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SEPTEMBER 2008: THE BAILOUT OF AIG

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Nine billion dollars is a lot of money, but as AIG executives and the board examined their balance sheet and pondered the markets in the second week of September 2008, they were almost certain \$9 billion in cash could not keep the company alive through the next week.¹ The AIG corporate empire held more than \$1 trillion in assets, but most of the liquid assets, including cash, were held by regulated insurance subsidiaries whose regulators did not allow the cash to flow freely up to the holding company, much less out to troubled subsidiaries such as AIG Financial Products.² The company’s liabilities, especially those due in the near future, were much larger than the \$9 billion on hand.

On Friday, September 12, 2008, AIG was facing challenges on a number of fronts. It had to fund \$1.4 billion of its own commercial paper on that day³ because traditional investors—for example, money market funds—no longer wanted even short-term unsecured exposure to AIG; and the company had another \$3.2 billion coming due the following week.⁴ On another front, the repo lenders—who had the comfort of holding collateral for their loans to AIG (\$9.7 billion in mostly overnight funding)⁵—were nonetheless becoming skittish about the perceived weakness of the company and the low quality of most of its collateral: mortgage-related securities.⁶

On a third front, AIG had already put up billions of dollars in collateral to its credit default swap counterparties. By June of 2008, counterparties were demanding \$15.7 billion, and AIG had posted \$13.2 billion. By September 12, the calls had soared to \$23.4 billion, and AIG had paid \$18.9 billion—\$7.6 billion to Goldman alone—and it looked very likely that AIG would need to post billions more in the near future.⁷ That day, S&P and Moody’s both warned of potential coming downgrades to AIG’s credit rating, which, if they happened, would lead to an estimated \$10 billion in new collateral calls.⁸ A downgrade would also trigger liquidity puts that

AIG had written on commercial paper, requiring AIG to come up with another \$4 to \$5 billion.⁹

Finally, AIG was increasingly strained by its securities lending business. As a lender of securities, AIG received cash from borrowers, typically equal to between 100% and 102% of the market value of the securities they lent. As borrowers began questioning AIG's stability, the company had to accept below-market terms—sometimes accepting cash equal to only 90% of the value of the securities.¹⁰ Furthermore, AIG had invested this cash in mortgage-related assets, whose value had fallen. Since September 2007, state regulators had worked with AIG to reduce exposures of the securities lending program to mortgage-related assets, according to testimony by Eric Dinallo, the former superintendent of the New York State Insurance Department (NYSID).¹¹ Still, by the end of June 2008, AIG had invested \$75 billion in cash in mortgage-related securities, which had declined in value to \$59.5 billion. By late August 2008, the parent company had to provide \$3.3 billion to its struggling securities lending subsidiary, and counterparties were demanding \$24 billion to offset the shortfall between the cash collateral provided and the diminished value of the securities.¹² According to Dinallo, the collateral call disputes between AIG and its credit default swap counterparties hindered an orderly wind down of the securities lending business, and in fact accelerated demands from securities lending counterparties.¹³

That Friday, AIG's board dispatched a team led by Vice Chairman Jacob Frenkel to meet with top officials at the Federal Reserve Bank of New York.¹⁴ Elsewhere in the building, Treasury Secretary Henry Paulson and New York Fed President Timothy Geithner were telling Wall Street bankers that they had the weekend to devise a solution to prevent Lehman's bankruptcy without government assistance. Now came this emergency meeting regarding another beleaguered American institution. "Bottom line," the New York Fed later reported of that meeting, "[AIG's] Treasurer estimates that parent and [Financial Products] have 5–10 days before they are out of liquidity."¹⁵

AIG posed a simple question: how could it obtain an emergency loan under the Federal Reserve's 13(3) authority? Without a solution, there was no way this conglomerate, despite more than \$1 trillion in assets, would survive another week.

