MVE220 FINANCIAL RISK

AIG near bankruptcy

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AIG stock price 1 Jan 2007 – 1 Jan 2010

Ylldrin has done the most research on the first parts and Anna on the later parts. Introduction and discussion is mutually written by the group members. Every part has been discussed and agreed on.

Contents

1. Introduction

How did American International Group (AIG) get in such a big crisis that almost led to bankruptcy? Why did the Federal Reserve bail them out? Which were the underlying reasons? Was the Federal Reserve's intervention correct? This is questions we have asked ourselves when writing this report and has tried to answer those questions.

During the financial crisis in 2008 many companies went bankrupt, AIG stood on the edge of meeting the same destiny but was saved by the American Federal Reserve. The main reason was, according to the Fed that AIG was too interconnected with other companies around the world to fail. The world's financial market would have suffered too much if AIG filed for bankruptcy.

We have put some focus on the background in the report, which concerns what kind of financial instruments AIG was dealing with. This is later connected to what really happened with AIG and our hope is that the case study will be more understandable with an explainable background.

At last we discuss our thoughts about the crisis, bailout and AIG's businesses overall.

2. Background

In this part we will be describing some facts about AIG, CDS, CDO, ratings and the financial crisis to make it easier to understand the case of AIG and their bailout.

2.1. AIG

The start of the American International Group (AIG) is considered to be 1919. Cornelius Vander Starr, born in Chicago with Dutch parents, founded a general insurance agency in Shanghai, called the American Asiatic Underwriters. It wasn't until the company opened its first U.S. office in New York that the name was changed to American International Underwriters. During the 1960s, the company changed its name again, this time to the name it still has.

AIG today is an insurance corporation which operates in more than 100 countries around the world. It is the biggest underwriter of industrial and commercial insurance, though it sells insurances in almost all industries, from travel insurance to real estate insurance (www.aig.com, 2012)

2.2. Credit Default Swap

In the financial world, one can insure his derivatives. This is called CDS, credit default swap, which is a financial switch agreement. It can easily be described like the seller of the CDS compensates the buyer of the CDS in case the reference entity defaults (F.A. Longstaff, S. Mithal & E. Neis, 2005). The reference entity might be a company or a government. The buyer pays the seller quarterly, and continues doing that until the reference entity defaults or until the contract expires (P. Wissén, U. Wissén, 2011) If the reference entity defaults, the buyer of the CDS gets a payment from the seller.

An important thing to know is that one does not have to own the financial instrument to buy a CDS. This means people are able to buy insurance for a "product" they in fact do not own (F.A. Longstaff, S. Mithal & E. Neis, 2005) .It's like a form of financial betting; but now you bet on the slowest horse to lose and really hope he is as slow as usual.

2.3. Collateralized Debt Obligations

A collateralized debt obligation, CDO, is a form of a structured credit instrument. It is asset-backed secured, which means its value is "backed up" by a pool of underlying asset. Its collateral is generally a portfolio of bonds or bank loans. A CDO consists of several tranches, which offer different degrees of risks and returns (D. Duffie, N. Gârleanu, 2001).

In simple terms, one could say that a CDO is like a vow to pay an amount of money to investors. This is done in pre-determined series. Of course, the amount of money depends on how much money the CDO gets from the underlying assets. The whole CDO-system is possible as long as investors are prepared to invest money, which is used to buy the group of assets the CDO owns(D. Duffie, N. Gârleanu, 2001)]. In other words, the CDO needs money invested in its foundation, which hopefully results in a good return.

The CDO has been used for about 35 years, with a major upswing year 2000. When the subprime mortgage crisis hit the world in 2007, the CDO volume dramatically fell. This was due to the subprime mortgage-backed bonds, which were the assets in many of the CDOs (P. Wissén, U. Wissén, 2011) One could say that a CDO is something similar to a fund, with the main difference that the CDO itself is salable, whilst a fund is a portfolio of different salable stocks, bonds etc.

2.4. Rating

Credit rating measures the risk that a borrower defaults on the debt by not being able to perform the payments it's obliged to do(R. Cantor, F. Packer, 1994). Credit ratings mainly concern big companies and governments. The rating is done by credit ratings agencies, and is of great importance to the investors.

