

# The Wall Street Journal<sup>1</sup>

NOVEMBER 20, 2009

## *AIG and Systemic Risk*

**Geithner says credit-default swaps weren't the problem, after all**

### REVIEW & OUTLOOK

TARP Inspector General Neil Barofsky keeps committing flagrant acts of political transparency, which if nothing else ought to inform the debate going forward over financial reform. In his latest bombshell, the IG discloses that the New York Federal Reserve did not believe that AIG's credit-default swap (CDS) counterparties posed a systemic financial risk.

Hello?

For the last year, the entire Beltway theory of the financial panic has been based on the claim that the "opaque," unregulated CDS market had forced the Fed to take over AIG and pay off its counterparties, lest the system collapse. Yet we now learn from Mr. Barofsky that saving the counterparties was not the reason for the bailout.

In the fall of 2008 the New York Fed drove a baby-soft bargain with AIG's credit-default-swap counterparties. The Fed's taxpayer-funded vehicle, Maiden Lane III, bought out the counterparties' mortgage-backed securities at 100 cents on the dollar, effectively canceling out the CDS contracts. This was miles above what those assets could have fetched in the market at that time, if they could have been sold at all.

The New York Fed president at the time was none other than Timothy Geithner, the current Treasury Secretary, and Mr. Geithner now tells Mr. Barofsky that in deciding to make the counterparties whole, "the financial condition of the counterparties was not a relevant factor."

This is startling. In April we noted in these columns that Goldman Sachs, a major AIG counterparty, would certainly have suffered from an AIG failure. And in his latest report, Mr. Barofsky comes to the same conclusion. But if Mr. Geithner now says the AIG bailout wasn't driven by a need to rescue CDS counterparties, then what was the point? Why pay Goldman and even foreign banks like Societe Generale billions of tax dollars to make them whole?

Both Treasury and the Fed say they think it would have been inappropriate for the government to muscle counterparties to accept haircuts, though the New York Fed tried to persuade them to accept less than par. Regulators say that having taxpayers buy out the counterparties improved AIG's liquidity position, but why was it important to keep AIG liquid if not to protect some class of creditors?

Yesterday, Mr. Geithner introduced a new explanation, which is that AIG might not have been able to pay claims to its insurance policy holders: "AIG was providing a range of insurance products to households across the country. And if AIG had defaulted, you would have seen a downgrade leading to the liquidation and failure of a set of insurance contracts that touched Americans across this country and, of course, savers around the world."

Yet, if there is one thing that all observers seemed to agree on last year, it was that AIG's money to pay policyholders was segregated and safe inside the regulated insurance subsidiaries. If the real systemic danger was the condition of these highly regulated subsidiaries—where there was no CDS trading—then the Beltway narrative implodes.

Interestingly, in Treasury's official response to the Barofsky report, Assistant Secretary Herbert Allison explains why the department acted to prevent an AIG bankruptcy. He mentions the "global scope of AIG, its importance to the American retirement system, and its presence in the commercial paper and other financial markets." He does not mention CDS.

All of this would seem to be relevant to the financial reform that Treasury wants to plow through Congress. For example, if AIG's CDS contracts were not the systemic risk, then what is the argument for restructuring the derivatives market? After Lehman's failure, CDS contracts were quickly settled according to the industry protocol. Despite fears of systemic risk, none of the large banks, either acting as a counterparty to Lehman or as a buyer of CDS on Lehman itself, turned out to have major exposure.

More broadly, lawmakers now have an opportunity to dig deeper into the nature of moral hazard and the restoration of a healthy financial system. Barney Frank and Chris Dodd are pushing to give regulators "resolution authority" for struggling firms. Under both of their bills, this would mean unlimited ability to spend unlimited taxpayer sums to prevent an unlimited universe of firms from failing.

