How AIG Is Driving GM Into Bankruptcy (AIG, GM)

Joe Weisenthal  |  Apr. 1, 2009, 3:48 PM  |  23
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GM (GM) has 58 days to negotiate to convince bondholders to take a major haircut or debt-for-equity swap. But it doesn't sound like it's going to happen.

Why not?

Because the bondholders don't seem interested in taking the ridiculous haircut that would be necessary for GM to be viable.

Why won't they take this haircut?  Because many of the same bondholders presumably own credit default swaps on GM debt with AIG.  And the US government has already made clear that it will cover those CDS's at 100 cents on the dollar.  In other words, if GM goes bankrupt (defaults), the bondholders may be assured of getting all their money back!

Karl Denninger explains:

The government has provided a history now that says that if you are a holder of CDS written by AIG, you will get 100 cents on the dollar, even if the notes don't default.  In addition that 100 cents is above what you would normally get even if there IS a default, because normally you have to tender the defaulted bond or the payout is limited by the recovery, and recovery on a defaulted bond is almost never zero.

So in this case the winning play, if you're a big bondholder, is to tell GM to suck eggs; you'll get paid 100 cents on your CDS even though AIG has no money, because the taxpayer will make you whole on those CDS, even if the bonds have a recovery in bankruptcy.

In other words you could conceivably get more than 100 cents if you hold those bonds - so long as you also hold a CDS as a hedge.

It must be nice to be able to screw the taxpayer for more than a 100% payout, right?

The bondholders "committee" is all made up of big players who presumably are hedged, ergo, this has to be assumed to be part of their "thought process" - if not the controlling factor.

Read the whole thing >

See Also:
We need the counter-argument that this is exactly why we bailed out AIG. It probbably goes something like. Thank god, GM is finally going bankrupt and will not ruin the economy for the next 30 years.

It does seem, however, that the bail out of GM directly actually screwed the bondholders. In a typical bankruptcy, the bondholders would get the assets of the company, but in this case, the government will be paid back first. (except that the bondholders got an extra quarterly payment).

The bondholders are probably also short the stock, so they make a little money on that play as well.

It's amazing with all this money flowing directly from the government to the banks that the banks are still in trouble.

Wait, so GM is like the burned Land Rovers in Iceland? B.r.i.l.l.i.a.n.t.

Joe, are you sure this is the way this works? I went to the link and read Denninger's whole posting, but I didn't see any backing for his "get more than 100% of their money back" argument. That is, of course, not the way a CDS would normally work at all, yet it is the whole premise for his piece. Someone correct me if I am wrong, and the government has in fact started having AIG pay out 100% CDS value PLUS the recovery on the underlying bond, but I certainly don't remember anything like that being disclosed.

The broader point about bondholders being unlikely to take a deep enough haircut outside of bankruptcy is probably true, but I think there are lots of reasons (some grounded in sound game theory) as to why that might be the case.

The government bailout ensured that the bondholders got the loss payment on the CDS, but that's not 100% UNLESS the loss on the underlying bond is 100 cents (rare since there is generally some positive option value in riding out the bankruptcy).

Not a big deal since the AIG bailout was ridiculous and unnecessary, but his article is wrong. (If I'm wrong please correct me)
Ron: How would any of you or Denninger know how AIG is paying out since the Treasury and the company both refuse to disclose how taxpayer money is being spent in regards to the bailout? The best thing to do is to end the bailouts unless there is full transparency, bonuses are wiped out, and pay is dropped to government levels.

IHOP: @Phil M: and you beat me...

Ron: @Phil M: You can assume that whatever their doing is a) legal and b) close to what they've done before, as it seems very little has changed over there.

IHOP: @Phil M: Thanks for going into more detail. I read the original post and couldn't believe someone hadn't corrected it in the comments already. Read it over twice thinking I was missing something, but he's just mistaken.

Phil M: @Ron: we all know because AIG did disclose this. This was all in the letter to Treasury they sent on March 15th. For example:

"Using funds from the emergency loan, financial counterparties listed on Attachment A (all attachments are posted online at http://www.aig.com/Related-Resources_385_136430.html ) received a total of $22.4 billion in collateral relating to CDS transactions from AIGFP between September 16, 2008 and December 31, 2008. This amount represents funds provided to such counterparties after the date on which AIG began receiving government assistance. The counterparties received additional collateral from AIG prior to September 16, 2008."

