

**GAO**

Testimony

Before the Subcommittee on Capital  
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on Financial Services

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# FEDERAL FINANCIAL ASSISTANCE

## Preliminary Observations on Assistance Provided to AIG

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Highlights of [GAO-09-490T](#), a testimony to Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives

## Why GAO Did This Study

The Board of Governors of the Federal Reserve System (Federal Reserve) and the Department of the Treasury (Treasury) have made available over \$182 billion in assistance to American International Group (AIG) to prevent its failure. However, questions have been raised about the goals of the assistance and how it is being monitored. Also, because AIG is generally known for its insurance operations, questions exist about the effect of the assistance on certain insurance markets.

This statement provides preliminary findings on (1) the goals and monitoring of federal assistance to AIG and challenges to AIG's repayment of the assistance; and (2) the potential effects of the federal assistance on the U.S. commercial property/casualty insurance market. GAO's work on these issues is ongoing. To date, we have reviewed relevant documents on the assistance and ongoing operations of AIG, as well as documents issued by the Federal Reserve and Treasury. We also interviewed officials from these organizations as well as industry participants (competitors, brokers, and customers) and insurance regulators, among others.

[View GAO-09-490T](#) or [key components](#). For more information, contact Orice M. Williams at (202) 512-86785555 or [williamso@gao.gov](mailto:williamso@gao.gov).

## FEDERAL FINANCIAL ASSISTANCE

### Preliminary Observations on Assistance Provided to AIG

#### What GAO Found

Federal financial assistance to AIG, both from the Federal Reserve and Federal Reserve Bank of New York through their authority to lend funds to critical nonbank institutions and from Treasury's Troubled Asset Relief Program (TARP), has focused on preventing systemic risk that could result from a rating downgrade or failure of AIG. The goal of the assistance and subsequent restructurings was to prevent systemic risk from the failure of AIG by allowing AIG to sell assets and restructure its operations in an orderly manner. The Federal Reserve has been monitoring AIG's operations since September, and Treasury has begun to more actively monitor AIG's operations as well. Although the ongoing federal assistance has prevented further downgrades in AIG's credit rating, AIG has had mixed success in fulfilling its other restructuring plans, such as terminating its securities lending program, selling assets, and unwinding its AIG Financial Products portfolio. For example, AIG has made efforts at selling certain business units and has begun an overall restructuring, but market and other conditions have prevented significant asset sales, and most restructuring efforts are still under way. AIG faces ongoing challenges from the continued overall economic deterioration and tight credit markets. AIG's ability to repay its obligations to the federal government has also been impaired by its deteriorating operations, inability to sell its assets and further declines in its assets. All of these issues will continue to adversely impact AIG's ability to repay its government assistance.

As part of GAO's ongoing work related to the federal assistance provided to AIG, GAO is reviewing the potential impact of the assistance on the commercial property/casualty insurance market. Specifically, GAO is reviewing potential effects of the assistance on AIG's pricing practices. According to some of AIG's competitors, federal assistance to AIG has allowed AIG's commercial property/casualty insurance companies to offer coverage at prices that are inadequate for the risk involved. Conversely, state insurance regulators, insurance brokers, and insurance buyers said that while AIG may be pricing somewhat more aggressively than in the past in order to retain business in light of damage to the parent company's reputation, they did not see indications that this pricing was inadequate or out of line with previous AIG pricing practices. Moreover, some have noted that AIG has lost business because of the problems encountered by its parent company. As GAO evaluates these issues, it faces a number of challenges associated with determining the adequacy of commercial property/casualty premium rates, especially in the short term. These challenges include the unique, negotiated nature of many commercial insurance policies, the subjective assumptions involved in determining premiums, and the fact that for some lines of commercial insurance it can take several years to determine if premiums charged were adequate for the related losses.

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Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to participate in today's hearing to provide preliminary observations on the federal government's assistance to the American International Group (AIG)—a large financial conglomerate with an estimated 70 U.S. insurance companies—and the potential impact of this assistance on U.S. insurance markets, especially the commercial property/casualty insurance market.<sup>1</sup> As you know, the Board of Governors of the Federal Reserve System (Federal Reserve) and the Federal Reserve Bank of New York (FRBNY) provided assistance to AIG in September 2008 following its rating downgrade, which had prompted collateral calls by its counterparties and raised concerns that a rapid failure of the company would further destabilize financial markets. However, AIG's condition continued to decline, and in November 2008 the Federal Reserve and the Department of the Treasury (Treasury) under the newly created Troubled Asset Relief Program (TARP) announced plans to restructure AIG's federal assistance to further strengthen its financial condition and, once again, prevent the failure of the company. On March 2, 2009, the Federal Reserve and Treasury provided additional assistance and further restructured the terms, which raised questions about the ongoing viability of the company and the likelihood that the federal assistance could be repaid.

The assistance provided to AIG has also raised questions among AIG's competitors about whether the assistance provided to AIG's parent company is being used to benefit its insurance companies. AIG's competitors have argued that the assistance has allowed AIG's insurance companies to price coverage aggressively compared to the premiums being charged by the rest of the market, thereby providing AIG with a competitive advantage, particularly in commercial property/casualty insurance markets.

