Ongoing Government Assistance for American International Group (AIG)

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March 16, 2009

Congressional Research Service
7-5700
www.crs.gov
R40438

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

In the beginning of 2008, American International Group (AIG) was one of the world's largest insurers, generally considered to be financially sound with an AA credit rating. By the end of the year, it had undergone a near bankruptcy and had been forced to seek up to $173.4 billion in financial assistance from the U.S. government. The CEO had been replaced at the government's behest, executive compensation was under limits, and shareholders in AIG had been nearly wiped out as their equity was diluted by a new 79.9% stake held by the government. The government assistance to AIG has been largely *ad hoc*. Even though the overarching AIG holding company was regulated by the Office of Thrift Supervision (OTS), since the company was essentially an insurer it was outside of the normal Federal Reserve (Fed) facilities that lend to banks facing liquidity difficulties. AIG was also outside of the normal receivership provisions that apply to banking institutions. Had AIG not been effectively deemed "too big to fail" and given assistance by the government, bankruptcy seemed a near certainty in September 2008.

The losses that led to AIG's essential failure resulted largely from two sources: the state-regulated AIG insurance subsidiaries' securities lending program, and the AIG Financial Products (AIGFP) subsidiary, a largely unregulated subsidiary that specialized in financial derivatives. The securities lending losses were largely due to investments in mortgage-backed securities, and are relatively well-defined at this point. At the end of 2008, the outstanding obligations from the AIG securities lending program were approximately $3 billion, down from over $82 billion at the start of 2008. The credit derivative losses from AIGFP, however, are potentially ongoing despite actions taken to limit them. AIG reported approximately $300 billion in continued notional net exposure to credit derivatives at the end of 2008, down from approximately $370 billion at the start of 2008.

The government assistance to AIG began with an $85 billion loan from the Fed in September 2008. This loan was on relatively onerous terms with a high interest rate and required a handover of 79.9% of the equity in AIG to the government. As AIG's financial position weakened after September, several rounds of additional funding were provided to AIG and the terms were loosened to some degree. The second major restructuring of the assistance to AIG was announced in March 2009 and has yet to be completed. Once it is completed, the assistance to AIG will comprise: (1) up to $70 billion in capital injections through preferred share purchases by the Treasury; (2) up to $40.3 billion in outstanding loans from the Fed; (3) up to $34.5 billion in Fed loans retired by securities and equity interests provided to the government by AIG; and (4) up to $52.5 billion in loans for troubled asset purchases—assets which are now owned by the government.

In addition to possible continuing losses on AIG's derivative portfolio, the ongoing weakness in the economy may weigh heavily on AIG's future results. It is not clear whether the ongoing government involvement in AIG might strengthen or weaken AIG's core insurance business, as consumers could conclude that their policy with AIG is safe due to the government involvement or they could conclude that their policy with AIG is more risky since the government could change the terms of its involvement at any time. This report will be updated as warranted by financial and legislative events.

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Introduction

In 2007, American International Group (AIG) was the fifth largest insurer in the world with $110 billion overall revenues. In the United States, it ranked second in property/casualty insurance premiums ($37.7 billion/7.5% market share) and first in life insurance premiums ($53.0 billion/8.9%). For particular lines, AIG ranked first in surplus lines, ninth in private passenger auto, first in overall commercial lines (fifth in commercial auto), and fourth in mortgage guaranty. It was outside the top ten in homeowners insurance.[1] According to the National Association of Insurance Commissioners, AIG had more than 70 state-regulated insurance subsidiaries in the United States, with more than 175 non-insurance or foreign entities under the general holding company.

While AIG is generally identified as an insurance company, the parent entity of the various subsidiaries is a thrift holding company and thus falls under the general supervision of the Office of Thrift Supervision. The individual regulation of the subsidiaries is done according to the function of that subsidiary—for example, insurance subsidiaries are regulated by state insurance regulators, bank subsidiaries are regulated by the appropriate banking regulator. This functional regulatory structure was enacted by Congress in the Gramm-Leach-Bliley Act of 1999 (P.L. 106-102, 113 Stat. 1338).

