of its financial modeling that, without harried pressure from the New York Fed, AIG would probably have been able to strike a better settlement with its most important counterparties and saved a lot of public money. In particular, the 2008 BlackRock study suggested that Goldman Sachs was, prior to the bailout, willing to take a haircut on its AIG CDS payouts—that is, taking something less than the par value of the relevant credit default swaps. (This conclusion seems unlikely in light of data presented in the 2010 report of the Congressional Oversight Panel discussed below.)

Secretary Geithner responded to the BlackRock report and similar analyses by testifying to the congressional committee that AIG would have collapsed if the government had forced counterparties to take less than they were entitled. "This was not a viable option. . . . If we had sought to force counterparties to accept less than they were legally entitled to, market participants would have lost confidence in AIG and the ratings agencies would have downgraded AIG again. This could have

[32] U.S. House of Representatives, 111th Congress, Committee on Oversight and Government Reform, "Public Disclosure as a Last Resort: How the Federal Reserve Fought to Cover Up the Details of the AIG Counterparties Bailout from the American People," January 25, 2010, 2, http://oversight.house.gov/wp-content/uploads/2012/01/20100125aigstaffreportwithcover.pdf.

led to the company's collapse, [and] threatened our efforts to rebuild confidence in the financial system."[33] But is this correct?

Further forensic work is required to complete an assessment of the so-called "risks of contagion" stemming from an AIG collapse. But pending such a definitive assessment, we need to understand that if we as a nation, influenced by inaccurate storytelling, end up mistaking abundant caution and existential fear for corruption and crony capitalism (and all the venality that this label connotes), then the chances of attracting and retaining truly knowledgeable and honest men and women from the private sector and academia to high-stakes and inevitably controversial positions in the public sector will diminish considerably—to our collective disadvantage.[34] Henry Paulson, who refused multiple invitations from President Bush to become his Treasury Secretary, along with his bailout partners at the Washington and New York Fed, may not have been the best possible person from business and academia to contain the unfolding financial crisis. But it is difficult to list many other qualified, deeply committed individuals for that job at that time.

## II. The Bailout Transaction

In 2008, AIG was one of the largest and most complex financial firms in the world, with assets of more than $1 trillion at its peak. The company, which operated in more than 100 countries around the world, had two core businesses. The first was a conventional insurance business (including property and casualty insurance and life insurance) with approximately 75 million corporate and individual customers in over 130 countries. In addition to insurance, AIG's primary business units included financial services and asset management. AIG was also the largest investor in corporate bonds in the U.S. and the second largest investor in U.S. municipal bonds.

[33] Secretary Timothy F. Geithner, "Written Testimony" to the House Committee on Oversight and Government Reform, January 27, 2010, 10, http://www.ft.com/intl/cms/78c5a070-0b56-11df-9109-00144feabdc0.pdf.

[34] Paulson noted in *On the Brink* that it was exceedingly difficult for him to attract to the Treasury people who understood the complexities of financial institutions and transactions that were central to the unfolding financial crisis. All of his aides necessarily came from Wall Street, because only they had the relevant specific knowledge and experience necessary to understand the critical details of mounting problems and practical possibilities facing financially vulnerable banks in 2007 and 2008.

As the world's largest insurer, this business was organized into multiple subsidiaries that were regulated and supervised separately by hundreds of state and national regulators. The second core business, which was run out of AIG's Financial Products Corporation subsidiary (AIGFP) and was largely unregulated, used AIG's strong credit rating (a source of relatively inexpensive funding)—tied to its diversified business and the profitability of its insurance subsidiaries—to provide credit and rate-of-return protection (in the form of credit default swaps or CDSs) for financial assets held by other institutions. AIG's CDSs gave its customers or counterparties the right to demand collateral to protect them against the possibility that AIG might not be able to honor its contractual commitments. AIGFP had hundreds of billions of dollars committed to this complex insurance business. In hindsight, the risks involved in this business were dramatically disproportionate to the revenue it produced for the holding company—a mere 7 percent of firm-wide net income in 2006.[35]

Another business, which was to figure prominently in the AIG bailout story, involved its securities lending business. AIG lent out securities owned by participating insurance subsidiaries in exchange for cash collateral that would be invested by AIG. More specifically, participating subsidiaries had securities lending agreements with AIG Securities Lending Corporation, which served as their authorized agent in lending their securities to pre-selected large banks and brokerage firms for their benefit. In this way, decisions involving the investment of the cash collateral received from securities lending counterparties could be centralized and more efficiently managed within AIG's asset management group.

Securities lending was a fairly common practice by insurance companies. It normally provided a low-risk way for insurance companies to earn modest returns on assets that would otherwise be sitting idle. As it turned out, there was nothing normal about the problems that this "low-risk" activity created for AIG.

[35] Congressional Oversight Panel, *June Oversight Report*, 28.

## Prologue: The Liquidity Crisis

On September 12, 2008, AIG executives notified the Federal Reserve and the Treasury Department that it was facing potentially fatal liquidity problems.[36] This liquidity crisis was triggered by counterparty claims under CDS contracts AIG sold to large banks and financial firms as protection for their holdings of collateralized debt obligations (or CDOs) backed by subprime mortgages and other asset-backed securities and bonds, which were plummeting as the financial crisis rolled through Wall Street. These claims involved the posting of cash collateral by AIG to CDS counterparties whose insured assets, such as CDOs, were fast depreciating in value. As the financial crisis deepened and the market value of insured securities nose-dived, counterparties demanded increased amounts of posted collateral from AIG. Soon, a vastly over-leveraged AIG no longer had the capital and liquid assets sufficient to back up its CDS commitments.[37]

These liquidity problems had the feel of a death spiral. CDS contracts had provisions that went beyond the posting of cash collateral for counterparties. As the value of the CDOs being insured in CDS contracts with banks like Goldman Sachs and Merrill Lynch continued to decline, AIG was forced by mark-to-market accounting rules to record decreased valuations of these contracts on their balance sheet, thereby threatening its all-important credit rating and a key source of funds.

---

[36] The evolving role of the Federal Reserve and the Treasury Department in the AIG bailout is an interesting topic in itself. The Federal Reserve did not have statutory supervisory authority over AIG or its subsidiaries. Its supervisory authority was limited to bank holding companies and state-chartered member banks. Neither did the U.S Treasury have regulatory authority. But the Fed and the Treasury were the obvious points of contacts for AIG in warning the government of its approaching crisis. Indeed, they were the only entities of government likely able to mount an effort to save the company. In addition, from a non-statutory perspective the general public and Congress would of course hold the Treasury Secretary and the President accountable for any adverse consequences of an AIG failure. And once the Fed became a creditor to AIG under the terms of the initial bailout plan, it naturally found itself in a new, more clearly defined role in overseeing the preservation of the essential parts of AIG and divesting the less essential parts. Once the bailout was in place, the FRBNY used its rights as a creditor to work with AIG management, which was a new and somewhat uncomfortable experience for both parties. In playing this new role, the New York Fed found it necessary to establish a 25-person work group to monitor AIG's cash flows and restructuring. Supplementing this group were over 100 people from the Bank of New York Mellon, the Morgan Stanley investment bank, and outside counsel Davis Polk & Wardwell.

[37] AIG's liquidity problems were not unknown in mid-September 2008. AIGFP had recognized over $11 billion in unrealized market valuation losses on its CDS contracts for the 4th quarter of 2007, and the head of this business had resigned. So, too, did AIG's president leave his post on June 15, 2008. Later that month, the company recognized $13.5 billion in unrealized losses against its RMBS and other structured securities investments. In addition, several financings were held during late spring 2008 as the company reached for more capital. Timothy Geithner had also been approached about gaining access to the Federal Reserve's Discount Window, and in late August, AIG approached triple-A-rated Berkshire Hathaway about the possibility of providing a $5 billion backstop to AIG's guaranteed investment contracts. (Berkshire demurred.) So while the September 12 death warning was a surprise, it did not come to Fed and Treasury officials out of the blue.

At the same time, as AIG's credit rating started to head downward (with more downgrades rumored), the amount of collateral that AIG was required to post went up, which further intensified pressure on AIG's credit rating and its ability to tap economical sources of funds. By mid-September 2008, AIG was unable both to post the level of collateral demanded by CDS counterparties and to meet the cash calls from the company's other jittery trading partners worried about the company's CDO exposure.[38]

Making the corporate liquidity problem even worse, AIG's securities lending program was creating higher than normal risks for this kind of operation. Rather than continuing to invest cash collateral (received in exchange for the loaned securities) in liquid securities like short-term T-bills, in 2005 AIG started investing some of this cash in AAA-rated residential mortgage-backed securities (RMBS), with the objective of maximizing its returns.[39] By 2007, 60 percent of the company's U.S. pool of cash received from its securities lending program—in total, $76 billion—was invested in RMBS. As the residential mortgage crisis developed, the market for these securities became increasingly illiquid, the credit ratings of RMBS deteriorated, and the prices that AIG could receive in selling these securities fell. When AIG's counterparties began to ask for a return of the

---

[38] Eleven months earlier, on August 5, 2007, AIG's Chief Risk Officer claimed in a conference call with investors that the risks embedded in its derivatives portfolio were minimal or non-existent: ". . . the risk actually undertaken is very modest and remote." Joseph Cassano, head of AIG Financial Products Corp. added, "It is hard for us with, and without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of these transactions. . . . We see no issues at all emerging (or) dollar loss." Quoted in Congressional Oversight Panel, *June Oversight Report*, 35. At least one CDS counterparty did not believe these statements. Between August and late October 2007, Goldman Sachs, concerned about the declining values of insured CDOs on its balance sheet, demanded that AIG post $4.5 billion in collateral against the CDS contracts insuring its depreciating CDOs. AIG agreed to post only a total of $1.95 billion. See http://insuranceproviders.com/aig-bailout-timeline/. Like much of the activity surrounding AIG's decline and bailout, there was much controversy surrounding Goldman Sachs' collateral calls on AIG. Goldman claims it was prescient about the declining values of CDOs, so its demands for cash margin from AIG, which had insured billions of dollars of CDOs for Goldman, was perfectly legitimate. Goldman's critics, while admitting that Goldman was smart and the executives at AIG "clueless," claim that Goldman's claims for margin were made in bad faith, and possibly under fraudulent pretenses. For a very detailed presentation of this critical view, see http://www.zerohedge.com/article/guest-post-dirty-little-secrets-about-goldmans-collateral-calls-aig.

[39] This change in investment strategy did not go unnoticed by the Congressional Oversight Panel. See Congressional Oversight Panel, *June Oversight Report*, 51. By November 2007, the Texas Department of Insurance, which served as the lead regulator for AIG's insurance subsidiaries, discovered that AIG had been purchasing RMBS with its securities lending collateral since 2005. Texas and various state insurance regulators were concerned by this discovery. Texas immediately began working with AIG to wind down the program gradually (so as not to force the subsidiaries to sell assets at a loss). Id., 56-57.

cash collateral they had borrowed, the company found itself increasingly exposed to bankruptcy.[40] In fact, the company was in double jeopardy.

## The Transaction(s)

AIG's insolvency and subsequent rescue led to the largest and most complex bailout in history. What follows is a bare-bones rendition of this brutally complex transaction.

