THE ECONOMY

How AIG Became Too Big to Fail

Years of unregulated and risky deals exposed the insurance giant to catastrophic losses. Now it's paying bonuses to the same people who helped create the mess. With our money. A look at why a dark corner of the global economy is costing U.S. taxpayers $170 billion—and counting

BY BILL SAPORITO

TREASURY SECRETARY TIM GEITHner had every reason to think he had seen all of AIG's dirty laundry. The government owned 80% of the company, and Geithner had just orchestrated AIG's most recent handout—its fourth, if you are keeping score, for $30 billion on March 2—to prevent the teetering insurance giant from going over the cliff and taking the rest of the global financial system with it. AIG had already cost the taxpayers some $170 billion, mostly to repair the damage done by one of its units, AIG Financial Products (AIG FP), which last year alone piled up $40 billion in losses related to its dealings in complex mortgage bond derivatives.

Then Geithner's staff made the discovery that would infuriate nearly everyone in Washington. On March 10, the Secretary learned, 10 days after his staff first got wind of it, that AIG had paid out $165 million in retention bonuses to executives at the unit that compelled the U.S. to bail out the company in the first place. It took Geithner until 7:40 the next night to place what must have been a tense phone call to AIG's newish CEO, Ed Liddy. The bonuses were not tenable; they had to be canceled, he demanded. Liddy, a dollar-a-year man who took over the company after the bonuses had been promised, replied that AIG's lawyers had decided that the contracts could not be broken without even bigger costs to taxpayers. Geithner sent Treasury's lawyers searching for a way out, but they couldn't find one.

On the balance sheet of debacles caused by this economic crisis—the $700 billion Troubled Asset Relief Program (TARP), the stock-market swoon, the credit crunch and the ongoing global recession—$165 million is small change. But the revelations of the AIG bonuses, like nothing else, seemed to finally tip the mounting public furor over corporate malpractice into a full-scale rebellion. Yet Geithner, embarrassed for discovering the bonuses so late, plans to dock AIG that much out of the next $30 billion in bailout funding when it is delivered—which amounts to a mere 0.1% of the total AIG has received. Assorted Senators, from New York Democrat Chuck Schumer to Montana Democrat Max Baucus and Iowa Republican Chuck Grassley, have proposed a number of tax and legal schemes to snatch back the bonus bucks from AIG FP executives—73 of whom got payouts of $1 million or more, according to New York State attorney general Andrew Cuomo.

With all the political theater and populist grandstanding, though, the bigger issue has been obscured. And that is, Just what is AIG doing with the $170 billion? Does the company's strategy, which is to wind down its exposure to toxic assets and sell some of its profitable insurance divisions to help pay off the government debt, stand a good chance of succeeding? And if it does, will

Illustration for TIME by Clark Mitchell

the world avert financial Armageddon?

Those questions have taken on greater urgency, since it turns out that AIG has become the banking industry's ATM, essentially passing along $52 billion of TARP money to an array of U.S. and foreign financial institutions—from Goldman Sachs to Switzerland's UBS. Those firms were counterparties to the credit-default swaps (CDSs) that AIG FP sold at least through 2005, and the companies were collecting on the insurance-like derivatives. AIG paid out an additional $43.7 billion to many of the same banks, which were also customers of the securities-lending operation run out of AIG's insurance division. In this case, AIG managed to take a business specifically designed to be low risk, low return and amp it into another dicey venture—with taxpayers on the hook.

The outrage will pass, and when it does, we're going to have to focus on whether keeping AIG afloat is preventing a sharp recession from becoming a prolonged one. The reason AIG has cost taxpayers $170 billion—and the reason the Obama Administration seemed willing, at least at first, to hold its nose and accede to bonuses for the company's managers—is that it's too big to fail. It's an often heard phrase, but what does it really mean?

The idea is that in a global economy so tightly linked that problems in the U.S. real estate market can help bring down Icelandic banks and Asian manufacturers, AIG sits at some of the critical switch points. Its failure, so the fear goes, would set off chains of others, rattling around the globe in short order. Although some critics say the fear is overblown and the world economy could absorb the blow, no one seems particularly keen on testing that approach.

How We Got Here

AIG SEEMS AN UNLIKELY CANDIDATE FOR the company that could bankrupt the planet. Founded 90 years ago in Shanghai, AIG moved its headquarters to New York City as the world headed toward war in 1939. After Maurice R. (Hank) Greenberg took over in 1967, AIG consolidated its global empire. By the time Greenberg was forced out in an accounting scandal 38 years later, AIG had become one of the world's biggest public companies, with sales of $113 billion in 2006 and 116,000 employees in 130 countries, from France to China.

