



AIG Remains in TARP as TARP's Largest Investment

Special Inspector General for the Troubled Asset Relief Program

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INTRODUCTIONⁱ

Treasury's largest TARP investment is American International Group, Inc., ("AIG") with Treasury holding 61% of AIG's common stock as of June 30, 2012. Once the world's largest insurance company, AIG became a central figure in the fixed-income securities market beginning in the 1990s by underwriting the risk on a number of structured products, including volatile residential mortgage-backed securities ("RMBS"). In 2008, AIG suffered a severe liquidity crisis and credit downgrades due to exposures on risky derivatives related to mortgage-backed securities in its subsidiary, AIG Financial Products Corporation ("AIGFP"). The Government, first through the Federal Reserve Bank of New York ("FRBNY"), and later through TARP's Systemically Significant Failing Institutions ("SSFI") program, bailed out AIG at a price tag of \$161 billion.ⁱⁱ Taxpayers are still owed more than half of the original TARP investment — a significant \$36 billion of the \$67.8 billion TARP investment. According to Treasury's TARP books and records, taxpayers have realized losses on the TARP investment from an accounting standpoint of \$5.5 billion on Treasury's sale of AIG stock. However, given the January 2011 restructuring of the FRBNY and Treasury investment, according to Treasury, the Government overall has made a gain thus far on the stock sales. According to Treasury, this leaves \$30.4 billion in TARP funds outstanding.¹ In return for that investment, Treasury holds 1.06 billion shares of AIG common stock (61% of AIG's common stock).

Post-bailout, there have been several changes to AIG's corporate governance, sales of AIG's subsidiaries and assets, and a reduction in AIG's exposure to risky derivatives. As controlling shareholder, Treasury has consented to or been consulted on many of these changes. Largely as a result of assets sales, by the end of 2011, assets had fallen from \$1 trillion in 2007 to \$552.4 billion.² Revenue decreased from \$81.5 billion in 2007 to \$64.3 billion in 2011.³ These are large numbers by any measure. AIG remains one of the world's largest insurance companies, and is the third largest in the United States by assets.⁴ Although AIG has sold several foreign life insurance subsidiaries, it still has 219 subsidiaries (compared with 245 in 2007) and continues to operate in more than 130 countries.⁵ AIGFP continues to exist, but with far less exposure, due to efforts by FRBNY to remove exposure and efforts by AIG to further reduce exposure.

AIG has operated in a changing regulatory environment. How it will be regulated in the future will not be known until Federal regulators designate which non-bank financial companies are systemically important financial institutions ("SIFI") as called for in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").⁶ There is no stated time when this designation will be made. For more than two years, AIG has had no consolidated banking regulator of its non-insurance financial business. AIG continues to operate its non-insurance financial business today, albeit with far less exposure than in 2008, in part due to Government action. Before it was abolished, the Office of Thrift Supervision

ⁱ This discussion is based on publicly available information. It is not an audit or evaluation under the Inspector General Act of 1978 as amended.

ⁱⁱ SSFI had only one participant, AIG.

(“OTS”) was AIG’s consolidated regulator based on AIG’s ownership of a small thrift. OTS officials admitted failures in their regulation of AIG. If AIG is designated a SIFI or recognized as a savings and loan holding company, the Federal Reserve will become AIG’s primary regulator and heightened regulatory requirements will apply. Regulatory oversight of AIG will be an enormous undertaking, presenting challenges in examination, enforcement, and supervision, particularly as it relates to risk, given AIG’s history. Effective, comprehensive, and rigorous regulation of AIG is vital to ensure that history does not repeat itself.

RISE AND FALL OF AIG PRIOR TO TARP

In the years before the Government bailout, AIG had a solid reputation, reliable earnings, and was generally perceived to be one of the stronger companies in the United States.⁷ Core insurance operations encompassed general insurance, including property and casualty, commercial, industrial, and life insurance, including annuities and retirement services. Insurance operations (including general insurance, life insurance, and retirement services) accounted for nearly 90% of AIG’s revenue, which is still the case today. Approximately half of the company’s revenue during this period came from outside the United States, largely from Asia. For decades, the company’s AAA credit rating helped bolster its insurance operations and allowed AIG to use its low cost of funds as leverage to boost non-insurance lines, including aircraft leasing and consumer finance.

AIG’s credit rating also increased its attractiveness as a counterparty in capital markets, helping the company expand its product base. Over the years, AIG expanded from insurance into other financial businesses. One of these was AIGFP, a subsidiary created in 1987 to conduct sophisticated financial market trades, many involving complex derivatives. Derivatives are financial instruments that can be used to hedge risks or to bet on market price trends, and are typically derived from underlying assets such as stocks, bonds, loans, currencies, or commodities. By the 1990s, AIGFP was a vital part of the fixed-income securities market as it related to RMBS and commercial mortgage-backed securities (“CMBS”). RMBS are financial instruments backed by a pool of residential mortgage loans; CMBS are backed by a pool of commercial mortgage loans. The loans are packaged into bundles of loans sharing similar characteristics, and then sold to investors. This process, called securitization, removes the loans from the balance sheets of banks and mortgage lenders and gives them cash to issue new loans. The RMBS and CMBS were often further pooled into bundles known as collateralized debt obligations (“CDOs”).