My statement today focuses on the preliminary results of our ongoing review of the federal financial assistance to AIG and its impact on the U.S. property/casualty insurance market, initiated at the request of Ranking Member Bachus (full committee) and Chairman Kanjorski (subcommittee). Specifically, I will discuss (1) the goals and monitoring of the federal government's assistance to AIG, the associated setbacks, and

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<sup>1</sup>AIG comprises at least 223 companies and it has operations in 130 countries and jurisdictions worldwide.

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challenges to AIG's repayment of this assistance and (2) the potential effects of this federal assistance to AIG on the U.S. insurance market, especially the commercial property/casualty market.

To achieve these objectives, we analyzed publicly available reports, congressional testimonies, and other documentation issued by the Federal Reserve, FRBNY, Treasury, Securities and Exchange Commission, Congressional Research Service, and rating agencies. We also conducted numerous interviews with officials and staff from the Federal Reserve, FRBNY, Treasury, three state insurance regulators with major roles in regulating AIG's insurance companies, the National Association of Insurance Commissioners (NAIC), five insurance brokers, four large commercial property/casualty insurers that compete with AIG, two reinsurers, three rating agencies, two industry observers, and an association representing purchasers of commercial property/casualty insurance. Finally, we consulted with a group of actuaries to discuss our methodology, bolster our understanding of insurance markets, and evaluate what we heard from others.

We conducted our work from January 2009 to March 2009, in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for our preliminary findings and conclusions.

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## Summary

Federal financial assistance to AIG, both from the Federal Reserve and FRBNY through their authority to lend funds to critical non-bank entities in certain circumstances and from Treasury's TARP, has focused on preventing the systemic risk that could result from a failure or further rating downgrade at AIG. The goal of the initial assistance and subsequent restructurings was to prevent systemic risk from the failure of AIG by allowing AIG to sell assets and restructure its operations in an orderly manner. The Federal Reserve has been monitoring AIG's operations since September, and Treasury will more actively monitor AIG's operations as well. Although the ongoing federal assistance has prevented further downgrades in AIG's credit rating, AIG has had mixed success in fulfilling its other restructuring plans, such as terminating its securities lending program, selling assets, and unwinding its AIG Financial Products (AIGFP) portfolio. For example, AIG has made efforts at selling certain business units and has begun an overall restructuring, but market and other

conditions have prevented significant asset sales, and most restructuring efforts are still under way. AIG faces ongoing challenges from the continued overall economic deterioration and tight credit markets. AIG's ability to repay its obligations to the federal government has also been impaired by its deteriorating operations, inability to sell its assets and further declines in its assets. All of these issues will continue to adversely impact AIG's ability to repay its government assistance. Table 1 provides an overview of the total federal investment in AIG of \$182.5 billion as of March 2, 2009.

**Table 1: Amounts of AIG Federal Assistance Used and Authorized as of March 2, 2009**

<i>Date Program Announced</i> <b>Program Title</b>	<b>Amount Borrowed/Used</b> (dollars in millions)	<b>Total Amount Authorized</b> (dollars in millions)	<b>Transaction Details</b>
<b>Federal Reserve Bank of New York (FRBNY)</b>			
<i>September 2008</i> Revolving Credit Facility	\$41,969 <sup>a,f</sup>	\$60,000 <sup>b,d</sup>	Revolving loan for the general corporate purposes of AIG and its subsidiaries, and to pay obligations as they come due. In September this comment was \$85 billion but was reduced to \$60 billion. By the end of the March 2009 the amount will be reduced to no less than \$25 billion.
<i>November 2008</i> Maiden Lane II LLC	19,500	22,500	FRBNY extended credit to Maiden Lane II to purchase residential mortgage-backed securities from the U.S. securities lending portfolio of AIG subsidiaries.
<i>November 2008</i> Maiden Lane III LLC	24,300	30,000	FRBNY extended credit to Maiden Lane III to purchase multi-sector collateralized debt obligations on which AIG Financial Products had written credit default swaps.
<i>March 2009</i> Securitization of domestic life insurance cash flows	0	(8,500) <sup>c</sup>	FRBNY loan to special purpose vehicles (SPVs) established by domestic life insurance subsidiaries of AIG. The SPVs would repay the loans from the net cash flows they receive from designated blocks of existing life insurance policies held by the parent insurance companies.
<i>March 2009</i> Preferred stock in foreign life companies		(26,000) <sup>d</sup>	Preferred interests in two SPVs created to hold all of the outstanding common stock of two life insurance holding company subsidiaries of AIG.

<i>Date Program Announced</i> <b>Program Title</b>	<b>Amount Borrowed/Used</b> (dollars in millions)	<b>Total Amount Authorized</b> (dollars in millions)	<b>Transaction Details</b>
<b>U.S. Treasury Department<sup>e</sup></b>			
<i>November 2008</i> Series D Preferred Stock	40,000 <sup>f</sup>	40,000	AIG issued Series D preferred stock to Treasury and proceeds of \$40 billion were used to pay down AIG's Revolving Credit Facility balance.
<i>March 2009</i> Equity Capital Facility <sup>g</sup>		30,000	This facility will be available for AIG to draw down cash as needed over time in exchange for non-cumulative preferred stock to the U.S. Treasury.
<b>Credit Facility Trust</b>			
<i>September 2008</i> Series C Preferred Stock	0.5		Shares of convertible preferred stock representing an approximately 77.9 percent equity interest in AIG.
<b>Total</b>	<b>\$125,770<sup>h</sup></b>	<b>\$182,500</b>	

Source: Federal Reserve, Treasury, and AIG data.

