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Audit Faults New York Fed in A.I.G. Bailout

By [MARY WILLIAMS WALSH](#)

The [Federal Reserve Bank of New York](#) gave up much of its power in high-pressure negotiations with the [American International Group's](#) trading partners last year, according to a government report made public on Monday.

Just two days before the New York Fed paid A.I.G.'s partners 100 cents on the dollar to tear up their contracts with the insurance giant, one bank volunteered to take a modest haircut — but it never got the chance.

[UBS](#), of Switzerland, alone offered to give a break to the New York Fed in the negotiations last November over how to keep A.I.G. from toppling and taking other banks down with it. It would have accepted 98 cents on the dollar.

But UBS's good-faith gesture was quickly drowned out by [Goldman Sachs](#) and the top French bank regulator. They argued, with others, that it would be improper and perhaps even criminal to force A.I.G.'s trading partners to bear losses outside of bankruptcy court.

The banks and the regulator were confident that the New York Fed was not willing to push A.I.G. into bankruptcy, because earlier in the fall the New York Fed had stepped in with \$85 billion to prop up the insurer.

The New York Fed, led then by [Timothy F. Geithner](#), who is now the [Treasury](#) secretary, therefore had little leverage in the negotiations, according to a post-mortem of what has emerged as the most inflammatory episode in the rescue of A.I.G.

The Fed "refused to use its considerable leverage," Neil M. Barofsky, the special inspector general for the [Troubled Asset Relief Program](#), wrote in a report to be officially released on Tuesday, examining the much-

criticized decision to make A.I.G.'s trading partners whole when people and businesses were taking painful losses in the financial markets.

There have been suggestions that the Fed chose to negotiate weakly, Mr. Barofsky said, to give a "backdoor bailout" to A.I.G.'s banks. He said Mr. Geithner and the Fed's lawyers had denied this, but added that "irrespective of their stated intent," there was no doubt about the result: "Tens of billions of dollars of government money was funneled inexorably and directly to A.I.G.'s counterparties."

Among its notable findings, the report challenged Goldman's position that it should not have been forced to bear losses on its dealings with A.I.G. because it had successfully hedged away any exposure. Mr. Barofsky said that Goldman's hedges were unlikely to have held up amid the market turbulence of late last year.

A spokesman for Goldman took issue with that finding, saying that the bank believed it had, in fact, successfully hedged its exposure to A.I.G. up until the point in November when the Fed was seeking a way to terminate all the trading partners' contracts with A.I.G.

He said any additional exposure to A.I.G.'s losses was a moot point, because the Fed's intervention had eliminated the risk.

The report concluded that the Fed's efforts to negotiate concessions from A.I.G.'s trading partners had no chance of success because of several crucial positions taken by the Fed.

First, the Fed considered itself a creditor of A.I.G., rather than a regulator that could impose its will on banks. It approached A.I.G.'s trading partners with a request for "voluntary" concessions. Mr. Barofsky said this differed from the government's role in the auto industry, where it lent the car makers money but also negotiated aggressively and won substantial concessions from other creditors.

The Fed also decided it could not treat foreign banks differently from American banks, for fear of setting off foreign retaliation.

While seeking concessions from the various banks, the Fed contacted the Commission Bancaire, a French regulator, to request support in its negotiations with two French institutions, [Société Générale](#) and Calyon.

The Commission Bancaire responded “forcibly” that unless A.I.G. were in bankruptcy, the French banks were “precluded by law from making concessions and could face potential criminal liability” if they helped.

By that time, seven of the eight banks had also refused to grant concessions. Officials at the Fed then met with Mr. Geithner. The officials recommended that the Fed stop seeking concessions.

The report said Mr. Geithner did not recall being told one bank was willing to take a haircut, but did not challenge the account of those on his staff.

The report also shed new light on the effect the rating agencies had on the way the Fed handled the A.I.G. emergency. The company’s run-on-the-bank disaster began with a major credit downgrade in September; the Fed quickly responded with an \$85 billion loan.

But because the Fed moved so quickly, it recycled a set of lending terms that had previously been devised for A. I.G. by lenders in the private sector. The interest rate was too high, given A.I.G.’s distress, and so the loan that was supposed to rescue the insurer ended up putting it at risk of a second credit downgrade. That, in turn, could have set off a second run-on-the-bank episode.

The Fed got caught in a no-win situation, the report said. While it might have been able to win concessions by threatening to withdraw support from A.I.G., it also ran the risk that the credit agencies would take the threat too seriously and impose another catastrophic downgrade.

Mr. Barofsky said the facts also undermined the Fed’s arguments that banking secrecy was an essential part of bank stability.

“The default position, whenever government funds are deployed in a crisis to support markets or institutions, should be that the public is entitled to know what is being done with government funds,” he said.

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