Greenberg

FACT SHEET ON AIGFP

Origins and Purposes of AIGFP

- Maurice R. ("Hank") Greenberg led American International Group, Inc. ("AIG") for almost 40 years until his retirement as Chairman and CEO in early 2005. Under Mr. Greenberg's leadership, AIG grew from a modest enterprise into the largest and most successful insurance company in the world. Its market capitalization increased approximately 40,000 percent between 1969, when AIG went public, and 2004, Mr. Greenberg's last full year as Chairman and CEO. AIG opened markets for U.S. businesses all over the world, and contributed significantly to U.S. gross domestic product. As a result of the hard work of tens of thousands of employees, AIG became a national asset. At the time of Mr. Greenberg's retirement in March 2005, AIG operated in over 130 countries and employed approximately 92,000 people. AIG had a market capitalization of $170 billion and its stock traded at $64 a share. AIG's net income per employee was over $100,000. The company also had the lowest expense ratio in the industry.

- A fundamental tenet of Hank Greenberg's risk management philosophy at AIG was maintaining a diversified earnings base. Generating earnings from diverse business lines added to earnings stability in the event that any particular business unit of AIG encountered a downturn.

- In 1985, the fire and casualty business in the United States recovered sharply from the distressed conditions that prevailed in 1984 and before. AIG, in part due to disciplined underwriting, kept its capital base intact, which led to AIG becoming the leading commercial and industrial insurer in the U.S. AIG also recognized that the property casualty business, by its very nature, was cyclical. Therefore, to maintain its earnings stability, AIG needed to diversify its earnings base.

- AIG first successfully diversified within the insurance industry. AIG created innovative products, such as directors and officers liability insurance, kidnap/ransom insurance and environmental protection insurance, and built a team of skilled underwriters who were capable of assessing and pricing risk. No one had offered these products before, so one could not write these policies out of a manual.

- AIG then diversified internationally, opening new markets in places like Korea, China and Japan. Long before the Berlin Wall fell, AIG operated behind the Iron Curtain in places like Hungary, Romania and Poland. AIG was also the first foreign company to write life insurance policies in Japan and other places in Asia. It was all part of a strategy to promote diversified growth. Along the way, AIG helped open new markets for U.S. businesses and created new products that enabled U.S. and multinational companies to grow and prosper.

- Following its international expansion, AIG began looking for business opportunities that could take advantage of AIG's presence in many countries and its superior credit rating. AIG began finance operations in locations such as Switzerland, Hong Kong, Thailand, Argentina, the Philippines and Poland.

- To further diversify its earnings base, AIG looked for opportunities in businesses that benefited from its AAA rating, strong capital base, risk management skills, as well as the intellectual capital needed to manage such diversification. This led to the creation of AIG Financial Products (AIGFP) in 1987. At that time, the derivatives market was small and growing. From the beginning, AIG's policy was for AIGFP to conduct its business on a "hedged" basis -- that is, its net profit should stem from the differences between the profit earned from the client and the cost of offsetting or hedging the risk in the market. AIGFP would therefore not be significantly exposed to directional changes in the fixed income, foreign exchange or equity markets.

AIGFP under Hank Greenberg's leadership

- Under Mr. Greenberg's leadership, AIGFP operated successfully for years.

- Prior to Mr. Greenberg's retirement in March 2005, AIG senior management closely monitored AIGFP and its risk portfolio. (*See* Lynnley Browning, "A.I.G.'s House of Cards," *Portfolio*, Sept. 28, 2008.) During this time, AIGFP was subject to numerous internal risk controls, including risk monitoring by several independent units of AIG, review of AIGFP transactions by outside auditors, consultants and internal auditors, and scrutiny by AIGFP's and AIG's Boards of Directors. Every new type of transaction or any transaction of size, including most credit default swaps, had to pass review by AIG's Chief Credit Officer.

- In addition, an Enterprise Risk Management structure headed by Bob Lewis was put in place that reported to Howard Smith, Chief Financial Officer, separate from the reporting line of AIGFP. Enterprise Risk Management signed off on most contracts issued by AIGFP and advised top management on risk concentration.