Notes:

<sup>a</sup>The debt outstanding in the Revolving Credit Facility includes accrued interest and has been reduced by the \$40 billion AIG received from issuing preferred stock to Treasury.

<sup>b</sup>The Revolving Credit Facility was initially authorized for up to \$85 billion but was reduced to \$60 billion in conjunction with the \$40 billion paydown of the outstanding debt. The amount of this facility will be reduced to no less than \$25 billion by the end of March 2009 based on the terms of the March 2 restructuring (see notes c and d).

<sup>c</sup>The proceeds from the new loans to SPVs established by domestic life insurance subsidiaries of AIG will be used to pay down an equivalent amount of outstanding debt under the Revolving Credit Facility up to an aggregate of about \$8.5 billion. Therefore, this amount does not affect total authorized amount outstanding.

<sup>d</sup>The revolving credit facility is to be reduced by up to about \$26 billion in exchange for preferred interest in two SPVs created to hold all of the outstanding common stock of two life insurance holding company subsidiaries of AIG. Therefore, this amount does not affect total authorized amount outstanding.

<sup>e</sup>Treasury provided the assistance under the Troubled Asset Relief Program's (TARP) Systemically Significant Failing Institutions (SSFI) Program.

<sup>f</sup>The \$40 billion was used to reduce the outstanding amount of the Revolving Credit Facility. The outstanding amount of \$42 billion reflects that reduction. As announced in the March 2, 2009 restructuring plan, the Treasury will exchange its existing \$40 billion cumulative perpetual preferred shares for new preferred shares with revised terms that more closely resemble common equity.

<sup>g</sup>As of March 16, 2009, Treasury was still in the process of finalizing the terms of this facility.

<sup>h</sup>This excludes the \$14 billion obtained from the Commercial Paper Lending Facility.

As part of our ongoing work on AIG, we are reviewing the potential impact of AIG's federal assistance on the commercial property/casualty insurance market. Specifically, we are reviewing potential effects on AIG's pricing practices. According to some of AIG's competitors, federal assistance to AIG has allowed AIG's commercial property/casualty insurance companies to offer coverage at prices that are inadequate for the risk involved.

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Conversely, state insurance regulators, insurance brokers, and insurance buyers said that while AIG may be pricing somewhat more aggressively than in the past in order to retain business in light of damage to the parent company's reputation, they did not see indications that this pricing was inadequate or out of line with previous AIG pricing practices. Moreover, some have noted that AIG has lost business because of the problems encountered by the parent company. As we evaluate these issues, we face a number of challenges associated with determining the adequacy of commercial property/casualty premium rates. For example, the terms of the policy are often negotiated, and pricing adequacy is ultimately determined by future losses.

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## Background

AIG is a holding company that, through its subsidiaries, is engaged in a broad range of insurance and insurance-related activities in the United States and abroad, including general insurance, life insurance and retirement services, financial services, and asset management. The AIG organization includes the largest domestic life insurer and the second largest domestic property/casualty insurer, and it has a large foreign general insurance business. It also has a financial products division, which has been a key source of AIG's financial difficulties, particularly AIGFP, which engaged in a wide variety of financial transactions, including standard and customized financial products.

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## AIG's Financial Problems Mounted Quickly

From July 2008 to August 2008, ongoing concerns about AIG's securities lending program and continuing declines in the value of super senior collateralized debt obligations (CDO) protected by AIGFP's super senior credit default swap (CDS) portfolio, along with ratings downgrades of the CDOs, resulted in AIGFP having to post additional cash collateral, which raised liquidity issues.<sup>2</sup> By early September, collateral postings and securities lending requirements were placing increased pressure on the AIG parent company's liquidity. AIG attempted to raise additional capital

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<sup>2</sup>The securities lending program allowed insurance companies, primarily the life insurance companies, to lend securities in return for cash collateral that was invested in residential mortgage-backed securities (RMBS). When the value of these securities declined in 2007, AIG incurred significant losses when it had to return the cash collateral when its borrowed securities were returned. Collateralized debt obligations are securities backed by a pool of bonds, loans, or other assets. Credit default swaps are bilateral contracts that are sold over the counter and transfer credit risks from one party to another. The seller, who is offering credit protection, agrees, in return for a periodic fee, to compensate the buyer, who is purchasing it, if a specified credit event, such as default, occurs.

in September but was unsuccessful. It was also unable to secure a bridge loan through a syndicated secured lending facility. On September 15, 2008, the rating agencies downgraded AIG's debt rating three notches, resulting in the need for an additional \$20 billion to fund its additional collateral demands and transaction termination payments. As AIG's share price continued to fall following the credit rating downgrade, counterparties withheld payments and refused to transact with AIG. Also around this time, the insurance regulators no longer allowed AIG's insurance subsidiaries to lend funds to the parent under a revolving credit facility that AIG maintained and demanded that any outstanding loans be repaid and that the facility be terminated.

