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Repercussions

How did AIG's Liquidity and Solvency Problems Affect Its Insurance Subsidiaries?

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Times of Crisis: The AIG Bailout

September 16, 2008

The Federal Reserve announces that it will provide $85 billion to AIG.

Over the next few months, bailout funding increases to $180 billion.

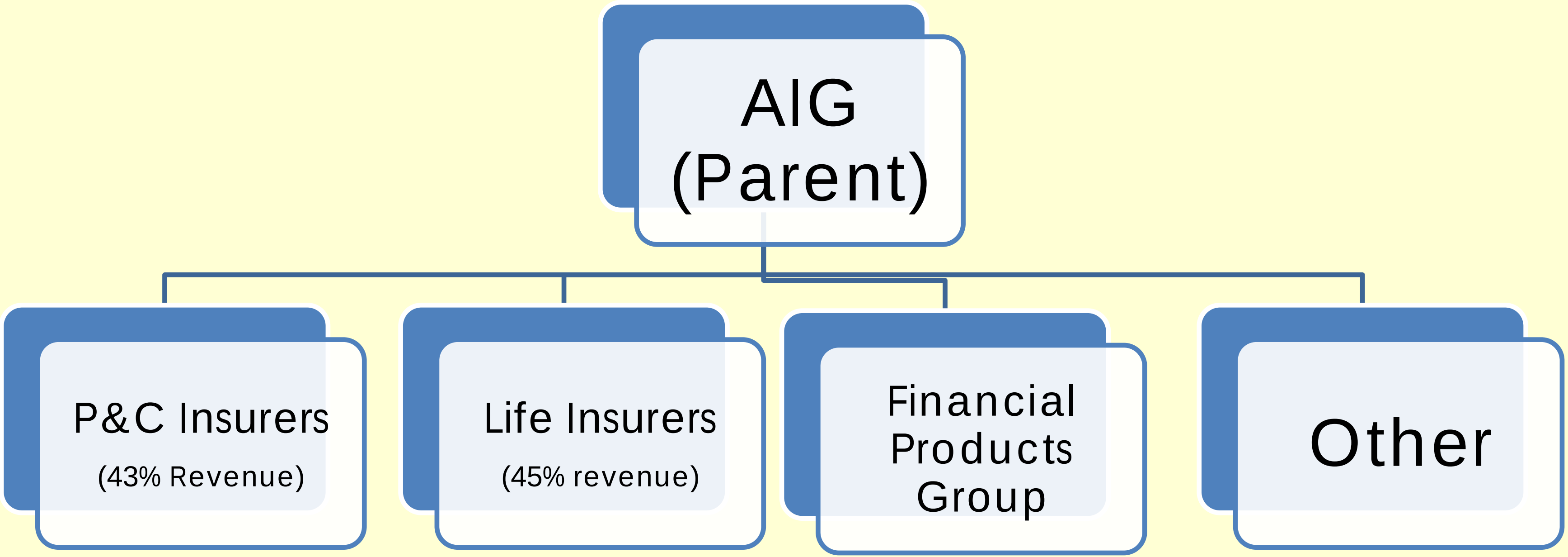
The US government becomes AIG's largest shareholder (79.9%).

Q. What went wrong?

What Went Wrong?

THE NEWSPAPERS' VERSION

AIG Structure



The Villain: AIG's Financial Products Group

- AIG FP invested recklessly
- AIG FP sold Credit Default Swaps and Other Derivatives - $2.7 Trillion (Face Value)
- These investments led to HUGE Losses in 2008
  - By September 2008, Unrealised Losses > $30 billion
  - -> Margin Calls from CDS Counterparties
  - BUT AIG FP doesn't have enough cash to pay the Margin Calls
- Turmoil in Financial Markets (Bear Stearns, Indymac, Fannie Mae, Lehman, etc etc etc)
- NO Liquidity from normal sources (e.g. Commercial Paper)

- **→ Liquidity Crisis for AIG**

But AIG's Insurance Subsidiaries were just fine?

- **Media Release from the State Insurance Regulators….NO DANGER**
- *The parent company is facing problems….*
- *….Because the parent company does not have to meet strict capital adequacy requirements;*
- *AIG's insurance subsidiaries are carefully regulated by state regulators,*
- *"The insurance companies are **solvent and able to pay their obligations**…."*
- *The regulators make sure the assets of the insurance companies are **walled off, protected from the parent company's troubles** and available to pay all the policyholders claims." (1)*

"Walled Off?" Really? Hmmm….

Sometimes walls have **small unlocked gates.**

Historically, determined people have often been able to find a way to get through the regulatory "walls" and obtain access to insurance company assets

Several previous studies (e.g. by AM Best) have shown that life insurers often suffer major losses when an affiliate is in trouble

What Went Wrong?

