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AIG 100-Cents Fed Deal Driven by France Belied by French Banks

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Jan. 20 (Bloomberg) -- The Federal Reserve Bank of New York paid French banks 100 cents on the dollar to settle trades with American International Group Inc. in November 2008, the same month an AIG competitor negotiated payments of less than a third of that to retire similar bets.

The decision to pay in full came after France's bank regulator insisted that Societe Generale SA and Credit Agricole SA's Calyon unit would be violating French law if they accepted less than they were owed, the New York Fed told a special inspector general. The Fed, which had rescued the insurer two months earlier after the collapse of Lehman Brothers Holdings Inc., paid face value to all 16 of AIG's counterparties, including Goldman Sachs Group Inc., a move that may have cost U.S. taxpayers as much as $43.5 billion.

French law didn't stop Societe Generale and BNP Paribas SA from taking $1 billion to settle $3.5 billion of trades the same month with New York-based bond insurer Ambac Financial Group Inc., according to three people familiar with the matter. Ambac's ability to negotiate a discount while the central bank of the world's biggest economy didn't adds another question for lawmakers as they examine the most contentious transaction of the government's bailout of the U.S. banking system.

"The Fed could have tried a little harder to get the French banks to take less than 100 cents on the dollar," said U.S. Representative Brad Miller, a North Carolina Democrat on the House Financial Services Committee, in an interview. "This creates the impression among the American people that the purpose was not to protect taxpayers or the economy but to protect the counterparty financial institutions."

Questions for Geithner

Treasury Secretary Timothy F. Geithner, president of the New York Fed during the biggest financial crisis since the Great Depression, will answer questions about the AIG payouts on Jan. 27 from the House Committee on Oversight and Government Reform. The committee's invitation came after Bloomberg reported that e- mail exchanges between the New York Fed and AIG show that the regulator asked the insurer to withhold details of the payments.

A statement posted by the New York Fed on its Web site yesterday said that "it is not in fact precisely accurate that counterparties received 100 percent" payments. The regulator also said in the statement that "the counterparties received essentially par value," or the full amount owed. The banks were paid $61.9 billion for securities with face value of $62.1 billion, or 99.7 percent, according to the Web site.

Reimbursing the banks was "absolutely" the right decision, Geithner said in an interview with CNBC on Jan. 14. "We did it in a way that I believe was not just least cost to the taxpayer, best deal for the taxpayer, but helped avoid much, much more damage than would have happened without that."

Questions for Geithner

Geithner recused himself from AIG matters when he was designated for the Treasury post on Nov. 24, 2008, Meg Reilly, a Treasury spokeswoman, said in an e-mail. That was the same day an AIG lawyer told the New York Fed that the insurer's executives wanted to publicly disclose details about retiring the swaps. The negotiations between the Fed and the banks over the AIG payouts took place on Nov. 6 and Nov. 7.

The New York Fed used the French regulator's opinion to help justify paying the full $62.1 billion that AIG could potentially owe counterparties on credit-default swaps it had sold, according to a Nov. 17, 2009, report by the special inspector general of the Treasury Department's Troubled Asset Relief Program.

Bernanke Response

"We believe that it would not have been appropriate to use our supervisory authority on behalf of AIG to obtain concessions from domestic counterparties in purely commercial transactions in which some of the foreign counterparties would not grant, or were legally barred from granting, concessions," Scott G. Alvarez, general counsel of the Fed Board of Governors, and Thomas C. Baxter Jr., the New York Fed's general counsel, wrote in a letter included in an appendix to the special inspector general's report.

Federal Reserve Chairman Ben S. Bernanke said yesterday in a letter to the Government Accountability Office that he would welcome a GAO review of the transactions. Lawmakers subpoenaed all documents related to the AIG payouts last week.

Bernanke, who said he wasn't "directly involved" in the negotiations, said it would not have been appropriate for the Fed to use its power as a regulator to force U.S. banks to make concessions, especially because that would have "provided an advantage to foreign counterparties over domestic counterparties."

"We believe the Federal Reserve acted appropriately in conducting the negotiations, and that the negotiating strategy, including the decision to treat all counterparties equally, was not flawed or unreasonably limited," Bernanke wrote Dec. 15 to Kentucky Republican Senator Jim Bunning.

'Backdoor Bailout'

AIG tried to persuade its counterparties to accept payments of 60 cents on the dollar before the New York Fed took over negotiations, according to people familiar with the matter.

The chairman of the House Committee on Oversight, Democrat Edolphus Towns of New York, and the committee's top Republican, Darrell E. Issa of California, have both called the full repayments a "backdoor bailout" of financial institutions.

Geithner told TARP's inspector general that the financial condition of the counterparties was not a relevant factor in the decision to pay full value, according to the report.

Paris-based Societe Generale, France's second-biggest bank by market value, received $16.5 billion from AIG, the most of any counterparty. It was followed by Goldman Sachs, with $14 billion, Frankfurt-based Deutsche Bank AG, with $8.5 billion, and Merrill Lynch & Co., now part of Charlotte, North Carolina-based Bank of America Corp., with $6.2 billion. Calyon received $4.3 billion.