## Overview of Federal Assistance Provided

Ongoing instability in global credit markets and other issues have resulted in over \$182 billion in federal assistance being made available to AIG. First, in September 2008, the Federal Reserve created the Revolving Credit Facility, which was intended to stabilize AIG by providing it with sufficient liquidity and enabling AIG to dispose of certain assets in an orderly manner while avoiding undue disruption to the economy and financial markets (see table 2). The original amount available under the facility was up to \$85 billion. While the amount borrowed reached \$82 billion, the debt was reduced by the proceeds from AIG's sale of preferred shares to Treasury as well as repayments from the Fed Securities Lending Agreement and the Commercial Paper Facility. As of February 18, 2009, AIG had \$38.8 billion in debt outstanding under this facility.

**Table 2: Use of Federal Funds and Borrowings Outstanding from the Federal Reserve Bank of New York Revolving Credit Facility as of February 18, 2009**

<b>Borrowings:</b>	<b>Total (millions)</b>
Loans for AIGFP to post for collateral required by its counterparties on credit default swaps and postings, guaranteed investment agreements (GIA) and payment of other maturing debts	\$47,547
Capital contributions to insurance companies <sup>a</sup>	20,850
Repayments of obligations to life companies in securities lending program	3,160
Repayments of short-term inter-company loans by annuity and life companies to parent company	1,528
Contributions to AIGCFG subsidiaries <sup>a</sup>	1,686
Repayments of AIG non-federal debt of AIG parent company	2,319
Funding for AIG's Equity interest in Maiden Lane III <sup>b</sup>	5,000
<b>Subtotal</b>	<b>\$82,090</b>



<b>Borrowings:</b>	<b>Total (millions)</b>
Repayment of Fed facility from proceeds of issuance of Series D Preferred Stock	(40,000)
Repayments of Fed facility from other sources <sup>c</sup>	(6,890)
<b>Net borrowings</b>	<b>\$35,200</b>
Accrued compounding interest and fees	3,631
<b>Total balances outstanding</b>	<b>\$38,831<sup>d</sup></b>

Sources: AIG Form 10-Q for Sept. 30, 2008, Form 10-K for Dec. 31, 2008.

Notes:

<sup>a</sup>During 2008 and through February 27, 2009, AIG contributed capital of \$22.7 billion (including \$18.0 billion borrowed under the Fed Facility) to its Domestic Life Insurance and Domestic Retirement Services subsidiaries. AIG also contributed \$4.4 billion to the Foreign Life Insurance companies during 2008 including \$4.0 billion from borrowings under the Fed Facility).

<sup>b</sup>AIG purchased its equity stake in Maiden Lane III with money borrowed from the Federal Reserve Bank of New York's facility.

<sup>c</sup>Includes repayments from funds received from the Fed Securities Lending Agreement and the Commercial Paper Funding Facility.

<sup>d</sup>According to the Federal Reserve, the Revolving Credit Facility balance was \$42 billion as of March 2, 2009, but AIG's 10-K provided details as of February 18, 2009.

Second, in November 2008, the Federal Reserve and Treasury announced additional assistance to AIG and restructured its original assistance. On November 9, 2008, the Treasury announced plans to use its Systemically Significant Failing Institutions (SSFI) Program, under TARP, to purchase \$40 billion in AIG preferred shares. This purchase allowed AIG to reduce its debt outstanding to the Federal Reserve and enabled the Federal Reserve to reduce the amount available under the Revolving Credit Facility from \$85 billion to \$60 billion. On November 10, 2008, the FRBNY announced plans to lend up to \$22.5 billion to Maiden Lane II LLC, a facility formed to purchase residential mortgage-backed securities (RMBS) from the U.S. securities lending investment portfolio of AIG subsidiaries. When this facility was established, it replaced an interim securities lending agreement with the Federal Reserve. Also on November 10, FRBNY announced plans to lend up to \$30 billion to Maiden Lane III LLC, a FRBNY facility formed to purchase multi-sector CDOs on which AIGFP had written CDS protection. In connection with the purchase of the CDOs, AIG's CDS counterparties agreed to terminate the CDS contracts.

Most recently, on March 2, 2009, the U.S. Treasury and FRBNY announced plans to further restructure the terms of the assistance. Consistent with earlier assistance, this was also designed to enhance the company's capital and liquidity in order to facilitate orderly restructuring of the company. The restructuring of the assistance would, among other things, provide the

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government with interests in two AIG foreign life insurance companies, as well as certain cash flows from certain domestic insurance companies, each in exchange for reducing AIG's Revolving Credit Facility balance. The assistance also would include a new Treasury equity capital facility that would allow AIG to draw down up to \$30 billion as needed over time in exchange for newly issued non-cumulative preferred stock to the U.S. Treasury. Treasury and FRBNY would also exchange the previously issued Series D preferred stock for Series E preferred stock that would more closely resemble common stock and provide for non-cumulative dividends. To date, AIG has not drawn against this facility.

As noted above, some federal assistance was designated for specific purposes, such as reducing the loan outstanding to the Federal Reserve or for purchasing specific assets, such as CDOs and RMBS. Other assistance, such as that available through the Federal Reserve Revolving Credit Facility, is available to meet the general financial needs of the parent company and its subsidiaries. Some of the assistance also places restrictions on actions that AIG can take while it has loans outstanding to the federal government or as long as the federal government has an ownership interest in AIG assets, as well as restrictions on executive compensation. Executive compensation restrictions for TARP recipients were also included in the American Recovery and Reinvestment Act of 2009, which was enacted on February 17, 2009. In general, the restrictions prohibit

- bonus and incentive compensation payments to certain employees, depending on the amount of TARP assistance received;
- golden parachutes; and
- compensation plans that encourage risk-taking.