AIG says it has written more than 81 million life-insurance policies, with a face value of $1.9 trillion. It covers roughly 180,000 small businesses and other corporate entities, which employ approximately 106 million people. That makes AIG America's largest life and health insurer; second largest in property and casualty. Through its aircraft-leasing subsidiary, AIG owns more than 950 airline jets. Just for good measure, AIG is a huge provider of insurance to U.S. municipalities, pension funds and other public and private bodies through guaranteed investment contracts and other products that protect participants in 401(k) plans. "We have no choice but to stabilize [it] or else risk enormous impact, not just in the financial system but on the whole U.S. economy," said Fed Chairman Ben Bernanke.

The risk is not in any one business but in the connections among them and in the industries in which they compete. As AIG has pointed out in its own analysis, "The extent and interconnectedness of AIG's business is far-reaching and encompasses customers across the globe ranging from governmental agencies, corporations and consumers to counterparties. A failure of AIG could create a chain reaction of enormous proportion." Among other effects, it could lead to mass redemptions of insurance policies, which would theoretically destabilize the industry; the withdrawal of $12 billion to $15 billion in U.S. consumer lending in a credit-short universe; and even damage airframe maker Boeing and jet-engine maker GE, since AIG's aircraft-leasing unit buys more jets than anyone else.

While AIG's holdings are diverse, nearly all its losses centered on AIG FP, which until March 2008 was led by its high-rolling president, Joseph Cassano, a tough-talking Brooklyn, N.Y., native who in the past eight years banked $280 million in cash compensation, or exactly $115 million more than the bonuses at the center of the current controversy. Cassano, who helped found

CLOCKWISE FROM TOP LEFT: EPA/STEPHEN CHERNIN; YOON S. BYUN—BOSTON GLOBE/LANDOV; JON SUPER—AP; GREG BAKER—AP; BOBBY YIP—REUTERS/LANDOV

MELTDOWN GLOSSARY

Credit-default swap
An insurance policy against a bond default. AIG sold fistfuls on mortgage-related securities that have collapsed in value

Counterparty
The company on the other side of a financial transaction. Bailout money has flowed to AIG counterparties such as U.S. and European banks

Securities-lending
Lending out holdings like bonds in exchange for a fee and cash—which AIG stashed in much too risky investments

Systemic risk
The chance that a problem in one part of the financial system will uncontrollably ripple to otherwise healthy parts

Deep Impact

In February, AIG circulated a report detailing how many people would be affected if the company were to go under. The scare tactic worked. AIG insures 180,000 entities, which collectively employ 106 million people in the U.S. alone. Among the list are tens of thousands of farms, hospitals and nonprofits. Stimulus spending? AIG says it insures every major infrastructure project in America. Retirement savings? The company manages nearly 7 million accounts. AIG itself employs 116,000. Yet a few hundred from its Financial Services division devised the toxic derivatives jeopardizing AIG—and the rest of us.

BY STEPHEN GANDEL AND BARBARA KIVIAT

Bailout Pass-Along

Banks on the other end of AIG's financial trades have received billions of dollars owed to them, making them big beneficiaries of the firm's new funding

Bank	Amount
Goldman Sachs	$12.9 billion
Société Générale	$11.9 billion
Deutsche Bank	$11.8 billion
Barclays	$8.5 billion
Merrill Lynch	$6.8 billion
Bank of America	$5.2 billion
UBS	$5.0 billion
BNP Paribas	$4.9 billion
HSBC	$3.5 billion
Dresdner Bank	$2.6 billion

THE BUSINESSES

Spoiled by One Very Rotten Apple

Life Insurance

As many as 81 million people around the world have life insurance through AIG. Face value: $2 trillion. Even in bad times, that's good business

Why it's a risk: While operating profits, which are what is shown in this chart, of the life-insurance business have held up, AIG has had bottom-line problems here due to bad bets in its securities-lending unit

2008 Earnings*

$6.9 billion

Profit ▲

Loss ▼

Asset Management

AIG invests billions in premiums a year. It owns more U.S. corporate bonds than anyone else, and real estate around the world. AIG also manages $165 billion in mutual funds and other accounts

Why it's a risk: The recession and rising corporate defaults spell trouble for these investments

$429 million loss

General Insurance

From tornadoes to kidnap ransom, name a business risk and AIG insures it. Of the 500 largest companies in the world, 94% have policies with AIG

