Blame for the Bailout-AIG

Risk Management Solutions

Greater Degree of Regulation over OTC markets
-Counter Party Risk minimization
-Interantaional Continental Exchange (ICE) for CDS transactions
-Dodd Frank Wall Street Reform

The Financial Crisis

-American Dream
-Aggressive Lending
-New Products
-Teaser Rates
-High commodity prices slowing growth
-Financial Products failure

CDS

Insurance on Bonds/Loan Obligations

Historically, bond issuers almost never go bankrupt. Banks and hedge funds were making a fortune by selling CDSs, keeping the premium, and almost never having to pay out anything.

SHORT OF RESERVES

With the eventual burst of the housing bubble, AIG was in a critical situation as it did not have enough capital reserves to cover potential claims in the first place. The CDS contracts also required that if AIG's credit rating drops below a certain level, it has to fork out over $13 billion in collateral to the buyers of the swaps. Because of the losses in AIGFP and AIG's investment portfolios, all major credit rating agencies reduced the company's credit rating, leading to its eventual liquidity crunch.

AIG

American International Group, Inc. – also known as AIG – is a multinational insurance corporation with over 63,000 employees globally. AIG companies serve customers in more than 130 countries around the world; the company is a provider of property casualty insurance, life insurance and retirement services, and mortgage insurance. As of March 21, 2014, it had a market capitalization of $73.67 billion.

The US govt had injected $180 billion in AIG and at one point owned 90+% stake in AIG

AIG

Conclusion

AIG's activities and bailout has been controversial, and will be studied as a case study for risk management, or rather lack of it.
Complex products such as CDS that have been put to blame for the crisis have not really been the root cause. Ironic as it may sound these instruments were created for risk management tools. Insufficient risk management, greed and moral hazard has made these risk management tools a weapon for the financial industry itself.

AIGFP

While banks and financial institutions were on a roll, furiously writing MBS, distributing and collecting fees from tranches. With almost willing compliance insurers like AIGFP, on the other hand, was furiously writing Credit Default Swaps to cover the MBS and collecting handsome premiums in return from the MBS writers. AIGFP had an exposure to about $440 billion in CDS.

While banks hedged their positions by buying and selling CDS at the same time AIG was only taking positions on the selling side

(Pakistan's total GDP (informal and formal is estimated to be $350 billion)

May 11 2011: Treasury launches its first sale of AIG stock, reducing its stake in the company from 92 percent to 77 percent.

Sept. 11, 2012: The U.S. says it stake in AIG to 16 percent from a majority, selling $20.7 billion of shares at $32.50 apiece in its fifth offering. Including the Fed's mortgage-bond sales, taxpayers have recouped the cost of the bailout with a profit.

Dec. 11, 2012: The Treasury says shares were priced at $32.50 in its last offering, raising $7.6 billion. Overall profit on the bailout climbs to $22.7 billion.

BAILOUT TIMELINE

2008
Sept. 16 : The government rescues AIG with an $85 billion bailout, as the company was minutes from bankruptcy.
Oct. 8: AIG and the Fed reach a deal for another $37.8 billion in liquidity.
Nov. 10, 2008: Treasury commits to invest $40 billion. The New York Fed agrees to create vehicles named Maiden Lane II and III to spend up to $52.5 billion buying mortgage-linked securities owned or backed by AIG. The credit line is cut to $60 billion and AIG wins a lower interest rate and three extra years to pay.

March 2, 2009: AIG reports a record fourth-quarter loss of more than $60 billion and gets an additional Treasury injection of as much as $29.8 billion, raising the bailout to $182.3 billion.

CDS and their market

Banks could make money without upfront payment by just promising to pay if something went wrong. This was more profitable than investing funds and earning meager 4-5%.

By 2007 market size of 60 trillion vs 137 trillion in total global debt market.

Joseph Cassano

Cassano was the head of AIGFP. He is also known as the 'Man who crashed the world'.
Under his autocratic leadership AIGFP took excessive positions in CDS. Their internal auditor St. Denis was kept away from the CDS valuation process.
Another indicator of poor management decisions was the fact that AIGFP did not even have a proper valuation model for its Super Senior CDS contracts before September 2007. In fact, St. Denis explained that back then, AIG simply used a [illegible] model

Capital Adequacy

Regulatory Framework to monitor capital adequacy and risk exposure of insurers.
-Basel III was a framework for banks and FI, however it is not perfectly compatible for insurers like AIG
-Need for comprehnsive regulatory and stress testing tool

Purpose of CDS

Believed to be developed by JP Morgan in 1994. CDS was originally conceptualized as a risk management tool that prevented concentration of risk in the financial sector.

Naked CDS- Whereby an investor would still receive compensation for a bond default even if he no exposure to it. Speculative purpose.
Around 80% of the CDS sold were naked CDS.

Proper Credit Ratings

Regulation of Credit Rating Agencies (CRA's) is required.

A move from issuer pay model to subscriber pay model is essential.

EGAN JONES rating agency (subscriber based model) successfully forecasted falls of Enron, WorldCom and Lehman Brothers.

AIG takes a hit

Mortgage-backed securities and collateralize debt obligations became nearly worthless, suddenly that seemingly low-risk event-an actual bond default-was happening daily.
The banks and hedge funds selling CDSs were no longer taking in free cash; they were having to pay out big money.
Banks netted out, AIG on the other hand was paying big cash and while no one else was covering it

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