See appendix I for a detailed chronology of events.

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## Federal Efforts Have Focused on Maintaining and Monitoring AIG's Solvency, but AIG Faces Challenges in Repaying Federal Assistance

Federal assistance to AIG has been focused on preventing systemic risk from a potential AIG failure and monitoring its progress, but AIG faces challenges in repaying the assistance. Federal Reserve and Treasury officials have said that a failure of AIG, potentially triggered by further credit downgrades or additional collateral calls, would result in liquidity concerns for other financial market participants. A disorderly failure of AIG would not only create difficulties for AIG's counterparties as described, but could further erode confidence in and uncertainty about the viability of other financial institutions. This, in turn, would further constrict the flow of credit to households and businesses, potentially deepening and lengthening the current recession. If the ultimate goal is avoiding the failure of AIG, the Federal Reserve and Treasury have achieved that goal in the short-term. However, maintaining solvency has required federal assistance beyond that provided in September and November 2008, and rating companies have stated that their current ratings are contingent on continued federal support for AIG. AIG and federal regulators acknowledge that there may be a need for further assistance given the significant challenges AIG continues to face. Therefore, more time is required to determine if the goal will be fully achieved in the long-term.

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## Federal and State Monitoring Efforts Are Focused on AIG Solvency

We asked Treasury and the Federal Reserve how they were monitoring AIG's progress toward reaching the goals of the federal financial assistance and AIG's compliance with the restrictions placed upon it as a condition of receiving the assistance. According to Treasury and Federal Reserve officials, the agencies are working together to monitor AIG's solvency by reviewing the reports required by the terms of the financial assistance, and the Federal Reserve is in contact daily with AIG officials regarding AIG's liquidity needs and their efforts to sell the company's assets. AIG regularly files several reports with FRB NY, including daily cash flow reports, reports identifying risk areas within the company, and daily liquidity requests/cash flow forecasts, allowing the Federal Reserve to monitor AIG's liquidity. Also, AIG has a divestiture team that meets at least weekly with the Federal Reserve to discuss potential sales deals, including bids from potential buyers, financing, and other terms of sales agreements, so that the Federal Reserve can monitor AIG's efforts to sell its assets.

The Federal Reserve and Treasury said that they are monitoring the various federal agreements with AIG, and these agreements place restrictions on AIG's use of the funds. For example, the Federal Reserve monitors restrictions on the Revolving Credit Facility, including whether

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AIG has inappropriately paid dividends or financed extraordinary corporate actions like acquisitions. According to Treasury officials, it is in the process of finalizing new executive compensation requirements based on the American Recovery and Reinvestment Act of 2009, and will begin monitoring AIG's compliance with those regulations once they are in place. This is an area we will continue to monitor as part of our broader TARP oversight.

State insurance regulators are responsible for monitoring the solvency of insurance companies generally, as well as for approving transactions regarding those companies, such as changes in control or significant transactions with the parent company or other subsidiaries. For example, regulators told us that AIG's insurance companies, like all insurance companies, file quarterly reports with them. Since AIG began receiving federal assistance in September 2008, regulators also said that AIG's insurance companies have been submitting additional reports on their liquidity, investment income, and statistics on surrender and renewal of policies, sometimes on a daily or weekly basis. The various regulators also coordinate their monitoring of the companies' insurance lines. State regulators also evaluate potential sales of AIG's domestic insurance companies. NAIC formed a working group designed to expedite any regulatory approvals required for asset sales, with a goal of completing the approvals within 45 days of filing for a sale.

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### AIG Faces a Number of Challenges to Its Ability to Repay Its Federal Funds

AIG's restructuring has hinged on efforts in three areas: (1) terminating its CDS portfolio, (2) terminating its securities lending program, and (3) selling assets. Federal assistance was targeted to the first two areas that posed a significant risk to AIG's solvency—AIGFP's CDS portfolio and the securities lending program—and the risks from both activities appear to have been reduced, but some risks remain. One arrangement, Maiden Lane III—the FRBNY facility created to purchase CDOs—has purchased approximately \$24.3 billion in multi-sector CDOs (with a par value of approximately \$62 billion), which were the assets underlying the CDS protection that AIG sold. Concurrent with the purchase of the underlying CDOs, AIGFP counterparties agreed to cancel the CDS written on the CDOs, thus unwinding significant portions of AIGFP's CDS portfolio. According to AIG, some arrangements did not qualify for sale to the facility, generally either because the counterparties did not own the instruments on which CDS were written or because they were in denominations other than U.S. dollars. As of February 18, 2009, approximately \$12.2 billion in notional amounts of CDS remained with AIG. According to AIG, these remaining CDS continue to present a risk to

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AIG, as further losses from these assets could require additional funding. A second FRBNY facility—Maiden Lane II—purchased approximately \$19.5 billion in RMBS and other assets related to the securities lending program. Both the Maiden Lane II and Maiden Lane III facilities allow AIG to participate in the residual proceeds after the FRBNY loan has been repaid. However, AIG faces other potential losses from other investments.