Why it's a risk: The profit margin is razor-thin. Last year, an 18% rise in claims wiped out the $10 billion AIG had in profits in 2007

$723 million loss

** Earnings and losses refer to operating income before net realized capital gains and losses*

$40.4 billion loss

Financial Services

This is the heart of the heart of darkness for AIG. The division wrote more than $2.7 trillion in derivatives contracts. Investors used one kind—called credit-default swaps—to hedge against bonds going bad. Banks bought the swaps, reassured by AIG's AAA debt rating, to manipulate capital requirements. When the bonds AIG insured against started to tank and the insurer's own rating was cut, it all came crashing down

Why it's a risk: AIG is still on the hook for as much as $300 billion in potential CDS losses. Yet the company has a book value of only $50 billion. That means if AIG has to pay out on those contracts, it will go bankrupt six times over

OTHER INTERESTS

More Than an Insurance Company

Ski resort *AIG's founder began Stowe Mountain Resort in Vermont in the 1940s*

Soccer team *AIG won't renew its Manchester (U.K.) United sponsorship*

Airplanes *International Lease Finance is one of the world's largest aircraft lessors*

Real estate *The firm owns or manages properties in more than 50 countries*

Public outcry *Protesters hold a rally outside AIG's L.A. offices. Speaking before Congress that same day, CEO Liddy said he asked executives to return at least half their bonus*

the AIG FP unit in 1987, built his money machine not on anything fraudulent but on what's been described as regulatory arbitrage. As Bernanke explained recently, "AIG exploited a huge gap in the regulatory system. There was no oversight of the Financial Products division. This was a hedge fund, basically, that was attached to a large and stable insurance company."

That hedge-fund-like unit built up a portfolio of $2.7 trillion in derivatives. AIG FP eagerly offered to insure billions of dollars in derivative portfolios, building up potential liabilities many times its capacity to pay out if the portfolios defaulted. Few financial experts ever imagined the scope of the impending defaults. Neither did regulators. AIG's uncollateralized insurance combine was regulated by Washington's Office of Thrift Supervision, whose task is to watch over savings-and-loan companies, not global insurers. And it wasn't watching.

AIG, like other institutions, was making a mint dealing in derivatives tied to the U.S. real estate market. The boom was financed in part by collateralized debt obligations (CDOs), securities based on subprime mortgages that have come to define *toxic asset*. Companies that held CDOs could offset their risk by buying CDSs from AIG FP. Or they could simply speculate with the instrument. It all worked fine until overbuilding by housing firms and overleveraging by consumers caused the bubble to burst. Which in turn caused the value of CDOs to plunge. Which caused holders of CDSs on such securities to demand payment from AIG.

Although a CDS is, in its simplest form, an insurance policy, AIG was selling something far more exotic. Say you buy a house and insure it. The insurer doesn't offer the same policy on your house to everyone else in the neighborhood; if it did and your house went up in flames, the insurer could get wiped out. In its CDS contracts, though, AIG wrote multiple insurance policies covering the same underlying package of increasingly toxic assets. In essence, it was underwriting systemic risk. This is the opposite of what insurance companies are supposed to do: diversify risk across the universe of policyholders. "One thing about the insurance model: it relies on diversification as its means to exist," says a top exec at an AIG competitor. "If an insurance company plays in a field where they underwrite systemic risk, that's a totally different experience." Is it ever. Insurance companies can handle catastrophic risk but not systemic risk. That's why you can buy hurricane insurance from private companies but not terrorism insurance. Only a government can take on that risk. At its most basic, AIG took on colossal risks that it could not afford.

'Of course they were going to run out of money. It was a liquidity crisis, not a solvency crisis.'
—HANK GREENBERG, FORMER CEO OF AIG

With its high credit rating, AIG FP wasn't required to stockpile reserves, or collateral, as traditional insurers must to cover potential losses. As the CDOs that AIG insured began to crater, the counterparties began asking for more collateral to back their policies, which was written into the contracts. Cassano said in August 2007 that he couldn't imagine a situation in which AIG would "lose one dollar in any of these transactions." He was right. AIG didn't lose a dollar; it lost billions of them.

In a rare interview, former CEO Greenberg, who is suing AIG and being sued by the company over financial-management

BETHANY MALMGRAM—PSLWEB.ORG

issues, tells TIME that once the company lost its top credit rating, AIG FP should have stopped writing swaps and hedged, or reinsured, its existing ones. But Cassano's unit doubled down after the spring of 2005, writing more and more subprime-linked swaps as the ratings plunged, which made the possible need for collateral enormous in the event its debt was downgraded. The downgrades occurred in 2008. "Of course they were going to run out of money," says Greenberg. He adds that as the liquidity crunch hit in 2008, AIG FP should have renegotiated terms with the banks to ease their demands on collateral. "You can renegotiate almost anything, anytime."