Americans know that's not the answer, but what is the best solution to the too-big-to-fail problem? And how exactly does one measure systemic risk? To answer these questions, it's essential that we first learn the lessons of 2008. This is where reports like Mr. Barofsky's are valuable, telling us things that the government doesn't want us to know.

In remarks Tuesday that were interpreted as a veiled response to Mr. Barofsky's report, Mr. Geithner said, "It's a great strength of our country, that you're going to have the chance for a range of people to look back at every decision made in every stage in this crisis, and look at the quality of judgments made and evaluate them with the benefit of hindsight." He added, "Now, you're going to see a lot of conviction in this, a lot of strong views—a lot of it untainted by experience."

Mr. Geithner has a point about Monday-morning quarterbacking. He and others had to make difficult choices in the autumn of 2008 with incomplete information and often with little time to think, much less to reflect. But that was last year. The task now is to learn the lessons of that crisis and minimize the moral hazard so we can reduce the chances that the panic and bailout happen again.

This means a more complete explanation from Mr. Geithner of what really drove his decisions last year, how he now defines systemic risk, and why he wants unlimited power to bail out creditors—before Congress grants the executive branch unlimited resolution authority that could lead to bailouts ad infinitum.

# The New York Times<sup>2</sup>

November 20, 2009

## *The Big Squander*

By PAUL KRUGMAN

Earlier this week, the inspector general for the Troubled Asset Relief Program, aka, the bank bailout fund, released his report on the 2008 rescue of the American International Group, the insurer. The gist of the report is that government officials made no serious attempt to extract concessions from bankers, even though these bankers received huge benefits from the rescue. And more than money was lost. By making what was in effect a multibillion-dollar gift to Wall Street, policy makers undermined their own credibility — and put the broader economy at risk.

For the A.I.G. rescue was part of a pattern: Throughout the financial crisis key officials — most notably Timothy Geithner, who was president of the New York Fed in 2008 and is now Treasury secretary — have shied away from doing anything that might rattle Wall Street. And the bitter paradox is that this play-it-safe approach has ended up undermining prospects for economic recovery. For the job of fixing the broken economy is far from done — yet finishing the job has become nearly impossible now that the public has lost faith in the government's efforts, viewing them as little more than handouts to the people who got us into this mess.

About the A.I.G. affair: During the bubble years, many financial companies created the illusion of financial soundness by buying credit-default swaps from A.I.G. — basically, insurance policies in which A.I.G. promised to make up the difference if borrowers defaulted on their debts. It was an illusion because the insurer didn't have remotely enough money to make good on its promises if things went bad. And sure enough, things went bad.

So why protect bankers from the consequences of their errors? Well, by the time A.I.G.'s hollowness became apparent, the world financial system was on the edge of collapse and officials judged — probably correctly — that letting A.I.G. go bankrupt would push the financial system over that edge. So A.I.G. was effectively nationalized; its promises became taxpayer liabilities.

But was there any way to limit those liabilities? After all, banks would have suffered huge losses if A.I.G. had been allowed to fail. So it seemed only fair for them to bear part of the cost of the bailout, which they could have done by accepting a "haircut" on the amounts A.I.G. owed them. Indeed, the government asked them to do just that. But they said no — and that was the end of the story. Taxpayers not only ended up honoring foolish promises made by other people, they ended up doing so at 100 cents on the dollar.

Could things have been different? Some commentators argue that government officials had no way to force the banks to accept a haircut — either they let A.I.G. go bankrupt, which they weren't ready to do, or they had to honor its contracts as written.

But this seems like a naïve view of how Wall Street works. Major financial firms are a small club, with a shared interest in sustaining the system; ever since the days of J.P. Morgan, it has been common in times of crisis to call on the big players to forgo short-term profits for the industry's common good. Back in 1998, it was a consortium of private bankers — not the government — that put up the funds to rescue the hedge fund Long Term Capital Management.

