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REPERCUSSIONS: The Impact of the AIG Bailout on it's Insurance Subsidiaries

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REPERCUSSIONS: The Impact of the AIG Bailout on its Insurance Subsidiaries

By Shauna Ferris (2012)[1]

INTRODUCTION

In September 2008, the US government announced a $85 billion bailout of the American International Group, Inc. (AIG). Over the next few months, the size of the bailout increased to about $180 billion.[2]

Initially, newspaper reports focussed on the problems at AIG's Financial Product Group (AIG FPG). The Financial Products Group had written credit default swaps and other derivatives which had a notional amount of $2.7 trillion[3]. As a result of the subprime debt crisis, the Financial Products Group had unrealised losses amounting to more than $30 billion dollars by September 2008. AIG had an obligation to meet margin calls on these derivatives. AIG's counterparties were demanding billions of dollars from AIG - and AIG did not have the cash [4]. As a result, AIG was facing a liquidity crisis, on the verge of declaring bankruptcy.

Initially, state insurance regulators insisted that AIG's insurance subsidiaries were in good shape, despite the losses incurred by the Financial Products Group. On 22 September 2008, Mr. Eric Dinallo, the Insurance Commissioner in New York issued a press statement to reassure policyholders….

> *"Dinallo explained that the trouble with AIG is largely with AIG's non-insurance parent company, which is not regulated by the states and therefore not held to the same investment, accounting, and capital adequacy requirements as its state-regulated insurance subsidiaries. The insurance companies are solvent and able to pay their obligations…."*

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[2] Government assistance was provided in a number of different forms, from both the Federal Reserve Bank and later from TARP funds. The first loan was a Revolving Credit Facility from the Federal Reserve Bank of New York, for up to $85 billion, announced on 16 September 2009. Congressional Oversight Panel June Oversight Report, June 2010. According to the Congressional Oversight Panel (COP), at the height of government support, AIG and its affiliates had received $89.5 billion in loan from the Federal Reserve, $43.8 billion through Maiden Lane II and Maiden Lane III, and $49.1 billion from Treasury (page 17 of COP June Oversight Report, June 2010). Higher amounts were authorised but were not fully drawn down.

[3] Michael Moriarty, New York State Insurance Commissioner, Testimony to the US Congressional Oversight Panel, Hearing on American International Group, May 26 2010 (Hereafter Moriarty (2010).

[4] Collateral postings on the Multi-Sector CDS portfolio jumped from less than $10 billion at 30 March 2008 to more than $30 billion by the end of September. COP June 2010 page 40.

"As an example, unlike the troubled parent company, the property and casualty insurance company New York regulates has significantly more in asset over and above the reserves required to cover all valid current and future claims. As regulators, we make sure the assets of the insurance companies are walled off, protected from the parent company's troubles and available to pay all your covered claims."[5]

No doubt this was reassuring to the general public. But was it true?

Theoretically, insurers might be "walled off" from problems, but in practice the parent company is often able to find a small side gate which has been left unlocked. Numerous studies have shown that insurance companies are often adversely affected by problems at a parent company. [6]

So how were AIG's insurance subsidiaries affected by the problems at AIGFP?

Since AIG's rescue required an enormous infusion of government funds, several Congressional Committees have conducted investigations into the causes of AIG's problems, and the application of the bailout funds provided by the government. These Committees and other government agencies have published voluminous reports into these events.

These reports do not paint quite such a rosy view of the management, regulation, and solvency of some of AIG's insurance subsidiaries.

As the story unfolded, it became clear the AIG's life insurance companies had also suffered quite substantial losses of their own, primarily via their involvement in AIG's Securities Lending Program (described in more detail below). As a result, some of these insurance subsidiaries required billions of dollars of financial support from the parent company, in order to maintain regulatory solvency. This support was only available because the government was funnelling money into the parent company.

The following graph shows AIG's use of $81 Billion of Federal funds, as at the end of 2008. As the graph shows, roughly $25 billion was used to provide capital infusions to insurance subsidiaries, compared to about $57 billion which was used for the Financial Products Group and other miscellaneous purposes.[7]

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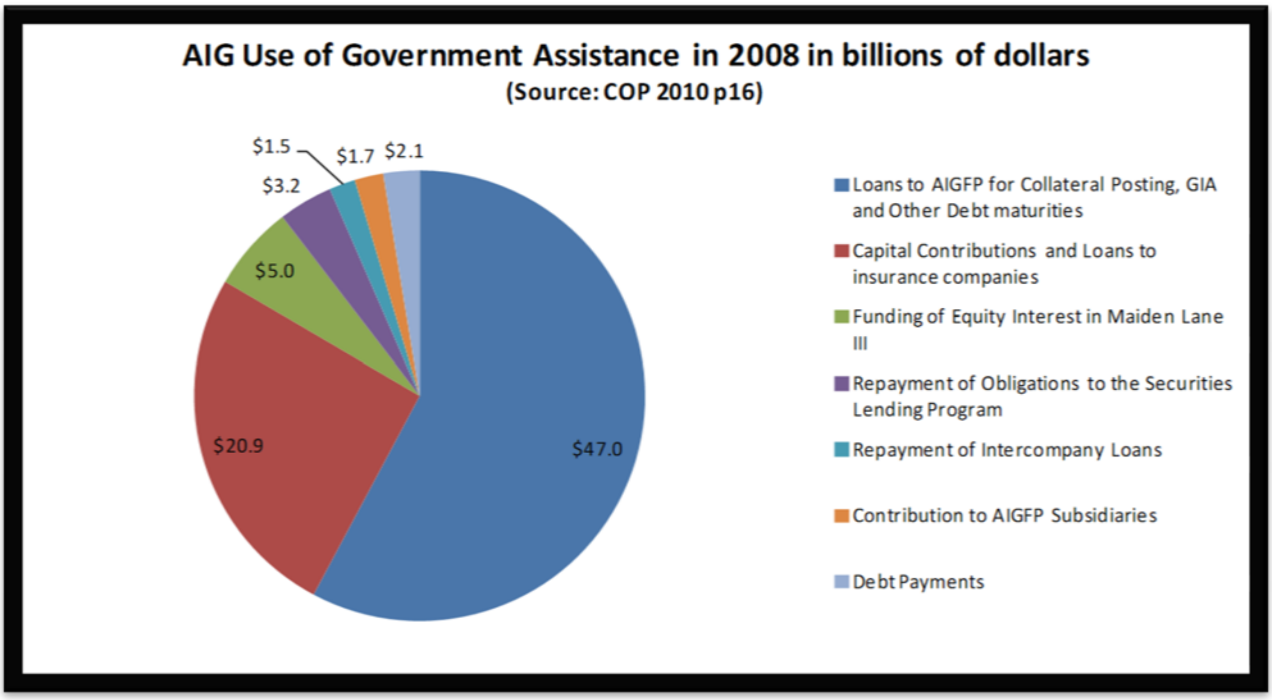
[5] AIG Policyholders should be careful if approached to Replace Policies, News Release from the New York State Insurance Department, issued 22 September 2008

[6] AM Best periodically analyses the main causes of financial impairment in US life/health insurers and US Property'Casualty insurers. In Australia, the Insurance and Superannuation Commissioner's study of Australian general insurance insolvencies also identified transactions with and/or investments in Related Bodies Corporate as a significant factor in several insolvencies. A European study of insurance insolvencies also identified problems caused by affiliates. (REF HERE)

[7] $20.850 billion was provided as capital contributions and loan to insurance companies, plus $3.160 billion was used to cover losses in the Securities Borrowing Facility (the government regulators had insisted on guarantees from the parent company). The government regulators also insisted on the repayment of loans that had been made from the insurance companies to the parent company, amounting to more than $1.5 billion dollars. See *Federal Financial Assistance: preliminary Observations on Capital Markets, Insurance, and Government Sponsored Enterprises*, by the Government Accountability Office March 18 2009 (GAO-09-490T), page 6



The insurers also needed liquidity support. As soon as the government bailed out AIG, the parent company's credit ratings fell and there was a great deal of adverse publicity. Over the next two weeks, this created severe liquidity problems for the life insurance companies, particularly in relation to their Securities Lending Program. In October 2008, the Federal Reserve Bank of New York set up a set up a special program called the Securities Borrowing Facility in order to provide approximately $20 billion in additional liquidity to the life insurance companies.[8]

During the crisis, it seems that the government authorities had conflicting objectives. The state insurance commissioners were trying to protect the insurance subsidiaries, e.g. by cutting off any intercompany loans from the insurance companies to the parent company. On the other hand, there were some proposals to use insurance company assets to provide additional liquidity to the parent company, via asset swaps.

After the immediate emergency eased, the insurance subsidiaries continued to suffer the effects of reputational damage, affecting the levels of new business and cancellations / surrenders.

The purpose of this paper is to provide a case study to illustrate the risks to insurance companies which may arise from management problems at a parent company.

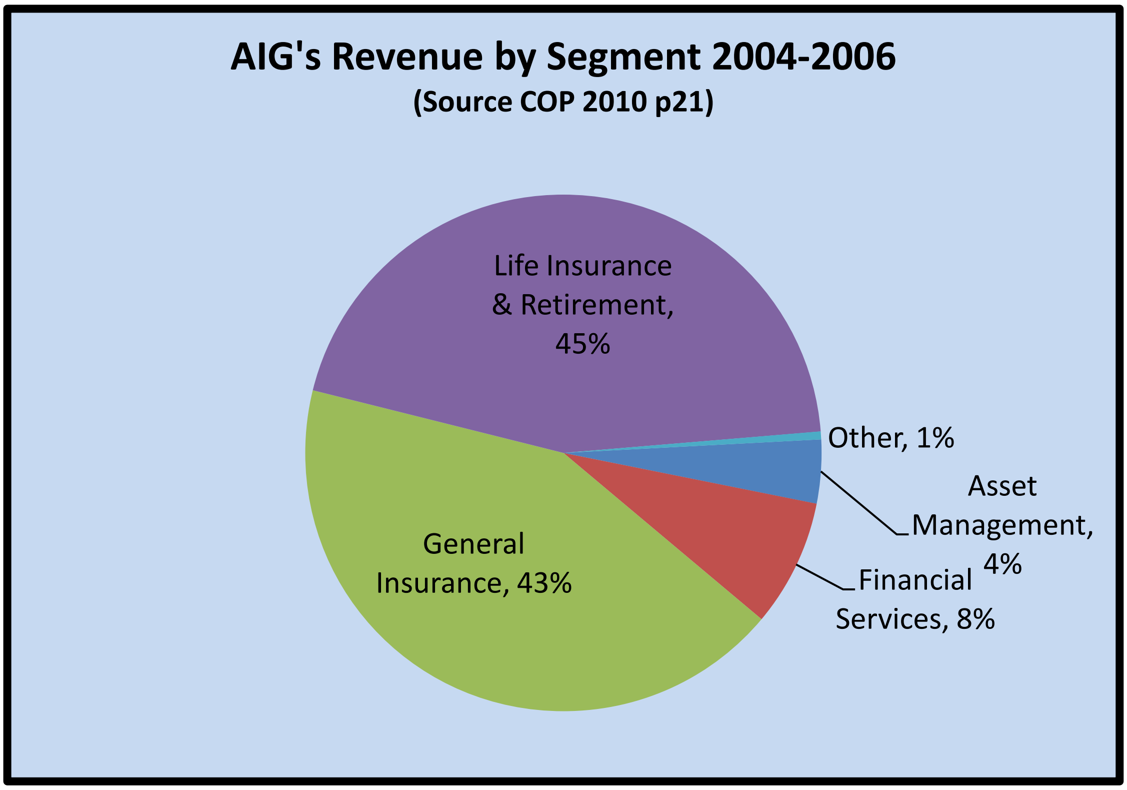
[8] As explained below, the Securities Borrowing Facility was later closed down and replaced with a new program, Maiden Lane II, which bought illiquid mortgage backed securities from the life insurance companies. This crystallised the losses arising from the Securities Borrowing Facility. (COP, June 2010)

BACKGROUND TO AIG'S BUSINESS ACTIVITIES

Sources of Revenue

AIG owned about 230 different companies, scattered all over the world.