The federal assistance has allowed AIG to undertake restructuring efforts, which continue. As of September 2008, AIG was to wind down the operations of AIGFP and sell certain businesses. In October 2008, the company announced plans to sell some of its life insurance operations and other businesses. AIG is continuing to wind down AIGFP but expects the process to take at least several years in order to avoid further losses given the current market conditions. AIG has been unable to sell its insurance assets for prices it deems acceptable given the general state of the global economy. As a result, the plan has been modified, and the federal government will now assume an ownership interest in some of AIG's life insurance companies. The federal government's ownership stake will be a percentage of the fair market value of these companies based on valuations acceptable to the Federal Reserve. In addition, AIG plans to consolidate its commercial property/casualty insurance operations in a free-standing entity and potentially offer an equity interest in part of this new entity to public investors.

Asset sales have been difficult, not only because tight credit markets are limiting buyers' ability to obtain the capital needed to purchase the companies, but also because of challenges faced by AIG in retaining key employees, who contribute to the value of the company. In addition, the timely sale of CDOs and RMBS held by the Federal Reserve facilities will be challenging, not only because it may be difficult to value those assets, but because many are tied to home values, which have been in decline.

AIG's ongoing financial problems have resulted in additional assistance and restructuring of the terms of the original assistance, and AIG faces numerous, significant challenges to its ability to repay federal assistance in the future. AIG's ability to repay the federal government hinges on it remaining solvent and effectively restructuring the organization, including the sale of subsidiaries. The federal government recouping its assistance also depends in part on FRBNY being able to obtain a satisfactory return on the sale of the CDO- and RMBS-related assets purchased by Maiden Lane II and III.

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AIG's ability to pay interest and dividend payments has been and may continue to be a challenge because its ability to make payments is dependent on the profitability of AIG operations, which face a number of hurdles. As of December 31, 2008, AIG insurance subsidiaries had statutory capital levels that exceeded the minimum requirements. However, damage to AIG's reputation has made it difficult for its insurance companies to maintain current business and write new business. In addition, profitability is also dependent on the overall state of the economy—many of AIG's insurance premium sources are tied to economic activity, such as payroll—and its insurers, especially its life insurers, depend on strong investment returns. To the extent the overall economy is experiencing difficulty, it will present challenges to the profitable operations of AIG's insurance companies. While recent federal assistance has been restructured to reduce AIG's interest and dividend payment requirements, it is too soon to tell whether further assistance or further restructuring will be needed in the future.

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## Some of AIG's Competitors Claim that AIG's Commercial Insurance Pricing Is Out of Line With Its Risks but Other Insurance Industry Participants and Observers Disagree

We are examining the potential effect of federal assistance to AIG on the insurance market, particularly AIG's pricing practices within the commercial property/casualty market. Market participants (actuaries, regulators, brokers, customers, and insurance companies) we talked with indicated that, foremost, insurance premium rates follow an insurance underwriting cycle that is generally characterized by a long period of "soft market" conditions, where premium rates are relatively low and underwriting standards are less stringent, followed by a much shorter period of "hard market" conditions, where premium rates flatten or increase and underwriting standards are more stringent. They explained that starting with the September 11, 2001, terrorist attacks and continuing until late 2003 or early 2004, the commercial property/casualty market was in a hard market, but since this time the markets have softened and premium rates have been declining. For example, according to the Council of Independent Agents and Brokers (CIAB) surveys, quarterly changes in commercial property/casualty premium rates have been negative (falling) for all commercial line accounts since the second quarter of 2004 (except for catastrophe-exposed property lines in early 2006), and while the magnitude of the changes leveled off in the last quarter of 2008, the average quarterly premium rate change was still negative in that period.

Industry participants also said that premiums charged by commercial property/casualty insurers for a given coverage are influenced by several factors that could allow one insurer to price lower than another on a given risk and that AIG Commercial Insurance historically had been able to take

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advantage of several of these factors. Such factors include a long history of experience with complex risks, a lower operating expense ratio relative to competitors, global operations that allow offsetting risks, and the ability to leverage the size and the financial strength of the parent company to write larger coverage amounts than competitors, in some cases without the need to purchase reinsurance. It is not yet clear to what extent the current financial difficulties the AIG parent company may have diminished these advantages for AIG Commercial Insurance.

Some insurers we spoke with said that they had observed instances, in some cases numerous instances, where AIG had sold commercial property/casualty coverage for a price that these insurers believed was inadequate for the risk involved. They cited examples where AIG Commercial Insurance's prices had decreased significantly from the prior year's price, when circumstances appeared to indicate that higher prices were warranted. Some insurers said that they had brought several of these instances to the attention of the relevant state insurance regulator. Insurers expressed concern that while current market conditions would dictate increased prices in most commercial property/casualty lines of insurance, they believe that AIG Commercial Insurance has decreased its prices. They added that when such pricing activity is combined with AIG Commercial Insurance's market power, AIG Commercial Insurance can prevent prices from increasing and thus hurt other insurers' ability to price insurance at a cost adequate to cover the risk involved. The insurers said they believed that AIG Commercial Insurance's recent pricing behavior is the result of its desire to retain existing business in the face of concerns over the financial health of its parent company, and some suggested that the federal financial assistance is providing them the means to do this. For example, some suggested that AIG Commercial Insurance officials know that the federal government will not let them fail, so they can charge very low prices without fear of the consequences when the premiums collected turn out to be less than the losses those premiums were meant to cover. Some also suggested that buyers in the market are choosing to stay with AIG Commercial Insurance because they also believe that the insurance company is now backed by the federal government and that their losses will ultimately be covered.