In the fall of 2008, facing losses on various operations, AIG experienced a significant decline in its stock price and downgrades from the major credit rating agencies.[2] These downgrades led to immediate demands for significant amounts of collateral (approximately $14 billion to $15 billion in collateral payments, according to contemporary press reports).[3] As financial demands on the company mounted, bankruptcy appeared a possibility, as occurred with Lehman Brothers. Fears about the spillover effects from such a failure brought calls for government action to avert such a failure. Many feared that AIG was "too big to fail" due to the potential for widespread disruption to financial markets resulting from such a failure. The New York Insurance Superintendent, primary regulator of many of the AIG insurance subsidiaries, led an effort to allow access by the parent holding company and other subsidiaries to up to $20 billion in cash from AIG's insurance subsidiaries, which were perceived as solvent and relatively liquid. Ultimately, however, this transfer did not take place; instead, the Federal Reserve (Fed) approved an up to $85 billion loan in September 2008, as detailed below.

[1] Statistics from *The I.I.I. Insurance Fact Book 2009*, (New York: Insurance Information Institute, 2009).

[2] In 2005, amid accounting irregularities that ultimately led to the resignation of then-CEO Maurice Greenberg, AIG was downgraded by S&P from AAA to AA+. Further downgrades followed in June 2005 and May 2008. In September 2008, S&P downgraded AIG to A-.

[3] See, for example, "U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up," *Wall Street Journal*, September 17, 2008, pp. A1-A6.

Too Big to Fail?[4]

Institutions that are too big to fail are ones that are deemed to be big enough that their failure could create *systemic risk*, the risk that the financial system as a whole would cease to function smoothly. A systemic risk episode could impose heavy costs on the overall economy, as the bank panics of the Great Depression demonstrated. Although too big to fail institutions are not offered explicit guarantees, it can be argued that they have implicit guarantees since the government would not be willing to allow a systemic risk episode. This accentuates a moral hazard problem whereby entities take on additional risks due to third party backing. There is no official governmental classification of which financial institutions are too big to fail, if any, in part because maintaining uncertainty over which institutions are too big to fail could help reduce the moral hazard problem. But the lack of official designation arguably creates a vacuum in terms of policy preparedness. (Making the problem more complex, as one report described the situation, "Officials grimly concluded that while Bear Stearns isn't too big to fail, it was too interconnected to be allowed to fail in just one day." It is unclear how to judge which institutions are too interconnected to fail.)[5]

Sources of AIG losses

AIG, as most financial institutions, has suffered losses on a wide variety of financial instruments due to the widespread market downturn. The exceptional losses resulting in essential failure of AIG have arisen primarily from two sources: the derivative activities of the AIG Financial Products (AIGFP) subsidiary and the securities lending activities managed by AIG Investments with securities largely from the AIG insurance subsidiaries.

AIG Financial Products

The AIGFP subsidiary was headquartered in Connecticut with major operations in London. According to AIG's website, it was "founded in 1987 as one of the first companies in the United States focused principally on OTC [over the counter] derivatives markets."[6] In recent years, it has moved into writing credit default swaps (CDS), particularly on mortgage-related securities. CDS can act essentially as insurance policies on securities. If CDS-backed securities default or are downgraded, the company selling the CDS must begin to pay off the claims on these CDS, or possibly to post collateral to cover future losses.[7] According to press reports, AIGFP's portfolio of CDS had a notional value of approximately $450 to $500 billion, including around $60 billion in CDS on securities linked to subprime loans. By August of 2008, approximately 64% of the subprime-linked securities backed by AIG had been downgraded and 6% were in default.[8] As

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[4] This section taken from page 25 of CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte. See this report, CRS Report RL34412, *Containing Financial Crisis*, by Mark Jickling, and CRS Report R40417, *Macroprudential Oversight: Monitoring the Financial System*, by Darryl E. Getter for more information on systemic risk and "too big to fail."

[5] Greg Ip, "Central Bank Offers Loans to Brokers, Cuts Key Rate," *Wall Street Journal*, March 17, 2008, p. A1.

