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### The True Cost of the AIG Bailout

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# The True Cost of the AIG Bailout

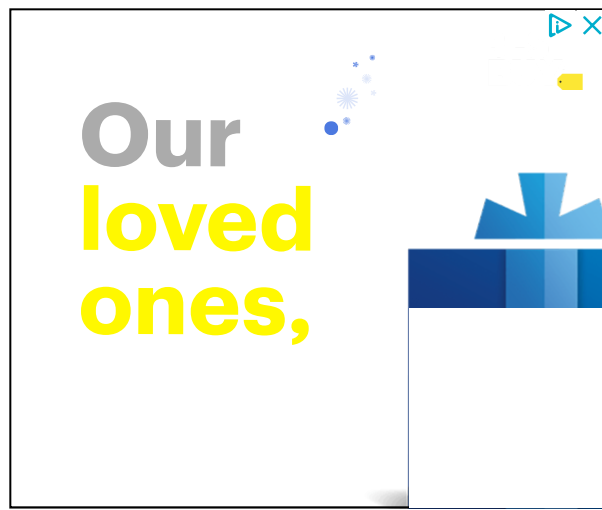
January 28, 2013 8:30am by

It Was Not a Free Lunch: The True Cost of the AIG Bailout  
James Tilson and Robert E. Prasch  
January 24, 2013



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“If it’s too good to be true, it probably is.” This old adage came to mind on December 11, 2012 when the U.S. Treasury made the announcement, reiterated unthinkingly by the press, that the AIG bailout was coming to an end with American taxpayers making a tidy profit on the deal. In an effort to capitalize on the news, AIG has spent millions of dollars on a primetime ad campaign thanking America for the bailout, highlighting its success: “We’ve repaid every dollar America lent us. Everything, plus a profit of more than 22 billion.” Unfortunately, this cleverly designed public relations maneuver deceives the taxpayer by distorting the perception of what has been a contentious use of government funds.

## THE BAILOUT

Readers may remember that AIG’s bailout began on September 16, 2008. That day, AIG’s stock dropped 60 percent at the opening of the New York Stock Exchange. Investors feared the imminent collapse of the insurance giant from a series of collateral calls on its derivative contracts. With a ratings downgrade the night before, AIG needed to deliver collateral of over \$10 billion ([http://www.nytimes.com/2008/09/28/business/28melt.html?pagewanted=all&\\_r=0%29](http://www.nytimes.com/2008/09/28/business/28melt.html?pagewanted=all&_r=0%29)). Later that evening, the Fed created a 24-month credit-liquidity facility from which AIG could draw up to \$85 billion in exchange for a 79.9 percent equity stake in the company. By May 2009, this and other programs of support from the Federal Reserve and the United States Treasury amounted to more than \$180 billion.

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The White House, Treasury, and the Fed have never failed to remind the citizenry that the several bailouts of 2008-09 “succeeded” in the narrow sense that most of the nation’s largest financial services firms survived. By contrast to these privileged firms, over 400 smaller banks were allowed to fail, millions of people lost their jobs, and millions lost homes to foreclosure, many of the

latter in proceedings later found to be of dubious legality. We should also remember that when these bailouts were authorized, there was no clear expectation that the loans would be paid back in full. In fact, a report by Bloomberg revealed that a draft of a presentation summarizing the Treasury's proposed investments described them as "highly speculative."

As things stand today, the Treasury has completely exited its AIG investment. Its December 11, 2012 sale of stock resulted, we are told, in the full recovery of the government's commitment along with an approximately \$22.7 billion combined return for the Treasury and the FRBNY, marking an incredible reversal of the original expectation of catastrophic losses (<http://www.treasury.gov/press-center/press-releases/Pages/tg1796.aspx>). Sadly, the Treasury's statements are highly misleading. In its accounting for the AIG bailout, the Treasury simply left out a number of salient facts when it announced that American taxpayers made a profit. Stated simply, we did not.