AIG told us that AIG Commercial Insurance has the biggest policyholder surplus in the industry and that they are solvent and financially sound. They maintained that they are charging prices adequate for the risk being covered and that their commercial insurance rates have been mirroring the overall trends in the current soft market. That is, they indicated that their rates have been declining at an increasingly slower pace since the

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fourth quarter of 2008, and in some cases have increased. They also cited other factors that they said would indicate that they were not pricing inadequately or taking market share from other companies. First, AIG Commercial Insurance told us that they have actually been losing market share because the financial situation of the parent company had impacted the reputation of the AIG commercial insurance companies. In addition, they cited instances where competitors were using the AIG parent company's financial problems as a way to discourage customers from buying AIG commercial insurance coverage. Finally, AIG Commercial Insurance provided us with examples of recent contracts that they have lost to competitor bids that were below their own. However, AIG Commercial Insurance acknowledges that these examples reflect the nature of the business, not necessarily inappropriate pricing by the competitors.

State insurance regulators, insurance brokers, and insurance buyers that we have spoken to said that they have seen no indications that AIG's commercial property/casualty insurers are selling coverage at prices inadequate to cover the risk involved:

- State insurance regulators we spoke to said that they generally do not closely watch commercial insurance rates because they may have been largely deregulated by the states, as well as because of the highly negotiated nature and complexity of many commercial lines of insurance. However, they said that they investigate complaints about pricing activities and monitor insurer solvency measures that would indicate inadequate pricing—although in some lines the consequences of such pricing may not show up in these measures for several years. State regulators indicated that complaints of pricing inadequate for the risk involved would need to be numerous enough to indicate a potential systemic problem or would need to prove an intentional predatory strategy from the part of a particular company. Based on what they have reviewed, the regulators we spoke with said they have seen no indications of inadequate pricing by AIG's commercial property/casualty insurers.
- Insurance brokers we spoke with said that when helping a customer obtain coverage, they see all of the prices and conditions offered by each insurer placing a bid on that coverage. They also indicated that commercial property/casualty insurance is competitive, and that in several lines of commercial insurance, especially where large coverage amounts are involved, prices offered by insurers can deviate significantly on the same risk. For example, one broker said that insurers' bids on large policies regularly vary by as much as 20 percent below and above the median bid. Several brokers told us that AIG Commercial Insurance has



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historically priced aggressively in some lines, and that while in some instances in the past several months AIG Commercial Insurance may have priced more aggressively in order to retain certain customers, it did not appear to be a widespread practice and was viewed as an expected response given the reputational hit the company has taken. They also cited instances where AIG Commercial Insurance has lost business because other insurers' prices were lower than theirs.

- Insurance buyers, who also see all of the prices and conditions offered by each insurer bidding on their coverage, said that AIG Commercial Insurance is known to be competitive in some lines and that they have not seen any indications of a widespread change in pricing by AIG's commercial insurers. They also said that they would recognize, and be concerned about, an insurer charging suspiciously low rates for the coverage because it would create a risk that the insurer would be unable to pay the policyholder's claim.

However, according to insurance regulators and other industry participants, for many lines of commercial insurance, determining whether prices charged by a commercial property/casualty insurer are adequate for the risk involved pose a number of challenges:

- In many lines of commercial insurance, in the case of very large risks as opposed to routine policies, the terms of coverage, in addition to the price, are often negotiated, resulting in unique policies. For example, the amount of a claim the policyholder would be responsible for, and the collateral the policyholder would be required to post to guarantee payment of this amount, would be negotiated. Without knowing all the terms of an individual policy, it could be difficult to determine the extent to which that policy was priced adequately for the risk involved.
- Insurers price policies based on predictions of future losses, which contain a number of subjective assumptions about risk, interest rates, litigation costs, and other costs. Underwriters may price a given risk differently and still be able to defend the reasoning behind their calculations.
- The most concrete indication of systematic inadequate pricing comes several years later, depending on how far into the future the losses associated with the policies in question are realized. However, a company may ultimately end up with higher-than-expected losses even if it charged actuarially determined premiums using reasonable assumptions at the time the policies were written.

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In closing, the extent to which the assistance provided by the government will achieve its goal of preventing systemic risk continues to unfold and will be largely influenced by AIG's success in meeting its ongoing challenges in trying to restructure its operations. Likewise, it is too soon to tell whether AIG will be able to repay its outstanding debt to the federal government, which in large part depends on the stability of the overall financial system. While we have found no evidence that federal assistance has been provided directly to AIG's property/casualty insurers, as has been the case for AIG life insurers, AIG's insurance companies have likely received some indirect benefit to the extent that the property/casualty insurers would have been adversely affected by a credit downgrade or failure of the AIG parent. While we are continuing to complete our work in the area, some of AIG's competitors claim that AIG's commercial insurance pricing is out of line with its risks but other insurance industry participants and observers disagree. At this time, we have not drawn any final conclusions about how the assistance has impacted the overall competitiveness of the commercial property/casualty market.

