



The AIG Saga: A Brief Primer

BY DEAN BAKER *

The awarding of \$165 million in bonuses to AIG executives has dominated the news in the last week. There has been widespread outrage over the idea that taxpayers' dollars are being used to reward the people who effectively bankrupted AIG and cost the government more than \$160 billion in bailout funds to meet the company's obligations. This primer addresses some of the issues raised by both the bonuses and the much larger sum going toward the AIG bailout.

The Bonuses: What Did They Know and When Did They Know It?

One of the silliest distractions in the AIG saga has been the various accounts of when AIG told Treasury Secretary Geithner of the bonuses and when Geithner passed the information along to President Obama. This discussion is silly because Geithner almost certainly knew of the bonuses ever since the initial takeover on September 15th. He just didn't think they were important.

Geithner was the chair of the New York Fed at the time of the original takeover. In that capacity, he was the person directly overseeing the takeover. As the chairman of the New York Fed, Mr. Geithner was undoubtedly familiar with the Wall Street culture and knew that financial firms paid out large bonuses each year to their most-valued employees. Since he did not issue any directives to AIG telling them not to pay bonuses, it was reasonable to expect that AIG would do so, just like it always did.

In other words, Geithner had every reason to believe that AIG would continue to pay out bonuses even after it was bailed out by the government, because he did not tell it stop paying bonuses. He may not have considered this issue important until the last week. And, he may not have known the exact size and the structure of the bonuses, but for all practical purposes he has known for six months that AIG would be issuing million dollar bonuses to certain employees, in spite of the fact that it was dependent on massive infusions of government money to stay alive.

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Does the Government Have to Pay the Money?

It is not easy to find legal ways to avoid paying for work that was already done. It is possible that the government could make it difficult for the bonuses to be collected by breaking off AIG's Financial Products division (the one responsible for bankrupting the company) and then letting this company go bankrupt.¹

However, this route has two major problems. First, a main purpose of the bailout was precisely that the government wanted to honor the obligations of the Financial Products division, ostensibly to maintain the stability of the financial system. If this division went bankrupt, then it could pose risks to the stability of the financial system. The second problem is that the bonuses have already been paid. Any action would now require taking back money that was already paid out. This is considerably more difficult than preventing money from being paid in the first place.

A second path that is currently being pursued by Congress is to tax back the bonuses with a tax that is designed explicitly to apply to bonuses given to workers for companies that are being bailed out by the government. This sort of measure is a rather blunt instrument to address the problem. The resulting compensation system is certainly less than perfect (the bill passed by the House would tax back 90 percent of the bonuses received by highly paid executives), but it could hardly be worse than the compensation structure currently in place.

A third possibility is to insist that the private shareholders pay for the bonuses. Private shareholders still own 20 percent of the company. The market capitalization is approximately \$2.6 billion. This means that the 20 percent stake (\$520 million) owned by private shareholders can easily cover the \$165 million in bonuses.

Under this arrangement, the government would tell AIG to sell enough new shares to cover the \$165 million cost of the bonus. Since the money is supposed to come from the private shareholders 20 percent stake, for every share that AIG sells to the public, 4 shares will be awarded to the government. This keeps the government stake at 80 percent.

The current share price is about 95 cents. If it fell to 60 cents as a result of the newly issued shares, the company would have to sell 275 million shares to the public and issue another 1.1 billion shares to the government. This would leave the government's stake unaffected, while cutting the value of the current private shareholders' stake by roughly one-third. This route would leave the executives with their bonuses, but they would come at the expense of the private shareholders, not the taxpayers.

AIG Bailout Issues

Thus far \$170 billion has been spent on the AIG bailout, more than 1000 times as much as is at stake with the bonuses. For the first time last weekend, the Treasury Department released information about how this bailout money was used. It reported that much of the AIG money went

¹ The route of breaking off the Financial Products division and allowing it to go bankrupt has been suggested in a short piece by Bill Black, Tome Ferguson, Rob Johnson, and Walker Todd "How to Stop AIG Bonuses," available at http://www.huffingtonpost.com/william-black-tom-ferguson-rob-johnson-walker-todd/how-to-stop-aigs-bonuses_b_175351.html.

to large U.S. banks, most notably Goldman Sachs, Bank of America, and Merrill Lynch, in addition to several large foreign banks, including the French bank Societe Generale and Deutsche Bank. Most of these payments were in connection with their holdings of credit default swaps (CDS) issued by AIG.