Misuse of Assets

Spokeswomen Stephanie Carson-Parker of Societe Generale, Christelle Maldague of BNP Paribas and Anne Robert of Calyon declined to comment. So did AIG spokesman Mark Herr, Ambac spokesman Peter Poillon and Corinne Dromer, a spokeswoman for French regulator Commission Bancaire.

The French law that the Commission Bancaire may have cited is called "abus de biens sociaux," or misuse of company assets, said David Chijner, a partner with Fried, Frank, Harris, Shriver & Jacobson LLP in Paris who specializes in corporate restructuring and mergers.

The law prohibits company executives from making decisions they know to be contrary to the interests of the company. Violators can be jailed for up to five years and fined as much as 375,000 euros ($545,000).

"It could be considered an 'abus de biens sociaux' in extreme circumstances," Chijner said.

'Bunch of Hooey'

James D. Cox, a professor of corporate and securities law at Duke University School of Law in Durham, North Carolina, said it is "preposterous" that reaching a settlement for less than 100 cents "could be a criminal act in a developed Western country in the depths of a financial crisis."

"Even if you concede the point, it was not a crime for Goldman Sachs to take less than 100 percent," Cox said. "Treating all the banks the same is a bunch of hooey."

New York Fed spokeswoman Deborah Kilroe declined to comment. William C. Dudley, who took over as president of the New York Fed after Geithner became Treasury secretary, told PBS last week that the Fed didn't want to choose who would be hurt by an AIG bankruptcy.

"When we made the decision to intervene to prevent the bankruptcy, we were protecting everybody," Dudley said.

UBS AG, Switzerland's largest bank by revenue, told the New York Fed that it would accept a 2 percent discount if other banks would, according to the special inspector general's report. Kelly Smith, a spokeswoman for UBS in New York, declined to comment.

Blankfein Not Asked

At a Jan. 13 hearing of the Financial Crisis Inquiry Commission, formed by Congress to report on the causes of the credit crisis and the recession that followed, Goldman Sachs Chief Executive Officer Lloyd C. Blankfein said New York Fed negotiators asked a Goldman employee if the investment bank would accept less than face value for AIG debts. The employee replied that it was a decision he couldn't make at his level, Blankfein said.

The Goldman employee wasn't contacted again, Blankfein said, and neither was he.

"It didn't come up in any conversation that I can recall," Blankfein said.

The French banks had a duty to "maximize recovery" of their investments, Chijner said. That may have meant accepting a discount, also known as a haircut, from Ambac and no less than face value from AIG, whose largest investor was the U.S. government.

Ambac, AIG

"If Ambac had nobody's backing and was in a near insolvency situation, then indeed the prudent French director would have a duty to try to maximize recovery," Chijner said.

Even with government support, AIG had a greater chance of going under than Ambac did, according to credit-default swap pricing at the time. On Sept. 21, 2008, five days after the U.S. loaned AIG $85 billion and agreed to take a 79.9 percent stake in the insurer, then-Treasury Secretary Henry M. Paulson told the NBC-TV interview program "Meet the Press" that the action would "allow the government to liquidate this company."

AIG had an implied 87 percent chance of missing debt payments on Nov. 7, 2008, the day the New York Fed negotiated the repayments, according to CMA DataVision, a London-based information provider. The chance of an Ambac default that day was an implied 77 percent.

Collateral Calls

Credit-default swaps pay the buyer of the insurance face value of a security if a borrower fails to make a payment. In exchange, the buyer hands over the security or the cash equivalent.

AIG's insurance contracts differed from Ambac's because they required AIG to send collateral to counterparties when certain events, called triggers, occurred, said Jim Millstein, the Treasury Department's chief restructuring officer.

The agreements required the insurer to post collateral when the assets it guaranteed, such as home loans, declined in value or when AIG's credit rating was downgraded, Millstein said. Ambac guaranteed assets without triggers, so no payments were required until the assets matured, he said.

"It was just AIG's pure arrogance that led them to do this," Millstein said. "But they did it, and that was what the federal government inherited."

Buying the assets underlying the credit-default swaps at face value and ripping up the guarantees to AIG's counterparties stopped calls for collateral and staunched the bleeding from AIG's balance sheet, Millstein said. It also may have prevented a run on AIG's insurance business, he said.

Maiden Lane

Maiden Lane III, an off-balance-sheet entity created by the Fed, purchased $27.1 billion of underlying securities from AIG's counterparties, according to the inspector general's report. That money, combined with $35 billion in collateral funded in part by the government's original bailout, equaled the $62.1 billion value of the assets, the report said.

AIG and Ambac wrote insurance on mortgage-linked securities, and losses piled up when U.S. borrowers began to miss monthly payments at a faster pace at the beginning of 2007. Delinquencies of all home loans have doubled since then, to 9.6 percent of all homeowners in the third quarter of 2009 from 4.8 percent in the first quarter of 2007, according to the Washington-based Mortgage Bankers Association.

Neither Ambac nor AIG has ever filed for bankruptcy. Neither Societe Generale nor BNP Paribas has been prosecuted for accepting a discounted payment from Ambac.

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