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Mr. Chairman, this completes my prepared statement. I would be pleased to answer any questions that you or Members of the Subcommittee may have.

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## Contact and Acknowledgements

For further information about this testimony, please contact Orice M. Williams at (202) 512-8678 or [williamsso@gao.gov](mailto:williamsso@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Patrick Ward (Assistant Director), Joe Applebaum (Chief Actuary), Susan Offutt (Chief Economist), Silvia Arbelaez-Ellis, Tania Calhoun, John Forrester, Dana Hopings, Jennifer Schwartz, and Melvin Thomas.

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# Appendix I – Timeline of AIG Financial Difficulties Leading Up to Federal Assistance

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- July 2008 to August 31, 2008:
  - The super senior collateralized debt obligation (CDO) securities protected by American International Group Financial Products' (AIGFP) super senior credit default swap (CDS) portfolio continued to decline and ratings of CDO securities were downgraded, resulting in AIGFP posting additional \$5.9 billion collateral.
  - AIG was doing a strategic review of AIG's businesses and reviewing measures to address the liquidity concerns in AIG's securities lending portfolio and to address the ongoing collateral calls regarding AIGFP's super senior multi-sector CDS portfolio, which as of July 31, 2008, totaled \$16.1 billion.
- Early September 2008: These collateral postings and securities lending requirements were placing increasing stress on the AIG parent company's liquidity.
- September 8 to September 12, 2008: AIG's common stock price declined from \$22.76 to \$12.14, making it unlikely that AIG would be able to raise the large amounts of capital that would be necessary if AIG's long-term debt ratings were downgraded.
- September 11 or 12, 2008: AIG approached the Federal Reserve with two concerns:
  - AIG had significant losses in the first two quarters of calendar year 2008, primarily attributable to AIGFP and decreasing values in their securities, leading AIG to request to place large amounts of cash collateral.
  - AIG's investments in mortgage-backed securities (MBS) were very illiquid. Consequently, AIG would not be able to liquidate its assets to meet the demands of counterparties. Since AIG is not regulated by the Federal Reserve, the agency was not aware of the company's financial problems.

Also, because AIG was facing a downgrade in its credit rating the next week, it needed immediate liquidity help. Over the weekend, the Federal Reserve was examining AIG to determine if it was systemically important, meaning that its failure would have a broader effect on the economy. This was the same weekend that Lehman Brothers went into bankruptcy.

- September 12, 2008:
  - Standard & Poor's (S&P), placed AIG on CreditWatch with negative implications and noted that upon completion of its review, the agency could affirm the AIG parent company's current rating of AA- or lower the rating by one to three notches.

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- AIG's subsidiaries, International Lease Finance Corporation (ILFC) and American General Finance, Inc. (AGF), were unable to replace all of their maturing commercial paper with new issuances of commercial paper. As a result, AIG advanced loans to these subsidiaries to meet their commercial paper obligations.
  - September 13 and 14, 2008: AIG accelerated the process of attempting to raise additional capital and discussed potential capital injections and other liquidity measures with private equity firms, sovereign wealth funds and other potential investors. AIG also met with Blackstone Advisory Services LP to discuss possible options.
  - September 15, 2008:
    - AIG was again unable to access the commercial paper market for its primary commercial paper programs, AIG Funding, ILFC and AGF. AIG advanced loans to ILFC and AGF to meet their funding obligations.
    - AIG met with representatives of Goldman, Sachs & Co., J.P. Morgan, and the Federal Reserve Bank of New York (FRBNY) to discuss the creation of a \$75 billion secured lending facility.
    - S&P, Moody's, and Fitch Ratings (Fitch) downgraded AIG's long-term debt rating. As a result, AIGFP estimated that it needed in excess of \$20 billion to fund additional collateral demands and transaction termination payments in a short period of time.
  - September 15, 2008: AIG's common stock price fell to \$4.76 per share.
  - September 16, 2008:
    - AIG's strategy to obtain private financing failed. Goldman, Sachs & Co. and J.P. Morgan were unable to syndicate a lending facility. Consequently, counterparties were withholding payments from AIG, and AIG was unable to borrow in the short-term lending markets.
    - To provide liquidity, both ILFC and AGF drew down on their existing revolving credit facilities, resulting in borrowings of approximately \$6.5 billion and \$4.6 billion, respectively.
    - AIG was notified by its insurance regulators that it would no longer be permitted to borrow funds from its insurance company subsidiaries under a revolving credit facility that AIG maintained with certain of its insurance subsidiaries acting as lenders. Subsequently, the insurance regulators required AIG to repay any outstanding loans under that facility and to terminate it.
    - The Federal Reserve extended the facility to AIG to prevent systemic failure. AIG had no viable private sector solution to its liquidity issues. It received the terms of a secured lending agreement that FRBNY was prepared to provide. AIG estimated that it had an immediate need for

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cash in excess of its available liquid resources. That night, AIG's Board of Directors approved borrowing from FRBNY based on a term sheet that set forth the terms of the secured credit agreement and related equity participation.

- September 22, 2008:
  - The inter-company facility was terminated effective September 22, 2008.
  - AIG entered into the Fed Credit Agreement in the form of a two-year secured loan.

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