On September 16—the day after Lehman Brothers filed for Chapter 11 bankruptcy protection, and three days after it became obvious that no private sector rescue was possible—AIG received a two-year, $85 billion line of credit from the FRBNY after the government judged AIG's severe liquidity crisis as putting the company on the brink of bankruptcy. In return for the $85 billion loan, the New York Fed received an 80 percent ownership interest in AIG. This first step in the AIG bailout reflected the most important decision in the bailout story: that the government decided to rescue AIG as a whole rather than to push for some sharing of losses with creditors, either through negotiation or bankruptcy.[41]

Throughout the rest of September and October of 2008, AIG was forced to post increasing amounts of collateral to its CDS counterparties. Even with the Fed committing an additional $37.8 billion to AIG on October 8, in the form of a Securities Borrowing Facility, the company had run through $61 billion of its credit line by early November. In addition, AIG's stock price had continued to fall to unheard of levels, and the company was having problems rolling over (selling) its commercial paper and securing overnight repo funding. (Repos are a form of short-term borrowing whereby a holder of securities—typically government securities—is sold to investors and then bought back the following day. Repos are used to raise short-term capital.)

---

[40] State insurance regulators, who apparently had no concerns about the securities lending program, have asserted that the lending program alone would not have caused the insolvency of the insurance subsidiaries because "there would have been sufficient assets in the companies and in the parent to maintain the solvency of all the [insurance] companies." The COP report pointed out that that this conclusion assumes that these assets were not needed for AIGFP, which was "a big assumption." See id., 46.

[41] See **p. 37-40 below** for a discussion of why the bankruptcy option was rejected by the Federal Reserve and Treasury officials. Emails between federal officials and bankruptcy attorneys at Davis Polk & Wardwell obtained by Fox News shows that the initial decision to avoid bankruptcy was revisited and rejected several times after September 16, 2008. Eric Morath, "AIG Bankruptcy Contemplated in Feds Emails to Davis Polk," *Wall Street Journal*, June 29, 2009, http://blogs.wsj.com/bankruptcy/2009/06/29/aig-bankruptcy-contemplated-in-feds-emails-to-davis-polk/.

To complicate matters, AIG's assets were illiquid and declining in value, its borrowing had become extremely restricted, and the price of the company's credit default swaps had reached historic highs. By mid-September the cost of protection on AIG's debts and liabilities had reached a level equivalent to paying $1.4 million per year to insure $10 million of AIG debt.[42] These high credit insurance costs reflected the considerable market risk and credit risks that AIG was shouldering from both its holdings of residential mortgage-backed securities and the credit default swaps it had written on residential mortgage-backed securities. Under the terms of the CDS contracts, AIG was required to post collateral either on a decline in value of the underlying CDOs (collateralized debt obligations), or in the event of an AIG credit rating downgrade. The prospects and realities of both events were triggering cash collateral calls that created enormous liquidity problems for AIG.

Thus, even after the government's $85 billion loan, the market could see that AIG's capital structure was unsustainable. The interest rate on the government's loan—8.5 percentage points over LIBOR—and the short duration of the loan was creating a great deal of pressure for AIG to sell assets quickly, at deep discounts, in a weak market.[43] As bad as this looked from the outside, AIG surprised the market by reporting breathtaking third-quarter losses of $24.5 billion. In anticipation of poor quarterly results, credit rating agencies had been threatening to downgrade AIG's debt.[44] If such a downgrade were to happen, it seemed clear to Treasury officials that it would have accelerated over $40 billion in collateral calls, which, without an infusion of capital, would have led to the company's total collapse.

---

[42] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, 347.

[43] The high interest rate was a holdover from the term sheet of the aborted private sector rescue plan prepared by Goldman Sachs and Morgan Stanley, which envisioned lending AIG $75 billion. There were no buyers of this plan.

[44] As early as November 2007, at least one of PricewaterhouseCoopers' auditors was privately warning AIG's CEO, Martin Sullivan, that the company could have "material weaknesses" in its risk management of credit default swaps. This warning was subsequently disclosed in a regulatory filing. In November and December, the company first started reporting unrealized losses in its swaps portfolio, but continued to claim on conference calls with investors that "AIG's economic loss is close to zero." By the end of February 2008, AIG reported losses of $11.5 billion for 2007. It also reported posting $5.3 billion of collateral on the $527 billion notional value of its swap portfolio. AIG's CEO continued to report to investors that the company expected these losses to "reverse over the remaining life" of the contracts, but in a seeming contradiction Joseph Cassano, head of the Financial Products division, resigned (albeit with a $1 million per month consulting contract). Throughout 2008, unrealized losses from credit default swaps continued to grow, reaching $42.5 billion by November 2008, two months after third-quarter losses of $24.5 billion were reported and the initial bailout was structured. See http://insuranceproviders.com/aig-bailout-timeline/.

To stave off such a bankruptcy, the Treasury and the New York Fed acted quickly in early November to restructure the bailout and inject an additional $40 billion of TARP capital into AIG. As part of this transaction, the Treasury purchased $40 billion of senior preferred shares in AIG, in return for a 10 percent dividend and warrants for 2 percent of the company's shares. In addition, the Fed scrapped the $85 billion two-year loan, substituting a five-year $60 billion loan and cutting the interest rate from 8.5 to 3.0 points over LIBOR. Under this plan the Fed's credit facility was reduced, while the government's 80 percent equity ownership stake remained intact.

Under the November restructuring plan put together by the New York Fed, $52 billion worth of CDOs underlying AIG's increasingly problematic credit default swaps were shifted into to two new Fed special purpose vehicles called Maiden Lane II (or ML2) and Maiden Lane III (or ML3).[45] As one part of this plan (Maiden Lane III), the FRBNY decided, with Treasury's agreement, to loan up to $30 billion to purchase at market value collateralized debt obligations insured by CDS contracts from AIG counterparties.

The decision of the FRBNY to finance the purchase the CDOs underlying the CDSs rather than purchasing the CDSs themselves is noteworthy. The Fed most likely presumed that this was a more attractive option for seemingly intransigent counterparties because it took all the depreciating ("toxic") assets off their balance sheets once and for all. This approach also enabled the Fed to avoid having to post further collateral postings under those contracts once an agreement with the counterparties was reached.[46]

Under this plan, AIGFP's counterparties were allowed to keep $35 billion in cash

---

[45] Maiden Lane II and III were formed to facilitate the restructuring of AIG. More specifically, the New York Fed extended credit to ML2 to purchase residential mortgage-backed securities accumulated by AIG Asset Management in the company's securities lending operation described above. The New York Fed then extended credit to ML3 to acquire collateralized debt obligations from several counterparties of AIG's Financial Products Corporation (subsidiary). The creation of both ML2 and ML3 allowed the FRBNY to deter a credit downgrade of AIG by transferring risks related to further losses from the company's securities lending and CDS programs to the New York Fed, which was charged with managing those transferred assets for the benefit of U.S. taxpayers. In compensation for this newly assumed risk, the FRBNY stood to share in 83 percent of any gains in the sale of these assets, many of which were purchased at significantly discounted prices. Congressional Oversight Panel, *June Oversight Report*, 169, note 664. (The initial Maiden Lane special purpose vehicle was initially created to facilitate the merger of Bear Stearns and JPMorgan Chase. The New York Fed extended credit to Maiden Lane so that it could acquire certain Bear Stearns assets.)

[46] AIG also made a $5 billion equity investment in ML3 as part of the November 10 restructuring of the bailout.

collateral that had already been paid by AIGFP, which meant that counterparties received the entire par value of their CDOs at a time when the market value of these securities had declined to less than one half of their par value. Here's the math. The combination of this $35 billion in cash collateral already paid to counterparties, plus ML3's purchases of CDOs at depressed market value from counterparties, approximated the par value of all CDO CDS contracts, or a total of $62 billion.[47]

The top five counterparties thus relieved of the CDO liabilities were Goldman Sachs, Merrill Lynch, Société Générale, Deutsche Bank, and Calyon (formerly, Crédit Agricole). Note that three of the top five counterparties were non-U.S. banks.

FRBNY officials argued that purchasing the insured CDO securities from the counterparties, canceling the CDS contracts, and compensating the counterparties 100 cents on the dollar was necessary to get the counterparties to agree with the plan. In pursuing this "make-the-counterparties-whole" strategy, the New York Fed reasoned that it didn't want to use its role as regulator to force concessions from institutions that it oversaw. Once the Fed decided not to force AIG to seek bankruptcy protection, it was not in a position to negotiate with the threat of bankruptcy and force counterparties to accept discounts or losses in closing out their existing CDS contracts with AIG (as I explain in Section IV, below).

Executing this plan, sweet as it was for counterparties, was critical to bailout sponsors because then AIG would no longer have to post collateral, thereby easing its liquidity problems and avoiding another credit downgrade. However, this feature of the second bailout—and especially the retention of the $35 billion in cash collateral by AIGFP's counterparties—subsequently became, and still remains, highly controversial. A final feature of this restructuring plan was the requirement that AIG sell more than 20 subsidiaries, thereby becoming a much smaller and narrowly focused property and casualty insurer.

---

[47] According to the COP report (p. 90), the FRBNY considered two other options. The first involved convincing AIGFP's counterparties to cancel their credit default swap contracts and take over the risk of their holding now-uninsured CDOs. Since there was no incentive for counterparties to cooperate, this option died a quick death. The second option involved counterparties placing CDS contracts in SPVs (off-balance sheet special purpose vehicles) guaranteed by FRBNY, while getting counterparties to agree not to demand any further collateral. This option reflected the Fed's concerns about any open-ended liability. Under this option, counterparties would probably have had to return part of the collateral paid to them by AIGFP as the quality of their CDS contracts improved due to government backing. This feature was recognized as difficult to implement, and this option died, too.

In mid-March 2009, nearly six months after the government's initial intervention, the final piece of the AIG bailout transaction was put in place. The Treasury committed an additional $30 billion to AIG through TARP, while reducing its credit facility by $25 billion in exchange for preferred interests in special purpose entities holding two of the company's largest life insurance subsidiaries (which were to be sold).

In total, the Fed and the Treasury together committed $182.3 billion to AIG between October 2008 and March 2009. It is important to understand that the four principal transactions comprising the bailout were incremental and opportunistic in nature, tailored to the evolving (both deteriorating and improving) conditions of AIG and the external capital market. Viewed in retrospect, it is difficult to claim—in light of the bailout's incrementally pieced-together structure—that any grand plan for subsidizing AIG's customers/counterparties was imagined. Indeed, the highly incremental nature of the bailout suggests continuing improvisation by the government in the face of largely unknowable systemic risks and capital market conditions. (For a more detailed summary of the transactions comprising the AIG bailout, readers can refer to Figures 1 and 2 at the end of this paper.)

However we assess the government's motivations and actions in AIG's bailout, it is now clear that the bailout was, in the end, a profitable set of transactions according to U.S. Treasury accounting. As noted above, the government's overall positive return on its efforts to stabilize AIG during the financial crisis was $22.7 billion, with the Treasury realizing a positive return of $5.0 billion and the Federal Reserve realizing a $17.7 positive return.

In addition, the size of the company by assets was cut nearly in half since 2008, through divestitures of life insurance subsidiaries and the streamlining of remaining property and casualty insurance businesses. Similarly, by December 2012, the notional value of the legacy derivatives at AIG Financial Products Corporation had been reduced by 90 percent.

Despite this good news, important questions await answers.

# III. Controversy #1: Was the Bailout Essential to Financial System Security?

Critics of the AIG bailout like David Stockman have argued that there was "no basis in fact" for an AIG bailout—that the government's fear that an AIG collapse would be catastrophic, leading to "systematic consequences" across the U.S. and international economies, was completely unjustifiable. Since there are never any facts about the future, it is unclear what Stockman was referring to. What we need to consider here are competing judgments about the bailout, not competing facts.