In 1998, AIGFP began to sell insurance-like contracts called credit default swaps (“CDS”) that provided protection to investors against losses from RMBS and CMBS that had been bundled into CDOs. The firm purchasing the CDS (the “counterparty” to AIG), would pay AIG regular insurance-like premiums and in return AIG would pay the counterparty if the CDO should default. Due to AIG’s AAA rating, AIG was able to enter into these insurance-like contracts without

posting any collateral, a benefit not available to lower-rated firms. Included in these CDS contracts was a provision that, should AIG's credit rating be downgraded, AIG would be required to post collateral to ensure payment on these contracts. In addition, if the value of the securities that AIG was insuring fell, AIG was contractually obligated to produce quickly the collateral to its counterparty to make up for the difference in the drop in value of the security. That collateral could be either cash or AAA-rated securities. AIGFP sold CDS to firms that bought or sold mortgages or CDOs and to unrelated investors.

AIG had grown into a global giant with a top-tier AAA credit rating largely under the direction of one man, Hank Greenberg, who was chief executive officer from 1968 to 2005.⁸ Beginning in 2004, however, AIG became embroiled in a series of fraud investigations conducted by the Securities and Exchange Commission ("SEC"), the Department of Justice, the New York State Insurance Department, and the New York State Attorney General's Office. Amid those investigations, AIG's board forced Greenberg to step down on March 14, 2005.

In early May 2005, AIG restated five years of its financial results, cutting \$3.9 billion off reported profit over that period and reducing its book value by \$2.7 billion.⁹ Credit rating agencies began questioning AIG's creditworthiness, and in March and June of 2005, Standard & Poor's and Moody's Investors Service downgraded AIG's AAA rating.¹⁰ An S&P executive testified to Congress that the downgrade was due to "the company's involvement in a number of questionable financial transactions."¹¹

Starting in the third quarter of 2007 and continuing through 2008, AIG's financial condition deteriorated, causing a decline in market confidence that, in turn, brought downgrades of AIG's credit rating and nearly caused the company's collapse. The trigger and primary cause was AIGFP.

While AIGFP's operating income grew from \$131 million in 1994 to \$949 million in 2006, closely tracking the boom in the CDS market and the overall derivatives market, the risk involved in this business turned out to be dramatically disproportionate to the income produced.¹² As of June 2008, AIG provided more than \$400 billion of credit protection, primarily to banks, through AIGFP CDS.¹³ AIG was exposed to the underlying securities, which were composed largely of subprime mortgages in CDOs that were initially rated AAA.

When the U.S. residential mortgage market deteriorated, the securities underlying AIGFP's CDS contracts turned toxic as home prices tumbled and defaults skyrocketed. The value of the underlying securities plummeted, and the credit ratings of those securities were downgraded. In the fourth quarter of 2007, counterparties began making significant collateral calls to AIG, which only continued. With its credit no longer rated AAA, AIG posted collateral in cash. According to AIG's 2008 Form 10-K, "From July 1, 2008, to August 31, 2008, the continuing decline in value of the super senior CDO securities protected by AIGFP's super senior CDS portfolio, together with rating downgrades of such CDO securities, resulted in AIGFP posting additional collateral in an aggregate net amount of \$5.9 billion. By the beginning of September 2008, these collateral postings and securities lending requirements were placing increasing stress on AIG parent's liquidity."¹⁴

AIG was also taking risks with the assets of its life insurance subsidiaries through its securities-lending program. AIG made short-term loans of securities it owned and used the fees it earned on those loans to invest in RMBS. The value of these and other AIG real estate-related investments also declined sharply, and contributed to further downgrades of AIG's credit ratings in May 2008. The problems in AIGFP exacerbated the problems in securities lending, and vice versa, as collateral demands from both sets of counterparties left the company struggling to find cash. In September 2008, AIG's credit ratings were downgraded again, triggering additional collateral calls and cash requirements in excess of \$20 billion.¹⁵ AIG, facing an acute liquidity crisis, was on the brink of collapse, unable to access credit in the private markets and bleeding cash.

The Congressional Oversight Panel ("COP") found that AIG was brought down by the company's "insatiable appetite for risk and blindness to its own liabilities."¹⁶ According to the Financial Crisis Inquiry Commission ("FCIC"), "AIG failed and was rescued by the Government primarily because its enormous sales of credit default swaps were made without putting up initial collateral, setting aside capital reserves, or hedging its exposure — a profound failure in corporate governance, particularly its risk management practices."¹⁷

AIG sought and received Government support through a revolving credit facility from FRBNY and later TARP funding from Treasury. Officials involved in the rescue maintained that if AIG went under, it would have taken down other financial institutions and caused havoc around the world.¹⁸ Then-Treasury Secretary Henry M. Paulson wrote in his memoir, "An AIG collapse would be much more devastating than the Lehman failure because of its size and the damage it would do to millions of individuals whose retirement accounts it insured."¹⁹

CHANGES AT AIG AFTER THE GOVERNMENT BAILOUT

Since the Government bailout, AIG has undergone some key changes.ⁱⁱⁱ Some were a direct result of the bailout, including a change in AIG's capital structure such that the Government took an ownership interest in AIG that was eventually converted to common stock. AIG's CEO, chairman of the board, and other management and directors have changed, leaving only a few from pre-bailout times. FRBNY created its Maiden Lane II and III investment vehicles to remove a large part of AIG's liquidity strain caused by its securities-lending portfolio and AIGFP's exposure to RMBS under its CDS contracts. AIG has sold a number of subsidiaries, primarily foreign life insurance subsidiaries, using proceeds to pay down what was owed to the Government.

