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Two at Fed Had Doubts Over Payout by A.I.G.

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Weeks after rescuing the American International Group with an $85 billion taxpayer loan in late 2008, Federal Reserve Board officials rejected a proposal that would have forced the insurer's trading partners to return $30 billion in cash that they had received from A.I.G. in the preceding months.

The Fed chose instead to let the banks keep the cash and to receive additional billions from taxpayers. This decision was made, internal documents show, after two Fed governors expressed concern that such a plan might be "a gift" to the company's trading partners, including Goldman Sachs and Société Générale, a major French bank. The documents were provided to Congressional investigators by the Federal Reserve and were obtained by The New York Times.

Lawyers for the Fed argued in the documents that it did not have the legal authority to guarantee A.I.G.'s obligations. The New York Fed's chief counsel is expected to reiterate this point in Congressional testimony on Wednesday.

Of all the government rescues undertaken during the credit crisis of 2008, none has stirred more outrage and raised more questions than the bailout of A.I.G., a global insurer that has received $180 billion in taxpayer commitments since its collapse 16 months ago. More fireworks are expected Wednesday as lawmakers hear testimony about the insurer's rescue from the two men most closely associated with it: Timothy F. Geithner, the Treasury secretary and former president of the New York Fed; and Henry M. Paulson Jr., the former secretary of the Treasury.

The hearing, convened by the House Committee on Oversight and Government Reform led by Edolphus Towns, Democrat of New York, is expected to focus on the Fed's decision to pay billions to the large banks doing business with A.I.G. to unwind the insurance contracts they had struck with the company.
Of particular interest to many in Congress is why those negotiating on behalf of the taxpayers did not push the banks to make concessions like returning the collateral to A.I.G. or accepting less than full value for their contracts with the insurer.

"I really want to find out what led them to pay 100 percent to the counterparties," Mr. Towns said Tuesday. "The whole credibility of the Federal Reserve is called into question when you do things like that in secrecy, and that is something we need to change the culture of."

The hearings come at a difficult moment for the Obama administration, which is still recovering from the loss of the Massachusetts Senate seat in a special election last week. While the A.I.G. bailout was conducted during the previous administration, its oversight by Mr. Geithner makes the rescue a problem for the current administration.

Democrats and Republicans appear eager to pillory him at the hearing for his role in the bailout.
Ben S. Bernanke, the chairman of the Fed who is facing confirmation for a second term, is not among those called to testify on Wednesday. But the Fed's involvement in the bailout has raised doubts about him among some lawmakers, who have withdrawn their support for him.

Donald L. Kohn, the vice chairman of the Federal Reserve Board, has also come under fire for his role in the A.I.G. bailout. Testifying before Congress last March, Mr. Kohn refused to identify those banks that received taxpayer funds as A.I.G. counterparties, saying that the stability of the financial markets would be undermined if the insurer's trading partners were disclosed.

According to the documents, Mr. Kohn is one of the two Fed governors — the other was Kevin M. Warsh — who expressed worry that paying the counterparties receipt of 100 cents on the dollar to unwind their insurance contracts could be a gift to the banks.

Lawmakers may also ask Mr. Paulson about the extensive bailout work done by Dan Jester, a Treasury adviser who was a top executive alongside Mr. Paulson at Goldman Sachs. Mr. Jester, who did not return calls seeking comment, was instrumental in the Treasury's handling of A.I.G. until a new person was hired by the Treasury to handle the bailout. Mr. Jester ceased having any role in late October because of his stockholdings in Goldman Sachs, according to a person briefed on the matter who was not authorized to discuss it and so asked for anonymity.

Goldman, which was later identified as A.I.G.'s largest trading partner, received the most money — $12.9 billion — in the payments to counterparties.

A.I.G. got into trouble after its Financial Products unit wrote insurance on mortgage bonds held by large banks and financial institutions. Merrill Lynch, Goldman Sachs, Deutsche Bank and Société Générale were among the buyers of A.I.G.'s credit insurance, which promised to pay them if their bonds went bad.
Under the terms of these contracts, the banks had the right to demand that A.I.G. put up cash or securities as collateral when the market value of the insured bonds fell or when A.I.G.'s credit rating was cut.

When the mortgage market went south in 2007 and 2008, the banks to whom A.I.G. had sold credit insurance demanded billions of dollars in collateral. The payments weakened the insurer's financial position significantly and brought it to the brink of failure. On Sept. 16, 2008, the government stepped in.
Although that rescue provided $85 billion, the company's problems continued to grow, requiring it to deliver additional collateral to its counterparties. By late October 2008, A.I.G. had put up nearly $30 billion to satisfy the banks, about half the value of the mortgage bonds they held.

Amid this increasingly perilous situation, Fed officials discussed how to eliminate the risk of even more collateral calls, the internal documents show. One proposal involved the government guaranteeing the contracts; this meant the banks would no longer be able to demand collateral because the government would cover any losses on the mortgage bonds. Many of the bonds on which A.I.G. had posted collateral had not defaulted; instead, their market prices had dropped.

Under this proposal, the $30 billion in collateral would have been returned to the insurer to help pay off some of its loan from the Fed, the documents show. A.I.G. executives may have preferred this approach because it would have reduced the company's reliance on the government rather than expand it.

This alternative, though, would have most likely met with opposition from the company's counterparties, which would have had to return to A.I.G. all the collateral they had received over the previous year. But with the failure of Lehman Brothers and the seizing up of the money markets still fresh in everyone's minds, bankers wanted to keep as much cash on hand as possible. According to an Oct. 26, 2008, presentation by Morgan Stanley, an adviser to the Fed, Goldman would have had to return $7.1 billion to A.I.G. and Merrill, $3.1 billion.

The debate within the Fed centered on which part of the government could provide the guarantee, according to the documents. Staff at the Board of Governors told Fed officials in New York that a Fed guarantee "was off the table," according to an e-mail message to Mr. Geithner and others on Oct. 15 from Sarah Dahlgren, the New York Fed official overseeing the A.I.G. rescue.

"We countered with questions about why it was so clearly off the table and suggested, as well, that perhaps this was something that Treasury could do," Ms. Dahlgren continued.

Supporters of the plan considered a guarantee a good option because A.I.G.'s debt rating was at risk of a downgrade by the credit rating agencies and the company would then have to post more collateral with the banks.

"If a ratings downgrade happens at any time in the next three weeks or afterward, we will need this to protect any value in the insurance companies and, importantly, to avoid a disorderly seizure," Ms. Dahlgren wrote.

The New York Fed pursued the guarantee option with the Treasury, the documents indicate. But by Oct. 23, the Treasury had refused to provide the guarantee, according to an e-mail message sent by Ms. Dahlgren to Mr. Geithner. In early November, the Fed decided to make the counterparties whole on their insurance contracts.