ACCOUNTING RESEARCH PAPER

AIG Liquidity crisis

Submitted to:

Sir Haroon Rashid

Submitted By:

Ayesha Younis

Sehrish Akhtar

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ABSTRACT:

This research paper analysis the causes and effects of the financial crisis that recently occurred in the USA. We limit our research to the effects this crisis had on American International Inc (AIG).AIG encountered a liquidity crisis following this national crisis. The Federal Reserve Bank offered the troubled Insurer a bailout under certain terms and conditions, which are discussed in this research paper.

INTRODUCTION

AIG, American International Group Inc. is American largest insurance company. It was founded in 1919 in Shangai, China. It serves in USA and worldwide (about 130 countries) though a network of head offices in NY, London,Paris and Hongkong. AIG was rated 18th largest public company in the world. Apart from its man field of business, that is General Insurance & Retirement services, it also offers financial services.

The subprime mortgage crisis in the USA preceded the bigger financial crisis, which casted a dark shadow on every business & financial institution of USA. Business giants like Lehman Brothers declared bankruptcy following this crisis. Merill Lynch was bought by the bank of London.

AIG'S financial product Unit, in the recent years issued many CDS, which provide a protection to the buyer in case of any default in specific assets, including subprime mortgages. As a result of the subprime mortgages crisis, the value of the CDS market, faced a loss of $18billion, corresponding to this decline plus it had to put up billions of collateral. The pressure was doubled by AIG credit downgrading. After seeing the impact of decline of Lehman Brothers, the Federal Reserve Bank offered a bailout for AIG in Sep. worth $80billion. The bailout was restructured accompanied by a credit facility in November.

LITERATURE REVIEW[1]

Jerry J. Weyghandt, Donald E. Keiso and Walter G. Kell in their book" Accounting Principals" state "liquidity" as: It is an ability to pay obligations that one expected to become due within the next year or operating cycle.

Austin Murphy (2008) found out the basic cause of the financial crisis faced by the U.S economy. According to **Mr. Murphy**, wrong assumptions regarding the pricing in the huge market of Credit Default Swaps was the core cause of this financial crisis. The increase in residential Mortgage defaults hit hardly upon the CDS market, soaring billions of investments. He found the bailout on expensive way of dealing with this problem.

Stephen Saver(2007),by analyzing in detail the stock market crash in 1987 , the LTCM crisis in 1998 and financial market instability in Sep 2001 , found that the central bank especially the federal reserve should take into notice the interbank market, before providing bailouts or other facilities to. Otherwise instead of solving liquidity problems, it will instabilize the prices of various commodities.

Eric Dickinson(2008)found out that CDS , though very valuable , enable a few participants of the market to shake the whole economy. In his paper, he shows how CDS pose a threat to the economy and whether CDS had something to do with the rise in mortgage backed securities asset bubble, which further caused the present financial crisis. Another greater risk posed by CDS is that they have the power to destabilize huge business institutions, such as the trillion

[1] Source:www.wikipedia.com

dollar company **AIG**. He found that if the participants of the CDS market maintain a huge capital reserve, and confidently keep the Federation aware of their current CDS position and if banks do not extend credit to unworthy borrowers, then a crisis can be averted. **Dickinson's** proposed measures although, costly for market participants and society yet promise a stable, highly beneficial economy.

M.Turnbull, **Crouchy** and **A.Jarrow**(2008) found out that the factors which supported the Financial crisis of -07 were search for higher profit, inability of rating agencies to detect a change in conditions, defects of valuation model, failure in the regulatory management to assume the expected crisis, plus poor risk management systems of huge institutions.

Ashok Bardhan (2008) found out that the financial crisis triggered by the disability in the housing market and increased foreclosures, has started casting it's shadow over **Fannie** and **Freddie**, the government sponsored enterprises, various banks and financial institutions that are members of the mortgage market. This financial crisis further caused global imbalance and inflation.