ⁱⁱⁱ This discussion does not attempt to chronicle all of the changes at AIG while it has been in TARP.

Changes to Balance Sheet As a Result of the Bailout

The bailout and subsequent restructuring significantly altered AIG's capital structure. Prior to the bailout, AIG's balance sheet consisted of \$95.8 billion in equity and \$952.5 billion in total liabilities.²⁰ For the year ended December 31, 2011, AIG's balance sheet consisted of approximately \$105 billion in equity and \$441.4 billion in total liabilities.²¹ In the bailout, the Government injected capital into AIG and became AIG's largest shareholder.

Changes to AIG's Corporate Governance After the Government Bailout

There have been substantial changes to AIG's corporate governance while the Government has been AIG's largest shareholder. Changes in management after the Government bailout included a new CEO, Edward M. Liddy, a former Allstate Corporation CEO, who was appointed in September 2008 after discussions with Treasury. Less than a year after he became CEO, Liddy resigned. Liddy was succeeded in August 2009 by Robert H. Benmosche, former CEO of MetLife, Inc. As of June 30, 2012, out of AIG's ten executives listed in its Form 10-K, only four were executives with the company prior to TARP. They are William Dooley, executive vice president of investments and financial services, who has been with AIG since 1992; David Herzog, chief financial officer, who was hired in 2005; Brian Schreiber, treasurer, who has been an AIG executive since 2002; and Jay Wintrob, executive vice president of domestic life and retirement services, who has been with AIG since 1999.²²

There have been significant changes to AIG's board while the company has been in TARP. Although Greenberg had long been gone from AIG by the time of the bailout, several board members appointed during Greenberg's tenure remained.²³ During the nearly four decades that Greenberg ran AIG, the company's board of directors played a minor role in governing the company, according to corporate governance expert Jennifer S. Taub, an associate law professor at Vermont Law School.²⁴ In the boardroom, there were as many as nine AIG executives seated on the company's 20-member board of directors in 2002.²⁵ In 2008, the year of the bailout, five AIG directors resigned. Two more followed in May 2009, while two others did not seek re-election.²⁶ Chairman Harvey Golub resigned in July 2010 and was replaced by AIG director Steve Miller, a former chairman of auto parts manufacturer Delphi Corp.²⁷

AIG's annual proxy mailing to shareholders ahead of its 2009 annual meeting included a new set of corporate governance guidelines adopted by the board. The guidelines trimmed the board size to between 8 and 12 directors and described that a lead independent director would annually review the CEO's performance.²⁸

As of June 30, 2012, AIG's 12-member board includes only two people who have been directors since before TARP.²⁸ George L. Miles, Jr., chairman of Chester Engineers, Inc., joined the AIG board in 2005 and Suzanne Nora Johnson, former vice chairman of Goldman Sachs Group, became a director in July 2008. Other current board members include fund managers in charge of Oak Street Management Co. and Marblegate Asset Management; the former head of KPMG LLP's banking and finance practice; and the ex-CEO of Sears, Roebuck and Co.

Two other board directors have significant aircraft industry experience: one is the CEO of aircraft maker Hawker Beechcraft, Inc., and the other once headed Northwest Airlines Corp.³⁰

In April 2010, after AIG had missed five TARP dividend payments, Treasury exercised its right to appoint two directors to the AIG board.³¹ Treasury named Ronald Rittenmeyer, head of a private equity firm, and Donald Layton, a veteran of JPMorgan Chase.³² Layton resigned from the AIG board in May 2012 to become CEO of Freddie Mac.³³ On July 11, 2012, a retired AIG director, Morris W. Offit, was re-elected to the board.³⁴

No Changes to AIG's Outside Independent Auditor While in TARP

AIG has not changed its outside auditor while it has been in TARP.

PricewaterhouseCoopers has been AIG's auditor for decades and continues to serve in that role.

FRBNY Took Significant Mortgage-Backed Securities Off AIG's Books

AIG held nearly \$141 billion worth of RMBS, CMBS, derivatives, and asset-backed securities investments on its books at the end of 2007.³⁵ The holdings were slashed to \$34.6 billion at the end of 2010, in part due to the actions taken by FRBNY.³⁶ The 2008 liquidity pressures on AIG were concentrated in two areas, securities lending and CDS, insurance-like protection on CDOs (generally bundles of RMBS). As part of the Federal bailout, most of the securities involved in those areas were unloaded into two newly created special purpose vehicles: Maiden Lane II (which held the RMBS associated with AIG's securities-lending program) and Maiden Lane III (which held the underlying CDO securities associated with the CDS). Maiden Lane is the street behind the FRBNY building in the heart of Manhattan's financial district.

FRBNY made a \$19.5 billion loan to Maiden Lane II which was used to purchase subprime RMBS in AIG's securities-lending portfolio that FRBNY put into Maiden Lane II. FRBNY had sole control over Maiden Lane II and sales of the RMBS in it.³⁷ Last year, AIG offered to buy the entire portfolio for \$15.7 billion. The FRBNY declined and instead held a series of auctions for the assets.³⁸ Investment banks that won the auctions turned around and re-sold the securities to clients, including AIG.

