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Throwing a Lifeline to a Troubled Giant

By Eric Dash and Andrew Ross Sorkin

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The first call from the Treasury Secretary Henry M. Paulson Jr. came at 3:30 p.m. Tuesday, and the message was innocuous, to avoid setting off alarms. And when he finally got through to the Senate majority leader, Harry Reid of Nevada, Mr. Paulson simply said he wanted to brief Congressional leaders “about recent developments on the economy.”

In fact, Mr. Paulson along with the Federal Reserve chairman, Ben S. Bernanke would deliver stunning news that would reverberate throughout markets worldwide and leave top lawmakers “petrified,” in the words of a senior aide.

A frenzied effort to prop up the American International Group, the ailing insurance giant, had failed. The Fed had decided it had no choice but to do the unthinkable: bail out A.I.G. with an $85 billion loan or risk a potential financial catastrophe of unknown proportions.

Over the preceding five days, A.I.G., the world’s largest insurance company, had exhausted every other option. The company had sought a lifeline from some of the nation’s largest banks, as well as from big private investment funds on Wall Street, but no one dared come to the rescue. As potential saviors pored over A.I.G.’s books, the holes they discovered kept growing first from $20 billion, then to $40 billion, then to $80 billion, then even more. The sharpest minds on Wall Street could not fathom where the bottom was.

Even more than the government’s decision to take control of the mortgage giants Fannie Mae and Freddie Mac, or its role in rescuing Bear Stearns, the decision was a watershed event.

Some Congressional leaders who initially seemed to accept the decision at the meeting Tuesday evening sharply questioned the move on Wednesday. They said the rescue put taxpayers’ money at risk to save a private enterprise that should have been regulated more closely.

Ben S. Bernanke, left, the Fed chairman, at the Capitol offices of Harry Reid, the Senate majority leader, on Tuesday. Brendan Hoffman for The New York Times

The debate in Washington over how and why the government bailed out A.I.G. could shape future decisions to intervene in troubled financial companies.

With all the attention paid to beleaguered investment banks, few seemed to realize the risks that A.I.G. posed. The company, whose businesses stretched from leasing aircraft to selling life insurance in rural India, had become dangerously entangled with the financial industry because of its web of complex insurance contracts.

A.I.G. began to unravel three weeks ago, when its chief executive, Robert B. Willumstad, learned that Moody's planned to lower the company's credit ratings unless it raised billions of dollars in capital. A downgrade would deal a potentially fatal blow to A.I.G.

The news touched off a panic inside A.I.G.'s headquarters in lower Manhattan. Mr. Willumstad huddled with senior executives and bankers from JPMorgan Chase, Citigroup and the Blackstone Group, hoping to save his company by raising capital and selling assets. After the Bush administration took control of Fannie Mae and Freddie Mac, the financial markets seemed to calm down.

But then the Wall Street bank Lehman Brothers began to hurtle toward bankruptcy, and Mr. Willumstad realized that A.I.G. was running out of time. His company was only days away from insolvency.

A.I.G. beseeched insurance regulators in New York, led by Eric R. Dinallo, to borrow $20 billion from subsidiaries. Mr. Dinallo briefed Gov. David A. Paterson of New York last Friday. The answer was clear.

Treasury Secretary Henry M. Paulson Jr. arriving at the Capitol. Brendan Hoffman for The New York Times

“That’s what we should do,” the governor told Mr. Dinallo. “Do it.”

In Washington, Mr. Paulson and Mr. Bernanke watched the events unfold on Wall Street with increasing alarm. As Lehman Brothers teetered and panic threatened to engulf other Wall Street banks, Timothy F. Geithner, the president of the Federal Reserve Bank of New York, summoned the heads of major financial institutions to an emergency meeting at the New York Fed’s headquarters on Friday evening. Mr. Paulson flew by private jet from Washington to Teeterboro, N.J., and arrived around 5 p.m.

At A.I.G., only blocks away, the panic was building. Mr. Willumstad called Fed officials that night to alert them that A.I.G. needed to raise $30 billion by Monday or it would face a calamitous ratings downgrade.

Bankers worked until dawn, poring over A.I.G.’s books. But when Mr. Paulson arrived on Saturday morning, the bankers gave him startling news: A.I.G. in fact needed $40 billion.

The 18th floor of A.I.G was aflutter at 9 a.m., as the company reached out to possible buyers to help it stay afloat.

But then Mr. Willumstad delivered grim news to Mr. Paulson and Mr. Geithner: A.I.G. no longer thought it could raise the money it needed on its own.

Big private equity funds descended on A.I.G.’s headquarters to consider investing in the company. In one conference room, was Kohlberg Kravis Roberts, with Henry Kravis and George Roberts, the firm’s founders, on speaker phone. Down the hall, J. C. Flowers, the financial services investor, was combing through the company’s numbers. Other firms were also going through the books.