Bebchuk (2008) through his research criticized the government's way of dealing with the financial crisis i.e. providing emergency credit facility worth $700 billion US dollars. He proposed a comparatively cheaper and effective plan to address this crisis. The main points of this plan were that troubled assets should be bought at fair market price. Buying troubled assets at fair market would surely leave firms undercapitalized; to deal with this the National treasury should extend purchaser but that too on fair market price. Plus the firms should raise capital by making the right offer to their shareholders instead of generating funds from public sector.

METHODOLOGY:

Our research paper is based on qualitative analysis of the liquidity crisis faced by AIG. The following sources were used for this research:

- Websites
- Online newspaper articles(Advisen)
- Research papers of scholars

The websites plus the citation of the articles are given in the references.

FINDINGS

Causes:

1. Bursting of U.S Housing bubble & the subprime mortgage crisis:

The bursting of housing bubble in the U.S, led to a credit and housing market instability. It posed a great risk to the U.S economy. The increase rate of foreclosures & interest rate further led to a subprime mortgage crisis, which as a matter of fact is a financial crisis, hitting hard all the business related to CDO (collateralized debt obligation) mortgage, credit & foreign bank market.

2.CDS transactions:

CDOs are securities backed by pools of mortgages or other assets[2]. The credit crisis has decreased the value of these securities.*CDS or credit default swaps are financial instruments or contract*[3] the protect the client against the deterioration in the value of the asset bought. It is obligatory for the sellers of the CDS to pay the clients in case of any deterioration in the value of the concerned asset.

AIG unlike other insurance groups earns revenues from business not related to simple provision of insurance. One of its businesses is the **AIG** financial services that issues CDS on assets related to cooperate debt and mortgage securities.

Being on active member of the CDS market **AIG** financial services issued many CDS from 2005-2008 worth billions. As a result of the subprime mortgage crisis, it became obligatory for **AIG** to post billions of dollars in collateral.

A point worth mentioning is that the bursting of the housing bubble was predicted since the start of 2006. The company officials should have estimated by viewing the CDS portfolio that they would have to face a massive loss if they keep on issuing CDS tied to cooperate debt & mortgage securities. Since the start of 2008 this loss was expected, yet no satisfactory step was taken to avoid or to reduce its magnitude.

IMPACT OF THE CRISIS:

1. Impact on the financial market:

Following the subprime mortgage crisis, all financial institutions of the U.S suffered badly. On 6th of Sep'08 the government took over **Fannie Mae** and **Freddie Mac**. On Sep 14th 2008, the

[2] Source:www.wikipedia.com
[3] Source:www.wikipedia.com

Massive Wall Street, institution, Lehman Brothers declared bankruptcy. While **Merill Lynch** bank was taken over by Bank of America. This effect spread globally, as many of U.S financial institutions have international corporate business.

2. Impact on AIG

Being an active port of the CDS market, AIG forced a huge loss. The stock prices of AIG shares have been declining for 2 quarters now. It is difficult to calculate the exact magnitude of the decline or its value keep on changing on daily basis. According to a recently published online article, written by Mathew Karnitschnig, **AIG** has faced 94% decline in share prices.

AIG had quite enough in the form of non liquid that could be sold to earn cash, but the time to post the collateral was too short not enough to sell to asset. So it can be said that AIG is facing a liquidity crisis not a capital crisis. The recent credit downgrading of AIG by the rating companies have intensified its liquidity crisis, forcing it to past collateral of about 14.5 billion.

Initially **AIG** officials planned to raise funds from private sector banks but raising such a large amount is anything but possible.

It must be noted here that AIG is facing losses in the corporate sector, not in its regular insurance business level. As the losses faced by the main parent body of **AIG** continue to pile up, the regulated subsidiaries of **AIG** are not forcing much of a risk. This is because of the manner in which AIG is structured. These regulated units have assets to pay the claims of their respective customers and under the U.S law; the main body cannot shift these assets to meet its own financial needs. To do this approval of regulatory units is required.