[6] http://www.aig.com/AIG-Financial-Products-Corp_20_20258.html.

[7] For more information on CDS see CRS Report RS22932, *Credit Default Swaps: Frequently Asked Questions*, by Edward V. Murphy.

[8] For examples, see "Goldman, Merrill Collect Billions After Fed's AIG Bailout Loans," Bloomberg, available at (continued...)

over the counter derivatives, CDS can take any form desired by the two parties writing the contracts in question. In typical CDS contracts, collateral requirements are placed on CDS sellers such that, even before default occurs, the seller may be required to post cash collateral as either the seller's financial condition weakens, or the likelihood of default increases. AIG has been forced to post increasing collateral on the CDS written by AIGFP. These collateral calls were an important factor driving the need for a rescue in September 2008, and a primary motivation for the Federal Reserve's creation of the Maiden Lane III Limited Liability Corporation (LLC) in the November 2008 restructuring of the AIG intervention (see below for more details on these interventions).

Securities Lending Program

Securities lending is a not uncommon practice where the holder of a security agrees to lend a security to another party.[9] Such transactions are, like CDS, done over the counter, rather than on exchanges, and thus can take almost any form desired by the two parties. Typically the borrower provides some form of collateral, often cash, which the lender invests to profit from the transaction beyond whatever fee is paid by the borrower. The timing aspects of the transactions, such as when and how loaned securities are returned, are up to the contract specifics negotiated by the two parties.

Although managed centrally by AIG Investments, the securities for AIG's securities lending have originated primarily from its state-regulated insurance subsidiaries. As of June 30, 2008, 71% of the lending came from AIG's U.S. life insurers and retirement services and 4% from AIG's U.S. property/casualty insurers. In return for lending securities, AIG typically received cash collateral worth between 100% and 102% of the securities being lent and then invested this cash until the loaned securities were returned, at which point the cash collateral had to be returned. In mid-2008, AIG's total liability for the return of securities lending collateral equaled $75.1 billion. The market value of the investments made by AIG with this collateral (largely in mortgage-backed securities) totaled only $59.5 billion.[10] As AIG suffered downgrades and increased market skepticism in Fall 2008, increasing numbers of AIG's counterparties in securities lending agreements returned the original securities and expected return of their cash collateral. This demand for cash led to the Securities Borrowing Facility, announced by the Fed on October 8, 2008, and the creation of the Maiden Lane II LLC in November 2008, as detailed below.

Legal Authority for Assistance to AIG

All Fed assistance to AIG is authorized under Section 13(3) of the Federal Reserve Act, the same emergency authorization used for numerous other Fed actions in the ongoing financial crisis. This emergency authorization was needed because the Fed cannot normally lend to a financial firm

(...continued)

http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aTzTYtlNHSG8 and "Behind Insurer's Crisis, Blind Eye to a Web of Risk," New York Times, Sept. 27, p. A1.

[9] The International Securities Lending Association estimates that the global amount of loaned securities is greater than 1 trillion pounds (approximately $1.4 trillion).

[10] Statistics from American International Group, Inc., *Form 10-Q*, for the quarterly period ending June 30, 2008, pp. 111-112, available at http://media.corporate-ir.net/media_files/irol/76/76115/reports/Q210Q.pdf.

that is neither a depository institution nor a primary dealer. Under the EESA, the Fed is require to report on emergency loans under Section 13(3).[11] Treasury assistance to AIG is authorized under Section 101 of the Emergency Economic Stabilization Act, which authorizes the purchase of "troubled assets" by the Treasury. Part (B) of the act's definition of "troubled assets" defines such assets as "any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability." Treasury is required to report on its transactions under the EESA.[12]