Furthermore, big financial firms have a long-term relationship, both with the government and with each other, and can pay a price if they act selfishly in times of crisis. Bear Stearns, the

investment bank, earned itself a lot of ill will by refusing to participate in that 1998 rescue, and it's widely believed that this ill will played a major factor in the demise of Bear Stearns itself, 10 years later.

So officials could have called on bankers to offer a better deal, for their own sake, and simultaneously threatened to name and shame those who balked. It was their choice not to do that, just as it was their choice not to push for more control over bailed-out banks in early 2009.

And, as I said, these seemingly safe choices have now placed the economy in grave danger.

For the economy is still in deep trouble and needs much more government help. Unemployment is in double-digits; we desperately need more government spending on job creation. Banks are still weak, and credit is still tight; we desperately need more government aid to the financial sector. But try to talk to an ordinary voter about this, and the response you're likely to get is: "No way. All they'll do is hand out more money to Wall Street."

So here's the real tragedy of the botched bailout: Government officials, perhaps influenced by spending too much time with bankers, forgot that if you want to govern effectively you have retain the trust of the people. And by treating the financial industry — which got us into this mess in the first place — with kid gloves, they have squandered that trust.

# The Wall Street Journal<sup>3</sup>

November 19, 2009, 1:28 PM ET

## *GS a short? And five reasons we hate Goldman Sachs*

Cody Willard

Here are five reasons why we want Goldman Sachs destroyed and buried so we can dance on its grave and why these crony apologists are wrong when they say that the “populist outrage at Goldman Sachs is misplaced”.

1. The AIG bailout was a covert bailout of Goldman and we want our money back. Every dime of it. Goldman had been placing a bunch of bets against real estate derivatives at a casino called AIG. Goldman started to realize that AIG didn't have enough money to pay all the bets they'd taken, so sucked some \$6 billion out of AIG in the weeks before AIG went belly up (a cash drain which indeed helped caused AIG to go belly up). But Goldman still had \$13 billion in profitable bets that they'd placed at the AIG casino and without the cash they were due from those bets, Goldman would be insolvent and be forced into bankruptcy. So Goldman called up the chairman at the NY Fed, one Stephen Friedman, and asked for welfare help. Stephen used to run Goldman before he decided to move over and run the NY Fed arm of Goldman — I mean, the NY Fed arm of the Federal Reserve (which come to think of it, is owned by Goldman and the other banks that it bailed out with your taxpayer money). Stephen promptly went out and bought tens of thousands of shares of Goldman Sachs stock to supplement the millions he already owned of it, and then had the NY Fed cover all the bets at the AIG casino in full with taxpayer money.

Yup, Goldman's former chairman used his power despite all those obvious conflicts of interest, and funneled a full \$13 billion of taxpayer money to Goldman Sachs via the bailout of AIG.

We want every dime of the AIG counterparty bailout back. We could buy 2.6 million Americans \$5000 worth of insurance with the amount of money that Goldman got from AIG from the taxpayer.

2. Goldman became a “financial holding company” after it became a “bank holding company” after it realized it was going to be insolvent even after it got Stephen Friedman to write them a \$13 billion check from AIG funded with taxpayer money. Goldman had to lobby for special exemptions and all kinds of favoritism in order to get such a petition passed by all the bureaucracies who are supposed to be doing all kinds of due diligence in order to make us citizens believe that either of the “holding company” status means anything other than the fact that the “holding company” gets access to cheap welfare loans from the Fed and guarantees against losses for the holding company which mean that the taxpayer is always left holding the bag.

Okay, and here's where we really get outraged by this “financial holding company” status crap. See, since Goldman's got that status (and since it's also “too big to fail” of course) it can go out and gamble tens of billions of dollars on currencies, commodities, bonds,

Treasuries, stocks, derivatives, private equity, venture capital and anything else they want to gamble on — and if they make money, they keep the profits and payout bonuses, but if they, heaven forbid, actually lose money on that levered gambling addiction they have, well, that taxpayer is going to eat the losses.

