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Congressional Oversight Panel Examines AIG Rescue and Its Impact on Markets

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For Immediate Release

Government Failed to Exhaust All Options Before Committing to a Full Taxpayer-Funded Rescue

WASHINGTON, D.C. — The Congressional Oversight Panel today released its June oversight report, “The AIG Rescue, Its Impact on Markets, and the Government’s Exit Strategy.” The Panel found that the Federal Reserve and Treasury failed to exhaust all other options before undertaking their unprecedented, taxpayer-backed rescue of American International Group (AIG) and its creditors. This rescue resulted in extraordinary risk to taxpayers and a fundamental redefinition of the relationship between the government and the country’s most sophisticated financial institutions.

On September 16, 2008, the Federal Reserve Bank of New York (FRBNY), with the full support of Treasury, rescued AIG with an $85 billion, taxpayer-backed Revolving Credit Facility. These funds would later be supplemented by $49.1 billion from Treasury under the Troubled Asset Relief Program (TARP) as well as additional funds from the Federal Reserve, with $133.3 billion outstanding in total. The total government assistance reached $182 billion.

The Panel conducted a comprehensive overview of the AIG transactions based on a review of thousands of documents. Through a series of actions, including the rescue of AIG, the government succeeded in averting a financial collapse, and nothing in this report takes away from that accomplishment. But after reviewing the federal government’s actions leading up to the AIG rescue and the actions of Treasury, the Panel identified several major concerns:

The government failed to exhaust all options before initially committing $85 billion in taxpayer funds. In previous rescue efforts, the government had placed a high priority on avoiding direct taxpayer liability for the rescue of private businesses. With AIG, the Federal Reserve and Treasury broke new ground by putting US taxpayers on the line for the full cost and risk of rescuing a failing company. The government has repeatedly stated that they faced a “binary choice”: either allow AIG to fail, or rescue the entire institution, including payment in full to all of its business partners. The Panel rejected this reasoning. The government had additional options, such as orchestrating a rescue funded entirely or in part by private parties. It failed to exhaust these possibilities before committing $85 billion in taxpayer dollars. Earlier and more aggressive efforts to protect taxpayers and maintain market discipline would, if successful, have had an enormous calming effect on the market — and even if ultimately unsuccessful, they would have strengthened the government’s credibility with taxpayers during a time of crisis. The importance of exhausting all options upfront is even greater given the government’s contention that, once the initial financial commitment was in place, any withdrawal of government support would have led to a catastrophic collapse of market confidence.

The rescue of AIG distorted the marketplace by transforming highly risky derivatives bets into fully guaranteed payment obligations. In the ordinary course of business, the costs of AIG's inability to meet its derivative obligations would have been borne entirely by AIG's shareholders and creditors. But rather than sharing the pain among AIG's creditors, the government instead shifted those costs in full onto taxpayers. The result was the government backed up the entire derivatives market, as if high-profit, high-risk trading deserved the same taxpayer backstop as savings deposits and checking accounts. Every counterparty — from pension funds for retired workers and individual insurance policies, to sophisticated investors and other financial institutions — received exactly the same deal: a complete rescue at taxpayer expense.

Throughout its rescue of AIG, the government failed to address perceived conflicts of interest. People from the same small group of law firms, investment banks, and regulators appeared in the AIG saga in many roles, switching sides in a matter of minutes. These entanglements created the perception that the government was quietly helped banking insiders at the expense of accountability and transparency.

Even at this late stage, it remains unclear whether taxpayers will ever be repaid in full. AIG and Treasury have provided optimistic assessments of AIG's value. The Congressional Budget Office, however, currently estimates that taxpayers will lose $36 billion. The uncertainty lies in whether AIG's remaining business units are will able to generate sufficient new business to create the necessary shareholder value to repay taxpayers in full. The ultimate cost or profit to taxpayers is unknowable, but it is clear that taxpayers remain at risk for severe losses.

The government's rescue of AIG continues to have a poisonous effect on the marketplace. Markets have interpreted the government's willingness to rescue AIG as a sign of a broader implicit guarantee of "too big to fail" firms. 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. So long as this belief continues to hold sway among investors, the worst effects of AIG's rescue on the marketplace will linger.

The full report is available at cop.senate.gov.

The Congressional Oversight Panel was created to oversee the expenditure of the Troubled Asset Relief Program (TARP) funds authorized by Congress in the Emergency Economic Stabilization Act of 2008 (EESA) and to provide recommendations on regulatory reform. The Panel members are: J. Mark McWatters; Richard H. Neiman, Superintendent of Banks for the State of New York; Damon Silvers, Policy Director and Special Counsel for the AFL-CIO; Kenneth Troske, William B. Sturgill Professor of Economics at the University of Kentucky; and Elizabeth Warren, Leo Gottlieb Professor of Law at Harvard Law School.

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