SO WHAT *REALLY* HAPPENED?

Summary

- The newspapers were **right** about AIG FP
- -> They lost about $50 billion

- But they were **wrong** about the life insurance subsidiaries
- -> They were <u>not</u> really in such great shape
- -> They were <u>not</u> really very well regulated
- -> They were <u>not</u> effectively “walled off” from the parent
- -> In fact they lost about $42 billion in 2008

- NOTE : AIG’s total capital at the start of 2008 was $100 billion

Government Reports on the AIG Bailout

– Numerous Congressional Committees held hearings – (who to blame)

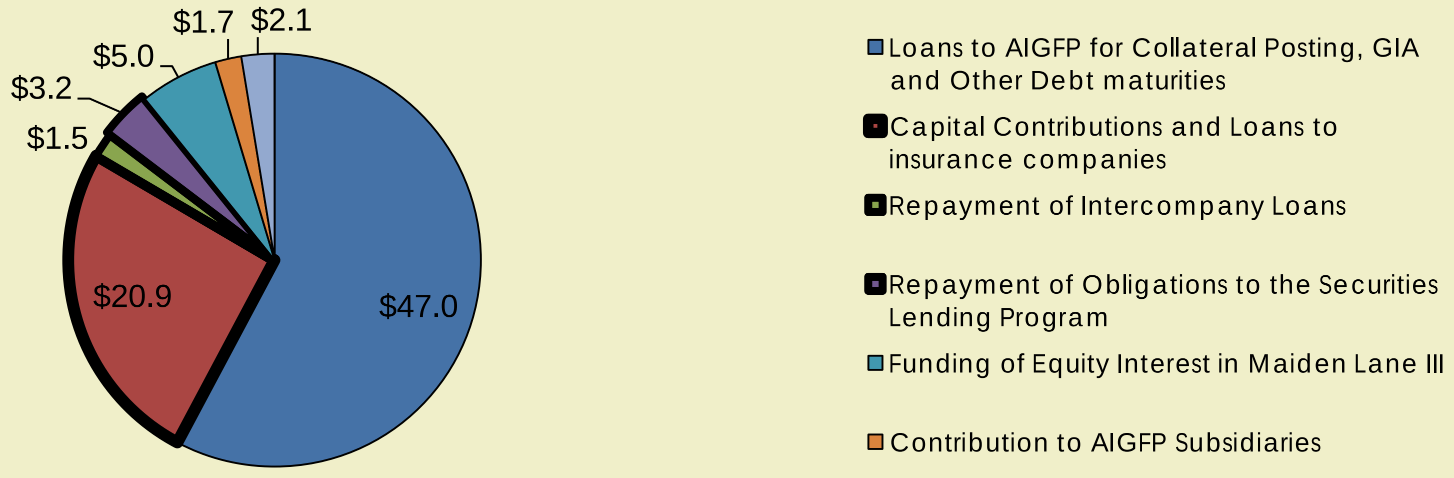
– Government Accountability Office – (Government is owner of AIG)

– Congressional Oversight Panel (Elizabeth Warren – bane of Wall Street)

– Financial Crisis Inquiry (complete with FRBNY internal documents/emails)

Q.Where did the money go?

AIG Use of Government Assistance in 2008 ($US billions) (2)



NYSID Dinallo:

