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SECURITIES LENDING AND THE UNTOLD STORY IN THE
COLLAPSE OF AIG

by Hester Peirce



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Abstract

American International Group, Inc. (AIG), a large insurance company, received a massive bailout during the financial crisis in response to difficulties centered on the company's multifaceted exposure to residential mortgage-backed securities. The company is back on its feet, albeit in more streamlined form and with a new overseer—the Federal Reserve. This paper focuses on a piece of the AIG story that is rarely told—the role of the company's securities-lending program in imperiling the company and some of its insurance subsidiaries. The paper argues that regulatory responses to AIG have been inapt. AIG did not need another regulator, but better risk management. The markets would have conveyed that message clearly had regulators not intervened to ensure AIG's survival. This paper adds the missing piece to the AIG story in an effort to challenge the notion that more regulatory oversight for companies like AIG will prevent future crises.

JEL codes: G1, G2, G3, H1, H7, K2, N2, N8

Keywords: securities lending, American International Group, AIG, insurance regulation, Dodd-Frank, financial regulation, market discipline, financial crisis, Federal Reserve, bailout, credit default swaps, derivatives, insolvency

Securities Lending and the Untold Story in the Collapse of AIG

Hester Peirce

American International Group, Inc. (AIG), an insurance company that has nearly a century of history and operates in almost every country in the world, was also one of the largest recipients of the U.S. government's 2008 financial company bailouts. Beginning in 2007, AIG experienced severe financial difficulties, centered on the company's multifaceted exposure to residential mortgage-backed securities, that escalated through 2007 and into 2008. AIG's troubles reached a peak during the early fall of 2008, at the same time that Lehman Brothers failed. During 2008 and 2009, the federal government committed over \$180 billion in aid to the company, which enabled AIG to avoid bankruptcy and—according to some observers—averted an even more serious financial crisis. Today, the company is back on its feet, albeit in more streamlined form and with a new overseer—the Federal Reserve.

That AIG is still largely intact is troubling, because its failure was not—as some have suggested—the result of mistakes by one aggressive unit of an otherwise well-run company. Its problems ran deeper, including into AIG's regulated insurance subsidiaries. AIG was wrongly spared the necessary market discipline for its failures, and many other companies will be, too, under the new regulatory structure that Congress and the regulators have built in response to the misconception of AIG's problems. AIG did not need another regulator. It needed better risk management, a message the markets would have conveyed in no uncertain terms had regulators not intervened to ensure AIG's survival. This paper adds the missing piece to the AIG story in an effort to challenge the notion that more regulatory oversight for companies like AIG will prevent another crisis like AIG's.

Although some academics, journalists, and other observers have told a more balanced story,¹ the standard, popularly believed, and oft-repeated explanation for AIG's problems and subsequent bailout continues to center almost exclusively on the derivatives products sold by AIG Financial Products (AIGFP).² Federal Reserve Chairman Ben Bernanke's conclusion that "AIG's financial difficulties stemmed primarily from the loss of liquidity to fund collateral calls on its unhedged derivatives positions in one part of the company—its Financial Products Division"—is typical of official accounts of the crisis.³ AIGFP was certainly an important part of the story. It built a large, unhedged portfolio of credit derivatives linked to subprime mortgage assets. During 2007 and 2008, as the value of the underlying mortgage assets dropped, AIGFP faced devastating collateral calls in connection with its derivatives portfolio that threatened AIG's liquidity and its credit rating.

Focusing only on this important part of AIG's demise ignores an equally big piece of the story: the problems faced by AIG's life-insurance subsidiaries because of their heavy participation in the residential mortgage-backed securities market through a large securities-lending program.⁴ The securities-lending program experienced a run at the height of the crisis, and AIG could not meet the massive repayment demands. Certain AIG life-insurance subsidiaries' capital levels fell dangerously low. Questions about the role of the securities-lending program in AIG's downfall have not been asked or answered satisfactorily.⁵ Although the securities-lending program exposed AIG's regulated life-insurance subsidiaries to great risk, in the standard AIGFP-centric narrative, securities lending is little more than a footnote.⁶

The single-minded focus on AIGFP manifested itself in regulatory-reform debates and the end product of those debates: the Dodd-Frank Act.⁷ AIG became the rallying cry for

derivatives reform, a key component of Dodd-Frank.⁸ AIGFP was decried for being unregulated, and so AIG also has been at the root of the push toward systemic oversight.

Allowing the securities-lending portion of the story to slip out of the history books (or to never slip into them) means that we will not learn from the business and regulatory failures associated with the securities-lending problems at AIG. Even five years after AIG's bailout, it is not too late to learn these lessons and to consider their policy implications. To the credit of the new Federal Insurance Office, it considered the securities-lending issues briefly in its recently released report on modernizing the insurance-regulation system mandated by Dodd-Frank.⁹ The report's conclusion—that AIG's failure “underscored the need to supervise firms on a consolidated basis”¹⁰—misses the true lesson of AIG's struggles, which is that even heavily regulated companies run into trouble and must be permitted to fail so that their resources can move into other private hands that will manage them better.

Section 1 provides a brief overview of AIG and its regulatory framework. Section 2 discusses the problems at AIGFP, which are central to the standard explanation for AIG's downfall. Section 3 describes the securities-lending program, the role of which policymakers have largely ignored in considerations of AIG's crisis. Section 4 describes the government rescue. Section 5 discusses the serious threat that the securities-lending program posed to the solvency of AIG's domestic life-insurance subsidiaries and the government's role in rescuing those companies from insolvency. Section 6 considers the policy implications. Section 7 concludes.

I. AIG: A Highly Regulated Company

AIG got its start in 1919 when Cornelius Vander Starr founded an insurance company in Shanghai, China.¹¹ By the end of 2007, AIG operated in more than 130 countries with 116,000 employees

engaged in a broad range of insurance and other financial businesses.¹² AIG held nearly \$1 trillion in assets at the end of 2007, which made it the sixth-largest publicly traded company at the time.¹³ In early 2013, it had fallen to sixty-second place with just over half the assets it held in 2007.¹⁴

A key moment in AIG's history—one that arguably helped to lay the groundwork for the company's subsequent troubles¹⁵—was the departure of Maurice “Hank” Greenberg in March 2005 in response to investigations by New York attorney general Eliot Spitzer and the Securities and Exchange Commission.¹⁶ Greenberg joined C.V. Starr & Company in 1960, presided over the reorganization of many of C.V. Starr's insurance companies into the publicly owned AIG, and served as chief executive officer during the period when much of the company's growth took place, from the late 1960s through his departure in 2005.¹⁷

When Greenberg left, AIG insider Martin Sullivan took over as CEO.¹⁸ In addition to adjusting to the departure of its CEO of nearly four decades, the company was faced with ongoing state and federal investigations, internal control problems, a credit-rating downgrade, a restatement of the company's financial statements, and significant updates in the company's information-technology systems.¹⁹ AIG settled with the Department of Justice, the SEC, and New York authorities in 2006.²⁰ In June 2008, after large losses and the initiation of a new round of government investigations, AIG's board replaced Sullivan with Robert Willumstad.²¹

At the time of the bailout, AIG was subdivided into four major business segments: (1) General Insurance, which sold commercial property and casualty insurance, automobile and other personal insurance, and residential mortgage guaranty insurance; (2) Life-Insurance and Retirement Services, which sold individual and group life insurance, endowment and accident insurance, health and accident insurance, and annuities; (3) Financial Services, which included aircraft leasing, capital markets (including AIGFP), consumer finance, and insurance premium

finance; and (4) Asset Management, which offered investment products and services for individuals, pension plans, and institutions.²² AIG conducted these businesses through more than 200 subsidiaries.²³ Although it was engaged in other businesses, AIG was primarily an insurance company, and its insurance operations generated more than ninety percent of the company's revenues in 2007.²⁴ There were seventy-one U.S. insurance subsidiaries,²⁵ and the company maintained a strong overseas presence as well. For example, seventy-nine percent of its life-insurance and retirement-services premiums came from outside the United States in 2007.²⁶

Contrary to the standard characterization of AIG as an unregulated entity, it was regulated by more than 400 domestic and international regulators.²⁷ Most of these regulators—which included insurance, securities, and banking regulators—were responsible for discrete parts of the company, rather than for the company as a whole.²⁸ State insurance departments regulated AIG pursuant to the McCarran-Ferguson Act, which provides for state, rather than federal, regulation of insurance.²⁹ AIG had more than one hundred foreign insurance regulators.³⁰

Insurers, once licensed to write insurance in a particular state, are subject to that state's insurance regulations. State insurance regulation seeks to prevent insurers from “incur[ring] an excessive risk of insolvency or engag[ing] in market abuses that hurt customers.”³¹ Accordingly, state insurance regulators oversee insurers' market conduct and financial solvency, and typical state insurance-law requirements include “compliance with investment statutes and regulations regarding types of permissible investments and diversification and liquidity of investments, compliance with (minimum) reserving standards and minimum capital and surplus requirements (including [risk-based capital]), and the restriction of certain reinsurance activities.”³²

Although insurance is not federally regulated, states often coordinate their insurance regulation. The National Association of Insurance Commissioners (NAIC), a voluntary but

influential organization of state insurance regulators, identified a lead regulator to coordinate (but not to supplant) the work of all the responsible state regulators, with respect to each type of insurance that AIG offered.³³ Texas was the lead regulator for life insurance, Pennsylvania for property and casualty insurance, New York for personal insurance lines, and Delaware for “surplus” or specialized insurance lines.³⁴

The Office of Thrift Supervision (OTS) was the regulator with the broadest authority over AIG. The OTS became the holding-company regulator of AIG in 1999, when AIG Federal Savings Bank (AIGFSB) received an OTS charter.³⁵ Even though AIGFSB, with 0.14% of the company’s assets at the end of 2008, represented a tiny fraction of the overall AIG enterprise,³⁶ as holding-company regulator, the OTS could look comprehensively at AIG.³⁷ Initially, its focus was on protecting the safety and soundness of AIGFSB, but over time, it more purposefully undertook enterprise-wide supervision.³⁸ In January 2007, the French banking regulator recognized the OTS as AIG’s holding-company regulator for the purposes of the European Union’s Financial Conglomerates Directive, which requires companies to have a consolidated supervisor.³⁹ This recognition did not alter the OTS’s authority over AIG, but it provided a framework for minimizing regulatory overlap and facilitating regulatory coordination.⁴⁰

The OTS coordinated with other regulators and, beginning in 2005, hosted an annual supervisory college for AIG’s key regulators, including state insurance regulators.⁴¹ The OTS began tailoring its supervisory approach to conglomerates such as AIG in 2003 and formalized this approach in 2006.⁴² The OTS evaluated and rated AIG according to its capital, organizational structure, risk management, and earnings, the so-called “CORE” factors, but deferred to other regulators with respect to the parts of AIG they regulated.⁴³ The OTS, in its view, for example, generally “did not have the authority to go in and examine insurance companies that were

regulated by other regulators.”⁴⁴ Because “[a]pproximately 85 percent of AIG, as measured by allocated capital, was contained within entities regulated or licensed by other supervisors,”⁴⁵ the OTS relied heavily on other regulators. Table 1 lists some of AIG’s regulators.

Table 1. A Partial List of AIG’s Regulators in 2008

AIG entity	Regulator
AIG Holding Company	Office of Thrift Supervision
domestic insurance companies	state insurance regulators
foreign insurance companies	foreign insurance regulators
AIG Federal Savings Bank	Office of Thrift Supervision
AIG Securities Lending Corp. (after registering as broker-dealer in 2006)	Securities and Exchange Commission/ Financial Industry Regulatory Authority
AIG’s European operations	French Commission Bancaire (coordinating supervisor)

Sources: AIG, ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007, 13 (2008); CONGRESSIONAL OVERSIGHT PANEL: JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS AND THE GOVERNMENT’S EXIT STRATEGY 15–18, 43 (2010), *available at* <http://cybercemetery.unt.edu/archive/cop/20110402010341/http://cop.senate.gov/documents/cop-061010-report.pdf>; SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, AIG REMAINS IN TARP AS TARP’S LARGEST INVESTMENT 12–13 (2012), *available at* http://www.sig tarp.gov/Audit%20Reports/AIG_Remains_in_TARP_Mini_Book.pdf.

Although the OTS has been criticized (including from within the OTS) for not overseeing AIG more vigorously,⁴⁶ the OTS identified a number of problems at AIG, including risk-management issues.⁴⁷ The OTS took a cursory look at AIGFP’s credit default swap portfolio during 2007 and planned an in-depth analysis of AIGFP’s subprime exposures during 2008.⁴⁸ Its preliminary look resulted in a recommendation “that the company revisit its financial modeling assumptions in light of deteriorating subprime market conditions.”⁴⁹ In March 2008, the OTS downgraded AIG’s CORE rating, and in August, the OTS approved AIG’s remediation plan in response to that downgrade.⁵⁰ In September 2008, the OTS placed constraints on AIGFSB’s activities to prevent the bank from taking actions that might affect its ability to repay depositors and might result in losses to the deposit insurance fund.⁵¹

The OTS's focus on subprime exposures came too late, and it does not appear to have focused specifically on securities lending as a source of liquidity risk. The OTS's supervision of AIG appears to have been stymied by shifting responsibility for AIG among OTS divisions and staff and by inadequate examination personnel.⁵² Even if it had had more examiners, focusing only on the issues at AIGFP would have given the OTS only part of the story. The OTS's experience with AIG highlights the danger of relying on regulators to timely and comprehensively identify problems, let alone to craft appropriate solutions for them.

II. AIG Financial Products: One Part of the Story

AIG formed AIG Financial Products, the focal point on which the standard explanation of AIG's downfall centers, in 1987, when AIG entered into a joint venture with a number of defectors from Drexel Burnham Lambert to conduct derivatives transactions.⁵³ After AIGFP's first CEO, Howard Sosin, clashed with Greenberg, Tom Savage took over in 1994.⁵⁴ Among his guiding principles was avoiding mortgage-related assets.⁵⁵ In 2002, Joseph Cassano, a long-time AIGFP employee, became CEO and expanded its product offerings to include the type of credit default swaps (CDS) that got AIGFP into trouble during the crisis.⁵⁶

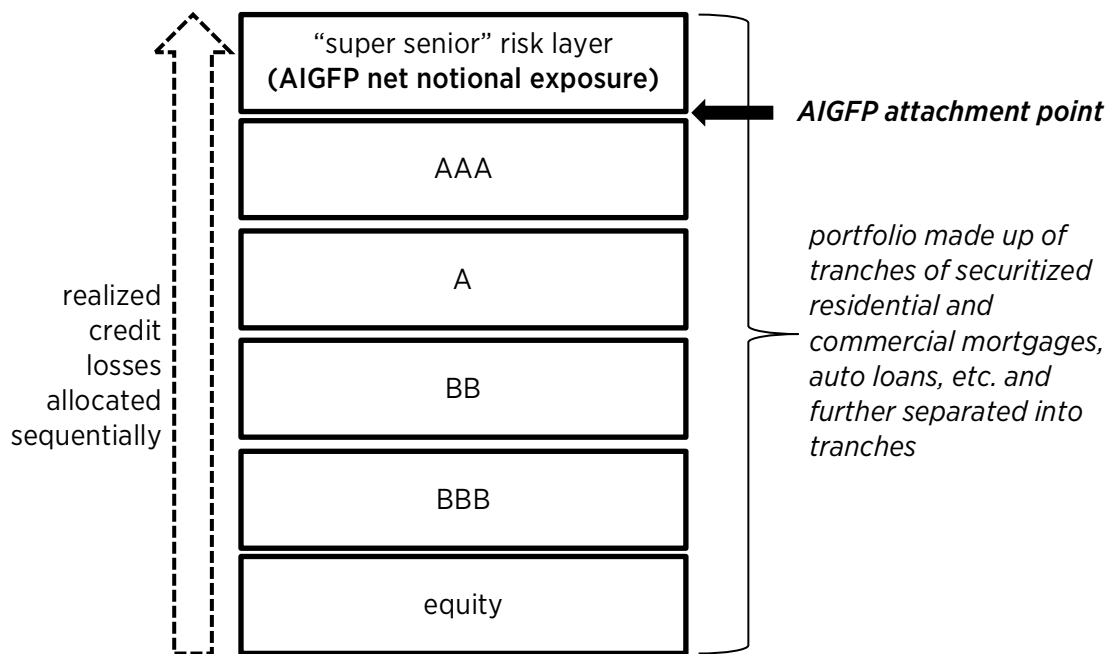
AIGFP began selling CDS in 1998.⁵⁷ CDS are "a type of credit derivative in which the credit derivative buyer makes periodic payments to the credit derivative seller, who pays the buyer if and when a credit loss is incurred in the reference entity."⁵⁸ AIGFP's CDS counterparties, which were major financial institutions such as Goldman Sachs, generally were trying to lay off risk from other activities, including transactions with customers. AIGFP was a desirable counterparty because of the strength of its parent's credit rating, which was AAA until early 2005.⁵⁹

Among the CDS sold by AIGFP was a portfolio of “super-senior” CDS. This portfolio included corporate arbitrage CDS,⁶⁰ regulatory arbitrage CDS,⁶¹ and CDS on multisector collateralized debt obligations (CDOs).⁶² AIGFP’s problems were concentrated in the latter category, which AIG began to write in 2004,⁶³ and which accounted for \$78.2 billion of the \$527.3 billion in notional value of the super-senior CDS portfolio at the end of 2007.⁶⁴ The multisector CDOs were heavily concentrated in U.S. residential mortgage-backed securities (RMBS).⁶⁵ A substantial portion of the transactions included subprime exposure.⁶⁶

The super-senior tranche had the highest priority in the payment waterfall—higher even than the AAA tranches—and was thus the least likely tranche to bear losses.⁶⁷ According to AIG, a tranche only qualified as super senior if “there [was] no expected loss at contract inception, even under its conservative stress assumptions.”⁶⁸ As figure 1 depicts, the credit protection that AIGFP sold was triggered only if losses extended into the super-senior tranche of the underlying CDOs. AIGFP set what it believed to be a conservative attachment point, the point at which AIGFP’s payment obligation would arise.⁶⁹

AIGFP believed that it was selling “significantly out-of-the-money put options that are insensitive to normal changes in market credit spreads.”⁷⁰ AIGFP did not hedge these CDS transactions by entering into offsetting transactions, but relied instead on the expectation that the underlying securities would never incur losses high enough to trigger a payout by AIGFP.⁷¹ AIGFP’s plan was to collect its counterparties’ periodic payments and retain its CDS positions until the underlying CDOs matured, without having to make any payouts.⁷² If losses on the underlying portfolio reached the attachment point—the point at which losses are allocated to the super-senior tranche—AIGFP would have to purchase the underlying super-senior securities at par.⁷³

Figure 1. AIG's Super Senior Credit Default Swaps



Source: Based on illustration in AIG, Residential Mortgage Presentation 42 (Nov. 8, 2007), available at http://media.corporate-ir.net/media_files/irol/76/76115/Revised_AIG_and_the_Residential_Mortgage_Market_3rd_Quarter_2007_Final_110807r.pdf.

Note: The illustration does not reflect the collateral payments that AIGFP was required to make to its counterparty when the underlying securities deteriorated in value or when AIG's credit rating fell.

Even in the absence of realized economic losses, AIGFP faced potential collateral calls in connection with the multisector CDS portfolio. Because of AIG's AAA credit rating at the time it wrote many of the CDS at issue, AIGFP was not required to post collateral unless certain triggering events occurred. In the case of the CDS written on super-senior tranches of multisector CDOs, however, AIGFP's counterparties had the right to request collateral based on the value of the underlying security on which the CDS was written.⁷⁴ In other words, "as CDO values tanked, AIG was required to post more and more cash collateral."⁷⁵ Changes in AIGFP's or AIG's credit rating could also affect collateral payments.⁷⁶

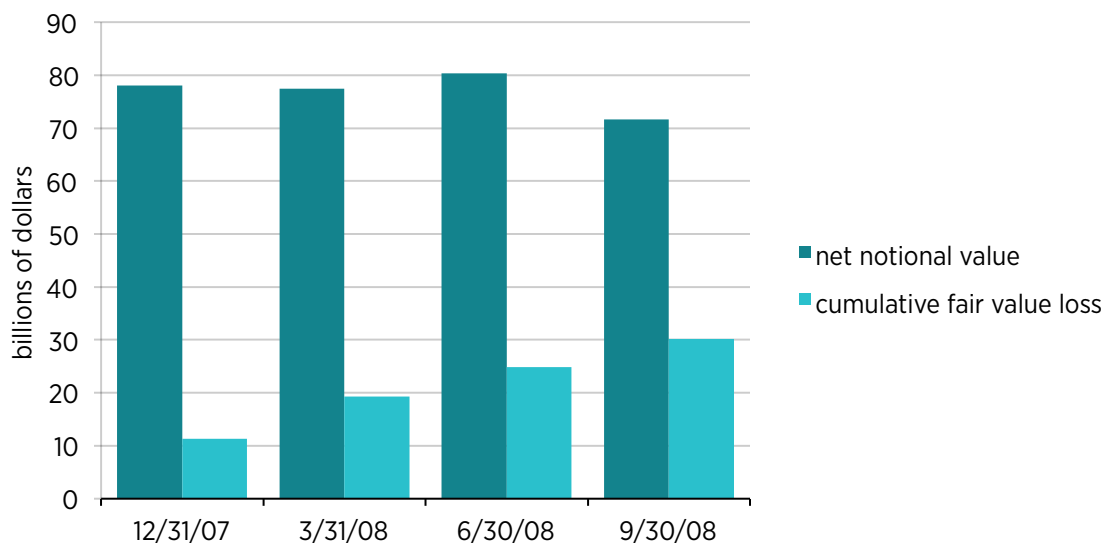
AIGFP CEO Cassano contended that AIGFP maintained a pool of liquid securities to meet collateral calls arising from the CDS portfolio,⁷⁷ but that pool proved inadequate for the

volume and magnitude of collateral calls that came in during 2007 and 2008. Because AIGFP was no longer able to fund itself, it had to rely on AIG for liquidity.⁷⁸ AIG, the executives of which were not aware of the link between collateral requirements and the value of the underlying securities, had not prepared for this liquidity demand.⁷⁹

AIGFP began to receive collateral calls in the summer of 2007, and they continued into the fall of 2008. Goldman Sachs (Goldman) made the first \$1.8 billion collateral call on July 27, 2007.⁸⁰ Less than a week later, Goldman reduced its demand to \$1.2 billion.⁸¹ AIGFP disputed both the initial and revised collateral calls as well as Goldman's valuations of the underlying securities.⁸² Market illiquidity and AIGFP's lack of an internal valuation model complicated AIGFP's efforts to contest collateral calls.⁸³ Meanwhile, the collateral disputes with Goldman continued and escalated,⁸⁴ AIGFP made partial payments,⁸⁵ and additional collateral calls came in from other counterparties.⁸⁶ By the end of July 2008, AIGFP had posted \$16.5 billion in collateral, principally in relation to the multisector CDO portfolio.⁸⁷ At the time of AIG's bailout, demands for collateral from AIGFP's counterparties were nearly \$24 billion.⁸⁸

AIG was also posting mark-to-market losses—unrealized losses that are required under generally accepted accounting principles to be reflected in the income statement and balance sheet—in connection with its CDS portfolio. In the third quarter of 2007, AIG took a charge to net income of \$352 million for unrealized mark-to-market losses arising from AIGFP's super-senior CDS portfolio.⁸⁹ By the end of 2007, AIGFP's mark-to-market losses on its CDS on multisector super-senior CDOs was \$11.3 billion on a notional amount of \$78.2 billion.⁹⁰ Figure 2 shows the notional value of, and the mark-to-market losses on, the multisector CDS portfolio.

Figure 2. AIG's Portfolio of Multisector Super-Senior Credit Derivatives



Sources: AIG, Conference Call Credit Presentation Supplemental Materials, at 30 (Feb. 29, 2008), *available at* http://media.corporate-ir.net/media_files/irol/76/76115/CallSupplement.pdf; AIG, Conference Call Credit Presentation, at 34 (May 9, 2008), *available at* http://media.corporate-ir.net/media_files/irol/76/76115/ConferenceCallCreditPresentation_05_09_08.pdf; AIG, Conference Call Credit Presentation, at 24 (Aug. 7, 2008), *available at* http://media.corporate-ir.net/media_files/irol/76/76115/FinalConf_revised_08-13-08.pdf; AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008, at 121 (Nov. 10, 2008).