Forms of Assistance for AIG

Initial Loan

On September 16, 2008, the Fed announced, after consultation with the Treasury Department, that it would lend up to $85 billion to AIG over the next two years. Drawing from the loan facility can only be done at the discretion of the Fed, not AIG. A new CEO was put in place after the intervention and Fed staff has been on site with the company to oversee operations. The interest rate on the funds drawn from the Fed was 8.5 percentage points above the London Interbank Offered Rate (LIBOR), a rate that banks charge to lend to each other. AIG also had to pay a flat 8.5% interest rate on any funds that it is does not draw from the facility. The government also received warrants that, if exercised, would give the government a 79.9% ownership stake in AIG. Three independent trustees were to be named by the Fed to oversee the firm for the duration of the loan. The trustees for the AIG Credit Trust were announced on January 16, 2009.[13]

The lending facility was backed by the assets of AIG's holding company and non-regulated subsidiaries.[14] In other words, the Fed can seize AIG's assets if the firm fails to honor the terms of the loan. This reduces the risk that the Fed (and ultimately, taxpayers) would suffer a loss. The risk still remains that if AIG turned out to be insolvent, its assets would be insufficient to cover the amount it had borrowed from the Fed. If AIG is indeed too big to fail, however, it is unclear how its assets could be seized in the event of non-payment without precipitating system-wide problems.

On September 18, the Fed announced that it had initially lent $28 billion of the $85 billion possible. This amount grew to approximately $61 billion on November 5, shortly before the restructuring of the loan discussed below.[15]

[11] Section 13(3) reports can be found at http://www.federalreserve.gov/monetarypolicy/bst_reportsresources.htm.

[12] These transactions reports can be found at http://ustreas.gov/initiatives/eesa/transactions.shtml.

[13] See http://www.newyorkfed.org/newsevents/news/markets/2009/an090116.html.

[14] The regulated subsidiaries are primarily the state-chartered insurance subsidiaries. Thus, if AIG were to default on the loan, the Fed could seize the insurance subsidiary stock held by the holding company, but not the actual assets held by the insurance companies.

[15] Federal Reserve, "Factors Affecting Reserve Balances," Statistical Release H.4.1, Sept. 18, 2008. See http://www.federalreserve.gov/releases/h41/20080918/; and "Report Pursuant to Section 129 of the Emergency Economic Stabilization Act of 2008: Restructuring of the Government's Financial Support to the American International Group, Inc. on November 10, 2008, p. 4. See http://www.federalreserve.gov/monetarypolicy/files/129aigrestructure.pdf.

Securities Borrowing Facility[16]

On October 8, the Fed announced that it was expanding its assistance to AIG by swapping cash for up to $37.8 billion of AIG's investment-grade, fixed-income securities. These securities, belonging to AIG's insurance subsidiaries, had been previously lent out under the securities lending program (described above). As some counterparties stopped participating in the lending program and AIG realized losses on investments it had made with the collateral,[17] AIG needed liquidity from the Fed to cover these losses and counterparty withdrawals. This facility was to extend for nearly two years, until September 16, 2010, and advances from the securities borrowing facility to AIG paid an interest rate of 1% over the average overnight repo rate. As of November 5, 2008, $19.9 billion of the $37.8 billion was outstanding.

Although this assistance resembles a typical collateralized loan (the Fed receives assets as collateral, and the borrower receives cash), the Fed characterized the agreement as a loan of securities from AIG to the Fed in exchange for cash collateral. It appears the arrangement was structured this way because New York insurance law prevents AIG from using the securities as collateral in a loan.[18]

Commercial Paper Funding Facility

The general Commercial Paper Funding Facility (CPFF) was initially announced by the Fed on October 7, 2008, as a measure to provide a liquidity backstop to issuers of commercial paper. Through the CPFF, the Fed purchases both asset-backed and unsecured commercial paper. Rather than charging an interest rate, the Fed purchases the paper at a discount based on the three-month overnight index swap rate. Unsecured paper is discounted by 3%, while secured paper is discounted by 1%. Individual participants in this facility and the amounts accessed are not announced by the Fed.

AIG itself announced that, as of November 5, 2008, it had been authorized to issue up to $20.9 billion of commercial paper to the CPFF and had actually issued approximately $15.3 billion of this amount. Subsequent downgrades of AIG's airline leasing subsidiary (ILFC) reduced the total amount AIG could access from the CPFF to $15.2 billion in early January 2009. ILFC had approximately $1.7 billion outstanding to the CPFF when it was downgraded; this amount was repaid by January 28, 2009. As of February 18, 2009, the reported total outstanding was $14 billion of the $15.2 billion in remaining capacity.