- The model worked. From 1987 to 2004, AIGFP contributed over $5 billion to AIG's pre-tax income. During that period, AIG's market capitalization increased from $11 billion to $181 billion, and its stock price increased from $4.50 per share to $62.34 per share.

- As of the end of 2004, AIGFP's credit default swap (CDS) exposure was predominantly from a "corporate" CDS program. That program consisted of credit default protection written for European banks, also sometimes referred to as "regulatory capital relief transactions".[1]

[1] Earlier this decade, regulators imposed a capital charge on commercial banks for unused bank lines outstanding to clients. AIGFP created a product that would assume approximately 90% of the credit risk in these credit lines for a fee which would be less than the capital charge the commercial banks would otherwise incur. AIGFP retained for itself this "super senior" layer, reasoning that the risk of loss in this layer was exceedingly remote.

- The "corporate" CDS program was successful and AIGFP, to this day, has not suffered significant losses on that portfolio (although AIG has had to post limited amounts of collateral to counterparties in connection with this program as AIG's credit rating has declined, as described below).
    - This was confirmed by Gerry Pasciucco, the current chief operating officer of AIGFP, in an interview with *Bloomberg*, which reported: "By Sept. 30, 2008, AIG had $250 billion in net notional CDS exposure to such [corporate] loans, and has had no material losses on them, Pasciucco says." ("Unwinding at AIG Prompts Pasciucco to Ponder Systemic Failure," Richard Teitelbaum and Hugh Son, *Bloomberg*, July 1, 2009.)
    - According to *Vanity Fair*: "Even now A.I.G.F.P's $450 billion portfolio of corporate credit-default swaps, which dwarfs the $75 billion portfolio of subprime-mortgage credit-default swaps, has avoided losses." ("The Man Who Crashed the World," *Vanity Fair*, August 2009.)

<u>AIGFP: 2005-2008</u>

- Mr. Greenberg was forced to retire from AIG in March 2005. After Mr. Greenberg's retirement, his successor, Martin Sullivan, led extensive reviews of AIG's business operations and risk management practices.
- Massive losses at AIG in 2007 and 2008 resulted significantly from a shift in the way AIGFP did business in the four years after Mr. Greenberg retired.
- AIGFP's creation in 1987 was based in part on its ability to take advantage of AIG's AAA credit rating. Among other things, the AAA credit rating had reduced or eliminated the need for AIG under certain circumstances to post collateral for the benefit of counterparties in connection with writing credit default protection. However, following Mr. Greenberg's retirement in spring 2005, AIG was downgraded by the major ratings agencies.[2]
- As AIG acknowledged at the time, these downgrades had a significant impact on AIGFP's credit default swap business and on the prospects for that business in the event of further downgrades.[3]

[2] "From March through June of 2005, the major rating agencies downgraded AIG's ratings in a series of actions. Standard & Poor's, a division of The McGraw–Hill Companies, Inc. (S&P), lowered the long–term senior debt and counterparty ratings of AIG from 'AAA' to 'AA' and changed the rating outlook to negative. Moody's Investors Service (Moody's) lowered AIG's long–term senior debt rating from 'Aaa' to 'Aa2' and changed the outlook to stable. Fitch Ratings (Fitch) downgraded the long–term senior debt ratings of AIG from 'AAA' to 'AA' and placed the ratings on Rating Watch Negative." AIG's 2004 10-K, filed 3/16/06, at 14.

[3] "As a result of the downgrades of AIG's long-term senior debt ratings, AIG has been required to post approximately $1.16 billion of collateral with counterparties to municipal guaranteed investment contracts and financial derivatives transactions. In the event of a further downgrade, AIG will be required to post additional collateral… Additional obligations to post collateral will increase the demand on AIG's liquidity." AIG 2004 10-K, filed 5/31/05, at 90.