## The Government's Argument

The government's case for supporting AIG was constructed by senior Treasury and Fed officials and their professional staffs, many of whom had deep knowledge of global credit markets. Over time, the justification for government intervention expanded as AIG's condition and market conditions deteriorated through the fall of 2008 and winter of 2009. Not surprisingly, much of what was being forged together into a rescue plan and then publicly justified was necessarily being done on the fly and with very incomplete information about AIG's true balance sheet and liabilities.[48]

Yet, it must be said that neither the Treasury nor the Fed saw fit to share with the public any detailed macro-economic modeling or quantitative estimates of potential outcomes of an AIG-type collapse, even though we now know that the New York Fed had been following the deteriorating financial situation closely and that some modeling of this sort was being conducted under orders of Treasury Secretary Henry Paulson starting when he assumed office in 2006 (See below.) It is, perhaps, due to this lack of more explicit economic predictions that the decisions of Secretary Henry Paulson, New York Federal Reserve Bank president Timothy Geithner, and Federal Reserve Board chairman Ben Bernanke pertaining to AIG are being second-guessed five years later.

---

[48] The COP report reveals that AIG was not able to provide "a sense of its balance sheet and its exposure" to either the government or potential private sector investors. In addition, the report quotes Geithner's testimony before the Panel noting that "neither AIG's management nor any of AIG's principal supervisors—including the state insurance commissioners and the OTS—understood the magnitude of risks AIG had taken or the threat that AIG posed to the entire financial system." Congressional Oversight Panel, *June Oversight Report*, 137, note 528.

## Paulson's Concerns and Testimony

That said, Henry Paulson (Treasury Secretary under President George W. Bush) has been one of the strongest and most eloquent supporters of the AIG bailout. In his testimony before the House Committee on Oversight and Government Reform in January 2010, Paulson said,

> The rescue of AIG was necessary, and I believe that we in government who acted to rescue it—including Secretary Geithner, Chairman Bernanke, and me—acted properly and in the best interests of our country. The reasons the rescue of AIG was necessary are well worth examining. I believe they are representative of the causes of other aspects of the crisis and indicate where regulatory reform is necessary. There are three reasons we needed to intercede to save AIG that stand out in my mind.
>
> First, AIG was incredibly large and interconnected. It had a $1 trillion dollar balance sheet; a massive derivatives business that connected it to hundreds of financial institutions, businesses, and governments; tens of millions of life insurance customers; and tens of billions of dollars of contracts guaranteeing the retirement savings of individuals. If AIG collapsed, it would have buckled our financial system and wrought economic havoc on the lives of millions of our citizens.
>
> Second, AIG was seriously under-regulated. Although, many of AIG's subsidiaries—including its insurance companies—were subject to varying levels of regulation, the parent entity was, for all practical purposes, an unregulated holding company.
>
> Consequently, there was no one regulator with a complete picture of AIG or a comprehensive understanding of how it was run. It was not until AIG started to fail that regulators began to understand how badly managed it had been and how much the toxic aspects of parts of its business had infected otherwise healthy parts.
>
> Third, AIG could not be effectively wound down. Unlike failed depository institutions which can be taken over by the FDIC with little or no harm to depositors, or the GSEs which were seamlessly placed into

> conservatorship by Treasury and the Federal Housing Finance Agency, there was—and is—no resolution authority available to wind down a failing institution like AIG. The only option is bankruptcy, a process that is simply not capable of protecting the millions of Americans whose finances are intertwined with AIG's.[49]

Paulson's justification of the AIG bailout should not be read as a one-off defense of a totally unexpected crack in the financial system. For one thing, his testimony was certainly vetted by Treasury colleagues. Equally as important, Paulson's frame of mind had long been one of extreme caution. Ever since he accepted the Treasury job in 2006, Paulson was jumpy about the economic situation and fearful of some sort of financial crisis. As explained in his 2010 book, *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*, Paulson was well aware that markets rarely went many years without a severe disruption and that there had not been a financial blowup since 1998. With credit being so cheap and easy to tap for so long, he was deeply concerned that "people were not braced for a systemic shock."

But this was only the beginning of Paulson's concerns. In addition to free-flowing credit and capital market excesses, Paulson saw the nation facing several other, unattended economic problems. Two wars needed to be financed while entitlement spending kept growing, making budget deficits especially difficult to manage. Further, the country was facing increasing trade imbalances resulting from unprecedented consumer spending and low saving, which meant that the country needed to borrow huge amounts from abroad, mostly from China. While these purchases of U.S. debt eventually found their way back through Wall Street, making for a banking bonanza, Paulson was openly worried about how long this situation could last before our creditors decided to take a breather and trigger a crisis. To make matters even more worrisome for Paulson, the big increase in the size of

---

[49] Available at http://oversight.house.gov/wp-content/uploads/2012/01/20100127paulson.pdf. Paulson's opposition to bankruptcy reflected concerns by the Federal Reserve Board that such a filing would be a lengthy and disorderly process, adding significant uncertainty and risk to the financial system. Indeed, Paulson's statement to the Congressional House Committee reflected, in part, the substance of a statement posted by the Federal Reserve Board on its website on September 17, 2008, saying it had determined that a disorderly failure of AIG could add to already significant levels of financial market fragility and materially weaken the economy. As a point of fact, the case of Lehman Brothers took three and a half years in bankruptcy court, and this reorganization is generally thought to have been a marvel of efficiency on the part of the court and the company's creditors. **See pages 37-40** for further discussion of the AIG bankruptcy option.

unregulated pools of capital such as hedge funds and private equity funds, and the exponential growth of unregulated over-the-counter derivatives like credit default swaps, all of which operated with enormous amount of leverage and some of which were highly speculative, represented unknown risks. Finally, and more specific to the insurance industry about which he had become quite knowledgeable (AIG had been a Goldman client), Paulson knew that any crack in AIG's solvency would panic already-nervous foreign governments, especially in Asia, that owned its debt.[50] For all these reasons, starting as early as 2006 and persisting into the third quarter of 2008, Paulson had become increasingly unnerved and kept a very keen eye on the task of crisis prevention. According to his memoir *On the Brink*, Paulson's number one concern quickly became "the likelihood of a financial crisis." One of his earliest personal goals became finding a way "to pre-empt market panic."

To calm his anxieties and prepare the Administration for some unknowable crisis, Paulson ordered various financial scenarios prepared for study by the President's Working Group on Financial Markets. This group met regularly every four to six weeks, and was led by the Secretary of the Treasury and included chairs of the SEC and the Commodities Futures Trading Commission. Scenarios prepared for the working group included the failure of a major bank, the blowup of a major investment bank, a spike in oil prices, and so on. So, when in early September 2008 the true weakness of Fannie Mae and Freddie Mac became known to Treasury officials, and required hundreds of billions of dollars in capital infusions and back-up support (and their CEOs forced to resign), and when Wachovia Corporation, Washington Mutual, and Lehman Brothers were all on the government's watch list, with all commercial and investment bank stocks now coming under increasing pressure, Paulson's intellectual pump was fully primed. For sure, the one-two-three punch of a Fannie Mae/Freddie Mac—Lehman Brothers—AIG collapse came as an unwelcome surprise, since the government had not modeled the possibility of "everyone" failing at once. Still, Paulson was as well prepared as any government official could be. His recommended actions and supporting arguments for dealing with Fannie Mae/Freddie Mac, Lehman Brothers, and AIG—as controversial as they might be—cannot be accurately seen as total improvisation. Paulson had been thinking about the possibility of a financial panic for at least two years.

---

[50] Sorkin, *Too Big to Fail*, 396.

## Geithner's Concerns and Testimony

Like Paulson, Timothy Geithner, Treasury Secretary in the Obama Administration and former president of the Federal Reserve Bank of New York, was on high alert and reasonably well primed when the crisis hit. Geithner, after all, had been at the center of the Bear Stearns collapse and shot-gun marriage with JPMorgan Chase in March 2008. And like many others on Wall Street, Geithner's eyes were fixed on Lehman Brothers. When that bank failed only days before he received news of AIG's impending calamity, he knew that confidence in Morgan Stanley was bound to collapse (it did) and that Goldman Sachs was assumed to be the next in line. Since all of these banks borrowed enormous amounts in the short term (much of it on an overnight basis) to fund long-term activities and obligations, a crack in confidence could shut down a bank more or less instantaneously. Geithner's intimate knowledge of the state of play on Wall Street—along with his prominent presence at the finance industry's "ground zero"—were two of the principal reasons that he quickly became such a close and able partner for Paulson (according to the latter's autobiography) during the onslaught on the financial crisis.

In contrast to the relatively calm reception of former Secretary Paulson's testimony to the House Committee at the January 27, 2010 hearing, Secretary Geithner's testimony about the AIG bailout (which actually preceded Paulson's) was met by withering anger and criticism from both Republican and Democratic members. Geithner's problem was that many committee members thought Geithner's formal statement explaining the AIG bailout was old, tired, incomplete news. According to reporting by Mary Williams Walsh in *The New York Times,* filed immediately after the January 27$^{th}$ hearing, Geithner's critics made clear that they had heard his "lame story" defending the bailout many times before (the Treasury Secretary had previously appeared 22 times on the Hill). What they really wanted to hear was Geithner's justification of large executive bonuses at the government-owned AIG,[51] and his response to charges that the FRBNY had prevented AIG from revealing certain facts pertaining to the $30 billion of bailout money transferred to AIG's trading partners (through CDO buybacks) like Goldman Sachs, Merrill Lynch,

[51] Many members of the committee, like many citizens, were outraged that AIG felt it necessary to pay $165 million in annual bonuses to retain executives and traders at the division that had nearly brought the entire company to its knees three months earlier.

Société Générale, and Deutsche Bank.[52] The Committee's aggressiveness on these matters had been primed by the Committee's release of a report, just two days previously on January 25, 2010, entitled "Public Disclosure as a Last Resort: How the Federal Reserve Fought to Cover Up the Details of the AIG Counterparties Bailout from the American People." This report, based on 250,000 pages of documents and emails subpoenaed from the New York Fed, was a scathing attack of the handling of the cash transfers to banks under the Maiden Lane III transaction. This report was nothing other than a broadside attack on FRBNY's decision to finance AIG's repurchase of insured CDOs at par value, rather than at some discounted value (thereby cancelling existing CDS contracts insuring CDOs). It also lambasted the Fed's commitment to confidentiality in unwinding AIG's CDS contracts, which the committee interpreted as a deliberate effort to conceal information about counterparty payments from the public and the Committee.

Whatever the then-current mood of Committee members, reading Geithner's prepared testimony today provides a useful summary of the thoughts of Fed officials and other decision-makers, back in the fall of 2008, pertaining to how the failure of AIG would affect the financial system and the broader economy. I summarize it here because it is more finely grained than Secretary Paulson's overview.

Geithner reminded the Committee that in September 2008 the financial crisis had been rolling throughout the economy for a year. Countrywide Financial, Bear Stearns, and IndyMac had collapsed. After a year of financial turmoil, Geithner concluded that "peoples' trust and confidence in the stability of major institutions, such as AIG, and the capacity of the government to contain the damage was vanishing." To make matters worse, the call from AIG to the Federal Reserve and the Treasury Department on Friday, September 12, 2008, informing officials that the company was facing potentially fatal liquidity problems, caught everyone by surprise. AIG had hundreds of billions of dollars of in commitments in the form of

[52] After his prepared comments, Geithner countered accusations of a cover-up by saying that by the time the relevant SEC filings describing the transaction with trading partners were being prepared, he was Treasury Secretary-elect and had nothing to do with the reporting of the transaction by virtue of his own recusal. However, the fact that his Chief of Staff, then in charge in relevant filings, was revealed to be an ex-Goldman Sachs executive brought laughter and suspicion to the committee chamber. Subsequent to Geithner's congressional testimony, the New York Fed's general counsel, Thomas Baxter, tried to calm suspicions of duping the public by explaining that the flow of monies to trading partners were not needed in the submission in question because other regulatory filings offered more precise information.

credit and rate-of-return protection for financial products, without the capital to back them up. As surprising as this news was to Fed and Treasury officials, it was even more shocking to AIG's senior executives. In addition, neither of AIG's principal supervisors—the state insurance commissioners and the Office of Thrift Supervision—nor AIG management seemed to understand the magnitude of the risks AIG had taken and the threats that AIG's liquidity crisis posed to the entire financial system. And when, by Sunday, September 14, it was clear that there was no willing buyer for Lehman Brothers, which was about to declare bankruptcy, Fed and Treasury officials "knew that AIG was highly vulnerable." According to Geithner, the Unites States was facing a complete collapse of the financial system for the first time in 80 years.