The Treasury claims to have achieved a return of \$5.0 billion, but neglects to mention that the Federal Reserve gifted them more than 500 million shares of AIG. Moreover, they simply ignored the unique and preferential tax treatment accorded to the company that is estimated to have inflated its share price by at least \$5. Additionally, its estimates fail to compensate taxpayers for the true cost of capital or the risk assumed in its investments. After adjusting for the aforementioned factors, we find that the Treasury's investment in AIG was actually very costly for taxpayers.

As mentioned, the bailout began on September 16, 2008. After a series of complicated restructurings and additional government support, the Fed's credit facility was repaid in full, including interest and expenses. By the time it was all over, the Treasury had acquired a 92 percent common equity stake in the company, which was sold over time subject to market conditions at an average

price of \$31.18 (<http://www.newyorkfed.org/aboutthefed/aig/index.html>). At least initially, the terms of the secured loan were designed to protect the interests of the U.S. government and taxpayer.

## Share Gifting

Among the shares the Treasury sold were 562,868,096 gifted to them from the Credit Facility Trust. This trust had previously been established by the Federal Reserve Bank of New York for the sole benefit of the Treasury Department ([http://www.federalreserve.gov/newsevents/reform\\_aig.htm](http://www.federalreserve.gov/newsevents/reform_aig.htm)). When these shares are taken into account, only 65.99% of the total returns from the Treasury's sale of AIG common stock can be attributed to its original TARP investment, and the remainder should be credited to the FRBNY. The Treasury's calculation, however, does not adjust for this transfer of shares. The effect is to artificially boost the returns on its politically contentious TARP investment at the expense of the Federal Reserve. Not counting these gifted shares, the Treasury assumes a break-even price of \$28.73, but if we examine its investment in isolation, the true break-even is \$45.53. After adjusting all cash flows associated with sale of stock, the Treasury's profit of \$5 billion becomes a loss of \$12.7 billion.

## Deferred Tax Assets

As is well known, AIG's rescue was necessitated by the enormous operating losses it had accrued by recklessly insuring mortgage-backed securities ("Net Operating Losses" or NOLs). Now, United States' tax law typically allows corporations to carry forward NOLs to offset future tax liabilities, but with one exception: "In general, the rules of section 382 (<http://www.pmstax.com/afr/>) apply to limit a corporation's ability to utilize existing net operating loss carryovers once the corporation experiences an 'ownership change.'" () Stated simply, if a company files for bankruptcy or is taken over, it sacrifices any pre-existing NOLs. For this reason, AIG should have lost its ability to carry forward these NOLs since a controlling stake in the company had passed to the federal government in the course of its rescue. In late 2008, however, the Treasury issued a series of IRS Notices (<http://www.treasury.gov/connect/blog/Pages/Just-the-Facts-Government-Investments-in-Private-Companies-the-Tax-Code-and-Taxpayers-Interests.aspx>) regarding § 382, which stated that the rule did not apply to the government's investments—both its purchase and, within limitations, its subsequent sale of shares in private companies. ()

Consequently, AIG claimed "Deferred tax assets: Losses and tax credit carryforwards" of \$26.2 billion and an additional "Unrealized loss on investments" of \$8.7 billion in its 2009 Annual Report.

An accurate evaluation of the Treasury's investment in AIG should incorporate the effects of this tax advantage. So, rather than an average sale price of \$31.18, a more telling number would be the share price controlling for this preferential tax treatment. According to estimates (<http://dealbook.nytimes.com/2012/02/27/bending-the-tax-code-and-lifting-a-i-g-s-profit/>) by analysts at Bank of America and JPMorgan Chase, doing so would reduce AIG's share price by \$5 to \$6 dollars a share. ( ) If we were to adjust the sale price by \$6 per share, the Treasury's return is reduced from nearly \$5 billion to a loss of more than \$5 billion. Compounding this adjustment with that from the shares gifted by the Federal Reserve described above, the Treasury's return is further reduced to become more than a \$19 billion loss.