The FRBNY also created Maiden Lane III as a vehicle to buy from AIG's counterparties the CDOs that AIGFP had insured through CDS. The purchase of the underlying CDOs terminated AIGFP's obligations under the CDS contracts. SIGTARP previously reported in its audit, "Factors Affecting Efforts to Limit Payments to AIG Counterparties," issued in November 2009, that "FRBNY decided to pay the counterparties the full market value of the CDOs, which, when combined with the already posted collateral, meant that the counterparties were effectively paid full face (or par) value of the credit default swaps, an amount far above their market value at the time."³⁹ The face value amount of the securities was \$62.1 billion. AIG's counterparties retained \$35 billion in collateral posted by AIG

and were paid an additional \$26.8 billion.⁴⁰ The FRBNY began auctioning securities from Maiden Lane III in April 2012.

Maiden Lane III did not remove all of AIGFP's exposure on CDS contracts. For example, FRBNY did not purchase synthetic CDOs, which are CDOs backed by CDS rather than real estate loans. AIGFP still had about \$302 billion in exposure to CDS on its books on December 31, 2008, after Maiden Lane III was created.⁴¹

AIG Sales of Certain Foreign Life Insurance Subsidiaries and Other Assets

While in TARP, AIG has sold several of its foreign life insurance subsidiaries including Nan Shan, AIG Star Life Insurance Co., ALICO, and AIA. These transactions were with the consent of or in consultation with Treasury as AIG's controlling shareholder. Some of the transactions resulted in proceeds that went to pay down amounts owed to the Government as part of a plan to recapitalize the Government's interest in AIG. At the end of 2011, about 14% of AIG's consolidated assets were located outside the United States and Canada, down from 37% in 2008.⁴² Figure 3.1 shows recent major foreign divestitures of \$1 billion or more.

On the one hand, these transactions may be key steps in AIG's restructuring that have allowed AIG to meet working capital needs and to pay down the Government. As Benmosche stated in March 2010, "Clearly, we will be a smaller and more focused company than in the past. The only way we can repay taxpayers is to divest parts of the organization, and we are."⁴³

However, AIG's sales of ALICO and AIA, key pieces of AIG's foreign life insurance operations, meant losing what Benmosche described as some of "the company's crown jewels."⁴⁴ In 2010, AIG sold ALICO, one of the world's largest and most diversified international life insurance companies, to MetLife, Inc. The sale included the company's vast distribution network throughout four continents, including agents, brokers and financial institutions; 12,500 employees across more than 50 countries; and 20 million customers worldwide. The significance of ALICO's loss to AIG is best shown by the numbers. In 2008, ALICO generated revenue of \$32.3 billion, or approximately one-third of AIG's revenue that year.⁴⁵ The sale of AIA Group, Limited ("AIA") entailed AIG parting ways with a leading Pan-Asian life insurance organization that traces its roots in the Asia-Pacific region back more than 90 years. The sale included all of the AIA companies operating in 15 geographic markets across the Asia-Pacific region, including the company's international network of more than 320,000 agents and approximately 23,500 employees.⁴⁶ AIA accounted for \$9.3 billion of insurance premiums in 2010, about 12% of AIG's revenue that year.⁴⁷

In addition to these major transactions, AIG has sold its own Manhattan headquarters building; a commodity index; a U.S. rail services leasing unit; its U.S. personal auto insurance business; a German marine insurer; consumer finance businesses in Mexico, Argentina, and Thailand; life insurance operations in Canada, Japan, the Philippines, and Taiwan; and 80% of its consumer credit provider, American General Finance.

FIGURE 3.1

AIG'S MAJOR RECENT FOREIGN ASSET SALES

Nan Shan: On August 18, 2011, AIG sold its 97.6% interest in Nan Shan Life Insurance Company, Ltd., its Taiwanese life insurance unit, to Taiwan-based Ruen Chen Investment Holding Co., Ltd. for \$2.2 billion. Established in 1963, Nan Shan is the largest life insurer in Taiwan by total book value and the third largest by total premiums.

Star and Edison: On February 1, 2011, AIG sold its Japan-based life insurance subsidiaries, AIG Star Life Insurance Co., Ltd., and AIG Edison Life Insurance Company, to Prudential Financial, Inc., for a total of \$4.8 billion, made up of \$4.2 billion in cash and \$0.6 billion in the assumption of third-party debt. Star and Edison offer life, medical, and annuity products to individuals and groups.

ALICO: On November 1, 2010, AIG sold ALICO, a foreign life insurance company with operations on four continents, to MetLife for approximately \$16.2 billion (\$7.2 billion in cash and the remainder in securities of MetLife).

AIA: On October 29, 2010, AIG sold, in an initial public offering, 8.08 billion shares (or 67%) of Pan-Asian life insurer AIA for approximately \$20.5 billion. On March 8, 2012, AIG sold 1.72 billion shares of AIA to institutional investors for approximately \$6 billion.

AIGFP Energy and Infrastructure Portfolio: On August 11, 2009, AIG sold its remaining energy and infrastructure investment assets, including three Spanish solar power plants along with several U.S. assets, realizing aggregate net proceeds in excess of \$1.9 billion. This disposition effort began during the fall of 2008.

AIG Otemachi Building in Tokyo: On May 28, 2009, AIG sold its prime real estate holding in Tokyo, the AIG Otemachi Building and property, for approximately \$1.2 billion in cash to Nippon Life Insurance Company.