The failure of Lehman Brothers over that fateful weekend was only the most recent symptom of the financial storm gathering throughout the financial system. Virtually all financial institutions were aggressively shedding risk and, according to Geithner's testimony, "trying to shore up their balance sheets by selling risky assets, reducing exposure to other financial institutions, and hoarding cash." In addition, broadly based withdrawals from money market funds (typically thought of as one of the safest investments by Americans) were severely disrupting the commercial paper market (because money market funds were large purchases of high-quality commercial paper). Issuances of commercial paper had long been a vital source of funding for many banks. Further, with the Washington Mutual and Wachovia banks now experiencing debilitating deposit withdrawals and headed for collapse, an old-fashioned financial panic seemed to be in the making. With credit drying up, Fed and Treasury officials feared that the economy would grind to a halt: state and local governments would halt public works projects, hospitals and universities would halt their projects (Harvard's visionary Allston Project was indeed shut down), and thousands of factories and transport companies employing millions of Americans would pull back. Finally, during that fateful week in September, Secretary Paulson believed that Morgan Stanley was just days away from collapse.[53] Harboring similar fears, Fed Chairman Bernanke believed that

[53] Barofsky, *Bailout*, 25. Paulson was well aware that Morgan Stanley's traders had lost $9 billion on a complex mortgage trade in 2007 and that after Lehman Brothers collapsed, many of Morgan Stanley's trading clients started to pull assets from the firm. The bank's eroding liquidity had caused its stock price to fall precipitously, reflecting the incipient funding panic.

Goldman Sachs would have been the next to go.[54]

In this context, Geithner recalled that the team at the Fed and Treasury concluded, "AIG's failure would be catastrophic." An AIG bankruptcy would result in default on over $100 billion of debt, as well as trillions of dollars of derivatives—adversely affecting numerous financial institutions and the financial system as a whole. In addition, banks and other counterparties that used AIGFP CDSs as credit protection in the event of a loss on underlying securities would have seen their positions become unhedged and uncollateralized, exposing these institutions to reduced capital levels as market conditions worsened as the unhedged securities further declined in value. Geithner testified, "Such a filing would have caused insurance regulators in the United States and around the world to take over AIG's insurance subsidiaries, potentially disrupting households' and businesses' access to basic insurance. And since many of the [life] insurance products that AIG sold were a form of long-term savings, the seizure by local regulators of AIG's insurance subsidiaries could have delayed Americans' access to their savings, potentially triggering a run on other institutions." Furthermore, doubts about the value of AIG life insurance products, expressed in the form of liquidations, could have generated doubts about similar products provided by other life insurance companies—thereby "opening up an entirely new channel of contagion." One of the implications of Geithner's testimony is that an insurance industry in turmoil meant millions of policyholders facing sharply higher premiums, assuming they could get insurance at all.

## Was the Government's Decision to Rescue AIG Mistaken?

The decision of Fed and Treasury officials to act rested on two principal arguments:

> *Risks Related to Credit Insurance*. The failure or impairment of a large, global financial institution that had written billions of dollars of insurance (such as credit default swaps) on a wide range of financial instruments would have "dramatically amplified the crisis." If bankers and investors around the world pulled back from funding and extending credit out of a fear that other financial institutions would fail, the result would be, according to the

[54] Paulson, *On the Brink*, 323-324.

> government, dramatically increased borrowing costs for businesses, a sharp fall in already depressed pension fund values, and skyrocketing job losses.
>
> *Risks Related to Life and Property & Casualty Insurance*. As one of the largest life insurers, AIG's failure would have "threatened the savings of millions of Americans in a way that the Lehman bankruptcy did not," because AIG provided financial protection to municipalities, pension funds, and other public and private entities through guaranteed investment contracts and products that protected participants in 401(k) retirement plans. And more broadly, according to Geithner, "if AIG had failed, the crisis almost certainly would have spread to the entire insurance industry."

For both the life and property & casualty insurance businesses, Federal Reserve and Treasury officials believed that AIG's subsidiaries would not have been insulated from adverse consequences following a bankruptcy because they were so tied to each other and the holding company. Bailout critics, and especially David Stockman, have demurred, claiming that the benefits of life insurance policyholders were "ring-fenced" by state regulatory bodies whose task was to ensure access of policyholders to accumulated life insurance policy benefits. In addition, many state insurance commissioners (who had their own reputations to protect) testified before the Congressional Oversight Panel that they were convinced that the insurance subsidiaries were sufficiently well capitalized that they would have been able to remain operating throughout a bankruptcy, and would have been able to resolve the securities lending issues on their own. (Note that AIG's insurance subsidiaries would not have been included in a bankruptcy filing.)

## Bankruptcy Effects on the Insurance Industry and Policyholders

Geithner, in contrast to many state insurance commissioners, was very uncertain in September 2008 about whether AIG's foreign and domestic life insurance subsidiaries would be able to meet their obligations under the securities lending program and avoid liquidity or solvency concerns and potential ratings downgrades. His principal concern was that an AIG bankruptcy would have triggered the state seizure of financially disabled life insurance subsidiaries, which in turn could have thrown the insurance industry into turmoil and denied Americans' access to their savings and benefits, thereby "potentially triggering a run on other institutions."

In probing the question of whether or not bankruptcy would have been as bad as the government claimed for the global insurance business, the COP acknowledged right off that the question could not be answered with certainty. But, following this warning, the Panel went on to say that the consensus among industry analysts that it consulted was that "once confidence is lost in an insurance company like AIG, policyholders will pull their policies, insurance agents will dissuade clients from purchasing insurance policies from the company, and that, in effect, all the insurance companies would have become 'run-off' businesses." The "run-off" expression refers to policyholders cashing in their life insurance policies, further destabilizing the subsidiaries with the possibility of a run that forces them into failure. The Panel also cited a conversation with Warren Buffett on May 25, 2010, where he maintained that "the property/casualty business would have gone into run-off, while there would have been a disastrous run on the life insurance companies."[55]

Geithner and the COP understood that the vulnerability of even a single insurance subsidiary could have had major effects on the others. This is because many AIG subsidiaries had financial interests in other AIG entities—such as in the securities lending business—or provided capital to other entities, thereby forming part of these subsidiaries' regulatory capital. An AIG bankruptcy, the government argued, could have had a seriously destabilizing effect on AIG's subsidiaries.

While the government's position, that the benefits of life insurance policy holders were at serious risk, may seem a bit alarmist to some bailout critics, the COP report provides sufficient commentary to support Geithner's high level of uncertainty, in September 2008, about whether or not AIG's foreign and domestic life insurance subsidiaries were in fact protected from a run on policies, and able to avoid solvency concerns and potential rating downgrades (related to massive redemptions of policies and obligations under their securities lending programs).

## Other Systemic Effects of Bankruptcy

Fed and Treasury officials were also concerned by the possibility that an AIG bankruptcy would create havoc in the European banking system. Many European banks had entered into special CDSs with a France-based subsidiary of AIGFP in

[55] Congressional Oversight Panel, *June Oversight Report*, 152, note 585.

order to decrease the amount of regulatory capital they were required to hold. These swaps were known as regulatory capital swaps, and they enabled banks to operate with more favorable, lower levels of committed capital than otherwise would be possible. If AIG had declared bankruptcy, these banks would have had to raise additional capital or sell assets. While Fed officials did not communicate with European regulators about the extent of possible damage to their banking systems during bailout decision-making, it was a well-known contextual issue.[56] Finally, the Federal reserve and Treasury believed that an AIG default on the tens of billions of dollars of commercial paper that AIG had issued to money market mutual funds (four times the amount issued by Lehman Brothers) could have seriously weakened investor confidence in an already weak economy, disrupted the commercial paper market, and reduced credit availability and increased lending rates for short-term borrowers.

Federal Reserve Chairman Ben Bernanke subsequently backstopped Geithner's and Paulson's sense of urgency. Addressing the moment in time when AIG was failing and the financial crisis was unfolding, Bernanke later remarked that the crisis in the fall of 2008 was "the worst financial crisis in global history, including the Great Depression."[57] To claim that existential anxieties were part of decision-makers' state of mind is certainly not a stretch.

## The Bottom Line on Geithner's Testimony

Despite questions about Geithner's testimony, he presented a generally coherent and largely credible argument that an AIG bankruptcy posed large risks to the insurance industry and larger systemic risks to the global financial system than the Lehman Brothers bankruptcy.[58] While critics of the AIG bailout correctly note that AIG's insurance subsidiaries were solvent and that the cash value and expected

---

[56] Id., 111-114.

[57] Quoted in Binyamin Appelbaum, "The Audacious Pragmatist," *New York Times*, August 22, 2013.

[58] Prior to Geithner's testimony, Federal Reserve Chairman Ben Bernanke explained in a public address that the government's decision not to bail out Lehman Brothers was infeasible because, unlike AIG, the firm "could not post sufficient collateral to provide reasonable assurance that a loan from the Federal Reserve would be repaid, and the Treasury did not have the authority to absorb billions of dollars of expected losses to facilitate Lehman's acquisition by another firm." In the case of AIG, Bernanke said, "the Federal Reserve and the Treasury judged that a disorderly failure would have severely threatened global financial stability and the performance of the U.S. economy. We also judged that emergency Federal Reserve credit to AIG would be adequately secured by AIG's assets." Quotes from U.S. News Staff, "Ben Bernanke: Why We Didn't Bail Lehman Out," *U.S. News and World Report*, October 15, 2009, http://money.usnews.com/money/blogs/the-home-front/2008/10/15/ben-bernanke-why-we-didnt-bail-lehman-out.

benefits of U.S. life insurance policyholders appeared to be protected by state regulators—meaning that the holding company could not raid the capital of the life insurance subsidiaries to shore itself up without unlikely regulatory permission enabling the subsidiaries to make cash loans to the parent—we have seen that the interests of life insurance policyholders were not in all instances secure. In addition, an AIG bankruptcy could have had increasingly debilitating economic effects on the property and casualty insurance business. Purchasers of property and casualty insurance typically purchase and renew policies on a continual basis. In an AIG bankruptcy, many such customers would likely stop renewing their policies as AIG's capital base and reputation for rock-solid financial strength collapsed, thereby limiting AIG's capacity to borrow cheaply for both the holding company and its profitable insurance businesses. Such defections are not abnormal in the insurance property and casualty business, when insurance brokerage firms discover a decline in insurance companies' financial condition (and thus prospective ability to cover insured losses). To a lesser degree, such defections also occur in the life insurance business when financial advisors advise insurance policyholders to switch insurance providers for similar reasons.[59]

Geithner's testimony was subsequently validated by the Financial Crisis Inquiry Commission, which was empaneled by Congress and the President in 2009 and reported out in January 2011. Commission conclusions pertaining to the AIG rescue noted multiple "spillover effects" of an AIG collapse: "AIG was so interconnected with many large commercial banks, investment banks, and other financial institutions through counterparty credit relationships and credit default swaps and other activities such as securities lending that its potential failure created systemic risk. The government concluded AIG was too big to fail and committed more than $180 billion to its rescue. Without the bailout, AIG's default and collapse could have brought down its counterparties, causing cascading losses and collapses throughout the financial system."[60]

This conclusion was consistent with all that is known (from internal memos) about the internal deliberations and conclusions reached by the New York Fed. The Federal Reserve Board of Governors concurred with this conclusion in a September

---

[59] The author has been advised of this, and subsequently followed his advisors advice and defected from a leading life insurance company.