During the period 2004 to 2006, insurance operations provided nearly 90% of AIG's net revenue. [9]



Regulation of the US Insurance Subsidiaries

In the United States, insurance companies are regulated by the states.

Each company has its head office in one state (called the state of domicile). The Insurance Commissioner for the state of domicile would be the primary regulator for each insurer. If the insurance company was licensed to operate in other states, then the Insurance Commissioners in

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[9] COP (2010) p 20

those states would also be entitled to conduct their own examinations – however they would often simply rely on the primary regulator.[10]

The states worked together to supervise all of AIG's insurance subsidiaries. Texas was the lead regulator for life insurers; Pennsylvania was the lead regulator for property & casualty insurers; New York was the lead regulator for personal lines; and Delaware was the lead regulator for specialised lines ("surplus lines"). The lead regulators co-ordinated the activities of the other state regulators.[11]

Prior to the Global Financial Crisis, the American insurance regulators believed that both the core operations of the life insurance and general insurance companies were "generally sound" – apart from risks arising from the securities lending program.[12]

THE SECURITIES LENDING PROGRAM PRIOR TO THE CRISIS

AIG's life insurance companies became involved in securities lending in order to improve the returns on their portfolios. How did this work?

The life insurance companies owned securities. They would lend these securities to counterparties, which were generally major banks and brokerage firms[13].

The counterparties would provide cash collateral to the life insurance companies. Initially, the collateral was 102% to 105% of the value of the borrowed securities[14]. The life insurance companies could invest this cash collateral to earn additional income.

The counterparties would eventually return the securities, and then reclaim the cash collateral. Typically, the counterparties could do so at any time. Therefore the cash collateral was usually invested in very liquid securities, such as short term Treasury bonds. This was a very low risk strategy which was expected to provide relatively small increments in returns.

However, this low-risk investment program later morphed into a much more risky operation.

AIG's insurance subsidiaries did not manage their own Securities Lending Program. AIG set up the AIG Securities Lending Corporation (AIGSLC), which acted as an agent for the insurers. There were two separate pools : one held assets for twelve US-based life insurers, and the other held assets for non-US companies.[15]

> *"Several of AIG's life insurance subsidiaries participated in the securities lending program, which essentially aggregated the securities lending (and collateral investment) operations of these subsidiaries….This effectively centralised decisions relating to securities lending collateral within AIG's asset management operations group, and away from individual life*

[10] COP June 2010 page 22
[11] COP June 2010 page 22
[12] COP 2010 p 25
[13] COP 2010 p44. A list of all the counterparties is given on page 88 of the COP June Oversight Report. The top 5 counterparties were Barclays, Deutsche Bank, BNP Paribas, Goldman Sachs, and Bank of America.
[14] This was in line with NAIC guidelines on collateral requirements.
[15] Dinallo (2009)

insurance subsidiaries. By appointing an affiliated agent to manage the securities lending program, the subsidiaries provided AIG's asset management operations team with some measure of control of the securities lending program."

In 2005, AIG decided to change the investment strategy. The cash collateral would no longer be invested in low risk liquid securities; instead, the cash collateral would be invested in Residential Mortgage Backed Securities.

This was not a good time to be investing in mortgage backed securities. Even AIG's own Financial Products Group had decided that this line of business was too risky. By the end of 2005, AIG's Financial Products Group had already decided to stop underwriting subprime debt securities[16]. The Congressional Oversight Panel later commented that:

"…the life insurance subsidiaries were ramping up the purchase of RMBS at the same time that AIGFP had decided to stop writing swaps on subprime mortgage backed securities because of the riskiness of the underlying bonds, highlighting the failure of enterprise risk management at the company."

Over the next two years, AIG's Securities Lending Program aggressively expanded its investment in subprime debt. By late 2007, AIG's Securities Lending portfolio held $76 billion in liabilities, with 60% in Residential Mortgage Backed Securities (RMBS).[17]

To put this into perspective, the total assets of all the AIG domestic life insurance companies was about $400 million[18]. So about 11% of the life insurance company assets were invested in RMBS at that time – just as the market for these securities was becoming more illiquid.

The securities lending program had a built-in asset-liability mismatch. The counterparties could return the securities with very little notice, and demand a return of their cash collateral. But their cash was invested in soon-to-be-very-illiquid Residential Mortgage-Backed Securities. The Securities Lending portfolio held 16% in cash, 33% in securities with less than 2 years to maturity, 34%% in securities with 2 to 5 years to maturity, 15% in securities with 5 to 10 years to maturity, and 2% in securities with 2 to 5 years to maturity.[19]

According to Boyd (2011), the AIG subsidiary which managed the Securities Lending Program did not bother to inform the life insurance companies about the change in asset allocation. The fund managers simply made a small change in the prospectus, which gave them the freedom to invest in a riskier range of assets. [20] When officers from one of the life insurance companies asked questions

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[16] COP 2010 p34
[17] COP June 2010 page 43
[18] Dinallo Testimony to Senate Committee Senate Committee on Banking, Housing, and Urban Affairs, *American International Group: Examining What Went Wrong, Government Intervention, and Implications for the Future*, March 2009
[19] This asset liability mismatch is described in COP 2010 p24 footnote, and see also Dinallo's submission to the Senate Committee on Banking, Housing, and Urban Affairs, American International Group: Examining What Went Wrong, Government Intervention, and Implications for the Future, March 2009
[20] Boyd (2011) page 169, 227

about any exposure to subprime mortgages, they were given reassuring (buy misleading) answers about the excellence of the portfolio's risk management controls. [21]

Question for discussion: A life insurance company with sound risk management would normally scrutinise any investment management agreements, and in particular would impose controls on the asset allocation of managed funds. Did the AIG insurers relax their vigilance and/or lower their standards because they were dealing with an affiliated company?

Initially, it seems, the state insurance regulators were not aware of the shift in the investment strategy. [22]

However, by mid-2007, state regulators had become aware of the high proportion of RMBs in the securities lending portfolio[23]. These securities were still AAA-rated, but by this time the housing market had already begun to decline. The insurance regulators were concerned, and they insisted that AIG should take action to reduce the risks to the life insurers.

Firstly, the regulators asked AIG (the parent company) to provide guarantees to the life offices. In the fall of 2007, AIG provided a guarantee to cover up to $500 million of realised losses. As losses increased, the guarantee was increased to $1 billion on May 1, 2008, and then increased to $5 billion on June 17, 2008.[24]

Secondly, the regulators asked AIG to wind-down the program. The regulators required AIG to provide monthly reports on the securities lending program and also *"closely monitored… capital levels at the subsidiaries".*[25]

However, during 2007/2008 it was difficult to sell off increasingly illiquid RMBS.

Over the next year, the size of the RMBs portfolio in the US pool was reduced from $76 billion down to $58 billion by September 2008.

It is difficult to tell whether this reduction was achieved by the deliberate sale of assets, or by a fall in the market value of assets.

The value of assets in the Securities Lending Program certainly did decline:

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[21] Boyd (2011) p246

[22] State insurance regulators are supposed to review any transactions between insurance companies and affiliates. It appears that they did indeed approve the Securities Lending Program, but they were not aware of shift in the asset allocation. The Senate Committee on Banking, Housing, and Urban Affairs, was quite critical of the State Insurance Regulators for allowing the life insurance companies to invest so much money in this program. See hearings, *American International Group: Examining What Went Wrong, Government Intervention, and Implications for the Future,* March 2009

[23] According to COP 2010 footnote 168 on page 56, the Texas state regulators made this discovery during its examination process in mid 2007. The National Association of Insurance Commissioners has said that AIG should have disclosed this change in asset allocation to the regulator.

[24] COP 2010 footnote 107 on page 44, based on information provided by the NAIC. Although newspaper reports suggest that AIG was contributing cash to the Securities Lending Program to absorb the losses, the regulatory reports only refer to a guarantee, i.e. the subsidiaries would be creditors of the parent company. This seems consistent with the data which shows that AIG paid $3.16 billion into the Securities Lending subsidiary AFTER the bailout in 2008.

[25] COP 2010 p 57

"Through the wind-down of the program, the insurance subsidiaries had $5 billion in realised losses and $7.873 billion in unrealised losses, as of July 2008, from the securities lending program."[26]

Conditions continued to deteriorate,

By the end of September 2008, the securities lending portfolio held about $40 billion of RMBs with a fair value of approximately $23.5 billion, i.e. an unrealised loss of about 16.5 billion.[27]

Throughout this period the credit rating agencies repeatedly expressed concerns about the risks in the Securities Lending Program, and indeed this led to credit rating downgrades.

AIG to AbsorbUS$5B losses on securities lending: Insurance units wrote down $13B tied to mortgages (Bloomberg News 28 June 2008)

"American International Group Inc plans to absorb losses for a dozen insurance units after their securities lending accounts suffered $13 billion of write downs tied to the subprime mortgage collapse during the past year. The world's largest insurer will absorb as much as US$5 billion of any losses on sales of investments, up from a previous commitment of US$500 million, said Christopher Swift, vice-president for life and retirement services. AIG will also inject an undisclosed amount of capital into some of the subsidiaries, he said.

Moody's Investors Services and AM Best Co. both cited the write downs in May when they downgraded New York based AIG's credit ratings. State regulators in Texas said they didn't know AIG was investing cash collateral from the securities lending business in subprime-linked assets and were concerned the insurance units hadn't put aside enough capital to cover potential losses.

