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FAIR GAME

Revisiting a Fed Waltz With A.I.G.

By GRETCHEN MORGENSON

A RAY of sunlight broke through the Washington fog last week when Neil M. Barofsky, special inspector general for the Troubled Asset Relief Program, published his office's report on the government bailout last year of the American International Group.

It's must reading for any taxpayer hoping to understand why the $182 billion "rescue" of what was once the world's largest insurer still ranks as the most troubling episode of the financial disaster. And it couldn't have come at a more pivotal moment.

Many in Washington want to give more regulatory power to the Federal Reserve Board, the banking regulator that orchestrated the A.I.G. bailout. Through this prism, the actions taken in the deal by Treasury Secretary Timothy F. Geithner, who was president of the Federal Reserve Bank of New York at the time, grow curiouser and curiouser.

Of special note in the report: the Fed failed to develop a workable rescue plan when A.I.G., swamped by demands that it pay off huge insurance contracts that it couldn't make good on as the economy tanked, began to sink. The report takes the Fed to task as refusing to use its power and prestige to wrestle concessions from A.I.G.'s big, sophisticated and well-heeled trading partners when the government itself had to pay off the contracts.

The Fed, under Mr. Geithner's direction, caved in to A.I.G.'s counterparties, giving them 100 cents on the dollar for positions that would have been worth far less if A.I.G. had defaulted. Goldman Sachs, Merrill Lynch, Société Générale and other banks were in the group that got full value for their contracts when many others were accepting fire-sale prices.

On the question of whether this payout was what the report describes as a "backdoor bailout" of A.I.G.'s counterparties, Mr. Barofsky concluded: "The very design of the federal assistance to A.I.G. was that tens of billions of dollars of government money was funneled inexorably and directly to A.I.G.'s counterparties." The report noted that this was money the banks might not otherwise have received had A.I.G. gone belly-up.

The report zaps Fed claims that identifying banks that benefited from taxpayer largess would have dire consequences. Fed officials had refused to disclose the identities of the counterparties or details of the payments, warning "that disclosure of the names would undermine A.I.G.'s stability, the privacy and business interests of the counterparties, and the stability of the markets," the report said.

When the parties were named, "the sky did not fall," the report said.

Finally, Mr. Barofsky pokes holes in arguments made repeatedly over the past 14 months by Goldman Sachs, A.I.G.'s largest trading partner and recipient of $12.9 billion in taxpayer money in the bailout, that it had faced no material risk in an A.I.G. default — that, in effect, had A.I.G. cratered, Goldman wouldn't have suffered damage.

In short, there's an awful lot jammed into this 36-page report.

Even before publishing this analysis, Mr. Barofsky had made a name for himself as one of the few truth tellers in Washington. While others estimate how much the taxpayer will make on various bailout programs, Mr. Barofsky has said that returns are extremely unlikely.

His office has also opened 65 cases to investigate potential fraud in various bailout programs. "When I first took office, I can't tell you how many times I'd be having a sit-down and warning about potential fraud in the program and I would hear a response basically saying, 'Oh, they're bankers, and they wouldn't put their reputations at risk by committing fraud,' " Mr. Barofsky told Bloomberg News a little over a week ago, adding: "I think we've done a good job of instilling a greater degree of skepticism that what comes from Wall Street isn't necessarily the holy grail."

Mr. Barofsky says the Fed failed to strong-arm the banks when it was negotiating payouts on the A.I.G. contracts. Rather than forcing the banks to accept a steep discount, or "haircut," the Fed gave the banks $27 billion in taxpayer cash and allowed them to keep an additional $35 billion in collateral already posted by A.I.G. That amounted to about $62 billion for the contracts, which the report describes as "far above their market value at the time."

Mr. Geithner, who oversaw those negotiations, said in an interview on Friday that the terms of the A.I.G. deal were the best he could get for taxpayers. He considered bailing out A.I.G. to be "offensive,' he said, but deemed it necessary because a collapse would have undermined the financial system.

"We prevented A.I.G. from defaulting because our judgment was that the damage caused by failure would have been much more costly for the economy and the taxpayer," Mr. Geithner said. "To most Americans, this looked like a deeply unfair outcome and they find it hard to see any direct benefit. But in fact, their savings are more valuable and secure today."