Sources: AIG, Press Release, "AIG Reduces United States Treasury Investment in AIG Subsidiary by Approximately \$2 Billion," 8/18/2011, www.aigcorporate.com/newsroom/index.html, accessed 6/28/2012; AIG, Press Release, "AIG Enters Into Agreement to Sell Nan Shan to Taiwan-Based Consortium Led by the Roentex Group," 1/12/2011, www.aigcorporate.com/newsroom/index.html, accessed 6/29/2012; AIG, Press Release, "AIG Completes Sale of Star and Edison Companies," 2/1/2011, www.aigcorporate.com/newsroom/index.html, accessed 6/28/2012; AIG, Press Release, "AIG Raises Nearly \$37 Billion in Two Transactions to Repay Government," 11/1/2010, www.aigcorporate.com/newsroom/index.html, accessed 6/28/2012; AIG, Press Release, "AIG Announces Pricing of Sale of Ordinary Shares of AIA Group Limited," 3/5/2012, www.aigcorporate.com/newsroom/index.html, accessed 6/28/2012; AIG, Press Release, "AIG Financial Products Corp. Completes Disposition of Energy and Infrastructure Investment Portfolio," 8/11/2009, www.aigcorporate.com/newsroom/index.html, accessed 6/28/2012; AIG, Press Release, "AIG Completes Sale of Prime Tokyo Real Estate Asset to Nippon Life Insurance Company," 5/28/2009, www.aigcorporate.com/newsroom/index.html, accessed 6/28/2012.

AIG'S CURRENT BUSINESSES

For the year ending December 31, 2011, AIG reported the results of its businesses through four segments: Chartis, which writes policies for foreign property/casualty, commercial/industrial, and consumer insurance; SunAmerica Financial Group, which focuses on U.S. life insurance, retirement services, and annuities; Aircraft Leasing; and "Other Operations," which includes the remaining derivatives portfolio from AIGFP, other corporate investment operations, and AIG's insurance for residential mortgage lenders.⁴⁸ Insurance continues to account for almost 90% of the company's revenue, as was generally the case historically. Aircraft leasing accounts for 7% and other operations for 6%.⁴⁹

In TARP, AIG has sold certain subsidiaries and other assets and added several operations, although they are only a fraction of the size of those that it shed. Most notably, through transactions in 2010 and 2011, AIG increased its ownership stake in Japanese insurer Fuji Fire & Marine Insurance Company, Limited, from 41.7% to 100%.⁵⁰ Fuji is now part of Chartis, and largely because of that acquisition, consumer insurance accounted for 38% of Chartis's business in 2011, up from 30% in 2009.⁵¹ The company has also acquired financial assets, including mortgage securities.

Table 3.1. provides a snapshot of key AIG financial information from 2007 to 2011.

TABLE 3.1

AIG FINANCIAL HIGHLIGHTS (\$ BILLIONS EXCEPT FOR EARNINGS PER SHARE AND RETURN ON AVERAGE EQUITY)					
	2007	2008	2009	2010	2011
Assets	\$1,048.4	\$860.4	\$847.6	\$675.6	\$552.4
Liabilities	952.5	807.7	748.6	568.4	441.4
Revenue	81.5	(6.8)	75.4	77.5	64.3
Net income	7.5	(100.4)	(12.3)	12.3	21.3
Earnings per share	47.73	(756.85)	(90.48)	14.98	11.01
Return on average equity	7.2%	-130.7%	-18.2%	11.8%	24%

Notes: Earnings per share is fully diluted, after extraordinary items. Return on average equity is net income as a percent of average equity.

Source: SNL Financial; all data reflect company restatements of results as of April 20, 2012.

Chartis and SunAmerica

Chartis is AIG's largest subsidiary. Chartis generated \$40.7 billion in 2011 revenue primarily through the sale of property and casualty insurance policies to companies around the world for natural disasters and industrial accidents.^{iv} Chartis has had four consecutive years of underwriting losses, which in part reflect the severity of

^{iv} It also wrote policies to protect companies and wealthy individuals from specialized risks such as computer hackers, executive kidnappings, yachting mishaps, crisis management, and shareholder lawsuits.

recent disasters.⁵² The U.S. property/casualty industry saw underwriting net losses more than triple to \$36.5 billion in 2011 from the previous year after a string of costly catastrophes.⁵³ Chartis had \$3.2 billion in underwriting losses in 2011 from catastrophes including Japan's worst-ever earthquake, damages in the U.S. from Hurricane Irene and tornadoes, and deadly flooding in Thailand.⁵⁴

In its smaller consumer business, Chartis is using direct marketing to expand sales of health, accident, and auto insurance in Brazil, Mexico, United Arab Emirates, Turkey, Vietnam, Indonesia, India, and China. Revenue from consumer premiums rose to \$3.6 billion in the 2012 first quarter, accounting for 41% of Chartis's sales. Part of the increase was due to Chartis's 2010 acquisition of Japanese insurer Fuji, which sells mainly to Asian consumers. Meanwhile, commercial premiums declined to \$5.2 billion in the first quarter of 2012, down about \$500 million from a year ago.⁵⁵

AIG subsidiary SunAmerica sells bread-and-butter life and health insurance policies and retirement annuities to U.S. clients. SunAmerica also offers products such as brokerage services, financial planning, and retail mutual funds. SunAmerica's revenue of \$15.3 billion in 2011 accounted for 24% of AIG's total sales.⁵⁶