- When the AAA credit rating disappeared in spring 2005, it would have been logical for AIG to have exited or reduced its business of writing credit default swaps. Indeed, AIG acknowledged the new risk it faced of having to post additional collateral to counterparties:

  "The downgrade in AIG's long-term senior debt ratings will adversely affect AIGFP's ability to compete for certain businesses. Credit ratings are very important to the ability of financial institutions to compete in the derivative and structured transaction marketplaces. Historically, AIG's triple-A ratings provided AIGFP a competitive advantage. The downgrades will reduce this advantage and, for specialized financial transactions that generally are conducted only by triple-A rated financial institutions, counterparties may be unwilling to transact business with AIGFP except on a secured basis. This could require AIGFP to post more collateral to counterparties in the future." AIG 2004 10-K, filed 5/31/05, at 90.

- However, despite these acknowledged concerns, AIG -- according to several published reports -- drastically accelerated its credit default swap business for the remainder of 2005. As *Time* magazine pointed out in its March 30, 2009 cover story on AIG:

  "...[AIGFP head Joseph] Cassano's unit doubled down after the spring of 2005, writing more and more subprime-linked swaps as the ratings plunged, which made the possible need for collateral enormous in the event its debt was downgraded. The downgrades occurred in 2008." (*See* "How AIG Became Too Big to Fail," *Time*, March 30, 2009.)

- Significantly, the quality of what AIG wrote protection for deteriorated.

  "The consumer loan piles that Wall Street firms, led by Goldman Sachs, asked AIG FP to insure went from being 2 percent subprime mortgages to being 95 percent subprime mortgages. In a matter of months, AIG FP, in effect, bought $50 billion in triple-B-rated subprime mortgage bonds by insuring them against default. And yet no one said anything about it—not AIG CEO Martin Sullivan, not the head of AIG FP, Joe Cassano, not the guy in AIG FP's Connecticut office in charge of selling his firm's credit default swap services to the big Wall Street firms, Al Frost. The deals, by all accounts, were simply rubber-stamped inside AIG FP, and then again by AIG brass. Everyone concerned apparently assumed they were being paid insurance premiums to take basically the same sort of risk they had been taking for nearly a decade. They weren't. They were now, in

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Subsequent downgrades occurred in 2008. "In the third quarter of 2008, S&P, Moody's, Fitch and A.M. Best Company (A.M. Best) each downgraded the credit ratings of AIG Inc. and most of the Insurer Financial Strength Ratings of AIG's insurance operating subsidiaries. In particular, S&P downgraded AIG's long–term debt rating by three notches, Moody's downgraded AIG's long–term debt rating by two notches, Fitch downgraded AIG's long–term debt rating by two notches and A.M. Best downgraded AIG's issuer credit rating from a+ to bbb and most of AIG's Insurer Financial Strength Ratings from A+ to A." AIG 2008 10-K, filed 3/2/09, at 22-23.

effect, the world's biggest owners of subprime mortgage bonds." (Michael Lewis, *The Big Short*, at 71-72 (2010)).

- In fact, it has been reported that AIGFP wrote as many credit default swaps on collateralized debt obligations, or CDOs, in the nine months following Mr. Greenberg's departure as it had written in the entire previous seven years combined, and the majority of these credit default swaps were reportedly exposed to toxic sub-prime mortgages. (*See* James Bandler, "Hank's Last Stand," *Fortune*, October 13, 2008, at 126.) (These CDO transactions are sometimes referred to as "arbitrage transactions," in contrast to the "regulatory capital relief transactions" referred to on page 2).

- "Indeed, it has become widely accepted that without Joe Cassano and AIGFP around to insure the risk that Wall Street was taking in underwriting those increasingly squirrelly assets, the debt bubble might have run out of air before it did in 2007." (William Cohan, "Collapse of the House of Hank," *Institutional Investor*, April 2010.)

- Moreover, it appears that the additional risk that AIG took on through these new credit default swaps was entirely or substantially unhedged. The portfolio, accordingly, not only grew drastically in size when it should have been terminated, but the growing exposure remained largely unhedged when it could (and should) have been hedged. By 2006, "[AIGFP] sold no more credit default swaps to Wall Street but did nothing to offset the 50 billion dollars' worth that it had already sold."

- In addition, the risk controls that Mr. Greenberg and his team put in place reportedly were weakened or removed after his retirement. For example, the weekly meetings that Mr. Greenberg and his team used to conduct to review all of AIG's investments and risks were eliminated. These meetings kept the CEO abreast of AIGFP's credit exposure.