November 10, 2008 Revision of Assistance to AIG

On November 10, 2008, the Federal Reserve and the U.S. Treasury announced a restructuring of the federal intervention to support AIG. Since the initial loan, some, notably AIG's former CEO Maurice Greenberg, had criticized the terms as overly harsh, arguing that the loan itself might be contributing to AIG's eventual failure as a company. As evidenced by the additional borrowing

[16] Terms detailed by the Federal Reserve in "Report Pursuant to Section 129 of the Emergency Economic Stabilization Act of 2008: Securities Borrowing Facility for American International Group, Inc.," available at http://www.federalreserve.gov/monetarypolicy/files/129aigsecborrowfacility.pdf.

[17] Liam Pleven et al, "AIG Bailout Hit By New Cash Woes," *Wall Street Journal*, October 9, 2008, p. A1.

[18] N.Y. Ins. Law, Sec. 1410.

after the September 16 loan, AIG had continued to see cash flow out of the company. The revised agreement points to the tension between making the terms of the assistance undesirable enough to deter other firms from seeking government assistance in the future, compared to making the terms of assistance so punitive that they exacerbates the financial problems of the recipient firm. It also points to the risk that once a firm has been identified as too big to fail, government assistance to the firm can become open-ended, as the original amounts offered were quickly revised upward.

The restructuring eased the payment terms for AIG and had three primary parts: (1) restructuring of the initial $85 billion loan, (2) a $40 billion direct capital injection, and (3) up to $52.5 billion purchases of troubled assets. In addition, AIG continued to access the Fed commercial paper funding facility as described above.

Loan Restructuring

The Federal Reserve reduced the initial $85 billion loan facility to $60 billion, extended the time period to five years, and eased the financial terms considerably. Specifically, the interest rate on the amount outstanding was reduced by 5.5 percentage points (to LIBOR plus 3%); and the fee on undrawn funds was reduced by 7.75 percentage points (to 0.75%).

Direct Capital Injection

Through the Troubled Asset Relief Program (TARP),[19] the Treasury purchased $40 billion in preferred shares of AIG. In addition to the preferred shares, the Treasury also received warrants for common shares equal to 2% of the outstanding AIG shares. AIG was the first announced non-bank to receive TARP funds. The AIG intervention was under a new TARP “systemic significant failing institutions program,” and AIG is the only entity given assistance under this program. The $40 billion in preferred AIG shares held by the Treasury are slated to pay a 10% dividend per annum, accrued quarterly.[20] According to November 10, 2008, AIG filings with the Securities and Exchange Commission, the amount of shares held in trust for the benefit of the U.S. Treasury was to be reduced by the shares and warrants purchased under TARP, so the total equity interest currently held by the U.S. government equals 77.9% held by the trust, plus warrants to purchase another 2% held directly by the Treasury.

Executive Compensation Restrictions

While its financial obligations to the Treasury Department continue, AIG is subject to the executive compensation standards required primarily under Section 111 of EESA for their senior executive officers (SEOs, generally the chief executive officer, the chief financial, and the three next most highly compensated officials). Among the limits called for under EESA are

1. limits on compensation to prevent incentivizing SEOs from taking unnecessary and excessive risks that threaten the value of the company;
2. the recovery of any bonus or incentive compensation paid to an SEO if the financial criteria it was based on was later proven to be materially inaccurate;

[19] TARP was authorized by Congress in P.L. 110-343.

[20] Full details of the preferred shares can be found on the Treasury website at http://ustreas.gov/press/releases/reports/111008aigtermsheet.pdf.

3. a prohibition on golden parachute payments; and
4. a $500,000 limit on the tax deduction that a firm can take for remuneration paid to individual SEOs during taxable years. The limit includes performance-based compensation. (Firms outside of the program are subject to a $1,000,000 limit, which excludes performance-based pay.)