[60] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report,* 352.

16, 2008 press release, which stated that ". . . a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance."[61]

What the Fed knew, of course, was that the process of resolving an insolvency as large as AIG's could take even the most experienced insolvency lawyers months to navigate. Part of the problem was determining AIG's actual liabilities. Under a Chapter 11 bankruptcy reorganization, AIG's CDS contracts would have most probably been exempted from the automatic stay normally placed on debt in order to preserve the continued functioning of credit markets. This means that AIG's CDS contracts would still have to be settled. If the assets insured by these contracts continued to decline, more collateral would have to be posted by a bankrupt AIG, but how much more? No one knew.

No one knew because CDSs are traded over-the-counter rather than on an exchange. One financial institution just agrees with another to do a CDS deal. As a result, there is no way to track unannounced transactions, no way to know how exposed any particular banking institution is, and no way of getting a handle on how intertwined various banks were in lending to each other. In short, an AIG bankruptcy would create large-scale confusion over how large the contagion problem was. In addition, no one knew for sure what AIG's liabilities were likely to be in a bankruptcy scenario. [62]

## The Congressional Oversight Panel Demurs

As noted In **Section 1 above**, the COP had three principal criticisms of the government bailout summarized above—putting U.S taxpayers at risk for the full cost of rescuing a failing company, deciding to bail out AIG too hastily without a full testing of other rescue options, and failing to negotiate a lower price in retiring AIG's CDSs held by counterparties. The Congressional Oversight Panel also criticized the FRBNY for adopting the term sheet for rescuing AIG, which was developed by a consortium of potential private sector investors. This adoption

---

[61] Quoted in Dan Freed, "AIG Bankruptcy Threat Forced Fed's Hand," The Street.com, September 17, 2008. Available at http://www.thestreet.com/story/10437758/1/aig-bankruptcy-threat-forced-feds-hand.html.

[62] Similar uncertainties surrounded the cash liabilities linked to AIGFG's securities lending program and large-scale hedging operations.

inevitably led to a full bailout. The Panel interpreted the adoption of the private consortium's term sheet as evidence that the FRNBY explicitly chose to act in a way similar to that of a private investor (even though it did not ask for any fee or consideration for its role in saving AIG from bankruptcy), and in doing so failed to recognize that the AIG problem had serious public consequences, which required an examination of the full range of public and private rescue options available to the government. In other words, the decision facing the FRBNY was not an all-or-nothing or binary choice between bankruptcy and a full government rescue. Unexplored alternatives included a combined public/private rescue built on some government funding or guarantee, with some private sector funding (which in the Panel's view would have retained some market disciple), a loan conditioned on counterparties giving concessions, and a short-term bridge loan from FRBNY to provide AIG time for further thought and long-term restructuring.[63] The COP's accusation of haste in examining options expanded into charges of neglect in giving sufficient attention to public transparency and accountability—a charge that the New York Fed's general counsel subsequently acknowledged.

The New York Fed defended its quick action, saying that the COP report "overlooks the basic fact that the global economy was on the brink of collapse and there were only hours in which to make critical decisions."[64] During these frantic days, Geithner was actually still searching for a private sector solution, but once he discovered that private players were not willing to play ball without serious government involvement, immediate pressures to do something fast increased exponentially. The New York Fed began receiving panicked calls from hedge funds holding CDS contracts on CDOs, and AIG's stock price was in a free fall, down over 60 percent in one day (September 15). Even the COP, in its criticism of the initial bailout, recognized the temporal pressures and admitted that the chances of implementing other rescue options were negligible, especially after the private sector consortium had backed away from any rescue operation.[65] This sense of context no doubt held the COP back from actually second-guessing the FRBNY's ultimate bailout decision, which places its criticism more in the camp of poor method than inappropriate outcome:

---

[63] Congressional Oversight Panel, *June Oversight Report*, 139 and 230.
[64] Id., 350.
[65] Id., 140.

> The Panel does not take a position on whether the government was correct to choose rescue and acknowledges that this report is reviewing decisions made under very stressful conditions, but offers several observations on the decision and the justification offered for that decision and asks whether the government considered all the options that were available to a party with the enormous bargaining power that being the lender of last resort brings. While the government has claimed that the choice was binary (either let AIG file for bankruptcy on September 16, 2008 or step in to back AIG fully, which effectively meant it was guaranteeing that all creditors would be paid in full), this binary choice is too simplistic.[66]

Finally, the COP voiced now-familiar criticisms of the market distortions created by the government's implicit guarantee of all "too big to fail" firms and, in AIG's case, the transformation of highly risky derivatives bets into guaranteed payment obligations.[67] The Panel was additionally concerned by the fact that the conflicts of interest for the Fed and Treasury in the lead-up to the bailout gave a public impression of favoritism (even though the Panel found no evidence of this).[68]

## The ''Contagion-as-Smokescreen'' Claim

All these criticisms were amplified by the claim of "contagion-as-smokescreen" put forth by Stockman and others. What was typically meant by this phrase was that the government's justification of the AIG rescue—namely, limiting the spread of insolvency risk within the global financial system—was really no more than a cover for using taxpayer money to shore up favored trading banks when they were, in fact, in no danger of collapse. In other words, that an insolvent and bankrupt AIG would not have taken down major trading banks with it, and that Federal Reserve and Treasury officials presumably knew this. In contrast to the criticisms of the bailout by the Congressional Oversight Panel, Stockman's claim is short on

---

[66] Id., 144.

[67] Here is the Panel's precise wording on this point: ". . . by bailing out AIG and its counterparties, the federal government signaled that the entire derivatives market—which had been explicitly and completely deregulated by Congress through the Commodities Futures Modernization Act—would now benefit from the same government safety net provided to fully regulated financial products. In essence, the government distorted the marketplace by transforming highly risky derivative bets into fully guaranteed transactions, with the American taxpayer standing as guarantor." Id., 230.

[68] See p**. 15, note 26** above for the Panel's descriptions of these conflicting interests.

analysis. Indeed, his quick dismissal of the risks of contagion to the financial system flowing from an AIG collapse is quite remarkable.

Stockman's claim that there was a limited danger of contagion and financial catastrophe because only a dozen or so giant institutions were actually exposed to an AIG bankruptcy ignores that it only takes one or two big banking busts to shake system-wide confidence and bring credit flow to a standstill.[69]

Similarly, his estimate that the banks' collective exposure to losses related to an AIG bankruptcy was trivial—"$80 billion at most," a back-of-the envelope calculation based on losing 20 percent of the value of AIG's AAA paper held by banks—ignores the losses associated with potentially worthless AIG-issued CDS contracts supposedly providing insurance of securities held on banks' balance sheets.[70]

Even a cursory review of SEC filings by AIG's largest counterparties reveals why government officials were concerned about the solvency of major banks (as well the insurance industry and policyholders) during the August and September of 2008. With the benefit of 20-20 hindsight, the liquidity risks to individual banks and global credit markets may look more manageable now than they did then, but the record suggests there should be no question that the shudders of systemic fear that spread through the New York Fed and Treasury were reality-based.

Consider, for example, the situation of Merrill Lynch (ML). FY 2007 was a very bad year for the investment bank. It reported total losses of $7.8 billion, equivalent to 25 percent of its common shareholders' equity. Having reported profits of $7.3 billion in 2006, the 2007 results represented a $15 billion negative swing in annual earnings. (Twelve months later, ML reported losses of $27.6 billion—an amount that dwarfed its diminished shareholders' equity.)

Underlying the $7.8 billion loss are some revealing sub-totals. Realized losses on principal transactions plus unrealized losses totaled $14.5 billion for 2007. These losses and others, which contributed to a massively negative cash flow of $72.4 billion, were somewhat compensated for by a robust securitization business that brought in $175 billion in proceeds. In other words, mortgage securitizations

[69] Stockman, The Great Deformation, 7.

continued to surge as the bank was bleeding profits and cash flow!

During 2007, ML raised $165 billion in new long-term borrowings to shore up its deteriorating cash position. The good news was that the bank was still able to raise the long-term capital and sell short-term paper in its current state. The alarming news was that 25 percent of total long-term borrowings were due within one year. Clearly, ML now had little absorption power for shock. But three systemic shocks did arrive several months later: the failure of Bear Stearns in March of 2008, the collapse of Lehman Brothers the following September, and AIG's liquidity crisis two days later.

As Lehman Brothers' and AIG's financial condition worsened during the first three quarters of 2008, so too did ML's financial position continue to deteriorate—due largely to the steady decline in the market value of its portfolio of CDOs. It is easy to imagine that without the AIG bailout in September and the subsequent Fed-financed purchase of CDOs insured by AIG, ML's principal transaction and trading losses would have skyrocketed, along with its already deeply negative cash flows—thereby effectively cutting off ML from further sources of long- and short-term capital. Even without knowing the exact amount of AIG insured CDOs on ML's books, it should be no surprise that the Federal Reserve and the Treasury were predicting that ML would be the next bank in line to fail after AIG.[71]

Though to a lesser degree than Merrill Lynch, Morgan Stanley was also experiencing a significant deterioration in its financial condition. While the world's fifth largest issuer of debt continued to report profits, those profits were fast diminishing.

Net income had declined from $7.5 billion in 2006 to $3.1 billion in 2007—a 57% drop. Cash flow from investing activities was negative for the third year in a row. Overall, the bank's negative cash flow had jumped from a $2.4 billion drain in 2006 to an $11.4 billion drain in 2007. To cover losses on investing and financing activities and repayment of existing debt, the bank was forced to raise nearly $75 billion in new long-term borrowings. As MS financials deteriorated, its

---

[70] Id., 8.

[71] CDOs were not clearly were identified on the asset side of ML's published balance sheet. To further complicate understanding the bank's true exposure to CDO risk, many of these assets were sitting out-of-sight in unconsolidated, off-balance-sheet entities.

compensation and benefits expenses increased by nearly 20%—a very shocking statistic for many reasons, not the least of which was the pressing need to increase executive compensation in a down year to restrain the exit of key personnel to healthier firms.[72]

During the first nine months of 2008, net income continued to decline another 41%. These losses were driven in part by a $1.4 billion loss in mortgage proprietary trading and a write-down in the market value of mortgage-related securities. While the bank was able to raise another $43 billion of unsecured debt to cover cash-flow needs, all five major credit rating agencies had reduced Morgan Stanley's short-term and long-term debt ratings by September. Four of the five agencies also posted a negative rating outlook.

As with Merrill Lynch, liquidity was essential to Morgan Stanley's business. Like all trading banks, they relied on external sources to finance a significant portion of their operations. Thus, any negative perception of a bank's long- or short-term financial prospects could instantly impair its ability to raise funding. If access to such funding were restricted by a negative watch or, worse, a down-grade by credit rating agencies, it would not only raise the cost of borrowing and diminish trading revenues, but the bank would be required to start selling assets at a discount from market value to meet maturing liabilities.

As revealed in its SEC filings, Morgan Stanley officials fully understood this risk. So, too, did they understand that any changes in the market's perceptions of Morgan Stanley's financial strength and the flow of credit to Morgan Stanley could trigger almost instantaneously a cessation of operations and massive withdrawals of customers' funds as market confidence eroded. This was Morgan Stanley's greatest fear, one that was shared by government officials who were intent on not disrupting the global flow of credit.