"*Insurance Subsidiaries are AIG's Bars of Gold"*

<u>Question</u>

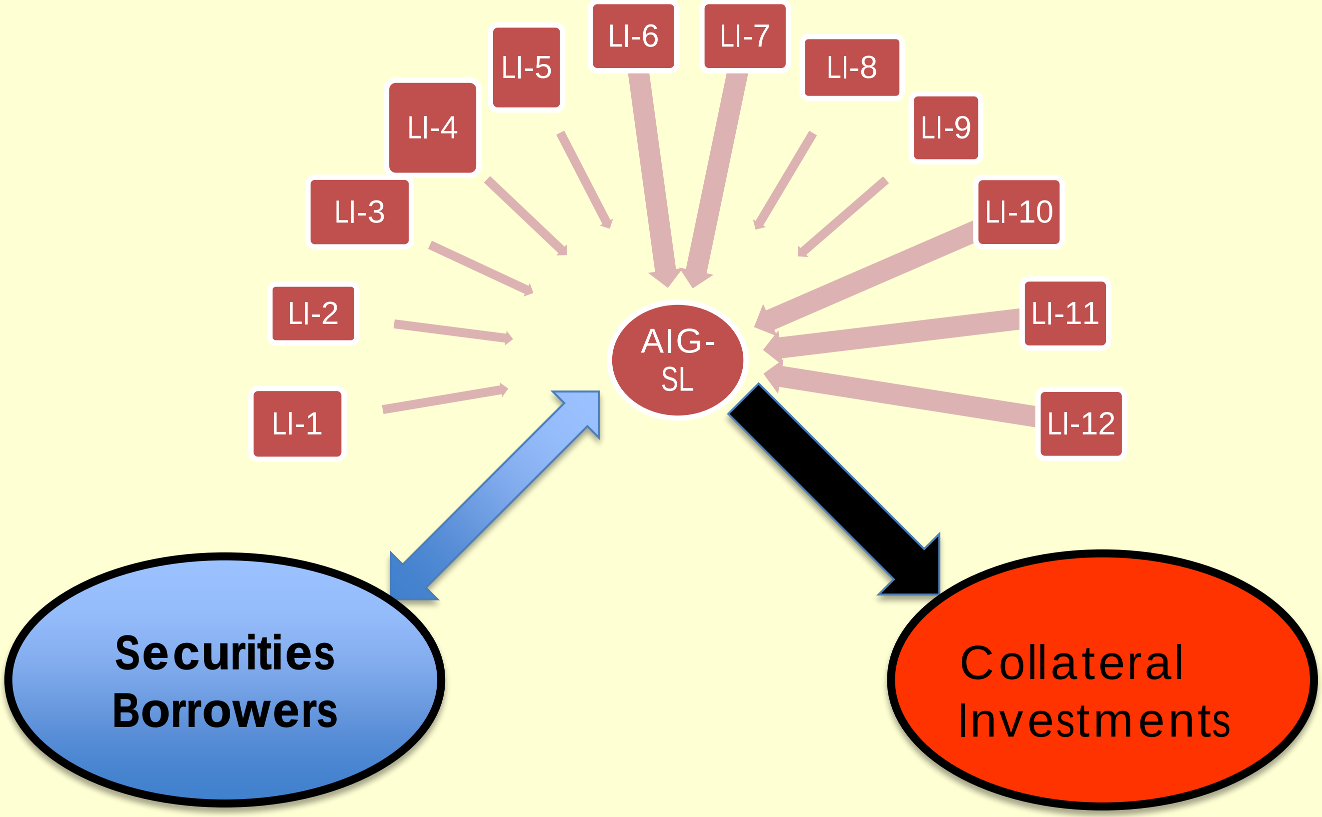
If AIG's life insurance subsidiaries

were in such great shape,

why did they need $25 billion from the FRBNY?

AIG's Securities Lending Program

For 12 of AIG's US life insurers



Growth of Securities Lending Program

- Previously: Collateral was invested very conservatively.

- In 2005, AIG's Securities Lending jumps in the deep end on RMBS

- By end 2007 - $76 billion in SL with about 60% in RMBS
- Roughly 10% of total Life Insurance Company Assets)

- 2006/2007 was definitely **NOT** a good time to be investing in RMBS

- In 2005, AIG FP backed away from RMBS and related assets
    - -> Much too risky!

Impact of Securities Lending on Life Insurers

- Total capital of domestic life insurers at 1/1/2008 was ~ $20 billion
- Risk Based Capital Requirement ~ $3 billion

- **Market Risk** – Securities Lending losses ~ $22 billion in 2008

- **Liquidity Risk** – The SL counterparties could normally return the borrowed securities and ask for their collateral back at any time.
  - But the collateral was invested in soon-to-be-very illiquid assets

Risk Management?

- The SL program was managed by AIG Global Investment Management
- Apparently…(hard to believe!)
- They did not tell the life insurers about the new asset allocation strategy
  - Simply changed the prospectus to allow flexibility
- They also did not mention this change to the state regulators
  - All off-balance sheet (non transparent)

Regulatory Response to Securities Lending

- Regulators eventually noticed but took a while to figure it out.

- In mid 2007, regulators became alarmed (Subprime meltdown in progress)

- -> Reduce portfolio (but difficult to sell)
- -> $5 billion in guarantees from AIG parent to cover realised losses etc.

