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Who Should Be Bailed Out?

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As governments around the world develop policies to deal with failing financial institutions, they should be sure to pick their beneficiaries wisely. In particular, they should study and avoid the mistakes made in the AIG bailout in late 2008.

A United States Special Inspector General recently issued a report criticizing the US government for failing to insist that AIG's counterparties in the market for financial derivatives bear some of the costs of bailing out the company. Indeed, bailouts of failed institutions should *never* extend the government's safety net to such counterparties.

The AIG bailout was one of the largest in history, with the US government injecting more than \$100 billion into the company. The bailout was brought about by AIG's large losses on derivative transactions with financial institutions, mostly sophisticated players such as Goldman Sachs and Spain's Banco Santander.

After the government's infusion of funds in September 2009, AIG's losses continued to mount, so the government provided substantial amounts of additional capital two months later. At this point, the government asked AIG's derivative counterparties to take a voluntary "haircut" – that is, accept a discount on the amount owed to them. When some of these parties refused, the government backed down and financed AIG's payment of all of its derivative obligations in full.

The US government felt that it had a weak hand, because it was not prepared to allow AIG to default on any of its obligations. This was a mistake. The government should have been prepared to place AIG into reorganization under Chapter 11 of the US bankruptcy code and force the derivative parties to take the desired haircut.

AIG is a holding company, and most of its business is conducted through insurance subsidiaries organized as separate legal entities. The huge losses on derivative transactions were generated by AIG's financial products unit. Although this unit was also a separate legal entity, AIG guaranteed its obligations toward derivative counterparties.

Had the government placed AIG into Chapter 11 reorganization in November 2008, AIG's creditors, including its derivative counterparties, would have ended up with the value of AIG's assets, which consisted mainly of shares in AIG's insurance subsidiaries. Without necessarily affecting the operations of AIG's insurance subsidiaries, the reorganization process would have simply shifted ownership of AIG's assets from AIG's existing shareholders to AIG's creditors.

To the extent that the value of these assets would not have been sufficient to cover all of the derivative creditors' claims, they would have had to bear some losses. Would that have been an unacceptable outcome? Not at all.

The government's reluctance to use such a process might have been motivated by AIG's major role in insurance markets around the world. But a reorganization of AIG and a shift in its ownership should not have been expected to endanger insurance policyholders. The insurance subsidiaries were not responsible for the obligations of their parent company, and their claims toward policyholders were backed by required reserves.

In any event, concerns about insurance policyholders should have led, at most, to a governmental commitment to back their claims if necessary. It did not require taxpayers to bail out the parent company's derivative counterparties.

The government might also have been motivated by concerns that losses to the derivative counterparties would deplete the capital of some significant financial institutions at a difficult time. Again, such concerns would have been better addressed in different ways – in particular, by providing institutions that needed capital with funds directly, and in return for securities. To address a potential capital shortage at Goldman Sachs, say, taxpayers would have been better off providing \$13 billion to Goldman in exchange for Goldman securities with adequate value, rather than footing the bill for the \$13 billion that AIG gave to Goldman.

In the future, governments should not bail out failing financial institutions' derivative counterparties, even when they provide a safety net to some of these institutions' creditors (such as depositors). Governments should not only follow such a policy, but also make absolutely clear in advance their commitment to doing so. Communicating such a commitment clearly would induce parties to derivative transactions not to rely on a governmental safety net, but to monitor whether their partners have adequate reserves.

A governmental commitment to exclude derivative creditors from any safety net extended when financial institutions fail would reduce future costs to taxpayers from cases like AIG. Indeed, it would reduce the likelihood that cases like AIG would ever arise.

Although the author is a consultant to the US government's office of the special master for TARP executive compensation, the views expressed in this article should not be attributed to that office.