"We were aware of this portfolio but we didn't have transparency on what was in it because it was off-balance sheet" in the company's statutory accounting reports, said Doug Slape, chief analyst at the Texas Department of Insurance, which oversees three AIG insurers that have suffered about 60% of the write downs.

By the end of 2008, AIG's life insurance companies had lost about $21 billion as a result of their investment in the securities lending program. This led to the need to recapitalise the insurers (described below).[28]

THE CRISIS IN SEPTEMBER 2008

The subprime debt crisis began to seriously affect AIG in late 2007. The decline in market values affected both AIG Financial Products and AIG's Securities Lending operations.

[2626] COP 2010 footnote 169, page 57, citing data provided by the Texas Department of Insurance
[27] COP 2010 footnote 112 p 46, data from AIG Form 10-Q for third quarter 2008
[28] *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation,* Hearings before the Committee on Banking, Housing, and Urban Affairs, United States Senate, March 5, 2009

Initially, AIG's Financial Products Group did not expect to suffer any losses due to subprime debt crisis. AIG held "super senior" tranches of Collateralised Debt Obligations. According to their own models, it was very unlikely that defaults would be severe enough to affect the super senior tranches. When reporting earnings in the second quarter of 2007, the head of AIGFP said that

> *"It is hard for use, 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".*

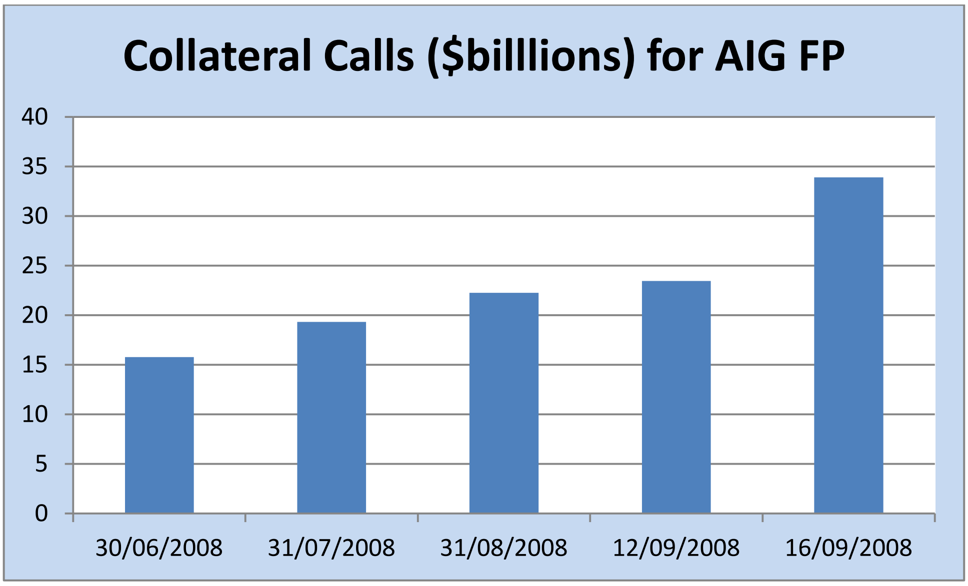
However, the market value of CDOs continued to fall – and as a result, AIG's counterparties began to make collateral calls against AIG. Initially AIG resisted meeting these collateral calls. According to AIG's models, these collateral calls were unnecessary. But the counterparties had their own models, which produced lower valuations for the CDOs. Ratings agencies downgraded some of the CDOs, and some market participants began to report losses. Eventually, in early 2008, AIG was forced to write down the value of its portfolio, recording an unrealised loss of $11.25 billion.

These write downs led to collateral calls from counterparties, creating a drain on AIG's cash resources.[29]

The ratings agencies realised that these write downs and collateral class were weakening AIG's financial position – and this led to downgrades. Prior to the crisis, AIG had a credit rating of AA from S&P. In February 2008, S&P put AIG on a negative watch.

The losses in the securities lending portfolio also began to affect AIG's credit rating. In May 2008, S&P's rating was reduced to AA-.

Ratings downgrades created a downwards spiral. The counterparties to the CDO contracts were entitled to call for additional collateral whenever AIG was downgraded. This created more liquidity problems for AIG. Collateral calls increased by billions of dollars every month. [30]



[29] COP 2010 p38

[30] A Timeline about collateral calls was included as evidence to the Financial Crisis Inquiry, downloaded from http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2010-07-01%20Goldman%20Sachs-AIG%20Collateral%20Call%20Timeline.pdf

By 16 September 2008, the collateral calls exceeded $33 billion.[31]

The liquidity problems at the parent company also affected the Securities Lending Program. The counterparties to AIG's Securities Lending operations also became worried about the ratings downgrades, and began to close out their contracts, asking for a return of their cash collateral. This created liquidity problems for the Securities Lending program, since a high proportion of the company's assets were illiquid RMBS.

In response, AIG decided that it needed to offer very attractive terms to the Securities Lending Program borrowers. When the program had first been set up, AIG required the borrowers to post collateral equal to at least 100% of the market value of the borrowed securities. But as the market became more competitive, AIG had relaxed its standards, and offered to accept lower levels of collateral. When the collateral was less than 100%, the parent company made up the difference.

> *"The situation (liquidity crisis) was further complicated by AIG's aforementioned subsidisation of below-market terms to its securities borrowers, as the company in desperate need for cash, began to accept collateral in some cases as low as 90 percent of the value of the securities borrowed. By the end of August 2008, AIG had provided $3.3 billion in the form of financing terms and investment sales, to its insurance subsidiaries to help plug the shortfall."*[32]

As a result, the insurers' liquidity problem became a solvency problem. If the securities lending counterparties became insolvent, and failed to return the borrowed securities, then the collateral might not be sufficient to cover the loss. The insurers would be dependent on the parent company to make up the shortfall – but would the parent company have the money to do so?

In any event, these measures were ultimately NOT successful in preventing the liquidity crisis.

The situation deteriorated sharply in August/September 2008.

Credit Default Swap Spreads on AIG rose from 300.7 basis points on August 15 2008, up to 1527.6 basis points on September 2008.[33]

AIG's share price fell from $22.76 on September 8 to $12.14 on September 12 and then to $4.76 on September 15. [34]

The entire financial system was in turmoil at this time: the government had arranged to take over Fannie Mae and Freddie Mac on September 7; Lehman Brothers collapsed on September 15; money market mutual funds "broke the buck"; the commercial paper market was locked up, creating liquidity problems for many companies (including some AIG subsidiaries, which were unable to roll over their commercial paper; the parent company provided funds, which created yet another drain on resources).

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[31] COP 2010 p 40

[32] It is not clear whether these top-up payments were negotiated by the life insurance companies, or whether the regulators insisted on these top-up payments. The Texas Department of Insurance estimated that by July 31 2008, roughly 1/3 to ¼ of the counterparties were providing less than 100% collateral.

[33] COP June 2010 p 60

[34] GAO-09-490T at page 17-18

By early September, government authorities were aware of serious liquidity problems at AIG; and they were desperately seeking a solution. [35]

Initially, AIG hoped to find a private sector solution to the problem, but the situation was deteriorating very quickly.

- On Friday September 12, AIG estimated that it would need $20 billion.
- By the evening of Saturday September 13, the estimate had increased to $40 billion.
- By Sunday night, the estimate had increased to $60 billion – with a worst-case scenario estimate of more than $120 billion. [36]

On September 15 2008, the major credit rating agencies all downgraded AIG (by three notches). [37] This triggered more collateral calls, for several billion dollars, from AIGFP's counterparties on credit derivative contracts .

Between September 12, 2008 and September 30, 2008, Securities Lending counterparties returned their borrowed securities and demanded approximately $24 billion in cash.[38]

Interactions

Theoretically, AIG FP's derivatives trading business was separate from the Securities Lending Program. But it is clear that there were correlations in the risks facing both businesses.

> *"In the words of Marshall Huebner of Davis Polk & Wardwell, a law firm that represented FRBNY, the securities lending problems contributed to a "double death spiral."22 The problems in AIGFP exacerbated the problems in securities lending, and vice versa, as collateral demands from both sets of counterparties quickly imperilled the company's liquidity position as it struggled to meet its cash demands."*[39]

This correlation of risks was probably exacerbated by the overlapping of counterparties. The same investment banks and hedge funds were the counterparties in both lines of business. The securities borrowers would have known about AIG's losses in its CDS portfolio, at least to some extent.

The following table shows the major counterparties for the securities lending program when Maiden Lane II was established in November 2008.[40] The table also shows the major counterparties for AIG FP that participated in the Maiden Lane III program. Many of the same names appear on both lists.

[35] According to the GAO Report (GAO-11-616), the Federal Reserve had been monitoring the situation at AIG since at least late 2007, and the FRBNY was aware of large losses in AIGFP and the securities lending program (Page 18-21 of Financial Crisis: Review of Federal Reserve Assistance to AIG Inc, September 2011)
[36] COP June 2010 page 64 and footnote 220
[37] Testimony by Orice M Williams, Director of Financial Markets and Community Investments, to the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, House Committee on Financial Services, March 18,2009, *Federal Financial Assistance, Preliminary Observations on Assistance Provided to AIG*, Government Accountability Office, page 6 GAO-09-490T
[38] COP 2010 p45, See also GAO-11-616 on page 30
[39] COP June 2010 p24
[40] COP June 2010 p88

Securities Lending Counterparties	Amount ($billions $)		AIG FP Counterparties	Amount ($billions $)
Barclays $7.0	7.0		Societe Generale	16.5
Deutsche Bank	6.4		Goldman Sachs	14.0
BNP Paribas	4.9		Deutsche Bank	8.5
Goldman Sachs	4.8		Merrill Lynch	6.2
Bank of America	4.5		Calyon	4.3
HSBC	3.3		UBS	3.8
Citigroup	2.3		DZ Bank	1.8
Dresdner Kleinwort	2.2		Barclays	1.5
Merrill Lynch	1.9		Bank of Montreal	1.4
UBS	1.7		Royal Bank of Scotland	1.1
ING	1.5		Wachovia	1.0
Morgan Stanley	1.0		Bank of America	0.8

The Congressional Oversight Panel commented on AIG's inability to assess risks across all its many subsidiaries.

> *"It is important to realize that since AIG was both insuring RMBS through their sale of CDS and also purchasing RMBS through their investment of securities lending collateral, in order to assess the risk to the company, one would need to know how these products moved together, or co-varied. And since AIG did not fully grasp the details of the securities underlying the CDS, it would be almost impossible to estimate the covariance, and therefore truly understand the risk they were facing in their aggregate exposures across AIGFP and the company's securities lending operations".*[41]

RESPONSE TO THE CRISIS: GOVERNMENT LIQUIDITY SUPPORT FOR THE SECURITIES LENDING PROGRAM

By the end of September, AIG's Securities Lending Program was collapsing. The Securities Lending counterparties were demanding cash, but the Securities Lending Program did not have enough liquid assets available to pay these counterparties.