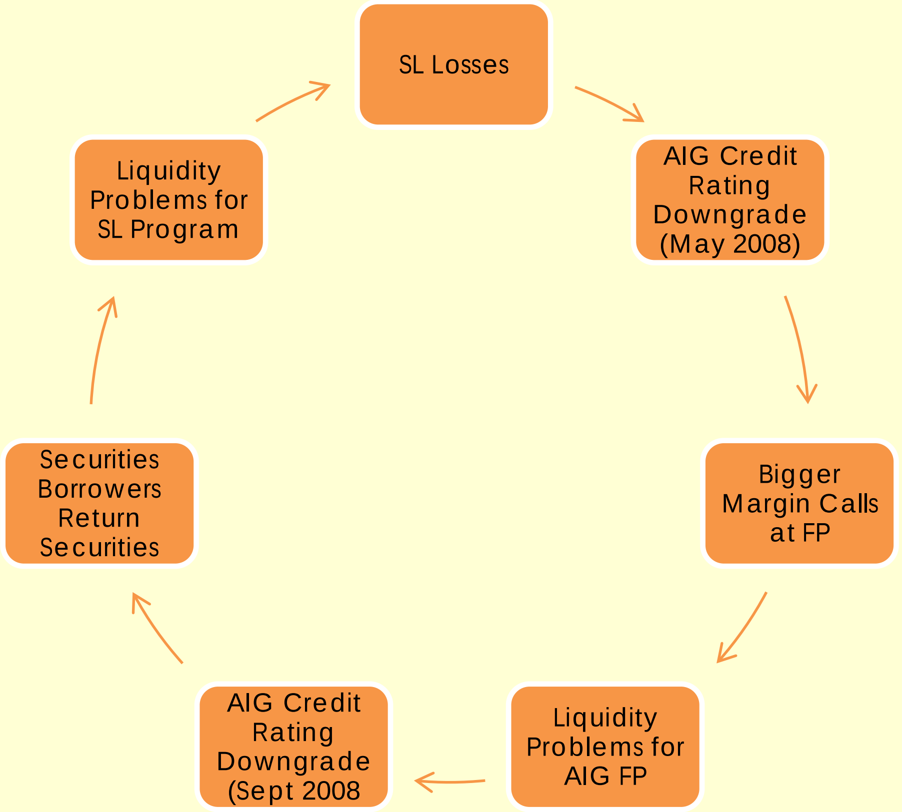
- Regulators proudly explained that portfolio was reduced
- from $76 billion (31/12/2007) to $58 billion (Sept 2008) = 18 billion reduction

- ???? But losses (fall in MV) were $16 billion during this period

THE LIQUIDITY CRISIS BEGINS ….

Interactions

Credit Rating downgrade automatically generates margin calls at AIG FP



Top 10 Securities Borrowers	Also an AIG FP Counterparty?
Barclays	Yes
Deutsche Bank	Yes
BNP Paribas	
Goldman Sachs	Yes
Bank of America	Yes
HSBC	Yes
Citigroup	
Dresdner	Yes
Merrill Lynch	Yes
UBS	Yes

Impact of Bailout on Securities Lending

- Three Credit Rating Agencies downgraded AIG on 15 September 2008
- Bailout announced 16 September 2008

- Over the next 2 weeks, Securities Lending Counterparties demanded a return of $24 billion in cash collateral
  - But the SL's assets were illiquid

- October 2008 (emergency stopgap)
  - FRBNY became the counterparty for $17 billion in securities borrowing, providing cash collateral

- November 2008
  - Maiden Lane II (funded by FRBNY) buys $39 billion of SL's assets for $20.5 billion
  - Reduces Life Insurers RBC requirements

Decision-Making during a Crisis

Q. When a parent company is in trouble,
Should its insurance subsidiaries provide support?

Crisis Weekend: Friday September 12, 2008

- Friday September 12 - AIG is expecting a credit rating downgrade on Monday
- $20 billion in liquidity will be needed for AIG FP and GICs

- **Q. WHERE WILL THEY GET THE MONEY?**

- Sept 12 – Drawdown $1 billion from life insurers under line of credit

- Sept 15 – Regulator says ***STOP THAT!***

- Sept 22 pm – Regulator says AIG must return all money borrowed ($1.5 billion)

Slightly different history (small footnote)

- **Q. WHERE WILL THEY GET THE MONEY?**

- Sept 12 – Drawdown $1 billion from life insurers under line of credit
- Sept 15 – Regulator says ***STOP THAT!***

- **Sept 16 am – AIG says: If you don't give us some money RIGHT NOW, we will default**
  - Regulator says OK – you can have $5 billion
- **Sept 16 pm – Bailout announced, AIG returns $5 billion**

- Sept 16 pm – Regulator says AIG must return all money borrowed ($1.5)

The Rescue Plan

- AIG's Property Casualty Companies
  - (a) have capital well above the regulatory minimum
  - (b) have liquid assets
- Proposed Asset Swap
  - P&C companies will buy shares in life insurers from AIG
  - In return will provide liquid assets to AIG ($20 billion)
- Plan was announced by Governor of New York on September 15
  - *We will save AIG*
  - Q. Why is the Governor of NY involved in this decision?

Was this a good idea?

- Did AIG's P&C insurers REALLY have a lot of excess capital?
- Might they need that capital to cope with the impending catastrophe?
- And did they really want to be part-owners of life insurance companies which desperately needed more capital?
- NYSID said this would not go ahead unless policyholders interests were protected.
- Plan was never implemented ($20 billion was not nearly enough to save AIG)

- *In giving his buddies at AIG a helping hand, Dinallo showed just how rapidly and completely a state insurance regulator can fold when the chips are down.*

- *This was a failure of insurance regulation on a monumental scale.*

- *Not only did the security guards fail to keep the bank robbers out,*
- *they unlocked the vault and helped load the truck.*

- *An article In Enforce, the Insurance Policy Enforcement Journal*
- *by David Wood & Eric Dinallo has arguments for and against the Rescue Plan*
- *http://www.andersonkill.com/webpdfext/publications/wbenf/pdf/enforce-vol7-issue1.pdf*

What Would Have Happened to AIG's Insurance Subsidiaries, if AIG had not been rescued?