Note: The cumulative fair value loss is “AIG’s best estimate of the amount it would need to pay to a willing, able and knowledgeable third party to assume the obligations under AIGFP’s super senior multi-sector credit default swap portfolio.” AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008, at 121 (Nov. 10, 2008).

AIGFP’s CDS portfolio and attendant collateral calls would have been even larger had AIGFP continued to sell multisector CDS throughout the housing boom. AIGFP made a deliberate decision in late 2005 and early 2006 to stop writing CDS on CDOs made up of subprime securities after employees at AIGFP and risk managers at AIG simultaneously grew concerned about the residential real estate market.⁹¹ These concerns were confirmed by a series of exploratory meetings in New York, during which AIGFP staff talked with a number of industry participants.⁹² A February 28, 2006, AIG email memorialized the decision to stop writing these types of CDS by “summariz[ing] the message we plan on delivering dealers later

this week with regard to our approach to the [collateralized debt obligation of asset-backed securities] business going forward”:

We feel that the [collateralized debt obligation of asset-backed securities] market has increasingly become less diverse over the last year or so and is currently at a state where deals are almost totally reliant on subprime/non prime residential mortgage collateral. Given current trends in the housing market, our perception of deteriorating underwriting standards, and the potential for higher rates we are no longer as comfortable taking such concentrated exposure to certain parts of the non prime mortgage securitizations.⁹³

Deals already in the pipeline at that time continued, and AIGFP entered into one additional transaction.⁹⁴ Aside from a single attempt to hedge an existing position, AIGFP left the positions on its books unhedged.⁹⁵ AIGFP’s concerns with subprime RMBS were not reflected in the actions of other parts of AIG, including the insurance subsidiaries’ securities-lending program.

III. The Threat Posed by AIG Insurance Companies’ Securities-Lending Activities

Securities lending, which involved AIG’s life-insurance companies, is the largely forgotten part of AIG’s downfall.⁹⁶ Securities lending at AIG—as at other insurance companies—was supposed to be a “low-risk, low-return business.”⁹⁷ The securities-lending program at AIG, however, became increasingly aggressive over time. As a consequence, securities lending imperiled both AIG and certain of its insurance subsidiaries.

A. Background on Securities Lending

Securities lending is a common practice in the financial industry.⁹⁸ The securities-lending markets are economically similar to, and interrelated with, the repurchase agreement (“repo”) markets.⁹⁹ Both markets enable counterparties to exchange cash for securities. In a repo transaction, the borrower obtains short-term financing by selling securities with an agreement to buy them back.¹⁰⁰ In a securities-lending transaction, the borrower borrows securities and

collateralizes them with other securities, a letter of credit, or cash.¹⁰¹ In the United States, borrowers typically post cash collateral of 102% of the value of the securities borrowed to secure the loan.¹⁰² Lenders ensure that collateral is maintained at that level by daily mark-to-market margin calls throughout the loan's duration.¹⁰³

Securities-lending transactions can be initiated because a borrower needs particular securities or because the lender needs cash.¹⁰⁴ Market participants with large pools of securities—such as mutual funds, pension plans, and insurance companies—are active securities lenders.¹⁰⁵ Borrowers—such as broker-dealers and hedge funds—use the securities for various purposes, including in connection with short selling, convertible arbitrage, warrant arbitrage, risk arbitrage, options trading, and long/short strategies.¹⁰⁶ The fees (“rebates”) paid in connection with the transaction depend on the scarcity, or “specialness,” of the security being lent; the more readily available the security, the higher the rebate the lender pays to the borrower. One expert explains the relationship as follows:

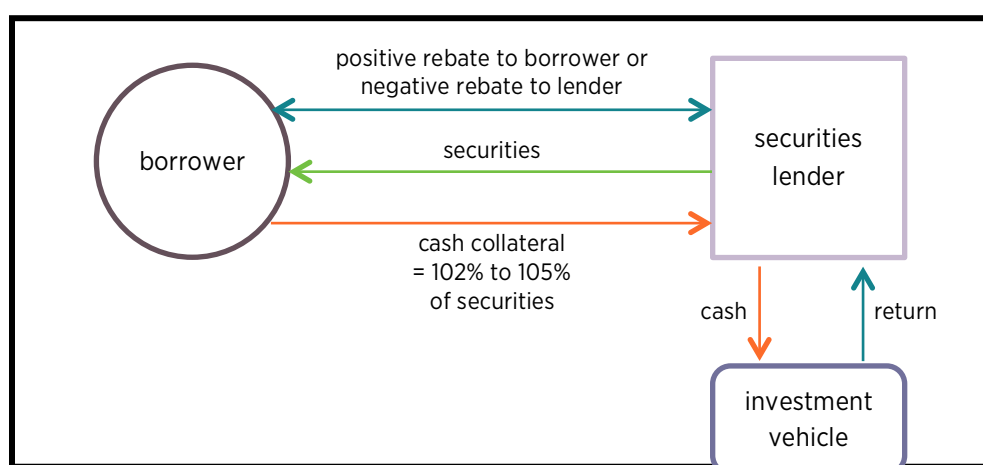
The securities lender wants to lend the securities at the lowest rebate rate possible to maximize their profit, and the securities borrower wants to earn the highest rebate rate possible for the same reason. If the securities being borrowed are readily available from multiple securities lenders (most S&P 500 securities are easy to borrow due to their extensive number of shares outstanding, being widely held, and relatively low short interest), the rebate rate will likely be close to the cash reinvestment rate If the securities are in high demand and not widely held, the laws of supply and demand will dictate a lower rebate rate be paid to the securities borrower. In the current low interest rate environment, many securities that are not easy to borrow are resulting in no rebate being paid to the borrowing broker-dealer or a negative rebate rate where the broker-dealer pays additional interest to the securities lender for the privilege of borrowing the securities.¹⁰⁷

Securities lenders can make money in two ways: from the intrinsic value of the securities being lent and from the reinvestment of cash collateral.¹⁰⁸ In many transactions, securities lending is primarily an investment activity, in which the reinvestment of cash collateral is the primary revenue generator.¹⁰⁹ The lender typically reinvests the cash collateral it receives from

the borrower in money-market instruments, repos, or other investments in order to generate a return.¹¹⁰ As traditionally conceived, securities lending offered the securities lender a little extra return on its investment portfolio without greatly increasing the risk.¹¹¹ One constraint on the risk taken in connection with the reinvestment of cash collateral is the lender's need to return the cash collateral at the expiration of the lending transaction.¹¹² Securities-lending transactions are typically very short in duration and roll over daily.¹¹³

The need to have sufficient liquidity to meet demands for cash collateral repayment is in tension with the incentive to increase reinvestment returns by investing in longer-term, higher-yielding investments. The tension is heightened by the involvement of securities-lending agents, who manage lending and reinvestment for securities lenders.¹¹⁴ Before the financial crisis, the emphasis on increasing securities-lending income caused some securities lenders to engage in less-conservative reinvestment practices by investing in less-creditworthy or less-liquid securities.¹¹⁵ Figure 3 depicts a sample securities-lending transaction.

Figure 3. Sample Securities-Lending Transaction



Source: Author's rendering. This diagram does not include a securities-lending agent or a broker-dealer, which act as intermediaries between the owner of the securities and the ultimate borrower. For a discussion of the role of these intermediaries, see JOSH GALPER, FINADIUM REPORT: THE ROLE OF SECURITIES LENDING IN US FINANCIAL MARKETS 5 (2011).

B. AIG's Securities-Lending Program

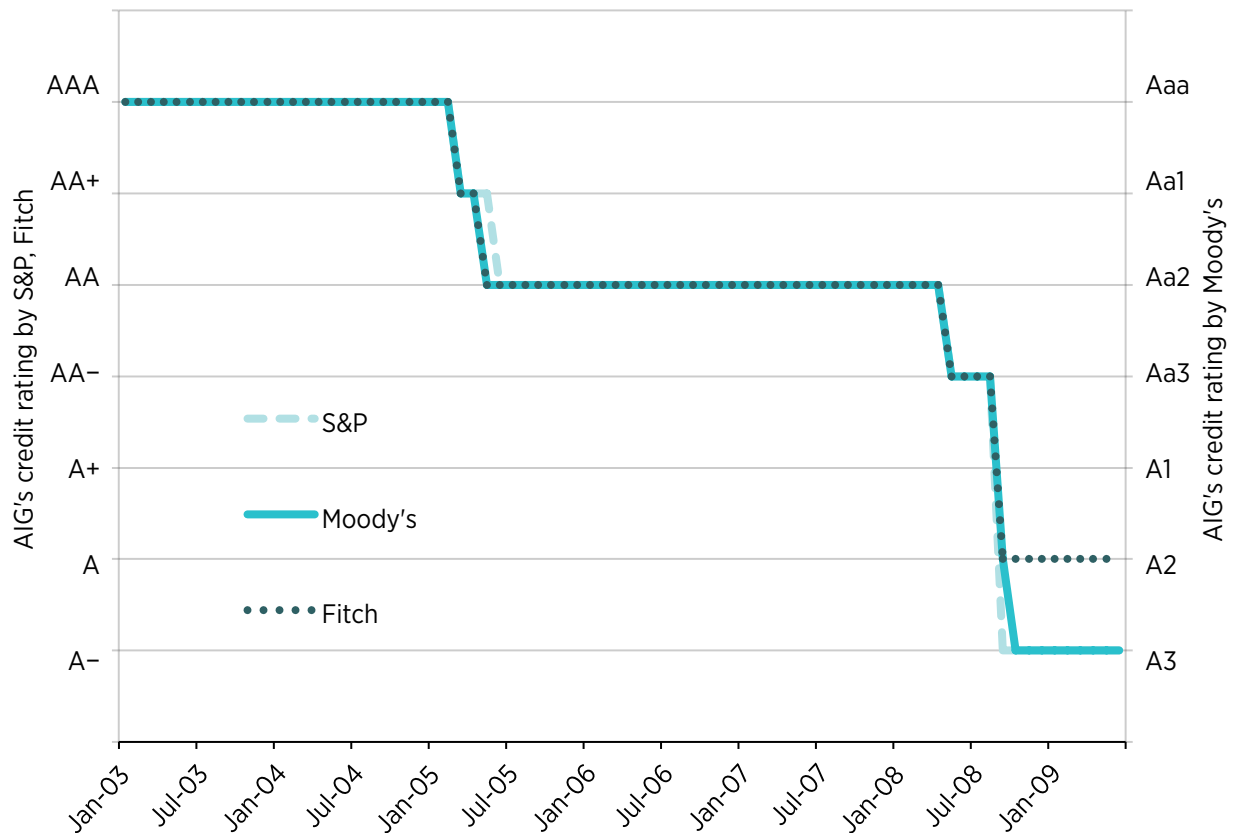
AIG was an active securities lender. It was an approximately \$80 billion participant in a worldwide market that represents approximately \$3.5 trillion in early 2008.¹¹⁶ It began lending securities in the early 1990s through a third-party lending agent.¹¹⁷ In 1997, AIG commenced the process of bringing the program in-house by setting up its own agent, AIG Global Asset Management Holdings Corporation,¹¹⁸ which ran the securities-lending program through its subsidiaries AIG Securities Lending Corp. (formerly AIG Global Securities Lending Corp.) and AIG Global Investment Corp.¹¹⁹ AIG's securities-lending agent lent securities in exchange for cash.¹²⁰ The securities-lending and collateral-reinvestment functions were distinct, although both were carried out by AIG entities.¹²¹ On the collateral-reinvestment side, there were people responsible for investing in long-term securities (including corporate bonds and asset-backed securities) and others responsible for investing in short-term securities.¹²² In return for its lending and reinvestment efforts, AIG's internal securities-lending agent equally shared the program's proceeds with the insurance companies.¹²³

The AIG insurance subsidiaries put securities from their investment portfolios into a common pool available for lending to banks, broker-dealers, and other financial institutions.¹²⁴ AIG, with its strong credit rating and \$160 billion portfolio of high-quality securities to lend, was an attractive counterparty.¹²⁵ Figure 4 shows AIG's historical credit rating.

AIG's counterpart borrowers were primarily using the securities in connection with financing transactions. In the words of an AIG securities lending employee, AIG's borrowers "were looking for a quality counterpart with a good return on the cash that could be done on a one-month basis and maybe [AIG's] rate was better than the rest of the Street."¹²⁶ Borrowers could be assured that they would get their cash collateral back because "the invested collateral,

the securities on loan as well as all of the assets of the participating companies [were] generally available to satisfy the liability for collateral received.”¹²⁷ In other words, the AIG insurance companies’ assets were available to make borrowers whole in the event that AIG could not return borrowers’ cash collateral.

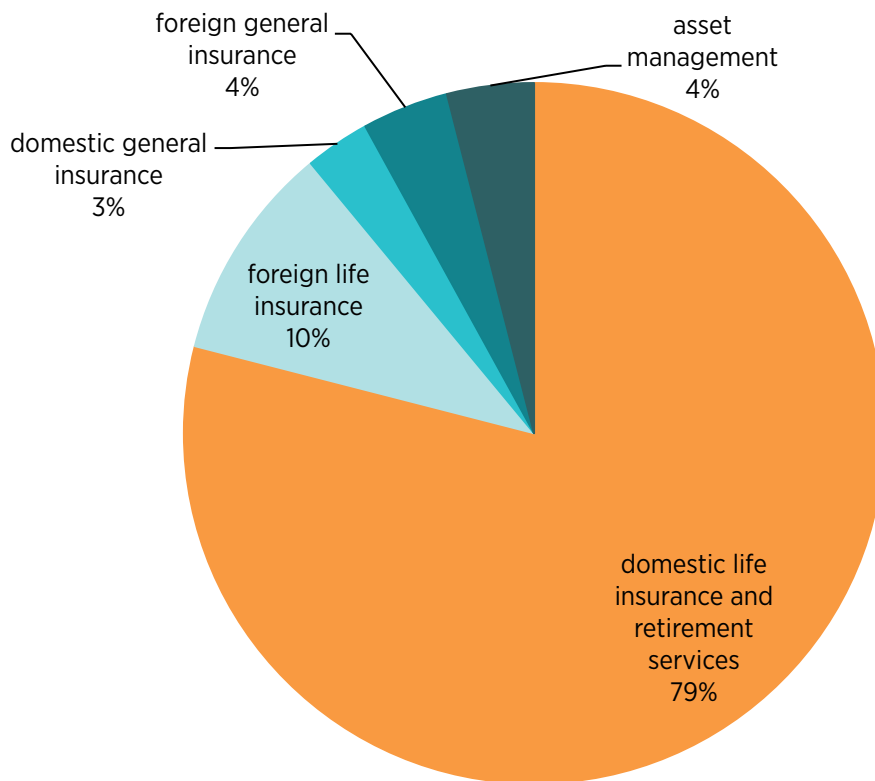
Figure 4. AIG Credit Ratings, June 1990–June 2009



Sources: American International Group’s Impact on the Global Economy: Before, During and After Federal Intervention, *Hearing Before the Subcomm. on Capital Markets, Insur., and Gov’t Sponsored Enterprises of the H. Comm. on Fin. Serv.*, 111th Cong., 1st Sess. 156 (2009) (written testimony of Rodney Clark, Managing Dir., Ratings Services, Standard & Poor’s Financial Services LLC) (providing a “[t]able of S&P ratings history for American International Group Inc. since June 1990”); Compilation of Rating Action for AIG Financial Products Corp., <https://www.moodys.com/credit-ratings/AIG-Financial-Products-Corp-credit-rating-782350> (last visited Mar. 21, 2014); Fitch Ratings, <https://www.fitchratings.com> (free registration required to access reports on Fitch ratings actions on AIG) (last visited Mar. 21, 2014).

As figure 5 shows, AIG’s domestic life-insurance and retirement-services unit accounted for nearly eighty percent of AIG’s securities-lending activities in 2007.

Figure 5. Participation in AIG’s Securities-Lending Program as of December 31, 2007



Source: AIG, ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007, 108 (2008).

AIG lent securities to generate cash for reinvestment.¹²⁸ As an employee involved in the securities-lending program explained, “We were very much doing sort of a repo-style practice. We wanted to have use of the cash. We wanted to lock that up so we didn’t have to pay people back on a regular basis.”¹²⁹ For this reason, most of AIG’s trades were not open—as is standard in securities lending—but rather were term loans, most of them for a term of one month.¹³⁰ At the end of 2007, 13.7% of the securities loans were one-day tenor.¹³¹ The rest of

the collateral AIG was lending was more readily available “general collateral.”¹³² The longer terms gave AIG some measure of security, but a maturity mismatch still existed and left AIG exposed to liquidity risk.

Before the crisis, AIG’s securities-lending transactions, consistent with the market standard, were overcollateralized; borrowers generally provided to AIG cash collateral worth 102–105% of the value of the securities borrowed.¹³³ Throughout the loan term, AIG marked the securities to market daily and made periodic collateral adjustments to ensure that AIG’s overall book with each borrower was at least 102% collateralized based on then-current market values.¹³⁴ That practice changed as the financial crisis swept over AIG and the rest of the marketplace.

C. AIG’s Exposure to the Troubled Mortgage Markets

AIGFP’s decision to stop taking on exposure to subprime mortgages did not reflect a broader company trend. Even as AIGFP was paring back its exposure to subprime securities at the end of 2005 and beginning of 2006, other areas of the company were escalating their exposure.¹³⁵ As AIG CEO Sullivan explained in a December 2007 conference call, “During 2005, AIG began to see mounting evidence that lending standards and pricing in the U.S. residential housing market were deteriorating at a significant pace. Each of our businesses with exposure to that sector saw the same environment and took corrective action at that time, consistent with their individual business models.”¹³⁶ AIG’s insurance companies, for example, were heavily exposed to RMBS, including late-vintage subprime RMBS, through their investment portfolio.¹³⁷ As AIG explained in an August 2007 presentation, it was “very comfortable with the size and quality of its [residential mortgage] investment portfolios and its operations” and “[t]he exposures to the

residential mortgage-backed securities market within AIG's portfolios are of high quality and enjoy substantial protection through collateral subordination."¹³⁸ With respect to its insurance investment portfolio (which included the securities-lending portfolio), AIG maintained that it had selected its RMBS carefully, avoided collateralized debt obligations, concentrated on highly rated securities, and consequently was "reasonably well positioned to withstand even a severe downturn in the U.S. housing market."¹³⁹ Robert Lewis, AIG's chief risk officer, explained that the decision to continue buying RMBS for the insurance companies was the result of a reasoned compromise:

The concerns that we had and discussed in the corporation about the deterioration of underwriting standards and lending practices in the banking industry were discussed with the Investment area. . . . [T]he Investment Department, who was tasked with investing AIG's cash, and also specifically the securities' [sic] lending business, they discussed those concerns with us. And there was a compromise reached. The Credit Committee of AIG agreed to allow up to a certain amount of investments in residential mortgage backed, or asset-backed securities, which included residential mortgage-backed securities. And the tradeoff that the Investment Department determined was to purchase only the highest quality investments available in the marketplace. And furthermore, their investment research people were concentrating on trying to select those securities by loan originators, by sponsors, by managers that they thought had a lower percentage of concern in the area of underwriting practices in the originating banks. But it was a tradeoff, a balancing of risk and return opportunity, and there was a tradeoff made.¹⁴⁰

As Lewis's explanation suggests, questions were raised from within and outside AIG about the company's exposure to the mortgage markets. Observers noted that some other insurance companies were reducing their RMBS exposure.¹⁴¹ The firm's auditor raised concerns during a November 29, 2007, meeting with AIG top management about "the fact the FP and AGF in late 2005 were reducing their exposure to subprime while AIG Investments and [United Guaranty Corporation, a mortgage guaranty provider] were increasing theirs—seemed to show a lack of cross AIG evaluation of risk exposure to a sector."¹⁴² Kevin McGinn, AIG's chief credit officer, later remarked that "all units were regularly apprised of our concerns about the housing

market. Some listened and responded; others simply chose not to listen and then, to add insult to injury, not to spot the manifest signs. ‘Nero playing the fiddle while Rome burns’ is my assessment of that.”¹⁴³

D. The Unraveling of the Securities-Lending Program

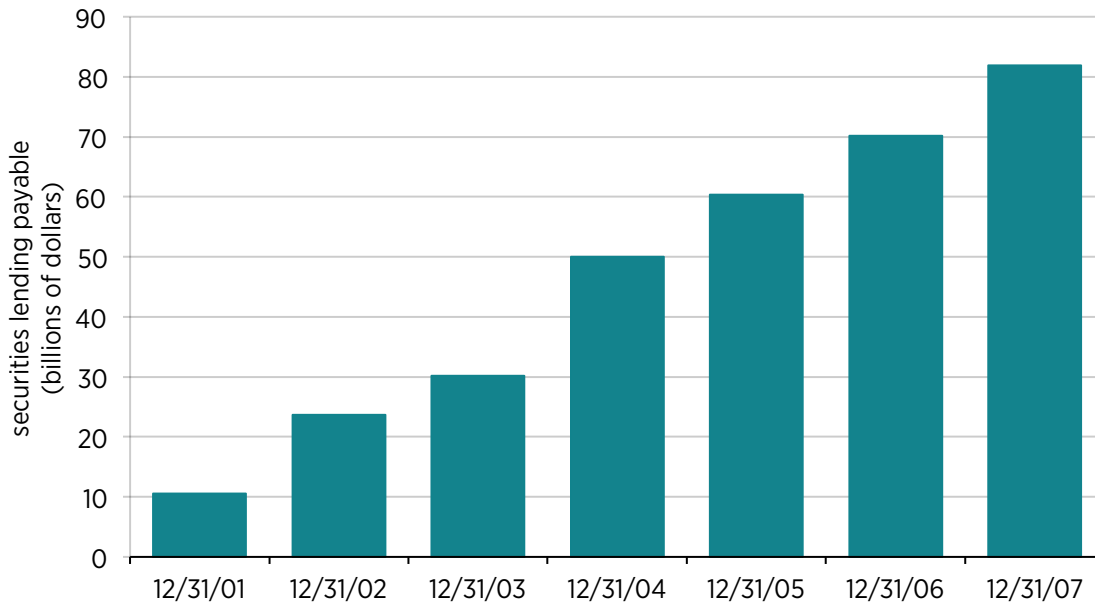
AIG’s insurance companies held RMBS and other asset-backed securities in their investment portfolios, including in the form of reinvested collateral from securities-lending transactions. As noted previously, AIG and some other securities lenders became more aggressive in their cash reinvestment practices over time.¹⁴⁴ In the words of the Financial Stability Board, the reinvestment of cash collateral by securities lenders “can mutate from conservative reinvestment of cash in ‘safe’ collateral into more risky reinvestment of cash collateral in search of greater investment returns (prior to the crisis, AIG was an extreme example of such behavior).”¹⁴⁵

AIG increased the percentage of its cash collateral that was invested in asset-backed securities (ABS). The cap on ABS rose from fifty percent of the reinvestment portfolio in 1999 to sixty-six percent in 2003 and then to seventy-five percent in December 2005.¹⁴⁶ The December 2005 guidelines placed limits on the credit quality of the ABS; generally, ninety-five percent of the ABS had to have a AAA rating from two credit-rating agencies.¹⁴⁷ Author Roddy Boyd notes a more subtle shift: language about “preserv[ing] principal value and maintaining a high degree of liquidity” was dropped from the securities-lending prospectus provided to AIG’s insurance subsidiaries.¹⁴⁸ The new objective was “protect[ing] principal value of cash collateral and maintain[ing] adequate liquidity.”¹⁴⁹

AIG increased the size of its securities-lending program by lending more securities to generate cash, which it then invested heavily in residential mortgage-backed securities (RMBS).

Figure 6 shows the increasing size of the securities-lending program.

Figure 6. Growth of AIG's Securities-Lending Program



Sources: AIG, ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006, 103 (2007); AIG, ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2004, 103 (2005); AIG, ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2002, 61 (2003).

