Professional Risk Managers' International Association

American Insurance Group (AIG)

June 2021

PRMIA
Professional Risk Managers' International Association

Summary

The financial crisis of 2007/2008 began in the United States (US) due to the collapse of the housing market. Subprime mortgages fueled the housing market crash, which led to an economic downturn called the Great Recession, and threatened to destroy the international financial system.[1]

American Insurance Group (AIG), a huge, international insurance company, suffered severe losses due to investments in subprime mortgages through credit default swaps, and wavered on the edge of bankruptcy. The US government determined that AIG's failure would create a domino effect that would seriously harm the US economy. AIG was seen as "too big to fail." As a result, the government, through the Federal Reserve of New York (the Fed), bailed out the company with a commitment that started with an $85 billion loan and a 79.9 percent equity stake in the company. Eventually, the total cost of the bailout was $182 billion. After AIG paid the loan off and the government sold its shares in the company, the taxpayers netted a $22.7 billion profit.[2]

Main Content

In 1919, American businessman Cornelius Vander Starr established the insurance company that would become American Insurance Group (AIG) in Shanghai, China. In 1939, when Japan invaded China, the company's headquarters moved from Shanghai to New York. In the decades that followed, the company expanded to Japan, Germany, the Middle East, the UK, South Korea, and Australia. Maurice Greenberg took over operations in 1968 and expanded it into China over the next decades. He also encouraged expanding operations beyond AIG's traditional insurance services. In 2005, Greenberg left AIG. [3]

By 2008, AIG operated in more than 130 countries, and derived about half of its revenues from overseas offices. Its assets exceeded one trillion dollars, and it had become one of the largest and most important financial companies in the world.[4]

Despite AIG's massive wealth and long-lived reputation, the economic calamities of late 2008 drove it to near bankruptcy, and necessitated bailout loans from the US government or face disastrous consequences for the American—and worldwide—economy.

[1] Duignan, B. (2019, October 7). *Financial crisis of 2007–08*. Encyclopedia Britannica. https://www.britannica.com/event/financial-crisis-of-2007-2008

[2] Amadeo, K. (2020, November 16). *This bailout made Bernanke angrier than anything else in the recession.* The Balance. https://www.thebalance.com/aig-bailout-cost-timeline-bonuses-causes-effects-3305693

[3] *Our timeline | AIG*. (n.d.). Individuals & Families - Insurance from AIG in the U.S. https://www.aig.com/about-us/history/timeline

[4] Sjostrom, William K., The AIG Bailout (November 1, 2009). Washington and Lee Law Review, Vol. 66, p. 943, 2009, Available at SSRN: https://ssrn.com/abstract=1346552

On September 16, 2008, the Federal Reserve Bank of New York (the Fed) agreed to lend up to $85 billion to AIG and take a 79.9 percent equity stake in the company.[5] The equity stake gave the government veto power over the company's important decisions such as making dividend payments and selling assets. (Amadeo, 2020) The loan had a term of two years and an interest rate of Libor (London interbank offered rate) plus 8.5 percentage points. The Fed explained that the loan would allow AIG to sell some of its businesses off in an orderly manner that preserved the economy's equilibrium. The Fed also demanded the resignation of AIG's CEO, Robert Willumstad. (Karnitschnig et al., 2008)

The Fed employed legal authority to make the bailout by citing a provision in the Federal Reserve Act which allows it to lend to nonbank institutions under unusual circumstances. This act put them in control of a private insurer that it previously had not even regulated. (Karnitschnig et al., 2008) The Fed had concluded that "because of AIG's size and interconnectedness, and the fact that financial markets were already under serious distress, it was feared that AIG's failure would lead to the collapse of the entire financial system." (Sjostrom, 2009)

Background

The financial crisis that erupted in 2007 and 2008 had been building for several years. In May 2000, the Fed began lowering the federal funds interest rate from 6.5 percent. The rate bottomed out at 1 percent in June 2003. The lowered rates were designed to boost the economy by providing businesses and consumers bargain rates for money.

Many consumers acquired property because of the low mortgage rates, and home prices began to rise. Among these consumers were subprime borrowers, or those with no credit history or poor credit.