Investments by Chartis and SunAmerica

Like other insurers, Chartis and SunAmerica invest insurance premium payments from customers to generate income for paying claims and benefits. Life insurers such as SunAmerica have a relatively predictable business and can invest in fixed maturity securities that match up with estimated payouts to customers. SunAmerica also invests in private equity funds, hedge funds, and affordable housing partnerships. Property insurers contend with unpredictable natural disasters such as earthquakes and hurricanes. While according to AIG, Chartis invests in relatively safe fixed-income securities such as municipal bonds, it also needs strong investment income to offset insurance policy underwriting losses. In recent years, it has lost money on underwriting, but attempted to make it up on profits from investments.⁵⁷ Average investments at Chartis and SunAmerica have steadily increased from 2009 to 2011. In 2011, Chartis and SunAmerica together held average investments of \$286.3 billion, up 12% from 2010 holdings.⁵⁸ However, pre-tax returns on those investments have fluctuated. Their combined portfolio produced \$14.2 billion in net investment income in 2011, a decline of 6% from the previous year.⁵⁹

Aircraft Leasing

AIG's International Lease Finance Corporation ("ILFC") leases commercial jet aircraft to foreign and domestic airlines. Revenue in the business has been steadily decreasing since 2009 — it fell 4% from 2009 to 2010, and then another 6% from 2010 to 2011.⁶⁰ The business's loss deepened from \$729 million in 2010 to \$1 billion in 2011, which included write-downs in the value of older aircraft.⁶¹

Mortgage-Backed Securities

According to AIG, to earn the higher returns needed to pay claims and benefits to insurance customers, AIG has returned to investing in mortgage-backed securities, although at a much smaller level than prior to TARP.⁶² From December 31, 2010, to March 31, 2012, AIG had more than doubled its CMBS and non-agency RMBS holdings to \$28.4 billion.⁶³ That did not include AIG's April 2012 purchase of \$600 million worth of CDOs that had been in the Maiden Lane III portfolio.⁶⁴

AIGFP and Other Securities Lending and CDS

AIG continues to maintain a portfolio of CDS and continues to engage in securities lending, albeit much smaller than prior to TARP. AIGFP continues to exist and was folded into the company's Global Capital Markets business along with a separate unit, AIG Markets Inc., which writes derivatives on behalf of other AIG subsidiaries.⁶⁵

AIGFP has sharply reduced its CDS portfolio to one-tenth its former size, from about \$2 trillion in net notional value in 2008 to about \$168 billion in net notional value at the end of its 2012 first quarter.⁶⁶ Net notional value is the total risk exposure for a transaction, or the maximum amount of money that would be transferred from the seller of protection to the buyer in the event of a credit default.⁶⁷ This reduction in exposure is due in part to FRBNY's actions with Maiden Lane III. The size of AIGFP's trading book is greatly diminished, but it may come as a surprise to some that any of AIGFP still exists at all. Former AIG CEO Edward M. Liddy told Congress in 2009 he was weighing a number of options to quickly shut down AIGFP and "break apart these trading books."⁶⁸ His successor and current CEO, Robert H. Benmosche, has been winding down some of AIGFP's trading books over time.⁶⁹ Benmosche hired Peter Hancock, the founder of JPMorgan's global derivatives group and now the head of AIG's Chartis unit, to manage what AIG has described as the "de-risking" of AIGFP.⁷⁰

AIG's 2008 Form 10-K stated that the orderly wind-down of AIGFP would take a substantial period of time. An AIG presentation about its first quarter 2012 results noted that AIGFP may be around for at least seven more years until its final contracts expire.⁷¹ The company says it manages the AIGFP portfolio "for maximum profit contribution and limited risk."⁷² According to AIG, active trading wound down in mid-2011, and AIGFP now enters into new derivative transactions only to hedge its portfolio, which according to AIG means to protect that portfolio by making an offsetting investment in a related security.⁷³ Its non-AIGFP divisions also use derivatives to hedge against risk. According to AIG, "Although the remaining AIGFP derivatives portfolio may experience periodic fair value volatility, the portfolio consists predominantly of transactions AIG believes are of low complexity, low risk, supportive of AIG's risk management objectives, or not economically appropriate to unwind based on a cost versus benefit analysis."⁷⁴ Table 3.2 shows how AIGFP's portfolio of investments has changed since 2008.

TABLE 3.2

AIGFP'S PORTFOLIO 2008-2012 (\$ BILLIONS)					
	12/31/2008	12/31/2009	12/31/2010	12/31/2011	3/31/2012
Market derivatives	~\$1,450	Not reported	Not reported	\$131	\$126
Stable value wraps	~40	Not reported	Not reported	20	19
Corporate debt CDS	~52	22	12	12	12
Regulatory capital CDS	~245	150	38	7	6
Multi-sector CDS	~13	8	7	6	5
Total	~\$1,800	\$940	\$352.8	\$176	\$168

Notes: Net notional value in billions of dollars.

Sources: AIG, conference call presentations, May 4, 2012, February 24, 2012, and February 25, 2011, www.aigcorporate.com/investors/financial_reports.html, accessed 7/21/2012; AIG 10-K for 2010, 2/24/2011, www.sec.gov/Archives/edgar/data/5272/000104746911001283/0001047469-11-001283-index.htm, accessed 6/28/2012.