Would the failure of the parent inevitably have led to the failure of the subsidiaries?

What would happen to AIG's insurance subsidiaries if AIG became bankrupt?

- **Insurance Regulators Said: It's all OK**

"The main reason why the federal government decided to rescue AIG was not because of its insurance companies.

…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

….The dependable moat of state regulation that protects policyholders remains solid." (4)

- **Federal Reserve / Treasury Said: Doomsday**
- If AIG had not been rescued, it would have been a disaster…
- for AIG's insurers, and
- for the entire insurance industry, and
- for every ordinary person who depends on these insurance companies
- Apparently widows and orphans and retirees are more popular than Goldman Sachs.

What would really happen? No one was sure

- 1. Would state regulators seize all the insurance companies to protect them?
- 2. How intertwined were all the different AIG companies?
- 3. How strong were the life insurance companies?
- 4. What would happen to their credit ratings?
- 5. How would policyholders react?

Q1. Would State Regulators Seize the Insurers?

- **Q. If you were the regulator, what would you do in these circumstances?**

- *A. "Whatever is necessary to protect our policyholders"*

Historically: State Regulators have **NOT** always worked together during a crisis

- **–** Each state (and foreign) regulator wants to protect his own constituency.
- *"One seizure could have led to a cascading effect of other seizures"*[(6)]
- Especially if companies have cross share-holdings and guarantees

In September 2008, while awaiting the bailout decision, the Texas Dept of Insurance had already drawn up the paperwork to seize 4 life insurers

Q2. How intertwined were all the AIG companies?

- *"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."* (3)

- *[How to Create Systemic Risk]*

Q3. Were the life insurers actually solvent?

- The state insurance regulators have repeatedly claimed that **AIG's life insurers were solvent**, and policyholders would be protected.

- Others – e.g. the Government Accounting Office and the Congressional Oversight Panel – claim that the life insurers would **NOT** have been able to meet the minimum capital standards without government assistance to AIG *(which was funnelled down to the life insurers)*[(9)]

- -> $25 billion of the AIG bailout money was used to pay AIG's debts to the subsidiaries and to recapitalise the life insurers

Q3. Were the life insurers actually solvent?

- Interesting (slightly horrifying) article by an actuary
- *"To What Degree Were AIG's Operating Insurance Subsidiaries Sound?"* by David Merkel (FSA)

Q4. Credit Ratings?

- All three major credit rating agencies downgraded the parent company on September 15, 2000
- At the same time, they ALSO downgraded the insurance subsidiaries
- Because:
  - * AIG will **no longer be able to provide support** to subsidiaries which suffer losses and need recapitalisation
  - * The insurers will suffer **reputational risk** as a result of the parent company's problems

Q4. What would the Credit Rating Agencies do?

- **Consequences of any further downgrade?**

- **Life Insurers** "*New domestic business would be severely affected, in several instances forcing the company to exit business lines that serve high net worth individuals or businesses governed by trust contracts.*" (S&P)

