American International Group: 2008 Crisis

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Abstract

This case study talks about an unthinkable catastrophic event for American International Group (AIG) on 16th September, 2008 when federal government had to release a bailout package of $85 billion in exchange for 79.9% firm equity in AIG.

AIG is one of the world's largest insurance providers and has a history of providing insurance to individuals, companies, etc.

If the US government had not given the financial assistance, AIG would have been down under, amputating the US economy system.

Keywords: *Global Meltdown, AIG, Credit Default Swap, Collateral Debt Obligation, Bailout*

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HISTORY

In 1919, American Asiatic Underwriters Federal, Inc. was founded at Shanghai by Cornelius Vander Star. The company moved its headquarters to New York in 1939 to operate its businesses from United States and in 1967 the company was renamed to American International Group – also popularly known as **AIG**.

In 1980, AIG extended its business to include mortgage insurance and was registered in New York Stock Exchange (NYSE). The mortgage business was an instant success for AIG, therefore AIG kept expanding themselves by diversifying its businesses into financial service industry.

By the end of 20th century AIG had made a strong presence in the US life insurance market.

In the year 2005, the company had seen one of the biggest accounting scandal by its CEO Hank Greenburg, which costed AIG about $1.6 billion fine to AIG.

Followed by Greenburg's departure as CEO, AIG started to take tens of billions of dollars' worth in risk associated with Credit Risk. AIG was making money on the risk taken, until 2007 where AIG realized that the mortgages were defaulting and it had to pay a significant amount ($182.3 billion) as a co-insurer to its partners leading to its bankruptcy. This event was classified as catastrophic and if US Govt. had not bailed out the AIG, AIG's existence would have been a history.

As of 2016, AIG has more than 88 million customers across 130 countries with an approximate 65,000 employees on its payroll. The company operates through three businesses: AIG Life and Retirement, AIG Property Casualty and United Guarantee Corporation (UGC). Today AIG has net assets worth $515.6 billion with an operative income of $10.5 billion.

Low Frequency – High Consequence Event (2008 Financial Crisis):

In 2005, after an accounting scandal, Greenburg stepped down as CEO of AIG group. AIG started to take credit risks worth billions of dollars in risk associated with mortgages.

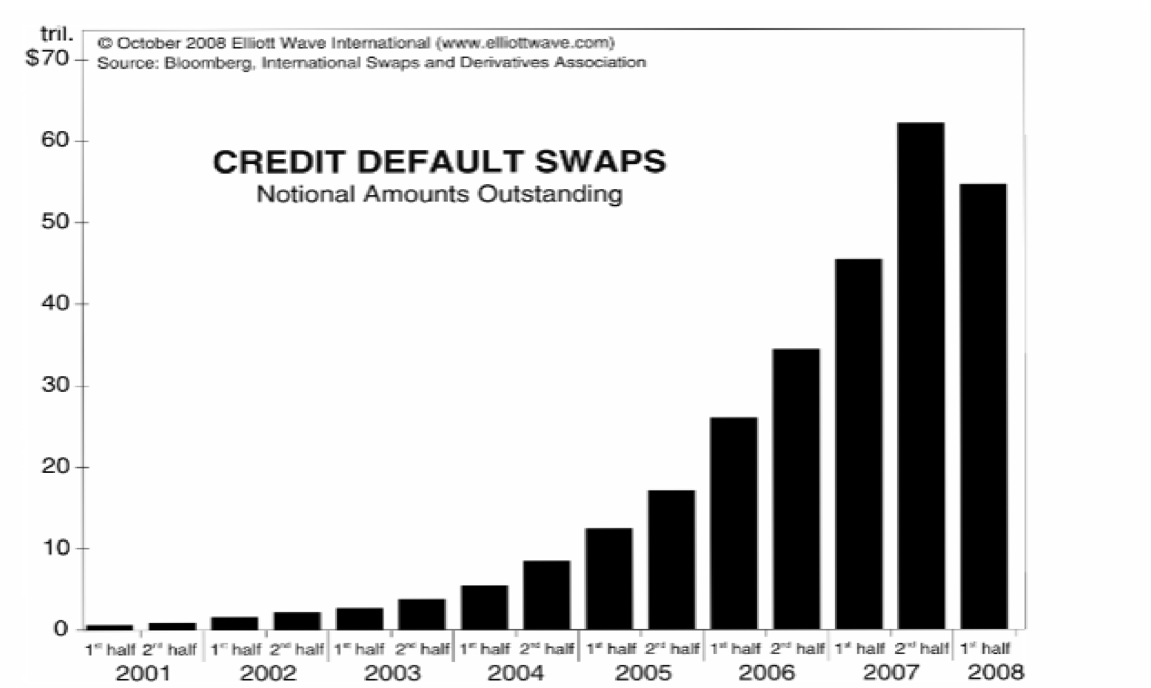
This activity was centered in AIG's Financial Products office in London which started selling Credit Default swaps in 2000.