---

[72] Executive compensation and benefits expenses at Morgan Stanley in 2007 totaled $16.6 billion, or about 45% of net revenues, and over 5 times pre-tax income in what was a down year. Morgan Stanley was not alone in spending such enormous sums of money on executive pay. In the frothy years from 1997 to 2007 leading up to the financial crisis, the five major U.S. investment banks (Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns) paid out in salaries and benefits each year an amount equal to twice their pre-tax income—a total of $421.8 billion in salaries and benefits versus $222.6 billion in pre-tax income. See Malcolm S. Salter, "Short-Termism at Its Worst: How Short-Termism Invites Corruption . . . and What To Do About It," *Edmond J. Safra Research Lab Working Papers*, No.5, (2013): 39.

For Morgan Stanley, the probabilities of such an illiquidity event increased substantially during the fall of 2008—even as the bank reported better than expected earnings. As the capital markets became more volatile, the cost and availability of critical, short-term funding became more problematic, for Morgan Stanley and everyone else in the credit issuance, intermediation, and investment business. Reflecting increasing funding uncertainties, the bank's stock price was being hammered. CEO John Mack was soon complaining loudly to the SEC and everyone else that short-sellers—who presumably smelled blood—were unreasonably attacking the bank's share price, creating a significant decline in the bank's market value, and creating unnecessary concerns over its future viability. (The SEC eventually took the "emergency measure" of temporarily banning investors from short-selling 799 financial companies, hoping to restore falling stock prices that had shattered confidence in financial markets. This "emergency measure" aimed at stabilizing security prices effectively squeezed the shorts, forcing them to cover their positions. Britain's Financial Services Authority also temporarily banned short-selling.)

If the government did not step in to rescue AIG, would Morgan Stanley have now faced a credible risk of insolvency as its depreciating CDOs lost the insurance provided by AIG's credit default swaps? Probably. The risk of Morgan Stanley losing access to low cost, short-term funding, which is so critical to any trading operation, certainly looks like a credible one—albeit at a lower level than for ML. I say "probably" because it is difficult to calculate from the outside Morgan Stanley's vulnerability to declining values of CDOs held in unconsolidated, off-balance sheet entities. Of course, the larger the CDO exposure in these entities, the larger the risk that credit default swaps purchased from AIG would not cover the loss in CDO market value.

Still, whatever the increasing probability of insolvency was, the capital market only needs a slight signal of weakness to lose confidence in an institution like Morgan Stanley and to act decisively. So if AIG, ML, and Morgan Stanley had all run out of money at more or less the same time—because their access to overnight funding and the commercial paper market evaporated—the systemic reverberations would have been significant and deeply recessionary. Bailout critics have never considered this possibility. In fact, they have trivialized the entire insolvency possibility by claiming that a collapse of leading credit issuers and intermediaries would have led to the rise of new dealers in credit more or less instantaneously, within three or four weeks of a major bank failure.[73] This assumption seems totally misinformed, ignoring the realities of putting in place all the building blocks necessary to establish trust and attract sophisticated investors in the commercial and government-backed securities business.

In contrast to bailout critics, Paulson and Geithner understood how fast serial insolvencies could spread to virtually any highly leveraged bank financed by short-term funding. They knew, and discussed, how the seemingly invincible Goldman Sachs was subject to the same credit market risks as Merrill Lynch and Morgan Stanley. Indeed, virtually everyone on Wall Street understood this dynamic—namely, that many great financial institutions have folded overnight when the trust and confidence of funders disappeared (most recently, Enron, which borrowed enormous amounts of capital to fund their energy trading operation, had collapsed practically overnight in the fall of 2002 as its creditors and counterparties called in their money). This is the reality-risk that captured the attention of Federal Reserve and Treasury officials who would have been held responsible for a collapse in the flow of credit, a breakdown of the insurance industry, and a slide into severe economic recession.

* * * * *

In light of this reading of the record and market conditions, it is difficult to characterize the government's choice between the bailout/no bailout options as a premeditated act of cronyism.

In economist-speak, once the government had sufficient reason to believe that the problems of lost "ex post efficiency" resulting from the bailout decision (in this case, the loss of a functioning credit market) exceeded any problems of lost "ex ante efficiency" in business decisions going forward (due to failure to eliminate moral hazard or the possibility of a future government bailout of banks if things go bad), then government's problem became how to execute the bailout as quickly as possible at the lowest cost and risk to U.S. taxpayers.[74] This appears to be exactly

[73] Stockman made this precise claim in a book tour talk and visit to the Edmond J. Safra Center for Ethics at Harvard University on September 26, 2013.

[74] My colleague, Malcolm Baker, offered this interpretation of the AIG bailout to me after reading an earlier draft of this paper (private communication, September 23, 2013).

the decision context that Paulson and Geithner faced, and according to the calculus of this framework, their decision to rescue AIG cannot be fairly presented as the poster boy for crony capitalism.

The three dissenting commissioners to The Financial Crisis Inquiry Commission (who actually concurred with the "risk of contagion" conclusions of the majority report) seem to have captured the essence of the government's decision-making:

> Given the preceding failures of Fannie Mae, Freddie Mac, the Merrill Lynch merger, Lehman's bankruptcy, and the Reserve Primary Fund breaking the buck, market confidence was on a knife's edge. A chain reaction could cause a run on the global financial system. They feared not just a run on the bank, but a generalized panic that might crash the entire system—that is, the risk of an event comparable to the Great Depression.
>
> For a policymaker, the calculus is simple: if you bail out AIG and you're wrong, you will have wasted taxpayer money and provoked public outrage. If you don't bail out AIG and you're wrong, the global financial system collapses. It should be easy to see why policymakers favored action—there was a chance of being wrong either way, and the costs of being wrong without action were far greater than the costs of being wrong with action.[75]

These conclusions do not, however, dispose of all the controversy surrounding this case. The remaining question concerns the eventual *form* of the AIG rescue. This structural matter merits further discussion.

## IV. Controversy #2: Is the Bailout's Form an Expression of Crony Capitalism?

A short, somewhat intemperate report by the House Committee on Oversight and Government Reform, issued on January 25, 2010, stoked considerable controversy about the form of the AIG bailout—namely, the government-financed payments that

[75] Dissenting Statement of Commissioners Keith Hennessey, Douglas Holtz-Eakin, and Bill Thomas, in Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, 433.

AIG made to banks that had purchased credit-default swap insurance from the firm before the financial crisis.

## Congressional Outrage, Paulson's Rebuttal

The committee had several beefs, all related to the Maiden Lane III transaction. While the New York Fed claimed that the transaction was a responsible use of taxpayer money and "may well yield a profit," the committee called it deceptive and dishonest. The committee was particularly peeved that the FRBNY allowed counterparties to keep the $35 billion in collateral that AIG had posted as the assets underlying the credit default swap contracts declined. The committee argued that as the value of the underlying assets recovered, some of that money should have been returned to AIG (and the American taxpayers who now owned approximately 80 percent of the company). In their ending coda, the committee struck the following tone: "*When the value of the assets of ML3 is measured against the total cost of the counterparty payments, the idea that taxpayers will profit is ludicrous*."[76]

Notwithstanding the fact that the U.S. Treasury reported in December 2012 that the transaction had generated a positive return of $9.5 billion, the committee's statement suggests that it may have misunderstood the transaction two years before. Once the Federal Reserve decided to pay counterparties par value for the CDOs underlying AIG's CDS contracts, par value became the sum of the collateral posted and the price actually paid for the depreciated CDOs. (**See p. 28 above**.)

The House Committee on Oversight and Government Reform was not an isolated voice on this aspect of the AIG bailout. Bailout critics seized on conjecture that Secretary Paulson, as the former head of former Goldman Sachs, somehow played a prejudicial role in financing cash payments paid to Goldman Sachs and other large banks when trying to wind down AIG's liabilities under its credit default swap and securities lending programs.

The source of such speculation is obvious. More than a quarter of the bailout

[76] Committee on Oversight and Government Reform, "Public Disclosure as a Last Resort," 4. The committee report also complained that the FRBNY initially edited AIG's SEC filings to remove information about payments to counterparties and subsequently dragged its feet in revealing both the names of domestic and foreign counterparties and the compensation of AIG officials—all purported attempts by the FRBNY to avoid scrutiny over the conduct of the AIG bailout. For the record, all drafts of AIG's SEC filings were approved by the New York Fed's outside counsel, Davis Polk Wardwell, LLC.

monies that AIG paid out to parties holding its CDSs and participating in its securities lending program went to large banks like Goldman Sachs, Merrill Lynch, and Deutsche Bank. And since Goldman was the largest recipient of these payments, receiving $12.9 billion, this inevitably produced a variety of conspiracy theories in both Congress and beyond about what strings were being pulled behind the scenes to get such assistance. Indeed, some wags began referring to the U.S. Treasury as "Government Sachs."[77]

Paulson has long argued that this claim is false and testified at the January 2010 congressional hearing that he had no knowledge of any payments that AIG made to particular banks, although he was generally supportive of the AIG bailout. Despite the seeming plausibility of this statement (since the bailout was almost entirely put together by Geithner), Paulson's disclaimer did not end suspicions about his role in post-bailout payouts from AIG to counterparties that prominently included Goldman Sachs—perhaps because he was still in office at the time that the Maiden Lane III special purpose vehicle was created as a conduit for such payments.

## What the Evidence Reveals

The only way to settle this pivotal charge of cronyism is to discover precisely what Paulson and Geithner actually knew about Goldman Sachs' vulnerabilities to an AIG collapse when the Maiden Lane III transaction was being put together. If Paulson, and more importantly, Geithner, approved the transaction knowing that Goldman Sachs had (a) sold off most of its CDOs to third parties and was therefore more a "conduit" than an investor in CDOs and (b) hedged the residual risks of AIG being unable to make payments to Goldman's customers holding CDOs under existing CDS contracts—and was therefore not materially exposed to an AIG collapse—then the ML3 transaction would indeed raise a red flag of cronyism or unjustifiable generosity.

What we now know is that Goldman was pretty close to being perfectly hedged (as described below). But did Paulson and Geithner know this when Maiden Lane III was being structured? If the Treasury and the New York Fed did not know this, then

[77] Sorkin, *Too Big to Fail*, 632.

they had every reason to think that Goldman was as exposed as Merrill Lynch and Morgan Stanley in the mortgage-backed securities business.

I have found no evidence, however, that either Geithner or his staff had any knowledge of Goldman's trading book or hedged positions. Normally, this information is water-tight confidential. I can only conclude that Goldman did not share—and had no reason to share—this information with the New York Fed.

With respect to Paulson's knowledge of the ML3 transaction and his possible role in setting it up, he has testified under oath to the negative. Unless we have reason to believe that Paulson was lying—which we do not—his testimony before Congress is a critical piece of evidence in rebutting charges of cronyism.[78]

Of course, even if Geithner and Paulson had no detailed knowledge of Goldman's exposure to an AIG bankruptcy, there is the possibility that some sort of cultural biases were at work at the Treasury and the New York Fed arising out of their social networks and group identifications.[79] As Nobel laureate Joseph Stiglitz has famously observed (and been substantiated through social science research), "I think that mindsets can be shaped by people you associate with, and you come to think that what's good for Wall Street is good for America."[80] Some such dynamic may indeed have been at work this case, but by its very nature it is difficult to detect. In fact, I would point out that much of what Treasury Secretary Paulson advocated in September 2008 constituted a major departure from his more laissez-faire, non-interventionist policy beliefs and ideological preferences. In addition, the senior staff at the New York Fed monitoring AIG throughout the summer and early fall of 2008 were, if not fully seasoned, responsible professionals who provided Geithner and his Washington colleagues with "pro" and "con" summaries for bailout (financing) options being considered.[81] Unconstrained cognitive biases were unlikely to survive this discipline for very long, except under extreme conditions of near-total cultural capture by Wall Street interests.