The banks then sold those loans on to Wall Street banks, and packaged them into mortgage-backed securities and collateralized debt obligations (CDOs), which were presented as low risk investments.

By 2004, home ownership in the US reached a saturation point of 69.2 percent. The Fed began to raise interest rates to 5.25 percent.

Home prices began to decrease and soon some borrowers found their homes worth less than they had paid for them, making them responsible for the difference if they sold their houses. Those with adjustable rate mortgages found their interest rates continuing to rise. These factors resulted in increasing abandonment of mortgages and foreclosure by financial institutions.

Numerous subprime lenders went out of business throughout 2007. Bear Stearns collapsed in March 2008. In September 2008 home lenders Fannie Mae and Freddie Mac were seized by the government. Lehman Brothers floundered and requested government help, but was denied, and fell into bankruptcy.[6]

---

[5] Karnitschnig, M., Solomon, D., & Liam Pleven and Jon E. Hilsenrath. (2008, September 17). *U.S. to take over AIG in $85 billion bailout; Central banks inject cash as credit dries up*. WSJ. https://www.wsj.com/articles/SB122156561931242905

[6] Singh, M. (2021, January 11). *The 2007-08 financial crisis in review*. Investopedia. https://www.investopedia.com/articles/economics/09/financial-crisis-review.asp

Bailout

On September 15, 2008, Lehman Brothers failed after the government declined to offer them a bailout. AIG's credit rating plummeted, forcing the company to come up with $15 billion in additional collateral.[7] Over the prior weekend, the federal government had tried to get private companies to commit funds to assist AIG, but these interests declined to help, saying that organizing a loan of the size needed by AIG would be impossible. Concerned that AIG's asset defaults would create a "domino effect" that would crash markets in the US, not to mention Europe and Asia, the government concluded that the bailout was necessary. (Karnitschnig et al., 2008)

AIG's structure and certain regulations protected the company's millions of policyholders. However, this was not the case for a wide array of investors, from the bearers of money market funds to hedge funds and pensions, who were in danger of losing billions.[8]

What Led to AIG's Trouble?

AIG encountered huge losses because they had become a major producer of credit default swaps. Intended to increase profits, these swaps insured assets supporting corporate debt and mortgages. The vulnerability of subprime mortgages drove AIG's losses. When they became liable for the mortgages that defaulted, they had to raise millions of dollars to pay out claims. AIG's position worsened when stockholders heard about the situation and began to sell their shares. Although AIG's assets would have covered the swaps, they could not come up with the funds ahead of the dates that the swaps came due, leaving them without a means to pay the swap claims. (Amadeo, 2020)

Like Long-Term Capital Management before it, AIG had relied on sophisticated computer models to assess risk in sophisticated credit-default swaps, which helped them decide the swap deals that were likely safe. These mathematical models convinced executives of AIG's Financial Services Division, based in London, that credit-default swaps were a goldmine of free money. For a while, this was true. In a five-year period, the division's revenues skyrocketed from $737 million to $3 billion plus. (Gethard, 2020)

AIG's Financial Services Division provided an array of high finance and equipment leasing services and sold the credit-default swaps to begin with. (Amadeo, 2020) Previous AIG CEO, Maurice Greenberg, had expanded the company into financial-products units outside the scope of its traditional insurance origins before being forced out amidst an accounting scandal in 2005. (Karnitschnig et al., 2008)

AIG's swaps became more complex around 2004 when the company began selling CDOs backed by mortgage bonds and other securities, bundled into packages ranging from very safe to very risky. (Karnitschnig et al., 2008) These packages are known as tranches, and they included subprime loans. (Gethard, 2020) In an influential journal article William K. Sjostrom, Jr. discusses tranches. "The basic idea is

---

[7] Morgenson, G. (2015, January 20). *Behind insurer's crisis, blind eye to a web of risk (Published 2008)*. The New York Times - Breaking News, US News, World News and Videos. https://www.nytimes.com/2008/09/28/business/28melt.html

[8] Gethard, G. (2020, March 30). *Falling giant: A case study of AIG*. Investopedia. https://www.investopedia.com/articles/economics/09/american-investment-group-aig-bailout.asp

to convert a pool of financial assets with a single rating into various debt securities with ratings at, above, and below the pool's rating." (Sjostrom, 2009)