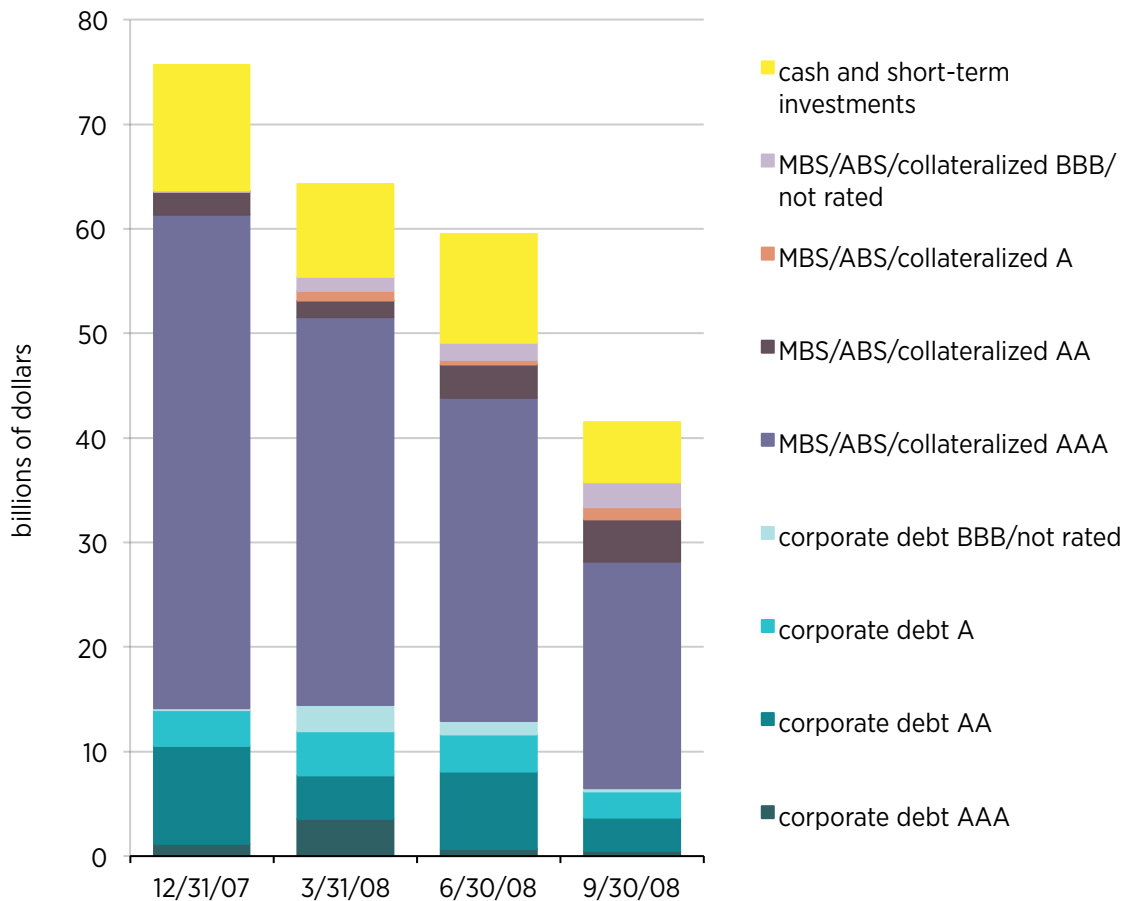
One academic article describes the changes as follows:

Securities lending is traditionally a low margin business, but AIG was determined to make it profitable. There are two ways to increase profit: expand the underlying portfolio such that sheer volume compensates for low yields, and invest the cash collateral into riskier securities that provide a marginally higher return. AIG did both: they dramatically expanded their securities lending portfolio in a few years and invested the majority of their cash collateral into highly rated RMBS.¹⁵⁰

Figure 7 shows the effects of the changes in the composition of AIG's securities-lending portfolio. As the figure shows, the portfolio was heavily concentrated in mortgage-backed and other ABS and had little cash. For example, the figure shows that at the end of 2007, 65 percent

of the portfolio was in ABS. By comparison, a sample of other securities-lending cash-reinvestment programs in 2007 held 26 percent of their investments in asset-backed securities.¹⁵¹

Figure 7. Securities-Lending Portfolio Invested Collateral by Credit Rating and Type



Source: AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2008, 144 (Nov. 10, 2008); AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2008, 111 (Aug. 6, 2008); AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTER ENDED MARCH 31, 2008, 95 (May 5, 2008); AIG, ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007, 108 (2008).

AIG’s investment arm perceived highly rated RMBS—regardless of temporary drops in value—to be a good long-term investment. The company explained in August 2007 that it had no plans to sell its “mortgage related securities and does not depend on them for its liquidity needs. Temporary market disruptions may have some non-economic effect on AIG through unrealized

losses. However, the sound credit quality of the portfolios should result in collection of substantially all principal and interest under any reasonable scenario.”¹⁵² AIG’s senior vice president of investments, Richard Scott, in whose purview securities lending fell, echoed this optimism several months later:

One of the clear opportunities here is that if you believe, as we do, that the AAA sector of the RMBS market is money good and if you could truly buy those securities at significant discounts, there’s a huge opportunity. And there’s a bit of resistance to catching the falling knife. But on the other hand, we’ve got a long-term view. And if we can buy that paper at meaningful discounts to par and have high confidence that we’re going to get paid back over the next three or four years, we should be buying a lot of that.¹⁵³

Regardless of the long-term prospects of RMBS, the concentration of securities-lending collateral in RMBS was risky because it gave rise to a maturity mismatch; the term of the RMBS was longer than that of the securities loans that generated the cash.¹⁵⁴ AIG had only a very small cash cushion to meet redemptions from counterparties that wanted their cash back.¹⁵⁵ The ability of AIG’s securities-lending program to hold on to the RMBS long term depended on the willingness of the majority of borrowers to keep rolling over their loans and keep posting cash collateral without altering the loans’ terms. Historically, borrowers had seamlessly and routinely rolled their loans over, but that behavior changed during the crisis.

In August 2007, as AIGFP was contending with its initial collateral calls on its multisector CDS portfolio, AIG’s securities-lending program also began to experience problems. Mark Hutchings, an employee in AIG’s securities-lending arm, explained how the problems first came to light in August 2007, when “the crisis first raised its head for us here in securities lending”:

I came back from vacation and had never heard before I’d gone on vacation [the term] “subprime,” and it was suddenly the big issue—how much subprime did we have in our investment pool? And there was a lot of concern from senior management. And the strategy straightaway was don’t invest any more of the cash collateral in anything other than overnight time deposits. We need to raise our threshold of actual cash liquidity. . . . You can sell investments we already have in our collateral account to raise cash, or we can lend more securities to give ourselves that cushion of comfort. And again what we’re

protecting ourselves [from] was a run on the bank—the fact that we do not want to see everybody suddenly coming in and wanting their money back because clearly we’ve got it tied up in investments that may or may not be very quickly sold.¹⁵⁶

The company took several steps to address what threatened to become a very dire situation: it lent out additional securities to generate cash, stopped reinvesting the cash collateral it received in anything other than cash equivalents, and sold securities from the collateral investment pool that it could sell at no loss or a small loss.¹⁵⁷ The additional lending brought the size of the securities-lending program from \$70 billion in August 2007 to its all-time high—\$94 billion—in October 2007.¹⁵⁸ AIG repaid redeeming borrowers with the proceeds of the new securities-lending transactions, a situation Boyd likened to “a giant Ponzi scheme.”¹⁵⁹

AIG’s attempts to mitigate the securities-lending issues came at a cost. Its borrower counterparties knew they had AIG “over a barrel”; AIG wanted to hold on to its cash and did not want to sell the securities in its reinvestment pool.¹⁶⁰ It needed to keep lending securities, even at the higher rebates its counterparties were demanding.¹⁶¹ The balance shifted more and more in favor of borrowers as the financial crisis deepened and firms became increasingly zealous in building up their own liquidity. AIG was paying borrowers more for the cash collateral than it received on its investment of that cash.¹⁶²

Borrowers also used their leverage to push AIG below the 102% collateralization that historically had characterized securities-lending transactions. AIG started accepting 100% collateral. It made this concession even though collateral had to remain at or above 102% to satisfy participating insurance companies’ regulatory requirements.¹⁶³ Through its Matched Investment Program, the AIG holding company made up the difference by placing compensating funds into the collateral pool.¹⁶⁴ It contributed \$3.3 billion into the collateral pool through the end of August 2008 to make up for the undercollateralization and for losses on the securities sold

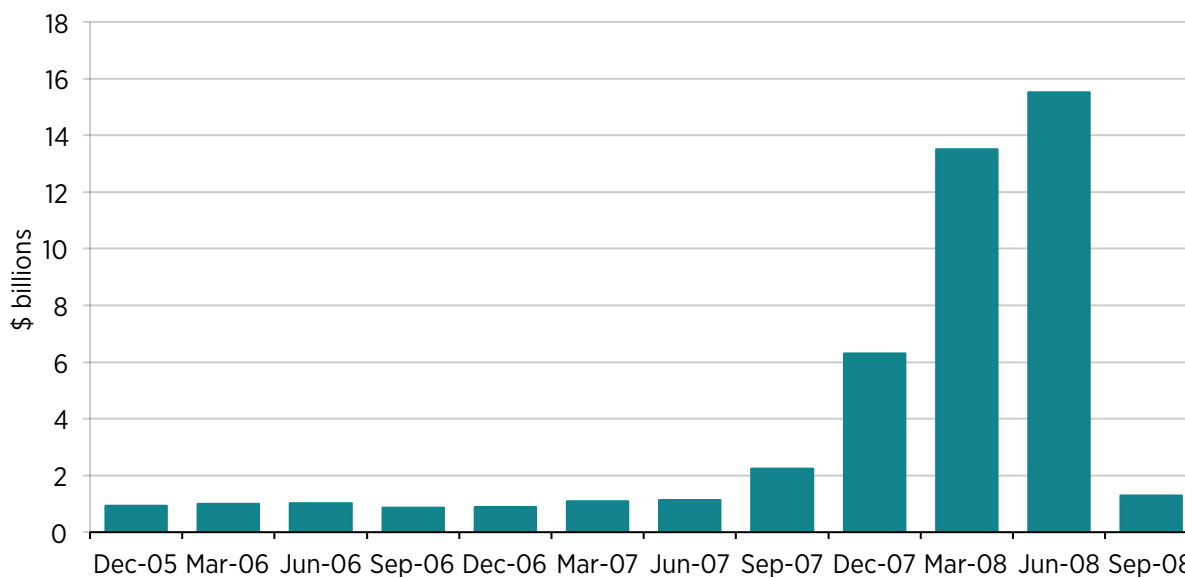
by the pool.¹⁶⁵ As AIG weakened, borrowers pushed AIG further to ninety-eight and ninety-five percent, and by September 2008, some parties were posting only seventy-three (Barclays) or eighty percent (Credit Suisse).¹⁶⁶ Even though “all of the assets of the participating [insurance] companies [were] generally available to satisfy the liability for the collateral received,”¹⁶⁷ the borrowers preferred to keep collateral at a low enough level to be sure that if AIG could not repay the cash collateral, the proceeds from selling the securities would make them whole. Some of these collateral levels were so low that AIG had to account for the purported loan transactions as sales and take the attendant losses.¹⁶⁸

AIG was, by no means, the only securities lender to get into trouble during the crisis.¹⁶⁹ Other securities lenders also took extreme measures to hold on to cash and prevent borrowers from running. One market observer described the unenviable position in which AIG and other lenders found themselves:

[T]he investments that were in those pools were being stressed by the need to sell them off in order to repay the cash collateral to the borrowers who were lining up in order to get their cash back, because they were deleveraging. . . . the cash managers for the securities lending programs in the fourth quarter of '08 actually went negative intrinsic value across the board, meaning they were paying borrowers to leave balances in the pools to avoid having to sell off those assets.¹⁷⁰

AIG's securities-lending program had a reputation for being riskier than most.¹⁷¹ As a result, the pressures it faced during the financial crisis and the measures it took in response were also unusual. The consequences of AIG's emergency liquidity measures and the continuing decline in the value of the RMBS in which the securities-lending collateral was reinvested are reflected in figure 8, which shows the gap between the collateral AIG had received and the value of the securities in which it had invested the collateral. The value of the reinvested collateral fell dramatically in comparison to what AIG owed borrowers. In the event of a run, AIG would not be able to rely on selling the reinvested collateral in order to generate cash to return to borrowers.

Figure 8. Difference between Securities-Lending Payable and Reinvested Collateral



Sources: AIG, ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005, at 72–3 (2006); AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2006, at 1–2 (2006); AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006, at 1–2 (2006); AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006, at 1–2 (2006); AIG, ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006, at 102–3 (2007); AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2007, at 1–2 (2007); AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2007, at 1–2 (2007); AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007, at 1–2 (2007); AIG, ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007, at 130–31 (2008); AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTERLY PERIOD ENDED MARCH 30, 2008, at 1–2 (2008); AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2008, at 1–2 (2008); AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008, at 1–2 (2008).

The run started in earnest during September 2008.¹⁷² As Professor Scott Harrington points out, AIG could have used sources other than its securities-lending collateral to meet those demands, but AIG’s company-wide liquidity was stretched thin.¹⁷³ An impending ratings downgrade only promised to make liquidity problems across the whole company—including in securities lending—much worse.¹⁷⁴ AIG paid out \$5.2 billion in cash to securities-lending counterparties on a single day—September 15, 2008.¹⁷⁵

Not only was the securities-lending program a burgeoning liquidity drain, it was also taking a toll on AIG’s earnings and the insurance subsidiaries’ capital levels. The company projected that “the investments were all money-good” and “that it was better to hang on to these

for the long-term and they would come good in the long-term.”¹⁷⁶ In order to generate liquidity, however, AIG was forced to sell some securities from its cash-reinvestment portfolio and incur the attendant losses.¹⁷⁷ Even for the securities it retained, however, accounting rules required AIG’s financial statements to reflect the mark-to-market losses—the losses based on the current price at which the securities would sell.¹⁷⁸ If these losses on AIG’s securities-lending reinvestments became “other than temporary,” accounting rules required that they be reflected in AIG’s income statement.¹⁷⁹

The losses on the securities thus had a follow-on effect on the participating insurance companies’ capital. As will be discussed later, state insurance regulators require insurance companies to maintain certain capital levels. In order to keep the insurance subsidiaries in good regulatory standing, AIG had to make capital contributions to certain insurance subsidiaries.¹⁸⁰

E. State Insurance Regulators and AIG’s Securities-Lending Program

Insurance companies’ securities-lending practices are subject to state insurance law. Along with other investment practices, securities-lending practices can affect the companies’ ability to meet policyholders’ claims. Some states have specific statutes governing securities lending.¹⁸¹ New York approved participation by one of its regulated insurance companies in AIG’s securities-lending program.¹⁸² Aside from the existence of the program, insurance regulators should have been aware that the securities-lending program was run for the AIG insurance companies by an affiliated securities-lending agent.¹⁸³ Although state insurance regulators had the authority to look at AIG’s securities-lending program, extensive disclosures were not then explicitly required, nor did AIG provide them.¹⁸⁴ Moreover, the way in which it was run may have dissuaded some insurance regulators from actively scrutinizing it. As former New York

insurance superintendent Eric Dinallo pointed out, the pooled nature of the securities-lending program undermined regulatory accountability:

I do think that a pooled securities lending business is not a wise idea, on reflection, because I think it leads to sort of regulatory assignment questions. So it was pooled at the holding company level, and that meant that several states were all somewhat responsible for it.¹⁸⁵

There are conflicting accounts about when the insurance regulators began to notice the problems in the securities-lending program and what the nature of their response was. Insurance regulators contend that they started asking questions in 2006,¹⁸⁶ and in 2007, they ordered AIG to wind down the securities-lending program.¹⁸⁷ New York's regulator contends that it was instrumental in the wind-down of the securities-lending program in 2007.¹⁸⁸ No written record exists.¹⁸⁹ Robert Lewis, AIG's chief risk officer, did not recall the insurance regulators' concern or their role in the shrinkage of the securities-lending portfolio.¹⁹⁰ The Government Accountability Office (GAO) found that "[p]rior to mid-2007, state regulators had not identified losses in the securities-lending program, and the lead life-insurance regulator had reviewed the program without major concerns."¹⁹¹

A number of state insurance examinations conducted during 2007 turned up the securities-lending issue. The reports for some of these exams were not completed until mid-2008.¹⁹² The first regulator to have raised concerns with the company and with other regulators appears to have been the Texas Department of Insurance. Reacting to its findings in a joint examination with certain other regulators commenced in December 2006, the Texas regulator raised the issue with AIG in October and with other regulators at the OTS's supervisory college in November 2007.¹⁹³ The Congressional Oversight Panel reports that "various state insurance regulators began working closely with management to develop both short (guarantees) and long (wind-down) plans to address the regulators' concerns."¹⁹⁴ The GAO reports that the state

insurers did not really focus on securities lending until AIG reported the large 2007 losses on securities lending to them.¹⁹⁵ Before that, “the consensus among the state regulators was that the securities-lending losses, while of concern, did not present imminent danger as long as AIG’s counterparties did not terminate their lending transactions.”¹⁹⁶ Before the 2007 losses came to light, the AAA rating on the securities in the collateral reinvestment pool may have given the insurance regulators the same comfort they had given to the company itself.¹⁹⁷

State insurance regulators undertook a number of efforts in connection with securities lending in 2008. In February, AIG and the Texas Department of Insurance discussed a plan for winding down the securities-lending program over the next one to two years.¹⁹⁸ In July 2008, New York’s insurance department issued generally applicable guidance on securities lending:

It has come to the Department’s attention that some insurers engaged in securities lending actually have experienced significant losses in the last six to twelve months. Specifically, cash received as collateral was reinvested into securities whose value has significantly declined. As we see increased volumes in securities lending activity, we are concerned that some insurers may not be maintaining adequate collateral and effectively managing the risks associated with the securities lending function.¹⁹⁹

After considering the results of a September 2008 document request, the New York Insurance Department concluded that AIG’s aggressive securities-lending program was not characteristic of the rest of the life-insurance industry.²⁰⁰ Also in 2008, insurance regulators began quarterly meetings with AIG about its securities-lending program.²⁰¹ In one of these meetings, in August 2008, insurance regulators raised concerns about the AIG holding company’s liquidity and asked for a briefing at the next meeting.²⁰²

As is often the case with regulatory intervention, state insurance regulators’ efforts to reverse AIG’s poor decisions with respect to its securities-lending program were overtaken by the market’s attempts to make the company accountable for those decisions. To avert the market’s chastening, the company turned to the federal government for assistance.

IV. The Government Rescue

The problems at AIG came to a head when many other financial firms were facing their own liquidity and solvency problems.²⁰³ Fannie Mae and Freddie Mac were placed in receivership in early September 2008. AIG's crisis moment came in mid-September 2008, just as Lehman Brothers was collapsing.

A. Building Troubles

As noted earlier, AIG's financial strains—with respect both to its CDS portfolio and its securities-lending program—began in the late summer of 2007. During the latter half of 2007, “there was a significant effort made by the corporation to model—to try to anticipate how much liquidity would be needed in stress scenarios in the event that the market continued to deteriorate.”²⁰⁴ This effort was new for the company, which had previously managed liquidity in “fiefdoms,” rather than at the holding-company level.²⁰⁵ Compounding difficulties at AIGFP and in the securities-lending program, in connection with the 2007 audit, AIG's auditors identified a material weakness in internal control over financial reporting relating to the way AIG valued its supersenior CDS.²⁰⁶ In addition, as table 2 shows, AIG was incurring large losses.

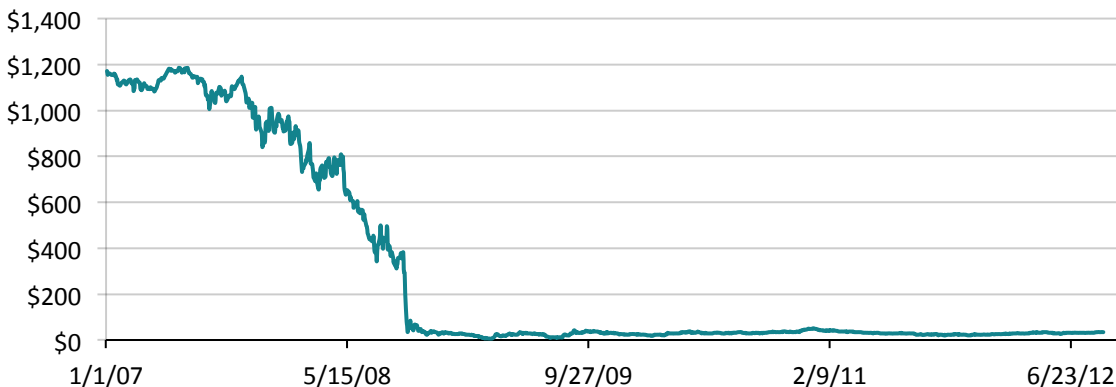
AIG took steps to “shore up [its] balance sheet from a liquidity standpoint, and also try to replace some of the capital that had been eroded by the unrealized valuation losses that were being taken.”²⁰⁷ In May 2008, AIG raised \$20 billion in capital.²⁰⁸ Nevertheless, rating agencies were not satisfied that the new capital was a complete solution.²⁰⁹ AIG's capital and liquidity challenges were not limited to the problems at AIGFP and the securities-lending issues.²¹⁰ As would be expected, AIG's stock price was suffering, as figure 9 illustrates.

Table 2. AIG’s Net Income (Loss)

Reporting period	Net income (loss), billions of dollars
2004	9.84
2005	10.48
2006	14.05
1st quarter 2007	4.13
2nd quarter 2007	4.28
3rd quarter 2007	3.09
4th quarter 2007	(5.29)
1st quarter 2008	(7.81)
2nd quarter 2008	(5.36)
3rd quarter 2008	(24.47)
4th quarter 2008	(61.66)

Sources: AIG, ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006, at 24 (2007); AIG, ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007, at 197 (2008); AIG, ANNUAL REPORT ON FORM 10-K FOR THE ANNUAL YEAR ENDED DECEMBER 31, 2008, at 315 (2009).

Figure 9. AIG’s Stock Price (Adjusted Close), 2007–2012



Source: http://www.aigcorporate.com/investors/stock_chart.html. Compounding the securities-lending losses for at least one of the insurance subsidiaries were losses in the value of AIG stock, which it owned. For American Life Insurance Company (ALICO), AIG stock was approximately thirty-one percent of its reported capital and surplus at year-end 2007 and, due to the dramatic drop in the stock price, only two percent of its reported capital and surplus at year-end 2008. Delaware Department of Insurance, Report on Examination of the American Life Insurance Company as of December 31, 2007, at 38 (June 30, 2009), available at <http://www.delawareinsurance.gov/departments/berg/ExamReports/ALICO2007web.pdf>. ALICO’s ownership of AIG stock was grandfathered out of compliance with the Delaware Insurance Code. *Id.* at 37–38.