In addition to these general restrictions, Treasury has imposed additional executive compensation restrictions on AIG that are more stringent than for other participants in TARP: for the top 70 company executives, it has placed limits on the provision of golden parachutes payments and a freeze on the size of the annual bonus pool.[21]

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009, which amends Section 111 of EESA to further limit executive compensation for financial institutions receiving assistance under that act, including AIG. As written, the rules appear to be intended to apply retroactively to all TARP recipients and must be adopted by Treasury to be implemented. Among other things, for applicable companies, the new language requires the adoption of standards by Treasury that (1) prohibit paying certain executives any bonus, retention or incentive compensation other than certain long-term restricted stock that has a value not greater than one-third of the total annual compensation of the employee receiving the stock (the determination of how many executives will be subject to these limitations depends on the amount of funds received by the TARP recipient); (2) require the recovery of any bonus, retention award or incentive compensation paid to senior executive officers and the next 20 most highly compensated employees based on earnings, revenues, gains or other criteria that are later found to be materially inaccurate; (3) prohibit any compensation plan that would encourage manipulation of the reported earnings of the firm to enhance the compensation of any of its employees; (4) prohibit the provision of "golden parachute" payment to an SEO and the next five most highly compensated employees for departure from a company for any reason, except for payments for services performed or benefits accrued; and (5) prohibit any compensation plan that would encourage manipulation of the reported earnings of the firm to enhance the compensation of any of its employees.

Purchase of Troubled Assets

While P.L. 110-343 provided for Treasury purchase of troubled assets under TARP, the troubled asset purchases related to AIG are being done by limited liability corporations (LLCs) created and controlled by the Federal Reserve. This structure is similar to that created by the Federal Reserve to facilitate the purchase of Bear Stearns by JPMorgan Chase in March 2008. There are two LLCs set up for AIG—Maiden Lane II for residential mortgage-backed securities (RMBS) and Maiden Lane III for collateralized debt obligations (CDO).[22]

[21] U.S. Treasury, "Treasury to Invest in AIG Restructuring Under the Emergency Economic Stabilization Act," hp-1261, Nov. 10, 2008, available at http://www.ustreas.gov/press/releases/hp1261.htm.

[22] The headquarters of the Federal Reserve Bank of New York sits between Maiden Lane and Liberty Street in downtown New York City.

Residential Mortgage-Backed Securities/Maiden Lane II

Under the agreement, the RMBS LLC/Maiden Lane II can be lent up to $22.5 billion by the Federal Reserve and $1 billion from AIG to purchase RMBS from AIG's securities lending portfolio. The previous $37.8 billion securities lending loan facility was repaid and terminated following the creation of this LLC. The Fed will be credited with interest from its loan at a rate of LIBOR plus 1% for a term of six years, extendable by the Fed. The $1 billion loan from AIG will be credited with interest at a rate of LIBOR plus 3%, however, the AIG loan is subordinate to the Fed's. Any proceeds from Maiden Lane II are to be distributed in the following order: (1) operating expenses of the LLC, (2) principal due to the Fed, (3) interest due to the Fed, and (4) deferred payment and interest due to AIG. Should additional funds remain at the liquidation of the LLC, these remaining funds are to be shared by the Fed and AIG with AIG's insurance subsidiaries receiving one sixth of the value.

On December 13, 2008, the Fed extended an $18.8 billion loan to Maiden Lane II, which purchased RMBS with this amount and the $1 billion loan from AIG. The securities purchased had a face value of nearly double the purchase price ($39.3 billion). As of March 11, 2009, the reported market value of the RMBS portfolio holdings was $18.4 billion.[23]

Collateralized Debt Obligations/Maiden Lane III

Under the agreement, the CDO LLC/Maiden Lane III can be lent up to $30 billion from the Federal Reserve and $5 billion from AIG to purchase CDOs on which AIG has written credit default swaps. The Fed and AIG will be credited with interest from the loans at a rate of LIBOR plus 3% until the LLC is ultimately liquidated. The proceeds from Maiden Lane III are to be distributed in the following order: (1) operating expenses of the LLC, (2) principal due to the Fed, (3) interest due to the Fed, and (4) deferred payment and interest due to AIG. Should any funds remain after this distribution, they are to go two thirds to the Fed and one third to AIG.