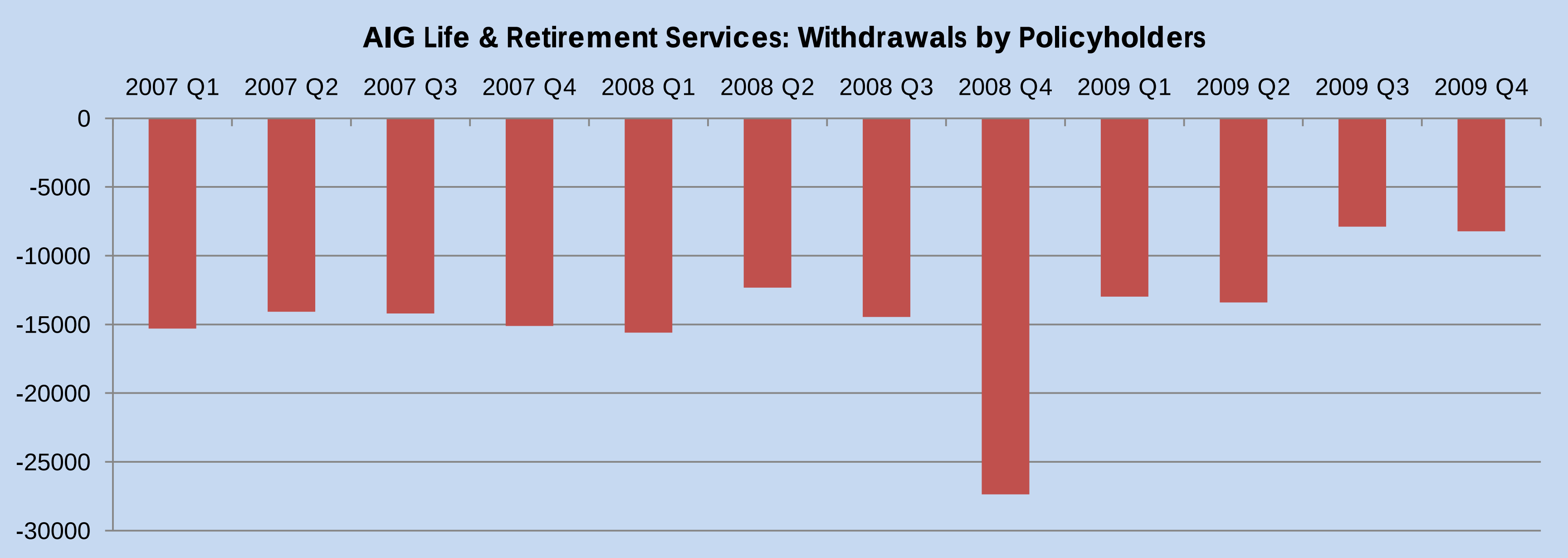
- **General Insurers:** "*AIG commercial P&C expect that a financial strength rating downgrade would result in a loss of approximately 50% of net premium written*" (AM Best)

- **Bailout terms and conditions became more and more lenient**

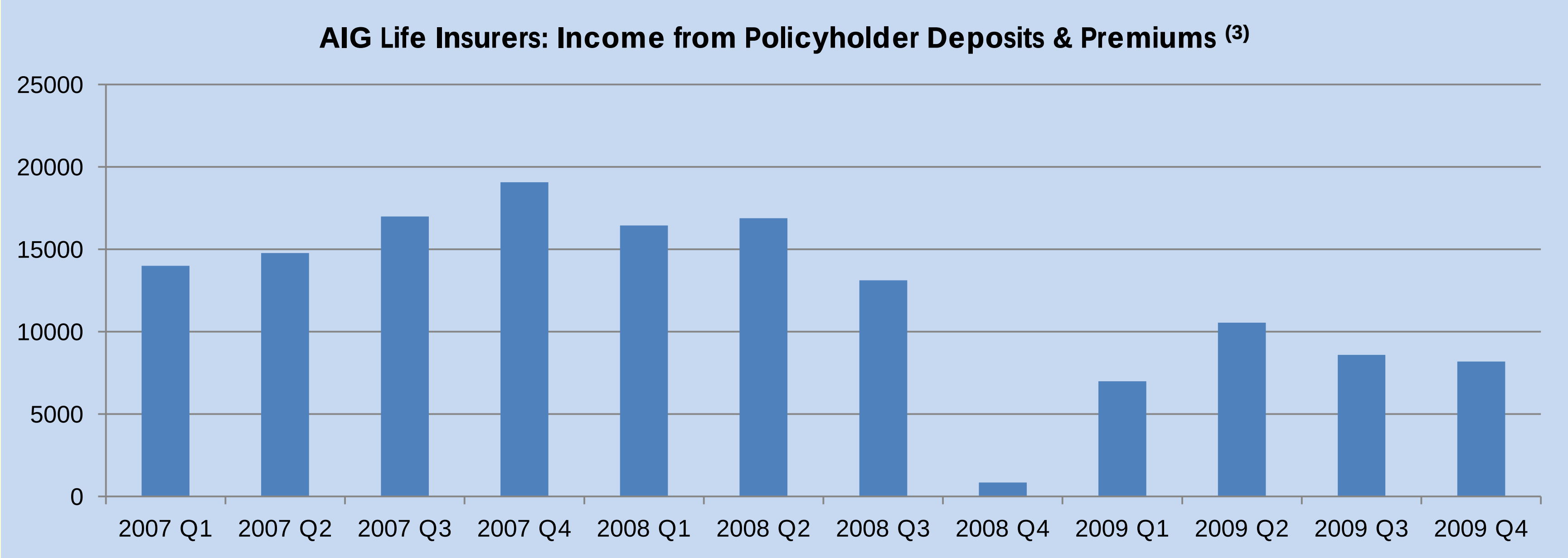
Q5. Policyholder Reaction?