Looking at that letter, Denninger may also be confusing the payments made under the Maiden Lane III facility to another list of counterparties. That was another $27 billion of payments. But those are not corporate CDS - those are CDOs, so there is no concept of bankruptcy. In the Maiden Lane III deals, GS or whomever bought the supersenior tranche of a CDO and bought protection from AIG. Maiden Lane III was created to just buy the CDO supersenior from the counterparty for par and tear up the insurance contract. Ridiculous, as usual, but there is no possibility for a "greater than 100 cents" payout because the bondholder no longer owns the bond.

Ron: @Phil M: I think he's confusing the idea of collateral. From what I understand, AIGFP paid out money for two things - collateral calls and imairments to the CDOs they own. The collateral is in event of default. So, if there is no default, AIGFP will be returned the collateral (plus interest) at the end of the life of the contract. (Depending on the contract, the repayment terms may differ.) So, it's not like you get two things. If you own the bond and an equal notional value of face of the CDS against it, what happens if there's a default is you get the recovery value on the bond and (100% - recovery) on the CDS, so 100% of whatever notional value you started with. The reason why someone who holds the bond and the CDS would rather not take a haircut is because taking a haircut means getting a value that is less than 100%. So...you're better off burning the car and getting the insurance. At least, that's how I understand it. I could be wrong.

Phil M: @Ron: no, you're just a conspiracy-loving buffoon. There are enough problems out there and fair criticisms that I see no reason to waste time on idiotic conspiracy theories that would be inconsequential even if they were true.

Your clause (b) @me is irrelevant: if the underlying reference bonds were in default, then it would've been a final payment, not collateral, but it would be at the same mark-to-market value, not 100 cents. And what happens to the reference bond if there was a default (if the CDS counterparty was holding it) doesn't matter either: either (A) they cash settled (in which case the counterparty kept it and received Par minus Recovery) or (B) they physically settled (in which case the counterparty delivered the bond and received par). Economically, they are practically the same thing (the "practically" is because there is a cheapest to deliver option where you could squeeze out a little extra profit ... but still it's not a 100 cent net payment). So, what's your point?

Re: your clause (a), the fact is that neither you nor I KNOW that any alleged fact about anything is true. I don't KNOW that AIG really paid out anything. I don't KNOW that you're a cross-dresser. But, if we don't make some reasonable assumptions, how can we even discuss anything? And why are you asking? Why don't you come up with a list of past disclosures that AIG has made that turned out to be lies? Then maybe we can discuss whether to believe anything they say. But, these numbers are large enough and the names of the counterparties embarassing enough, that I don't see how it makes a difference.

IHOP: @Ron: If you reject the real world and instead choose to live in one full of mad conspiracies, please leave me out of it.
And obviously the Gov and AIG have earned the right for us to give them the benefit of a doubt and assume it's all legal.

@djrichard: But what's the big conspiracy here? These were run of the mill CDS contracts. Why should we assume that they weren't handled in accordance with their terms? There's no evidence to the contrary. The reality is bad enough!! Want to say it was criminal that AIG entered into $1.4 trillion in notional amount of CDS without the capacity to make 100% loss payments under those contracts? I'd agree with that. But, this stuff about whether the bailout money was used to further some conspiracy is just ridiculous. They used it to make sure dozens of private counterparties were fully protected against an AIG default on trades that were way in the money to these private counterparties. Isn't that bad enough? I don't get what the conspiracy could possibly be on top of that!!

Now the interesting question hinted at in Denninger's piece, but written about elsewhere for a long time (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=960512) is the "decoupling" phenomenon where the entities that have the voting power (because they hold the bonds) are actually hedged and will get a better payoff if there is a bankruptcy and a huge loss. Many feel this will hurt the chances for out-of-court (and in-court) restructurings for the foreseeable future.

Denniger's and Wiesenthal's understanding of how these derivatives payoff are striking. I am surprised at their demonstrated lack of knowledge. A little knowledge is indeed a dangerous thing.

Gee, I wonder why there are conspiracy theories? Could it be because more than one person at AIG conspired to commit the massive fraud? Nah, that wouldn't count as a conspiracy, you ignorant jackass.

Your stupidity is in your assumption that AIG has stopped lying and committing crimes since the bailout began. We know they have a track record of lying and deception. We know they lied about their finances. We know they lied about the size of the bonuses. Now we're supposed to believe whatever vague details they posted on their website. You really are an idiot.

I thought the implied recovery rate for a GM CDS is about 0.16, so it could be that AIG has posted a lot of collateral. However, I doubt that PIMCO is 100% hedged against a GM default. Otherwise, they are earning LIBOR.

Everyone likes to stick it up the Dumb suckers (tax payers)!! This will go on endlessly unless there is a TAX PAYER REVOLT!! See what happened to AIG bonus when people raised their voices! The voice should be LOUDER when the amounts involved is 100 TIMES LARGER!!