As explained earlier the point where AIG losses occurred is its financial services segment. General insurance segment was the only segment where AIG had a profitable business in second quarter of 2008(Refer to annexure for financial statements).Though this profit was less than the profit earned in the same segment last year. In 2nd quarter of 2008 a loss of $5.91(taken in billions) occurred in the financial statement. The deteriorating position of AIG in 2008 can be speculated from the point that AIG faced a loss in only one sector in 2007 corresponding to a profit in only one sector in 2008.Crisis in capital market was the main cause of loss in the financial services segment, while consumer finance contributed a little to the loss. Aircraft leasing department of financial services segment had profitable business, reducing the less to some extent. This department was bought in 1990, under the instruction of the CEO of AIG, Mr. Maurice.R.Hank Greenberg. His efforts made AIG different from the rest of the insurance companies. Undoubtedly, the loss AIG faced could have been greater if IAG had not had the Aircraft Leasing Department.

Federal Relief Funds

The Fed developed a soft corner for AIG and on Sep 16 2008 offered AIG a loan worth $85 billion from the Federal Reserve Bank because they knew that the decline of the American largest insurance company was going to have a massive impact on the U.S economy. As a part of the deal the government will get hold of 79.9% equity of AIG plus the right to make some important decisions. As a part of the deal the then CEO of AIG, Mr. Williamstad was replaced by Mr.Liddy.

The Federal Reserve Board held a restructuring of the loan in November according to an online article of Advisen:

"These new measures establish a more durable capital structure, resolve liquidity issues, facilitate AIG's execution of its plan to sell certain of its business in an orderly manner, promote market stability and protect the interest of the U.S government & taxpayers"

Initially AIG was given 2 years time period to repay the loan. Under the restructuring process, this period was extended to 5 years term plus a 5 % reduction in interest rate. In addition to that a government aid of $150 billion further lifted the pressure from the insurer. $60 billion of this aid was a loan, $40 billion investment and $60 billion in capital.

CONCLUSION

The crisis faced by AIG was a result of accrued losses from the special financial instruments called CDS (credit default swaps).AIG's subsidiary, AIG financial services, issued CDS worth billions, tied to the mortgage market. The recent meltdown in the housing market of USA, led to a decline in the value of these contracts.AIG had to post billions in collateral in a short span of time, although AIG had assets worth a lot, but it was a matter of unavailability of liquidity. The loan from Federal Reserve Bank and the credit facility from the government temporarily stabilized the insurer and provided AIG with sufficient time to increase its liquidity

The AIG Liquidity Crisis and Its Impact on the Insurance Market

An Advisen Briefing

Essence: *Liabilities incurred under sophisticated financial instruments ravaged American International Group. As AIG teetered on the verge of bankruptcy Monday and Tuesday, brokers were flooded with calls from nervous AIG policyholders. However, the financial strength of AIG's insurance subsidiaries was not threatened: insurance regulations insulated the insurance entities from the losses. Tuesday evening the U.S. government announced an $85 billion loan to the company, averting a collapse. Assuming AIG's customers don't abandon the company in large numbers, the long-term impact of the crisis on the insurance pricing cycle should be minimal.*

What went wrong?

AIG is often described as an "insurance giant," but the company also derives income from businesses unrelated to traditional insurance products. The crisis at AIG is driven in large part by losses on a type of financial instrument called a credit default swap (CDS) issued by AIG Financial Services, a unit separate from the insurance businesses. A CDS operates something like an unregulated insurance contract. It provides protection against a default on assets tied to corporate debt and mortgage securities. Losses under these instruments – which at this point are accrued losses rather than paid losses – were triggered by the meltdown of the subprime mortgage market. AIG is one of the largest players in the CDS market, with almost $600 billion of gross notional exposure in "super senior" credit derivatives, including $80 billion tied to subprime mortgages.

