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MACROCOSM

AIG: Rescue or Bag Run?

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Government rescues are making the most important firms "too big to *not* fail."

Update to strategic view

US STOCKS, US FINANCIAL STOCKS: An immediate and enormous threat to the financial sector and to markets overall has been defused with the Fed's rescue of AIG. But the relief reaction may not be as euphoric as one might expect, at least not right away. The nationalization of shareholder value reinforces the dangerous precedents of the Bear Stearns, Fannie Mae and Freddie Mac interventions -- signaling to speculators and natural holders that pivotal firms subject to potential rescue are, ironically, made especially vulnerable by virtue of the possibility of rescue itself.

[see Investment Strategy Dashboard]

The Fed's rescue of American International Group is a case of doing the right thing in a terribly wrong way. Until the announcement last night of an $85 billion bridge loan to AIG in exchange for 79.9% of the company, the Fed had been doing everything right. It was right to let Lehman fail over the weekend without financing a predatory acquisition, as the Fed had done in the case of Bear Stearns (see "Tough Love for Lehman" September 14, 2008). And it was right to leave rates unchanged at yesterday's FOMC meeting (see "How Tough is Ben's Tough Love?" September 16, 2008). Markets reacted just as we thought they would to the FOMC -- first lower, then higher -- perhaps ultimately inferring that the Fed must be planning some kind of solution for AIG, or it wouldn't have dared to disappoint market expectations for a rate cut. But now the expropriation of AIG shareholders -- just as Bear Stearns, Fannie Mae and Freddie Mac shareholders had been expropriated as the price of their rescues -- may undo much of the good created by the courageous Lehman and FOMC decisions. Considering the great relief that eliminating the possibility of an AIG default ought to be, the market reaction to the Fed's announcement, as of this writing before the opening of US markets on Wednesday, has been decidedly unenthusiastic. It's possible that markets are now sensitized to an entirely different kind of systemic risk, triggered by the government rescues themselves -- we've already called it "nationalization risk" and "immoral hazard" (see "Your Speculative Attacks Dollars At Work" September 11, 2008; and, again, "Tough Love for Lehman"). We'd like to think that the rescue within just ten days of four distressed and pivotal firms -- Fannie, Freddie, Merrill Lynch and now AIG -- would restore confidence, and set in motion the process of healing that we've been forecasting for far too long. That may be just the way it plays out. Maybe the dam-break stops here. But we are concerned that the Fed may, instead, be perpetuating the unraveling it is trying to halt.

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We're not saying that AIG should have been left to fail as Lehman was. A joke told to us by a client yesterday says it nicely. It's set in a world in which AIG fails:

> *Client:* Crazy markets! How is my investment with you doing?
>
> *Hedge fund manager:* Well, I have good news, bad news and worse news.
>
> *Client:* Okay, give me the good news first.
>
> *Manager:* We were long credit default swaps on Lehman Brothers. I bought them two years ago, when they were dirt cheap. We just made a killing!
>
> *Client:* Great! So what's the bad news?
>
> *Manager:* I took profits too soon! I offset them last week with Goldman before Lehman declared bankruptcy. We're out -- we have an offsetting long and short. We left a lot on the table, but it was still a killing.
>
> *Client:* That's fine. We don't want to be greedy. So what's the worse news?
>
> *Manager:* Uh, the counterparty on our long side was AIG. Gotta go -- a margin clerk at Goldman is calling on the other line…

Because of the cost of such consequences cascading through the entire global derivatives market, AIG simply had to be stabilized. The Fed had no choice. Unfortunately, the Fed wasted precious time trying -- and failing -- to engineer a private sector solution. Apparently the private sector wasn't willing to be the lender of last resort that the Federal Reserve System was created to be almost a century ago. So like a team of paramedics arriving too late at the scene of an injury-accident, the Fed missed the "golden hour" in which the victim could have been easily saved. We guessed on Sunday that the Fed would make a discount window loan to AIG on Monday -- at that point, something like $20 to $40 billion probably would have done the job (again, see "Tough Love for Lehman"). When Standard and Poor's downgraded AIG by three notches Monday night, the stakes went up.

Apparently the amount of money required for an AIG rescue rose beyond the point at which the Fed could conceive it as a standard discount window loan. So taking 79.9% of the company was the price for such a large and unconventional loan. This ruinous shareholder dilution can be said to be an act of discipline, aimed at curbing moral hazard. Indeed, why should shareholders not be ruined when a company behaves so stupidly, gets itself into so much trouble, and has to be bailed out at taxpayer risk? Indeed, but one might as well ask why the Fed was created in the first place as a lender of last resort. Every discount window loan is, in the most fundamental sense, a rescue. The price for such rescues has not traditionally been extinguishment of shareholder value, but rather just a somewhat higher-than-market interest rate.

