

What Went Wrong at AIG?

Unpacking the insurance giant's collapse.

The collapse and near-failure of insurance giant American International Group (AIG) was a major moment in the recent financial crisis. AIG, a global company with about \$1 trillion in assets prior to the crisis, lost \$99.2 billion in 2008. On September 16 of that year, the Federal Reserve Bank of New York stepped in with an \$85 billion loan to keep the failing company from going under.

Based on the research of Robert McDonald and Anna Paulson

The company's credit default swaps are generally cited as playing a major role in the collapse, losing AIG \$30 billion. But they were not the only culprit. Securities lending, a less-discussed facet of the business, lost AIG \$21 billion and bears a large part of the blame, the authors concluded.

What's more, McDonald and Paulson examined the ^{assumption} assertion that the mortgage-backed securities underlying AIG's transactions would not default. "After the crisis, there was a claim that these assets had been money-good," meaning they were sound investments that may have suffered a decline in the short term but were safe overall, McDonald says. "I was deeply interested in learning whether that was true."

① Risky Credit Default Swaps

Most of the post-mortems of AIG focus on its selling of credit default swaps, which are financial instruments that act like insurance contracts on bonds. In these transactions, the insurance seller (in this case, AIG) in some ways becomes the bond owner.

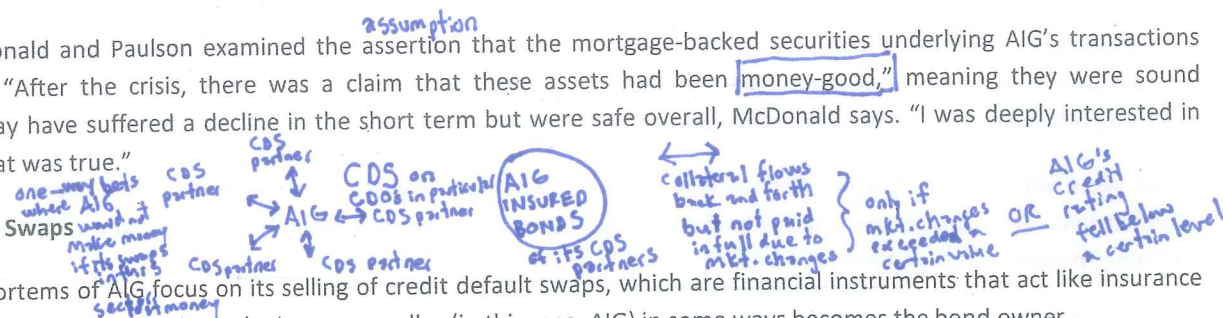
"Think about home insurance," McDonald says. "If you've sold insurance on a house, and the house burns to the ground, you have to pay. The insurance seller has the same risk as an uninsured homeowner." Likewise, if the bonds AIG insured did not pay out, the company was on the hook for those losses.

Over the course of these agreements, the value of the underlying asset will change, and one party will pay the other money, called collateral, based on that change; that collateral can flow back and forth between the two parties as the market moves. AIG's credit default swaps did not call for collateral to be paid in full due to market changes. "In most cases, the agreement said that the collateral was owed only if market changes exceeded a certain value or if AIG's credit rating fell below a certain level," McDonald says.

AIG was accruing unpaid debts—collateral it owed its credit default swap partners, but did not have to hand over due to the agreements' collateral provisions. But when AIG's credit rating was lowered, those collateral provisions kicked in—and AIG suddenly owed its counterparties a great deal of money.

On September 15, 2008, the day all three major agencies downgraded AIG to a credit rating below AA-, calls for collateral on its credit default swaps rose to \$32 billion and its shortfall hit \$12.4 billion—a huge change from \$8.6 billion in collateral calls and \$4.5 billion in shortfall just three days earlier. While this debt kicked in automatically because of the provisions in AIG's agreements, rather than the willful terminations of its securities lending agreements, "it's still a little like a bank run, in the sense that all of a sudden you're in trouble, and the fact that you're in trouble means you get a big call on your assets," McDonald says.

AIG had written credit default swaps on over \$500 billion in assets. But it was the \$78 billion in credit default swaps on multi-sector collateralized debt obligations—a security backed by debt payments from residential and commercial mortgages, home equity loans,



and more—that proved most troublesome. AIG's problems were exacerbated by the fact that these were one-way bets. AIG didn't have any offsetting positions that would make money if its swaps in this sector lost money.

② Securities Lending Rounds Out the Story

McDonald and Paulson's analysis showed that there was more to the problem than just the credit default swaps. Securities lending lost the company a massive amount of money as well.

Securities lending is a common financial transaction where one institution borrows a security from another and gives a deposit of collateral, usually cash, to the lender.

Say, for instance, that you run a fund with a large investment in IBM. "There will often be reasons people want to borrow your IBM shares, and this is a standard way to make a little extra money on the stock you have," McDonald says. AIG was primarily lending out securities held by its subsidiary life insurance companies, centralized through a noninsurance, securities lending-focused subsidiary.

* Companies that lend securities usually take that cash collateral and invest it in something short term and relatively safe. But AIG invested heavily in high-yield—and high-risk—assets. This included assets backed by subprime residential mortgage loans.

* "They had this propensity to invest in real estate," McDonald says. "There was this idea that real estate investments were safe because the securities had a AAA credit rating." In the run-up to September 2008, AIG securities lending business grew substantially, going from less than \$30 billion in 2007 to \$88.4 billion in the third quarter of 2008.

The borrowers of a security can typically terminate the transaction at any time by returning the security to the lender and getting their collateral back. But since AIG had invested primarily in longer-term assets with liquidity that could vary substantially in the short term, returning cash collateral on short notice was not so easy.

"People were worried about AIG in the summer of 2008," when an analyst report suggested the company was in for trouble, McDonald said. "AIG's credit rating had been downgraded by all three major agencies in May and June of 2008, and in August and September, people started to terminate their agreements," asking for their collateral back.

The values of the securities underlying these transactions were falling, due to falling real estate prices and higher foreclosures, and AIG did not have enough other liquid assets to meet all the redemption requests. And just as a possibly crumbling bank can lead depositors to withdraw their cash in a hurry, AIG's weakened stance led even more securities lending counterparties to return their securities and ask for their cash—which left AIG worse off still.

Not "Money-good"

Problems in both its securities lending business and its credit default business made AIG doubly vulnerable—and meant it had a great deal of outstanding debts. Wherever counterparties could extract themselves from existing business, or not roll over existing agreements, they did: "Everyone wanted to unwind their position with [AIG]," McDonald says. And because of that, the firm "simply had to supply billions of dollars they couldn't easily come up with."

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