The crisis at AIG is a "question of liquidity, not of capital," according to Rob Schimek, EVP and CFO of AIG Property Casualty Group. Although there have been few losses paid under the CDSs, contract provisions require AIG to post collateral in cash if the value of the assets underlying a CDS deteriorates. At the parent level, AIG has nearly $80 billion in shareholder equity, but most of that is locked in the company's insurance operations and cannot be liquidated to meet the collateral calls of the financial products unit. Schimek cites $26.7b in statutory policyholders' surplus for U.S. commercial lines with international commercial lines and personal lines having additional surplus. U.S. regulations prevent the parent from taking dividends from insurance subsidiaries of more 10 percent of policyholders' surplus in a given year. That is good news for AIG policyholders – the assets of the insurance companies are all but untouchable – but it means that as the demand for collateral grew, AIG found itself in a bind with few alternatives available to quickly raise the necessary cash.

AIG's need for cash reached crisis proportions just as a tidal wave of defaults under subprime mortgages was causing chaos throughout the world's financial markets. As a precursor to the AIG situation, on September 6th government regulators seized mortgage giants Fannie Mae and Freddie Mac. On September 14th, a 150 year-old Wall Street institution, Lehman Brothers, declared bankruptcy and rival investment bank, Merrill Lynch, agreed to be acquired by Bank of America.

On September 11th S&P placed AIG Holding's credit ratings on negative watch forcing AIG to raise yet more cash. Over the weekend AIG was unable to raise enough cash to deal with these increasing obligations, and on September 15th the major credit rating agencies cut its ratings. The rating downgrades significantly exacerbated AIG's already dire situation, triggering contract provisions that required the company to post $14.5 billion in collateral. Since it did not have enough cash to meet the collateral demands, the company faced bankruptcy protection and Chapter 11 reorganization.

The Fed steps in

Initially, federal officials, other regulators and AIG tried to access the capital markets to alleviate the liquidity crisis. When that failed, the government announced it would provide AIG an $85 billion loan. The Federal Reserve said in a statement that it determined that a failure of AIG could hurt the U.S. economy and financial markets already reeling from subprime losses. In return for the loan, the government will receive rights to a 79.9 percent equity stake in AIG. Warrant triggers and other loan terms are still being finalized.

AIG will pay interest at 8.5 percentage points above the three-month London Interbank Offered Rate, or about 11.4 percent. The steep interest rate gives AIG incentive to quickly sell off assets to pay back the loan. According to Schimek, AIG had intended to hold an investor meeting on September 25th to discuss the process of selling assets. The list of likely assets, according to Schimek, does not include core insurance assets. Speculation is that the first properties on the block will be the company's profitable aircraft leasing arm, its stake in reinsurer Transatlantic Holdings, and its consumer lending and variable annuities businesses.

While the company has made no comments about which assets will be sold, the magnitude of its liabilities suggests AIG may sell at least some insurance subsidiaries. The most likely U.S. candidates are those companies that are comparatively autonomous and which serve well-defined sectors such as Hartford Steam Boiler Inspection & Insurance Company (boiler & machinery specialist), 21st Century Insurance Company (personal automobile business in 14 states) and Audubon Insurance Company (personal and small commercial lines in 12 states). Other AIG insurance units are deeply entwined through interlocking business models and inter-company pooling arrangements that would have to be disentangled before selling the companies as discreet entities. The National Union Inter-Company Pool, for example, has nine companies including flagship commercial lines carriers National Union and American Home. These companies represent the core of AIG's presence in the property & casualty market and are unlikely to be sold except under extremely dire circumstances. Several companies already have expressed interest in, or are seen as likely candidates for, portions of the insurance operations. C.V. Starr, a company led by former AIG CEO Maurice "Hank" Greenberg, stated in a SEC filing on Tuesday that it was pursuing options to acquire some or all of AIG. Munich Re chief executive Nikolaus von Bomhard said in a newspaper interview that the German reinsurer is interested in a number of AIG's assets. Acquisitive Japanese and Australian insurance groups are likely bidders for pieces of the insurance business.

Insurance industry impact

According to an informal poll of insurance brokers, of those AIG insureds that contacted their brokers on Monday and Tuesday, about one third requested their brokers get quotes from AIG's competitors. There was little reason for panic, however. AIG's insurance operations are insulated from the losses in other segments of the company by insurance regulations that essentially wall off insurance company assets. The parent company was in trouble, but the insurance entities were profitable, and their balance sheets were unaffected.