The government stepped in to assist, by becoming a substitute securities borrower.

0n 8 October 2008, the Federal Reserve Bank of New York borrowed investment grade fixed income securities from AIG in exchange for cash collateral. This loan was called the *Securities Borrowing Facility* (SBF). The amount borrowed was approximately $17.5 billion.[42]

[41] COP 2010 p 45 footnote 108
[42] COP June 2010 Oversight Report page 12

The Securities Borrowing Facility was just a stop-gap measure. On 10 November 2008, the Federal Reserve Bank of New York set up Maiden Lane II, a limited liability company. The FRBNY lent money to Maiden Lane II, which then used the money to buy Residential Mortgage Backed Securities (RMBS) from AIG's insurance subsidiaries. The Securities Borrowing Facility was terminated.[43]

The purpose of the Maiden Lane II deal was "*to get contingent liabilities off AIG's balance sheet*". The elimination of these contingent liabilities would reduce the risk-based capital requirements, and would also make it easier to sell the life insurance subsidiaries (and then repay the government bailout loans).

The FRBNY paid in $19.5 billion, and AIG put in $1 billion[44]. Maiden Lane II purchased securities with a face value of about $39 billion, but paid only fair market value for these securities, i.e. $20.8 billion.[45] This crystallised the losses.

Maiden Lane II was managed by Blackrock. Over the next few years, Maiden Lane II received income and maturity proceeds from the securities, and ultimately sold off the remaining securities in 2012. Over time, the loans to the FRBNY were fully repaid and indeed the FRBNY made a profit. [46]

RESPONSE TO THE CRISIS: TRANSACTIONS BETWEEN AIG AND ITS INSURANCE SUBSIDIARIES

During the crisis, regulatory authorities were facing a dilemma. There was pressure to use the insurance subsidiaries assets to provide support for the parent company, i.e. to rescue AIG. But there was also a desire to protect the solvency of the insurance companies and their policyholders.

The regulators might also be concerned with the systemic impact of any insurance company insolvencies. Most American states have guaranty funds: if any insurer becomes insolvent, the guaranty fund provides protection for the policyholders. However, the guaranty funds rely on levies from all the other insurance companies in the state. AIG's insurance subsidiaries were relatively large, and these levies might have imposed a significant burden on the rest of the insurance industry. The imposition of levies might have endangered the solvency of other insurers, creating a systemic risk. Therefore the regulators had a strong incentive to find a solution.

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[43] Maiden Lane refers to the address of the FRBNY. The first Maiden Lane arrangement was created to deal with Bear Stearns. Maiden Lane II dealt with AIG's Securities Lending program and Maiden Lane III dealt with AIG's Financial Products Group liabilities. Maiden Lane III was the most controversial, since it effectively provided financial benefits for AIG's CDS counterparties as well as AIG.

[44] The details are not entirely clear, but it seems that the AIG contribution was made on a deferred purchase basis. The income from these securities was firstly used to pay off the FRBNY loan; then to repay AIG's contribution; and any remaining profits will be split between FRBNY (5/6ths) and AIG (1/6th)

[45] See ANNEX VI to the 2010 COP report.

[46] Press Release by New York Federal Reserve Bank dated 28 February 2012, *New York Fed Sells Remainder of Maiden Lane II LLC Securities; Approximately $2.8 Billion Net Gain Generated for US Public from the Portfo*lio; downloaded from www.newyorkfed.org/newsevents/news/markets/2012/an120228. Although the FRBNY made a notional profit, the size of any profit would depend on the interest rate charged on the loan from the FRBNY to Maiden Lane II. Was the loan made at commercial rates?

The National Association of Insurance Commissioners (NAIC) set up a Task Force to co-ordinate the efforts of all the state regulators. New York State Insurance Superintendant Eric Dinallo was the chairman of the Task Force, and was involved in the crisis talks with AIG management, the Federal Reserve Bank, and other officials.

During the days of crisis, some of AIG's insurance subsidiaries faced risks from inter-company transactions.

Loans from Insurance Companies to the Parent Company

As AIG teetered on the verge of bankruptcy, the insurance regulators initially took action to protect the insurance companies.

In September 2008, AIG was facing a liquidity crisis. It started to pull down all of its lines of credit – and at that time it had a revolving credit facility which allowed the parent company to borrow money from the insurance subsidiaries.

On September 12, AIG moved about $1 billion from its life insurance companies to the parent company.

On September 15, the lead regulator "*called a halt to further transfers, saying it needed to better understand the situation.*" (Note that the state insurance regulators have the power to approve or disapprove transactions with affiliates)

However, AIG told the regulator that it urgently needed to borrow another $5 billion to $7 billion from the life insurers. Otherwise, AIG might be forced to default.

On September 16, the regulator reluctantly agreed to allow the parent company to take another $5 billion in assets from the life insurers. The regulator said that "*this transfer provided AIG with several hours of relief while arrangements on the Federal Reserve System assistance were being finalised.*"[47]

The federal bailout package was approved by the AIG Board of Directors on the evening of September 16 and the $5 billion loan was returned.

After September 16, the state insurance regulators refused to allow AIG to borrow any more money from the subsidiaries, and also insisted that the prior loans (amounting to more than $1 billion) should be repaid. [48] The money provided by the Federal Reserve Bank of New York was used to repay these loans.

Question for discussion: Was it reasonable to allow the parent company to borrow $5 billion from the life insurance companies in these circumstances? Apparently no one else was willing to lend AIG money at this time.

The Rescue Plan

[47] GAO-11-616 (September 2011) page 24 footnote 40
[48] GAO-09-490T (March 2009) page 6

During the second week of September, there were desperate attempts to find a private sector solution to AIG's problems. Several private sector deals were considered.

One of the proposed deals included an asset swap. The property casualty companies would be asked to swap their liquid assets for some of the illiquid assets owned by the life insurance companies. This would have provided much-needed liquidity to the life insurers.[49]

The New York State Insurance Department was involved in discussions regarding this swap, and apparently the Superintendent of Insurance (Mr Dinallo) was in favour of approving the deal. Internal documents record the decision-making process. Note that "muni's" are municipal bonds.[50]

> *Dinallo outlined the same plan that AIG gave us earlier --- i.e. move muni's from P&C subs to parent, and parent send equity in life insurance subs to the P&C subs in return. There are a number of multi-state regulatory hurdles to this, but Dinallo thinks it is possible to do. Dinallo described P&C companies in NY and PA as having very large capital cushions, and so he thinks that they can accommodate this. He also noted negative consequences in insurance markets in general if AIG goes down (i.e. cost of insurance is likely be much higher if they file) and negative consequences in muni bond market if GICs default, so regulatory forbearance can be justified politically. ..My impression is that while they are comfortable with the capital dilution at the P&C companies, they are less knowledgeable and comfortable about the equity value of the life companies, so they have work to do on that front.*

Dinallo recommended this swap to the Governor of New York, David Paterson[51]. On September 15 2008 the governor issued a press release announcing the deal.[52]

GOVERNOR PATERSON ANNOUNCES NEW YORK WILL FACILITATE FINANCING PLANS FOR WORLD'S LARGEST INSURANCE PROVIDER

AIG Financing Plan Only Possible Following Approval from Insurance Department

No State or Federal Money Will be Used; Plan will Cost New York Taxpayers Nothing

Governor David A. Paterson today announced a multi-billion dollar financing plan to stabilize American International Group (AIG), the world's largest insurance provider, at no cost to New York taxpayers. The plan calls for AIG to transfer some assets to provide necessary cash for short-term liquidity, a move that requires regulatory oversight approval from the New York Insurance Department. AIG will undertake a series of transactions that are expected to raise about $20 billion, solving the company's immediate liquidity problem. Additionally, Governor Paterson has sent Insurance Superintendent Eric Dinallo to work with the Federal Reserve on a plan to help AIG.

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[49] GAO-11-616 Financial Crisis page 28

[50] The Financial Crisis Inquiry has copies of internal documents from the FRBNY outlining the discussions, and Dinallo's arguments in favour of this proposal. http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-09-13%20FRBNY%20Email%20re%20AIG%20Update.pdf

[51] COP Jun Oversight Report Appendix page 245

[52] Press Release from the Governor of New York, September 15, 2008, downloaded from http://www.governor.ny.gov.

The National Association of Insurance Commissioners issued a press release, which said:

> *"State insurance regulators will only approve this type of action if they are assured it is part of a total resolution of the liquidity issue at the parent company and fairly compensates its insurance company subsidiaries".*[53]

This plan was never implemented. The private sector deal fell through after it became apparent that AIG's situation was worse than expected, and the proposed deal would not be enough to save the company.

Question for discussion: Was this a sensible proposal? AIG's property/casualty companies were often accused of under-reserving, and in the past these companies had often been forced to strengthen their reserves by billions of dollars[54]. The parent company was at risk of declaring bankruptcy, which would, no doubt, have created serious problems for the subsidiaries – so perhaps any spare capital would be needed to survive the crisis. And why would a property/casualty company want to own shares in undercapitalised life insurance companies which were suffering liquidity problems? Was this proposal in the best interests of the policyholders? Under these circumstances, who should be responsible for such decisions? Could the regulators be trusted to act in the best interests of the Property/Casualty policyholders, or would it be reasonable for them to provide assistance to the Life Insurance company shareholders at the expense of the P/C policyholders?

POTENTIAL IMPACT OF PARENT COMPANY BANKRUPTCY

Suppose the government had decided against a bailout. Suppose that AIG had defaulted on its obligations. How would this have affected AIG's insurance subsidiaries?

It is difficult to provide a clear answer to this question, because different government authorities have provided different opinions.

<u>The State insurance regulators</u> have been keen to assure the public that the insurance subsidiaries would have remained solvent, no matter what happened to the parent company. Several state insurance commissioners put out reassuring press releases, as did the National Association of Insurance Commissioners.

The New York Superintendent of Insurance, Eric Dinallo, later testified that:

> *"The main reason why the federal government decided to rescue AIG was not because of its insurance companies. Rather, it was because of the systemic risk created by Financial Products. There was systemic risk because of Financial Products relationships and transactions with virtually every major commercial and investment bank, not only in the U.S., but around the world….,*

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[53] Insurance Companies Protected by Solvency Standards, NAIC news release September 16,2008
[54] COP June 2010 Page 49ff for a discussion of under-reserving.

…even if there had been a run on the securities lending program with no federal rescue, our detailed analysis indicates that the AIG life insurance companies would not have been insolvent. Certainly, there would have been losses, with some companies hurt more than others. But we believe that there would have been sufficient assets in the companies and in the parent to maintain the solvency of all the companies.

….The dependable moat of state regulation that protects policyholders remains solid."[55]

The NAIC unequivocally stated that

"The federal bailout of the non-insurance portions of AIG does not negatively change the solvency strength of its insurance subsidiaries."[56]

On the other hand, **the Federal Reserve and the Treasury** were keen spell out the dire consequences of an AIG bankruptcy.