---

[78] I should also point out that according to government ethics laws, Paulson had to recuse himself from all Goldman matters and could not speak to the firm. But as the meltdown advanced, Paulson received an "exclusion" from Treasury lawyers to talk with Goldman Sachs, which he did many times, along with other important Wall Street banks. In my view, Paulson's sworn testimony trumps any suspicions that he discussed Goldman's trading position with his successor Lloyd Blankfein.

[79] Kwak, "Cultural Capture and the Financial Crisis," lays out these possibilities in excellent fashion.

[80] Jo Becker and Gretchen Morgenson, "Geithner, Member and Overseer of Finance Club," *New York Times*, April 26, 2009, http://www.nytimes.com/2009/04/27/business/27geithner.html.

Still, it is possible for a casual observer to see reasons for arguing the case of crony capitalism with respect to the *form* of the bailout—namely, the settlement of CDS contracts brokered by the FRBNY. I believe that would be mistaking appearances for reality. My investigation suggests that what went on—both the motivation and the strategy—is more subtle than bold-faced "crony capitalism." Rather, my current sense of things is that the Maiden Lane III payments to AIG counterparties reflect a combination of decision-makers' practical judgments and deeply ingrained fears about how the market and CDS counterparties would react to other settlement options. These judgments led to outcomes, however controversial, that cannot be accurately characterized as crony capitalism—previously defined as a purposeful or calculated corruption of the political process whereby the success or survival of a business is dependent on the favoritism it is shown by the ruling government instead of being determined by a free market.

For example, FRBNY has given a number of reasons for closing out the CDS contracts at their face value minus the collateral paid out.[82]

- After the government had made it clear in September that it was going to stand behind AIG, the threat of an imminent AIG bankruptcy had effectively been removed. Any threat of a default (meaning anything less than payment of the full amount due on the CDSs) amounted to a threat of bankruptcy, which, once the government had indicated it would support AIG, would not be taken seriously.
- FRBNY was concerned that threatening default would introduce doubt in the capital markets about the resolve of the government to stand behind its commitments, which would adversely affect the stability of the capital markets, reintroducing the systemic risk it had sought to quell.
- FRBNY was also concerned about the reaction of the rating agencies to attempts to pay less than the full amount due on the CDSs, which could have led to further downgrades on AIG's credit rating.
- There was little time, significant execution risk, and the possibility of significant harm if the transaction was not effected by November 10.

---

[81] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, 348.

[82] Congressional Oversight Panel, *June Oversight Report*, 172.

The testimony received by the Congressional Oversight Panel also provides substantial evidence that the government faced a tougher bargaining situation than most critics admit. Take for example the case of Goldman Sachs, the second largest holder (after Société Générale) of AIG's CDS contracts. The Panel's report describes why Goldman was indifferent between an AIG bankruptcy and a bailout, and hostile to negotiated concessions. Other counterparties presumably had other reasons as well.

In brief, a year after the ML3 transaction Goldman Sachs revealed that it had not been exposed to AIG counterparty credit risk (meaning the risk that AIG might be unable to make a payment due under its CDS contract) in the event of a bankruptcy. That was because the bank resold these CDS contracts to clients with views of the market that were compatible with the contracts. As the bank's chief financial officer, David Viniar, told the Panel, "the net risk we were exposed to is consistent with our role as a market intermediary rather than a proprietary market participant."[83]

As the Panel correctly pointed out, Goldman was not entirely in a riskless position vis-à-vis AIG. This was because Goldman was still on the hook to its own clients. "If AIG had failed, Goldman would have been exposed to its own clients to the entire extent of the notional amount of the CDSs it had written, and its ability to do so would have depended on the strength of its own hedges and its negotiating position vis-à-vis its own counterparties."[84]

However, to mitigate this remaining risk, Goldman had taken out two types of protection against the failure of AIG: (1) CDSs purchased from AIG itself that required AIG to put up cash collateral in the event of a downgrade in either AIG's credit rating, AIGFP's credit rating, or a decrease in the market value of the reference CDOs, and (2) CDS protection purchased during 2007 and 2008 from many other large financial institutions both inside and outside the U.S.

Commenting in 2009 on Goldman Sachs' interactions with AIG during the bailout, Viniar said, "In the middle of September [2008], it was clear that AIG would either be supported by the government and meet its obligations by making payments or

[83] Id., 174.

[84] Id.

posting collateral, or it would fail. In the case of the latter, we would have collected on our hedges and retained the collateral posted by AIG. That is why we are able to say that whether it failed or not, AIG would have had no material direct impact on Goldman Sachs."[85]

On this basis, Goldman refused to make concessions on CDS repurchases with the FRBNY. Even the COP, ever critical of bailout methods and outcomes, conceded that Goldman had nothing to lose in not cooperating in price negotiations pertaining to the CDS repurchases.[86]

Given the government's negotiating stance that it had to treat all parties equally, Goldman Sachs' position more or less set the norm on price. One other AIG counterparty, the Swiss bank UBS, did agree to accept a 2 percent haircut provided other counterparties did as well, but this offer fell on deaf ears. All other counterparties refused to budge on price, no doubt realizing that the government had already decided that it would not to let AIG fall into bankruptcy. One result of Goldman Sachs' intransigence in bargaining on prices and the "me-too" strategies pursued by other AIG counterparties is that banks more vulnerable than Goldman were saved from serious losses and the related erosion of their regulatory capital.

## The Matter of Government Negotiations with AIG Counterparties

While there are good explanations of counterparty intransigence on the price of repurchased CDSs, the question lingers about whether the government could still have applied greater leverage in negotiations with AIG's counterparties. It is difficult to explain this conundrum with confidence, but there are several plausible possibilities:

- Perhaps the fact that much of the AIG bailout negotiations was delegated to relatively junior government officials mistakenly limited the face-to-face involvement of an intensely harried Secretary Paulson and President

[85] Goldman Sachs, "Overview of Goldman Sachs' Interaction with AIG and Goldman Sachs' Approach to Risk Management," March 20, 2009, cited in Congressional Oversight Panel, *June Oversight Report*, 176.
[86] Id., 175-176.

Geithner in the final bargaining with peers, who actually stood to lose the most from a financial panic.[87]

- Perhaps the midlevel staffers selected to negotiate with AIG's counterparties were constrained by an extremely limiting script, such as: any price concessions would need to be "entirely voluntary" and no concessions by counterparties could be accepted unless all of the banks agreed to the exact percentage reduction.[88]
- Perhaps the Fed and Treasury were concerned that if a negotiated settlement with AIGFP's counterparties and debt holders resulted in less than 100 cents on the dollar, it would have caused credit ratings agencies to downgrade AIG claiming that such a settlement would be viewed by the agencies as a default (assuming that full payment is the essence of an investment grade rating).[89]
- Perhaps such a credit downgrading might have led insurance regulators to seize AIG's insurance subsidiaries.[90]
- Perhaps once Goldman Sachs refused to negotiate a price discount, and knowing that the government would not let AIG file for bankruptcy, no other bank could conceive of giving concessions, especially if they were more vulnerable to insolvency than Goldman appeared to be.
- Perhaps the FRBNY choice of Davis Polk as its outside counsel—a law firm that had previously represented private parties in matters related to AIG and had strong ties to Wall Street—somehow contaminated the negotiating process, or at least gave the impression of doing so.[91]
- Perhaps the task of working simultaneously with multiple institutions in unprecedented trouble, in a crisis mode and under great time pressure, simply truncated the negotiations process.

None of these possibilities can be strongly substantiated, but the last possibility strikes me as being the strongest explanation. To paraphrase Robert Rubin's

---

[87] Id., 140.

[88] Barofsky, *Bailout*, 184.

[89] Id., 150.

[90] Id., 291.

[91] Id.

advice to President Clinton, “it’s the incentives, stupid!” There were, in the end, few strong economic incentives for AIG’s counterparties to negotiate on CDS prices, and Geithner understood this. Seen in this light, the eventual form of the AIG bailout does not suggest crony capitalism at work. Still, even in the absence of cronyism, it is troublesome that a small number of “too big to fail” members of the global financial system were rescued or assisted without any cost to them.

## V. Summing Up

In the argot of detective stories, the staging of the AIG bailout has the superficial look of a crime scene, but what is the crime? Or put more accurately, the AIG bailout may look like crony capitalism, but where is the evidence?

Proponents of the crony capitalism claim fail to make their case. Indeed, it looks to me that we were fortunate to have had two successive Treasury secretaries who had the capacity to make inevitably controversial decisions under conditions of extreme uncertainty and imperfect information during the two days following Lehman Brothers’ collapse.

Yet much of the public nevertheless appears to agree with critics’ false claims of cronyism. And five years after the AIG bailout, these claims continue to receive journalistic attention. The best explanation for this phenomenon is continuing public anger over the fact that the bailout saved some unquestionably irresponsible—and, in some instances—corrupt institutions from their own, mortal mistakes. But the uncomfortable reality of the AIG bailout—at least in the eyes of its architects—is that protecting the flow of global credit from a massive shutdown, and fending off a 1930s-type depression, required protecting some irresponsible and corrupt institutions. This twist in the AIG story seems to be either ignored or carelessly discounted in many versions of the story’s telling.

Cronyism is a problem in contemporary American capitalism; perhaps an intensifying problem, as Simon Johnson and James Kwak argue in *13 Bankers*. But an incorrect identification and labeling of crony capitalism subverts meaningful reform. In addition, a misreading of the AIG story detracts attention from the essential question suggested by this case: how systemic risks presented by our global financial system can be best managed short of routinely submitting the state and its citizenry to the sizeable costs of institutional and economic failure.

**Figure 1: Overview of the AIG Transactions: Funding Facilities Provided by Different Government Entities, with Various Changes to the Transactions over Time***

| Trans-action Date | Type of Transaction/ Security | Length of Loan/ Term of Invest-ment | Capital/ Available Credit to AIG or ML Entity | Interest Rate | Oversight | Changes to Previous Transactions | Status Over Time: Exposure at Height; Total Current Exposure |
|---|---|---|---|---|---|---|---|
| **Federal Reserve Revolving Credit Facility** | | | | | | | |
| 9/16/08 | FRBNY received Series C Perpetual, Convertible, Partici-pating Preferred Stock convertible into 79.9% of issued & outstanding common shares | 2 years | Up to $85B | 3-month LIBOR + 8.5% on drawn funds; 8.5% fee on undrawn but available funds; one-time commitment fee of 2% of loan principal | Three independent trustees to oversee equity interest for duration of loan | N/A | Exposure at height of facility: $72B (10/2008)<br><br>Total current exposure: $26.1B outstanding as of 5/27/2010 |
| 11/25/08 | Reduction in loan ceiling and interest rate | Extended to 5 years | Reduced to $60B | 3-month LIBOR (with a minimum floor of 3.5%) +3% on drawn funds; 0.75% fee on undrawn funds | | Loan term extended; credit available reduced; interest rate reduced; fee on undrawn funds reduced by 7.75% points to 0.75% | |
| 4/17/09 | Reduction in interest rate | | | 3-month LIBOR (no floor) + 3% on drawn funds; 0.75% fee on undrawn funds | | Removed minimum 3.5% LIBOR borrowing floor; permitted issuance of pre-ferred stock to Treasury | |
| 12/1/09 | Debt for equity swap | | Reduced to $35B | | | Reduced loan ceiling by $25B in exchange for FRBNY obtaining a preferred interest in AIA and ALICO SPVs | |
| 5/6/10 | Reduction in loan ceiling | | Reduced to $34B | | | Reduced loan ceiling due to sale of HighStar Port Partners, L.P. | |

* Congressional Oversight Panel, June Oversight Report: The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy, June 10, 2010, 11-13.