The report said that while bailing out Goldman and other investment banks might not have been the intent behind the Fed's A.I.G. rescue, it certainly was its effect. "By providing A.I.G. with the capital to make these payments, Federal Reserve officials provided A.I.G.'s counterparties with tens of billions of dollars they likely would have not otherwise received had A.I.G. gone into bankruptcy," the report stated.

As Goldman prepares to pay out nearly $17 billion in bonuses to its employees in one of its most profitable years ever, it is important that an authoritative, independent voice like Mr. Barofsky's reminds us how the taxpayer bailout of A.I.G. benefited Goldman.

A Goldman spokesman, Lucas van Praag, said that Goldman believed "that a collapse of A.I.G. would have had a very disruptive effect on the financial system and that everyone benefited from the rescue of A.I.G." Regarding his firm's own dealings with A.I.G., Mr. van Praag said that Goldman believed that its "exposure was close to zero" because it insulated itself from a downturn in A.I.G.'s fortunes through hedges and collateral it had already received. (Goldman's complete response is here.)

The inspector noted in his report that Goldman made several arguments for why it believed it was not materially at risk in an A.I.G. default, but he is skeptical of the firm's reasoning.

So is Janet Tavakoli, an expert in derivatives at Tavakoli Structured Finance, a consulting firm. "On Sept. 16, 2008, David Viniar, Goldman's chief financial officer, said that whatever the outcome at A.I.G., the direct impact of Goldman's credit exposure would be immaterial," she said. "That was false. The report states that if the New York Fed had negotiated concessions, Goldman would have suffered a loss."

The report says that Goldman would have had difficulty collecting on the hedges it used to insulate itself from an A.I.G. default because everyone's wallets would have been closing in a panic.

"The prices of the collateralized debt obligations against which Goldman bought protection from A.I.G. were in sickening free fall, and the cost of replacing A.I.G.'s protection would have been sky-high," she said. "Goldman must have known this, because it underwrote some of those value-destroying C.D.O.'s."

Ms. Tavakoli argues that Goldman should refund the money it received in the bailout and take back the toxic C.D.O.'s now residing on the Fed's books — and to do so before it begins showering bonuses on its taxpayer-protected employees.

"A.I.G., a sophisticated investor, foolishly took this risk," she said. "But the U.S. taxpayer never agreed to be a victim of investments that should undergo a rigorous audit."

Perhaps Mr. Barofsky will do that audit, and closely examine the securities that A.I.G. insured and that Wall Street titans like Goldman underwrote.

Goldman contends that it had a contractual right to the funds it received in the A.I.G. bailout and that the securities it returned to the government in the deal have increased in value.

For his part, Mr. Geithner disputed much of the inspector general's findings. He also took issue with the conclusion that the Fed failed to develop a contingency plan for an A.I.G. rescue and largely depended on plans proffered by the banks themselves.

He said the report's view that the Fed didn't use its might to get better terms in the rescue was unfair. "This idea that we were unwilling to use leverage to get better terms misses the central reality of the situation — the choice we had was to let A.I.G. default or to prevent default," he said. "We could not enforce haircuts without causing selective defaults and selective defaults would have brought down the company."

Mr. Geithner also said that the "perception that this decision by the government, not my decision alone, was made to protect any individual investment bank is unfounded."

Less than two weeks after the A.I.G. bailout, Mr. Geithner took the firm's side when he criticized a Sept. 28, 2008, article in The New York Times that I wrote about the A.I.G. bailout. That article included Goldman's statement that it wouldn't have been affected by an A.I.G. collapse. Among other things, the article, like Mr. Barofsky's report, questioned Goldman's assertion.

According to an e-mail message that Goldman sent to the New York Fed at the time, Mr. Geithner talked about the article with Mr. Viniar, Goldman's chief financial officer, before calling me. When Mr. Geithner called, he said that Goldman had no exposure to an A.I.G. collapse and that the article had left an incorrect impression about that. When I asked Mr. Geithner if he, as head of the regulatory agency overseeing

Goldman, had closely examined the firm's hedges, he said he had not.

Mr. Geithner told me on Friday that he spoke with Mr. Viniar that day to ensure that Goldman's hedges were adequate. And, notwithstanding the inspector general's findings, he said he still believes Goldman was hedged.

Probing, in-depth analyses of regulatory responses to the financial meltdown are worth their weight in gold. Mr. Barofsky's certainly is. Yet in its rush to put financial reforms into effect, Congress seems uninterested in investigating or grappling with truths contained in such reports — and until it does, our country's economic and financial system will continue to be at risk.