On November 25, 2008, the Fed extended a $24.3 billion loan to Maiden Lane III, while AIG has funded the LLC with the $5 billion loan. In addition to these loans, Maiden Lane III purchase of CDOs has also been funded by $9.2 billion in cash collateral previously posted to holders of CDS by AIGFP. In return for the use of this collateral, AIGFP received approximately $2.5 billion from the LLC. The total par value of CDOs purchased by Maiden Lane III is approximately $62.1 billion. As of March 11, 2009, the reported market value of the CDO portfolio holdings was $27.6 billion. At the same time that the CDOs are purchased, the CDS written on these CDOs are terminated, relieving financial pressure on AIG. Some credit default swaps, however, may have been purchased by entities not holding the underlying CDOs; it is unclear how, or if, such credit default swaps written by AIG will be addressed.[24]

[23] Information on Maiden Lane II from the Federal Reserve, "Factors Affecting Reserve Balances," Statistical Release H.4.1, Mar. 12, 2009, available at http://www.federalreserve.gov/releases/h41/Current/, and an AIG press release dated Dec. 15, 2008 available at http://media.corporate-ir.net/media_files/irol/76/76115/releases/121508.pdf.

[24] Information on Maiden Lane III from the Federal Reserve, "Factors Affecting Reserve Balances," Statistical Release H.4.1, Mar. 12, 2009, available at http://www.federalreserve.gov/releases/h41/Current/, and AIG press releases dated Dec. 2, 2008 and Dec. 24, 2008 available at http://media.corporate-ir.net/media_files/irol/76/76115/releases/120208.pdf and http://media.corporate-ir.net/media_files/irol/76/76115/releases/122408.pdf.

March 2, 2009 Revision of Assistance to AIG

On March 2, 2009, the Treasury and Fed announced another revision of the financial assistance to AIG. On the same day, AIG announced a loss of more than $60 billion in the fourth quarter of 2008. In response to the poor results and ongoing financial turmoil, the ratings agencies were reportedly considering further downgrading AIG, which would most likely have resulted in further significant cash demands due to collateral calls.[25] According to the Treasury, AIG "continues to face significant challenges, driven by the rapid deterioration in certain financial markets in the last two months of the year and continued turbulence in the markets generally." The revised assistance is intended to "enhance the company's capital and liquidity in order to facilitate the orderly completion of the company's global divestiture program."[26]

The revised assistance includes:

- Exchange of the existing $40 billion in preferred shares purchased through the TARP program for preferred shares that "more closely resemble common equity," thus improving AIG's financial position. Dividends paid on these new shares will remain at 10%, but will be non-cumulative and only be paid as declared by AIG's Board of Directors. Should dividends not be paid for four consecutive quarters, the government has the right to appoint at least two new directors to the Board.
- Commitment of up to $30 billion in additional preferred share purchases from TARP.
- Reduction of interest rate on the existing Fed loan facility by removing the current floor of 3.5% over the LIBOR portion of the rate. The rate will now simply be three month LIBOR plus 3%, which is approximately 4.25%.
- Limit on Fed revolving credit facility will be reduced from $60 billion to $25 billion.
- Up to $34.5 billion of the approximately $38 billion outstanding on the Fed credit facility will be repaid by asset transfers from AIG to the Fed. Specifically, (1) $8.5 billion in ongoing life insurance cash flows will be securitized by AIG and transferred to the Fed; and (2) approximately $26 billion in preferred interests in two of AIG's large life insurance subsidiaries will be issued to the Fed. This effectively transfers a majority stake in these companies to the Fed, but the companies will still be managed by AIG.

In addition to the new assistance, AIG announced that it was forming a new holding company to include its primary property/casualty insurance subsidiaries. Since the first assistance in September 2008, AIG has sought to sell subsidiaries to repay the loans and reduce its holdings to a core property/casualty business. Such sales have been difficult during the ongoing financial turmoil. By effectively transferring the two life insurance subsidiaries to the Fed and gathering property casualty subsidiaries in a new holding company, AIG is arguably progressing toward this goal.