In response to the losses, the poor performance of AIG's stock, and concerns from AIG's auditors, AIG made management changes at AIGFP and at the holding-company level. Most significantly, on June 15, 2008, AIG board chairman Robert Willumstad replaced Martin Sullivan as chief executive officer.²¹¹ Willumstad worked on a long-term strategic plan, hired an outside adviser to assess AIGFP's RMBS exposure, sought forbearance from the credit-rating agencies, looked for pieces of the firm to sell, and halted acquisitions.²¹² Willumstad became particularly concerned about the possibility of a run on the securities-lending program:

I had some concern over liquidity in the event of a liquidity crisis, if you will. And that was largely brought about, in my view anyway, more by securities lending than it was the credit default swap book. . . . [T]he credit default swap book, the demands for collateral were going to be based on the valuation of the securities. In the securities lending business, all it would have required is for the counterparties just to demand their cash back. It had nothing to do with securities valuation. So any of the counterparties who could have concluded that, for any number of reasons—their own reason for liquidity issues (the counterparty's liquidity issues) or lack of confidence in AIG—counterparties could have essentially just come in and demanded to have their cash returned to them, and that would have been the equivalent of a run on the bank and that would have been, obviously put AIG, into a serious liquidity problem. So it was unrelated to, specifically to the valuation of the securities, but more to do with either the condition of the counterparties or their perception of AIG.²¹³

In addition to pursuing private-sector solutions to AIG's problems, Willumstad looked for government help. On July 29, 2008, he approached Timothy Geithner, then-president of the Federal Reserve Bank of New York (FRBNY), to ask, "since the Fed had made the Fed window available to—after Bear Stearns to Lehman and Goldman Sachs and Morgan Stanley, institutions that they traditionally had not regulated, would it be possible, if need be, could the Fed make its Fed window available in a time of crisis to AIG[?]"²¹⁴ According to Willumstad, Geithner responded negatively on the grounds that discount-window access could "exacerbate what I was trying to avoid, which would have been the prospective run on the bank which is what the securities-lending program effectively would have been if all of the lenders wanted their cash

back.”²¹⁵ At this point, Geithner likely had some familiarity with AIG since FRBNY staff had been monitoring the company since at least October 2007.²¹⁶

In August 2008, AIG announced a second-quarter loss of \$5.36 billion, which brought the net loss for the first six months of the year to \$13.16 billion.²¹⁷ These losses set AIG back further in its efforts to shore up liquidity. Analysts issued negative reports, and the rating agencies started considering downgrading the company.²¹⁸ Goldman Sachs issued a report “recommend[ing] investors stay on the sidelines with AIG, as the potential for a capital raise and/or ratings downgrades becomes increasingly likely.”²¹⁹ A credit-rating downgrade, among other things, would have triggered additional collateral calls for AIGFP, would have decreased AIG’s ability to issue commercial paper, and would have provided an additional reason for securities-lending counterparties to terminate their transactions.²²⁰

AIG continued to pursue both government and private solutions. On September 9, 2008, Willumstad met with Geithner to ask about becoming a primary dealer in order to gain discount-window access, an option FRBNY staff had already been considering for AIG.²²¹ Willumstad also approached, and was rejected by, Warren Buffett.²²² Buffet later explained that AIG “needed more than we could supply by far. I didn’t know the extent of it, but I knew that.”²²³

During the weekend of September 13, 2008—the so-called “Lehman Weekend,” during which regulators decided how to react to Lehman’s problems—the gravity of AIG’s problems also deepened. On Friday, September 12, 2008, Standard & Poor’s put AIG and its subsidiaries on CreditWatch with negative implications, which indicated that the rating agency would be watching AIG closely and might lower its rating.²²⁴ At a meeting that same day, AIG informed the FRBNY of its precarious liquidity position, described efforts to find a private-sector solution, appealed for government help, and applied to be a primary dealer.²²⁵ This last avenue to liquidity

would take too long, so the next day, AIG suggested assistance under section 13(3) of the Federal Reserve Act, which allows the Federal Reserve to lend to a private company “[i]n unusual and exigent circumstances.”²²⁶

AIG continued to work on other solutions. One of these was a plan crafted with the help of New York and Pennsylvania insurance regulators, under which liquidity would be moved from certain insurance subsidiaries to the holding company. Under that plan, \$20 billion of liquid assets (municipal bonds) would be transferred from several AIG property and casualty insurance companies to the AIG holding company in exchange for illiquid assets, including the stock of two life-insurance holding companies.²²⁷ AIG would use these securities as collateral to borrow from the Federal Reserve, a plan that seems to have frustrated the Federal Reserve, which would have preferred for AIG to use the securities to borrow in the private market.²²⁸ The life-insurance companies would become subsidiaries of the property and casualty companies, which would later sell the life-insurance companies.²²⁹ The Governor of New York tentatively approved this plan on September 15, 2008.²³⁰ Had this plan gone forward, it could have imperiled the property and casualty companies, which would have acquired the massive securities-lending losses of the life-insurance companies. The state insurance plan had been part of a larger plan, which would have included AIG’s raising capital from private sources. When it became clear that private money was not forthcoming, the state insurance plan ceased to be discussed.²³¹

AIG was simultaneously considering private financing options. Among others, private-equity investment firm J.C. Flowers, first on its own and then with the German insurance company Allianz, looked at possible transactions with AIG.²³² AIG secured agreements for \$20 billion in bank loans. AIG also arranged for \$10 billion from private-equity investors.²³³ AIG’s liquidity needs, however, were growing so rapidly over the weekend that the funding sources

AIG had identified would not provide the money without assurance in the form of a government guarantee of liquidity from the Federal Reserve that AIG would not file for bankruptcy.²³⁴

After Lehman Brothers filed its bankruptcy petition on the morning of Monday, September 15, 2008, Geithner convened a meeting of regulators, AIG representatives, and representatives of JPMorgan Chase, Goldman Sachs, and other firms.²³⁵ He told them there would not be government money for AIG.²³⁶

Meanwhile, AIG's situation grew worse. AIG was unable to borrow money and "experienced returns under its securities lending programs which led to cash payments of \$5.2 billion to securities lending counterparts on that day."²³⁷ The dreaded credit-rating downgrades came that afternoon, and AIG anticipated more than an additional \$20 billion in collateral calls as a result.²³⁸

By the morning of Tuesday, September 16, 2008, it was clear that there would not be a private-sector loan.²³⁹ In the estimation of one of the participating investment banks, AIG did not have enough assets to back a loan of the size it needed.²⁴⁰ The private banks that looked at AIG in conjunction with the government concluded that "the value of the company in its entirety was not necessarily sufficient to cover the liquidity need that the company had."²⁴¹ Another potential liquidity source dried up when state insurance regulators cut off an existing intracompany funding facility that had allowed the holding company to borrow from the insurance subsidiaries and demanded repayment of existing loans.²⁴² Presumably, regulators took this step to prevent the insurance companies from lending money to a holding company that was in such bad shape that it would not be able to repay the loan.

B. The Bailout

The Federal Reserve, under the pressure of the developing financial crisis and despairing of a private solution, stepped in at this point. On the evening of September 16, 2008, the FRBNY received approval from the Federal Reserve Board to lend \$85 billion to AIG through a revolving credit facility under section 13(3) of the Federal Reserve Act.²⁴³ The loan was collateralized by AIG's assets, including the stock it held in its insurance subsidiaries and the assets of its primary non-regulated subsidiaries.²⁴⁴ AIG was expected to repay the loan from the proceeds of the sales of its assets.²⁴⁵ The government also received preferred securities convertible into 79.9 percent of the company's voting shares and the right to veto dividend payments to other shareholders.²⁴⁶ Table 3 tracks the development of the terms and conditions of government support to AIG, starting with the initial bailout in September 2008.

Table 3. The AIG Bailout

Date	FRBNY loans	TARP investment	Special-purpose vehicles
Sept. 2008	\$85 billion revolving credit facility (terms: 2-year term; 3-month LIBOR + 8.5% on drawn funds and 8.5% on undrawn; commitment fee: 2% of loan principal) in return for preferred stock convertible to 79.9% of AIG common stock.		
Oct. 2008	Securities Lending Agreement: FRBNY agrees to borrow for one-day terms up to \$37.8 billion in securities from AIG so that AIG can return cash collateral to counterparties.		

Date	FRBNY loans	TARP investment	Special-purpose vehicles
Nov. 2008	Revised terms of credit facility: \$60 billion limit; 5-year term; interest rate of 3-month LIBOR (with floor of 3.5%) + 3% on drawn funds and 0.75% on undrawn. Lowered government ownership to 77.9%.	Treasury bought \$40 billion in cumulative preferred stock (10% coupon); warrants for 2% common stock. Proceeds pay down FRBNY credit facility.	<u>Maiden Lane II</u> Created to purchase and hold RMBS from securities-lending portfolio; funded with \$1 billion subordinated from AIG and \$19.5 billion senior from FRBNY; any returns on RMBS to be shared; purchased \$39.3 billion face value RMBS from insurance subsidiaries <u>Maiden Lane III</u> Created to purchase and hold up to \$70 billion in multisector CDOs from counterparties with which AIGFP had CDS contracts; funded with up to \$5 billion subordinated from AIG and \$24.3 billion senior from FRBNY, and the \$35 billion in cash collateral that AIG had already paid out on these contracts.
March–April 2009	Revised terms of credit facility: 3-month LIBOR (no floor) + 3.5% on drawn funds and 0.75% on undrawn.	Treasury gave up cumulative preferred stock received in November and received \$41.6 billion of noncumulative preferred stock.* AIG received right to additional \$29.8 billion in exchange for additional 300,000 shares cumulative preferred stock and warrants to purchase up to 3,000 shares of common stock.	Creation of two new SPVs, AIA Aurora LLC and ALICO Holdings LLC, as transition to sale or IPO of two life-insurance subsidiaries held by the SPVs. FRBNY to acquire \$26 billion of preferred equity in SPVs as payment for portion of FRBNY’s loan to AIG.
Jan. 2011	Extinguishment of credit facility.	Treasury’s preferred stock converted to common stock, resulting in 92.1% government ownership of AIG. AIG obtained right to additional \$2 billion in exchange for additional cumulative preferred stock and warrants.	FRBNY’s ownership interests in SPVs transferred to Treasury.

* This amount was \$1.6 billion higher than the November amount to reflect \$1.6 billion in missed dividends.

Sources: Board of Governors of the Federal Reserve System, Regulatory Reform: American International Group (AIG), Maiden Lane II and III, http://www.federalreserve.gov/newsevents/reform_aig.htm (last visited Mar. 21, 2014); CONGRESSIONAL OVERSIGHT PANEL: JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS AND THE GOVERNMENT’S EXIT STRATEGY 134–35, 138, 144 & 146 (2010), *available at* <http://cybercemetery.unt.edu/archive/cop/20110402010341/http://cop.senate.gov/documents/cop-061010-report.pdf>; GOVERNMENT ACCOUNTABILITY OFFICE, TROUBLED ASSET RELIEF PROGRAM: GOVERNMENT’S EXPOSURE TO AIG LESSONS AS EQUITY INVESTMENTS ARE SOLD 8–13 (May 2012), *available at* <http://www.gao.gov/assets/600/590677.pdf>; GAO, TROUBLED ASSET RELIEF PROGRAM: THE GOVERNMENT’S EXPOSURE TO AIG FOLLOWING THE COMPANY’S RECAPITALIZATION, 14 (July 2011), *available at* <http://www.gao.gov/new.items/d11716.pdf>; SPECIAL INSPECTOR GENERAL FOR TARP, FACTORS AFFECTING EFFORTS TO LIMIT PAYMENTS TO AIG COUNTERPARTIES 11 (Nov. 17, 2009), *available at* http://www.sig tarp.gov/Audit%20Reports/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf.

As table 3 indicates, the government revisited the bailout's terms multiple times as the nature and depth of AIG's problems became more evident.²⁴⁷ The need for revisions is not surprising given the haste with which the government crafted the initial bailout. The big question leading up to the rescue was whether to bail AIG out, not what the terms of the bailout should be.²⁴⁸ As the special inspector general for the Troubled Asset Relief Program explained, "[T]he decision to acquire a controlling interest in one of the world's most troubled corporations was done with almost no independent consideration of the terms of the transaction or the impact that those terms might have on the future of AIG."²⁴⁹ The FRBNY stated that it simply adopted the terms of the private deal under consideration over the weekend, except that the loan was \$85 billion instead of the \$75 billion contemplated in the JPMorgan/Goldman deal.²⁵⁰

The FRBNY and AIG expected that there would be additional steps in the AIG rescue.²⁵¹ The government's rescue brought a temporary reprieve from immediate liquidity concerns, but AIG's core liquidity challenges remained. The securities-lending program was one of the main trouble spots.²⁵² Borrowers asked for \$24 billion of their cash collateral from September 12 through 30, 2008.²⁵³ Nine of the twelve borrowing counterparties left the program completely.²⁵⁴ By the end of September, AIG had borrowed \$11.5 billion from the FRBNY credit facility to provide liquidity in the securities-lending program.²⁵⁵

On October 6, 2008, the Federal Reserve authorized a new program under section 13(3) of the Federal Reserve Act in order to accomplish the following:

address[] the liquidity strains placed on AIG due to the ongoing withdrawal of counterparties from securities borrowing transactions and permit[] AIG to use the remaining amounts of the September Facility for other uses. The Secured Borrowing Facility will reduce the pressure on AIG to liquidate immediately the portfolio of residential mortgage-backed securities (RMBS) that were purchased with the proceeds of the securities lending transactions.²⁵⁶

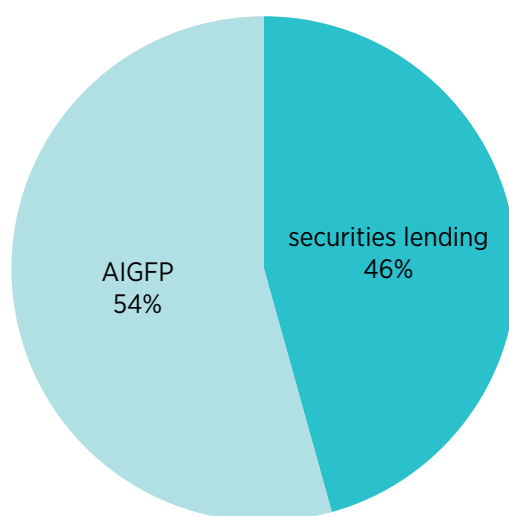
Under this authority, the FRBNY essentially stepped into the shoes of the borrowers as they left the securities-lending program.²⁵⁷ The FRBNY agreed to borrow up to \$37.8 billion in investment-grade fixed-income securities in exchange for cash collateral.²⁵⁸ The facility's size allowed for the possibility that all of AIG's securities-lending counterparties might demand their collateral back. Having the FRBNY stand in for AIG's securities-lending counterparties, however, did not address the falling values of the reinvested securities-lending collateral.²⁵⁹

In early November, AIG announced a loss of \$24.47 billion for the third quarter of 2008.²⁶⁰ AIGFP accounted for more than \$8 billion of the losses, and the securities-lending losses were \$11.7 billion.²⁶¹ At the same time, the government eased the terms of the AIG assistance package and tapped a new source of assistance: the Treasury's newly approved Troubled Asset Relief Program (TARP).²⁶² The Treasury made a \$40 billion capital injection in exchange for preferred stock, and the cap on the FRBNY lending facility was dropped from \$85 billion to \$60 billion.²⁶³

Under the restructuring, two new entities—Maiden Lane II and Maiden Lane III—would address AIG's securities-lending and AIGFP trouble spots, respectively. Maiden Lane II, a limited liability company with the FRBNY as its sole member, purchased RMBS with a par value of \$39.3 billion from the U.S. life-insurance companies.²⁶⁴ Maiden Lane II was funded with a subordinated contribution of \$1 billion from AIG and \$19.5 billion provided by the FRBNY in the form of a six-year loan. AIG used money received from Maiden Lane II to repay the \$19.9 billion in outstanding obligations to securities-lending counterparties, including the FRBNY, and thus end the securities-lending program.²⁶⁵ In exchange for the payments, the counterparties returned the securities they had borrowed from AIG.²⁶⁶ Through the Maiden Lane II structure, the government effectively capped AIG's responsibility for further losses on the RMBS at \$1 billion. Any profits from Maiden Lane II would be shared with the FRBNY, with AIG entitled to one-sixth.²⁶⁷

The Maiden Lane III program stopped AIGFP's collateral calls by purchasing many of the collateralized debt obligations and terminating the associated CDS.²⁶⁸ The FRBNY put \$24.5 billion into Maiden Lane III, and AIG contributed \$5 billion. After loan payback, the FRBNY and AIG would share any proceeds from these securities roughly in proportion to the financing each provided. Maiden Lane III purchased at par value the CDOs on which AIG had written CDS. The government's decision to purchase through Maiden Lane III the CDOs at par value rather than at a discount attracted a lot of negative attention from politicians, the press, and the public, who viewed these purchases as windfalls to AIG's CDS counterparties.²⁶⁹ The intense criticism associated with this decision likely helped focus the public's attention on AIGFP and away from AIG's securities-lending activities. As figure 10 and table 4 demonstrate, however, securities-lending payouts also were substantial. The pie chart compares the funds that went to counterparties of AIG with those that went to securities-lending counterparties. The table identifies the corporate counterparties that received funds.

Figure 10. Payments to AIG Counterparties



Source: AIG, AIG Discloses Counterparties to CDS, GIA and Securities Lending Transactions (Mar. 15, 2009), available at http://www.aig.com/aigweb/internet/en/files/CounterpartyAttachments031809_tcm385-155645.pdf.

Table 4. Counterparties That Received Government-Funded Payments from AIG, September 16–December 31, 2008 (billions of dollars)

Counterparty	Securities lending	AIGFP collateral postings	Maiden Lane III payments to AIGFP CDS counterparties	TOTAL
AIG International, Inc.	0.6			0.6
Banco Santander		0.3		0.3
Bank of America	4.5	0.2	0.5	5.2
Bank of Montreal		0.2	0.9	1.1
Barclays	7.0	0.9	0.6	8.5
BNP Paribas	4.9			4.9
Calyon		1.1	1.2	2.3
Citadel	0.2			0.2
Citigroup	2.3			2.3
Credit Suisse	0.4			0.4
Danske		0.2		0.2
Deutsche Bank	6.4	2.6	2.8	11.8
Deutsche Zentral-Genossenschaftsbank			1.0	1.0
Dresdner Bank AG			0.4	0.4
Dresdner Kleinwort	2.2			2.2
DZ Bank		0.7		0.7
Goldman Sachs	4.8	2.5	5.6	12.9
HSBC Bank	3.3	0.2		3.5
ING	1.5			1.5
JPMorgan		0.4		0.4
KFW		0.5		0.5
Landesbank Baden-Wuerttemberg			0.1	0.1
Merrill Lynch	1.9	1.8	3.1	6.8
Morgan Stanley	1.0	0.2		1.2
Other		4.1		4.1
Paloma Securities	0.2			0.2
Rabobank		0.5	0.3	0.8
Reconstruction Finance Corp.		0.2		0.2
Royal Bank of Scotland		0.2	0.5	0.7
Société Générale	0.9	4.1	6.9	11.9
UBS	1.7	0.8	2.5	5.0
Wachovia		0.7	0.8	1.5
TOTAL	43.8	22.4	27.2	93.4

Source: AIG, AIG Discloses Counterparties to CDS, GIA and Securities Lending Transactions (Mar. 15, 2009), available at http://www.aig.com/aigweb/internet/en/files/CounterpartyAttachments031809_tcm385-155645.pdf.

Note: The table excludes the \$12.1 billion that AIGFP paid to municipalities to satisfy guaranteed investment agreements (GIAs). Only the top twenty counterparties were listed by name. The summed numbers differ slightly because of rounding. States, which received \$9.5 billion in connection with GIAs, are not listed, but those payments are included in figure 10.

Even after the restructuring, AIG continued to have problems, which were reflected in a fourth-quarter loss of \$61.7 billion, the biggest quarterly loss in corporate history.²⁷⁰ The

quarter's losses brought AIG's cumulative net losses for 2008 to over \$99 billion.²⁷¹ AIGFP and the insurance companies contributed \$16.2 billion and \$18.6 billion respectively to the fourth-quarter losses.²⁷² Given AIG's ongoing difficulties, in March and April 2009 the government again modified the assistance package to be more favorable for AIG.²⁷³

V. The Gravity of the Securities-Lending Problems

Among the beneficiaries of the government's rescue efforts were a number of AIG's life-insurance subsidiaries, which were under substantial liquidity and capital stress largely as a result of the losses in the securities-lending programs. The timely inflow of government money makes it more difficult to contest the claims of those who argue that AIG's insurance companies were uniformly sound. Those claims ought to be looked at more closely, not to condemn insurance regulators, but to serve as a reminder that even regulated entities can run into trouble.

A. AIG's Regulated Insurance Companies as a Source of Strength

State regulators have claimed that AIG's insurance companies were financially healthy at the time of the rescue and, in fact, were the assets against which the Federal Reserve could lend money to AIG. For example, the then-President of the National Association of Insurance Commissioners (NAIC) wrote in late September 2008 that "AIG's 71 state-regulated insurance companies are financially sound. They have the capital to honor the promises they've made to policyholders, and, as the 'crown jewels' of the holding company, their assets are the basis for the Federal Reserve's extension of credit."²⁷⁴ State regulators have argued, as Pennsylvania's insurance commissioner Joseph Ario did, that "the reason the federal government decided to rescue AIG was not because of the insurance companies, which were stable and well

capitalized,” but “because of the systemic risk created by Financial Products.”²⁷⁵ Dinallo

expressed it this way:

It is important to understand that securities lending did not cause the crisis at AIG. AIG Financial Products did. If there had been no Financial Products unit and only the securities lending program as it was, we would not be here today. There would have been no federal rescue of AIG. Financial Products’ trillions of dollars of transactions created systemic risk. Securities lending did not.²⁷⁶

State insurance regulators are not alone in making these claims. The Federal Reserve, in explaining why it used its authority under Federal Reserve Act section 13(3) to rescue AIG after *not* using it to rescue Lehman, also has pointed to the soundness of AIG’s insurance subsidiaries. One criterion governing the use of section 13(3) authority is that the loan be secured to the Federal Reserve’s satisfaction. Lehman, the Federal Reserve argues, did not have enough collateral to back a loan.²⁷⁷ Bernanke explains why AIG was different:

These facts distinguish Lehman in a number of critical ways from the [sic] AIG. In contrast to Lehman, the core operations of AIG were viable and profitable insurance companies. AIG’s financial difficulties stemmed primarily from the loss of liquidity to fund collateral calls on its unhedged derivatives positions in one part of the company—its Financial Products Division. AIG’s problems appeared at the time to be more classical liquidity needs that were quantifiable in amounts and could be covered with borrowings secured by valuable available collateral: the shares of stock of profitable insurance companies and other businesses.²⁷⁸

Again, in another context, Bernanke emphasized the importance of the insurance companies in justifying the Federal Reserve’s decision to lend to AIG:

Now, fortunately, from the perspective of lender of last resort theory, AIG was taking a lot of losses in its financial products division. But underlying that, those losses was the world’s largest insurance company. So, it had lots and lots of perfectly good assets. And as a result, it had collateral which it could offer to the Fed to allow us to make a loan to provide the liquidity needed to stay afloat.²⁷⁹

Likewise, AIG, in an effort to preserve its reputation and thus the desirability of its insurance products, has a clear incentive to keep the focus on AIGFP and distance the insurance subsidiaries from any problems. The explanation of the crisis on AIG’s website mentions

securities lending without reference to the insurance subsidiaries and emphasizes that AIGFP's losses did not touch the insurance subsidiaries.²⁸⁰

B. AIG's Regulated Insurance Companies as a Source of Weakness

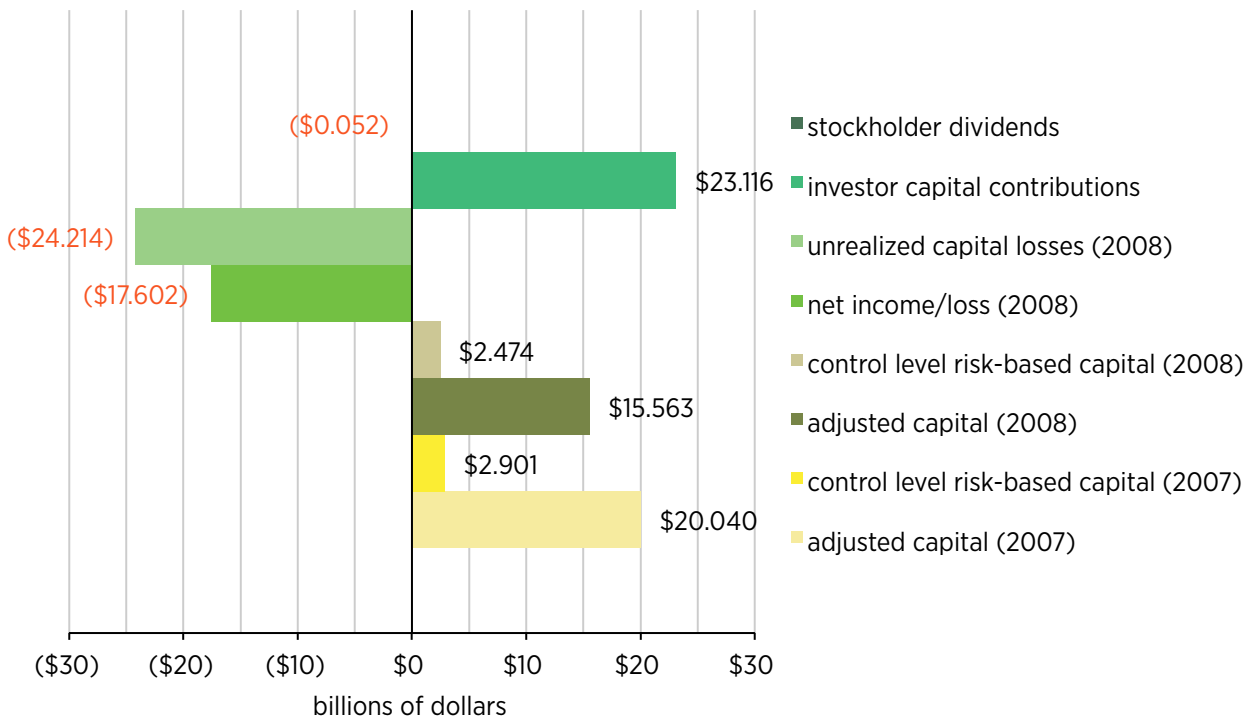
A chief aim of insurance regulation is ensuring that policyholders' claims get paid in a timely manner. Accordingly, "insurers are required to maintain reserves and capital and surplus at all times and in such forms so as to provide an adequate margin of safety."²⁸¹ State insurance regulators monitor the adequacy of insurance companies' solvency.²⁸² To help insurance regulators fulfill this objective, the NAIC has developed a risk-based capital system "to provide a capital adequacy standard that is related to risk, raises a safety net for insurers, is uniform among the states, and provides regulatory authority for timely action."²⁸³ Most state insurance regulators have adopted the NAIC's risk-based capital model to assist them in identifying inadequately capitalized insurance companies.²⁸⁴

The risk-based capital approach "is designed to measure the adequacy of an insurer's statutory surplus in relation to the risks inherent in its business."²⁸⁵ An insurance company's total adjusted capital (TAC) is measured annually against the Authorized Control Level Risk-Based Capital (ACL), which is determined according to a formula that accounts for the company's unique characteristics.²⁸⁶ The goal is to maintain TAC of 200% or more of the ACL.²⁸⁷ If TAC falls below 70%, which can occur before technical insolvency, a regulator must take control of the company.²⁸⁸ In between the no-action and seizure levels, there are three intermediary levels. If TAC is 150–200% of the ACL, the company must submit a corrective plan.²⁸⁹ If the range is between 100% and 150%, the regulator must, as necessary, perform examinations and analyses and issue corrective orders.²⁹⁰ Between 70% and 100%, the

insurance regulator is authorized to take control of the insurer.²⁹¹ Insurance regulators have broad discretion to act when there are problems.²⁹² Insurance companies cannot file for bankruptcy, but state regulators can seize them and wind them down. Ex-post assessments on other insurance companies absorb the costs of the insolvency.