According to the Congressional Oversight Panel (COP), the government's justification for the AIG bailout evolved over time. The COP suggested that in the midst of the crisis, in September 2008, the Fed and Treasury officials were primarily concerned about the problems at AIG's Financial Products Group, and the systemic impact of defaults on trillions of dollars of Credit Default Swaps. In other words, these officers were most concerned about the flow-on effects to investment banks and hedge funds.

However, testimony from Federal Reserve and Treasury officials, which was provided to Congressional Committees many months after the crisis, tends to put much more emphasis on the insurance-related risks, and the flow-on effects to ordinary American policyholders. For example, Treasury Secretary Paulson provided the following testimony to a Congressional committee:

Testimony of Treasury Secretary Paulson to the House Committee on Oversight and Government Reform on 27/1/2010[57]

How would the failure of AIG affect the financial system and the broader economy?

The team concluded that AIG's failure would be catastrophic. AIG was much larger than Lehman, it was spread across more countries than Lehman, and while it posed many of the same basic risks as Lehman, they were actually greater because of AIG's role as an insurance company.

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55 TESTIMONY TO THE UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, HEARING ON "AMERICAN INTERNATIONAL GROUP: EXAMINING WHAT WENT WRONG, GOVERNMENT INTERVENTION, AND IMPLICATIONS FOR FUTURE REGULATION", BY SUPERINTENDENT ERIC DINALLO NEW YORK STATE INSURANCE DEPARTMENT THURSDAY, MARCH 5, 2009

56 AIG Solvency FAQ, published by the National Association of Insurance Commissioners,

57 Secretary Written Testimony before the House Committee on Oversight and Government Reform 27 January 2010 downloaded from http://www.treasury.gov/press-center/press-releases/Pages/tg514.aspx.

AIG was one of the largest life and health insurers in the United States. AIG was also one of the largest property and casualty insurers in the United States, providing insurance to 180,000 small businesses and other corporate entities, which employ about 100 million people. History suggests that the withdrawal of a major underwriter from a particular market can have large, long-lasting effects on the households and businesses that rely on basic insurance protection.

AIG's failure directly threatened the savings of millions of Americans in ways that the Lehman bankruptcy did not. AIG had provided financial protection to municipalities, pension funds, and other public and private entities through guaranteed investment contracts and products that protect participants in 401(k) retirement plans.

More broadly, if AIG had failed, the crisis almost certainly would have spread to the entire insurance industry. Life insurance posed a particular threat. Many life insurance products are effectively a form of long-term savings. In the wake of a failure of AIG, policy holders could have sought to liquidate life insurance policies underwritten by AIG. Doubts about the value of AIG life insurance products could have generated doubts about similar products provided by other life insurance companies, opening up an entirely new channel of contagion.

The Federal Reserve Bank of New York has also described the dire consequences of an AIG bankruptcy. This is an extract from the FRBNY website. [58]

The failure of AIG, a company with more than 76 million customers in approximately 140 countries—more than 30 million customers in the United States alone—posed a direct threat to millions of policyholders, state and local government agencies, 401(k) participants, banks and other financial institutions in the United States and abroad, and would have shattered confidence in already fragile financial markets.

If AIG had been allowed to fail and the parent company had filed for bankruptcy, the consequences and effects could have been severe:

Many of AIG's insurance subsidiaries could have been seized by their state and foreign regulators, leaving policyholders facing uncertainty about their rights and claims.

Seizure of AIG subsidiaries would likely have put a moratorium on claims and withdrawals and could have impaired those claims in the longer term.

A run on AIG, in the form of a massive cashing in of insurance policies and annuities, would have strained the company's ability to meet its obligations to millions of policyholders.

State and local government entities that had lent investment funds to AIG would have been exposed to losses in an already difficult and deteriorating municipal budget environment.

Workers whose 401(k) plans had purchased guarantees in the form of stable-value contracts from AIG could have lost that insurance.

[58] Downloaded from the Federal Reserve Bank of New York website at http://www.newyorkfed.org/aboutthefed/aig/

Pension plans would have been forced to write down their AIG-related assets, resulting in significant losses in participants' portfolios.

The resulting losses to money market mutual funds, to which millions of Americans entrust their savings, would have had potentially devastating effects on confidence and would have accelerated the run on various financial institutions.

Global commercial banks and investment banks would have suffered losses on loans and lines of credit to AIG and on derivatives contracts and other transactions, potentially causing even greater constraints on the availability of credit to homeowners and businesses.

Confidence in other insurance providers could have been impacted, leading to a possible run on the industry.

The Congressional Oversight Panel (COP) has suggested that some officials might be reinterpreting the past in order to make the bailout decision more palatable to the public. The decision to bail out AIG's CDS counterparties – Goldman Sachs et al – was not at all politically popular. The COP has suggested that *"regulators tried to respond to public displeasure with the AIG bailout by looking for more sympathetic beneficiaries of their decision to intervene than financial institutions."*[59] During Congressional investigations, AIG's executives repeatedly argued that "*AIG's Rescue was as much about Main Street as it was about Wall Street".*[60]

In fact, contemporaneous documents from September 2008 show that the Fed officials did indeed consider the impact that AIG's bankruptcy might have on its insurance subsidiaries. However, since they did not have reliable information on the solvency of the insurers, they could only speculate. They believed that the subsidiaries would survive if they were financially healthy - but they also expressed some doubts about the health of the life insurance subsidiaries. [61]

In fact, it was very difficult for anyone to predict the potential consequences of AIG's bankruptcy. The Congressional Oversight Panel later concluded that:

> *"It is unclear how a bankruptcy filing would have affected the business or solvency of the insurance subsidiaries, the actions of various insurance regulators, or the decisions of current and prospective insurance customers regarding insurance cover."*[62]

In order to assess the impact of an AIG bankruptcy on its insurance subsidiaries, we would have to consider:

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[59] COP June 2010 page 136

[60] Submission from AIG to American International Group's Impact on the Global Economy: Before During and After Federal Intervention Hearing before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services, March 18 2009 page 175

[61] This memo was included in evidence to the Financial Crisis Inquiry and is available in their archives, downloaded from http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-09-16%20Systemic%20Impact of AIG Bankruptcy attachment to FRBNY %20 internal email from Alejandro LaTorre to Geithner.pdf. See also a memo about the pros and cons of lending to AIG, http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/0000-00-00%20FRBNY%20Document%20on%20Pros%20and%20Cons%20of%20Lending%20to%20AIG.pdf

[62] COP June 2010 p78

- The reaction of state insurance regulators – would they seize the insurance companies?
- The solvency of the insurance companies – would they be strong enough to survive?
- The inter-relationships between the insurance subsidiaries and other AIG entities – how closely were they intertwined?
- The impact on credit ratings – would the credit rating agencies downgrade the insurers?
- The reaction of the policyholders – would there be a run on the insurers?

a. The Reaction of State Insurance Regulators

If the government had decided not to rescue AIG, then it is seems likely that state regulators would have seized the insurance subsidiaries.

The Congressional Oversight Panel later asked the state insurance commissioners how they would have reacted if AIG has filed for bankruptcy. The state insurance regulators said that they *"would not necessarily have seized the insurance companies"*, but they would have done so if it was "*necessary to protect the insurance subsidiaries or their policyholders".*[63]

When making this decision, each state regulator would need to consider the reaction of all the other state regulators, and also the reactions of regulators in other (international) jurisdictions. Each insurance commissioner has the responsibility to protect his own constituents: hence each insurance commissioner has an incentive to be the first to seize assets (before any other regulator takes control of those assets). This is particularly likely to be an issue when the financial affairs of various companies are inter-twined, e.g. by way of guarantees, reinsurance arrangements, etc. Such situations may well lead to legal disputes about the ownership and control of assets. Under such circumstances, state regulators might decide to take action promptly. [64] And as soon as one regulator started to seize assets, others would be likely to follow suit, i.e. "one seizure could have led to a cascading effect of other seizures."

According to Boyle (2011), as AIG was teetering on the brink of bankruptcy in September 2008, the Texas Department of Insurance had already instructed legal counsel to draw up the legal documents necessary to seize four AIG subsidiaries. [65]

b. The Solvency of the Insurance Companies

If the insurance companies were indeed financially strong, then they would have had a much better chance of surviving the bankruptcy of the parent company. But were they really so strong?

During the crisis, state insurance regulators repeatedly provided assurances to the public, claiming that there was no cause for concern about the solvency of AIG's insurance subsidiaries. For example, the NAIC issued an unequivocal press release on September 16, 2008

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[63] COP June 2010 p78 and see also COP page 107 footnote 408. The regulators seem uncertain about how they would have behaved, sometimes claiming that they probably would seize the companies and at other times stating that they would not have done so. A further discussion of this issue is given at COP (2010) page 116
[64] Historically, when large insurers have failed, the state insurance regulators have not always worked well together. The failure of the Executive Life Group in 1991 is one example.
[65] Boyd (2011) p280

"We have a very strong message for consumers: If you have a policy with an AIG insurance company, they are solvent and have the capability to pay claims."[66]

Of course, the regulators were undoubtedly wanted to allay panic and protect the insurance companies from runs.

The state regulators also took the opportunity to proclaim their own merits.

"State regulators have done what we do best to ensure that the AIG insurance companies, and the companies they serve, were not harmed by the financial troubles of the parent company."

"Strict solvency standards and keen financial oversight – based on conservative investment and accounting rules – continue to be the bedrock of state-based insurance regulations."[67]

Over the next few months, there were several Congressional investigations into the AIG bailout. Witnesses repeatedly claimed that the AIG insurance subsidiaries were solvent. In fact the state insurance commissioners referred to the insurance companies as the "bars of gold" which would be sold to repay AIG's debt to the government.

Of course, by this stage, the government was the majority shareholder in AIG. The government was planning to recoup its investments by selling off many of the insurance subsidiaries. Under the circumstances, it would have been counterproductive to cast aspersions on the solvency of these companies.

However, despite these assertions, it seems that AIG's life insurance companies were not really in very good shape.

The Government Accountability Office provides a more objective assessment of the insurance company's solvency. When the government became a major shareholder and creditor of AIG, Congress asked the GAO to monitor the government's exposure to financial risks. The GAO produce several reports on AIG over the period 2009 to 2012. These do not paint a very rosy picture of AIG's life insurers.

The GAO states that AIG's domestic life companies were only able to maintain their capital ratios with Federal assistance. The graph below shows the deterioration of the companies during 2008.

The life insurers had more than $20 billion in regulatory capital at the start of 2008 – compared to the authorised control level of risk based capital of $2.9 billion[68]. During the year, the companies suffered realised capital losses of more than $24 billion. The combined net losses for the year were about $17.6 billion. There were also additional unrealised capital losses, of unknown amount (unrealised losses are not included in net income in NAIC financial statements).