Goldman is guaranteed privatized gains and socialized losses. We want that stopped now and we want every dime of profit they've made gambling this year applied against the government deficit.

3. We know for a fact that Goldman's executives get to talk to and even advise the Treasury and the Fed on how the Treasury and the Fed should be buying and selling in the Treasuries market, in the derivatives markets, in the overnights markets, in the CDO markets and so on. Does anybody reading this article actually believe that Goldman doesn't use all that information to place those bets that are resulting in all those record trading profits for Goldman this year? Come on. And not only are they screwing other private investors with such front-running, but it's usually you and me the taxpayers on the other side of these trades this year.

We want Goldman execs to have absolutely no private access to government officials. Given all the obvious and repeated conflicts of interest in such interactions with taxpayer funds and policies on the line, let's require Goldman and the Treasury/Fed to conduct all interactions completely in the public via webcam, conference calls, or even Op Eds. But no more calls or private meetings between Goldman dudes and government dudes.

4. Goldman was packaging and selling toxic derivatives for hundreds of billions of dollars to investors around the world, telling those investors that such derivatives were safe and smart bets. At the same time, Goldman was out at the AIG casino not just hedging their own exposure to the derivatives while they were packaging them, but Goldman was actually betting against those very products. They were literally selling products they were so confident would fail that they bet tens of billions of dollars of their own money at AIG against those products they were telling investors were safe.

We want some perpwalks for this obvious fraud.

5. Goldman propaganda is insulting to anybody paying any attention.

- Goldman says: "We didn't want or need TARP money." Lie! They were so desperate for capital at that point, they took \$10 billion in TARP funds and needed ANOTHER \$5 billion in funds from Warren Buffett. Buffett put the screws on Goldman with onerous, expensive terms on that loan, and Goldman was so desperate they took it anyway.

- Goldman says: "We already paid back the taxpayer." Uh, like I said above, you're still gambling with my money keeping the profits since you got lucky and front ran the taxpayer in a bull market for the last six months and we still want every dime of the AIG bailout back too. Goldman and the taxpayer ain't even close to square.

- Goldman says: "We were just smart and have done nothing wrong." Oh, wait Lloyd Blankfein, the CEO, finally admitted that the company "participated in things that were clearly wrong." Like I said, let's prosecute those clear wrongdoings!

- Goldman says: “We were hedged against any AIG losses even without the taxpayer.” Lie — those AIG bets would have been a \$13 billion write off that Goldman would have been fighting for in a legal bankruptcy if Stephen Friedman, former Goldman chairman, hadn’t orchestrated a complete bailout for Goldman via AIG when Stephen was buying Goldman stock behind the scenes while running the NY Fed. That’s part of why everybody said it was a “credit crisis” at the time — nobody had the money to cover all the bets and the counter bets and the hedges at places like Goldman.

---

Goldman begged for and got tons of help from the taxpayer, and even if you weren’t against the Wall Street bailouts like I was from day one, you’re probably livid at Goldman’s arrogance and greed and denials.

Hey Goldman, if nothing else, how about a little gratitude for us saving your butt when you needed it.

The rage against Goldman isn’t just populist. The rage against Goldman isn’t just popular. The rage against Goldman is right.

And unfortunately, the only thing you and I can do about it is to vote out every single incumbent who empowered Goldman and its ilk with all their bailouts, stimulus and other wealth redistribution policies.

I’d also look to short Goldman on strength now that the stock has finally dipped about 10% from its highs. I’m not sure what else this company can do to jack up its profits in the near term even as it destroys its brand for the future. I’d look at slowly but surely building a Goldman short position. Maybe even some long-dated put options — say something at the \$200 strike range out in 2011 or so. You’d pay a little premium once again, but you’d expose less capital and limit your losses by using the put instead of outright shorting the stock.

Regardless of Goldman as a trade or an investment — but for the sake of our society:  
You tell me — would America be better off without Goldman Sachs?

