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# Back to Bailouts



Congratulations, taxpayers, you are now the proud owners of a debt-strapped insurance company.

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THAT WAS QUICK. On Monday, it appeared that the federal government, having allowed two investment banks, Lehman Brothers and Merrill Lynch, to disappear as independent entities, might be embarking on a new "no bailouts" policy for Wall Street. Special systemic risks posed by Bear Stearns, Fannie Mae and Freddie Mac justified government relief, it seemed, but from now on, financial firms would sink or swim, as per textbook economics. Then, on Tuesday night, the Federal Reserve Board launched a de facto takeover of insurance giant American International Group. Yesterday, American taxpayers woke up to find themselves in the insurance business.

You can construct a plausible case that the government's actions have been consistent. The argument would be that, each in its own way, Bear, Fannie, Freddie and now AIG posed such sudden and catastrophic danger to the overall financial system if they were to collapse that there was no alternative but the assumption of long-term taxpayer risk -- whereas markets were better prepared for the long-incubating troubles at Lehman and Merrill, which were, in any case, less threatening to wider financial stability. Certainly we wouldn't quarrel with the determination by Fed Chairman Ben S. Bernanke and Treasury Secretary Henry M. Paulson Jr. that AIG could have brought the financial world down with it. It was on the hook for $441 billion of credit default swaps -- essentially contracts to reimburse holders of mortgage-backed and other securities if that paper went bad. If AIG defaulted on those, the resulting cascade of losses could have frozen global markets. The Fed had no time to ponder the irony that AIG's death spiral was set in motion by a lower rating from the same credit agencies that had enabled so many risky mortgage-backed securities in the first place.

The Fed hardly wrote AIG a blank check: In exchange for $85 billion in loans, which have to be repaid with interest in two years, it gets control of management and first dibs on proceeds from the sale of AIG's assets, as well as profits from its fairly sound global insurance business. The government fired the top executives who presided over this debacle; holders of the company's now worthless stock probably don't feel like the recipients of a bailout. "Moral hazard," though hardly eliminated, was not ignored.

The problem here is that federal authorities are still in reactive mode, responding to the crisis of the day served up by panicky markets. Among the many risks this creates is that traders can essentially stampede government into bailing out one company after another -- until even Washington runs out of cash. The bill so far this year: $29 billion for the Bear rescue; up to $200 billion in equity injections for Fannie Mae and Freddie Mac (plus $5 billion to buy their mortgage securities) and now $85 billion for AIG. Notably, the Fed had to ask the Treasury for a fresh $40 billion in government securities yesterday, just in case.

The losses are far from over. Government must devise a more predictable and transparent way to help wind up the financial sector's bad investments -- along with new rules to help prevent a repeat performance in the future. That's asking a lot. It's asking even more to insist that it be done in the middle of a crisis and when Congress, a weakened president and two presidential candidates are fully engaged in election-year politics. But no economic issue is more urgent, and the winners in November will have to face it squarely.