



Editor: Daniel Zhao

Danyang.Zhao@stern.nyu.edu

IAG Insider Team

Daniel Zhao

Ken Knight

Lionel Yu

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There seems to be much truth to the phrase "March Madness". For the better part of last month, the scandal centered on AIG bonus payouts has consumed the nation. Genuine popular outrage and disgust are in the air (almost like those associated with

with torches and pitchforks), backed up by the House overwhelmingly passing a bill to institute a "punishment tax" of 90% on the bonus of executives whose firms received more than \$5 billion in bailout money. Let's take an in-depth look at AIG and find out how AIG got into the mess it finds itself in today and dispel some popular misconceptions about the firm.

AIG of today is essentially made up of two components - the good part and the bad (a gross understatement) part. Despite how its recent woes, probably 95% of AIG is actually a well-run, conservatively-operated, and AAA rated insurance company that made money the old fashioned way. AIG is the largest underwriter of commercial insurance in the country. Its products include life, real estate, and auto insurance. AIG's main client base is the everyday American people. This part of AIG is simple enough that even your editor can easily understand the business model: AIG collected insurance premiums, invested them in prudent investments, and paid out indemnities when calamities occurred, keeping the remainder as profit. The laws of statistics guaranteed a steady income for the firm. This part of AIG is no worse than a company like Warren Buffett's Geico. The "good insurance company" is complemented by a "bad hedge fund" of AIG's Financial Products (AIGFP) Division that specialized in credit default swaps and other risky derivatives. AIGFP's existence was little regulated and its operations even less transparent. AIGFP essentially operated as a structured finance hedge fund selling an

absurd amount of credit default swaps to other hedge funds, investment bank trading desks, and general speculators, a very different crowd from the average American purchasing a life insurance product. Essentially, a credit default swap (CDS) is almost similar to an insurance policy. **A CDS is a derivative where the buyer would make fixed and predetermined periodic payments to the seller of the instrument, in return receiving a payoff should the financial instrument protected under the CDS defaults.** However, unlike an insurance policy, buyers of CDS are not required to actually own the underlying financial instrument. In other words, buyers of CDS are often pure speculators rather than prudent investors seeking to protect their investment. The CDS market is thus a zero-sum game between buyers and sellers.

Under the directions of Mr. Joseph Cassano - who aggressively pushed for the company to seek new revenue sources - AIGFP had underwritten over \$440 billion worth of CDS against less than \$200 billion in assets of AIG. Mr. Cassano's division was able to accomplish this absurdity because it leveraged the up-until-now sterling reputation of AIG and its AAA credit rating. AIG's biggest customers, hedge funds and investment banks, bought the swaps to insure against defaults on a variety of debt holdings, including pools of toxic mortgages and corporate loans. Because of the way AIG wrote its swaps, and because the company's credit rating, it did not have to put up collateral to assure its customers that it would be able to pay on the insurance if necessary. Collateral would be required

Taking it to the next level.

only if AIG's credit rating were cut - an unthinkable event a few years ago. During the peak of the housing bubble, AIGFP became a star division, pulling in billions in profits, while Mr. Cassano was made a centi-millionaire. In fact, Mr. Cassano once boasted that "it is hard for us . . . to even see a scenario within any kind of realm of reason that would see us losing even one dollar." Mr. Cassano's extreme confidence was based on the complex mathematical models that AIGFP's quantitative analysts have developed to calculate the expected return the division's CDS portfolio. Mr. Cassano and his division firmly believed that CDS could provide the same level of steady and almost risk-less income as normal insurance products, except at a much higher margin.

The "unthinkable" indeed occurred in 2008. In hindsight, AIGFP had grossly underestimated the correlation of default rates on financial instruments during a severe downturn in the economy. Unlike car accidents or other misfortunes in life where the probability of the misfortune occurring are fully independent of each other, defaults and subsequent write-downs on different CDOs containing sub-prime real estate loans collectively skyrocketed as housing prices collapsed in 2008. AIGFP soon found itself in a death spiral. AIG was initially forced to payout an ever increasing amount of "coverage" to its clients on the CDS. The payouts seriously undermined AIG's total financial position and soon rating agencies began to question AIG's AAA rating. As the financial crisis deepened and defaults soared, AIG was downgraded numerous times. The downgrades proved to be the fatal blow to AIG. Suddenly, AIG had to cough up collateral even on higher-quality debts that it guaranteed - those did not nor are in reasonable danger of defaulting. Such collateral requirements further undermined AIG's cash position and led to further loss of confidence and invited further downgrades, accelerating the vicious cycle and leading to complete insolvency. In September of 2008, the Federal Reserve intervened and injected \$85 billion into AIG in exchange for an 80% stake, and the rest is history. To date, the US

government has pumped more than \$200 billion of taxpayer money into the black hole that is known as AIGFP's CDS book. Never before had the actions of so few resulted in a loss for so many. Had AIG never entered the CDS business it would most likely still be profitable, and definitely still solvent.

The irony is that the overwhelming majority of government money entered and left AIG as if going through a revolving door, ultimately going to AIG's counterparties - hedge funds, investment banks (Goldman Sachs, Merrill Lynch and even foreign banks like Societe General and Deutsche Bank), and private speculators, the vast majority of whom never owned a single CDO but simply speculated on their default. To date, AIG and the Federal Reserve have been stubbornly unwilling to reveal the exact identity of and the amount owed to AIG's counterparties. Why is this the case? Some sources have estimated that \$25 billion had gone to Goldman alone! Clearly the authorities do not want angry taxpayers with torches and pitchforks marching to the steps of Capitol Hill should the truth be known to all. The question every self-respecting taxpayer should be asking himself is why exactly these firms and speculators are being made whole at taxpayer's expense. Hedgies, investment bank trading desks, and speculators, by buying a CDS (an unregulated financial product in a chaotic market) from AIG, assumed a risk that AIG would default and unable to make its payouts. This risk was assumed freely and by buyers of CDS alone, not by the taxpayers. The Federal Reserve and Treasury Department's actions amounts to nothing less than a backdoor bailout of entities including foreign investment banks with American tax dollars! Further, exactly what regulators were doing for all of these years while the CDS market functioned like the Wild West? Why are speculators (anyone who does not own the underlying asset) allowed to gamble on CDS? Can Goldman dig any deeper in at the Treasury? These are the hard questions to which a justly angry citizenry demand an answer.