The AIG Backdoor Bailout

But a bailout of whom?

BY DINO KOS

Why did the U.S. government bail out American International Group? The commonly accepted version of events has the Federal Reserve and U.S. Treasury engineering a "backdoor bailout" of Wall Street as money injected into AIG was quickly paid out to Goldman Sachs and other banks then under duress.

No doubt Wall Street banks—including Goldman, despite its protestations—were huge beneficiaries. However, they were not the only ones. Who else was exposed to AIG? A review of its 2008 SEC filings shows that another group—European banks—was even more exposed. Confronted with the risk of falling dominos on the continent immediately after Lehman's bankruptcy, it's easy to see why allowing AIG to fail was never a serious option.

European banks were exposed to AIG in at least three ways. First, they were large purchasers of credit default swaps on pools of assets to reduce regulatory capital requirements. Second, they purchased credit default swaps against subprime mortgage and other so-called "multi-sector" collateralized debt obligations. Finally, they were exposed to AIG's substantial—and very poorly managed—securities lending operation. We look at each in turn.

REGULATORY CAPITAL REDUCTIONS FOR BANKS

Why would AIG be involved with regulatory capital requirements for European banks? This calls for a quick explanation of Basel I. Each country implements the basic Basel framework, with some adjustment for each coun-

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try's unique circumstances. In theory the Basel Accord, negotiated by the Basel Committee on Banking Supervision, sets the "minimum" standard for everyone, though countries can always be tougher. In practice countries do not always abide by that principle.

A case in point is the implementation of credit risk standards in Europe. Under Basel I, banks were required to hold varying degrees of capital depending on the riskiness of the asset: typically 8 percent for private-sector claims, 4 percent against mortgages, and so on until reaching claims on governments which did not require capital (though later an interest rate risk charge was added). Capital charges for structured products were viewed to be especially high. Somehow European banks convinced regulators to reduce capital charges for pools of assets that were insured with financially sound third parties such as highly rated insurers.

The goal was to shift credit risk from bank balance sheets to insurers and others willing to take on the risk. Banks moved quickly and purchased significant amounts of protection. Who were the sellers? The biggest by far was AIG. How big? According to the company's 10-Q (as of June 30, 2008), about $312 billion (including $6 billion of mezzanine tranches) out of the total $446 billion book was written to "facilitate regulatory capital relief for financial institutions primarily in Europe."

Table 1 replicates a table from the AIG 10-Q. This was the most current publicly available information before the AIG collapse. The largest component—though not riskiest—was the regulatory capital business insuring more than $300 billion of assets for banks across Europe.

Since these swaps reduced the banks' capital requirements, the failure of AIG would have wiped out that pro-

Table 1 AIGFP Super Senior Credit Default Swap Portfolio on June 30, 2008
millions of dollars

			Unrealized Market Valuation Loss	
	Notional Amount, June 30, 2008	Fair Value of Loss, June 30, 2008	Three Months Ending June 30, 2008	Six Months Ending June 30, 2008
Regulatory Capital				
Corporate Loans	$172,717	—	—	—
Prime Residential Mortgages	$132,612	—	—	—
Other	$1,619	$125	$125	$125
Total Regulatory Capital	$306,948	$125	$125	$125
Arbitrage				
Multi-Sector CDOs	80,301	$24,785	$5,569	$13,606
Corporate Debt/CLOs	53,767	$996	($126)	$770
Total Arbitrage	$134,068	$25,781	$5,443	$14,376
Mezzanine Tranches	$5,824	$171	($3)	$171
TOTAL	**$446,840**	**$26,077**	**$5,565**	**$14,672**

Source: Company filings, Portales Partners.

tection and immediately required the banks to raise new capital to make up the shortfall. Alternatively, the banks could sell off assets at a time when prices were falling and there were no buyers. Moreover, since the industry (if not all regulators) was aware of AIG's role, its failure could have led to a further loss of confidence in European banks and further strains on funding markets that already were barely functioning. The bailout avoided these dire scenarios.

How have these swaps performed subsequently? AIG claims no losses have been incurred and the credit default swap book has been shrunk in half to $150 billion. However, all is not necessarily well. In mid-2008, AIG said it expected that "the majority of these transactions will be terminated within the next nine to twenty-one months by AIGFP's counterparties when they no longer provide the regulatory capital benefit." Basel II does not give credit for insured loans. The transition to Basel II is now complete, implying banks have no incentive to keep paying the premium and retain the credit default swap protection. Given the level of subordination (amount of loss eaten by the bank before the insurance kicks in), AIG never anticipated losses would rise to the point where they would actually pay on the credit default swaps. However, one crisis

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Table 2 CDO Payments to Counterparties

Institution	Collateral Postings ($B)	Maiden Lane III Payments Made to Counterparties ($B)	TOTAL ($B)
Société Générale	$4.1	$6.9	$11.0
Goldman Sachs	2.5	5.6	8.1
Deutsche Bank	2.6	2.8	5.4
Merrill Lynch	1.8	3.1	4.9
UBS	0.8	2.5	3.3
Calyon	1.1	1.2	2.3
Barclays	0.9	0.6	1.5
Wachovia	0.7	0.8	1.5
Bank of Montreal	0.2	0.9	1.1
Deutsche Zentral-Genossenschaftsbank	0.0	1.0	1.0
Rabobank	0.5	0.3	0.8
DZ Bank	0.7	0.0	0.7
Bank of America	0.2	0.5	0.7
Royal Bank of Scotland	0.2	0.5	0.7
KfW	0.5	0.0	0.5
JPMorgan	0.4	0.0	0.4
Dresdner Bank AG	0.0	0.4	0.4
Banco Santander	0.3	0.0	0.3
Danske	0.2	0.0	0.2
Reconstruction Finance Corp	0.2	0.0	0.2
HSBC	0.2	0.0	0.2
Morgan Stanley	0.2	0.0	0.2
Landesbank Baden-Württemberg	0.0	0.1	0.1
	$18.3	$27.2	$45.5
		Of which amount derived from European institutions	$28.4