Figure 11 shows that, in both 2007 and 2008, AIG’s life-insurance companies’ levels of adjusted capital exceeded 600% of the control level risk-based capital level. However, had it not been for the capital contributions that came primarily from the federal government to support the securities-lending program, adjusted capital levels would have fallen well below the critical 200% level.

Figure 11. AIG’s Largest Domestic Life-Insurance/Retirement-Services Companies’ Regulatory Capital and Related Events



Source: GAO, Troubled Asset Relief Program: Status of Government Assistance Provided to AIG, at 77 (Sept. 2009), available at <http://www.gao.gov/assets/300/295521.pdf>.

Under the risk-based capital approach, claims about insurance companies' solvency are assessed at the individual insurance company level. With regard to AIG, solvency claims are often aggregated across all AIG's insurance companies.²⁹³ Professor Harrington points out that one difficulty of looking at the company in the aggregate is that doing so leaves open "the question of how fungible the capital held by different AIG subsidiaries would be, so that heavily capitalized subsidiaries, their resources could somehow make up for any shortfall in a few of the entities that may have been underfunded."²⁹⁴ The property and casualty insurance-company regulators looked at the possibility of transferring assets to the holding company, but ultimately discontinued even the existing lending facility.²⁹⁵ Accordingly, table 5 considers statutory capital on a company-by-company basis. Even assuming the insurance companies were well above the desired TAC ratio of 200% of the ACL at the beginning of 2008, losses were large enough that most of these companies were at risk of dropping below the ACL—the point at which the insurance regulator can take control—during 2008 had they not received capital contributions.

Figure 12, based on actuary David Merkel's painstaking work, compares losses in securities lending to the year-end surplus of AIG's largest insurance subsidiaries. The losses exceeded the 2007 surplus for some of these companies.

At the end of 2008, AIG's life-insurance companies had adequate TAC under this framework.²⁹⁶ No corrective action by the company or intervention by the state regulators was necessary, but likely only because of the FRBNY's intrayear contributions.²⁹⁷ State regulators' solvency conclusions seem to depend on the continuing capital infusions from the AIG holding company, a questionable assumption given the strains in the market and on AIG at the time.²⁹⁸

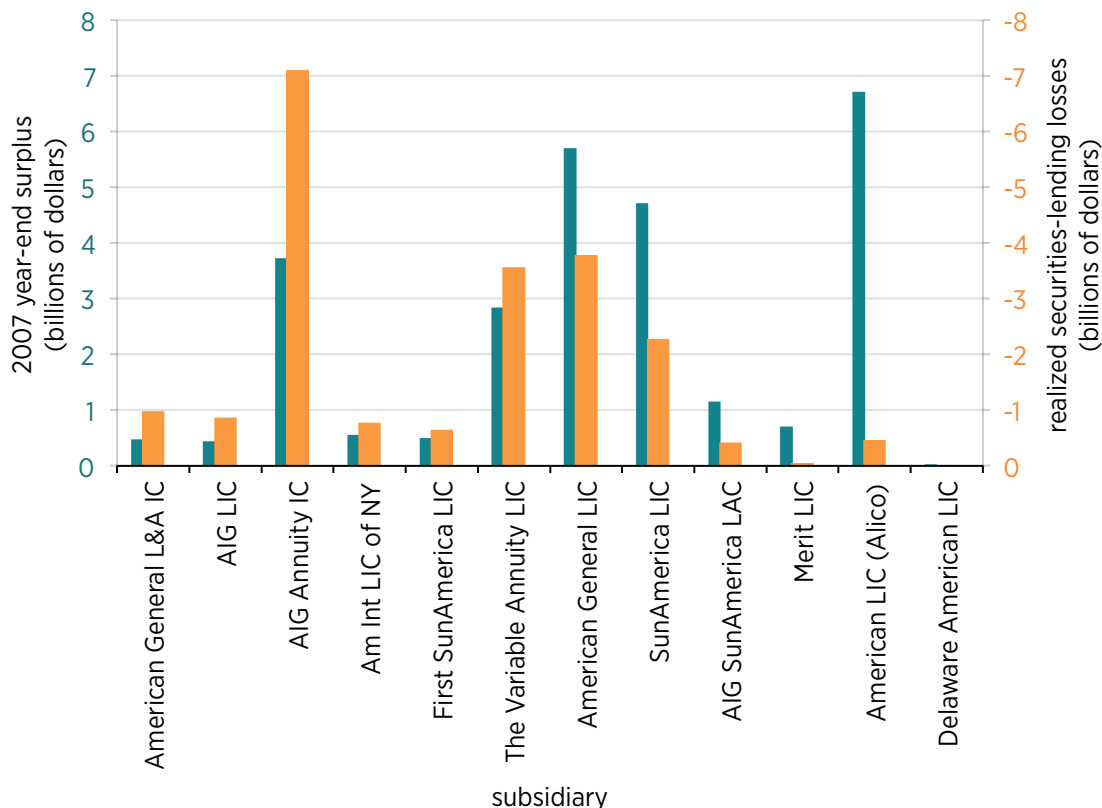
Table 5. AIG Insurance Subsidiaries' Securities-Lending Losses and Statutory Capital (millions of dollars)

Insurance subsidiary	Primary state regulator	Statutory total adjusted capital, 12/31/2007	Securities-lending losses, 2008	Capital contributions, 2008 (pre-bailout)	Capital contributions, 2008 (post-bailout)	Statutory total adjusted capital, 12/31/2008
AIG SunAmerica Life Assurance Co.	Arizona	\$1,222	(\$425)	\$6	\$280	\$1,317
SunAmerica Life Insurance Co.	Arizona	\$5,976	(\$2,281)	\$925	\$1,725	\$4,805
AIG Life Insurance Co.	Delaware	\$538	(\$870)	\$235	\$679	\$465
American Life Insurance Co. (ALICO)	Delaware	\$5,307	(\$470)	\$15	\$967	\$4,332
American International Life Insurance Co. of NY	New York	\$662	(\$771)	\$151	\$801	\$458
First SunAmerica Life Insurance Co.	New York	\$509	(\$654)	\$568	\$644	\$550
The United States Life Insurance Co. in the City of NY	New York	\$511	(\$395)	\$3	\$456	\$305
American General Life and Accident Insurance Co.	Tennessee	\$620	(\$977)	\$28	\$765	\$594
AIG Annuity Insurance Co.	Texas	\$4,878	(\$7,109)	\$1,596	\$6,047	\$3,242
American General Life Insurance Co.	Texas	\$3,223	(\$3,790)	\$905	\$3,084	\$2,844
The Variable Annuity Life Insurance Co. (VALIC)	Texas	\$3,632	(\$3,563)	\$955	\$3,620	\$2,940
Companies that exited before 9/30/2008*	Various	\$13,037	(\$101)	\$2	\$915	\$11,217
AIG	N/A	N/A	(\$100)	\$1	\$9	N/A
TOTAL		\$40,114	\$(21,505)	\$5,390	\$19,994	\$33,130

* These companies include American Home Assurance Co., Lexington Insurance Co., New Hampshire Insurance Co., American General Insurance Co., Delaware American Life Insurance Co., and Merit Life Insurance Co.

Source: *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 111th Cong., 1st Sess. 43 (2009).*

Figure 12. Realized Securities-Lending Losses vs. Year-End Surplus of AIG’s Largest Insurance Subsidiaries, 2007



Source: DAVID MERKEL, TO WHAT DEGREE WERE AIG’S OPERATING INSURANCE SUBSIDIARIES SOUND? 4 (2009), available at <http://alephblog.com/wp-content/uploads/2009/04/To%20What%20Degree%20Were%20AIG%E2%80%99s%20Operating%20Subsidiaries%20Sound.pdf>.

Others that have taken a detailed look at the effect of the securities-lending program have not been as confident about how the life-insurance subsidiaries would have fared. David Merkel, a life-insurance actuary and former AIG employee, conducted an extensive analysis of reams of AIG’s statutory data and concluded, “If AIG did not have AIGFP, and no bailout from the US Government, the company as a whole would have come under severe stress, and some of the life and mortgage subsidiaries would have gone into insolvency, but the company as a whole would probably have survived.”²⁹⁹ The Treasury and the FRBNY acknowledged to the Congressional Oversight Panel that capital may not have been adequate to cover insurance policyholders’

claims.³⁰⁰ The Congressional Oversight Panel concluded, “The need for capital infusions suggests that securities lending obligations could have resulted in liquidity or solvency concerns for some of AIG’s insurance subsidiaries.”³⁰¹

Table 6 shows the statutory net income and statutory surplus of AIG’s life-insurance and retirement-services subsidiaries in 2006, 2007, and 2008. The magnitude of the 2008 loss is noteworthy.³⁰² A note to the financial statements indicates that due to an accounting change made on October 1, 2008, the 2008 surplus was approximately \$7 billion more than it would have been under the old practice.³⁰³

Table 6. Year-End Statutory Surplus and Statutory Net Income at AIG’s Life-Insurance and Retirement-Services Subsidiaries (millions of dollars)

Year	Statutory surplus	Statutory net income (loss)
2006	\$35,058	\$5,088
2007	\$33,212	\$4,465
2008	\$24,511	(\$23,558)

Sources: AIG, Annual Report on Form 10-K For the Fiscal Year Ended December 31, 2006, at 130 (2007); AIG, Annual Report on Form 10-K For the Fiscal Year Ended December 31, 2007, at 182 (2008) AIG, Annual Report on Form 10-K For the Fiscal Year Ended December 31, 2008, at 297 (2009).

AIG acknowledged that “[t]he recognition of other-than-temporary impairment charges for the securities lending collateral investments placed significant stress on the statutory surplus of the participating insurance companies.”³⁰⁴ The company also recognized the importance of the government money in relieving the stress:

Certain subsidiaries also have been dependent on the NY Fed and the United States Department of the Treasury to meet collateral posting requirements, [to] make debt repayments as amounts came due, and *to meet capital or liquidity requirements at the insurance companies* (primarily in the Life Insurance & Retirement Services segment) and other financial services operations.³⁰⁵

A New York Insurance Department examination report recognized that “participants in the securities-lending program recorded significant capital losses.”³⁰⁶ A broader analysis—reflected in table 7—showed that the New York life-insurance companies were deeply affected: the three life-insurance companies had combined TAC of \$1.7 billion at the end of 2007 and securities-lending losses in 2008 of \$1.8 billion.³⁰⁷

Table 7. Adjusted Capital and Surplus for AIG Life-Insurance Companies Participating in Securities Lending (billions of dollars)

State	Percentage of pool	Total adjusted capital, 12-31-2007 (includes asset valuation reserve)	Securities-lending losses, 2008	Gross cap (C&S losses)	Parent capital infusions pre-FRBNY	Net surplus (gap) before FRBNY	12-31-2008 after FRBNY capital infusions
3 New York companies	8.4%	\$1.682	(\$1.82)	(\$0.138)	\$0.722	\$0.584	\$1.901
All AIG	100%	\$27.078	(\$21.305)	\$5.773	\$5.387	\$11.16	\$19.069

Source: *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 111th Cong., 1st Sess. 67 (2009)* (statement of Eric Dinallo).

As the chart shows, capital infusions from the AIG holding company and the FRBNY were critical. A more-than-\$700 million capital infusion from AIG brought the company to a more-than-\$500 million net surplus, and the FRBNY provided another capital infusion of \$1.9 billion.³⁰⁸

Through February 2009, AIG injected \$22.7 billion into the Domestic Life Insurance and Retirement Services subsidiaries and \$4.0 billion into the foreign life-insurance companies.³⁰⁹ Almost all this money came from the government. When compared to the Life Insurance and Retirement Services’ statutory surplus—\$24.5 billion at the end of 2008, down from \$33.2 billion at the end of 2007—government funds were meaningful contributors to the insurance

companies' ability to meet their statutory capital requirements. Perhaps no less important than the money was the government's imprimatur in the form of its pledge to stand behind AIG.

VI. Relearning Regulatory Lessons from AIG

Putting securities lending back into the historical record of AIG's downfall is important because that record has served and will continue to serve as a basis for decisions about how the financial system should be regulated. If the history is wrong, the lessons we draw from it will also be wrong. Dinallo may be correct in arguing that "as with kindergarten, everything you ever want to know about the financial crisis you can learn from AIG, across the board."³¹⁰ Unfortunately, we have learned the wrong lessons.

The misuse of AIG's crisis as an example in the regulatory debate has already happened. For example, the following recounting of AIG's crisis has become an oft-repeated mantra in discussions about derivatives regulation: "The story of AIG is well known. Its subsidiary, AIG Financial Products, operating out of London, brought down the company and nearly toppled the U.S. economy."³¹¹ The new derivatives regulatory regime, with its clearinghouses and trading platforms, is posited as a solution to what happened at AIG.³¹² Even if AIG's CDS were the only cause of AIG's downfall, Dodd-Frank's new derivatives-clearing and exchange-trading regime would not have been an effective solution. The CDS that AIG was writing on super-senior tranches of multisector CDOs were very different from the standardized derivatives that are appropriate for central clearing, let alone exchange trading, which requires an even higher level of standardization than central clearing.

The incomplete history has also been used as an argument for the need to plug the holes in the financial regulatory framework. This is a lesson that Bernanke highlighted:

I think if there is a single episode in this entire 18 months that has made me more angry, I cannot think of one [other] than AIG. 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, made huge numbers of irresponsible debts, took huge losses. There was no regulatory oversight because there was a gap in the system.³¹³

The securities-lending side of the story shows that the irresponsibility and losses were not limited to AIGFP, but were also occurring in the regulated insurance companies. Moreover, the OTS had authority over AIGFP and had indeed used that authority to look into AIGFP's activities, albeit not as rigorously as hindsight would demand.

AIG's problems also have been used as a basis for the new systemic risk regulatory framework under Dodd-Frank. The now-defunct OTS called for a systemic risk regulator based on lessons that it had learned from AIG.³¹⁴ The Federal Reserve, AIG's new systemic overseer, may believe that it will do a better job, but the problems that prevented the OTS from doing a better job overseeing AIG—shifting personnel and organizational changes within the OTS—could as easily plague the Federal Reserve. Similarly, the insurance regulators' failure with respect to AIG—not timely recognizing the aggressive nature of AIG's securities-lending program—could as easily occur at the Federal Reserve, which also overlooked increasing risks during the last crisis.

AIG's failings have been used to argue against a federal optional charter for insurance companies. If, as some contend, insurance regulators outperformed other regulators during the crisis, the state-based system should be retained.³¹⁵ Adding the securities-lending piece to the story might instead lead to calls for an optional federal charter, and perhaps a federal charter would offer benefits, such as better coordination and lower costs for consumers. But a federal insurance charter undoubtedly would be accompanied by calls for explicit federal insurance guarantees.³¹⁶

Ultimately, however, AIG's lessons are not about derivatives, securities lending, or adjusting regulatory structures so that they finally produce an omniscient, prescient, infallible set of regulators. AIG's lessons are much more basic. Adding the securities-lending angle paints a much different picture of AIG's difficulties during the financial crisis. AIG was not a well-functioning company with one unregulated rogue subsidiary. AIG's problems ran deeper. The company had many good parts, including many of the insurance subsidiaries, but the liquidity and risk-management issues that ran through it suggested that AIG was due for some market discipline.

Just as the market was preparing to mete it out, the government stepped in and rescued AIG. The government's assistance allowed AIG to hide from its own bad decisions. AIG was allowed to survive as a smaller, albeit still very large, corporation. Compounding the moral hazard created by AIG's bailout is the systemic regulation that has emerged in response to it.

The systemic regulatory regime that Dodd-Frank embraces further dissuades companies from making sound business decisions. Instead, it relies on regulators to pull strings all across the financial system. Regulators will not be guided by what is best for a particular firm, but by what is purportedly best for the system. Regulated companies will be forced to follow suit and consider the effects that their actions will have on the financial system, instead of the effects that their actions will have on their own viability and profitability. The vague guideposts offered by systemic regulation and the regulators seeking to implement it will only further dissuade companies from learning the lesson they ought to have learned from AIG's crisis: if a company is bad at managing its own risk, the markets will make that company pay and perhaps disappear in whole or in part.

Not rescuing AIG would have been very difficult for regulators in the midst of the financial crisis, yet there were many factors militating against rescue. The FRBNY conducted a

quantitative analysis of AIG's systemic risk before Lehman's failure and determined that AIG was *not* systemically important.³¹⁷ Lehman's failure may have changed the quantitative analysis and certainly affected the qualitative analysis, but because AIG required multiple bailouts, systemic importance was not a one-time consideration. The government was legally obligated to ask itself each time whether AIG needed the additional aid. Bankruptcy was not off the table after the original rescue.³¹⁸ Once the FRBNY made the initial loan, one of the factors that drove it to continue aiding AIG was how not doing so would reflect on its credibility.³¹⁹ Sjoström surmised that the bailout may have been a result of both an exaggeration by AIG of its own systemic importance and the government's inability to assess the propriety of a bailout given its distraction with other firms' issues, its lack of time to analyze AIG, and its lack of information about AIG.³²⁰

An AIG bankruptcy undoubtedly would have been very painful, but every large bankruptcy is. AIG's many good assets would have found buyers. Displaced customers would have found new insurance providers. Many securities-lending and derivatives counterparties would have been protected, because they were at least partially collateralized. There would have been many challenges in connection with individual insurance subsidiaries as insurance regulators decided how to react. The insurance regulators might have seized the insurance subsidiaries for which they were responsible.³²¹ Some state guaranty funds likely would have had to absorb large losses.³²² If AIG had filed for bankruptcy, it is also possible that the capital contributions it made to the insurance companies to make up for securities-lending losses would have been treated as preferential transfers.³²³ Bankruptcy would not have been easy or cheap, but the bailout and its legacy also have been costly and difficult. Efforts to ensure the bankruptcy regime's viability for large financial companies could help to reverse that legacy.

VII. Conclusion

The Financial Stability Oversight Council has designated AIG as “systemic” under Dodd-Frank and handed it over to the Federal Reserve for special regulation.³²⁴ AIG has repaid its loan, and the Department of Treasury deems it to have been a profitable investment for taxpayers.³²⁵ What is left out of the calculus is the more pernicious cost: the cost of AIG’s bailout on the ability of markets to discipline errant firms. This cost comes not only directly from the bailout itself, but indirectly from the regulatory structure that has grown out of AIG.

Leaving one major part of AIG’s crisis out of the history books has influenced the regulatory dialogue. We have forgotten that AIG’s problems were not isolated to an unregulated corner of the company engaged in derivatives, but were rampant in AIG’s heavily regulated life-insurance subsidiaries. Adding securities lending back into the story should cause us to rethink solutions that rely on regulators instead of markets to discipline companies that make poor choices.

The lesson we can learn from AIG is not fundamentally about securities lending or derivatives. It is about getting companies to think about their risks, wherever they may lie. The fact that the securities-lending issues arose in regulated life-insurance companies should remind us that merely making sure that every entity has a regulator will not fix the financial markets. The markets themselves are the regulators, if the government allows them to be. A company like AIG, with pervasive problems—as the addition of the securities-lending piece shows—was a perfect candidate for such discipline. The new systemic approach makes the purported good of the whole financial system the regulatory objective. It thus impairs the ability of companies (which need to please their regulators) to think strategically about their own risks, something AIG failed to do. AIG’s crisis was much more complicated than many contend, but the regulatory response should be less complicated than the one created by Dodd-Frank.

Notes

¹ Professor Scott Harrington, for example, explained in an insightful article that assessed the role of insurance companies in the crisis and the implications for reform, that “[a]lthough AIG’s problems with its CDS portfolio often are regarded as the sine qua non of its liquidity crisis and federal intervention, it was also threatened by billions of dollars of collateral calls under its securities lending program associated with its domestic life insurance subsidiaries.” Scott E. Harrington, *The Financial Crisis, Systemic Risk, and Insurance Regulation*, 76 J. RISK & INSUR. 785, 792 (2009). See also RODDY BOYD, FATAL RISK: A CAUTIONARY TALE OF AIG’S CORPORATE SUICIDE (2011) [hereinafter BOYD] (an entertaining history of AIG’s downfall, which includes a discussion of securities lending); William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943 (2009) [hereinafter Sjostrom], available at <http://law.wlu.edu/deptimages/Law%20Review/66-3Sjostrom.pdf> (discussing the securities-lending aspect of the downfall, but focusing largely on the derivatives aspects of AIG); IRVIN CHAN, THE ROLE OF REPURCHASE AGREEMENTS AND SECURITIES LENDING IN DISTRESSED FINANCIAL INSTITUTIONS (Honors Thesis for New York University’s Leonard N. Stern School of Business, 2010) [hereinafter CHAN], available at http://w4.stern.nyu.edu/uc/honorsprogram/2010/Thesis_2010_Irvin%20Chan.pdf (looking at the role of liquidity pressures associated with AIG’s securities lending program in AIG’s downfall); DAVID J. MERKEL, TO WHAT DEGREE WERE AIG’S OPERATING INSURANCE SUBSIDIARIES SOUND? (2009), available at <http://alephblog.com/wp-content/uploads/2009/04/To%20What%20Degree%20Were%20AIG%E2%80%99s%20Operating%20Subsidiaries%20Sound.pdf> (a detailed, expert analysis by a former AIG actuary, which, by focusing on the health of the insurance subsidiaries, “is meant to be complementary to” the “many attempts to explain the problems at AIG, with most of the attention paid to AIG Financial Products”). Serena Ng & Liam Plevin, *An AIG Unit’s Quest to Juice Profit*, WALL ST. J., Feb. 5, 2009, available at <http://online.wsj.com/article/SB123380106666350625.html> (“Accounts of AIG’s near collapse have largely focused on soured trades entered into by the company’s Financial Products division. But a close look at the 2,000-employee AIG Investments unit shows how this part of the conglomerate made gambles that helped cripple the firm.”); BOB EISENBEIS, AIG: AN INTERESTING HEARING—PART ONE OF THREE (Mar. 18, 2009), available at http://www.cumber.com/commentary.aspx?file=031809.asp&n=1_mc (emphasizing that AIG’s problems included credit default swaps, securities lending, and exposure to real estate in the company’s investment portfolio). See also Mary Williams Walsh, *Fresh Details on the Fed Rescue of A.I.G.’s Insurance Units*, N.Y. TIMES, Dec. 1, 2010, available at http://www.nytimes.com/2010/12/02/business/02aig.html?_r=1 (describing why, in addition to AIGFP, AIG’s insurance subsidiaries needed assistance from the Federal Reserve); René Stulz, *Credit Default Swaps and the Credit Crisis*, 24 J. ECON. PERSPECTIVES 73, 83 (2010) (while not mentioning securities lending specifically, explaining that “even in the case of AIG, credit default swaps were not the only or even the primary reason for its problems—nor were its credit default swaps the only or the primary reason for its problems—nor were its credit default swaps the only or even the primary reason why the firm was bailed out. AIG didn’t just write protection on subprime securitizations, it also borrowed heavily to purchase these securities on its own. In fact, AIG made even larger losses on its portfolio of mortgage securities on its own.”).