- In 2008, AIG's independent auditors, PricewaterhouseCoopers, found AIG to have a material weakness in its internal controls relating to the AIGFP super senior credit default swap portfolio valuation process and oversight thereof. On November 29, 2007, PwC had raised with Mr. Sullivan and Mr. Bensinger, AIG's then-CFO, their concerns about possible material weaknesses relating to risk management in certain areas and business units, including AIGFP. Nonetheless, AIG continued to insist publicly that there were no problems at AIGFP, including at an all-day investor conference only days later, on December 5, 2007, convened specifically to assuage market concerns about the sub-prime exposure at AIGFP that had accrued under Mr. Sullivan's leadership.

- In response to concerns regarding the remediation of entity-wide material weaknesses at AIG, the company hired Joseph St. Denis, a former Assistant Chief Accountant at the SEC Enforcement Division, to address certain accounting and reporting policies, including those specifically relating to AIGFP. During a hearing on AIG held by the House Oversight and Government Reform Committee in October 2008, it was revealed that Mr. St. Denis had become deeply concerned about AIGFP's valuation of its super senior credit default swaps portfolio in September 2007, after learning that AIG had received a multibillion-dollar collateral call on certain CDS's.

- In a letter to the House Oversight Committee, Mr. St. Denis stated that he was prevented from learning more about AIGFP's CDS valuation model by Joseph Cassano, who told him, "I have deliberately excluded you from the valuation of the Super Seniors because I was concerned that you would pollute the process." In his letter to the House Oversight Committee, Mr. St. Denis said, "Mr. Cassano took actions that I believe were intended to prevent me from performing the job duties for which I was hired." Mr. Denis also stated, "My belief is that the 'pollution' Mr. Cassano was concerned about was the transparency I brought to AIGFP's accounting policy process."

- Mr. St. Denis resigned in protest in October 2007, forfeiting his bonus. He reported the circumstances of his departure to Michael Roemer, AIG's Director of Internal Audit, who briefed the board's audit committee on the matter. (*See* Transcript, "Hearing on the Causes and Effects of the AIG Bailout", October 7, 2008, House of Representatives, Committee on Oversight and Government Reform. *See also* Letter from Joseph St. Denis to House Committee on Oversight and Government Reform, October 4, 2008.)

- Based on published information from AIG, AIG's net notional exposure to Multi-Sector CDOs at June 30, 2008 amounted to $80.3 billion, of which $57.8 billion contained sub-prime mortgage collateral.

- The vast preponderance of this unhedged, sub-prime-related exposure accrued after Mr. Greenberg's departure from AIG. As noted above, AIGFP wrote credit default swaps when Mr. Greenberg was CEO, but that was predominantly for the "corporate" CDS program, which has resulted in minimal losses to AIG to this day.

- The multi-sector CDO program has also resulted in enormous collateral calls from AIG's counterparties, as AIG's own filings in spring 2005 acknowledged might result from AIG's downgrading by credit agencies at that time. As AIG acknowledged in its 2008 10-K filed on March 2, 2009: "Since [June 30, 2007] and through February 18, 2009, counterparties have made large collateral calls against AIGFP, in particular related to the multi-sector CDO portfolio....AIGFP has received collateral calls from counterparties in respect of certain super senior credit default swaps, of which a large majority relate to multi-sector CDOs. To a lesser extent, AIGFP has also received collateral calls in respect of certain super senior credit default swaps entered into by counterparties for regulatory capital relief purposes and in respect of corporate arbitrage." AIG 2008 10-K, filed 3/2/09, at 145, 268.

- Specifically, of $32.8 billion in collateral postings as of September 30, 2008, $31.5 billion were made in connection the multi-sector CDOs that exploded after Mr. Greenberg's departure from AIG. AIG 2008 10-K, filed 3/2/09, at 146. In addition, of $28 billion in unrealized market valuation loss for the year ended December 31, 2008, $25.7 billion was attributable to the multi-sector CDOs. *Id.*, at 265.