AIG considered the possibility of paying out enough claims to begin defaulting on CDOs was a remote possibility even in a recession. (Karnitschnig et al., 2008) However, these swaps exposed AIG to three risks. One was that CDO buyers, known as counterparties (or trading partners), had the right to demand collateral from AIG if their corporate-debt rating was cut or if the securities that the swaps insured declined in value. Also, AIG had to take write downs if the value of the contracts on its books fell due to their market value.[9]

AIG's mathematical models did not account for the swap values and collateral risk until 2007, after the swaps had been sold. Carrick Mollenkamp for the Wall Street Journal indicates that: "The firm [AIG] left itself exposed to potentially large collateral calls because it had agreed to insure so much debt without protecting itself adequately through hedging." (Mollenkamp et al., 2008)

Alterations to Bailout Terms

After the initial September bailout terms, on October 8, 2008, the Fed restructured terms by agreeing to lend AIG subsidiaries $37.8 billion in exchange for fixed-income securities. (Amadeo, 2020) Fixed-income securities are investments with returns in fixed periodic interest payments and, at maturity, the return of principal. They are attractive because the payments are known in advance unlike with variable-income securities.[10]

The Fed again restructured its aid to AIG on November 10, 2008 by reducing the $85 billion loan to $60 billion. It created two limited liability companies named Maiden Lane II and Maiden Lane III. In exchange for mortgage-backed securities, the Fed loaned $20.5 billion to Maiden Lane II. In exchange for CDOs, the Fed loaned Maiden Lane III $29.3 billion. It also paid off the $37.8 billion loan from October 2008. (Amadeo, 2020)

In addition, the Treasury Department used Troubled Asset Relief Program (TARP) funds to purchase $40 billion in AIG preferred shares. These funds assisted AIG in retiring its credit default swaps and shoring themselves up against bankruptcy. (Amadeo, 2020)

Reported on March 2, 2009, AIG's fourth-quarter loss in 2008 was a record $62 billion. That day, the Dow fell nearly 300 points to close at 6,763.29.

On March 2, 2009 the Fed and Treasury Department announced changes to the bailout. It created a new equity capital facility, removed 350 basis points from the three-month LIBOR, reduced the credit facility by

[9] Mollenkamp, C., Ng, S., Pleven, L., & Smith, R. (2008, November 1). *Behind AIG's fall, risk models failed to pass real-world test*. WSJ. https://www.wsj.com/articles/SB122538449722784635
[10] Murphy, C. B. (2020, August 31). *The benefits and disadvantages of investing in fixed-income securities*. Investopedia. https://www.investopedia.com/terms/f/fixed-incomesecurity.asp

$26 billion in favor of giving the Fed preferred interest in two of AIG's subsidiaries, and reduced the amount of credit available from $60 billion to $35 billion.[11]

The Treasury Department loaned another $29.84 billion to AIG in April 2009. This brought the total bailout package to $182 billion. (Amadeo, 2020)

Public outrage erupted when it became known that AIG paid $165 million to employees as retention bonuses. The employees were asked to safely decommission the credit default swaps. The Balance reports that, "These derivatives were so complicated that no one else understood them … Letting these swaps fall apart could have cost the U.S. government more than $165 million." Still, the fact that AIG paid out bonuses after being bailed out by the taxpayers did not look good. (Amadeo, 2020)

In 2009, it was revealed that $62 billion of AIG's bailout was passed through to big banks like Goldman Sachs, Merrill Lynch, and Bank of America, a fact that the government had not publicized beforehand. Again, AIG was a subject of public wrath. (Newman, 2012)

The last of the Treasury Department's remaining shares of AIG stock were sold off in December 2012, netting the taxpayers a $22.7 billion profit from the bailout.[12]

In 2015, AIG paid out nearly $1 billion to settle a lawsuit by Michigan's state pension, who accused the company of misleading shareholders about credit default swaps' risks between 2006 and 2008.

