

AIG Still Isn't Too Big to Fail

By [LUCIAN BEBCHUK](#)

The AIG bailout — at \$170 billion and rising — may end up as the costliest rescue of a single firm in history. There is much debate about bonuses paid to AIG's executives. But there is far too little debate on the government's willingness to back all of AIG's obligations.

The company claims any failure by the government to do so would have catastrophic consequences. This claim is exaggerated. Serious consideration should be given to forcing AIG's partners in derivative transactions -- which are mainly buyers of credit default swaps from the company -- to take a substantial haircut.

AIG is a holding company, conducting most of its business through insurance subsidiaries organized as separate legal entities. The financial products subsidiary, which has produced the huge losses from derivative transactions that brought AIG down, is also a separate legal entity -- but AIG has guaranteed the subsidiary's obligations.

While AIG has thus far been able to cover derivative losses using government funds, the possibility of large additional losses must be recognized. AIG recently stated that it still has about \$1.6 trillion in "notional derivatives exposure." Suppose, for example, that AIG ends up with losses equal to, say, 20% of this exposure -- that is, \$320 billion. Suppose also that the value of AIG's current assets, including the shares in its insurance subsidiaries, is \$160 billion. In this scenario, the government's fully backing AIG's obligations would produce an additional loss of \$160 billion for taxpayers. Should the government be prepared to do so?

The alternative would be to put AIG into Chapter 11. In this case, AIG's creditors, including its derivative counterparties, would obtain the company's assets. They would end up with a 50% recovery on their claims, bearing those \$160 billion of losses themselves.

AIG recently stated that failure to meet all of the company's obligations could lead to a "run on the bank" by customers seeking to surrender insurance policies and "would have sweeping impacts across the economy." But insurance policyholders wouldn't be at risk if AIG failed to meet its obligations. The insurance subsidiaries are not responsible for the debts of their parent AIG, and insurance policy claims are backed both by the subsidiaries' required reserves and state insurance funds.

Still, what about the concern that losses to derivative counterparties -- which are now known to include major U.S. and foreign banks -- would substantially deplete the capital of some of them? That concern would be best addressed by the U.S. government (or foreign governments in the case of their banks) infusing capital directly -- in return for shares -- into the banks that need it. There is no reason to back AIG's obligations as an instrument for infusing capital (with taxpayers getting nothing in return) into, say, Goldman Sachs or Spain's Banco Santander.

It is true that the collapse of Lehman Brothers last September led to a crisis of confidence among depositors in banks and money-market funds, which had a dramatic effect on markets. Letting AIG's derivative counterparties take a significant haircut, however, should not lead to such a crisis. AIG's obligations are to derivative counterparties, not to depositors. Moreover, governments world-wide are now committed to backing fully the claims of depositors in financial institutions.

It is important to understand that the government can also employ intermediate approaches between fully backing AIG's derivative obligations and no backing. For example, the government could place AIG in Chapter 11, but commit to provide supplemental coverage that would make up any difference between the value that creditors would get from AIG'S reorganization and, say, an 80% recovery. Such an approach could allow setting different haircuts for different classes of creditors. The government, for example, might elect not to provide such supplemental coverage to executives owed money by AIG.

At a minimum, the government should conduct "stress tests," estimating potential losses in alternative scenarios, and formulate a policy on the magnitude and fraction of derivative losses it would be willing to cover. A policy that doesn't fully back AIG's obligations should be seriously considered.

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