Brussels: Dexia once boasted about its swaps. The bank was just bailed out

A LETHAL LOOPHOLE AT EUROPE'S BANKS

Firms are being battered because they used AIG's complex financial instruments to skirt capital rules

By David Henry, Matthew Goldstein, and Carol Matlack

European banks didn't gorge on subprime assets as much as their U.S. counterparts did. So why do foreign lenders suddenly need a bailout? Their deals with insurer American International Group may offer a clue.

Before the financial crisis hit, AIG did a booming business in credit default swaps, complex instruments originally designed to protect lenders if borrowers fail to make debt payments. The biggest buyers were European banks, whose deals last year with AIG totaled a staggering $426 billion. But the banks didn't always buy the swaps as insurance against defaults—they often used them to skirt capital requirements. AIG declined to comment.

Under international regulations known as the Basel Accords, European lenders have to set aside a certain amount of money to cover potential losses. By owning credit default swaps, banks could make it appear as if they had off-loaded most of the risk of a loan to AIG or another firm, thereby reducing their capital needs. The perfectly legal ploy allowed banks across the Continent to free up money to make more loans. It was part of the game taking place across the global financial system. During the boom, firms seemingly created money out of nothing, propelling the markets to unsustainable heights.

Such excessive risk-taking has brought down several European lenders. Consider Dexia, which received an $8.7 billion bailout from regulators in late September. The Brussels bank boasted about its credit default swaps in a press release last year, saying that the deals "freed up regulatory capital." A Dexia spokesman now says the firm made little use of such swaps.

Another busted bank, Fortis, noted in a May 2007 investor presentation that it planned to use "capital relief transactions" to help fund its purchase of ABN AMRO assets. A Fortis spokesman says the bank didn't buy swaps to improve its capital position.

Until late 2007, AIG gave its deals with European banks cursory mention in filings. Then the insurer got smacked by subprime losses on unrelated transactions. After that, investors pressured AIG to come clean about all of its sophisticated deals. AIG officials said in a Dec, 5 conference call that banks using credit default swaps could set aside capital that amounted to only 1.6% of a loan's value, vs. 8% without.

European banks didn't tap only AIG. Bermuda's Primus Guaranty, a firm that sprang up during the boom, targeted European banks looking to game regulations. Philadelphia bond insurer Radian Group marketed "Basel-friendly" swaps. Says Daniel Gros, director of the Centre for European Policy Studies in Brussels: "Through adjustments, [banks] could convince regulators that there was low or no risk."

AIG's credit default swaps, though, delivered an extra dose of leverage to the financial system. Given its high credit rating, AIG could make deals that required it to put up a meager amount of collateral, or cushion, against losses. The upshot: AIG boosted lending with little money.

$426 billion

The dollar value of derivatives European banks bought from AIG for "regulatory relief"

Data: AIG

But the gambit worked only as long as AIG maintained its credit rating. If the insurer were downgraded, AIG would have to pony up more cash. Otherwise the deals would fail—and banks would have to raise capital or dump assets.

That very scenario started to unfold on Sept. 15 when AIG got downgraded. Within 24 hours, the Federal Reserve stepped in with an $85 billion bailout to'save the company. These days, AIG no longer makes such deals. It's just another way credit is contracting as the financial system pays for the excesses of the past.

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