- After the AIG bailout package was announced, State Insurance Commissioners issued press releases (22 September 2008)
  - *“The Insurers are financially sound,*
  - *“Surrendering can be expensive and have tax consequences*
  - *“If someone tells you to replace any policy because any AIG insurance company is in trouble and may not be able to pay your claim, that is not only untrue, it is against the law. Call us. Some regulators have received reports this is happening. We will not allow it to happen in New York.”* (5)
- *Q. What if it IS true?*

Q5. Policyholder Reaction?



Q5. Policyholder Reaction?



Amount Lost by Reputational Damage?

- *SunAmerica Financial, AIG's umbrella for its life and retirement insurance companies, has estimated that it lost between $2 and $3 billion in Sales between September 2008 and March 2009* (8)

Q. Risks from Sales of Life Insurance Subsidiaries ?

- Government is keen to receive repayment of loans (reluctant shareholder)
- AIG : selling off many of its companies in order to pay back the Government
- Difficulties in finding buyers (depressed markets)

- **Q. Is this a risk to the policyholders?**

- Legislation usually controls transfers of life insurance liabilities
- To protect policyholders, the buyer should be financially sound / fit & proper
- Historically, standards have sometimes been relaxed when the seller is keen to sell
- In this case one arm of government will be approving sales which provide a financial benefit to another arm of government

A brief glance at AIG's P&C subsidiaries

- Generally considered to be solvent

- But suffered loss of business due to reputational damage

- Also - Loss of experienced employees

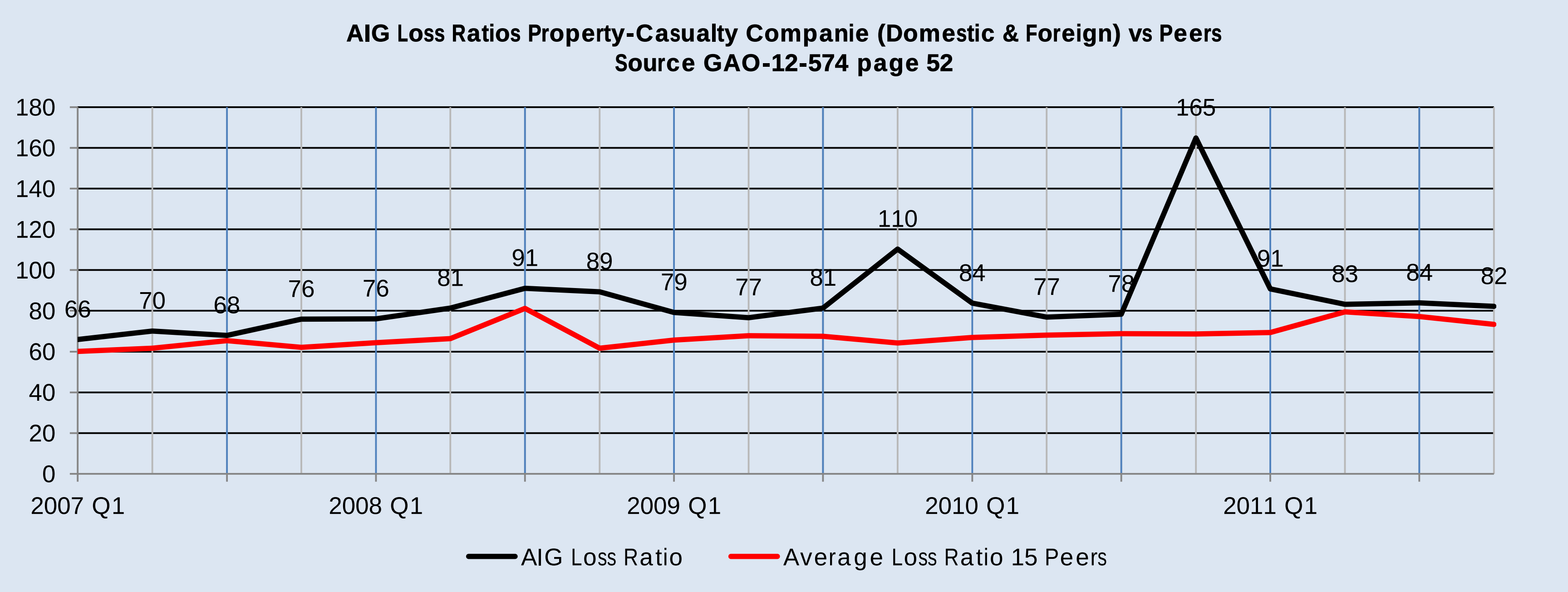
- Decline in premium income
- -> General decline for the whole industry (economic conditions)
- -> But AIG subsidiaries had much bigger declines

