Bailout Baloney — Insurance

On Wednesday, February 10, Federal Reserve Chairman Ben Bernanke expressed confidence that every cent of the Federal Reserve's exposure to insurance giant AIG would be repaid. Regarding a combined $116 billion dollars that the Fed provided in emergency loans to shore up AIG and back the purchase of Bear Stearns — an amount that totals about one-fifth of the Fed's entire balance sheet, Bernanke said that the Fed "expects these exposures to decline gradually over time. The [Federal Reserve] Board continues to anticipate that the Federal Reserve will ultimately incur no loss on these loans as well."

Back in September 2008, when AIG was on the verge of implosion, the Federal Reserve extended an emergency loan of $85 billion to the terminally ill insurance behemoth, the first installment on what eventually mushroomed into a $185 billion government bailout. The drastic action, it was argued at the time, was necessary to rescue the entire financial system from collapse; detractors pointed out that, not only was the coercive extraction of taxpayer funds to reward risky behavior on the part of the world's wealthiest a moral and fiscal outrage, it would do little besides postpone the evil day. Sixteen months on, AIG has faded from the public consciousness, but we would do well to keep tabs on what may quite possibly be the single largest recipient of the dole in all of human history. The price to keep AIG afloat is approximately one-twentieth of last year's entire federal budget — roughly the same as the amount tendered in interest payments on federal debt, or one-third of the entire sum allocated to national defense.

American International Group, Inc., was once the largest insurance company in the United States. Despite its name, it was actually founded in Shanghai in 1919, by an American entrepreneur and World War I vet, Cornelius Vander Starr, who arrived in the Far East with the equivalent of only a few dollars in his pocket. The company expanded rapidly in places like the Philippines and Indonesia, and even today, although AIG was eventually driven out of Shanghai by Mao Zedong's communists, roughly half of the giant insurer's employees work in Asia. The man who built AIG into a superstar, however, was Maurice Greenberg, who joined the company in 1960. A man who thought big, Greenberg increased enormously AIG's share of the life insurance business and began writing what decades ago were highly unusual policies: insurance against kidnapping and policies that protected a company's officer's from lawsuits.

More recently, the innovative Greenberg began insuring mortgage-backed securities by selling the now-notorious credit default swaps. Unfortunately, AIG failed to reckon on the possibility of a complete meltdown in the mortgage markets. When housing prices in the United States cratered, AIG was forced to write down massive amounts of assets, leading to -insolvency.

Only starting to come to light are the shady dealings between AIG and investment banking giant

Goldman Sachs, another beneficiary of federal largesse, which turned itself into a commercial bank in late 2008 in order to qualify for bailout money. For it was AIG that, for years, had been Goldman Sachs' underwriter, insuring, among other things, Goldman's booming mortgage securities. In 2003, AIG began insuring subprime mortgage securities. Beginning in 2007, when the mortgage market started declining, Goldman Sachs started demanding insurance payouts on its depreciated mortgage-backed assets. By January 2008, AIG had already paid Goldman Sachs $2 billion, and the investment banking giant was demanding much, much more.

The relationship between the two companies strained to the breaking point as Goldman Sachs continued to demand billions in additional premiums to cover the huge losses it had incurred, and AIG balked. Accusations flew, with AIG, unable to afford the enormous payoff Goldman was demanding, trying to buy time by insisting Goldman was overstating its losses. In the end, of course, the insolvency of AIG was laid bare, and the federal government settled the dispute with taxpayer dollars.

Beginning in September of 2008, the federal government embarked on a program to rescue AIG at any cost, ultimately ponying up $185 billion dollars, of which, as of December, roughly $124 billion had yet to be repaid. This almost unimaginable sum includes $45 billion in TARP funds, which the U.S. Treasury used to purchase shares of AIG preferred stock. The rest is owed to the New York Federal Reserve in various forms, including about $17 billion in direct debt and $25 billion that was used to purchase preferred stock in two AIG subsidiaries, American International Assurance and American Life Insurance (Alico). The New York Fed also provided $44 billion for the purchase of AIG debt equities, which now reside in two special vehicles, Maiden Lane II and Maiden Lane III; $37 billion of that lump of debt is outstanding.

While the federal government continues to issue breezy assurances that the colossal sums owed by AIG will eventually be collected, there are already signs aplenty that Fed Chairman Bernanke and company are indulging baseless hope. For one thing, AIG is now in talks with MetLife to sell its Alico subsidiary. Its book value (as much as $15 billion) would appear to exceed the amount ($9 billion) owed to the federal government for its preferred stake in the life-insurance vehicle. But in all likelihood, MetLife will insist on swapping stock shares for some of the purchase price. This will leave the federal government, not with a cash repayment, but with shares of yet another insurance company. And the deal has so far not been consummated. Such are the unforeseen consequences when the government begins acquiring stakes in private corporations.

The value of AIG shares in the two Maiden Lane vehicles has risen with the recent market rally, encouraging the belief that these two huge chunks of debt will also be repaid sooner or later. This hope, however, is supported by a very slender reed indeed, the probably fatuous expectation that the market rally will continue and betoken a smooth transition back into robust economic growth. Far more likely is that the recent rally will fizzle, given the precarious nature of government debt in countries like Greece and Spain (not to mention the United States), as well as the fictive economic recovery fueled mostly by government funny money that has done nothing to increase the capital base.

If the economic malaise continues, or the markets lose ground, tens of billions of dollars — perhaps more that $100 billion — of the AIG bailout will never be repaid, and the U.S. taxpayer will be required to make up the difference. Such a body blow to the U.S. economy will only plunge the government further into debt that will never be squared. But unlike AIG, there will be no one left to bail out our insolvent superpower.

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