"CURRENT LIQUIDITY POSITION IS PRECARIOUS"

AIG's visit to the New York Fed may have been an emergency, but it should not have been a surprise. With the Primary Dealer Credit Facility (PDCF), the Fed had effectively opened its discount window—traditionally available only to depository institutions—to investment banks that qualified as primary dealers; AIG did not qualify. But over the summer, New York Fed officials had begun to consider providing emergency collateralized funding to even more large institutions that were systemically important. That led the regulators to look closely at two trillion-dollar holding companies, AIG and GE Capital. Both were large participants in the commercial paper market: AIG with \$20 billion in outstanding paper, GE Capital with \$90 billion.¹⁶ In

August, the New York Fed set up a team to study the two companies' funding and liquidity risk.

On August 11, New York Fed officials met with Office of Thrift Supervision (OTS) regulators to discuss AIG.¹⁷ The OTS said that it was "generally comfortable with [the] firm's current liquidity . . . [and] confident that the firm could access the capital markets with no problem if it had to."¹⁸ The New York Fed did not agree. On August 14, 2008, Kevin Coffey, an analyst from the Financial Sector Policy and Analysis unit, wrote that despite raising \$20 billion earlier in the year, "AIG is under increasing capital and liquidity pressure" and "appears to need to raise substantial longer term funds to address the impact of deteriorating asset values on its capital and available liquidity as well as to address certain asset/liability funding mismatches."¹⁹

Coffey listed six concerns: (1) AIG's significant losses on investments, primarily because of securities lending activities; (2) \$26.5 billion in mark-to-market losses on AIG Financial Products' credit default swap book and related margin calls, for which AIG had posted \$16.5 billion in collateral by mid-August; (3) significant near-term liabilities; (4) commitments to purchase collateralized debt obligations due to outstanding liquidity puts; (5) ratings-based triggers in derivative contracts that could cause significant additional collateral calls if AIG were downgraded; and (6) limited standby credit facilities to manage sudden cash needs. He noted Moody's and S&P had highlighted worries about earnings, capital, and liquidity following AIG's 2008 second-quarter earnings. The agencies warned they would downgrade AIG if it did not address these issues.²⁰

Four days later, Goldman Sachs issued a report to clients that echoed much of Coffey's internal analysis. The report, "Don't Buy AIG: Potential Downgrades, Capital Raise on the Horizon," warned that "we foresee \$9–\$20 billion in economic losses from [AIG's credit default swap] book, which could result in larger cash outlays . . . resulting in a significant shift in the risk quality of AIG's assets. . . . Put simply, we have seen this credit overhang story before with another stock in our coverage universe, and foresee outcomes similar in nature but on a much larger scale."²¹ Goldman appeared to be referring to Bear Stearns. Ira Selig, a manager at the New York Fed, emailed the Goldman report to Coffey and others. "The bottom line: large scale cash outflows and posting of collateral could substantially weaken AIG's balance sheet," the manager wrote.²²

On September 2, the New York Fed's Danielle Vicente noted the situation had worsened: "AIG's current liquidity position is precarious and asset liability management appears inadequate given the substantial off balance sheet liquidity needs." Liquidating an \$835 billion securities portfolio to cover liabilities would mean substantial losses and "potentially" affect prices, she wrote. Borrowing against AIG's securities through the Fed's PDCF might allow AIG to unwind its positions calmly while satisfying immediate cash needs, but Vicente questioned whether the PDCF was "necessary for the survival of the firm."²³ Arguably, however, AIG's volatile funding sources made the firm vulnerable to runs. Off-balance-sheet commitments—including collateral calls, contract terminations, and liquidity puts—could be as high as

\$33 billion if AIG was downgraded. Yet AIG had only \$4 billion of revolving credit facilities in addition to the \$12 to \$13 billion of cash it had on hand at the time.²⁴

The rating agencies waited to see how AIG would address its liquidity and capital needs. Analysts worried about the losses in AIG's credit default swaps and investment portfolios, about rating agency actions, and about subsequent impacts on capital. Indeed, Goldman's August 18 report on AIG concluded that the firm itself and the rating agencies were in denial about impending losses.²⁵