There are at least three obvious issues that arise with these payouts:

- 1) Did the banks hold the underlying assets, or just the CDS?
- 2) Did the government have to buy back the underlying assets from the banks, or could it have waited to see what happened?
- 3) Could the support for the banks have been done directly, including some quid pro quo, without having AIG as an intermediary?

These three issues are outlined below.

CDS: Insurance or Gambling?

In 2007 the outstanding nominal value of all credit default swaps was close to \$75 trillion. This was approximately five times as large as the outstanding value of insurable bonds. This meant that there was an average of five CDSs issued for every insurable bond, which implies that at least 80 percent of CDSs were not owned by institutions that actually owned the bond being insured.

The Treasury and Fed have not released the rules they applied in dealing with AIG's CDS. They may have only honored CDS where the institution held the bond being insured or they may have honored all of AIG's CDSs, regardless of whether or not the bank held the bond being insured.

This makes a big difference in terms of the purpose of the bailout. If a bank had bought a CDS to protect itself against losses on a mortgage backed security, and the CDS was not honored, then it would be an unexpected blow to its balance sheet. On the other hand, if the bank was just gambling that a bond that it did not hold would go bad by buying a CDS issued against it, it is difficult to see how a failure to honor the CDS would impose a serious hardship.

There may be legal issues that would prevent a non-bankrupt AIG from choosing which CDSs it chooses to honor, but that fact may have implications for the wisdom of rescuing AIG, as opposed to just directly supporting the counterparties, where it is considered appropriate.

Did the Government Pay Off the Bets Before the Race Was Over?

The government, through AIG, paid an additional \$30 billion to counterparties because it paid off CDSs at their notional value rather than their market value. In principle, AIG would have owed the notional value of the CDSs if the underlying bond had defaulted. In these cases, the bond had not defaulted. In effect, the government acted as though AIG had already lost its bet, at a time when it was still possible that the underlying bonds would not go bad.

It is important to keep in mind that CDSs are typically relatively short-lived assets. Many provide insurance for only three years and most insure bonds for five years or less. Most of AIG's CDSs were issued before 2007. This means that by late 2008, they would have already been two years old

or older. In this context, it might have been reasonable to take a chance to see whether the CDS would actually have to be paid. In any case, there was no obvious reason to pay above the market value for the CDS. This seems like a straight gift to the banks.

Should the Government Have Gotten Something in Return for Giving Tens of Billions to the Banks?

When the government lent hundreds of billions of dollars to the banks through TARP, it got preferred shares of stock in return, in addition to placing conditions on the banks' conduct. By contrast, the government received absolutely nothing for the tens of billions of dollars that it passed on to the banks through AIG. It may have been desirable to ensure that AIG's defaults did not lead to the collapse of the major banks that were its counterparties, but this could have been accomplished by directly giving these banks capital through TARP or some equivalent mechanism. There is no obvious reason why it was necessary to give the money through AIG without getting anything in return.

It is worth noting that if the government had instead lent the AIG money to the banks through TARP, and under similar conditions, it would own an even larger share of these banks. Obviously the banks prefer that the money instead pass through AIG without conditions, but there is no reason that the taxpayers should prefer this route.

It is also worth noting that several of the recipients of AIG money were foreign banks. While the public has an interest in the stability of the world economy, which means preventing major foreign banks from going bankrupt, there is no obvious reason that American taxpayers should be forced to bail out foreign banks of wealthy countries. It is possible that there is some quid pro quo under which foreign governments are bailing out U.S. banks on losses suffered in their countries, but there has been no public acknowledgement of such an arrangement.

There is a possible alternative explanation. The government may have made these payments in order to preserve the international reputation of the U.S. financial industry. If that is the case, then this is a rather expensive subsidy to the financial industry. To date there has been no explanation as to the reason for making these payments.