Credit default swap was a financial product used to insure collateralized debt obligations (CDO's) against default.

CDO's were a new investment vehicle used to lump various type of debt – both safe and risky- into one bundle product, many of which had exposure to subprime mortgages.

Thus, AIG was insuring the securities for a fee, which guaranteed the value of the securities,

The CDO insurance plan was working was fine for few years, raising the FP's unit revenue from $737 million to $3 billion in five years.



As seen from the graph above, AIG began to experience significant losses as the value of the securities they were guaranteeing plummeted significantly.

These securities were none other than the real-estate market in the United States, which took a downturn as people were unable to pay their mortgages.

As a result, AIG counter parties demanded the company to provide with the collateral amount for the falling securities value. On 15th September 2008, Standard & Poor (S&P) downgraded AIG's credit rating to "AA-" from "AAA" resulting in a liquidity crisis for the company.

As evident from the chart above, the stock price of AIG went 90% down in matter of 10 days.

The US Federal Reserve had to provide $85 billion credit facility next day, to help AIG meet its collateral obligations. In exchange, the US government received a 79.9% equity interest in AIG.

In Nov 2008, AIG and the US Government reached a new agreement for a total bailout package of $182.3 billion.

The event resulted in eviction of 20,000 AIG employees just before the Christmas, which created a negative image of the company.

The insurance business also got hit as they were no more insurance policy renewals as well as number of policy surrenders also increased.

Surprisingly, AIG had a Risk Management Plan before the meltdown. According to Hank Greenberg, former chairman and CEO of AIG, AIG's 2008 financial meltdown was a result failure of internal risk management. "Reports indicate that the risk controls his team and he put in place were weakened or eliminated after his retirement," he wrote in a statement for an October 2008 hearing by the House Committee on Oversight and Government Reform.

Before 2008, AIG had a Risk Management Division which divided risks broadly into two categories: Credit and Corporate Risks.

So, now the question arises, what went wrong for AIG?

A closer look reveals that it was not a failure of risk management, but according to Risk and Management Society (RIMS) this failure resulted from a system wide failure to embrace risk management behaviors.

Like every other financial institution in market, AIG were also using mathematical and financial models – models, in this case, estimated the probability of default on the various bonds AIG was insuring by "selling" credit default swaps.

The WSJ article says that AIG was (a) using default-prediction models to determine the likelihood that it would ever have to pay out on credit default swaps, but did not have models (until it was too late) for two other risks: (b) the risk that increasing probability of default (as reflected in CDS spreads) would trigger collateral calls by counterparties, and (c) the risk that increasing probability of default would show up as write-downs on AIG's balance sheet.

The above mentioned conditions were considered to be tail-like events in a statistical model, which quantitative analysts usually tend to avoid as these were the most unlikely events to occur.

Additionally, there was a failure to develop and reward internal risk management competencies. Risks taken were presumably were rewarded for immediate profit alone leaving behind the bigger picture.

Finally, there was a failure to use ERM to inform management's decision making for both risk-taking and risk-avoiding decisions.

EMERGENGY RESPONSE:

The US Government had to come with Emergency Economic Stabilization Act of 2008, where it had given $85 billion credit facility, to help AIG meet its collateral obligations. In exchange, the US government received a 79.9% equity interest in AIG.