If shareholders of irresponsible firms should not be rewarded, then should speculators conducting bear-raids be rewarded? Should panicky shareholders who dump their holdings at the first sign of trouble be rewarded? *Those* are the behaviors incentivized by system in which the market expects a government agency to step in and coercively extinguish shareholder value through nationalization, expropriating that value for itself (as in Fannie, Freddie and AIG) or for a private sector acquirer (as in Bear Stearns). That system paints a target on the foreheads of the largest and most important firms, because only those are "too big to fail." *They* are the ones likely to get expropriated in the name of the public good if they are seen -- or made to be seen -- to be at risk. So speculators have a perfect incentive to drive the share price of such a firm ever lower, eventually hitting the price at which the government will step in; and natural holders have every incentive to sell before that price is hit, making it all the more likely that it will be hit. Thus such firms have become potentially "too big to *not* fail."

The dynamic is much like a "bag run" -- a manipulation seen in pit-trading of commodities. Say the price of some commodity is 101, and the traders in the crowd learn that a broker is holding a stop-loss order for a customer, for 1000 contracts at 100. If the price of 100 is hit, the order becomes a market-order to sell. So the traders, possessing knowledge of this order, can nearly risklessly short up to 1000 contracts down to 100, knowing that the moment that price is hit there will be a market-order to sell 1000 contracts -- giving the traders who sold above 100 the opportunity to cover, with the broker's customer having no choice about the price.

We've seen this movie before. The crash of October 19, 1987, was a case of the same dynamic, but without government involvement. In that instance, the culprit was "portfolio insurance" -- an elaborate lattice of stop-loss orders requiring the insurer to sell stocks (or stock futures) whenever stock index prices fell to predetermined levels. Those levels were well known to the Wall Street firms that executed trades for the insurers. There is little doubt that the crash was triggered initially and then exacerbated by these firms deliberately shorting futures into those levels, forcing their own clients to then dump stocks at lower and lower prices.

AIG was especially vulnerable because of *two* stop-loss orders working at the same time. Not only was AIG an obvious subject of the stop-loss order of potential nationalization. At the same time, the terms of its credit default swaps, requiring it it to post collateral with counterparties in the event of a ratings downgrade, was a second stop-loss order. Under these provisions, once the company was weakened sufficiently to be downgraded in the first place, it would be then be weakened further by the need to come up with collateral. And the market knew this perfectly well, since the downgrade provisions were in counterparty contracts known to every credit market participant in the world. So anyone wishing to mount a speculative attack knew all that was required for a successful bag run was to short AIG's stock to the point required to trigger a downgrade, and then a further drop in the stock was virtually assured. From there, nationalization would be *coup de grâce*.

What's the limit to the scope of such a "bag run" on today's Wall Street, with short-side speculators, predatory competitors and nervous stockholders all knowing that nationalization risk is, in effect, an infinitely large stop-loss order on the shares of the most pivotal companies? What’s to prevent Morgan Stanley from being bagged next? Or Goldman? In the case of the crash of 1987, the cascade ended when all the portfolio insurers had sold all the stock they had. What ends the dynamic that just claimed AIG? The takeover of Merrill Lynch by Bank of America at an above-market price might have sent a positive signal that the dynamic could be arrested. But now the AIG intervention has potentially set it in motion again. It's possible that Morgan and Goldman have the resources to defend themselves. But until that is proven by experience, we suspect that the stock market will not permit itself the full measure of euphoria one might have otherwise expected given the prevention of an AIG default.

Another negative here -- and one that will be with us for many years -- is what the AIG intervention says about the Federal Reserve. The Fed's partnering with Treasury to use its lending facilities to acquire, on behalf of the government, a controlling interest in a publicly traded corporation is nothing less than epoch-making. If there had been sufficient time, we think that ideally this would have been handled entirely by Treasury, and with congressional authority, as the Fannie/Freddie takeover was. The Fed had to be involved because only it could take such a large and dramatic action without congressional approval. There was surely no choice -- this is the way it had to be done. But the price is the potentially irretrievable loss of the Fed's political independence, and a profound redefinition of both its powers and methods. For an institution so reliant on market confidence to carry out its mission, the AIG rescue comes at a high cost -- and owning 79.9% of AIG doesn't compensate for it.

BOTTOM LINE: An immediate and enormous threat to the financial sector and to markets overall has been defused with the Fed's rescue of AIG. But the relief reaction may not be as euphoric as one might expect, at least not right away. The nationalization of shareholder value reinforces the dangerous precedents of the Bear Stearns, Fannie Mae and Freddie Mac interventions -- signaling to speculators and natural holders that pivotal firms subject to potential rescue are, ironically, made especially vulnerable by virtue of the possibility of rescue itself.