Clearly at least some of AIG's life insurers needed a capital infusion in order to meet regulatory solvency standards by the end of 2008.

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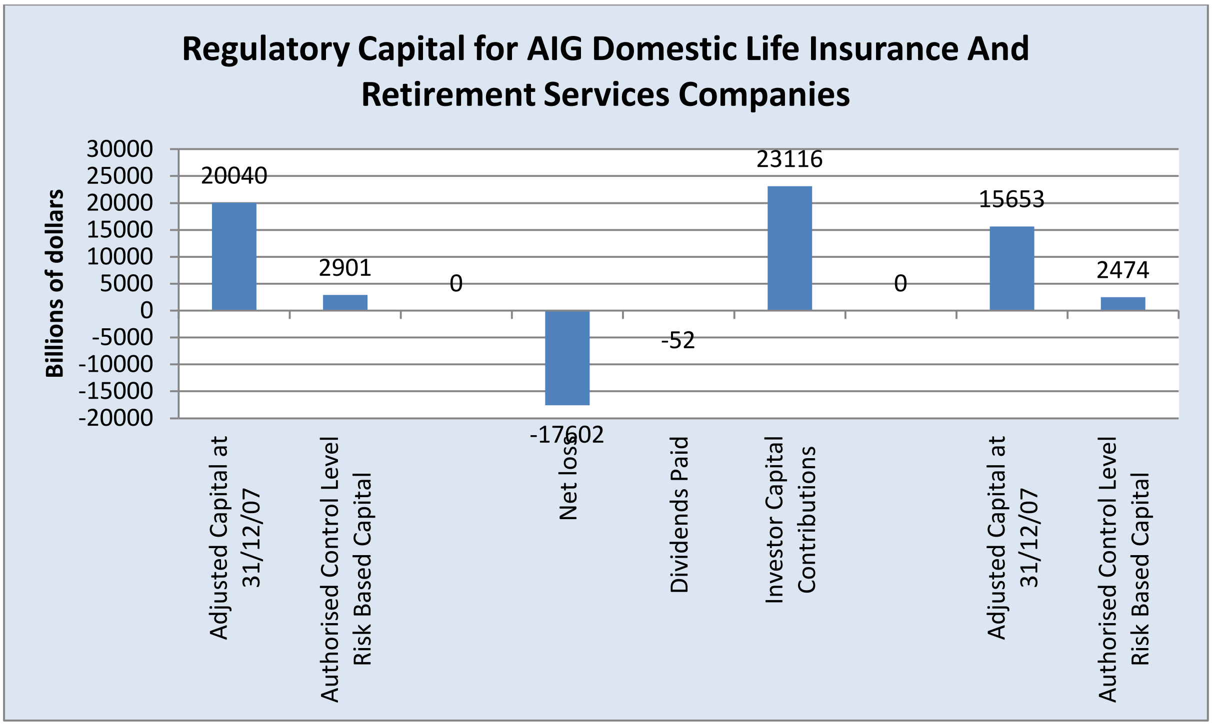
[66] *Insurance Consumers Protected by Solvency Standards,* NAIC press Release September 16 2008
[67] AIG Regulatory FAQs, published by the National Association of Insurance Commissioners
[68] When regulatory capital falls below the authorised control level, the regulator can seize control of the insurer.



This should not be surprising. As stated previously, AIG's own financial statements show that a substantial component of the government's emergency funding was used to provide financial support to AIG's insurance subsidiaries.

The report from the Congressional Oversight Panel confirmed these facts.

> *"Through 2008 and 2009, AIG provided capital contributions to its subsidiaries. In total, AIG provided $27.2 billion to its subsidiaries in 2008 and $5.7 billion in 2009. Of the 2008 capital contributions, $22.7 billion went to the domestic life insurance companies, primarily to cover losses in the securities lending portfolio. In 2008, the parent company contributed $4.4 billion to the foreign life insurance subsidiaries after they experienced "significant capital needs following publicity of AIG parent's liquidity issues and related credit downgrades and reflecting the decline in equity markets."*[69]

> *"These entities (AIG's life insurance subsidiaries) were direct beneficiaries of the government rescue. By receiving capital contributions from the government, the foreign and domestic life insurance subsidiaries were able to meet their obligations under the securities lending program and avoid liquidity or solvency concerns and potential ratings downgrades."*[70]

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[69] COP 2010 p51 Annex 1 of the June 2010 COP Report has a more detailed breakdown of the capital contributions to each insurer.

[70] COP June 2010 p 106

"The need for capital infusions suggests that securities lending obligations could have resulted in liquidity or solvency concerns for some of AIG's insurance subsidiaries." [71]

The regulators stated that the insurance companies, as a whole, had sufficient capital to maintain solvency. However, this statement is rather deceptive. It is not reasonable to consider the combined position of all the subsidiaries, because money cannot be easily transferred from one company to another. Some companies might have been relatively healthy, whereas others were in a very weak position.

Merkel (2009) provides a breakdown of the statutory returns for each individual company. His research shows that some companies suffered losses suffered securities lending investment losses in 2008 which would have wiped out their surplus. Many of them also suffered additional losses as a result of affiliate investments.

Subsidiary	Surplus at end of 2007	Realised losses on securities lending	Losses as a percentage of Surplus
American General L&A IC	471	977	207%
AIG LIC	440	871	198%
AIG Annuity IC	3,729	7,110	191%
Am Int LIC of NY	553	771	139%
First SunAmerica LIC	501	653	130%
Variable Annuity LIC	2,838	3,562	126%
American General LIC	5,704	3,790	66%
SunAmerica LIC	4,716	2,281	48%

Many of these companies received large capital contributions during the year.

Subsidiary	Surplus at end of 2007	Net Capital Contributed	Net Capital Contributed as a percentage of 2007 surplus
American General	471	872	185%
AIG LIC	440	895	12%
AIG Annuity IC	3,729	6,223	167%
Am Int LIC of NY	553	557	101%
First SunAmerica LIC	501	768	153%
Variable Annuity LIC	2,838	3,213	113%
American General LIC	5,704	7,004	123%
SunAmerica LIC	4,716	2,696	57%

Based on the GAO data, and Merkel's assessment of the statutory returns, it seems that the regulators were rather optimistic in their assessment of the solvency of AIG's life insurance subsidiaries.

On the other hand, both the GAO reports and Merkel's analysis confirm that the Property/Casualty companies were "basically sound".

[71] COP June 1010 footnote 445 page 116

c. Inter-relationships between AIG Affiliates

The solvency of AIG's insurance subsidiaries was also threatened by cross-shareholdings.

> *"Intercompany transactions and cross-holdings complicated AIG's financial position. Many of AIG's insurance subsidiaries held common stock in other AIG subsidiaries. This stock was counted towards regulatory capital of the insurance subsidiaries. In addition to common stock, some subsidiaries provided guarantees for smaller subsidiaries."*[72]

An American actuary, David Merkel, has analysed the solvency of AIG's life insurance subsidiaries in 2008. He found that the insurance subsidiaries suffered large losses on affiliated Company stocks. For example, almost all of ALICO's surplus assets were invested in AIG common stock – and as noted previously, AIG's share price plummeted in 2008.

Merkel's article describes the risks of "capital stacking" by investment in affiliates. This appears to increase the solvency of each company, but it also increases systemic risk. [73]

d. The Impact on Credit Ratings

What would have happened to the insurance subsidiaries' credit ratings, if the parent company had declared bankruptcy?

Representatives of the Credit Rating Agencies answered this question in their Congressional testimony.

Standard and Poor's Managing Director testified as follows:

> *"With respect to the effect of AIG's current financial situation on the creditworthiness of its subsidiaries, we believe that the subsidiaries are to some extent insulated. …This is because the insurance subsidiaries' capital is generally insulated by state insurance laws and regulations.*
>
> *Nevertheless when S&P lowered its credit rating on AIG to "A-" on September 15, we also lowered the ratings on most of AIG's insurance subsidiaries to "A+" from "AA+"…While AIG's financial problems have no direct effect on the solvency of its insurance subsidiaries, we believe that the creditworthiness of those subsidiaries is nevertheless affected in two primary respects. First, in our opinion financial pressures at AIG generally make it less likely that AIG will be able to provide additional capital to its subsidiaries in the event the subsidiaries suffer investment losses of their own or otherwise require recapitalisation….The second issue we see affecting the creditworthiness of AIG's insurance subsidiaries relates more generally to overall reputational risk resulting from the parent company's financial problems. For*

[72] COP 2010 p 50
[73] *To What Degree were AIG's Operating Subsidiaries Sound*? By David Merkel (28 April 2009)

example it may be more difficult for subsidiaries to retain and attract new customers where there is uncertainty surrounding the parent company."[74]

In the months and years after the initial bailout, the government restructured the bailout package several times – generally swapping debt for equity, e.g. the government loans were swapped for equity-type assets. These restructures were largely motivated by the need to maintain AIG's credit ratings. As a result of this government support, AIG's (parent company) credit rating was five or six notches higher than it would have been otherwise.

According to the GAO report dated January 2011, a reduction in financial strength ratings for the insurers would have had dire consequences:

"A downgrade in AIG's credit ratings may result in a downgrade of the financial strength ratings of AIG's insurance subsidiaries."

"Domestic retirement services would be severely affected by a high surrender rate and further suspension of sales in some firms, and would suffer a significant loss of wholesalers. Domestic life new business would be severely affected, in several instances forcing the company to exit businesses that serve either the high-net-worth marketplace or business that are covered by trust contracts."

"*AIG's commercial property/casualty businesses expect that a financial strength rating downgrade would result in a loss of approximately 50 percent of the net premiums written and operating losses for the domestic business….staff retention could become a key issue… "*[75]

Policyholder Reactions

A number of regulators testified that the AIG bailout was necessary in order to prevent policyholder runs on AIG's insurance subsidiaries. [76]

During September 2008, Insurance regulators issued press releases, urging AIG's life insurance customers to think carefully before surrendering their policies.

However, these press releases were not entirely successful in preventing a flood of surrenders, in both domestic (US) insurers and overseas.