² The standard explanation of AIG’s downfall has been repeated by the full range of observers, from regulators and market participants to politicians and the mainstream media. See, e.g., Carl Levin, Senator, Floor Statement in Opposition to S.A. 814 (Nov. 1, 2011), available at <http://www.levin.senate.gov/newsroom/speeches/speech/senate-floor-statement-in-opposition-to-sa-814/?section=alltypes> (“So let me remind us all about AIG. A small unit, based in London and buried within the bowels of AIG, nearly brought about the collapse of the firm, and with it, the world economy. They sold a type of derivative called a credit default swap. Lots of them. While they got paid for taking on the risk behind those swaps, they had insufficient reserves to pay off the bets if they lost. Later, when all of those swaps went bad, they simply did not have the funds to pay off their bets. And only AIG knew how much it owed to whom, because the swaps market had no transparency. Federal regulators were prohibited by law from overseeing swaps. Worse yet, federal regulators could not just let AIG fail, because the losses to those on the other side of their bets could have brought them down as well. A global nightmare caused by one small unit of one company, allowed to run wild by selling a ton of swaps without the reserves to pay off the bets if they lost. So taxpayers bailed out AIG, and through them, the banks and companies that did business with AIG. If those banks had been allowed to collapse, the financial markets would have frozen. Companies would have been unable to get funds they needed to operate and grow. Families would have been unable to get loans to fund their educations, to buy cars and homes, and live.”); Gary Gensler, Chairman, Commodity Futures Trading Commission, Keynote Address on the Cross-Border Application of Dodd-Frank Swaps Market Reforms before the 2012 FINRA Annual Conference (May 21, 2012)

[hereinafter Gensler Speech], available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-113> (“The story of AIG is well known. Its subsidiary, AIG Financial Products, operating out of London, brought down the company and nearly toppled the U.S. economy.”); Gary Gensler, Chairman, Commodity Futures Trading Commission, *Testimony Before the House Comm. on Agriculture* (Mar. 14, 2013), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-136> (“AIG Financial Products, for instance, was a Connecticut subsidiary of the New York insurance giant that used a French bank license to run its swaps operations out of a Mayfair branch in London. Its near-collapse ultimately required a government bailout of more than \$180 billion and nearly brought down the U.S. economy.”); Lynn A. Stout, *Derivatives and the Legal Origins of the 2008 Credit Crisis*, 1 HAR. B.L. REV. 1, at 32, available at http://www.hblr.org/download/HBLR_1_1/Stout-Derivatives_and_the_Credit_Crisis.pdf (“Insurance regulation is typically a matter of state law, and, while state law may be imperfect, it does not appear to have played any role in the crisis; AIG’s derivatives trading losses were not suffered in its state-regulated insurance operations but in a special offshore subsidiary called the Financial Products Division.”) (citing the Financial Crisis Inquiry Commission report); Robert O’Harrow, Jr., and Brady Dennis, *A Beautiful Machine Part III: Downgrades and Downfall*, WASH. POST, Dec. 31, 2008, at A1 (explaining how “a single unit of AIG [could] cause the giant company’s near-ruin and become a fulcrum of the global financial crisis”); Gregory Gethard, *Failing Giant: A Case Study of AIG*, INVESTOPEDIA.COM (Mar. 25, 2009), available at <http://www.investopedia.com/articles/economics/09/american-investment-group-aig-bailout.asp> (“The epicenter of the near-collapse of AIG was an office in London. A division of the company, entitled AIG Financial Products (AIGFP), nearly led to the downfall of a pillar of American capitalism.”).

³ Letter from Ben Bernanke, Chairman, Bd. of Governors of the Fed’l Reserve Sys., to Philip Angelides, Chairman, and William Thomas, Vice Chairman, FCIC 13 (Nov. 4, 2010) [hereinafter Bernanke Letter], available at http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/TBTF/Chairman%20Bernanke%20Follow%20Up.pdf. See also SPECIAL INSPECTOR GENERAL FOR TARP, FACTORS AFFECTING EFFORTS TO LIMIT PAYMENTS TO AIG COUNTERPARTIES n. 14 (Nov. 17, 2009) [hereinafter SIGTARP AIG REPORT], available at http://www.sigtarp.gov/Audit%20Reports/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf (relegating the securities lending component of the liquidity crisis at AIG to a footnote); CONGRESSIONAL OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT’S EXIT STRATEGY 24 (2010) [hereinafter COP AIG REPORT], available at <http://cybercemetery.unt.edu/archive/cop/20110402010341/http://cop.senate.gov/documents/cop-061010-report.pdf> (although the report, of necessity, discussed the securities lending issues at the insurance subsidiaries, the executive summary focuses almost entirely on AIGFP and mentions the securities lending issues only once).

⁴ In fact, some accounts of AIG’s demise go to great lengths to defend the soundness of AIG’s insurance subsidiaries. See, e.g., Shah Gilani, *The Inside Story of the Collapse of AIG*, MORNING MONEY (Sept. 23, 2008), available at <http://moneymorning.com/2008/09/23/credit-default-swaps-3/> (“There’s nothing fundamentally wrong with the core insurance business units of American International Group Inc. (AIG). Nothing at all. What imploded the venerable insurance giant was an accumulation of misplaced bets on credit default swaps.”).

⁵ Senator Shelby, a notable exception, focused on securities lending in a March 2009 hearing on AIG. *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 111th Cong., 1st Sess. 4 (2009) [hereinafter *Senate AIG Hearing*], available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg51303/pdf/CHRG-111shrg51303.pdf> (statement of Richard C. Shelby, Senator) (“AIG’s problems, however, were not isolated to its credit default swap business. Significant losses in AIG’s State-regulated life insurance companies also contributed to the company’s collapse.”). Brooksley Born, serving on the Financial Crisis Inquiry Commission, asked about securities lending in the following exchange with AIG’s chief risk officer, which did not yield a definitive answer:

COMMISSIONER BORN: If we are looking to what the primary cause of AIG’s failure and the need for the government bailout is, which cause was it? Or was it just equally both, the credit default swap portfolio, or the securities lending diminution of the RMBS?

WITNESS LEWIS: . . . [L]ooking back on it now, from my point of view the disparity, or the gapping out, if you will, of what we risk professionals and insurance professionals thought was the underlying value of the credit quality, or the intrinsic value of the portfolios, whether it was in securities lending or in FP, that value diverged just tremendously in this marketplace where liquidity dried up. And if you will the failure in my view is that, clearly knowing what we know now, we did not stress the disparity between our

underlying views of credit quality, which was shared by others, including rating agencies, et cetera, that we did not stress enough how much the market value and liquidity could diverge from people's view of intrinsic value. And as we went through this decline, there were many changes by all of the experts and economists around the globe as to how bad this could get, and how much deterioration in housing there could be. And we adjusted as we went along. But the intrinsic value was not the issue. The issue was the divergence of intrinsic value or credit quality and liquidity available in the market for those instruments.

The Role of Derivatives in the Financial Crisis: Hearing Before the Financial Crisis Inquiry Commission 256–57 (June 30, 2010) [hereinafter *FCIC Hearing Day 1*], available at http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0630-Transcript.pdf.

⁶ See, e.g., COP AIG REPORT, *supra* note 3, at 24 (acknowledging that securities lending aggravated AIG's problems, but noting that "[t]he trigger and primary cause of AIG's collapse came from inside AIGFP"); NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, FINANCIAL CRISIS INQUIRY REPORT (2011) [hereinafter *FCIC REPORT*], available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf (discussing the securities-lending aspect of AIG's downfall, but focusing much more intensively on AIGFP's activities); *American International Group's Impact on the Global Economy: Before, During, and After Federal Intervention: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Financial Services Comm.*, 111th Cong., 1st Sess. (2009), available at <http://www.gpo.gov/fdsys/pkg/CHRG-111hhrg48868/pdf/CHRG-111hhrg48868.pdf> (in a 380-page transcript, the term "securities lending" only appears twelve times).

⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1377 (2010) [hereinafter *Dodd-Frank*].

⁸ Title VII of Dodd-Frank deals largely with derivatives. A key architect of Title VII, Senator Blanche Lincoln, pointed to AIG as an important motivation. See, e.g., Letter from Blanche L. Lincoln, Senator, to Maria Cantwell, Senator, et al. (Apr. 13, 2010), at 4, available at http://www.cantwell.senate.gov/news/041310_Lincoln_response.pdf (describing plans for derivatives legislation and explaining that "[i]t was AIG's uncleared swaps, and the failure to see this build up of risk, that triggered the credit crisis"). See also Elisse Walter, Commissioner, Securities and Exchange Comm'n, Speech before the American Bar Association Spring Meeting (Apr. 6, 2013), available at https://www.sec.gov/News/Speech/Detail/Speech/1365171515202#.Uksh-39kj_Y (explaining that "experiences of companies like AIG" led to derivatives reform). Despite the role that the AIG experience played in laying the groundwork for derivatives reform, many of the key reforms such as mandatory clearing—which apply to standardized derivatives—would not apply to the customized derivatives that AIG sold. See, e.g., Darrell Duffie, *How Should We Regulate Derivatives Markets?*, DEFINING IDEAS (Aug. 25, 2009), available at <http://www.hoover.org/publications/defining-ideas/article/5345> ("Even had CDS clearing existed at the time, the AIG credit default swaps would not have been sufficiently standard to have been cleared. Only better risk management by AIG and better regulatory supervision could have prevented the disaster.").

⁹ Dodd-Frank required the Director of the Federal Insurance Office to "submit a report to Congress on how to modernize and improve the system of insurance regulation in the United States." 31 U.S.C. § 313(p). That report was due eighteen months after the enactment of Dodd-Frank (January 2012), but was not released until December 2013. FEDERAL INSURANCE OFFICE, U.S. DEP'T OF THE TREASURY, HOW TO MODERNIZE AND IMPROVE THE SYSTEM OF INSURANCE REGULATION IN THE UNITED STATES (Dec. 2013), available at <http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/How%20to%20Modernize%20and%20Improve%20the%20System%20of%20Insurance%20Regulation%20in%20the%20United%20States.pdf>. Box 2 of the report discusses AIG's derivatives and securities-lending issues. The report focuses on the fact that the insurance companies engaged in securities lending through their agent—AIG Securities Lending Corporation—but outsourcing a function does not put it beyond the reach of state insurance regulators.

¹⁰ *Id.* at 2.

¹¹ See AIG, CHRONICLING OVER 90 YEARS, available at http://www.aig.com/our-90-year-history_3171_437854.html (last visited Oct. 1, 2013). See also MAURICE R. GREENBERG & LAWRENCE A. CUNNINGHAM, THE AIG STORY (2013).

¹² See AIG, ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007, 3 and 20 (2008) [hereinafter *AIG 2007 10-K*].

¹³ *The Global 2000*, FORBES.COM, Mar. 2007, available at http://www.forbes.com/lists/2007/18/biz_07forbes2000_The-Global-2000_Rank.html.

¹⁴ Scott DeCarlo, ed., *The World's Biggest Public Companies*, FORBES, Apr. 17, 2013, available at <http://www.forbes.com/global2000/>.

¹⁵ Greenberg had a reputation for keeping very detailed control of every aspect of the company. See, e.g., *Hank Yanked: Regicide in the Insurance Industry*, THE ECONOMIST, May 17, 2005, available at <http://www.economist.com/node/3772986> (“The effect of Mr Greenberg’s departure—if he really is going—on AIG’s management will be worth watching. Mr Sullivan, although he began in the company decades ago, is unlikely to have Mr Greenberg’s detailed control of the organisation. Never having presided over the life-insurance division, for instance, he is likely to rely on other divisional managers.”). See also Financial Crisis Inquiry Comm’n Staff Interview of Gene Park, Part I, Former Managing Director, AIGFP (May 18, 2010) (at approximately 13:11) [hereinafter Park Interview Part I], available at <http://fcic.law.stanford.edu/resource/interviews#P> (explaining that “the CEO had a direct line to Hank Greenberg. Hank Greenberg was extremely hands on. That was almost a day-to-day, hour-to-hour interaction. But obviously when Hank left, the place kind of changed a lot.”).

¹⁶ See Andrew G. Simpson, *More Spitzer/SEC Fallout: AIG’s Greenberg Out; Sullivan Named CEO; Annual Report Delayed*, INS. J., Mar. 14, 2005, available at <http://www.insurancejournal.com/news/national/2005/03/14/52566.htm>.

¹⁷ See generally David Schiff, *AIG Replaces Greenberg as CEO: The Inevitable Hour*, SCHIFF’S INS. OBSERVER, Mar. 15, 2005, available at <http://www.insuranceobserver.com/PDF/2005/031505.pdf>; GREENBERG AND CUNNINGHAM, *supra* note 11.

¹⁸ See Simpson, *More Spitzer/SEC Fallout*, *supra* note 16.

¹⁹ For a discussion of the issues confronting AIG during its leadership transition, see BOYD, *supra* note 1, at 140–160; JP Donlon, *AIG CEO Martin Sullivan: Act II: Finding a New Balance*, CHIEFEXECUTIVE.NET, Aug. 14, 2006 (interview with Martin Sullivan), available at <http://chiefexecutive.net/aig-ceo-martin-sullivan-act-ii-finding-a-new-balance>.

²⁰ SEC, Press Release, AIG to Pay \$800 Million to Settle Securities Fraud Charges by the SEC, Over \$1.6 Billion to Be Paid to Resolve Federal and New York State Actions (Feb. 9, 2006), available at <http://www.sec.gov/news/press/2006-19.htm> (announcing global settlement).

²¹ See, e.g., Hugh Son, *AIG Replaces Sullivan with Willumstad After Losses*, BLOOMBERG, June 15, 2008, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&refer=&sid=a4Vp8Z0IUdbY>.

²² AIG, ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2008 (2009), at 224 [hereinafter AIG 2008 10-K].

²³ AIG 2007 10-K, *supra* note 12, at 215–20 (exhibit listing subsidiaries).

²⁴ *Id.* at 36 (reporting revenues of \$51,708 million from the general insurance segment and \$53,570 million from the life-insurance and retirement-services segment out of a total of \$110,064 million total revenue).

²⁵ *American International Group’s Impact on the Global Economy: Before, During, and After Federal Intervention: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Financial Services Comm.*, 111th Cong. 137 (2009) (statement of Joel Ario, Insurance Commissioner, Pennsylvania Department of Insurance) [hereinafter Ario Statement].

²⁶ AIG 2007 10-K, *supra* note 12, at 10.

²⁷ COP AIG REPORT, *supra* note 3, at 162 (noting that AIG had more than 400 regulators in 2008, more than half of which were overseas).

²⁸ AIG 2007 10-K, *supra* note 12, at 19 (noting that “AIG’s operations around the world are subject to regulation by different types of regulatory authorities, including insurance, securities, investment advisory, banking and thrift regulators in the United States and abroad”).

²⁹ 15 U.S.C. §§ 1011 *et seq.*

³⁰ See REPORT OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS AND THE FEDERAL RESERVE SYSTEM JOINT TROUBLED COMPANY SUBGROUP, A COMPARISON OF THE INSURANCE AND BANKING REGULATORY FRAMEWORKS FOR IDENTIFYING AND SUPERVISING COMPANIES IN WEAKENED FINANCIAL CONDITION 11 (Apr. 19, 2005).

³¹ See *id.* at 5.

³² NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, THE UNITED STATES INSURANCE FINANCIAL SOLVENCY FRAMEWORK 247, n. 11 (2010), available at http://www.naic.org/documents/committees_e_us_solvency_framework.pdf. The NAIC Framework offers a clear description of how the state insurance regulatory regime works.

³³ See Ario Statement, *supra* note 25, at 137–38 (explaining that for each of AIG’s main lines of insurance, “there are lead regulatory states”).

³⁴ COP AIG REPORT, *supra* note 3, at 17. *But see* Ario Statement, *supra* note 25, at 137–38 (noting only three lead regulators: Pennsylvania for commercial insurance lines, New York for personal insurance lines, and Texas for life insurance and annuities).

³⁵ See AIG 2008 10-K, *supra* note 22, at 17 (stating that AIG became a unitary thrift holding company in 1999). *But see American International Group’s Impact on the Global Economy: Before, During, and After Federal Intervention: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Financial Services Comm., 111th Cong.* 216 (2009) (statement of Scott M. Polakoff, Acting Director, Office of Thrift Supervision) [hereinafter Polakoff House Statement] (noting that AIG began the application process in 1999, but did not receive its approval until 2000).

³⁶ COP AIG REPORT, *supra* note 3, at n. 149.

³⁷ See AIG 2008 10-K, *supra* note 22, at 17 (“AIG is subject to OTS regulation, examination, supervision and reporting requirements. In addition, the OTS has enforcement authority over AIG and its subsidiaries. Among other things, this permits the OTS to restrict or prohibit activities that are determined to be a serious risk to the financial safety, soundness or stability of AIG’s subsidiary savings association, AIG Federal Savings Bank.”).

³⁸ See Polakoff House Statement, *supra* note 35, at 217–18 (describing the OTS’s transition to a conglomerate-based supervisory approach).

³⁹ Press Release, Office of Thrift Supervision, OTS Receives EU Equivalency Designation for Supervision of AIG (Feb. 22, 2007), available at <http://www.occ.gov/static/news-issuances/ots/press-releases/ots-pr-2007-11.pdf> (explaining that “financial conglomerates operating in Europe [are required] to be subject to worldwide supervision equivalent to that required in the EU” and noting the French bank regulator’s January 17, 2007, finding that the OTS provides equivalent consolidated supervision for AIG).

⁴⁰ See *id.* (quoting C. K. Lee, Managing Director for Complex and International Organizations, Office of Thrift Supervision: “This determination ensures supervision of AIG’s global activities will occur with a minimum of regulatory overlap This finding will deepen our cooperation with the French and other EU regulators”). See also *The Role of Derivatives in the Financial Crisis: Hearing Before the Financial Crisis Inquiry Commission 2* (July 1, 2010) (statement of C. K. Lee, Former Managing Director for Complex and International Organizations, Office of Thrift Supervision) [hereinafter Lee FCIC Statement], available at http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0701-Lee.pdf (“OTS’s ‘equivalency status’ under the European Union’s Financial Conglomerates Directive did not convey any additional authority or powers to OTS for supervising AIG. It simply clarified how the European operations of US firms would be treated under European law and provided definition to the relationships between regulators.”).

⁴¹ See Polakoff House Statement, *supra* note 35, at 218 (describing annual supervisory college meetings with state insurance regulators and foreign regulators).

⁴² See Polakoff House Statement, *supra* note 35, at 217, 219 (noting that “in late 2003 OTS embraced a more enterprise-wide approach to supervising conglomerates” and “[i]n 2006, OTS formally adopted a risk-focused continuous supervision program for the oversight of large and complex holding companies”). See also Lee FCIC Statement, *supra* note 40, at 1 (stating that in early 2006, he was asked to build, based on earlier OTS efforts, a conglomerates program for General Electric, Ameriprise Financial, and AIG).

⁴³ See Polakoff House Statement, *supra* note 35, at 216.

⁴⁴ *TARP and Other Government Assistance for AIG: Hearing Before the Congressional Oversight Panel*, 111th Cong., 2d Sess. 97 (2010) (statement of Michael E. Finn, Northeast Regional Director, Office of Thrift Supervision) [hereinafter Finn COP Statement].

⁴⁵ *Id.* at 71.

⁴⁶ See, e.g., *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 111th Cong., 1st Sess. 19(2009) (statement of Scott M. Polakoff, Acting Director, Office of Thrift Supervision) [hereinafter Polakoff Senate Statement] (“[I]t is time for OTS to raise their hand and say we have some responsibility and accountability here. This entity was deemed a savings and loan holding company. We were deemed an accepted regulator for both U.S. domestic and international operations. The segment, this AIG Financial Products, was an unregulated, as that term is defined, subsidiary of AIG, but part of the overall consolidated regulator responsibilities of OTS.”).

⁴⁷ See, e.g., Lee Statement, *supra* note 42, at 2 (“In the 2006–2008 timeframe, OTS reports show increasing supervisory criticism of AIG’s risk management, financial reporting and corporate governance—including criticism of the parent’s oversight of AIG Financial Products (AIG FP). These criticisms culminated in a downgrade of the holding company’s ratings and an enforcement action in the form of a Supervisory Letter in March, 2008.”).

⁴⁸ Office of Thrift Supervision, Report on Targeted Review: American International Group, Inc., 9 (examination completion date July 13, 2007) available at http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2007-04-23_Office_of_the_Thrift_Supervision_Department_of_the_Treasury_Targeted_Review_of_AIG_REDACTED.pdf (“Despite analysis that indicates loss exposure is remote, the recent downturn in the subprime mortgage market may result in rated CDOs and underlying mortgage securities with sub-prime exposure not performing as similarly rated instruments have performed historically. OTS will conduct an in-depth review of sub-prime exposure, including sub-prime exposure within AIG-FP’s super senior credit default swap portfolio, as part of a targeted review in 2008.”).

⁴⁹ Finn COP Statement, *supra* note 44, at 72.

⁵⁰ Polakoff Senate Statement, *supra* note 46, at 52.

⁵¹ *Id.* at 53.

⁵² The OTS’s 2007 Supervisory Plan for AIG included the following illustrative statement:

At the time the 2007 Supervisory Plan was being drafted by the AIG on-site exam team and the 2007 Work Plan was being considered, the [examiner in chief] over the prior two year [sic] had been permanently assigned elsewhere in the Northeast Region during the fall of 2006 roll-up examination, and the Assistant EIC . . . was overseas on Reserve duty. No replacements or additional resources were being provided for additional leadership or examination work at that time. The Acting EIC and one other examiner was all that remained for that time period. These two individuals felt that, as difficult as it is to supervise a one trillion dollar company with the limited resources previously provided, it would be even more difficult in 2007.

See Financial Crisis Inquiry Comm’n Staff Interview of Michael E. Finn, Northeast Regional Director, Office of Thrift Supervision (June 18, 2010) (interviewer reads text beginning at approximately hour 1:46:39), available at <http://fcic.law.stanford.edu/resource/interviews#F>.

⁵³ Intriguing narratives of AIGFP’s history, which is quite colorful, are available. See, e.g., BOYD, *supra* note 1; Robert O’Howry, Jr., and Brady Dennis, *The Beautiful Machine*, WASH. POST, Dec. 29, 2008, A1, Part 1 of 3 available at http://www.washingtonpost.com/wp-dyn/content/article/2008/12/28/AR2008122801916_pf.html.

⁵⁴ See BOYD, *supra* note 1, at 40–44 (discussing deterioration of relationship between Sosin and AIG).

⁵⁵ See *id.* at 80–2.

⁵⁶ See *id.* at 87–92.

⁵⁷ See COP AIG REPORT, *supra* note 3, at 21.