Though their statutory financial statements were unchanged, A.M. Best downgraded the financial strength ratings of the domestic property & casualty subsidiaries to A (Excellent) form A+ (Superior). Edward M. Liddy, AIG's new CEO, and other top management have been meeting with ratings agencies, some of which have moved AIG from negative outlook to developing as a result of the loan from the Fed. A.M. Best, however, has announced that it is not ready to revise its outlook. "A.M. Best believes it is premature to declare financial stability to such an extent that a change in outlook or ratings is warranted," the rating agency stated in a press release.

Presumably the loan from the Fed will assuage the concerns of nervous policyholders and avert a wholesale exodus of AIG insurance customers. The downgrade in Best rating may encourage some insureds to diversify their programs, but it now is less likely that the company will lose a significant number of customers over the long term. If there is a massive market dislocation caused by a stampede of AIG policyholders, it will likely lead to a sudden, short term up-tick in commercial insurance rates. But if the market responds calmly, prevailing soft market conditions are likely to be unaffected. AIG's losses under credit default swaps have no impact on statutory policyholders' surplus, which equates to "supply" in the insurance supply-and-demand equation. The insurance industry remains overcapitalized, which barring a massive natural catastrophe should continue to exert downward pressure on rates at least through 2009.

The most significant impact of the AIG crisis would result from a sale of AIG insurance entities to companies with different business models and risk appetites. AIG has been an engine for product innovation, and was sometimes seemingly fearless in its willingness to assume risk. If AIG's insurance operations were acquired by more conservative companies, insurance buyers would stand to lose the far-reaching benefits of the company's innovations in the management and financing of risk, as well as the integrated delivery of global insurance solutions.

This Briefing was written by David Bradford, Executive Vice President and Editor-in-Chief, dbradford@advisen.com, 212.897.4776.

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AIG, Fed stemming insurer's liquidity crisis

A financing entity purchases $46.1B in troubled AIG debt securities, ending insurer's need to post additional collateral. AIG still looking to buy another $18.6B.

By Tami Luhby, CNNMoney.com senior writer
Last Updated: December 3, 2008: 6:54 AM ET

AMERICA'S MONEY CRISIS

- Homebuyers get a bonus in the stimulus bill

- Regulators back corporate credit union deposits
- Starbucks to close 300 stores as profit tumbles
- Mass layoffs hit seven-year high
- Employers cut 14,100 more jobs

Quick Vote

Can the Big Three make vehicles that Americans want to buy?

- Yes, if they get a bailout
- Yes, if they file for bankruptcy
- No

Vote or View results

NEW YORK(CNNMoney.com) -- Troubled insurer American International Group moved another step closer to stabilizing its finances on Tuesday.

The company announced that a financing entity -- funded by the Federal Reserve Bank of New York and AIG -- has purchased $46.1 billion in complex debt securities insured by AIG. As part of the deal, the insurance-type contracts, called credit default swaps, were terminated.

The insurer also has agreements to purchase another $7.4 billion of these debt securities, called collateralized debt obligations or CDOs.

The move stanches some of the bleeding at the insurer, which was on the verge of bankruptcy in September because of these CDOs. As the debt securities' value declined, AIG (AIG, Fortune 500) was forced to post more collateral to prove to swaps holders it could pay them if the debt securities defaulted.

The termination of the swaps ends AIG's obligation to post additional collateral, which it could not afford to continue doing.

The creation of the financing entity was unveiled last month as part of a broader restructuring of the federal government's bailout of AIG, which originally included an $85 billion bridge loan and $37.8 billion in Fed financing.

The entity now has $15.1 billion in Fed money and $5 billion from AIG. The Fed will ultimately double its commitment.

The money will be used to buy a total of roughly $65 billion of the debt securities at their current market price, which is far below their principal value. The deal calls for the swaps holders to keep the collateral posted by AIG, which totals nearly $26 billion, according to a filing with the Securities and Exchange Commission.

