US bailout inspector general faults windfall for AIG's creditors

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A report released Tuesday by Neil Barofsky, the special inspector general for the Troubled Asset Relief Program (TARP), criticizes Bush administration bank regulators and officials for agreeing to pay in full the bad debts owed to major banks and investment houses by American International Group (AIG) as part of last year's government bailout of the insurance giant.

Barofsky faults the officials for using public funds to pay the banks 100 cents on the dollar for $62 billion in mortgage-backed securities they had insured with AIG. Among those singled out, in addition to then-Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke, is Timothy Geithner, who was president of the Federal Reserve Bank of New York at the time.

Geithner played a pivotal role in engineering the initial $85 billion Fed loan to the failing insurance company, which was actually paid out by the New York Fed, and subsequently overseeing the deal that paid off AIG's counterparties at top dollar.

President Obama's appointment of Geithner as treasury secretary was a signal to Wall Street that his administration would continue the Bush administration's policy of placing the public treasury at the disposal of the most powerful banks and financial firms and protecting the wealth of the financial elite. Under Obama and Geithner, the original $700 billion bailout fund allocated under TARP, which was established by Congress in October of 2008, has become the starting point for trillions of dollars in cash injections, cheap loans, debt guarantees, government security purchases and other subsidies to Wall Street.

Government funds to bail out AIG alone have mushroomed from the initial $85 billion to $182 billion. Aside from the sheer scale of this diversion of public funds to the banks, the bailout has been carried out with virtually no strings attached. The single biggest beneficiary of the AIG bailout, Goldman Sachs, which faced losses of $12.6 billion in AIG-insured assets, has recorded record profits in recent months and set aside over $20 billion in bonuses to its executives and traders.

One of the dirty secrets of the bank bailout, illustrative of the corrupt relationship between the banks and top government officials and regulators, is the extraordinarily favorable treatment given Goldman Sachs by Treasury Secretary Paulson, who was CEO of the Wall Street giant before taking the post of treasury secretary under Bush. This relationship continues under Obama, who has appointed former Goldman executives to leading economic posts in his administration.

Geithner's office issued a perfunctory response to Barofsky's report, repeating previous statements that it had no choice in bailing out AIG and paying off its bad debts to the banks, on both legal grounds and because the alternative was a chain-reaction collapse of major Wall Street firms and a meltdown of the financial system.

Barofsky has issued a number of critical reports on the management of the TARP program, warning that the lack of government oversight of bailed-out banks has discredited the program and generated growing popular anger. He has repeatedly called for the Treasury Department to require banks receiving government aid to disclose to regulators what they are doing with the taxpayer money—a plea he repeats in the report issued Tuesday. His advice has been studiously ignored by Geithner and the Obama White House.

In the report, Barofsky writes, "[T]he structure and effect of FRBNY's (the Federal Reserve Bank of New York's) assistance to AIG, both initially and through loans to AIG, and through asset purchases…effectively transferred tens of billions of dollars of cash from the government to AIG's counterparties, even though senior policy makers contend that assistance to AIG's counterparties was not a relevant consideration in fashioning the assistance to AIG…."

He details the process by which Paulson, Geithner and others organized the initial bailout of AIG on September 16, 2008, one day after the collapse of Lehman Brothers, and two months later, when AIG was still bleeding cash and headed for bankruptcy, set up a government company, Maiden Lane III, to buy the mortgage-backed collateralized debt obligations on the banks' books that were insured by AIG. These assets had lost virtually all of their market value.

Barofsky reveals that Goldman, Merrill Lynch and five other major US and French banks heavily invested with AIG adamantly refused to accept anything less than 100 percent of the book value of their failing AIG-linked assets. Wall Street was, in effect, holding the entire world financial system to ransom in order to blackmail the government into paying its bad debts in full. In their rush to prop up AIG's major counterparty banks, Geithner and company ignored an offer by one of the affected firms, the Swiss bank UBS, to accept a slight discount of 2 percent.

The banks' threatened assets were in the form of credit default swap contracts with AIG, by far the world's largest seller of such contracts at the time. Credit default swaps are part of the vast and unregulated derivatives market that played a major role in the collapse of the speculative housing and credit bubble in September of last year. Banks and corporations purchase credit default swap contracts against the default of bonds issued by other banks and companies. If a seller of swaps goes bankrupt, its counterparties stand to lose billions and go bankrupt themselves.

When AIG was teetering on the edge of bankruptcy, government officials feared that its demise would be quickly followed by Goldman Sachs and other major Wall Street firms, as well as banks and investment houses internationally.

The decision to pay off the banks' bad assets in full, however, was highly controversial even within financial circles. Barofsky complains in his report that the Fed "refused to use its considerable leverage" to compel the banks to take losses.

He contrasts the government's treatment of the banks with its role in the forced bankruptcy of General Motors and Chrysler. The Obama administration and the Fed demanded and obtained concessions from the auto companies' creditors.

The difference reflects the degree to which finance capital dictates government policy in general, and the policies of the Obama administration in particular. What Barofsky does not point out is that the auto negotiations were driven by the administration's decision to impose sweeping cuts in wages, benefits and jobs on the auto workers.