Key figures, past remarks and events that might disturb the company's business is of importance when rating a company (R. Cantor, F. Packer, 1994). The rating is done on a financial instrument to the company, such as a bond, and consists of combinations of the letters A, B, C and D. The biggest rating agencies use AAA (or a similar form like Aaa) as the best "grade", and the scale then goes downwards from that. A rule of thumb is that everything below BBB/Baa is not good investments (R. Cantor, F. Packer, 1994).

2.5. Financial crisis

The worst financial crisis since the Great Depression occurred just a few years ago. It all started with the housing bubble in the United States in 2007. Loans were given to people, and there was a possibility that they wouldn't have the ability to do the payments according to the schedule. This is called subprime loans. The idea was that people would take a loan and buy their house, which would continue to grow in value (P. Wissén, U. Wissén, 2011). Shortly one could say that it wouldn't matter if the loaner wouldn't be able to pay back the loan since the house value would cover the loan. This was not what happened; instead, the bubble of the inflated house prices exploded and the values of the houses dropped sharply (P. Wissén, U. Wissén, 2011). The subprime mortgage crisis was a fact.

These subprime loans had often been been a part of CDOs, which also consisted of other, safer bonds/loans, giving the CDO a high rating. The CDOs then was sold to other investors, who sold it to other banks, and so it went on. Everything was fine, as long as the subprime loaners were working and their houses continued to increase in value. But as soon as the subprime mortgage crisis occurred, everything changed. The CDOs had been sold all over the globe and this could now affect everyone (P. Wissén, U. Wissén, 2011).

3. How it fell apart

When the credit market fell in 2008, AIG had made a lot of businesses with CDS. These CDS were mainly built of CDOs which were too high rated in the beginning. When the house market fell, the CDOs began to lose their value. Soon they started to default so the CDS was used. When the company sold CDS they got fees that they recognized as profit instead of reserves (A. Davidson, 2008).

The financial market began to fall and no bonds were longer stable. The policyholders began to use their insurances, or at least tried to use them. AIG could not possibly cover up for all the insurances since they were out of reserve for this kind of events. In almost no time the company began making big losses and since they, apart from most companies, only had sold CDS without buying any they had no income either (S.E. Harrington, 2009).

The business that earlier was their biggest asset was now killing them. In relation to before when CDS were a secure income without risks it was now one of the most dangerous financial instruments and almost everyone who had bought a CDS wanted their concern. AIG was now very close to bankruptcy.

In september 2008 AIG’s credit rating was downgraded below AA and as a consequence of this the company suffered a liquidity crisis. Even though AIG was on their way to collapse and made much more losses than many other companies, they were not alone. The financial crisis had hit the whole financial system very hard and there were more companies going down. Lehman Brothers stood on the edge of bankruptcy.

4. Federal Reserve bailout

AIG and Lehman Brothers were both going down and neither of them could save themselves. The 15th of September 2008, Lehman Brothers filed for bankruptcy. It was a big bank and their bankruptcy affected the economic world more than expected. Not only Wall Street but the financial crisis had also begun to hit the American families and the rest of the world. The Federal Reserve had not previously bailed out any private owned company in the financial crisis, but when they saw the consequences of Lehman Brothers bankruptcy they made a quick decision.

The day after, on the 16th of September AIG got a loan from the Federal Reserve Bank of $85 billion (10^9), they thought that AIG was too big to fail and the U.S. and the rest of the world could not take the consequences if they fell apart (V.V. Acharya, J. Biggs, M. Richardson, S. Ryan, 2009). Because of AIGs position and how big influence they had on many other big companies, the chain reaction was going to be enormous and the financial crisis would be even more crucial without a bailout.

In exchange of the loan did the Federal Reserve get warrants for 79.9% of their equity. Later the support was increased in 2009 with investments, credit lines and other supports with a total of $182.5 billion (S.E. Harrington, 2009).