⁵⁸ DON M. CHANCE & ROBERT BROOKS, AN INTRODUCTION TO DERIVATIVES AND RISK MANAGEMENT 548 (7th ed. 2007). See also Federal Reserve Bank of New York, Glossary of AIG Terms, http://www.newyorkfed.org/aboutthe_fed/aig/glossary_frame.html (last visited Oct. 3, 2013) (A CDS “[t]ransfers the credit exposure of fixed-income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. Risk of default is transferred from the holder of the fixed income security to the seller of the swap.”). See generally Hومان B. Shadab, *Counterparty Regulation and Its Limits: The Evolution of the Credit Default Swaps Market*, 54 N.Y. L. SCH. L. REV. 57, at 58 (2009) (describing what a CDS is and how it works). Some have argued that CDS are essentially insurance and should be regulated that way. They were not regulated as insurance at the time of the crisis, although there were subsequent efforts to draw CDS into the insurance regulatory regime. See, e.g., Press Release, State of New York, Governor Paterson Announces Plan to Limit Harm to Markets from Damaging Speculation (Sept. 22, 2008), available at <http://www.dfs.ny.gov/insurance/press/2008/p0809224.pdf> (announcing New York’s plan to regulate certain CDS as insurance starting in January 2009). That debate is beyond the scope of this article, except to the extent that this article attempts to show that insurance regulators should not use their supervisory record with respect to AIG’s insurance subsidiaries to argue for an expansion of their authority to include CDS.

⁵⁹ See COP AIG REPORT, *supra* note 3, at 20–21 (noting that “AIG’s sterling credit rating was a differentiator in the market, and allowed [AIGFP’s capital markets] division to move aggressively into new business lines with lower levels of competition, expanding its scope as counterparty to and underwriter of risk products”). AIG guaranteed the obligations of AIGFP. See AIG 2008 10-K, *supra* note 22, at note (d).

⁶⁰ AIG's corporate arbitrage CDS were CDS written on pools of corporate debt or collateralized loan obligations. See COP AIG REPORT, *supra* note 3, at 21.

⁶¹ AIG wrote protection on pools of residential mortgages and corporate loans held by European banks in order to lower the minimum capital requirements of the banks. See AIG 2008 10-K, *supra* note 22, at 133.

⁶² A CDO is an "[i]nvestment-grade security backed by a pool of bonds, loans and other assets with varying levels of risk. CDOs bundle the various types of debt into tranches of distinct maturities and risk levels, including tranches made of subprime loans." Federal Reserve Bank of New York, Glossary of AIG Terms, *supra* note 58.

⁶³ See COP AIG REPORT, *supra* note 3, at 27 (citing panel briefing with Weil Gotshal, which represented AIG).

⁶⁴ AIG, Conference Call Credit Presentation 10 (Feb. 28, 2008) [hereinafter AIG February 2008 Presentation], available at http://media.corporate-ir.net/media_files/irol/76/76115/Conference_Call_Credit_Presentation_031408_revised.pdf. Notional value refers to the value of the securities on which the CDS are written. See Shadab, *supra* note 58, at n. 5 ("The "notional value" of a CDS is the amount of the loan referenced by the contract. For example, a CDS contract that references a \$1 million loan has a notional value of \$1 million.").

⁶⁵ See, e.g., FCIC Hearing Day 1, *supra* note 5, at 152 (statement of Phil Angelides, Chairman, Financial Crisis Inquiry Commission) (stating that "in a survey we did of some of these CDOs that [AIGFP] issued protection on, 84 percent were backed by RMBS, residential mortgages in '05, 89 percent in '06"). An RMBS is a security that is backed by a pool of residential mortgages and repaid from the mortgage payments. See Federal Reserve Bank of New York, Glossary of AIG Terms, *supra* note 58 (defining an RMBS as a "[t]ype of mortgage-backed security composed of different noncommercial mortgage debts that securitizes the mortgage payments of non-commercial real estate" and stating that "[d]ifferent residential mortgages with varying credit ratings are pooled and sold in tranches to investors looking to diversify their portfolios or hedge against certain risks"). Underlying assets also included commercial mortgage-backed securities, auto loans, and credit cards. AIG, Residential Mortgage Presentation 28 (Aug. 9, 2007) [hereinafter AIG August 2007 Presentation], available at http://media.corporate-ir.net/media_files/irol/76/76115/REVISED_AIG_and_the_Residential_Mortgage_Market_FINAL_08-09-07.pdf.

⁶⁶ As of June 30, 2007, \$64 billion of the \$79 billion notional CDO exposure included some subprime deals. *Id.*

⁶⁷ See, e.g., AIG 2007 10-K, *supra* note 12, at 123 ("As of January 31, 2008, a significant majority of AIGFP's super senior exposures continued to have tranches below AIGFP's attachment point that have been explicitly rated AAA or, in AIGFP's judgment, would have been rated AAA had they been rated."); AIG August 2007 Presentation, *supra* note 65, at 29 ("All 'Super Senior' transactions are underwritten to a zero loss standard. At inception, the attributes of the underlying collateral assets, which may include varying quality by external rating, are analyzed and modeled to determine appropriate risk attachment points so that all transactions have AAA tranches of protection below AIGFP's attachment point.").

⁶⁸ AIG February 2008 Presentation, *supra* note 64, at 5.

⁶⁹ AIG August 2007 Presentation, *supra* note 65, at 29 ("At inception, the attributes of the underlying collateral assets, which may include varying quality by external rating, are analyzed and modeled to determine appropriate risk attachment points so that all transactions have AAA tranches of protection below AIGFP's attachment point.") See also Sjostrom, *supra* note 1, at 952-59 (providing a very thorough explanation of the mechanics of AIGFP's CDS).

⁷⁰ See, e.g., AIG, Conference Call Credit Presentation 33 (May 9, 2008) [hereinafter AIG May 2008 Presentation], available at http://media.corporate-ir.net/media_files/irol/76/76115/ConferenceCallCreditPresentation_05_09_08.pdf.

⁷¹ See, e.g., FCIC Hearing Day 1, *supra* note 5, at 145 (statement of Robert Lewis, Chief Risk Officer, AIG) ("FP's approach to the management of its risk was to structure the credit default swaps so that they would only be triggered if the underlying losses were severe enough to rise to the highest levels in the tower, a risk that FP determined to be exceedingly unlikely even under severe economic scenarios."); *id.* at 172 (statement of Joseph Cassano, former Chief Executive Officer, AIGFP) ("I've heard this phrase that it's a one-sided bet, but when you think about the protections that we built into the contracts through the subordination levels, through the structural supports that we built into the contracts, and then through the very, very strict underwriting standards we performed, this was extremely remote risk business.").

⁷² See AIG May 2008 Presentation, *supra* note 70, at 31 ("AIGFP wrote credit derivative protection as a principal and has the ability and intent to hold its positions until contract maturity or call by the counterparty.").

⁷³ See AIG 2008 10-K, *supra* note 22, at 141 ("For CDS transactions requiring physical settlement, AIGFP is generally required to pay unpaid principal and accrued interest for the relevant reference obligation in return for physical delivery of such reference obligation by the CDS buyer upon the occurrence of a credit event.") In this regard, the *physically* settled CDS on the super-senior tranches of the multisector CDOs differed from most of

AIGFP's other CDS, which were *cash*-settled, and thus an event of default would have triggered cash payments to cover actual losses rather than an obligation to purchase the underlying securities. *See* AIG 2007 10-K, *supra* note 12, at 100 (“The credit default swaps written by AIGFP on super senior tranches of multi-sector CDOs require, in most cases, physical settlement following an event constituting a failure to pay in respect of the underlying super senior CDO securities. The majority of the other credit default swaps are cash settled, whereby AIGFP would be required upon an event constituting a failure to pay in respect of the underlying super senior CDO securities to make cash payments to the counterparty equal to any actual losses that attach to the super senior risk layer, rather than to purchase the reference obligation.”) and 122 (“Under a physical settlement arrangement, AIGFP would be required to purchase the referenced super senior security at par in the event of a non-payment on that security.”).

⁷⁴ AIG 2007 10-K, *supra* note 12, at 122 (“In the case of most of the multi-sector CDO transactions, the amount of collateral required is determined based on the change in value of the underlying cash security that represents the super senior risk layer subject to credit protection, and not the change in value of the super senior credit derivative.”).

⁷⁵ Sjostrom, *supra* note 1, at 960.

⁷⁶ AIG August 2007 Presentation, *supra* note 65, at 26 (explaining that, with respect to the majority of multisector CDO and corporate arbitrage credit derivatives, “[t]he amount required for [collateral] posting is affected by AIG Inc.’s credit rating and that of the reference obligation”).

⁷⁷ *See FCIC Hearing Day 1*, *supra* note 5, at 182 (statement of Joseph Cassano) (AIGFP “managed some approximately \$50 billion in liquid securities. We could liquidate those securities and then use those to . . . pledge as collateral.”).

⁷⁸ AIG 2008 10-K, *supra* note 22, at 51 (“AIGFP had historically funded its operations through the issuance of notes and bonds, GIA borrowings and other structured financing transactions. AIGFP also obtained funding through repurchase agreements. In the last half of 2008, AIGFP’s access to its traditional sources of liquidity were [sic] significantly reduced and it relied on AIG Parent to meet most of its liquidity needs.”).

⁷⁹ The Financial Crisis Inquiry Commission staff found that, before the collateral calls started coming in, the link between collateral requirements and the value of the underlying bonds was not widely known among AIG senior management. *See* Financial Crisis Inquiry Commission Staff, Documents for the Record, AIG Risk Management 1 (undated) [hereinafter AIG Risk Management Memo], *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0630-AIG-Risk-Management.pdf (“Many current and former AIG executives . . . stated they did not know the contracts required collateral posting based on declines in the market value of the underlying bonds.”).

⁸⁰ FCIC REPORT, *supra* note 6, at 269. The FCIC Report includes an illuminating narrative of AIGFP’s collateral disputes. *See id.* at 265–74.

⁸¹ *Id.* at 269.

⁸² For a discussion of AIG’s collateral disputes with Goldman, *see, e.g., The Role of Derivatives in the Financial Crisis: Hearing Before the Financial Crisis Inquiry Comm’n* 13–17 (July 1, 2010) [hereinafter *FCIC Hearing Day 2*] (statement of David Lehman, Managing Director, Goldman Sachs Group, Inc.), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0701-Transcript.pdf.

⁸³ *See id.* at 22–29 (questioning by FCIC Commissioner Phil Angelides of Andrew Forster, former Executive Vice President, AIG) (discussing difficulties of pricing the securities in order to push back against collateral calls).

⁸⁴ *See, e.g., FCIC REPORT*, *supra* note 6, at 270 (reporting that, by the end of November, AIGFP had posted \$2 billion in collateral to Goldman).

⁸⁵ *See, e.g., id.* at 268 (reporting that, to satisfy Goldman’s initial collateral call, AIGFP posted \$450 million in collateral on August 10, 2007).

⁸⁶ *See, e.g., id.* (reporting that, by the middle of September, UBS and Société Générale made collateral calls of \$67 billion and \$40 billion respectively).

⁸⁷ AIG, Conference Call Credit Presentation 26 (Aug. 7, 2008) [hereinafter AIG August 2008 Presentation], *available at* http://media.corporate-ir.net/media_files/irol/76/76115/FinalConf_revised_08-13-08.pdf.

⁸⁸ FCIC REPORT, *supra* note 6, at 344.

⁸⁹ Press Release, AIG, AIG Reports Third Quarter 2007 Results 1 (Nov. 7, 2007) *available at* http://media.corporate-ir.net/media_files/irol/76/76115/releases/110707a.pdf.

⁹⁰ *See* AIG, Conference Call Credit Presentation Supplemental Materials 30 (Feb. 29, 2008), *available at* http://media.corporate-ir.net/media_files/irol/76/76115/CallSupplement.pdf. AIG attributed the write-down to the

“volatile market,” but predicted that any realized losses would be immaterial and “[e]xcept to the extent of credit impairment losses, expect[ed] the unrealized market valuation losses to reverse over the remaining life of the portfolio.” *Id.* at 47.

⁹¹ See *FCIC Hearing Day 1, supra* note 5, at 146 (statement of Robert E. Lewis, Senior Vice President and Chief Risk Officer, AIG) (“[I]n the latter part of 2005 [enterprise risk management] at the corporate level began to get concerned based on increasingly aggressive bank lending practices, and a housing market that was unduly heating up. In early 2006, my chief credit officer discussed these concerns with FP’s CEO in London who responded that FP’s own risk analysis was identifying the same concerns, and that he had decided it was time to shut down.”). See also Park Interview Part I, *supra* note 15 (starting at approximately 1:17) and Financial Crisis Inquiry Comm’n Staff Interview of Gene Park, Former Managing Director, AIGFP, Part II (May 18, 2010) [hereinafter Park Interview Part II] (starting at beginning), available at <http://fcic.law.stanford.edu/resource/interviews#P> (discussing how AIGFP came to the decision to stop writing multisector CDOs). Park’s recounting of events does not include a role for AIG’s risk management in shutting down the business. See *id.* (starting at approximately 1:09) (suggesting AIG’s risk managers were not involved in the decision to shut down the business).

⁹² See Park Interview Part II, *supra* note 91 (starting at approximately 7:55).

⁹³ Email from Gene Park, former Managing Director, AIGFP, to Joseph Cassano, former CEO, AIGFP (Feb. 28, 2006) (reprinted in FCIC REPORT, *supra* note 6, at 201), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2006-02-28_AIG_Email_from_Gene_Park_to_Joe_Cassano_Regarding_CDO_of_ABS_Approach.pdf.

⁹⁴ Park Interview Part II, *supra* note 91 (starting at approximately 41:00) (discussing 2006 subprime CDS deals).

⁹⁵ *Id.* (starting at approximately 1:03:40) (discussing AIGFP’s contemplation of hedge transactions with UBS and its having entered into a single \$150 million index-based hedge in early 2006).

⁹⁶ As noted earlier, although most accounts of AIG’s downfall give little attention to the company’s securities-lending problems, several careful accounts of AIG’s downfall have identified the important role that securities lending played. See *supra* note 1.

⁹⁷ FCIC Staff Interview with Mark Hutchings, AIG (June 22, 2010) [hereinafter Hutchings Interview] (at approximately 59:47), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-audio/2010-06-22%20FCIC%20staff%20audiotape%20of%20interview%20with%20Mark%20Hutchings,%20American%20International%20Group,%20Inc.mp3. See also NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, CAPITAL MARKETS SPECIAL REPORT: SECURITIES LENDING IN THE INSURANCE INDUSTRY (July 11, 2011) [hereinafter NAIC REPORT], available at http://www.naic.org/capital_markets_archive/110708.htm (“Insurance companies engage in securities lending to enhance returns on their investment portfolios, loaning out securities that are not actively traded. For most, securities lending is intended to be a low-risk investment strategy, for insurance companies to earn a modest income through fees charged to borrowers. Additional income may be generated by investing the cash collateral posted by the transactions’ borrowers.”).

⁹⁸ Securities lending got its start in the 1960s and 1970s. *Securities Lending and Short Sale Roundtable Before the Securities and Exchange Comm’n* 16–19 (Sept. 29, 2009) [hereinafter *SEC Roundtable*] (statement of Irving Klubeck, Managing Director, Pershing LLC), available at <http://www.sec.gov/news/openmeetings/2009/roundtable-transcript-092909.pdf> (explaining the growth of securities lending in response to the backlogs associated with paper stock certificates during the late 1960s and early 1970s). By the late 1980s, securities lending was widespread. See PAUL LIPSON ET AL., SECURITIES LENDING 3 (Fed’l Reserve Bank of New York Staff Report No. 555, 2012) [hereinafter LIPSON ET AL.].

⁹⁹ For a discussion of these markets, see Frank M. Keane, *Securities Loans Collateralized by Cash: Reinvestment Risk, Run Risk, and Incentive Issues*, 19 FED’L RESERVE BANK OF NEW YORK CURRENT ISSUES IN ECONOMICS AND FINANCE (2013) [hereinafter Keane]; LIPSON ET AL., *supra* note 98; FINANCIAL STABILITY BOARD, SECURITIES LENDING AND REPOS: MARKET OVERVIEW AND FINANCIAL STABILITY ISSUES: INTERIM REPORT OF THE FSB WORKSTREAM ON SECURITIES LENDING AND REPOS (Apr. 27, 2012) [hereinafter FSB REPORT], available at http://www.financialstabilityboard.org/publications/r_120427.pdf; TOBIAS ADRIAN ET AL., REPO AND SECURITIES LENDING (Federal Reserve Bank of New York Staff Report No. 529, 2013) [hereinafter ADRIAN ET AL.], available at http://www.newyorkfed.org/research/staff_reports/sr529.pdf.

¹⁰⁰ For an analysis of the repo markets, see Darrell Duffie, *Special Repo Rates*, 51 J. FINANCE 493 (1996).

¹⁰¹ See LIPSON ET AL., *supra* note 98, at 4–7 (describing each type of transaction). Securities lending can also take place as part of a program that allows the borrower to borrow from a portfolio of securities. See *id.* at 7–10.

¹⁰² See Irving Klubeck, Pershing LLC, submission to the Securities and Exchange Comm'n 1 (Sept. 28, 2009) [hereinafter Klubeck Submission], available at <http://www.sec.gov/comments/4-590/4590-16.pdf> (explaining that securities loans are typically overcollateralized at 102%). Noncash collateral is more common outside the United States. See *SEC Securities Lending Roundtable*, *supra* note 98 (statement of Kathy Rulong, Executive Director, BNY Mellon Global Securities Lending), at 83.

¹⁰³ See, e.g., *SEC Roundtable*, *supra* note 98, at 91 (statement of Patrick Avitabile, Managing Director, Citigroup) (explaining that marking collateral to market daily protects the lender).

¹⁰⁴ See ADRIAN ET AL., *supra* note 99, at 2 (“The motivation behind a specific repo or sec[urities] lending transaction can be either cash or security driven.”). But see Keane, *supra* note 99, at 4 (“If the rebate rate is equal to or above the relevant general collateral rate, then the transaction is motivated by the security lender’s desire to borrow money rather than by the security borrower’s demand for a security. Such a transaction is a ‘securities loan’ in name only.”).

¹⁰⁵ See JOSH GALPER, FINADIUM REPORT: THE ROLE OF SECURITIES LENDING IN US FINANCIAL MARKETS 5 (2011) (discussing beneficial owners that act as lenders in the securities lending markets). See also JOHN DEMBECK, REGULATION OF SECURITIES LENDING BY U.S. INSURERS 1 (Debevoise & Plimpton Financial Institutions Report 4–10 2010), available at <http://www.debevoise.com/files/Publication/638906aa-d679-4849-b7ee-c86c6a7d0910/Presentation/PublicationAttachment/53eed247-fa83-4371-b26a-cdc3473662e6/FIRreportNovember2010.pdf> (“Securities lending has long been an important component of insurance company investment strategies.”).

¹⁰⁶ Leslie S. Nelson, Managing Director, Goldman Sachs & Co., Submission to Securities and Exchange Comm'n 2 (Sept. 29, 2009), available at <http://www.sec.gov/comments/4-590/4590-29.pdf> (listing strategies in which securities borrowing plays a role).

¹⁰⁷ See Klubeck Submission, *supra* note 102, at 2. See also Keane, *supra* note 99, at 3–4 (explaining that the lender typically pays the borrower, but “for very scarce securities, rebate rates can be zero or negative”). By one estimate, fewer than ten percent of securities lending transactions involve hard-to-borrow stocks. *SEC Securities Lending Roundtable*, *supra* note 98, at 135 (statement of Shawn Sullivan, managing director, Credit Suisse).

¹⁰⁸ See Keane, *supra* note 99, at 4–5 (discussing the contributions to securities lending earnings from the intrinsic value of the securities being lent and the net reinvestment returns of the cash being invested).

¹⁰⁹ See, e.g., *SEC Roundtable*, *supra* note 98, at 13 (statement of William Pridmore, independent consultant), 24–25 (“[I]n the hard-to-borrow stocks, most of the compensation is coming from the intrinsic value of that lending transaction. For the more readily available securities, the portion of compensation that comes from the intrinsic value is very small, and most of the return is generated in that spread between where the cash collateral is invested and the rebate rate.”).

¹¹⁰ See Keane, *supra* note 99, at 2 (describing collateral reinvestment). See also GALPER, *supra* note 105, at 19–22 (2011) (presenting data about the nature of cash collateral reinvestments).

¹¹¹ FSB REPORT, *supra* note 99 (“Most lend out securities in order to generate additional income on their portfolio holdings at minimal risk, to help offset the cost of maintaining the portfolio, or to generate incremental returns.”).

¹¹² See, e.g., NATIONAL ASSOCIATION OF INSURANCE COMM'RS, CAPITAL MARKETS SPECIAL REPORT: SECURITIES LENDING IN THE INSURANCE INDUSTRY—PART 2: SECURITIES LENT (2011), available at http://www.naic.org/capital_markets_archive/110722.htm (“Securities lending agreements are often intended to be short-term in nature, and most agreements allow the borrower to return the loaned security(ies) on short notice (and at no penalty) in exchange for the cash collateral posted to the insurance company. As a result, the insurance company must be able to liquidate the reinvested collateral on short order to return the cash to the borrower.”).

¹¹³ See Keane, *supra* note 99, at 6.

¹¹⁴ See *id.* at 2 (explaining the agent’s role) and 6 (discussing how compensation arrangements, in which agents’ fees increase with reinvestment returns, create an incentive to aggressively seek returns).

¹¹⁵ See, e.g., *SEC Roundtable*, *supra* note 98, at 13 (statement of William Pridmore, independent consultant) (“Since cash was the predominant form of collateral, how that collateral was invested was a prime factor in determining lending income. Securities lending agents, both custodian and third party, realized they could boost earnings by taking more risk in the investment of cash collateral. For the most part, it was not done by taking credit default risk—beneficial owners could and did control that. But rather, the added risk came from taking on liquidity risk. Frequently beneficial owners did not understand the true dimension of that liquidity risk.”); Keane, *supra* note 99, at 6 (stating that “anecdotal evidence suggests that excessive risk was a problem in the lead-up to the financial crisis”).

¹¹⁶ Matthew Dive et al., *Developments in the Global Securities Lending Market*, BANK OF ENGLAND QUARTERLY BULLETIN 224, 224 (3rd Quarter 2011), available at <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb110303.pdf>.

¹¹⁷ AIG did not make extensive public disclosures of the details of how its securities-lending program functioned. AIG's auditor raised questions about inadequate disclosure about securities lending. AIG Risk Management Memo, *supra* note 79, at 15 (reproducing PricewaterhouseCoopers' notes of a November 29, 2007, meeting with AIG management at which one of the concerns raised was "the issues in AIG Investment concerning securities lending and the fact that if the exposure had been known prior to the q210Q being issued it is highly likely that the disclosures would have been changed"). The following description of AIG's securities-lending program therefore relies heavily on the Financial Crisis Inquiry Commission (FCIC) Staff's Interview with Mark Hutchings, who worked on the trading side of AIG's securities-lending program (i.e., matching securities borrowers with the securities from AIG's pool of loanable securities). Hutchings Interview, *supra* note 97. There is no public record of interviews by the FCIC or its staff with the AIG employees responsible for deciding how AIG's securities-lending collateral was invested. The absence of such interviews in the FCIC's public records is particularly notable because the FCIC staff noted its interest in following up with employees who had worked on the investment side of AIG's securities-lending program. *Id.* (starting at approximately 16:20) (Dixie Noonan, Senior Counsel, Financial Crisis Inquiry Commission, observed, "We're going to want to talk to someone who was actually involved on the investment side.").

¹¹⁸ Hutchings Interview, *supra* note 97 (starting at approximately 4:23).

¹¹⁹ AIG 2007 10-K, *supra* note 12, at 3 and 108.

¹²⁰ Hutchings Interview, *supra* note 97 (starting at approximately 10:30).

¹²¹ *Id.* (starting at approximately 10:50).

¹²² *Id.* (starting at approximately 12:15).