- In a recent editorial, *The Wall Street Journal* reached the following conclusions regarding the chain of events that led to AIG's current situation:

    "The housing trouble began -- as most of AIG's troubles did -- when the company's board buckled under pressure from then New York Attorney General Eliot Spitzer when it fired longtime CEO Hank Greenberg. Almost immediately, Fitch took away the company's triple-A credit rating, which allowed it to borrow at cheaper rates. AIG subsequently announced an earnings restatement. The restatement addressed alleged accounting sins that Mr. Spitzer trumpeted initially but later dropped from his civil complaint.

    "Other elements of the restatement were later reversed by AIG itself. But the damage had been done. The restatement triggered more credit ratings downgrades. Mr. Greenberg's successors seemed to understand that the game had changed, warning in a 2005 SEC filing that a lower credit rating meant the firm would likely have to post more collateral to trading counterparties. But rather than managing risks even more carefully, they went in the opposite direction. Tragically, they did what Mr. Greenberg's AIG never did -- bet big on housing." (*See* "The Real AIG Outrage," *The Wall Street Journal*, March 17, 2009.)

- Vanity Fair reached similar conclusions in its in-depth reporting on AIG's collapse:

    "In March 2005, however, Eliot Spitzer forced Greenberg to resign. And, as one trader puts it, 'the new guys running A.I.G had no idea.' They thought the money machine ran on its own, and Cassano did nothing to discourage the view. By 2005, A.I.G.F.P. was indeed, in effect, his company…

    "In 2003 there had been a few tens of billions of dollars of subprime-mortgage loans. From June 2004 until June 2007, Wall Street underwrote $1.6 trillion of new subprime-mortgage loans and another $1.2 trillion of so-called Alt-A loans…

    "A.I.G.F.P. was already insuring these big, diversified, AAA-rated piles of consumer loans; to get it to insure subprime mortgages was only a matter of pouring more and more of the things into the amorphous, unexamined piles. They went from being 2 percent subprime mortgages to being 95 percent subprime mortgages. And yet no one at A.I.G. said anything about it – not C.E.O. Martin Sullivan, not Joe Cassano, not Al Frost, the guy in A.I.G.F.P.'s Connecticut office in charge of selling his firm's credit-default-swap services to the big Wall Street firms. The deals, by all accounts, were simply rubber-stamped by Cassano and then again by A.I.G. brass – and, on the theory that this was just more of the same, no one paid them special attention. It's hard to know what Joe Cassano thought and when he thought it, but the traders inside A.I.G.F.P. are certain that neither Cassano nor the four or five people overseen directly by him, who worked in the unit that made the trades, realized how completely these piles of consumer loans had become, almost exclusively, composed of subprime mortgages." ("The Man Who Crashed the World," *Vanity Fair*, August 2009.)

A Failure of Management

- Sound management requires dynamic assessment of AIG's business as circumstances change and new ways to limit risk become available. The U.S. housing market was generally strong during Mr. Greenberg's tenure at AIG and only deteriorated after his retirement. Credit downgrades following Mr. Greenberg's retirement meant that AIG was required to post substantial cash collateral in connection with its CDS portfolio, a factor that had not ever been present during Mr. Greenberg's tenure as CEO.

- Notwithstanding changing circumstances, AIG *accelerated* writing CDS protection after Mr. Greenberg's retirement. The new CDS obligations were for subprime-linked CDOs of decreasing quality. According to numerous accounts and lawsuits, senior management then made public statements that sought to minimize or conceal this exposure. And senior management decided not to hedge this exposure even as new indices came on-line in 2006 and 2007 that would have enabled them to do so (following Mr. Greenberg's retirement) a series of ABX indices were created and could have been used to hedge AIGFP's newly acquired, massive sub-prime exposure). What occurred after Mr. Greenberg's retirement was a colossal failure of management, with devastating consequences for AIG stakeholders ranging from employees to pensioners, and the U.S. taxpayer.

- It was always the policy under Mr. Greenberg for AIGFP to hedge its exposure. We know that AIGFP employees were aware of the ABX index and encouraged senior management to hedge, and that they declined to do so.

- The real reason that AIG did not hedge is set out by senior management in comments made in analyst presentations and earnings calls. Senior management stated repeatedly that it did not expect to lose any money, and the problem that had developed after 2004 was manageable.