The president of U.S.A. at the time, George W Bush made his approval and stated that it would stable the world's financial market since many banks all over the world was leaning on AIG. Before the bailout AIG had lost over $13 billion during the first half of the same year and the same day as the bailout, 16th of September the stock price fell 60% when the stock market opened.

5. Criticism

The Federal Reserve got a lot of criticism on the bailout that concerned different parts and thoughts about their interference. Was AIG the most important company to save? Should the government help companies in crisis? Did AIG exert the money correct?

The explanation why the government saved AIG instead of e.g. Lehman Brother is according to the Federal Reserve that AIG had such important relations with other big banks all over the world and their bankruptcy would make the world's economic situation suffer. Other means that the fall of Lehman Brothers had consequences that the government had not predicted and they made up for their mistake of not helping them with a bailout of AIG.

The discussion concerning whether or not the government should help banks and companies has been discussed many times and there are different thoughts about it. Some people opine that if we help companies in crisis they will not be more careful the next time and other companies will neither be. On the other hand the aftermath is sometimes too big to ignore when a company falls and if too many will be suffering it is probably more important to save the company than that they should learn a lesson (W. Poole, 2009).

A week after the bailout employees and customers at AIG went on a trip to California with a price of $440 000 and activities like spa, golfing and banquets. They also paid for a hunting trip to England and an exclusive resort weekend the same year (E.L. Andrews & P. Barker, 2009). Further the company paid over $200 million to their employees the next year. These things did not help the company to get their customers and the tax payer's faith. But even though they did less smart things and they got further loans after the first bailout they managed to pay back their loans 2012 after selling a lot of their companies and other assets.

6. Discussion

We believe that the main reason why AIG could get in a crisis like this is how the financial market worked and was built at the time. Financial instruments were most often very complex, which resulted in a kind of cavalier handling of the instruments. This careless acting was not only done by AIG, but also from many of the other major players in the game. We assume that everyone got a bit carried away and did not look at the "declarations" of what really was in a CDO. This leaves us with some questions; why didn't anyone look at the CDOs? How could the rating system fail to show how safe the CDOs actually were?

We find the last question particularly interesting. A big part of the problem is that the rating of a CDO has a lot of parameters to bear in mind. If a CDO consists of a government bond with AAA-rating and a loan with rating CCC; does the CDO itself have an AAA-rating or should it have a BBB-rating? As far as we can see, it takes the higher rate. This is where we think AIG sort of bought a pig in a poke.

Sure, they got money from the buyers of the CDS, and sure, that could have been great business, if nothing would have happened. If the situation would have been a bit different; imagine if there was a company that in some magic ways had been enchanted to never ever stop increasing its value. To sell a CDS based on this magical company would be really smart; AIG would get a lot of money over a long period of time, and there would be no risk that they would have to pay the buyer anything (the company was magic). This was clearly not the case when dealing with the CDOs and CDS with subprime loans. As we've seen throughout the economic history; nothing increases in value for ever, sometimes everything peaks. AIG should have thought of this when working with CDS.

The financial market is like a gigantic spider web. Somehow, everything is connected and clearly no one is that independent that it could stand up against unpredicted events. We think that this kind of situation would not occur if the regulations were stricter when it comes to CDOs and how they should be dealt with. Even though regulations are said to inhibit the free market, we still think that there should be guide marks for the companies to follow. The rating system could use a modification as well, which should give a more fair view of what is being rated. Companies as AIG should carefully check every CDS that they might be offered to sell, in case the underlying asset isn't as sure as it seems.

Regarding the bailout we think that even though a company should be responsible for their own mistakes and that a bailout can affect other companies to be less cautious, sometimes the government has to interfere as in this case. A bailout was necessary for the world's economic situation and in the end, that is more important than the risk that other companies might be thinking that they may be in a common situation will be bailed out as well.

7. Reading guide

For the reader who wants to do extended reading on the subject, we recommend references [1] and [3] to get a deeper look at the financial crisis and AIG.
Reference [4] explains insurance companies and their risks and compares it in the end with a case study of AIG. A brief reading of [7] and [8] gives the reader a deeper understanding of what a CDS and a CDO really is, which is very helpful to understand how AIG almost fell.

8. References

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