When questioned about the rule bending, officials claimed AIG's tax benefit would help taxpayers by raising the insurer's share price. One might suppose that the federal government would come out close to even because, as the major shareholder, it was the primary beneficiary of this artificially inflated stock price. The drawback was that this tax-enhanced share price also benefited AIG's private stockholders and AIG executives, as the latter were heavily compensated through stock options. Damon Silvers, former member of the Congressional Oversight Panel for TARP explained, "By doing it this way... billions of dollars leak out to the benefits of private parties (<http://articles.latimes.com/2012/mar/12/business/la-fi-mo-aig-bailout-tax-20120312>), who really should not be benefiting from public policy in this way." Most importantly for our purposes, "This special tax deal also masks the true cost of TARP ([http://articles.washingtonpost.com/2012-03-29/opinions/35447277\\_1\\_tax-law-special-tax-corporate-tax-rate](http://articles.washingtonpost.com/2012-03-29/opinions/35447277_1_tax-law-special-tax-corporate-tax-rate)) by increasing the value of the government's AIG stock at the expense of future tax revenue."

## **Discounting Returns**

Had the government actually earned the \$5 billion profit that they claim, the bailout would appear to be a successful investment (although one might continue to raise questions of favoritism). However, adjusting for the level of risk and the "opportunity cost" of money in these investments drastically alters the picture. If the government were to extend a 30-year loan at a fraction of a percent of interest, and be repaid in full, it could claim to have made a profit. But this is not how accounting is ordinarily done. When evaluating an investment, it is necessary to take into account both the cost of capital, in this case the interest expense on Treasury bonds, and the level of risk assumed. For instance, if one were to discount the cash flows received by even the modest rate of 2 percent, the Treasury's return falls from roughly \$5 billion to \$1.5 billion.

Moreover, the normal procedure would discount returns by a rate that also accounts for the level of risk implicit in the transaction. Let us recall that the government initially believed that its investments were “highly speculative.” If, for instance, we were to discount returns by the initial rate charged by the FRBNY for the revolving credit facility (12 percent), the adjusted return would be a \$10.8 billion loss before factoring in the tax advantage and gifted shares, and a \$32.9 billion loss if we account for the latter. The latter number, we believe, is closer to the cost of the AIG bailout (so far).

### **PROTECTING TAXPAYERS**

Finally, and beyond the three adjustments described here, a complete analysis of the government’s investment in AIG would include the full range of social costs that are not typically captured by the profit and loss statement of a private firm. One would have to consider the cheap money the Federal Reserve used to keep the financial system afloat: one consequence of which is depressed rates for savers. Additionally, the government ultimately provided AIG and its counterparties with a sweetheart deal that, whether intended or not, in effect preserved and even exacerbated the problem of “Too Big to Fail” financial institutions and the perverse incentives and outcomes that such a doctrine promotes. The implications of this policy decision are as of yet unknown, but it is at least arguable that it has set the stage for the next financial disaster.

### **CONCLUSION**

With the sale of the last of its stake in AIG, the Treasury has reported a \$5 billion profit. Given the “creative” nature of the accounting used to derive this number, one is inclined to speculate on the motivations behind this announcement. Perhaps the Treasury hoped to reduce the public’s anger over a series of bailouts that appeared to exhibit the worst features of crony capitalism. As described above, Treasury’s estimate neglected to mention that approximately one-third of the AIG stock it sold came from the Federal Reserve rather than the initial TARP investment. Special tax treatment afforded uniquely and singularly to AIG also buoyed the share price — and will continue to provide AIG with billions of dollars in tax liabilities over the coming decade. The Treasury also failed to discount their returns by an amount even remotely reflecting the degree of risk involved. By including these omissions in the estimate it can only be concluded that the Treasury, and thereby United States’ taxpayers, actually lost money in the course of bailing out AIG.



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