By early September, management was no longer in denial. At the Friday, September 12, meeting at the New York Fed, AIG executives reported that the company was "facing serious liquidity issues that threaten[ed] its survival viability" and that a downgrade, possibly after a rating agency meeting September 15, would trigger billions of dollars in collateral calls, liquidity puts, and other liquidity needs.²⁶ AIG's stock had fallen significantly (shares hit an intraday low of \$11.49 Friday, down from a \$17.55 close the day before) and credit default swap spreads had reached 14% during the day,²⁷ indicating that protection on \$10 million of AIG debt would cost approximately \$1.4 million per year. AIG reported it was having problems with its commercial paper, able to roll only \$1.1 billion of the \$2.5 billion that matured on September 12.²⁸ In addition, some banks were pulling away and even refusing to provide repo funding.²⁹ Assets were illiquid, their values had declined, borrowing was restricted, and raising capital was not viable.

"SPILLOVER EFFECT"

The New York Fed knew that a failure of AIG would have dramatic, far-reaching consequences. By the evening of September 12, after the meeting with AIG executives, that possibility looked increasingly realistic. Hayley Boesky of the New York Fed emailed William Dudley and others. "More panic from [hedge funds]. Now focus is on AIG," she wrote. "I am hearing worse than LEH. Every bank and dealer has exposure to them."³⁰

Shortly before midnight, New York Fed Assistant Vice President Alejandro LaTorre emailed Geithner, Dudley, and other senior officials about AIG: "The key takeaway is that they are potentially facing a severe run on their liquidity over the course of the next several (approx. 10) days if they are downgraded. . . . Their risk exposures are concentrated among the 12 largest international banks (both U.S. and European) across a wide array of product types (bank lines, derivatives, securities lending, etc.) meaning [there] could be significant counterparty losses to those firms in the event of AIG's failure."³¹

New York Fed officials met on Saturday morning, and gathered additional information about AIG's financial condition, but according to New York Fed General Counsel Tom Baxter, it "seemed clear that the private sector solution would materialize for AIG."³² Indeed, Christopher Flowers, head of J. C. Flowers & Co., a private equity firm, had spoken to AIG CEO Robert Willumstad the prior Thursday, and the two had called Warren Buffett to discuss a possible deal. Willumstad told the FCIC

that he was in contact with about a dozen private equity firms over the weekend.³³ AIG executives also worked with then-Superintendent Eric Dinallo to help craft a deal that would have allowed AIG's regulated subsidiaries to essentially lend money to the parent company. Fed officials reported to AIG executives during a conference call on Saturday that "they should not be particularly optimistic [about financial assistance], given the hurtles [*sic*] and history of [the Fed's] 13-3 lending [authority]."³⁴ And by the end of the day on Saturday, AIG appeared to the Fed to be pursuing private-sector leads. "It was clear from the conversation that Flowers [is] actively involved in working with everything (AIG, regulators, bankers, etc) in putting together both the 'term sheet' with AIG, and providing analysis to NYSID on liquidity profile of the parent company," Patricia Mosser, a senior vice president at the New York Fed, wrote to LaTorre and others.³⁵

On Sunday morning, September 14, Adam Ashcraft of the New York Fed circulated a memo, "Comment on Possible 13-3 Lending to AIG," discussing the effect of a fire sale by AIG on asset markets.³⁶ In an accompanying email, Ashcraft wrote that the "threat" by AIG to sell assets was "a clear attempt to scare policymakers into giving [AIG] access to the discount window, and avoid making otherwise hard but viable options: sell or hedge the CDO risk (little to no impact on capital), sell subsidiaries, or raise capital."³⁷

