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AIG’s Rescue Had ‘Poisonous’ Effect, U.S. Panel Says (Update1)

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(Updates with Warren’s remarks in the ninth paragraph, panel’s comments on possible unit bankruptcies in the 13th.)

By Hugh Son

June 10 (Bloomberg) -- American International Group Inc.’s bailout had a “poisonous” effect on the U.S. financial system because it demonstrated the government would protect Wall Street firms from their own risk-taking, said a Congressional panel.

The Federal Reserve could have acted earlier to find a privately funded solution for New York-based AIG before the September 2008 rescue, the Congressional Oversight Panel said today in a report. The bailout, which has swelled to $182.3 billion, transformed banks’ financial bets into fully guaranteed obligations, the panel said.

“The government’s actions in rescuing AIG continue to have a poisonous effect on the marketplace,” said the panel, led by Harvard University law professor Elizabeth Warren. “The AIG rescue demonstrated that Treasury and the Federal Reserve would commit taxpayers to pay any price and bear any burden to prevent the collapse of America‘s largest financial institutions and to assure repayment to the creditors doing business with them.”

The rescue helped prevent an “utter collapse” of the U.S. economy, Treasury Secretary Timothy F. Geithner said in January. Geithner, 48, executed the bailout while he led the Federal Reserve Bank of New York in 2008. Lawmakers called the move a “backdoor bailout” because banks including Goldman Sachs Group Inc. and Societe Generale SA received payments from AIG to settle derivative contracts tied to subprime mortgages.

The report of more than 300 pages faults regulators and AIG management for AIG’s near-collapse. The New York Fed focused on a solution for Lehman Brothers Holdings Inc., which failed Sept. 15, 2008, a day before the AIG rescue was announced.

No Time

“By the time the Federal Reserve Bank reversed that approach, leaving Lehman to collapse into bankruptcy without help and concluding that AIG posed a greater threat to financial stability, time to explore other options was short,” the panel said.

The report “overlooks the basic fact that the global economy was on the brink of collapse and there were only hours in which to make critical decisions,” Andrew Williams, a Treasury spokesman, said in an e-mailed statement. “We have learned from that experience and have been fighting for more than a year to give the government authority to put firms, like AIG, out of existence when their failure poses a danger to our economic system.”

‘If Everything Goes Gangbusters’

The panel said in the report that the government’s prospects for recovering funds depends partly on the ability of AIG to find buyers for its units and on investors’ willingness to purchase shares if the Treasury Department sells its holdings. AIG turned over a stake of almost 80 percent as part of the bailout and the Treasury holds additional preferred shares from subsequent investments.

“If everything goes gangbusters, we will get paid back,” Warren said today in a Bloomberg Television interview. There is still a “lot of risk for the American taxpayer.”

The bailout includes a $60 billion Fed credit line, an investment of as much as $69.8 billion from the Treasury Department and up to $52.5 billion to buy mortgage-linked assets owned or backed by the insurer through swaps or securities lending.

AIG owes about $26.6 billion on the credit line and $49 billion to the Treasury. The company returned to profit in the first quarter, posting net income of $1.45 billion.

“I’m confident you’ll get your money, plus a profit,” AIG Chief Executive Officer Robert Benmosche told the panel in Washington on May 26. “We are a strong, vibrant company.”

Plane Leasing, Consumer Lending

If it becomes apparent that AIG won’t repay its rescue in full, the U.S. could consider breaking up the insurer and putting money-losing subsidiaries into bankruptcy, the panel said. Units that are candidates because they require outside funding and may have “limited potential sale value” include the consumer lending business and plane lessor, the panel said.

“Under this approach, the government could avoid indirectly subsidizing money-losing subsidiaries and their creditors, as is currently the case, if the subsidiaries could be put into bankruptcy without affecting other operations or the holding company,” the report said.

AIG leaders allowed the firm to accumulate “staggering amounts of risk” in derivatives and other areas, the panel said. The derivatives unit continued to assume through the beginning of 2008 that credit risk from credit-default swaps was “virtually non-existent,” according to the report.

‘Somewhat Odd’

“AIG’s assertion is somewhat odd given that the company underwrote this risk on behalf of clients who clearly believed there was some risk in these instruments worth insuring,” the panel said.

The insurer, once the world’s largest, insured 100,000 companies, municipalities and retirement plans, potentially affecting 100 million Americans, and was counterparty to some of the biggest financial firms, regulators said at the time of AIG’s bailout.

The breadth of operations weren’t “matched by a coherent regulatory structure to oversee its business.” The Office of Thrift Supervision had oversight of the parent company and failed to limit risks from swaps, the panel said.

Regulators have said that they were forced to save AIG to prevent a wave of failures that a collapse would have sparked.

‘The Blob’

“Panic was so heavy in the markets that it was almost a physical presence,” Fed Governor Elizabeth Duke said in a speech to bankers on June 8. “I kept having this image in my head of the panic being like the monster called ‘The Blob’ that I saw years ago in an old movie. Like the Blob, panic attacked one institution after another.”

Congress created the panel in 2008 to oversee Treasury activities in stabilizing the economy and the $700 billion Troubled Asset Relief Program. The program has been criticized by lawmakers including Senator Maria Cantwell, a Democrat from Washington, and Representative Jeb Hensarling, a Texas Republican, for helping big banks more than average citizens.

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