Afterward

Federal Reserve Chairman Ben Bernanke expressed his anger with AIG's reckless pursuit of profit, ending up with a federal bailout. He explained it: "AIG exploited a huge gap in the regulatory system. There was no oversight of the financial products division."[13]

In order to address the conditions which led to the 2007/2008 financial collapse, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by President Obama on July 21, 2010. The act was designed to protect consumers from the risks of investments like those taken by Wall Street.[14] Dodd-Frank established regulatory groups within the government such as the Financial Stability Oversight Council (FSOC) whose job it was to label certain financial firms as systemically important to the economic wellbeing of the country. These firms and banks with excess of $50 billion in assets were subjected to

---

[11] *The Fed - American international group (AIG), maiden lane II and III*. (2010, December 1). Federal Reserve Board. https://www.federalreserve.gov/regreform/reform-aig.htm

[12] Newman, R. (2012, December 11). *3 Lessons from the AIG Bailout.* US News & World Report. https://www.usnews.com/news/blogs/rick-newman/2012/12/11/3-lessons-from-the-aig-bailout

[13] Stout, D., & Knowlton, B. (2009, March 3). *Fed chief says insurance giant acted irresponsibly* (Published 2009). The New York Times - Breaking News, US News, World News and Videos. https://www.nytimes.com/2009/03/03/business/worldbusiness/03iht-03webecon.20567563.html

[14] Amadeo, K. (2020, October 30). *What is the Dodd-Frank Wall Street reform act?* The Balance. https://www.thebalance.com/dodd-frank-wall-street-reform-act-3305688

increased regulation and a special resolution process in order to prevent them from exposing the country to systemic risk.[15]

In September 2017 the FSOC removed AIG from the list of "too big to fail" companies. The reasoning was that AIG had not only worked with regulators to reduce risk but the company also shrank to half of its 2007 size. AIG no longer dabbled in speculation outside of property-casualty insurance, life, car, and home insurance, and annuities.

In 2018, Congress rolled back some provisions of the Dodd-Frank Act with the Economic Growth, Regulatory Relief, and Consumer Protection Act. This act eased regulations on small banks with assets between $100 billion and $250 billion, which freed them from running stress tests to prove they could withstand a financial catastrophe. It also allowed consumers to freeze their credit for free. (Amadeo, 2020)

AIG continues to operate today, with offices in approximately 80 countries and jurisdictions.[16]

Lessons Learned

1. Government bailouts need not waste taxpayer money. In fact, the country made $22.7 billion from the AIG bailout.
2. Transparency may prevent public backlash. AIG's payment of bonuses to senior executives and the fact that bailout funds were passed through to big banks angered the public. Explaining the necessity of these payments before the public got wind of them would have helped tamp down outrage about them.
3. Regulations may prevent future economic meltdowns. The fact that nonbanks such as AIG lacked meaningful regulation by states or the federal government caused problems. The Dodd-Frank Act was designed to close the regulation gap. Deregulation of the financial sector had occurred throughout the Clinton and George W. Bush presidencies, and arguably sowed the seeds for the AIG calamity.
4. Be wary of expanding beyond a company's core business. It wasn't until AIG expanded out of its traditional insurance offerings that they ran into trouble.
5. Greed leads to disaster. Greed was the ultimate cause of AIG's economic disaster. While greed is a core trait in human beings, it should be tempered as much as possible. Holding top management accountable for their decisions is one way of restraining such impulses.

[15] Webel, B. (2017, April 17). *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Background and Summary*. Congressional Research Service. https://crsreports.congress.gov/product/pdf/R/R41350/10
[16] *About us | AIG*. (n.d.). aig. https://www.aig.com/about-us