Source: Company filings, Portales Partners. Figures rounded to nearest $100 million.

and recession later, that is no longer certain. A further deterioration in the economy would degrade asset quality and kick up loan losses. The prudent course for marginal banks is to hold onto the insurance.

Unfortunately for AIG, the premiums collected are *de minimis.* The firm badly mispriced these swaps. During the first half of 2008, AIGFP generated $156 million of revenue on these swaps—less than ten basis points annualized relative to the gross exposure. The premium is low and counterparty risk is off the table now that AIG is owned and supported by the U.S. government. So why terminate if you have a secure and (very) low cost option?

Nevertheless, there is much irony here. Regulators sought to reduce risk in the system by encouraging banks to transfer credit risk to financial insurers. Instead, risk ended up concentrated in a single firm not on any regulator's radar screens that ultimately necessitated a massive taxpayer bailout. One wonders what incentives are embedded in the several hundred pages we call Basel II.

Somehow European banks convinced regulators to reduce capital charges for pools of assets that were insured with financially sound third parties such as highly rated insurers.

Table 3 Payments to AIG Securities Lending Counterparties

Barclays	$7.0
Deutsche Bank	6.4
BNP Paribas	4.9
Goldman Sachs	4.8
Bank of America	4.5
HSBC	3.3
Citigroup	2.3
Dresdner Kleinwort	2.2
Merrill Lynch	1.9
UBS	1.7
ING	1.5
Morgan Stanley	1.0
Société Général	0.9
AIG International	0.6
Credit Suisse	0.4
Paloma Securities	0.2
Citadel	0.2
TOTAL	$43.7
Of which amount paid to European recipients	$28.3

Billions of dollars. Figures may not sum due to rounding.
Source: Company filings, Portales Partners.

A second irony is that U.S. taxpayers now continue acting as the monoline insurer for European banks. At a time when the periphery is under threat and European banks are still thought to be hiding losses, is it any wonder many are holding on to their AIG swaps?

COLLATERAL POSTINGS RELATED TO COLLATERALIZED DEBT OBLIGATIONS

AIG also insured large amounts of CDOs for a range of dealers. Inside these CDOs were super-senior tranches of subprime, Alt-A, and other risky assets that essentially stopped trading during the crisis and fell in value. AIG was called on to post collateral to cover the fall in value. When it ran out of cash, it turned to the Fed for the initial $85 billion facility, subsequently expanded and modified repeatedly. AIG used the cash to avoid default and make margin payments to its counterparties.

Who were these counterparties? The Fed tried to keep this list quiet for months until AIG disclosed the information on March 15, 2009. Counterparties benefited in two ways. First, there were direct margin payments of cash from AIG. Second, the Fed ultimately purchased the CDOs (through a special purpose vehicle called Maiden Lane III) held by the dealers and then tore up the underlying CDS sold by AIG. Between the margin payments and the purchases of the CDOs, the dealers were paid "par" or 100 cents on the dollar.

Table 2 lists the firms with receiving payments from AIG or the Fed via Maiden Lane III. Of the $44.7 billion

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paid out to the largest counterparties, $28.4 billion—nearly two-thirds—was paid out to European banks.

SECURITIES LENDING

AIG made a disastrous decision in the middle of the decade to centralize its securities lending operation and maximize returns. This is typically a boring low-risk business. AIG is a large bondholder. It lends bonds and other securities for a small fee. In return for the bond it also receives cash as collateral. That cash can be invested to enhance returns. Given the short-term nature of the contract (the borrower of the bond can return it anytime and request back his collateral), the cash is typically invested in short-term very liquid obligations such as fed funds, repos, and commercial paper.

How did AIG invest the cash? It bought more than $40 billion dollars of subprime mortgage backed securities (MBS). Those securities lost roughly half their value and AIG was unable to sell the securities—even at that low price—since markets dried up. This was a catastrophic failure of risk management. And yes, this was in the core insurance operation, not in some outpost in London.

When the counterparties returned the bonds and demanded their cash, the till was empty. Through two separate maneuvers the Fed liquefied AIG and the counterparties were paid back in full to the tune of $43.7 billion. (Note: the Fed took over the underlying MBS and manages them in a separate facility called Maiden Lane II.)

Who were the recipients of the Fed's cash? Table 3 provides the list. The top three recipients were European, and $28.3 billion—again roughly two-thirds—of the total went to European names.

AIG was a hugely important insurer with global reach. Coming immediately on the heels of Lehman's failure (two days later), once can understand why U.S. policymakers made the decision to save AIG. Its failure would have badly damaged Wall Street. However, even more damaged would have been European banks—and potentially European taxpayers.

The story is still not over. Given the large amount of "regulatory swaps" still outstanding with European banks, the U.S. taxpayer remains on the hook if the European economy—and banks' credit quality—sags anew.

So AIG was a "backdoor bailout" of whom? ◆