Misrepresentations Regarding AIGFP exposure

- *AIG's August 9, 2007 Earnings Conference Call*

    - **Statement by Bob Lewis**: "In addition, we believe that it would take declines in housing values to reach depression proportions, along with default frequencies never experienced, before AAA and AA investments would be impaired."
    - **Statement by Bob Lewis**: "There are only three deals out of the entire 103 multi-sector CDOs transactions that have experienced any negative rating actions on any tranches subordinate to AIGFP's position. These three deals are rapidly amortizing and make up less than 0.5% of our CDO exposure, totaling just $296 million."

- **<u>Statement by Joe Cassano</u>**: "It is hard for us, without being flippant, to even see a scenario within any kind of realm or reason that would see us losing $1 in any of those transactions."

- *AIG's Form 10-Q, filed on November 7, 2007*

  - "AIG continues to believe that it is highly unlikely that AIGFP will be required to make payments with respect to" its CDS portfolio.
  - AIG claimed its CDS portfolio lost $352 million during the third quarter of 2007 and estimated a loss of only $550 million during October 2007. The actual loss through November 30, 2007 was <u>$5.96 billion</u>.

- *AIG's November 8, 2007 Earnings Conference Call*

  - **<u>Statement by Martin Sullivan</u>**: "While U.S. residential mortgage and credit market conditions adversely affected our results, our active and strong risk management processes helped contain the exposure."
  - **<u>Statement by Joe Cassano</u>**: "I think you should be rest assured, you've heard me say on previous calls, and on the previous call, and now, is that we have been husbanding our liquidity all through this very trying period, and we have plenty of resources and more than enough resources to meet any of the collateral calls that might come in."

- *AIG's December 5, 2007 Investor Meeting*

  - **<u>Statement by Martin Sullivan</u>**: "But because this business is carefully underwritten and structured with very high attachment points to the multiples of expected losses, we believe the probability that it will sustain an economic loss is close to zero."
  - **<u>Statement by Martin Sullivan</u>**: "We cannot predict the future, but we have . . . a high degree of certainty in what we have booked to date."
  - **<u>Statement by Joe Cassano</u>**: "Each of our trades combines the strengths of this thorough due diligence we keep talking about, this very selective process, the word we use is we positively select many of our portfolios, and this rigorous modeling assumption. And we always model to a worst-case scenario that Gary will talk through, and we always model to a 99.85% confidence level. But just for good measure, we always add buffers, because everybody knows models aren't perfect."

<u>The Government's Bailout of AIG</u>

- Shortly after AIG first received federal assistance in September 2008, former Treasury Secretary Hank Paulson went on "Meet the Press" to reveal that the government's intention was to liquidate AIG. That intention manifested itself through onerous loan terms that included a two-year repayment period and an interest rate in year one of around 14%; the idea was to sell off valuable parts of AIG immediately to pay off the government in full in two short years.

- That plan has failed. A successful liquidation is impossible in the present economic climate, since buyers for AIG assets at fair values simply do not exist at this time. Fire-sale prices will bring taxpayers, who now own almost eighty percent of AIG, only pennies on the dollar for their investment in AIG. One of the largest asset sales to date took place at a fraction of the asset's purchase price and at a small multiple of book value. That asset, Hartford Steam Boiler, was sold to a foreign company, meaning that many U.S.-based jobs may ultimately find their way overseas.

- Moreover, the failed plan ignored the key value driver of AIG. Since the day the Treasury announced its plan to liquidate AIG, value has been destroyed because AIG's people and their relationships -- AIG's business -- are leaving.

- Approximately $50 billion of taxpayer cash has been paid to U.S. and foreign financial firms who were AIG's counterparties in its credit default swap (CDS) business, and another $44 billion was paid over to counterparties in AIG's securities lending business. The cash payments to credit default swap counterparties were made to support collateral requirements and to purchase underlying subprime-linked securities at par.