Before a 2:30 P.M. meeting, LaTorre sent an analysis, "Pros and cons of lending to AIG," to colleagues. The pros included avoiding a messy collapse and dislocations in markets such as commercial paper. If AIG collapsed, it could have a "spillover effect on other firms involved in similar activities (e.g. GE Finance)" and would "lead to \$18B increase in European bank capital requirements." In other words, European banks that had lowered credit risk—and, as a result, lowered capital requirements—by buying credit default swaps from AIG would lose that protection if AIG failed. AIG's bankruptcy would also affect other companies because of its "non-trivial exotic derivatives book," a \$2.7 trillion over-the-counter derivatives portfolio of which \$1 trillion was concentrated in 12 large counterparties. The memo also noted that an AIG failure "could cause dislocations in CDS market [that] . . . could leave dealer books significantly unbalanced."³⁸

The cons of a bailout included a "chilling effect" on private-sector solutions thought to be under way; the possibility that a Fed loan would be insufficient to keep AIG afloat, "undermining efficacy of 13-3 lending as a policy tool"; an increase in moral hazard; the perception that it would be "incoherent" to lend to AIG and not Lehman; the possibility of assets being insufficient to cover the potential liquidity hole. LaTorre concluded, "Without punitive terms, lending [to AIG] could reward poor risk management," which included AIG's unwillingness to sell or hedge some of its CDO risk.³⁹

The private-sector solutions LaTorre referred to had hit a wall, however. By Sunday afternoon, Flowers had been "summarily dismissed" by AIG's board. Flowers told the FCIC that under his proposal, his firm and Allianz, the giant insurance company, would have each invested \$5 billion in exchange for the stock of AIG subsidiaries. With

approval from the NYSID, the subsidiaries would “upstream” \$20 billion to the parent company, and the parent company would get access to bridge financing from the Fed. Then, Allianz would take control of AIG almost immediately. Flowers said that he was surprised by AIG’s unwillingness to negotiate. “I’m not saying it would have worked or that it was perfect as written, but it was astounding to me that given what happened, nobody bothered to check this [deal] out,” he said.⁴⁰ Willumstad referred to the Flowers deal as a “so-called offer”—he did not consider it to be a “serious effort,” and so it was “dismissed immediately.” With respect to the other potential investors AIG spoke with over the weekend, Willumstad said that negotiations were unsuccessful because every potential deal would have required government assistance—something Willumstad had been assured by the “highest levels” would not be forthcoming.⁴¹

On Monday morning—after Lehman had declared bankruptcy, and with no private-sector solution on the horizon—the Fed initiated an effort to have JP Morgan and Goldman Sachs assemble a syndicate of banks to lend about \$75 billion to keep AIG afloat.⁴² In the afternoon, the rating agencies announced their assessments, which were even worse than expected. All three rating agencies announced downgrades of AIG: S&P by three notches to A-, and Moody’s and Fitch by two notches to A2 and A, respectively. The downgrades triggered an additional \$13 billion in cash collateral calls on AIG Financial Products’ credit default swaps. Goldman Sachs alone requested \$2.1 billion.⁴³ Demands hit \$32 billion, and AIG’s payouts increased to \$19.5 billion.⁴⁴ The company’s stock plummeted 61% to \$4.76 from the closing price of \$12.14 the previous Friday—a fraction of its all-time high of \$145.84.

The syndicate of banks did not agree on a deal, despite the expectations of Fed officials. “Once Lehman filed [for bankruptcy] on the morning of the 15th, everyone decided that, ‘we’ve got to protect our own balance sheet,’ and the banks that were going to provide the \$75 billion decided that they were not going to,” Baxter told the FCIC.⁴⁵ Sarah Dahlgren, a senior New York Fed official, agreed with Baxter. Lehman’s bankruptcy “was the end of the private-sector solution,” she told the Commission.⁴⁶

After the markets closed, AIG informed the New York Fed it was unable to access the short-term commercial paper market.⁴⁷ Regulators spent the next several hours preparing for a late-night teleconference with Geithner. The “Lead point,” according to an email circulated to the Fed’s AIG monitoring group, was that “the size, name, franchise and market presence (wholesale and retail) [of AIG] raise questions about potential worldwide contagion, should this franchise become impaired.”⁴⁸ Late that night, for the second time since the beginning of the crisis, the Federal Reserve Board invoked section 13(3) of the Federal Reserve Act to bail out a company. As it had done for Bear Stearns, the New York Fed, with the support of the Treasury, would rescue a brand-name financial institution.