Last September, with global stock markets collapsing and credit markets frozen, Geithner, then head of the New York Fed, and Bernanke believed AIG was too close to collapse to do anything other than stop the bleeding. Failure by AIG to pay might have threatened its counterparties—for instance, Citigroup and, in turn, Citi's counterparties. A bond or a derivative is, after all, a promise to pay someone, and if there is no confidence in its fulfillment, the financial system ceases to function. It is not a fear that has gone away simply because AIG has been stabilized.

Bailing Out the Bailed Out

KEEPING THE FINANCIAL SYSTEM FLUID might explain why so many banks got paid in full, which strikes some as a scandal way bigger than the bonus payouts. Many experts wondered why AIG paid 100 cents on the dollar. Among the biggest beneficiaries of the AIG pass-through, at $12.9 billion, was Goldman Sachs, the investment-banking house that has been the single largest supplier of financial talent to the government. Critics have been quick to note—and not favorably—the almost uncanny influence of former Goldman executives. Initial phases of the rescue were orchestrated by ex–Goldman chairman Hank Paulson, who was recruited as Treasury Secretary in part by former White House chief of staff and Goldman senior exec Josh Bolten. Goldman's current boss, Lloyd Blankfein, was invited to participate in meetings with the Fed. AIG's Liddy is a former Goldman director and an ex-CEO of Allstate. Another alum, Mark Patterson, once a Goldman lobbyist, serves as chief of staff at the Treasury, while Neel Kashkari, who runs TARP, was a Goldman vice president.

Goldman has repeatedly declared that its exposure to AIG was "immaterial" and fully hedged. But some rivals point to the fact that Goldman had uncharacteristically piled into contracts with a single counterparty. "I am shocked that Goldman had this much exposure [with AIG]," says an analyst at a competing bank. "This was a major failing, but they got bailed."

Goldman got bailed twice: first on its CDS exposure and a second time, to the tune of $4.8 billion, for another AIG fiasco, losses on its securities-lending business.

Securities-lending is supposed to be a sort of Christmas club of high finance. Companies like insurers, which own tons of equities and Treasury bonds that they are holding long term, lend them out short term, often overnight, to borrowers who need the shares to fulfill other commitments. For instance, if hedge funds want to sell shares short, they borrow them, putting up cash collateral that includes a small spread to the lender. Typically, the owner of the shares takes that collateral and invests it in something with low risk and of short duration, like commercial paper. The lender is exposed to some risk, but it usually isn't catastrophic. However, AIG took the collateral and invested in longer-term, higher-risk mortgage- and asset-backed securities. "Crap," as a portfolio lending expert describes them. When those securities crashed in value, so did AIG.

Between the CDS and securities-lending fiascoes, AIG still has lots of work to do. Gerry Pasciucco, the new head of AIG FP, is working to whittle down AIG's trading book by $1.1 trillion. Which raises the question, Does he really need those $165 million bonus babies to finish the job? AIG says yes, because they know the trades and the system, but not everyone agrees. "This is an engineering problem," says Rick Bookstaber, a risk expert and the author of *A Demon of Our Own Design*, which predicted the predicament we're in. "Right now there are probably a million guys out there who can do it."

THE PLAYERS

Who's to Blame?

Finger-pointing is all the rage both inside the Beltway and out. So here we go, with our take on some of those culpable at AIG:

Hank Greenberg
Chairman 1968-2005
Built AIG into the world's largest insurance outfit, then was forced out amid an accounting investigation

INNOCENT — GUILTY

Joseph Cassano
President, Financial Products 1987-2008 *A founding member of the division that gorged on risky derivatives, now at the center of AIG's woes*

INNOCENT — GUILTY

Martin Sullivan
CEO 2005-08
The former co-COO held that AIG's losses were "manageable" even as the firm unraveled

INNOCENT — GUILTY

Ed Liddy
CEO 2008-present
The former Allstate CEO took the AIG job for nearly no money but has been the target of ire over worker bonuses

INNOCENT — GUILTY

FROM TOP: AP; KEITH WALDGRAVE—SOLO SYNDICATION/ZUMA; LAWRENCE JACKSON—AP; KIN CHEUNG—AP

The Great Clawback

HOW WAS AIG ABLE TO LIVE SO DANGEROUSLY for so long? In part because for years Washington looked the other way. The company befriended politicians with campaign cash—$9.3 million divided evenly between Democrats and Republicans from 1990 to 2008, the Center for Responsive Politics reported. And it spent more than $70 million to lobby them over the past decade, escaping the kind of regulation that might have prevented the current crisis.