- According to a November 17, 2009 report by Treasury Special Inspector General Neil Barofsky, the AIG bailout resulted in tens of billions of dollars in taxpayer cash being "funneled inexorably and directly to AIG's counterparties." Moreover, "despite the willingness of at least one counterparty to engage in discussions about a potential haircut, all counterparties were paid effectively par value for the credit default swaps." (*See* "Factors Affecting Efforts to Limit Payments to AIG Counterparties", Office of the Special Inspector General for the Troubled Asset Relief Program, November 17, 2009, p. 30, 19.)

- According to investigative reporting by *Bloomberg*, some of these counterparties were prepared to accept far less than par to be cashed out of the underlying securities. In some cases, counterparties may have been prepared to accept 40 cents on the dollar. But they got 100 cents on the dollar instead. (*See* Richard Teitelbaum and Hugh Son, "New York Fed's Secret Choice to Pay for Swaps Hits Taxpayers," *Bloomberg*, October 27, 2009.)

- According to the Treasury Special Inspector General's report, the Federal Reserve and New York Fed refused "to use their considerable leverage" in negotiations with AIG's counterparties, making "the possibility of obtaining concessions from those counterparties extremely remote." ("Factors Affecting Efforts to Limit Payments to AIG Counterparties", Office of the Special Inspector General for the Troubled Asset Relief Program, November 17, 2009, p. 29.) Bloomberg estimates that the government's refusal to negotiate cost the taxpayers an additional $13 billion. (Richard Teitelbaum and Hugh Son, "New York Fed's Secret Choice to Pay for Swaps Hits Taxpayers," *Bloomberg*, October 27, 2009.)

- After the payments were made, some of the largest CDS counterparties said that their exposure to AIG was hedged and they would not have incurred material losses if cash payments had not been made. Moreover, in testimony before Congress on March 18, 2009, the head of the Office of Thrift Supervision testified that AIG had not realized any losses on its CDS portfolio.

- Some of AIG's major counterparties benefited substantially from the bailout. For example, *The Wall Street Journal* has reported, "When the federal government bailed out [AIG], Goldman avoided losses on its trades with AIG covering a total of $22 billion in assets." (*See* Serena Ng and Carrick Mollenkamp, "Goldman Fueled AIG Gambles," *The Wall Street Journal*, December 12, 2009.)

- The government's cash payments to CDS counterparties should never have occurred, and did not need to occur. A similar situation among "monoline" bond insurers is instructive. Monolines insure against the risk that a bond will default, and are major issuers of credit default swaps. But rather than collateralizing their CDS contracts (as AIG is doing), monolines have embraced commutation and restructuring opportunities with counterparties. In a number of instances, monoline insurance contracts have been terminated so that the monoline could face no more loss or volatility. In highly distressed cases where the likelihood of regulatory seizure was real (Syncora, FGIC, CIFG), the counterparties have settled in large numbers and for less cash than would have been required to collateralize the loss.

- This market context demonstrates that credit default swap counterparties have been willing to take a significant haircut in similar circumstances. AIG should have explored such opportunities with its counterparties. A recent report by the General Accounting Office (GAO) supported the notion that AIG should renegotiate certain contracts, including arrangements with counterparties:

  "... Treasury has an opportunity to take additional steps to strengthen its agreement with AIG by requiring AIG seek to [*sic*] negotiate concessions from management, employees, and counterparties, as appropriate, before the agreement is finalized. For example, Treasury could require that AIG seek to renegotiate contracts... with existing counterparties that would face substantial losses were AIG to have its credit downgraded or fail." (*See* GAO Report to Congressional Committees, "Troubled Asset Relief Program: March 2009 Status of Efforts to Address Transparency and Accountability Issues," page 61.)

- It would have been more beneficial for the American taxpayer if the federal government had walled off AIG Financial Products (AIGFP), the unit primarily responsible for the CDS obligations, and provided guarantees to AIGFP's counterparties, rather than putting up billions of dollars in cash collateral to those counterparties. The guarantees would have been similar to those put in place at Citigroup to ring-fence toxic assets destined for Citi's "bad bank."

- Had the Fed provided a guarantee to AIGFP, money would have stopped flying out the door that minute. There would have been no further calls for collateral; in fact, collateral would have been returned because AIGFP would have enjoyed a restored AAA rating. Taxpayers would have been out nothing. In fact, taxpayers would have stood to earn a fee for extending a guarantee that never would have been needed.