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[25] See, for example, "A.I.G. Reports Loss of $61.7 Billion as U.S. Gives More Aid," New York Times, March 2, 2009, p. A1.

[26] U.S. Treasury, "U.S. Treasury and Federal Reserve Board Announce Participation in AIG Restructuring Plan," Press Release dated March 2, 2009.

Table 1. Summary of Outstanding Assistance to AIG

Program	Maximum Announced Amount of Government Assistance	Current Amount Advanced by Government	Recompense to the Government/Value of Current Holdings
TARP Share Purchase	$70 billion	$40 billion	10% dividend
Current Federal Reserve Loan	$25 billion (after Mar. 2 restructuring completed)	$42.8 billion	3 month LIBOR+3%
Retired Federal Reserve Loan	$34.5 billion	$0 (transactions yet to occur)	$8.5 billion securities/ $26 billion equity
Commercial Paper Funding Facility	$15.3 billion	$14 billion	three-month overnight index swap (OIS) rate+3%
Maiden Lane II	$22.5 billion	$18.8 billion	$18.4 billion
Maiden Lane III	$30 billion	$24.3 billion	$27.6 billion

Source: Federal Reserve, U.S. Treasury, AIG 10-K Annual Statement

Notes: Dividend paid on shares under TARP is subject to the AIG board approval.

Who Benefits from Assistance to AIG?

While billions of dollars in government assistance have gone to the AIG, in many cases, one can argue that AIG has essentially acted as an intermediary for this assistance. In short order after drawing on government assistance, substantial funds have flowed out of AIG to entities on the other side of AIGs financial transactions, such as securities lending or credit default swaps. If AIG had been allowed to fail and had entered bankruptcy, as was the case with Lehman Brothers, then these counterparties in many cases would have been treated as unsecured creditors and received relatively little for their claims.

Seen from this view, the true beneficiaries of the billions in federal assistance that have flowed to AIG has not been AIG itself, but these counterparties. In the interest of transparency, many have argued that these counterparties need to be identified, so that both Congress and taxpayers can judge the efficacy and fairness of the assistance to AIG. Until March 15, 2009, no such list of counterparties, had been published by the Fed or AIG. Several Senators pressed Donald Kohn, the vice chairman of the Board of Governors of the Federal Reserve, on this point in a March 5 Senate hearing on AIG. Vice Chairman Kohn, however, expressed his judgment that "giving the names would undermine the stability of the company and could have serious knock-on effects to the rest of the financial markets and the government's efforts to stabilize them."[27] Ten days following the Senate hearing, on March 15, 2009, AIG released information detailing the counterparties to many of its transactions.[28] The released information detailed $52.0 billion of direct support to AIG that went to AIGFP related transactions, $29.6 billion in Maiden Lane III CDS-related transactions, and $43.7 billion in payments to securities lending counterparties.

[27] Donald Kohn, answering a question by Senator Christopher Dodd, reported in Federal News Services's transcript of the March 5, 2008 hearing of the Senate Committee On Banking, Housing, And Urban Affairs on "American International Group: Examining What Went Wrong, Government Intervention, and Implications For Future Regulation."

[28] See http://www.aig.com/aigweb/internet/en/files/Counterparties_tcm385-153017.pdf/.

Conclusion

Despite access to up to more than $190 billion in assistance from the federal government, the outlook for AIG appears very uncertain. While one source of the past losses has essentially been neutralized through government intervention, the obligations taken on by AIG through AIGFP's derivative operations continue to be substantial. Particularly if the credit rating of AIG were to be further downgraded, substantial amounts of cash collateral could be required. In addition, AIG is likely to suffer losses on investment portfolios due to the widespread financial downturn. Finally, the long-term effect of the government involvement with AIG is unclear. Potential customers of AIG may conclude that, because of the government backing, AIG is a safe and reliable company to purchase insurance from. On the other hand, such customers might equally well conclude that they do not want to rely on a business that depends on a government support to continue operating.

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