The fact that AIG was in Washington long before the current Administration hasn't spared the Obama team from criticism over the recent bonus payouts. The main target for the opprobrium is Geithner. He still enjoys the confidence of U.S. allies abroad and understands the deeply complicated world of global finance far better than the lawmakers who may soon write new legislation to regulate it. But he has not been a strong public face for a government that needs to project confidence. He has been slow to staff his department, hampering the Administration's ability to react to the crisis—and possibly helping explain Treasury's leaden-footed reaction to the AIG bonuses, which were first reported in January. A former Treasury official blames Geithner for a "strategic hesitation that has really affected the confidence index, not just in the financial marketplace but in the political marketplace." A veteran Washington Democrat was more direct: "He's not a wartime consigliere."

Geithner's backers note that he took over an office that was drowning in crises and has had to address failing banks; impossible-to-price toxic securities; a continuing auto-bailout program; woes at Citigroup,

AIG and other financial houses; a housing crisis; and an upcoming G-20 summit all at the same time. Even his detractors admit that the to-do list is the deepest any Treasury boss has faced in 80 years.

Which helps explain why, at least for now, Geithner benefits from a rare bipartisan agreement. Republicans have largely been reluctant to scare away a Treasury chief who has roots in the Bush era and understands their benefactors' core businesses; Democrats are even more reluctant to publicly criticize the President's choice at a moment of economic peril. "I have complete confidence in Tim Geithner and my entire economic team," Barack Obama said. "He is making all the right moves in terms of playing a bad hand." Still, a longtime Treasury observer says, "his margin for error has been reduced."

Geithner's failure to reckon quickly with the existence of large retention bonuses for AIG employees in the Financial Products division is perplexing. On Jan. 27, Bloomberg News reported that AIG has offered "about $450 million in retention pay" to the AIG FP staff, a program that AIG confirmed. Representative Elijah Cummings, a Maryland Democrat, knew about the bonuses two weeks earlier, on Jan. 15, when he met with Liddy, and the Congressman never kept his displeasure secret. Nor was he alone in raising alarms. In January, Richard Shelby, the ranking Republican on the Senate Banking Committee, called the bonuses a "waste of taxpayer money."

But Geithner, who was overseeing the AIG rescue effort with the Federal Reserve, says he had no idea until March 10 that more bonuses were in the pipeline for AIG FP. The President found out two days later, igniting an internal firestorm of White House indignation as officials scrambled to stem the public-relations damage. And now both the White House and Congress are determined to limit the pay packets of executives of any company that is getting TARP money or other government assistance.

There are proposals in Congress to reverse some of the bonuses through legislation, and Liddy called on executives to spit back half their bonus. Some have done so. The program for 2009 has already been pared. That my placate, for now, Main Street constituents who want to get back at those overpaid Wall Street types.

But, considering the risks still infecting the system, the clawback is pointless. Geithner and Bernanke have way more important things on their plate. Did we mention the economy, with unemployment headed toward 10%? And the upcoming G-20 meeting that has the U.S. and Europe at odds over what to do first—regulate the global economy or stimulate it? Nor will the albatross of AIG be removed from the government's neck anytime soon. Liddy said his goal is to restructure AIG's core businesses into "clearly separate, independent" companies that are "worthy of investor confidence." AIG has "made meaningful progress," but the company is still at the mercy of the economy. In the businesses it wants to keep, like commercial insurance, competitors sense an opportunity to grab market share. For the assets it wants to sell, there are few buyers. What remains is still a huge, vulnerable company.

Lastly, the Obama Administration will need perhaps $750 billion in new funding merely to stabilize U.S. banks, which it hopes will be enough to ease the credit markets, stimulate lending and get the economy moving again. There's no telling what kind of political wrangling will happen over that, but one thing seems certain: if you are an executive of a bank that gets federal money, it wouldn't be a smart idea to count on a bonus. —WITH REPORTING BY MASSIMO CALABRESI, MICHAEL DUFFY, JAY NEWTON-SMALL, MICHAEL SCHERER, MARK THOMPSON, MICHAEL WEISSKOPF AND ADAM ZAGORIN/WASHINGTON ■

Stress test *Treasury boss Geithner faces crises in autos, housing, banking and securities and has come under fire for missteps along the way*