Comment on possible 13-3 lending to AIG

Background:

S&P's current financial strength rating on AIG's leading insurance companies is AA+. The rating on the senior debt of the parent company is AA- (negative outlook). The outlook on these ratings is negative, which means there is a "meaningful chance" that S&P could downgrade the rating sometime over the next one-to-two years. S&P lowered the rating on the senior debt by one notch following AIG's first quarter earnings release. Following those earnings, AIG raised roughly $20 billion of capital in the form of equity, equity linked and debt securities. Following the 2Q loss, S&P affirmed the ratings and negative outlook stating that if earnings do not stabilize by the 3Q, a one-notch downgrade is likely.

S&P's view:

In an August 2008 conference call with Merrill, S&P suggested that they hoped to see a cessation of losses on mortgage related securities. They clarified this further by stating that would like to see losses "bottom out" and that they would not expect 3Q losses to "look anywhere near as bad as Q2" losses. Essentially, they want to see the value of these securities "move toward bottoming". Based on these comments, we infer than some level of loss might be acceptable, but the trend must suggest a notable improvement.

S&P is considering a long list of factors when evaluating its ratings on AIG. Still, there were issues that did not appear to be very pressing, immediate concerns such as CMBS, CDS outside of those backing multi-sector CDOs with sub-prime collateral, loss reserves and monoline exposure.

S&P noted that if 3Q results are disappointing, (prompting potential downgrade) raising capital may not be enough to offset risk management concerns.

Rationale for downgrade is risk management and not capital:

S&P loss estimates of $8 billion on CDO exposures are smaller than AIG stress estimates of $9 billion, as well as those from Investment Banks like Merril and Citi. Moreover, these stress estimates are lower than write-downs on these exposures to fair value of $24 billion. In other words, the market believes AIG to recover a significant portion of these write-downs as markets recover.[1] There is little doubt by market participants that AIG is not only solvent, but has a healthy amount of capital ($78 billion) for unexpected loss from further deterioration in the housing market, or from other sources of risk.

However, the crucial issue for AIG is that the company has not sold or hedged any of this exposure. In particular, these temporary losses are actual losses of capital which expose bondholders to the risk of a further deterioration in the housing market. The rating agency is revising its outlook for the timing of recovery in the housing market, delaying the expectation of gains from this portfolio from late 2008 to late 2009 or 2010. In summary, AIG is being downgraded by S&P because of its approach to risk management, wanting to keep all of the upside to itself and not giving up some of those potential gains to protect bond investors from further downside.

---

[1] AIG stopped wrapping CDO's with sub-prime exposure in 2005 and has a relatively limited exposure to 2006 and 2007-vintage sub-prime RMBS through managed CDO's. AIG's management has contended that the quality of the pre-2006 vintage mortgages is better than the mortgages originated in 2006 and 2007. S&P concurred with Merril's assessment, noting "the '05 vintage has its problems but its not performing nearly as poorly as the '06 and the '07 vintages.

Conclusion

The request by AIG for bridge financing is simply a request to buy time to sell assets from its investment portfolio in a more orderly fashion, which is another way for saying that it wants to sell them in a fashion that maximizes value to shareholders.

Such an accelerated sale undoubtedly would have an adverse impact on markets and potentially the marks of market participants. While the work by Tobias Adrian suggests that the market is not pricing in the impact of such an unwind, market participants appeared unaware that the firm would be unable to handle the liquidity demands created by a downgrade. In particular, S&P downplayed this concern in August, believing that the firm was "sitting on a pile of cash right now" from its recent $20 billion capital raise. During its 2Q conference call, management stated that the capital it raised "has not all been allocated. There is still a large sum of it left". The action in the share price over the last week obviously suggests that the market has caught up with the firms' own view of its liquidity position.

It is important to understand that the firm does have other options to deal with this problem other than dumping assets on the market. In particular, a 12 September 2008 note by Citibank suggests that the firm could sell the ABS CDO risk, sell subsidiaries, or raise more capital. Citi felt that the sale of subs could raise as much as $20 billion in additional capital even in stressed markets. The sale of CDO positions in principle have no impact capital, as the write-downs have already been taken, but would remove the risk of the downside. Moreover, the Citi note downplays liquidity concerns, writing that the Federal Reserve would likely grant access if this became a problem.

The proposed action of AIG, to forgo these options and dump securities on the market, in particular municipal securities, is a clear attempt to hold-up policymakers for an easy solution that preserves the upside of CDO exposures for shareholders.

That being said, if the Federal Reserve decides that the systemic consequences of such an unwind merit access to the discount window, it seems reasonable to argue that this institution should attach some important covenants to any such access associated with the firms' risk management. In particular, such access should be tied to a sale of all or part of the ABS CDO risk or sale of subsidiaries to raise capital.

References

"Standard and Poors on AIG," Merrill Lynch, 18 August 2008.
"AIG," Citibank Company Focus,12 September 2008.