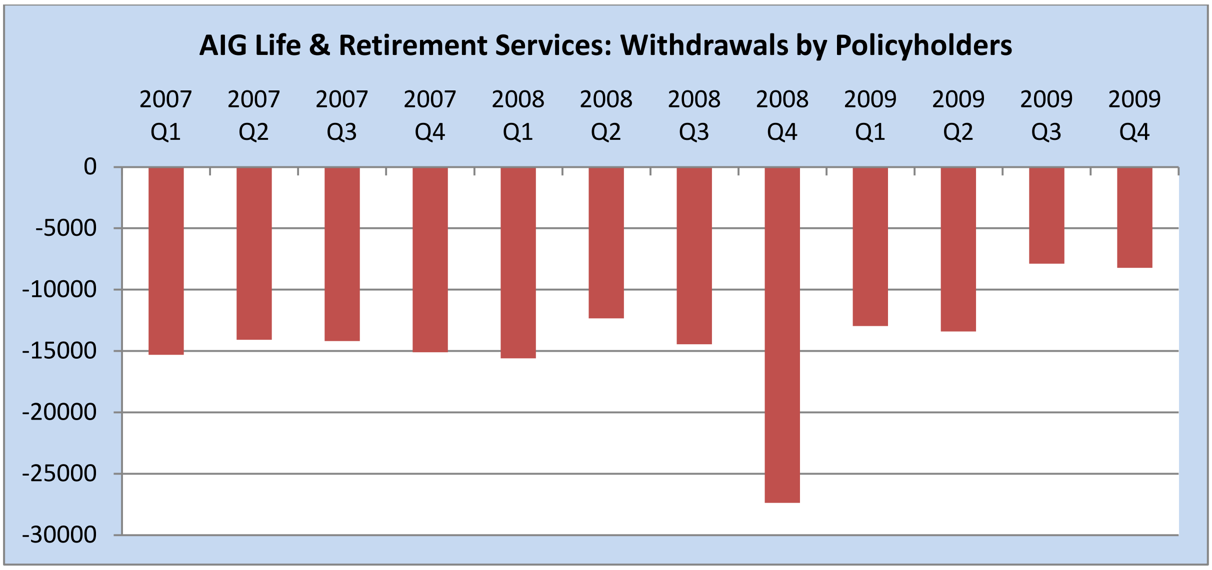
During the fall of 2008, total surrenders at AIG's Retirement Services division hit $800 million per week. [77]

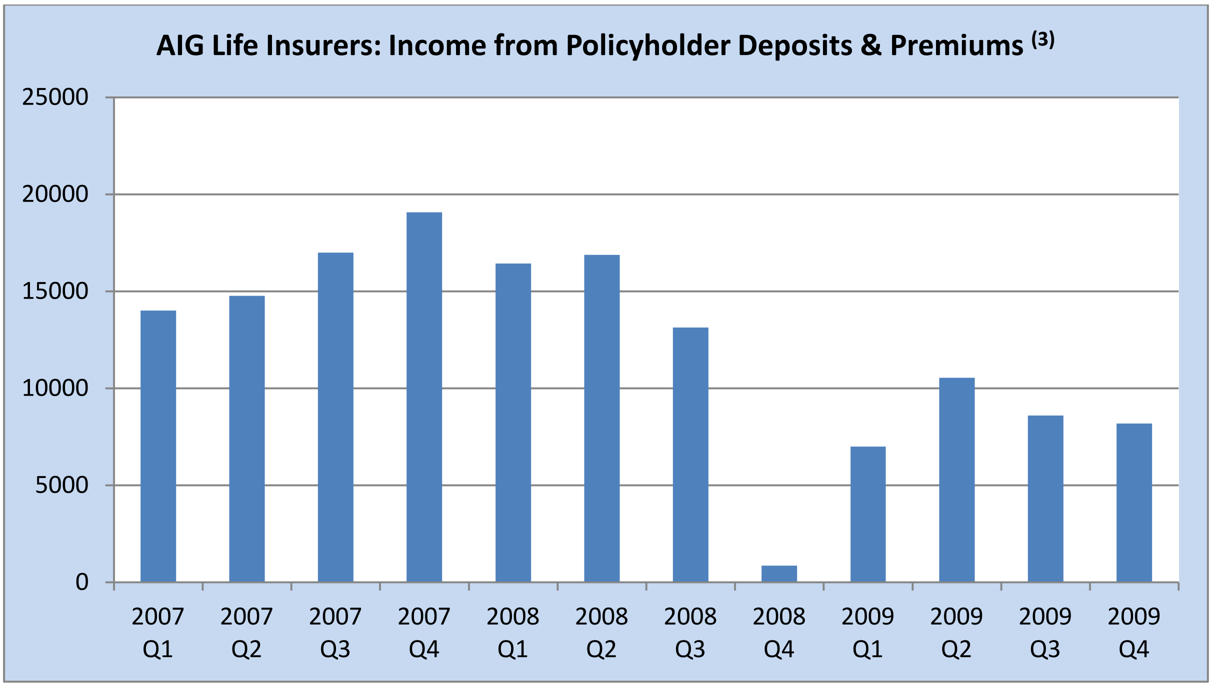
[74] Testimony of Rodney Clark, Standard and Poor's Managing Director, to the Congressional Oversight Panel, May 26, 2010

[75] GAO Report 11-46 page 80-81

[76] Testimony of Jim Millstein, Chief Restructuring Officer, US Department of Treasury, before the Congressional Oversight Panel, May 26 2010

The following graph shows the premium income and withdrawal outgo for AIG's life insurers, based on data provided by the Government Accountability Office.





According to newspaper reports, several of AIG's overseas life insurers also suffered policyholder runs.

In some cases, the policyholder runs had severe consequences for policyholders. For example, in the UK, an AIG life insurance subsidiary (ALICO) sold single premium investment bonds. The policyholders money was invested in a mix of assets, including rather illiquid mortgage backed

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[77] Testimony of Jim Millstein, Chief Restructuring Officer, US Department of Treasury, before the Congressional Oversight Panel, May 26 2010

securities. When the crisis occurred in September 2008, there was an immediate policyholder run, which created liquidity problems for the insurer.

> *On 15 September 2008, the day of Lehman Brothers' application for Chapter 11 bankruptcy protection in the US and a sudden drop in AIG's share price, a large number of investors sought to withdraw their investments and there was a run on the Fund. ALICO was unable to meet all withdrawal requests immediately. It established that it could not meet the requests without having to sell some of its longer dated assets for materially less than their book value, which would have given rise to a significant drop in the accrued value of customers' investments. ALICO suspended withdrawals (which the terms and conditions of the Fund allowed) and ultimately closed the Fund to new customers.*[78]

Policyholders were allowed to withdraw 50% of their money immediately. Most of the customers were persuaded to leave the rest of the money in the fund until 1 July 2012 (as an alternative, they could have received a reduced payout). In July 2012 the customers received the face value of their policies as at 14 December 2008, but they did not earn any additional investment income from December 2008 to July 2012.

AIG's Property Casualty Companies

So far, we have focussed on AIG's life insurance subsidiaries. The property-casualty subsidiaries did not participate in the Securities Lending Program, but they did suffer some ill-effects as a result of problems in the parent company.

The P&C companies suffered a fall in premium income in 2008/2009. Of course, the whole industry was suffering from the effects of the Global Financial Crisis – but AIG's P&C insurers suffered a relatively larger fall in premium income.

It seems likely that the premium income fell because AIG's subsidiaries had to cut premium rates to hold on to market share.

Soon after the government bailout, AIG's competitors began to complain. They claimed that AIG was pricing very aggressively in an attempt to maintain market share.

> *"Some insurers said that they had observed instances, in some cases numerous instances, where AIG had sold commercial property/casualty coverage for a price that the insurers believed was inadequate for the risks involved. The cited examples where AIG Commercial's prices had decreased significantly from the previous year's price, when circumstances appeared to indicate that higher prices were warranted."*[79]

AIG's competitors claimed that AIG had an unfair advantage, arising from an implicit government guarantee (i.e. because the government would not allow AIG's insurers to fail).

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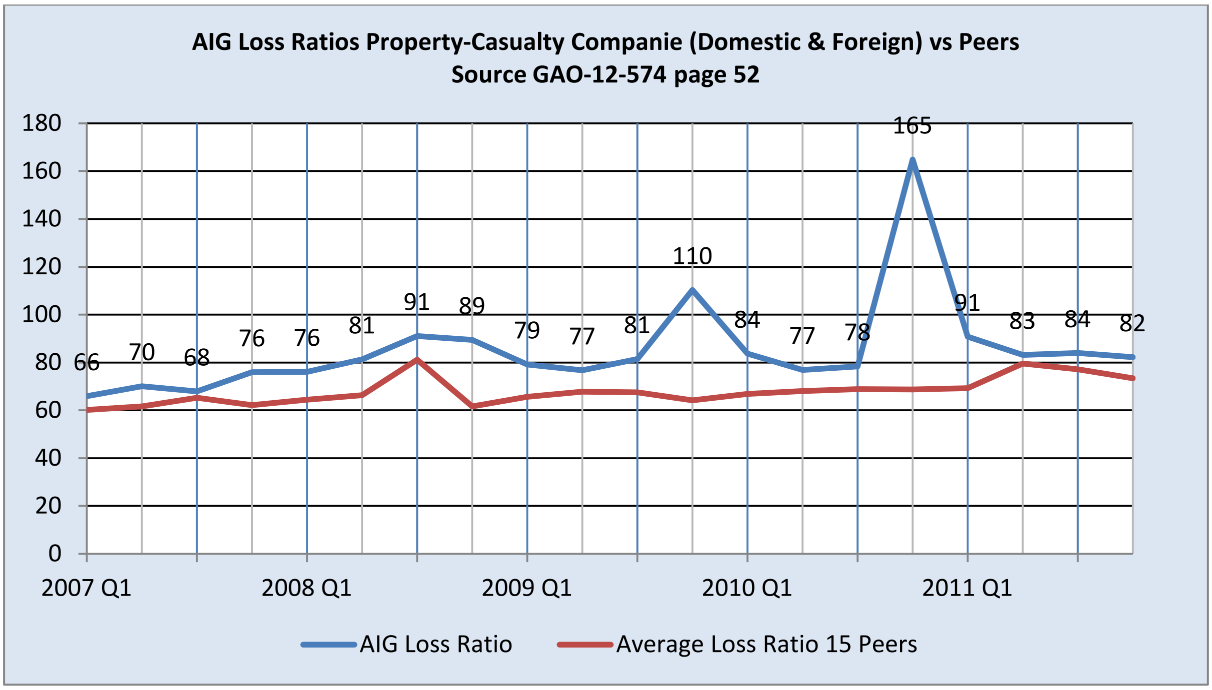
[78] FSA Final Notice to UBS
[79] GAO-09-490T at page 13

In 2009, the Government Accountability Office was asked to investigate these claims. The GAO spoke to a variety of market participants – brokers, customer, regulators, and actuaries – but they could not reach any conclusion about the validity of these allegations. The GAO pointed out that

- It was difficult to make comparisons of premium rates for large policies, since the terms and conditions for each policy are individually negotiated
- Pricing is subjective, depending on the judgement of the underwriters; therefore it is difficult to determine whether pricing will be adequate to cover losses;
- For long-tail business, it may be necessary to wait for several years in order to tell whether premiums were adequate.

The GAO's inconclusive report was published in March 2009.

The GAO continued monitoring the performance of AIG's property-casualty insurers over the next three years. The evidence shows that AIG's loss ratios and combined ratios are significantly higher than the average for their peers in the same industry[80].