Underpricing Controversy: Commercial Lines

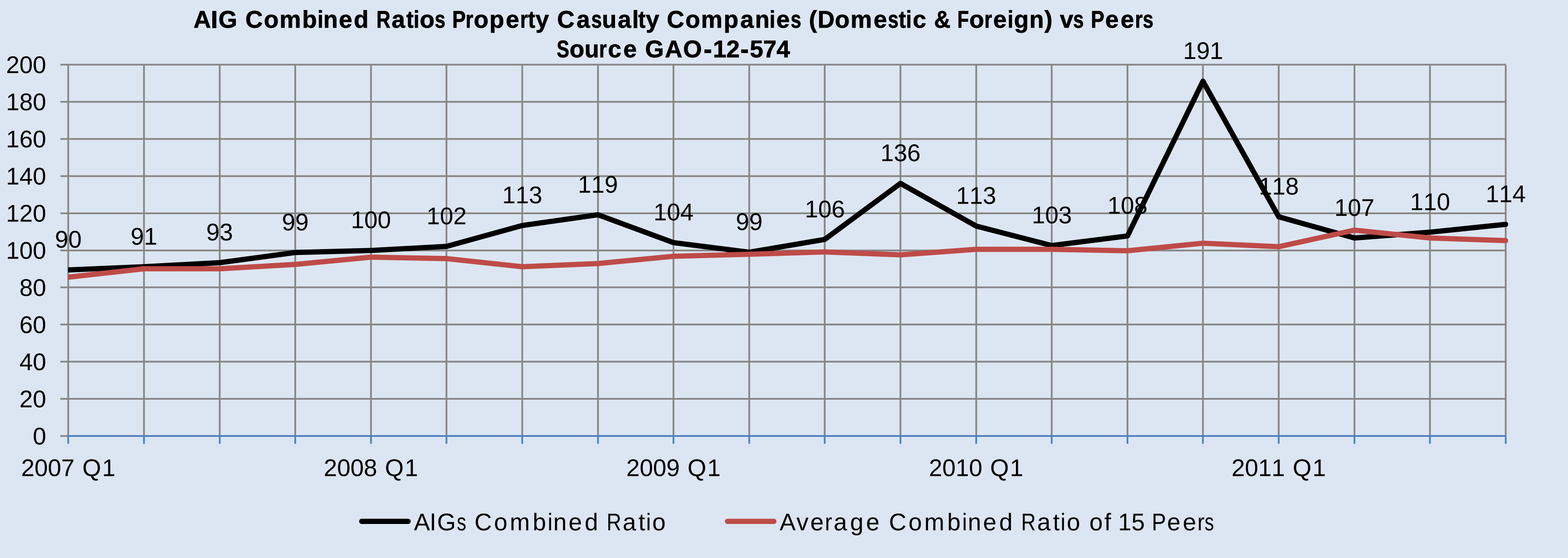
- AIG’s competitors complained
  - AIG was underpricing in order to retain market share
  - Premium rates too low relative to risk (sure to produce a loss)
  - Taking advantage of implicit government guarantee

- GAO Investigation (2009)
  - Impossible to reach any conclusion (AIG often lowest even before the bailout)
  - Too difficult to make comparisons
  - Reasonableness of premiums is subjective
  - Long tail business: Won’t be able to tell for several years

Loss Ratios


AIG Loss Ratios Property-Casualty Companie (Domestic & Foreign) vs Peers
Source GAO-12-574 page 52
180
160
140
120
100
80
60
40
20
0
66
70
68
76
76
81
91
89
79
77
81
110
84
77
78
165
91
83
84
82
2007 Q1
2008 Q1
2009 Q1
2010 Q1
2011 Q1
AIG Loss Ratio
Average Loss Ratio 15 Peers

Combined Ratios



Government Ownership: Conflict of Interest?

- *One arm of government (state regulators)*
- *is responsible for dealing with supervision of insurance companies*
- *owned by another arm of government*
- *where the government has a strong financial incentive to encourage the insurer to build up market share (prior to sale of shares)*
- *Is this an undesirable situation?*

Questions to discuss

- 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?

- Q2. What rules should apply to transactions between affiliates?

- Q3. Was it appropriate to call upon AIG's insurance subsidiaries to provide support for the AIG parent company?

  If the answer is "it depends on the circumstances", then who should decide?

- Q4. 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?

References

- (1) *AIG Policyholders should be careful if approached to Replace Policies*, News Release from the New York State Insurance Department, issued 22 September 2008

- (2) Congressional Oversight Panel, June Oversight Report (June 2010); see also Government Accountability Office

- (3) Congressional Oversight Panel, June 2010 Oversight Report, page 50

- (4) 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

- (5) *AIG Policyholders should be careful if approached to replace policies*, Press Release 22 September 2008, New York State Insurance Department

References

- (6) Congressional Oversight Panel, June Oversight Report (June 2010); page 155
- (7) Congressional Oversight Panel, June Oversight Report (June 2010); page 153
- (8) Congressional Oversight Panel, June Oversight Report (June 2010); page 154
- (9) Government Accountability Office Report 10-475 at page 36