In Nov 2008, AIG and the US Government reached a new agreement for a total bailout package of $182.3 billion.

The investors had lost confidence in AIG's management and the brand value was completely lost. If the US Government had not intervene, there would have been a collapse of AIG as well as of US economy.

In 2009, to gain confidence of the people and investors, AIG started its marketing campaign using mass media and through social networking channels.

Disaster Recovery:

After 2008 disaster for AIG, the short term recovery was AIG receiving the largest bailout till now by the US government.

Long term planning included: AIG renaming its international P&C operations from AIU holdings to Chartis operations. They sold their Japanese units of insurance subsidiaries to Prudential and American units of insurance businesses to MetLife. AIG was able to make massive recovery and were able to pay the Federal Reserve the full amount the owed. This allowed AIG to regain the trust of the investors. The treasury sold its stake in AIG through a series of stock sellouts which ended up with a profit of $22.7 Billion.

AIG marketed this success and reached out to the people by using appropriate social media channels.

The company rebranded its P&C division, SUN America to AIG Life and Retirement and Chartis to AIG property causality in third quarter of 2012.

Rebranding was necessary as about 50% of the insurance premiums were originating from United States. The recovery path was not easy for AIG as they were facing many lawsuits over unsettled claims, most of the bailout money was spent on settling up these claims and rebranding themselves in the eyes of their customers and investors for further businesses.

While, on the path to recovery, retention bonuses were given in millions to the higher executives which were highly condemned by the investors and were subjected to public outrage.

Apart from the above mentioned issues, they had to continue their business operations and stay abreast of latest technologies which required a huge capital investment.

Outcomes:

The disaster not only changed the AIG's risk management culture, but also of the entire financial industry.

When we look at the Risk Management culture, the risk management practices were already in existence, but AIG failed to:

- Embrace and demonstrate appropriate enterprise risk management behaviors
- They failed to develop an appropriate risk and reward structure, they were focusing more on the short term gains which eventually led to the downfall of the entire company
- They failed to use ERM approaches to inform and help management in taking and avoiding risks.

  After the disaster, AIG changed its ORG structure, they diversified and sold their units. The company made strict credit policies as a part of its credit risk management strategy.

AIG has transformed its risk management approach by dividing its risk structure into two groups/ product lines:

1. Life and Retirement
2. Model Risk Management

Life and Retirement is the traditional insurance product, whose risks associated are evaluated on continuous basis.

Model Risk Management is more quantitative, statistical measurement of business and credit models which are being evaluated on the regular basis.

The 2008 financial disaster was an outcome of poor Model Risk Management where AIG failed to evaluate the TAIL effects of the financial products model.

More research is now done for handling such kind of financial uncertainties.

Apart from handling the credit risk, more accountability measure were taken and contracts with the auditing firms were made more stringent.

In the 2008 meltdown case, Price water Coopers (Pwc) had to pay $1.2 Billion in settlement to AIG due to poor auditing procedures.

After the disaster, AIG has made a significant process, they returned each and every penny taken by the US federal government.

As of Q3 of 2015, AIG has a $12.82 Billion net sales of revenue with a gross profit of $1.28 Billion. The current stock price is around $60 which is equal to the stock price before the crisis.

The company stock had split 1:20 in the year 2009.

The downfall had led to the formation of many acts by the US government as they had taken many systemic risks, the major being the Housing and Economic Recovery Act of 2008 which included 6 other major acts designated to restore confidence in the domestic mortgage industry.

Lessons Learnt:

The lessons learnt from the 2008 financial crisis were:

- There had to be some strict regulations for the companies which could affect the whole economy of the country. After the Global Meltdown US government came up with some regulations such as Dodd - Frank Act in 2011 to maintain financial regulations
- Insurance must be avoided for those commodities whose risk cannot be quantified

- The Core businesses must be diversified and should be highly controlled and audited
- The risk management strategies already in place at AIG should have been embraced, the top management at AIG failed to pay attention towards the downside of the risk exposure as they were too focused on profits and income by the new financial product
- Auditors (Pwc) should have been proficient by conducting regular audit checks in their financial auditing as they failed to identify the risks and anomalies against the new financial product.

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