The "bumps" in the loss ratios for the fourth quarter of 2009 and 2010 apparently reflects adverse loss development ("strengthening of reserves"). [81]

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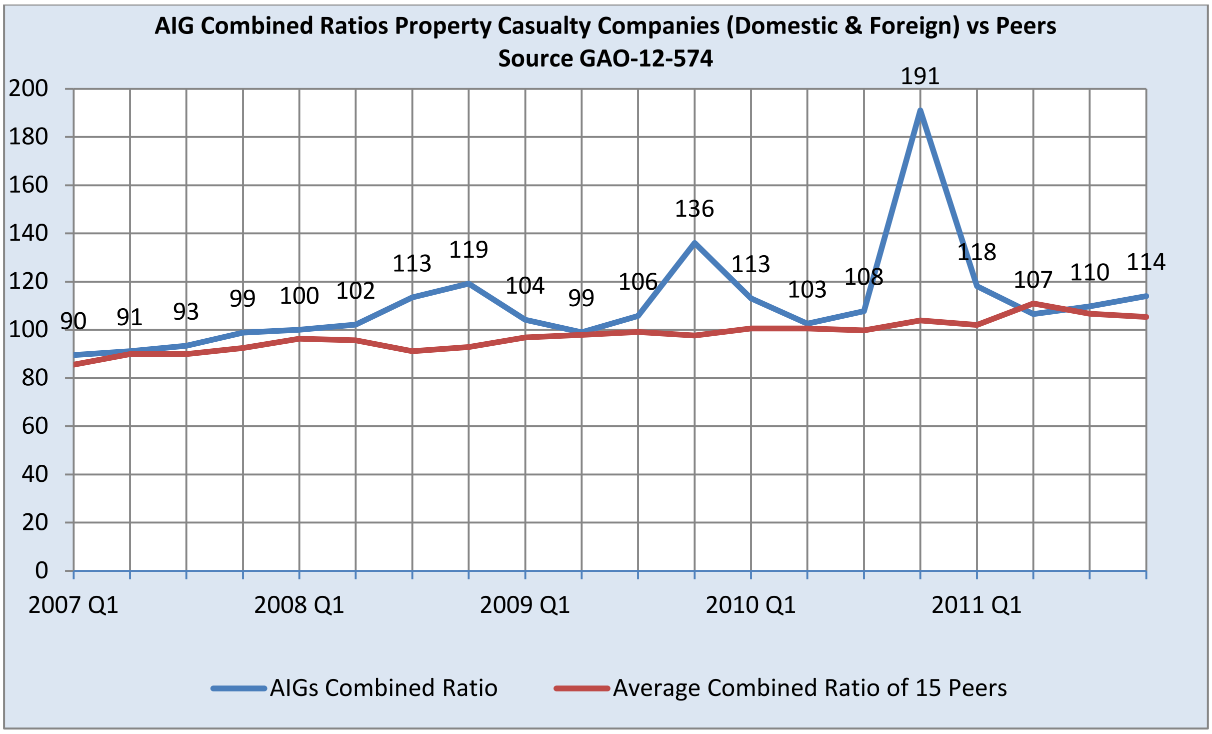
[80] See GAO-12-574 page 50 for a description of the method used to identify a peer comparison group. A "peer" was defined to be a company with more than $1 billion in direct premiums written, with at least 90% of its premiums coming from business lines that accounted for more than 60% of AIG's premium income.

[81] In early 2011, AIG announced that it intended to strengthen its loss reserves in its Chartis property-casualty subsidiaries by $4.2 billion. *AIG Expects to Record $4.1 Billion Net Charge in Fourth Quarter 2010 to strengthened Loss Reserves Associated with Long Term Lines in P&C Business*, AIG media release 9 February 2011

The combined ratio in the fourth quarter of 2009 also includes an expense charge of $1.2 billion resulting from a write-down of goodwill valuations.



The GAO Review noted that AIG was profitable in 16 quarters out of 20, because in those quarters investment income exceeded the underwriting deficit.

Question for discussion: One arm of government (Treasury) was a major shareholder in AIG's P&C companies: the Treasury had an interest in maximising the sale price of the insurers. Another arm of government (State regulators) was responsible for monitoring underpricing risks in the insurance industry. Does this create a conflict of interest? How can AIG's competitors be assured of fair treatment? Is there any objective way to assess or regulate underpricing?

CONFLICTS OF INTEREST IN THE SALE PROCESS

In order to repay its debt to the government, AIG was expected to sell off many of its subsidiaries, including insurance companies. The government was a reluctant shareholder, and no doubt it wished to expedite the sales. However, during the GFC it was difficult to find buyers.

Historically, the sale and purchase of insurance companies has is a risky business, for two reasons:

- The company might be sold to a financially weak or poorly regulated company; this would undermine the policyholder's security; and/or
- The buyer might pay too high a price for the insurance company, endangering the solvency of the buyer; this is more likely to be a problem if the insurance company has unreliable

accounting and/or poor record-keeping, so that the buyer underestimates the risks underlying the purchase.

In most countries, legislation imposes some controls over such transfers and amalgamations – typically, the approval of the regulator is required.

The AIG bailout created some difficulties for the American government regulators. On the one hand, as shareholders, they were keen to sell AIG's subsidiaries quickly, and at a high price. But as regulators, they were also keen to ensure that any sales would not simply transfer solvency problems to another financial institution.

The Americans realised that this might create a conflict of interest, and dealt with this by separation of duties.

> *"As an example of attention to separation of supervisory duties, FRBNY officials cited the case of MetLife, which in 2010 acquired AIG's ALICO unit. MetLife is a bank holding company which is regulated by the Federal Reserve System. At the time of the acquisition, there were inquiries from an FRBNY MetLife team to the AIG team. When that happened, officials said that they immediately put in place an information barrier to make clear that supervisory decisions would not be affected by information the AIG team had. Officials saw the matter as a serious potential conflict because FRBNY had an interest in seeing the acquisition being completed, as that would aid repayment of federal lending, while at the same time it had supervisory responsibility for MetLife."*[82]

Problems are likely to be exacerbated when the deals cross international boundaries. The regulators in one country may have less interest in protecting foreign policyholders; the regulators in one country may not be concerned about the risks to the buyer, when the buyer is a foreign company. Two or more regulators might be involved in assessing any deal – and these regulators may well have conflicting responsibilities.

For example, early in 2010 AIG attempted to sell its Asian insurance business (AIA) to a British life insurance company (the Prudential), for $35.5 billion. The US Treasury supported this proposal. The price was more than they could expect to receive from other alternatives, and the proceeds of the sale could have been used to pay down AIG's debt to the Us government. However, this was a risky deal for the Prudential. The Prudential would need to raise $20 billion in additional capital in order to pay for the acquisition.

The Prudential held secret discussions with AIG throughout December 2009 to February 2010. Normally, the UK's Financial Services Authority would be asked to give prior approval of this deal. However, the Prudential did not disclose the proposed deal to the FSA (and in fact failed to mention the deal during normal supervisory meetings held during this period). The FSA found about the deal on February 27, 2010, when rumours about the deal were published in the media. The Share Purchase Agreement was signed on March 1, 2010.

The Prudential's share price dropped immediately after the announcement; and financial analysts pointed out the risks underlying this acquisition.

[82] GAO11-616 p 119

Since the FSA had not been given advance notice of the deal, the regulator had very little time available to assess the impact on the Prudential's policyholders.

> *"[The FSA] had to consider the size and complexity of the transaction, its transformative nature for group strategy, the solvency and risk profile of the proposed enlarged group, the proposed internal controls, and the geographic scope of the deal (including the legitimate interests of overseas authorities)…."*
>
> *The FSA also complained that the delay in notification*
>
> *"….[hampered] the FSA's ability to meet its obligations by responding adequately to overseas' supervisors enquiries and requests for assistance when news of the deal broke".*

In the end, the FSA was unwilling to approve the proposed deal.

> *In the event, by 5 May 2010, Prudential was unable to satisfy (the FSA) that the enlarged group would have a sufficiently resilient financial position, including whether it would have a robust regulatory capital position and whether regulatory capital surpluses held in certain jurisdictions could be applied to meet potential capital demands which might arise in other areas of the group."*[83]

Many of the Prudential's shareholders strongly opposed the acquisition, and ultimately it fell through. However, the Prudential had to pay a break fee of more than $220 million. The Prudential also incurred hundreds of millions of dollars in transaction costs for the failed deal.[84] The FSA also imposed a £30 million fine on the Prudential for its failure to act in an "open and co-operative manner" when reporting to the regulator.

The FSA's comments show that a deal which was beneficial to the US government might well be detrimental to AIA's Asian policyholders and to the British life insurance industry. The FSA later stated that:

> *"The transaction in this case was so significant that it had potentially far-reaching consequences for tens of thousands of investors and for the stability and confidence of the financial system in the UK and abroad."* [85]

QUESTIONS TO CONSIDER

The AIG bailout raises many questions about systemic risk and affiliate risk for insurance companies.

Q1. Is it possible to evaluate the risks facing an insurance company subsidiary, without knowing anything about the business of the parent company and its affiliates?

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[83] FSA Final Notice to Mr Cheick Tidjane Thiam, 27 March 2013

83 *BIG SETBACK FOR A.I.G. IN REPAYING TAXPAYERS*, BY MARY WILLIAMS WALSH AND MICHAEL J. DE LA MERCED, NEW YORK TIMES, JUNE 1 2010

[85] FSA Final Notice to Mr Cheick Tidjane Thiam, 27 March 2013

Q2. Was it appropriate for regulators to call upon AIG's insurance subsidiaries to provide support for the AIG parent company? In general, under what circumstances should the assets of insurance subsidiaries be available to support a troubled parent company? If the answer is "it depends on the circumstances", then who should decide? Should the regulator act in the best interests of the group of policyholders as a whole (allowing the strong company to help the weaker one); or should the regulator refuse to allow transactions which have not been done on an arms-length basis?

Q3. AIG's insurers clearly suffered reputational damage, leading to a loss of business and liquidity problems. Is it possible to measure and manage reputational risk? If so, how should this be done?

Q4. Are some insurers "too big to fail"? How well would the state guaranty funds cope with the failure of a large insurer? Would these costs flow through to destabilise the industry?

Q5. When an insurance company requires a bailout from the government, should there be greater transparency? Or would this simply create panic and policyholder runs?

Q6. When the government has a financial interest in a failed insurer, how can conflicts of interest be managed?

Q7. When an insurance company is sold, are there adequate protections for policyholders? Who bears responsibility when the insurance company operates internationally, with policyholders in one jurisdiction, a vendor in a second jurisdiction, and a buyer in a third jurisdiction? To what extent should regulators co-operate across jurisdictions? Or should each regulator simply protect his own citizens?

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