The Federal Open Market Committee was briefed about AIG. Members were told that AIG faced a liquidity crisis but that it was unclear if there were also solvency issues. In addition, the staff noted that money market funds had even broader exposure to AIG than to Lehman and that the parent company could run out of money quite soon, even within days.⁴⁹

On Tuesday morning, the Fed put a number on the table: it would loan \$85 billion so that AIG could meet its immediate obligations. The collateral would be the assets of the parent company and its primary nonregulated subsidiaries, plus the stock of almost all the regulated insurance subsidiaries. The Fed stated that “a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance.”⁵⁰ By Wednesday, a share of AIG sold for as little as \$1.99. The previous eight years’ profits of \$66 billion would be dwarfed by the \$99.3 billion loss for this one year, 2008.

But \$85 billion would soon prove insufficient. Treasury added \$49.1 billion under its Troubled Asset Relief Program (TARP).⁵¹ Ultimately, according to the Congressional Oversight Panel, taxpayer funds committed to AIG reached \$182 billion. The panel faulted the government for deciding to bail out AIG too hastily: “With AIG, the Federal Reserve and Treasury broke new ground. They put the U.S. taxpayer on the line for the full cost and full risk of rescuing a failing company.”⁵² The Treasury Department defended its decision, saying that the panel report “overlooks the basic fact that the global economy was on the brink of collapse and there were only hours in which to make critical decisions.”⁵³

“LIKE A GNAT ON AN ELEPHANT”

The Office of Thrift Supervision has acknowledged failures in its oversight of AIG. In a March 18, 2009, congressional hearing, Acting Director Scott Polakoff testified that supervisors failed to recognize the extent of liquidity risk of the Financial Products subsidiary’s credit default swap portfolio.⁵⁴ John Reich, a former OTS director, told the FCIC that as late as September 2008, he had “no clue—no idea—what [AIG’s] CDS liability was.”⁵⁵

According to Mike Finn, the director for the OTS’s northeast region, the OTS’s authority to regulate holding companies was intended to ensure the safety and soundness of the FDIC-insured subsidiary of AIG and not to focus on the potential impact on AIG of an uninsured subsidiary like AIG Financial Products.⁵⁶ Finn ignored the OTS’s responsibilities under the European Union’s Financial Conglomerates Directive (FCD)—responsibilities the OTS had actively sought. The directive required foreign companies doing business in Europe to have the equivalent of a “consolidated supervisor” in their home country. Starting in 2004, the OTS worked to persuade the European Union that it was capable of serving as AIG’s “home country consolidated supervisor.”⁵⁷ In 2005 the agency wrote: “AIG and its subsidiaries are subject to consolidated supervision by OTS. . . . As part of its supervision, OTS will conduct continuous on-site reviews of AIG and its subsidiaries.”⁵⁸ Yet even Reich told FCIC staff that he did not understand his agency’s responsibilities under the FCD. The former director said he was never sure what authority the OTS had over AIG Financial Products, which he said had slipped through a regulatory gap.⁵⁹

Further undermining the OTS's claim that it lacked authority over AIG Financial Products are its own actions: the OTS did in fact examine the subsidiary, albeit much too late to matter. OTS examiners argued they got little cooperation from Joseph Cassano, the head of the subsidiary. Joseph Gonzales, the examiner in charge from April 2004 to November 2006, told FCIC staff, "I overheard one employee saying that Joe Cassano felt that [the OTS was] overreaching our scope by going into FP."⁶⁰