# The Wall Street Journal<sup>4</sup>

November 18, 2009, 2:43 PM ET

## *Mean Street: Don't Apologize for Anything, Goldman Sachs*

EVAN NEWMARK

Dear Lloyd Blankfein:

You know it, don't you? You know that it doesn't matter. You can't win.

You could shed tears in an hour-long mea culpa on Oprah! You could pay yourself no more than one dollar for the next ten years. You could pledge \$5 billion to a hundred of Barney Frank's favorite charities.

And it still wouldn't matter. The public anger towards Goldman is just too hardened. In an economy full of losers, everyone is fixated on hating the winner.

And that kind of hate doesn't just go away. It takes time to dissipate. And, unfortunately, the time-space continuum may be the one thing that Goldman Sachs can neither buy nor control.

I understand that being "an enemy of the people" isn't good for business. After all, I spent a decade at Goldman. And I get what you're doing with Tuesday's big PR exercise. But in fact, too many people get it. Really effective PR rarely tries so hard.

In the past 24 hours, we've had your confession: "We participated in things that were clearly wrong and have reason to regret. We apologize."

We've had your big act of contrition: the \$500 million charitable contribution for America's suffering small businesses and communities. And we've had the benediction: who better to bless your noble efforts than Warren Buffett?

But the exercise is so sequenced and packaged that it's bound to come across as disingenuous, even deeply cynical. And let's face it, the timing stinks.

Just this week, the TARP special inspector general produced facts that appear to contradict your version of the AIG bailout. Looking back, I bet you now wish your CFO had shown a little more humility about Goldman's ties to AIG.

And the TARP report comes out just as another bonus season bonanza is getting underway. It's amazing. According to the New York State Comptroller, 2009 will be a record year for Wall Street profits — even better than 2007.

But while Wall Street booms, Main Street suffers. And the American public knows it. And it knows that you will soon pay your people some of the biggest bonuses in Wall Street history.

The American people not only resent that. They hate you for it. They hate you for taking the TARP money. They hate you for making money in hard times.

And, sadly, there's not much you can do with that hate. Almost anything you do, any act of largesse, will be greeted by cries of "too little, too late". The only sure PR maneuver would be to donate all your profits to the city of Detroit.

And here's the really unfortunate aspect of your current predicament: it's undeserved. Sure, there was some clumsy PR out of Goldman over the past year. But I still can't figure out why and to whom you're apologizing.

"We participated in things that were clearly wrong", you said yesterday. But what "things" were you referring to? Leveraging up the balance sheet? Selling CMOs and CDOs to sophisticated investors? Trading credit default swaps with AIG?

And what specifically was “clearly wrong” about these things? If it was so clear, I doubt folks at Goldman would have done them.

Not that it matters. You’ll never please the public. This is a public that doesn’t demand apologies from Franklin Raines or Angelo Mozilo or Barney Frank. Nor does it demand apologies from the millions of Americans who have walked away from their mortgages.

It’s much easier for the public to point the finger at the great Goldman conspiracy than to point it at itself.

And that’s why, Lloyd, you’re apologizing. You’re apologizing because the American public wants you to. You’re apologizing because you want to have as many friends in Washington as you can.

And you’re apologizing because nobody can handle the real truth: Goldman Sachs exists solely to make profits for its employees and shareholders. The rest is just PR.

## Notes

<sup>1</sup><http://online.wsj.com/article/SB10001424052748704204304574543822135042160.html>

<sup>2</sup><http://www.nytimes.com/2009/11/20/opinion/20krugman.html?em>

<sup>3</sup><http://blogs.marketwatch.com/cody/2009/11/19/gs-a-short-and-five-reasons-we-hate-goldman-sachs/>

<sup>4</sup><http://blogs.wsj.com/deals/2009/11/18/mean-street-dont-apologize-for-anything-goldman-sachs/>