AIGFP's remaining portfolio includes these components:

- The largest group of securities is \$126 billion in what the company describes as “market derivatives” that are fully hedged. Managed by AIG’s Global Capital Markets Group, about three-fourths of these instruments are intended to protect AIG affiliate companies’ own assets, while the others are “legacy” third-party client trades left from before the bailout.⁷⁵
- Next in size is \$19 billion in AIGFP securities meant to smooth out interest rate volatility in stable value funds, which are similar to money market funds but offer higher returns. AIGFP’s instruments, known as stable value wraps, help fixed-income investments in stable value funds maintain book value even if market value drops.⁷⁶ On May 4, 2012, AIG said it expected to move the stable value wraps to one of its insurance entities this year.⁷⁷
- Another component of the AIGFP portfolio is \$12 billion in CDS contracts written for bundles of corporate debt.⁷⁸
- A dwindling number of CDS contracts that AIGFP tailored specifically for European banks also remain. Banks bought these regulatory capital swaps as protection from potential losses on mortgages and corporate loans so they could hold less capital and still comply with regulatory requirements.⁷⁹
- AIGFP’s portfolio includes \$5 billion in synthetic CDOs not placed into Maiden Lane III.⁸⁰ AIG said this set of securities “managed to retain significant future upside” for additional profits.

According to AIG’s 2011 Form 10-K, “The senior management of AIGFP reports the results of its operations to and reviews future strategies with AIG’s senior management.”⁸¹ The Form 10-K provided details about some components

of the AIGFP portfolio such as a breakdown of credit ratings, origination years of RMBS, and risk sensitivity of remaining swaps.

AIG began edging back into securities lending in 2011, when Chartis began lending municipal bonds and requiring counterparties to put up 102% collateral.⁸² SunAmerica began securities lending in early 2012.⁸³ As of March 31, 2012, AIG had securities valued at \$8.9 billion pledged in securities-lending programs.⁸⁴ That compares with about \$76 billion at the end of 2007 prior to the TARP injection.⁸⁵

AIG'S CHANGING REGULATORY ENVIRONMENT

In the years leading up to its near collapse, AIG's massive size, interconnectedness, geographic reach, and product breadth of operations were not matched by a coherent U.S. regulatory structure to oversee its business. A combination of state, international, and Federal authorities regulate AIG and its subsidiaries. There is currently no Federal banking regulator with responsibility for overseeing AIG's non-insurance financial businesses.

AIG's domestic, life, and property/casualty insurance subsidiaries are regulated by the state insurance regulators or foreign regulators where these companies are domiciled or operate.^v The state insurance regulators examine the parent company only to the extent that it relates to the insurance subsidiaries.^{vi} Foreign insurance regulators, operating under their own countries' laws, have jurisdiction over AIG's overseas insurance subsidiaries.

From 1999 to March 2010, OTS was the supervisor of AIG's non-insurance financial business because AIG was permitted to be considered a savings and loan holding company due to its ownership of a small Wilmington, Delaware, thrift, AIG Federal Savings Bank, which accounted for a tiny piece of its operations. This was significant because the European Union required foreign companies doing business in Europe to have the equivalent of a "consolidated supervisor" in their home country. Starting in 2004, OTS had worked to successfully persuade the European Union that it was capable of performing this role.⁸⁶ AIG was subject to OTS regulation, examination, supervision, and reporting requirements. OTS also had enforcement authority over AIG and its subsidiaries and could restrict or prohibit activities that were a serious risk to the financial safety, soundness, or stability of AIG Federal Savings Bank. The Office of the Comptroller of the Currency is now responsible for regulating AIG Federal Savings Bank, but not the rest of the company. Since 2010, AIG has been in discussions with European regulators concerning consolidated regulation.⁸⁷

^v The primary state insurance regulators include New York, Pennsylvania, and Texas.

^{vi} Though examinations of the AIG parent were limited to how it related to the subsidiaries, the regulators typically obtained additional information about the parent through informal channels, such as regular communications with parent company management and review of public filings. (Congressional Oversight Panel, "June Oversight Report: The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy," 6/10/2010, p. 23, <http://cybercemetery.unt.edu/archive/cop/20110401232818/http://cop.senate.gov/reports/library/report061010-cop.cfm>, accessed 6/28/2012.)

The Federal Reserve has not regulated AIG either before or after the bailout. Its involvement with the company was instead through the Federal Reserve's responsibility to maintain financial system stability and contain systemic risk that may arise in financial markets.

The significant interconnectedness and complexity of AIG's businesses, and the lack of effective regulatory oversight of AIG's financial business, were factors in AIG's near collapse and subsequent bailout. Despite what turned out to be AIG's key role as a financial institution, its only U.S. Federal banking regulator was OTS. AIGFP fell outside the scope of the state insurance regulators, even though its CDS had a function similar to insurance, and AIGFP's CDS trades fell outside OTS's regulatory authority. This regulatory structure meant there was no comprehensive examination and regulation of CDS activity within AIGFP. Certain other financial operations inside AIG — including capital markets, consumer finance, and aircraft leasing — were regulated on a piecemeal basis or escaped regulation entirely.