Timeline of events

September 6, 2008 —	The US takes over mortgage lenders Fannie Mae and Freddie Mac to save them from collapse. (Karnitschnig et al., 2008)
September 13-14, 2008 —	Federal officials attempt to get private companies to raise funds for AIG's rescue. The attempt fails. (Karnitschnig et al., 2008)
September 15, 2008 —	Lehman Brothers files for bankruptcy; AIG's credit ratings are slashed. (Mollenkamp et al., 2008)
September 16, 2008 —	After a failed last ditch effort by AIG to secure a $75 billion privately financed loan (Sjostrom, 2009), the Fed bails out AIG for a $85 billion loan and a 79.9 percent equity stake in the company.
October 2008 —	the Fed hires Edward Liddy as AIG CEO and Chairman in order to break up AIG and sell off pieces in order to repay the federal bailout. (Amadeo, 2020)
October 8, 2008 —	the Fed lends AIG subsidiaries $37.8 billion in exchange for fixed-income securities. (Amadeo, 2020)
November 10, 2008 —	the first restructure of the AIG bailout package occurs.
March 2, 2009 —	the Fed and Treasury Dept. announce another restructuring of the AIG bailout.
April 2009 —	the Treasury Dept. commits an additional $29.84 billion to AIG to bring the total bailout package to $182 billion. (Amadeo, 2020)
December 2012 —	the Treasury Dept. sells off last of its remaining AIG shares, netting the US government a $22.7 billion profit from AIG's bailout. (Amadeo, 2020)
September 29, 2017 —	the Financial Stability Oversight Council created by the Dodd-Frank Wall Street Reform Act removes AIG's designation as "too big to fail". (Amadeo, 2020)

References

About us | AIG. (n.d.). AIG. https://www.aig.com/about-us

Amadeo, K. (2020, November 16). *This* bailout made Bernanke angrier than anything else in the recession. The Balance. https://www.thebalance.com/aig-bailout-cost-timeline-bonuses-causes-effects-3305693

Amadeo, K. (2020, October 30). What is the Dodd-Frank Wall Street reform act? The Balance. https://www.thebalance.com/dodd-frank-wall-street-reform-act-3305688

Duignan, B. (2019, October 7). Financial crisis of 2007–08 | Definition, causes, effects, & facts. Encyclopedia Britannica. https://www.britannica.com/event/financial-crisis-of-2007-2008

The Fed - American international group (AIG), maiden lane II and III. (2010, December 1). Federal Reserve Board. https://www.federalreserve.gov/regreform/reform-aig.htm

Gethard, G. (2020, March 30). Falling giant: A case study of AIG. Investopedia. https://www.investopedia.com/articles/economics/09/american-investment-group-aig-bailout.asp

Karnitschnig, M., Solomon, D., & Liam Pleven and Jon E. Hilsenrath. (2008, September 17). U.S. to take over AIG in $85 billion bailout; Central banks inject cash as credit dries up. WSJ. https://www.wsj.com/articles/SB122156561931242905

Mollenkamp, C., Ng, S., Pleven, L., & Smith, R. (2008, November 1). Behind AIG's fall, risk models failed to pass real-world test. WSJ. https://www.wsj.com/articles/SB122538449722784635

Morgenson, G. (2015, January 20). Behind insurer's crisis, blind eye to a web of risk (Published 2008). The New York Times - Breaking News, US News, World News and Videos. https://www.nytimes.com/2008/09/28/business/28melt.html

Murphy, C. B. (2020, August 31). The benefits and disadvantages of investing in fixed-income securities. Investopedia. https://www.investopedia.com/terms/f/fixed-incomesecurity.asp

Newman, R. (2012, December 11). 3 Lessons from the AIG Bailout. US News & World Report. https://www.usnews.com/news/blogs/rick-newman/2012/12/11/3-lessons-from-the-aig-bailout

Our timeline | AIG. (n.d.). Individuals & Families - Insurance from AIG in the U.S. https://www.aig.com/about-us/history/timeline

Singh, M. (2021, January 11). The 2007-08 financial crisis in review. Investopedia. https://www.investopedia.com/articles/economics/09/financial-crisis-review.asp

Sjostrom, W. K. (2009, November 1). The AIG bailout. Washington and Lee Law Review, Vol. 66, p. 943, 2009. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1346552

Stout, D., & Knowlton, B. (2009, March 3). Fed chief says insurance giant acted irresponsibly (Published 2009). The New York Times. https://www.nytimes.com/2009/03/03/business/worldbusiness/03iht-03webecon.20567563.html

Webel, B. (2017, April 17). The Dodd-Frank Wall Street Reform and Consumer Protection Act: Background and Summary. Congressional Research Service. https://crsreports.congress.gov/product/pdf/R/R41350/10