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Federal Reserve Securities Borrowing Facility** | | | | | | | |
| 10/8/08 | FRBNY borrowed investment-grade, fixed income securities from AIG in exchange for cash collateral | | Up to $37.8B | | | Facility creates better terms for AIG, as the company is effectively the lender of securities for cash | Exposure at height of facility: $17.5B (10/2008)<br>Total current exposure:<br>None; became Maiden Lane II |
| **TARP-SSFI/AIGIP** | | | | | | | |
| 11/25/08 | Treasury purchased Series D Fixed Rate Cumulative Preferred and Warrants for common stock | Perpetual Life (Preferred); 10-year life (Warrants) | $40.0B | 10% quarterly dividends, cumulative | Treasury | Capital used to pay down original Fed credit facility; Trust ownership percentage on conversion becomes 77.9%, with Treasury holding warrants equal to an additional 2% common stock ownership | Total current exposure is highest to date.<br>Treasury holds:<br>– $40B in Series E Fixed Rate Non-Cumulative Preferred Stock<br>– $7.5B in Series F Fixed Rate Non-Cumulative Perpetual Preferred Stock<br>– Warrants equal to 2% of common shares outstanding<br>Accrued and unpaid dividends from original Series D Preferred<br>Stock of $1.6B outstanding must be paid at redemption.<br>Additional $0.2B commitment fee to be paid from AIG"s operating income in three equal installments over 5-year life of revolving credit facility |
| 4/17/09 | Treasury exchanged Series D for Series E Fixed Rate Non-Cumulative Preferred<br>Shares and Warrants for common stock | Perpetual Life | | 10% quarterly dividends, non-cumulative | Treasury | Treasury exchanged Series D Preferred Shares for Series E Fixed Rate Non-Cumulative Preferred Shares. Accrued and unpaid dividends of $1.6B from Series D shares must be paid at time of Series E redemption | |
| 4/17/09 | Treasury purchased additional Series F Fixed Rate Non-Cumulative Preferred Shares and Warrants for common stock | Perpetual Life (Preferred); 10-year life (Warrants) | $29.8B | 10% quarterly dividends, non-cumulative | Treasury | Additional capital injection that reflects a commitment of up to $30.0B reduced by $0.2B in retention payments made by AIGFP to employees in March 2009 | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Maiden Lane II** | | | | | | | |
| 11/10/08 | FRBNY formed LLC to purchase RMBS from AIG insurance subsidiaries, lending money to the LLC for this purpose | 6 years, to be extended at FRBNY's discretion | Up to $22.5B | 1-month LIBOR + 100 bps (loan by FRBNY); 1-month LIBOR + 300 bps (deferred purchase price to AIG subs) | FRBNY with asset management by BlackRock Financial Management | Terminates Securities Borrowing Facility. Formation of an LLC to be lent money from FRBNY to purchase RMBS from AIG insurance subsidiaries. AIG sub receives a 1/6 participation in any residual portfolio cash flows after loan repayment. FRBNY receives 5/6 of any residual cash flows. | Principal balance exposure at closing (height): $19.5B on Fed senior loan. Total current exposure on outstanding principal amount and accrued interest due to FRBNY: $14.9B as of 5/27/10, with deferred payment and accrued interest due to AIG subsidiaries of $1.1B as of 5/27/10 |
| **Maiden Lane III** | | | | | | | |
| 11/10/08 | FRBNY formed LLC to purchase multi-sector CDOs from counterparties of AIGFP, lending money to the LLC for this purpose | 6 years, to be extended at FRBNY"s discretion | Up to $30.0B | 1-month LIBOR + 100 bps (loan by FRBNY); 1-month LIBOR + 300 bps (repayment to AIG of equity contribution amount) | FRBNY with asset management by BlackRock Financial Management | Same as above, only for purchase of multi-sector CDOs from counterparties of AIGFP. AIG and FRBNY receive 33% and 67%, respectively, of any remaining proceeds after repayment of loan and equity contribution | Principal balance exposure at closing (height): $24.3B on Fed senior loan. Total current exposure on outstanding principal amount and accrued interest due to FRBNY: $16.6B as of 5/27/10, with outstanding principal and accrued interest on loan due to AIG of $5.3B as of 5/27/10 |

**Figure 2: Government Assistance to AIG as of May 27, 10 (millions of dollars)***

| | Amount Authorized |
|---|---|
| **FRBNY** | |
| Revolving Credit Facility | $34,000 |
| Maiden Lane II: Outstanding principal amount of loan extended by FRBNY | 22,500 |
| Net portfolio holdings of Maiden Lane II LLC | - |
| Accrued interest payable to FRBNY | - |
| Maiden Lane III: Outstanding principal amount of loan extended by FRBNY | 30,000 |
| Net portfolio holdings of Maiden Lane III LLC[2] | - |
| Accrued interest payable to FRBNY | - |
| Preferred interest in AIA Aurora LLC | 16,000 |
| Accrued dividends on preferred interests in AIA Aurora LLC | |
| Preferred interest in ALICO SPV | 9,000 |
| Accrued dividends on preferred interests in ALICO Holdings LLC | |
| **Total FRBNY** | **111,500** |
| **TARP** | |
| Series E Non-cumulative Preferred stock | 40,000 |
| Unpaid dividends on Series D Preferred stock | |
| Series F Non-cumulative Preferred stock | 29,835 |
| **Total TARP** | **69,835** |
| Net borrowings | 181,335 |
| Accrued interest payable and unpaid dividends | |
| **Total Balance Outstanding** | **$181,335** |

[1] U.S. Department of the Treasury, "Troubled Asset Relief Program Transactions Report for Period Ending May 26, 2010," May 28, 2010, 18 (online at www.financialstability.gov/docs/transaction-reports/5-28-10%20Transactions%20Report%20as%20of%205-26-10.pdf) (hereinafter "Treasury Transactions Report"); and Board of Governors of the Federal Reserve System, "Factors Affecting Reserve Balances" (H.4.1) May 27, 2010 (http://www.federalreserve.gov/releases/h41/20100527/ )(hereinafter "Federal Reserve H.4.1 Statistical Release").

[2] Federal Reserve H.4.1 Statistical Release ("Dividends accrue as a percentage of the FRBNY's preferred interests in AIA Aurora LLC and ALICO Holdings LLC. On a quarterly basis, the accrued dividends are capitalized and added to the FRBNY's preferred interests in AIA Aurora LLC and ALICO Holdings LLC.").

* Congressional Oversight Panel, 15

## Working Paper Series

Research in Action
WORKING PAPER

*Institutional Corruptions*
by Lawrence Lessig
Edmond J. Safra Research Lab Working Papers, No. 1

*Strengthening the Theory of Institutional Corruptions: Broadening, Clarifying, and Measuring*
by Donald W. Light
Edmond J. Safra Research Lab Working Papers, No. 2

*Influence Incognito*
by Brooke Williams
Edmond J. Safra Research Lab Working Papers, No. 3

*Professionalism and Moral Behavior: Does A Professional Self-Conception Make One More Unethical?*
by Maryam Kouchaki
Edmond J. Safra Research Lab Working Papers, No. 4

*Short-Termism At Its Worst: How Short-Termism Invites Corruption… and What to Do About It*
by Malcolm S. Salter
Edmond J. Safra Research Lab Working Papers, No. 5

*What Institutional Corruption Shares with Obscenity*
by Gregg Fields
Edmond J. Safra Research Lab Working Papers, No. 6

*Investment Consultants and Institutional Corruption*
by Jay Youngdahl
Edmond J. Safra Research Lab Working Papers, No. 7

*Does the Gender of Directors Matter?*
by Miriam Schwartz-Ziv
Edmond J. Safra Research Lab Working Papers, No. 8

*Finding Solutions to Institutional Corruption: Lessons from Cognitive Dissonance Theory*
by Lisa Cosgrove and Robert Whitaker
Edmond J. Safra Research Lab Working Papers, No. 9

*Democracy in Poverty: A View From Below*

by Daniel M. Weeks
Edmond J. Safra Research Lab Working Papers, No. 10

*What's the Big Deal?: The Ethics of Public-Private Partnerships Related to Food and Health*
by Jonathan H. Marks
Edmond J. Safra Research Lab Working Papers, No. 11

*Tax-Exempt Corruption: Exploring Elements of Institutional Corruption in Bond Finance*
by Zachary Fox
Edmond J. Safra Research Lab Working Papers, No. 12

*Second Thoughts on Second Opinions: Conflicted Advisors Reduce the Quality of Their Advice When They Know They Will be "Second-Guessed"*
by Sunita Sah and George Loewenstein
Edmond J. Safra Research Lab Working Papers, No. 13

*Culture Wars: Rate Manipulation, Institutional Corruption, and the Lost Underpinnings of Market Conduct Regulation*
by Justin O'Brien
Edmond J. Safra Research Lab Working Papers, No. 14

*Institutional Corruption and the Crisis of Liberal Democracy*
by William English
Edmond J. Safra Research Lab Working Papers, No. 15

*Two Concepts of Corruption*
by Dennis F. Thompson
Edmond J. Safra Research Lab Working Papers, No. 16

*Think Tanks' Dirty Little Secret: Power, Public Policy, and Plagiarism*
by J.H. Snider
Edmond J. Safra Research Lab Working Papers, No. 17

*Rooting Out Institutional Corruption To Manage Inappropriate Off-Label Drug Use*
by Marc A. Rodwin
Edmond J. Safra Research Lab Working Papers, No. 18

*Divided Loyalties: Using Fiduciary Law to Show Institutional Corruption*
by Michael Pierce
Edmond J. Safra Research Lab Working Papers, No. 19

*Political Finance in the United Kingdom*
by Timothy Winters
Edmond J. Safra Research Lab Working Papers, No. 20

*Blinding as a Solution to Institutional Corruption*
by Christopher Robertson
Edmond J. Safra Research Lab Working Papers, No. 21

*A Passport at Any Price? Citizenship by Investment through the Prism of Institutional Corruption*
by Laura Johnston
Edmond J. Safra Research Lab Working Papers, No. 22

*Independent Drug Testing to Ensure Drug Safety and Efficacy*
by Marc A. Rodwin
Edmond J. Safra Research Lab Working Papers, No. 23

*Brazil's Case Against Private-Sponsored Events for Judges:*
*A Not-yet-perfect Attempt at Fighting Institutional Corruption*
by José Vicente Santos de Mendonça
Edmond J. Safra Research Lab Working Papers, No. 24

*Institutional Corruption: A Fiduciary Theory*
by M.E. Newhouse
Edmond J. Safra Research Lab Working Papers, No. 25

*"You're Not Just a Paid Monkey Reading Slides:" How Key Opinion Leaders Explain and Justify Their Work*
by Sergio Sismondo
Edmond J. Safra Research Lab Working Papers, No. 26

*The Power of Perception: Reconciling Competing Hypotheses about the Influence of NRA Money in Politics*
by Arjun Ponnambalam
Edmond J. Safra Research Lab Working Papers, No. 27

*Does Trust Matter?*
*Corruption and Environmental Regulatory Policy in the United States*
by Oguzhan Dincer and Per Fredriksson
Edmond J. Safra Research Lab Working Papers, No. 28

*Singapore Sling: How Coercion May Cure the Hangover in Financial Benchmark Governance*
by Justin O'Brien
Edmond J. Safra Research Lab Working Papers, No. 29

*Justification of Academic Corruption at Russian Universities: A Student Perspective*
by Elena Denisova-Schmidt
Edmond J. Safra Research Lab Working Papers, No. 30

*Fighting Corruption in Education: A Call for Sector Integrity Standards*
by Mihaylo Milovanovitch
Edmond J. Safra Research Lab Working Papers, No. 31

*Annals of Crony Capitalism: Revisiting the AIG Bailout*
by Malcolm S. Salter
Edmond J. Safra Research Lab Working Papers, No. 32



Research in Action
WORKING PAPER