As the FCIC and COP concluded in separate reports to Congress, OTS failed in its role as AIG's consolidated supervisor; it neither understood its responsibility nor had the tools to oversee the entire company's complex financial services, including AIGFP. As AIG's holding company regulator, OTS was charged with overseeing the parent and had the power and the duty to spot and require the company to curtail its risk, but according to COP, it "failed to do so."⁸⁸ At a March 2009 congressional hearing, then-Acting OTS Director Scott Polakoff acknowledged that his agency failed to recognize the extent of the liquidity risk in AIGFP's CDS portfolio. In addition, John Reich, a former OTS director, told the FCIC that as late as September 2008, he had "no clue — no idea — what [AIG's] CDS liability was."⁸⁹ He further told the FCIC, "At the simplest level, . . . an organization like OTS cannot supervise AIG, GE, Merrill Lynch, and entities that have worldwide offices. . . it's like a gnat on an elephant — there's no way."⁹⁰

The Dodd-Frank Act may subject AIG to substantial additional Federal regulation. The law abolished OTS and moved supervision of savings and loan institutions to the OCC and supervision of their holding companies to the Federal Reserve. The Federal Reserve could take over regulating AIG if it recognizes AIG as a savings and loan holding company under the Home Owners' Loan Act. However, AIG anticipates that it will not be a savings and loan holding company until Treasury holds less than 50% ownership interest.⁹¹ The Dodd-Frank Act also set up a new framework for supervising nonbank financial companies designated as systemically important financial institutions because of the role they play in the financial system. SIFIs face more stringent capital and liquidity requirements and annual stress tests, among other things. They also will be required to follow heightened corporate governance requirements and to prepare "living wills" — plans on how they could be unwound if they fail.

Nonbank SIFI designations have not yet been made and there is no stated time frame to do so. On April 3, 2012, the Financial Stability Oversight Council ("FSOC"), a collection of regulators responsible for rule-making in this area, issued a final rule effective May 11, 2012, with the criteria and process it will

use to decide which large U.S. nonbank financial firms are designated as SIFIs. A nonbank financial institution may be designated a SIFI if it is predominantly engaged in financial activities. FSOC currently is analyzing the potential systemic importance of individual companies. However, before any SIFI determination can be made, the Federal Reserve Board must define what it means for a company to be “predominantly engaged in financial activities.”

If FSOC designates AIG as a nonbank SIFI, AIG would be subject to Federal Reserve examination, enforcement, and supervision. AIG’s senior managers expect AIG to be named a SIFI, and they say that AIG has begun preparing for this designation. “People say, ‘Are you worried about being a SIFI? Are you worried about the Federal Reserve?’ No. I welcome it,” Benmosche said at an insurance conference earlier this year.⁹² Peter Hancock, the head of AIG’s Chartis insurance unit, told a conference last December, “We’ve done more to de-lever our balance sheet and become Fed-ready, because we expect to be regulated by the Fed, than I think almost any other large insurance company.”⁹³

While the Dodd-Frank Act’s nonbank SIFI designation process was intended to give regulators better oversight of nonbank financial players that have crucial roles in the nation’s financial system and subject those designated entities to prudential standards promulgated by the Federal Reserve, the designation of a company as a SIFI is only the first step in a host of challenges Federal regulators face in implementing financial reform. If AIG is designated as a SIFI or recognized as a savings and loan holding company, the Federal Reserve, as its primary supervisor, will face enormous examination, enforcement, supervision, and logistical challenges in its responsibility to provide comprehensive and effective oversight. This is particularly true as it relates to risk, given AIG’s history.

Although AIG has made changes while in TARP, it remains one of the world’s largest companies, with hundreds of subsidiaries in more than 130 countries. Comprehensive and effective oversight of AIG would require the Federal Reserve to have extensive expertise with and knowledge of a wide array of nonbanking businesses and their risks, including AIG’s insurance operations, aircraft leasing business, its mortgage guaranty, securities lending, and other derivatives trading business.

One vital concern for AIG (and any future regulator of AIG) is determining the proper level of risk to make a profit while minimizing the chance of failure. Although this is a continuing challenge for all companies, given its history, risk is of particular concern for AIG. In its 2011 annual report, AIG said, “Risk management is a key element of AIG’s approach to corporate governance.”⁹⁴ This statement is not much different from statements made before the company crashed. In its 2007 annual report, the company said, “AIG believes that strong risk management practices and a sound internal control environment are fundamental to its continued success and profitable growth.”⁹⁵ And until shortly before the company imploded, AIG executives denied there was much, if any, risk from its derivatives portfolio. Even during an August 2007 investor presentation in which AIG revealed that AIGFP had \$79 billion in exposure to super-senior multi-sector CDOs (largely U.S. subprime mortgages), and that the AIG securities lending portfolio included

\$28.7 billion in sub-prime RMBS, accompanying slides emphasized that risk was “extremely remote.”⁹⁶ On a telephone call with analysts that day, Joseph Cassano, then the head of AIGFP, said, “It is hard for us, without being flippant, to even see a scenario within any kind of realm or reason that would see us losing \$1 in any of those transactions.”⁹⁷ Within a year, the bottom dropped out.

The decisions regulators make today about AIG will be crucial to protecting taxpayers in the future. Proper and effective supervision of AIG is just one of the many challenges regulators will likely face in the months and years to come. Effective, comprehensive, and rigorous regulation of AIG is vital to ensure that history does not repeat itself and that taxpayers are protected.

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