Retirement Income
JOURNAL

Where's the Scandal?

By Edward Jay Epstein *Tue, Sep 21, 2010*

Did the New York Fed blunder when it bought the CDOs owned by big banks and insured by AIG? So far, the government hasn't done badly, says our guest author.

The idea that Goldman Sachs, Citibank and other big banks duped Fed officials into buying their distressed pools of debt at 100 cents on the dollar has become a relentless part of the public post-mortem on the financial crisis of 2008.

To be sure, the New York Federal Reserve Bank, using a vehicle called Maiden Lane III, paid billions of dollars to 16 banks for collateralized debt obligations (CDOs) insured by AIG through credit default swaps, and canceled AIG's contractual responsibility for that insurance. By doing so, the 16 banks got the plunging CDOs off their books and AIG got rid of an albatross around its neck.

But did the Fed really make a deal with the devil?

Opinion makers thought so. Describing the deal in the Times, Nobel laureate Paul Krugman wrote that "Taxpayers not only ended up honoring foolish promises made by other people, they ended up doing so at 100 cents on the dollar," adding, "By making what was in effect a multibillion-dollar gift to Wall Street, policy makers undermined their own credibility—and put the broader economy at risk."

Eliot Spitzer, the former governor of New York, was even more severe, terming the payments to the banks a "real disgrace." And during the public hearings held by the Congressionally-appointed Financial Crisis Inquiry Commission in July 2010, commission member Brooksley Born expressed bitter indignation that Goldman Sachs was "100% recompensed on that deal" and that "the only people who were out money were the American public."

Such charges neglected three pertinent facts. First, the Fed did not pay "100 cents on the dollar." According to the Fed's website, it paid $29.1 billion for CDOs with a face value of $62.1 billion, or about 48 cents on the dollar.

Second, U.S. taxpayers did not lose money on the CDOs. The Fed bought these securities very close to their price nadir in November 2008, and they rose in value with the bond rally in 2009 and 2010. In fact, as of September 8, 2010, the Fed has earned a $7.9 billion profit on them—at least on paper.

Third, the CDOs have continued repaying large amounts of principal and interest. To finance their acquisition, the Fed made a $24.3 billion loan to Maiden Lane III. So far the CDOs have paid back over $9.3 billion. At the current rate, the remaining loan will be repaid in less than four years. Meanwhile, the Fed earns interest of one percent above the London Interbank Offered Rate (LIBOR) on the loan.

The outrage over this deal has not focused on the supposed damage to the Fed, or even to American taxpayers. The outrage has been about the lack of damage the deal caused the 16 banks that had bought insurance on their CDOs. These 16 banks wound up getting back roughly their entire insured investment.

But not entirely at taxpayer's expense. When the market value of the CDOs began plunging in July 2007, and their ratings were downgraded, AIG, which had issued their credit default swaps, had a contractual obligation to send them "collateral payments" equivalent to the drop in the CDO's market value.

By November 2008, though AIG teetered on bankruptcy from making these payments, the 16 banks' actual exposure on the CDOs was only their depressed market value. When the Fed bought back the CDOs at their market value, the banks got back what remained of their insured investment.

As Macaulay observed, the Puritans objected to the sport of bearbaiting not because it hurt the bear but because it gave pleasure to spectators. In the Fed bailout, the critics complained that the banks, especially Goldman Sachs, did not suffer enough pain.

Critics pointed out, correctly, that the U.S. government had the power to force the banks that received TARP funds to accept less than market value for the CDOs—or take a "haircut," in the parlance of Wall Street. Such a haircut would have allowed the Fed to earn even more than it eventually did on the appreciation of the CDOs. AIG, which was the Fed's junior partner in the profits of Maiden Lane III and is now 79.8% owned by the U.S., would have benefited as well.

But such an accommodation, if it took place, would have required the agreement of all 16 banks, raising a problem. Twelve of the 16 banks were foreign-owned and held approximately two-thirds of the AIG-insured CDOs. These banks had little incentive to accept anything below the market price for their CDOs because their AIG insurance coverage was still in force.

Indeed, the French bank Société Générale SA, which was the single largest holder of AIG-insured CDOs, informed the Fed that its regulators in France would not permit it to sell the CDOs below their market value and that it could not legally accept a haircut as long as AIG was solvent. This position, which other European banks took, ruled out a voluntary haircut.

The Fed could still have exercised the nuclear option: letting AIG go bankrupt. But such a move would have released the evils of a Pandora's box—not because AIG, with a trillion dollars in assets, was too big to fail, but because it was too interwoven into the fabric of the global financial system.

AIG's subsidiaries, operating in 130 countries, insured a large part of the commerce flowing between China, North America and Europe. Their seizure by state and government regulatory authorities could have paralyzed world trade and caused a panic among the insured. In the U.S. alone, AIG insured 30 million people. The billions of dollars worth of state and local funds in its guaranteed investment programs would have been frozen.

An AIG bankruptcy could cause an even greater financial crisis abroad. European banks depended on AIG's French subsidiary, Banque AIG, for the "regulatory capital" they needed to meet government-mandated capital-to-debt ratios. AIG performed this feat through complex derivative swaps. A bankruptcy, or even change of ownership in Banque AIG, would require major European banks to call in hundreds of billions of dollars in loans.

Rather than risk financial Armageddon, the U.S. government decided to save AIG. The Fed now could hardly threaten to put AIG into bankruptcy to pressure the banks to take a haircut. So Goldman Sachs, Société Générale, Citibank, JP Morgan Chase and the other counter parties won their huge bet on CDOs. They bet not merely on the securities, or even on AIG's solvency, but that, even if AIG's obligations exceeded its means, the U.S. government would not allow AIG to fail. That assessment was correct.

But the Fed, which financed the purchase of the CDOs from the banks, also did not lose. The market price that the Fed paid for the CDOs at the depths of the crisis—48 cents on the dollar— turned out to be much less than their actual value. So the Fed now stands to make a multi-billion dollar profit.

AIG of course lost heavily, with the U.S. Treasury getting almost 80% of the company. But that is the consequence of a bad bet: that CDOs would not be downgraded and plunge in value. Whether or not the U.S. recoups its investment in AIG is still an open question. But, by saving AIG, the Fed prevented the collapse of the international financial system. So where is the scandal?