The OTS did not look carefully at the credit default swap portfolio guaranteed by the parent company—even though AIG did describe the nature of its super-senior portfolio in its annual reports at that time, including the dollar amount of total credit default swaps that it had written. Gonzales said that the OTS did not know about the CDS during the 2004–05 period.⁶¹ After a limited review in July 2007—conducted a week before Goldman sent AIG Financial Products its first demand for collateral—the OTS concluded that the risk in the CDS book was too small to be measured and decided to put off a more detailed review until 2008.⁶² The agency's stated reason was its limited time and staff resources.⁶³

In February 2008, AIG reported billions of dollars in losses and material weaknesses in the way it valued credit default swap positions. Yet the OTS did not initiate an in-depth review of the credit default swaps until September 2008—ten days before AIG went to the Fed seeking a rescue—completing the review on October 17, more than a month after AIG failed. It was, former OTS director of Conglomerate Operations Brad Waring admitted, "in hindsight, a bad choice."⁶⁴

Reich told the FCIC that before 2008, AIG had not been a great concern. He also acknowledged that the OTS had never fully understood the Financial Products unit, and thus couldn't regulate it. "At the simplest level, . . . an organization like OTS cannot supervise AIG, GE, Merrill Lynch, and entities that have worldwide offices. . . . I would be the first to say that for an organization like OTS to pretend that it has total responsibility over AIG and all of its subsidiaries . . . it's like a gnat on an elephant—there's no way." Reich said that for the OTS to think it could regulate AIG was "totally impractical and unrealistic. . . . I think we thought we could grow into that responsibility. . . . But I think that was sort of pie in the sky dreaming."⁶⁵

Geithner agreed, and told Reich so bluntly. Reich told the FCIC about a phone call from Geithner after the rescue. "About all I can remember is the foul language that I heard on the other end of the line," Reich said. He recalled Geithner telling him. "You guys have handed me a bag of sh*t. I just listened."⁶⁶

COMMISSION CONCLUSIONS ON CHAPTER 19

The Commission concludes AIG failed and was rescued by the government primarily because its enormous sales of credit default swaps were made without putting up initial collateral, setting aside capital reserves, or hedging its exposure—a profound failure in corporate governance, particularly its risk management practices.

AIG's failure was possible because of the sweeping deregulation of over-the-counter (OTC) derivatives, including credit default swaps, which effectively eliminated federal and state regulation of these products, including capital and margin requirements that would have lessened the likelihood of AIG's failure. The OTC derivatives market's lack of transparency and of effective price discovery exacerbated the collateral disputes of AIG and Goldman Sachs and similar disputes between other derivatives counterparties. AIG engaged in regulatory arbitrage by setting up a major business in this unregulated product, locating much of the business in London, and selecting a weak federal regulator, the Office of Thrift Supervision (OTS).

The OTS failed to effectively exercise its authority over AIG and its affiliates: it lacked the capability to supervise an institution of the size and complexity of AIG, did not recognize the risks inherent in AIG's sales of credit default swaps, and did not understand its responsibility to oversee the entire company, including AIG Financial Products. Furthermore, because of the deregulation of OTC derivatives, state insurance supervisors were barred from regulating AIG's sale of credit default swaps even though they were similar in effect to insurance contracts. If they had been regulated as insurance contracts, AIG would have been required to maintain adequate capital reserves, would not have been able to enter into contracts requiring the posting of collateral, and would not have been able to provide default protection to speculators; thus AIG would have been prevented from acting in such a risky manner.

AIG was so interconnected with many large commercial banks, investment banks, and other financial institutions through counterparty credit relationships on credit default swaps and other activities such as securities lending that its potential failure created systemic risk. The government concluded AIG was too big to fail and committed more than \$180 billion to its rescue. Without the bailout, AIG's default and collapse could have brought down its counterparties, causing cascading losses and collapses throughout the financial system.