Harry Reid, left, with Senator Charles E. Schumer, met with Mr. Bernanke and Mr. Paulson at the Capitol. Brendan Hoffman for The New York Times

But a bigger problem loomed. JPMorgan's bankers discovered the shortfall at A.I.G. was not just $40 billion, but might be closer to $65 billion, because so much of A.I.G.'s securities lending business was tied up in illiquid assets.

Meanwhile, as concerns over Lehman and then Merrill Lynch boiled over, Mr. Paulson, from a suite at the Waldorf-Astoria hotel, worked the phones until 1 a.m. By 9 the next morning, he was back at the Fed.

By Sunday, K.K.R. and the Texas Pacific Group made it clear they would not come to the rescue, worried that A.I.G. might be taken over by the government, wiping out their investments. Goldman Sachs also balked.

Lawyers began drawing up papers for what would have seemed impossible only days before: a bankruptcy of the world's largest insurance company.

But inside the Fed, everyone was consumed by the fates of Lehman and Merrill. When it came to A.I.G., the Fed and Treasury were in "a listen-only mode," a person briefed on the talks said. Mr. Willumstad shuttled between A.I.G.'s headquarters and the Fed, pleading his case.

But on Monday morning, after Lehman spiraled into bankruptcy and Merrill had thrown itself the arms of Bank of America, Mr. Paulson seemed to dismiss reports that the federal government would bail out A.I.G.

Representative Barney Frank spoke with reporters. Brendan Hoffman for The New York Times

Hours later, the Fed had taken over the discussions and asked JPMorgan and Goldman Sachs to help rescue A.I.G. by arranging $75 billion in loans. But banks said they could not. Time was running out.

"We began to realize that Willumstad wasn't calling the shots," said one banker involved in the talks. "The banks kept calling A.I.G. to find out what was going on. The answer from top A.I.G. executives was, 'We don't know. We just don't know.' "

By Monday evening, A.I.G.'s credit ratings were cut. Within 72 hours, the amount of money A.I.G. need had grown from $20 billion to $85 billion. By one internal estimate, A.I.G. might need more than $100 billion.

"The threat of bankruptcy was a real threat," Mr. Dinallo said. The government began to fear that the collapse of A.I.G. would lead to devastating losses across the financial industry.

Mr. Paulson concluded only one option remained: the Fed had to step in. By 1:30 p.m. on Tuesday, the Fed had taken charge. Mr. Paulson informed the president, while the Treasury began calling Congressional leaders, saying Mr. Paulson wanted to brief them on recent developments.

The Fed, Mr. Paulson said, would bail out A.I.G. with an $85 billion loan.

The meeting Tuesday on Capitol Hill, lasted for slightly less than an hour. It was organized by Mr. Reid of Nevada, and attended by leaders of both parties, including Senator Mitch McConnell of Kentucky, the Senate minority leader, and Representative John A. Boehner of Ohio, the House minority leader.

Representative Spencer Bachus spoke with reporters. Brendan Hoffman for The New York Times

The meeting, which had a somber tone from beginning to end, began with a presentation by Mr. Bernanke, who laid out the plan to rescue A.I.G., including a detailed description of its business operations, including its relatively solid insurance businesses and an overarching holding company that effectively come to function as an immense and, ultimately, failing hedge fund.

Among the points highlighted for lawmakers was that A.I.G. was one of the 10 most widely held stocks in 401(k) retirement plans, and that its collapse could potentially cause an enormous run on mutual funds.

Or as Mr. Schumer explained after the meeting: "If A.I.G. went down, it would affect Main Street more than Wall Street."

Among the questions that lawmakers posed was whether there was any way of knowing whether this would be the last major government intervention. Mr. Bernanke and Mr. Paulson said there was not, but that the economic situation would certainly get worse without government action to stabilize the insurance giant.

Top lawmakers from both the House and Senate emerged from the meeting with Mr. Paulson and Mr. Bernanke looking grim but generally expressing support for the plan to rescue A.I.G.

“It’s heavy, heavy, heavy,” said Senator Charles E. Schumer, Democrat of New York, the chairman of the Joint Economic Committee. “But I don’t think we have much choice.”

Senator Christopher J. Dodd, Democrat of Connecticut and chairman of the Senate Banking, Housing and Urban Affairs Committee, said in an interview that he would use forthcoming Congressional hearings to press Mr. Bernanke and Mr. Paulson to defend their decision to rescue A.I.G., and to prod the administration to do more to address the problems in the housing market.

Mr. Dodd said he twice pressed for assurances that the administration and the Fed had the legal authority for the bailout of A.I.G. and Mr. Bernanke and Mr. Paulson said that they believed the Fed could aid any company posing systemic risk to the economy. Mr. Dodd also said they offered no rosy assurances about how the entire effort would turn out.

“There were no guarantees in the room that the $85 billion would be compensated for,” Mr. Dodd said. “Nor is there any guarantee that this is the end of it. There may be other shoes to fall.”