In addition to this financing entity, the restructured bailout calls for the government to: buy $40 billion in preferred stock in AIG; lend the company $60 billion over five years; purchase up to $20.9 billion of AIG's short-term debt, called commercial paper, and fund a second financing entity with $22.5 billion to purchase residential mortgage-backed securities AIG had invested in in its securities lending business.

AIG is seeking to sell its sprawling global operations, which had $1 trillion in assets, to repay the government. It hopes to keep its property and casualty businesses and a majority stake in its foreign life insurance division. ■

AIG, facing liquidity crisis, seeks Fed lifeline

(Agencies)
Updated: 2008-09-15 19:43

Comments(1) Print Mail

NEW YORK -- Insurer American International Group Inc (AIG.N), working to stave off rating downgrades and shore up the capital of its holding company, has made an unprecedented approach to the Federal Reserve seeking $40 billion in short-term financing, the New York Times said.

Chief Executive Robert Willumstad reached out to the Fed late on Sunday, according to reports in the Times, the Wall Street Journal and business news channel CNBC.

AIG's scramble to secure a Fed lifeline came late into one of the worst-ever days on Wall Street, with Lehman Bros on the verge of collapse, and Bank of America moving to takeover Merrill Lynch & Co.

The Fed normally oversees monetary policy and supervision of banks, but CNBC said AIG was seeking the funds as a temporary measure and planned to repay the Fed with the proceeds from asset sales.

Rating agencies have threatened to downgrade AIG's ratings by Monday morning, said the New York Times.

AIG officials did not immediately respond to requests for comment.

The company, until recently the world's biggest insurer by market capitalization, has been attempting to hammer out an emergency strategic plan after its shares fell nearly 50 percent last week on fears it faced a liquidity crisis.

AIG has been negotiating with various parties including officials from the New York Insurance Department and private equity firms as it seeks ways to free up capital, raise new capital and protect policyholders.

Regulators including New York Insurance Superintendent Eric Dinallo have been holed up at AIG's New York offices over the past two days trying to hammer out a plan.

"We are working to craft a solution to protect the company and policyholders," said a person from the New York Insurance Department, who asked not to be named.

Former AIG CEO Maurice "Hank" Greenberg, who ran the company for nearly four decades, was not involved in any of the discussions, said his spokesman, Glen Rochkind.

"He repeatedly offered to assist in any way he could," added Rochkind.

CASH CRUNCH

AIG, hit by $18 billion in losses over the past three quarters from guarantees it wrote on mortgage derivatives, has had to act quickly after Standard & Poor's said on Friday it may downgrade AIG's ratings.

Ratings downgrades could force AIG to post up to $14.5 billion more in collateral, according to a regulatory filing last month.

Downgrades could also be detrimental to AIG's insurance business, since some policies carry clauses that nullify a contract in the event of downgrades below a certain level.

Over the weekend, the insurer has been working on a three-part plan involving asset sales, shifting regulated capital from the insurance operations to the holding company, and working with private equity investors, said a person familiar with the negotiations.

The New York Times said AIG's plans to shift capital had to be put on ice because of the time and complexity involved, and that private equity firms withdrew interest over the company's precarious financial health.

Parties in capital-raising talks with AIG included buyout firms Kohlberg Kravis Roberts & Co and J.C. Flowers & Co, another person familiar with the talks said.

An AIG spokesman earlier confirmed the company was evaluating a wide range of options, including asset sales.

Media reports have said that one of the companies on the block was AIG's highly profitable aircraft leasing arm, but the spokesman declined to confirm this was the case.

In late June, AIG said the unit, International Lease Finance Corp, would remain part of AIG.

AIG was founded in China 89 years ago. In the years since, largely under Greenberg's watch, it grew into one of the world's largest insurers, spanning 130 countries and territories and serving 74 million customers.

Greenberg stepped down in 2005, in the midst of an accounting scandal. His successor, Martin Sullivan, was replaced by Willumstad in June after investors grew disgruntled over its three quarters of losses.

Greenberg owns or controls about 12 percent of AIG's stock, making him the largest shareholder.