- It is not even clear that an express guarantee -- of the sort extended to Citi -- was needed for AIG. A strong argument could be made that AIG, by the time of the government's second bailout in November 2008, enjoyed an implicit federal guarantee by virtue of the fact that the government owned 79.9% of the company. Unless Secretaries Paulson or Geithner had affirmatively said otherwise, it was reasonable to assume that the government stood behind AIG.

- Carrying over the government's AAA credit rating to AIG would have changed the dialogue with AIG's counterparties substantially. AIG could have demanded back previously posted collateral and withstood any additional cash demands based on the mark-to-market deterioration in underlying CDOs.

- Only now are the consequences of the Federal Reserve's decision to pay out cash instead becoming clear. In October 2009, *The Wall Street Journal* reported that billions of dollars in collateral paid out to AIG's counterparties is being returned to the company, as the value of the underlying securities recovers. But unfortunately, AIG stands to only partially recoup its collateral payments, because many of the transactions were cashed out in their entirety last year. (*See* Liam Pleven, "In Reversal of Fortune, AIG Recoups Collateral," *The Wall Street Journal*, October 30, 2009.) If a federal guarantee had been interposed instead, that guarantee could have been pared back over time as the assets recovered, and AIG would not have been left on the hook for billions of dollars in money that passed straight out the back door to the counterparties.

- The public policy reasons behind the federal bailout of AIG are still unclear. In testimony before Congress on November 19, 2009, Treasury Secretary Tim Geithner offered a new justification for the government's intervention at AIG: that it was motivated out of concern for AIG's insurance policyholders. (Joint Economic Committee, Hearing on Financial Regulatory Reform, November 19, 2009.) But AIG's policyholders were never in jeopardy. AIG's insurance companies – which are separate legal entities from the parent company – were adequately capitalized (as they are required to be under state law) and would not have been affected by the parent company's short-term liquidity crisis.

<u>A Better Approach</u>

- In testimony before the House Committee on Oversight and Government Reform on April 2, 2009 and elsewhere, Mr. Greenberg has put forth a new plan for AIG, which calls for abandonment of the liquidation approach and focuses instead on rebuilding AIG so that it is better positioned to pay back the taxpayer.

- Mr. Greenberg's approach relies on government guarantees and long-term government-funded debt, and encourages third-party capital rather than relying on government ownership. Most important, it requires AIG to continue operating and building its core insurance businesses as the mechanism for paying back the government loans over time.

- The major components of Mr. Greenberg's plan include:

  1. Eliminate taxpayer-funded indebtedness where possible, and replace it with guarantees. This would be particularly relevant for any of AIG's remaining CDS exposure.

  2. Where assets are transferred to the Treasury or Federal Reserve (through the government-controlled Maiden Lane entities) in exchange for certain loans that have been made, provide appropriate cancellation of indebtedness for the value of assets transferred, including a reasonable assumption for recovery value.

  3. Extend the maturity of all remaining indebtedness to a 20-year term.

  4. Reduce the rate on all remaining indebtedness to 5%, consistent with TARP investments made in the banking sector.

  5. Reduce the government ownership to 15% common equity, again consistent with TARP investments, and a necessary step to encouraging private capital to replace taxpayer capital over time.

  6. Stop all asset sales for core insurance properties, income from which is necessary to pay back taxpayers.

  7. Ring-fence AIGFP and securities lending through a government controlled entity that would manage the run-off of those businesses.

  8. Inject new equity capital in the form of newly issued common stock and through a rights offering to existing shareholders, with a minimum of $30 billion of new capital. The reduction of the government's ownership to 15% would make this possible.

  9. Pressure should be applied to CDS counterparties to provide some of this new equity capital. These CDS counterparties should contribute back to AIG a portion of the over $100 billion in taxpayer money that has been paid out to them since September 2008, and would become shareholders of the newly constituted AIG in return. They would have a keen interest as shareholders in not only paying back the government loans, but in building the value of AIG and running it with proper risk controls -- objectives that are aligned with the interests of the Treasury, the Federal Reserve and American taxpayers.