¹²³ See, e.g., AIG Securities Lending Corp., Annual Audited Report on Form X-17A-5 (Mar. 31, 2008), at 3, available at <http://www.sec.gov/Archives/edgar/vpr/08/9999999997-08-018307> (explaining that AIG Securities Lending Corp. "primarily serves as a non-custodial lending agent for US domiciled AIG companies and AIG managed funds. Cash collateral from securities borrowing counterparties is directed into a segregated collateral pool for the securities lenders. The cash in the collateral pool is invested by an affiliate of [AIG Securities Lending Corp.] in order to generate rebates for the securities borrowers and revenue for the securities lenders. AIG Securities Lending Corp earns agency fees from the lenders in accordance with a predetermined revenue split agreement."); TENNESSEE DEP'T OF COMMERCE AND INSURANCE, REPORT ON EXAMINATION OF THE AMERICAN GENERAL LIFE AND ACCIDENT INSURANCE COMPANY AS OF DECEMBER 31, 2006, 22 (June 2, 2008) [hereinafter 2006 TENNESSEE REPORT], available at <http://www.tn.gov/commerce/insurance/documents/AGLAICexam123106.pdf> (noting that AIG Securities Lending Corporation was entitled to 50 percent of all fees, compensation, and income received by the insurance company).

¹²⁴ *Id.* (starting at approximately 26:30) (describing the pool); AIG 2007 10-K, *supra* note 12, at 108 ("Securities are loaned to various financial institutions, primarily major banks and brokerage firms.").

¹²⁵ Hutchings Interview, *supra* note 97 (starting at approximately 52:10). AIG had approximately \$160 billion of securities available to lend. *Id.* (starting at approximately 55:15). By comparison, as of March 31, 2011, the entire insurance industry had \$56 billion in securities lent out through securities lending programs. NAIC REPORT, *supra* note 97.

¹²⁶ Hutchings Interview, *supra* note 97 (starting at approximately 41:20).

¹²⁷ AIG 2007 10-K, *supra* note 12, at 108.

¹²⁸ *Id.* ("The cash collateral is invested in highly-rated fixed income securities to earn a net spread."). That is why Keane opined that AIG's program was "Securities Lending in Name Only." See Keane, *supra* note 99, at 6.

¹²⁹ Hutchings Interview, *supra* note 97 (starting at approximately 25:10). See also Keane, *supra* note 99, at 6 ("AIG used this form of securities lending as a mechanism for raising cash to support a yield-enhancement reinvestment strategy with no collateral market purpose, and such use was subject to the same run risk as exists in repo markets.").

¹³⁰ Hutchings Interview, *supra* note 97 (at approximately 22:45).

¹³¹ AIG 2007 10-K, *supra* note 12, at 108 (reporting that 13.7% of the liabilities were one-day tenor, and the rest matured within three months). See also Hutchings Interview, *supra* note 97 (starting at approximately 24:00) (one or two percent of their loans were "specials"—scarce securities—that were open transactions that expired daily).

¹³² Hutchings Interview, *supra* note 97 (starting at approximately 25:00).

¹³³ This collateralization level was mandatory under the AIG securities-lending agent's agreement with the AIG insurance subsidiaries. The 105 level was required in cross-currency securities lending. *Id.* (starting at approximately 20:50).

¹³⁴ *Id.* (starting at approximately 23:10 and 32:00).

¹³⁵ For an overview of the different areas in which AIG was exposed to RMBS generally and subprime RMBS specifically, see AIG August 2007 Presentation, *supra* note 65. For example, AIG's insurance investment portfolio also contained RMBS and AIG was also a mortgage lender through American General Finance and a mortgage insurer through United Guaranty. See *id.* at 4 and 6.

¹³⁶ Transcript of AIG Investor Meeting Presentation 2 (Dec. 5, 2007) [hereinafter AIG December 2007 Conference Call] (statement of Martin Sullivan, CEO, AIG), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2007-12-05%20AIG%20Conference%20Call%20Transcript.pdf. See also *id.* at 59 (statement of Robert Lewis, Chief Risk Officer, AIG) ("Now, AIG is a decentralized organization, and our business executives make decisions on businesses to achieve risk-adjusted returns over their—in their business models, over their cycles and in their businesses. What we do at the holding level is to ensure that that's done with integrity, done with quality and that the aggregation of those risks do [sic] not rise to anything that would be a concentration of risk at the AIG level.").

¹³⁷ By March, 31, 2008, the insurance companies' investment portfolio included \$82.3 billion of RMBS exposure (approximately 9.7% of AIG insurance companies' total invested assets), including \$21.6 billion in subprime RMBS exposure and another \$23.7 billion in Alt-A RMBS exposure, almost all of which was of vintage 2005 through 2007. AIG May 2008 Presentation, *supra* note 70, at 57, 58, 63, and 66. By contrast, AIGFP's multisector portfolio, by virtue of when the CDS were written, was weighted toward earlier vintages. See AIG, Residential Mortgage Presentation 43 (Nov. 8, 2007) [hereinafter AIG November 2007 Presentation], available at http://media.corporate-ir.net/media_files/irol/76/76115/Revised_AIG_and_the_Residential_Mortgage_Market_3rd_Quarter_2007_Final_110807r.pdf ("AIGFP stopped committing to writing new 'Super Senior' protection that included sub-prime collateral in December 2005, and thus its total exposure, after deducting all subordination, across all deals to the vintages of 2006 and 2007 totals just \$323 Million"). However, managers of the CDOs on which AIGFP sold CDS were authorized to substitute later-vintage securities for earlier ones. See COP AIG REPORT, *supra* note 3, at 31.

¹³⁸ AIG August 2007 Presentation, *supra* note 65, at 3 and 35. See also AIG December 2007 Conference Call, *supra* note 136 (statement of Martin Sullivan, CEO, AIG) (highlighting the "effectiveness of [AIG's] risk management practices" in connection with RMBS and belief that AIG's "exposure levels [to the housing market] are manageable, given [AIG's] size, strength, and financial diversification").

¹³⁹ *Id.* at 39–40 and preceding text (statement of Richard Scott, Senior Vice President, Investments, AIG).

¹⁴⁰ FCIC Hearing Day 1, *supra* note 5, at 244–45.

¹⁴¹ See Lavonne Kuykendall, *AIG Comfortable with Mortgage-Market Exposure*, MARKETWATCH (Aug. 9, 2007), available at <http://www.marketwatch.com/story/aig-comfortable-with-mortgage-market-exposure> (Unlike some other insurers that had pared back their exposure to subprime RMBS, AIG had increased it, and "Bob Lewis, AIG's chief risk officer, said the company doesn't expect to lose money on any of its residential mortgage-backed securities. 'It would take declines in housing values to reach depression proportions, along with default frequencies never experienced,' before the company's AAA- and AA-rated investments would be affected, he said during the call.").

¹⁴² AIG Risk Management Memo, *supra* note 79, at 15 (reproducing PricewaterhouseCoopers' notes of a November 29, 2007, meeting with AIG management).

¹⁴³ See *id.* at 27 (reproducing email from Kevin McGinn, Chief Credit Officer, AIG, to Paul Narayanan, AIG, Nov. 20, 2007). But see FCIC Staff Interview of Robert Lewis, Chief Risk Officer, AIG (June 15, 2010) (starting around hour 1:58), available at <http://fcic.law.stanford.edu/resource/interviews#L> (when asked about the decision by AIG Investments (AIGI) to invest in RMBS as AIGFP turned away from securities-related to subprime investments, Lewis downplayed the depth of the risk management staff's concerns about the securities-lending portfolio and stated that it was not until sometime in 2008 that McGinn capped the securities-lending portfolio's exposure to RMBS); FCIC Staff Interview of Kevin McGinn, Chief Credit Officer, AIG, Part II (June 10, 2010) (starting around 52:00), available at [http://fcic-static.law.stanford.edu/cdn_media/fcic-audio/2010-06-10%20FCIC%20staff%20audiotape%20of%20interview%20with%20Kevin%20McGinn,%20American%20International%20Group,%20Inc.%20\(Part%202\).mp3](http://fcic-static.law.stanford.edu/cdn_media/fcic-audio/2010-06-10%20FCIC%20staff%20audiotape%20of%20interview%20with%20Kevin%20McGinn,%20American%20International%20Group,%20Inc.%20(Part%202).mp3) (explaining that while he had warned AIGI of the problems in the housing market, AIGI's securities had relevant distinguishing features as compared to AIGFP's CDS and AIGI took steps to tighten up the credit-quality standards of the securities it was purchasing).

¹⁴⁴ See, e.g., Ario Statement, *supra* note 25, at 9 (“Traditionally securities lending pools operated by insurers primarily invest in conservative, highly liquid investments, such as treasuries and short-term paper, and include cash set aside to offset some liquidity risk with these transactions. The AIG securities lending program initially operated in this more traditional manner; however, as with some other holding company activities, the special unit changed course and became more aggressive in its management and collateral investment practices to generate additional revenue for AIG.”).

¹⁴⁵ FINANCIAL STABILITY BOARD, SECURITIES LENDING AND REPOS: MARKET OVERVIEW AND FINANCIAL STABILITY ISSUES: INTERIM REPORT OF THE FSB WORKSTREAM ON SECURITIES LENDING AND REPOS 9 (Apr. 27, 2012), available at http://www.financialstabilityboard.org/publications/r_120427.pdf.

¹⁴⁶ Hutchings Interview, *supra* note 97 (starting at approximately 61:20). The December 2005 investment guidelines are available at AIG Risk Management Memo, *supra* note 79, at 22–25. See also *id.* at 21 (reproducing a December 5, 2008, memorandum from Kevin B. McGinn to the AIG Credit Risk Committee that identifies, and seeks approval for, “[s]ignificant changes to the existing [Cash Collateral Investment] policy” that “are reasonable and do not expose the portfolio to any significant high degree of risk”).

¹⁴⁷ AIG Risk Management Memo, *supra* note 79, at 24–25.

¹⁴⁸ BOYD, *supra* note 1, at 168.

¹⁴⁹ AIG Risk Management Memo, *supra* note 79, at 22 (emphasis added).

¹⁵⁰ CHAN, *supra* note 1, at 28.

¹⁵¹ Dive et al., *supra* note 116, at 228.

¹⁵² AIG August 2007 Presentation, *supra* note 65, at 35.

¹⁵³ AIG December 2007 Conference Call, *supra* note 136, at 43 (statement of Richard Scott, Senior Vice President, Investments, AIG).

¹⁵⁴ See AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2008, at 143 (November 10, 2008) (“A significant portion of the collateral received was invested in RMBS with cash flows with tenors longer than the liabilities to the counterparties.”).

¹⁵⁵ See Hutchings Interview, *supra* note 97 (at approximately 39:05) (AIG’s securities-lending program had approximately four percent in overnight cash).

¹⁵⁶ *Id.* (starting at approximately 37:35).

¹⁵⁷ *Id.* (starting at approximately 39:10). See also AIG 2007 10-K, *supra* note 12, at 38 (“As a result of the disruption in the credit markets during 2007, AIG took steps to enhance the liquidity of its portfolios, including increasing the liquidity of the collateral in the securities lending program.”).

¹⁵⁸ See Hutchings Interview, *supra* note 97 (at approximately 55:30).

¹⁵⁹ BOYD, *supra* note 1, at 228.

¹⁶⁰ See Hutchings Interview, *supra* note 97 (at approximately 36:10).

¹⁶¹ *Id.* (starting at approximately 40:50).

¹⁶² *Id.* (starting at approximately 45:30).

¹⁶³ AIG 2008 10-K, *supra* note 22, at 3 (“In light of more favorable terms offered by other lenders of securities, AIG accepted cash advanced by borrowers of less than the 102 percent historically required by insurance regulators.”).

¹⁶⁴ See *id.*; Hutchings Interview, *supra* note 97 (at approximately 34:55).

¹⁶⁵ AIG 2008 10-K, *supra* note 22, at 3.

¹⁶⁶ Hutchings Interview, *supra* note 97 (starting at approximately 35:20). Credit Suisse apparently told staff from the Federal Reserve that it resisted overcollateralizing the securities it borrowed, because it did not need the securities and knew AIG was using the transactions to raise cash. Email from Kevin Coffey, Federal Reserve, to Terrence Checki, Federal Reserve et al. (Aug. 14, 2008), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-09-12%20FRBNY%20Email%20re%20AIG%20Meeting%20with%20OTS.pdf (explaining that, contrary to the belief of the Office of Thrift Supervision, the securities AIG was lending were in high demand, and “CSG’s CPC team indicated today that . . . CSG does not need the securities it borrows but instead AIG is using the deals to raise cash. As such, CSG is looking to take a haircut on AIG’s securities as opposed to posting cash to AIG in excess of the securities value which is the market standard”).

¹⁶⁷ AIG 2008 10-K, *supra* note 22, at 143.

¹⁶⁸ See, e.g., *id.* at 67 (noting that in the fourth quarter of 2008, AIG recognized a deemed sale loss of \$2.4 billion “in connection with certain securities lending transactions, [therefore] AIG met the requirements of sale accounting

under FAS 140 because collateral received was insufficient to fund substantially all of the cost of purchasing replacement assets for the securities lent to various counterparties”).

¹⁶⁹ In 2009, the Securities and Exchange Commission held a roundtable on securities lending, during which problems that securities lenders faced during the crisis were discussed. *SEC Roundtable, supra* note 98.

¹⁷⁰ *Id.* at 81–82 (statement of Ed Blount, Founder & Executive Director, Center for the Study of Financial Market Evolution). *See also id.* at 32 (statement of William Pridmore, independent consultant) (“I don’t think that there’s a major securities lending program that didn’t have some less-than-liquid securities in their cash collateral investment portfolios.”).

¹⁷¹ *See, e.g.,* THOMAS V. CHOLNOKY ET AL., COMPANY UPDATE: AMERICAN INTERNATIONAL GROUP (AIG) 4 (Goldman Sachs Global Investment Research Aug. 18, 2008) (noting that “AIG is said to be one of the more risky securities lending insurance participants”). In a potential indication of the relative risk of the program, one insurance company participant in the lending program that was later sold by AIG received a \$75 million award in an arbitration based on AIG’s poor management of the securities-lending program. At least one of the insurance subsidiaries reportedly raised concerns about the securities lending program’s investment portfolios. *See* BOYD, *supra* note 1, at 247–48 (discussing frustrated attempts by Transatlantic Holdings to understand the securities lending activities); AIG, QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2012, at 57 (2012) (disclosing that AIG was ordered to pay \$75 million in an arbitration proceeding based on allegations of “breach of contract, breach of fiduciary duty, and common law fraud in connection with certain securities lending agency agreements”).

¹⁷² AIG 2008 10-K, *supra* note 22, at 40 (“During September 2008, borrowers began in increasing numbers to request a return of their cash collateral.”).

¹⁷³ Harrington, *supra* note 1, at 792 (explaining that “AIG could have sold other, more liquid assets to meet security lending collateral demands,” if there had been any available). For a window into the magnitude of these problems, *see* FEDERAL RESERVE BANK OF NEW YORK, AIG MEETING NOTES 1 (Sept. 12, 2008), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-09-12_Federal_Reserve_Bank_AIG_Meeting_Notes.pdf (explaining that “AIG is facing serious liquidity issues that threaten its survival viability”).

¹⁷⁴ *See* AIG 2008 10-K, *supra* note 22, at 3–4 (discussing interaction between liquidity issues and credit rating agency determinations). *See also* Financial Crisis Inquiry Comm’n, Notes of Staff Interview of James M. Mahoney, Federal Reserve Bank of New York 2–3 (Apr. 30, 2010) [hereinafter Mahoney Interview] (discussing the importance of ratings in securities lending).

¹⁷⁵ AIG 2008 10-K, *supra* note 22, at 4.

¹⁷⁶ Hutchings Interview, *supra* note 97 (starting at approximately 44:57).

¹⁷⁷ *See, e.g.,* DELAWARE DEPARTMENT OF INSURANCE, REPORT ON EXAMINATION OF THE LEXINGTON INSURANCE COMPANY AS OF DECEMBER 31, 2008 44 (July 1, 2010), *available at* <http://www.delawareinsurance.gov/departments/berg/ExamReports/LexingtonInsCo2008web.pdf> (reporting that AIG’s holding company “agreed to make the [Lexington Insurance] Company whole for any pretax realized losses due to sales of reinvested collateral during the period August 1, 2007 through August 1, 2008”).

¹⁷⁸ AIG 2007 10-K, *supra* note 12, at 108 (explaining that “the invested securities are carried at fair value with unrealized gains and losses recorded in accumulated other comprehensive income (loss) while net realized gains and losses are recorded in earnings.”).

¹⁷⁹ Other-than-temporary-impairments reflect a judgment that a decline in an affected security’s value will likely not be reversed in the near future. *See* AIG November 2007 Presentation, *supra* note 137, at 36 (describing AIG’s process for assessing whether securities have suffered an “other than temporary decline”).

¹⁸⁰ *See* AIG 2008 10-K, *supra* note 22, at 167 (explaining that AIG had “contributed \$21.5 billion to certain of its Domestic Life Insurance and Domestic Retirement Services subsidiaries, largely related to the “other-than temporary impairment charges for securities lending collateral investments”).

¹⁸¹ *See, e.g.,* Tex. Ins. Code Ann. § 425.121 (Vernon 2007) (permitting insurance companies to engage in securities lending, but placing certain limits on the practice, including a written agreement and a cap of 40 percent of the insurer’s assets).

¹⁸² *See, e.g.,* STATE OF NEW YORK INSURANCE DEPARTMENT, REPORT ON EXAMINATION OF THE TRANSATLANTIC REINSURANCE COMPANY AS OF DECEMBER 31, 2004, at 23 (Mar. 26, 2007), *available at* http://www.dfs.ny.gov/insurance/exam_rpt/19453f04.pdf (noting that the Department approved the company’s securities-lending

agreement in April 1999). The report faulted the insurance company for failing to report that \$670 million of its securities were not in its control, but were lent out in securities-lending transactions. *Id.* at 30–31.

¹⁸³ See, e.g., Kris DeFrain, *Insurance Group Supervision*, CIPR NEWSLETTER (Apr. 2012), available at http://www.naic.org/cipr_newsletter_archive/vol3_ins_group_supervision.htm (describing the long-standing principle that “the most effective regulatory system is one premised on disclosure and regulation of significant intrasystem transactions involving the insurer, and verification by examination when necessary”).

¹⁸⁴ The GAO reported state insurance regulators’ complaints that AIG’s disclosures about securities lending and the resultant losses were limited. GOVERNMENT ACCOUNTABILITY OFFICE, FINANCIAL CRISIS: REVIEW OF FEDERAL RESERVE SYSTEM ASSISTANCE TO AMERICAN INTERNATIONAL GROUP, INC. 15 (Sept. 2011) [hereinafter GAO AIG REPORT], available at <http://www.gao.gov/new.items/d11616.pdf>. Similarly, the NAIC contends that “AIG’s securities lending portfolio had not been included on the company’s balance sheet due to a liberal interpretation of the accounting requirements; therefore, there was no transparency with regard to how AIG had invested the borrowers’ posted cash collateral.” NAIC REPORT, *supra* note 97. The NAIC has subsequently, partially in response to the problems at AIG, made changes to increase insurance companies’ transparency about their securities-lending portfolios. See *id.* (discussing changes, including new disclosures about the duration of securities-lending arrangements and the maturities of reinvested collateral, risk-based capital charges for on- and off-balance-sheet reinvested collateral, greater on-balance-sheet reporting of reinvested cash collateral, and a new annual Schedule DL to provide a detailed listing of reinvested collateral).

¹⁸⁵ FCIC Hearing Day 2, *supra* note 82, at 206. See also Senate AIG Hearing, *supra* note 5, at 15 (statement of Eric Dinallo, Superintendent, New York State Insurance Department) (explaining that securities lending “was orchestrated and coordinated by the holding company”).

¹⁸⁶ Eric Dinallo, Former Superintendent, New York State Insurance Dep’t, *Written Testimony Before the Financial Crisis Inquiry Comm’n* 15 (July 1, 2010) [hereinafter *Dinallo FCIC Testimony*], available at http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0701-Dinallo.pdf (“As early as July 2006, the New York Department and other state regulators were engaged in discussions about the securities lending program with AIG. Those discussions at first related to the issue of risk-based capital and how the companies were reporting their securities lending program on their financial statements. It was in the course of those discussions that we learned about the details of AIG’s securities lending program.”). See also Ario Statement, *supra* note 25, at 144–45 (contending that AIG’s more aggressive approach to securities lending “came to light in 2006” and “state insurance regulators immediately began working with the companies to deal with” issues related to the collateral reinvestments).

¹⁸⁷ *Dinallo FCIC Testimony*, *supra* note 186, at 22 (Dinallo explained that “[s]tarting in 2007, we did begin to wind down—the New York insurance Department led the group that began to wind down the securities lending”).

¹⁸⁸ See, e.g., TARP and Other Government Assistance for AIG: Hearing Before the Cong’l Oversight Panel, 11th Cong., 2nd Sess. 132 (2010) [hereinafter *COP AIG Hearing*] (statement of Michael Moriarty, Deputy Superintendent for Property and Casualty Markets, New York State Insurance Department) (“When the size of the counterparty lending program in the insurance companies became known to the insurance companies in terms of its size, which was probably in the *beginning* of 2007, we, with other states, worked with AIG to begin to wind down the securities lending in an orderly fashion and did go from a high of \$76 billion in the beginning of 2007 down to \$58 billion right before the implosion of AIG in September of 2008.”) (emphasis added).

¹⁸⁹ See *Dinallo FCIC Testimony*, *supra* note 186, at 16 (“Neither the NYSID nor any other state regulator issued a written directive to AIG to wind down the securities lending business. The lack of a directive is not unusual. First, regulators are usually able to ask for and obtain even substantial changes in insurers’ behavior without having to make a formal, written demand. Insurers recognize that state regulators have substantial power and usually prefer to cooperate. Second, a written request that would be disclosable to the public asking a company to sell a large quantity of securities would alert others to the insurer’s plans thus making sales more difficult and expensive. Also, in the case of securities lending, raising written (and thus public) questions about the program could cause counterparties to contractually end the loans (versus continuing to roll over the loans) and cause forced sales and losses. The state regulators were successfully working with AIG to expeditiously reduce the size of the program in an orderly manner to reduce losses without the complications of a written request.”).

¹⁹⁰ FCIC Staff Interview with Robert Lewis, Chief Risk Officer, AIG (June 15, 2010) (starting at approximately 2:05:40), available at <http://fcic.law.stanford.edu/resource/interviews#L>. See also GAO AIG REPORT, *supra* note 184, at 15, available at <http://www.gao.gov/assets/590/585560.pdf> (“Another state insurance regulator told us that as part of its review, it noted that AIG life insurance companies engaging in securities lending were not correctly

providing information in annual statements or taking an appropriate charge against capital for the securities lending activities. This regulator said it began discussions with the company about securities lending in 2006. AIG told us it was unaware of the regulator’s concerns.”).

¹⁹¹ See *id.* at 13 (“Prior to mid-2007, state regulators had not identified losses in the securities lending program, and the lead life insurance regulator had reviewed the program without major concerns.”).

¹⁹² See, e.g., DELAWARE INSURANCE DEPARTMENT, REPORT ON EXAMINATION OF AIG LIFE INSURANCE COMPANY AS OF DECEMBER 31, 2006, at 39 (May 30, 2008), available at <http://delawareinsurance.gov/departments/berg/ExamReports/AIGLIFE2006web.pdf> (“As of September, 2007, the Company reported approximately \$36.3 million in unrealized losses associated with sub-prime investments. The investments were made in conjunction with the Company’s securities lending activities.”); 2006 TENNESSEE REPORT, *supra* note 123, at 25–26 (noting that the fair value of the investments in AIG’s domestic securities-lending portfolio had fallen \$4.84 billion below amortized cost by the end of 2007 and \$7.845 billion below amortized cost by the end of February, but noting that AIG and the insurance company subsidiary “believe this is a temporary decline in the value of securities lending collateral and is more reflective of the macroeconomic conditions in the marketplace; is unrelated to their credit quality or expected future cash flow performance; and that if held they can reasonably be expected to recover their value.”). Neither regulator made specific securities-lending recommendations.

¹⁹³ For an account of these events, see COP AIG REPORT, *supra* note 3, at 45–46; GAO AIG REPORT, *supra* note 184, at 13–16. GAO did not disclose the identity of the lead life insurance regulator, but Texas has been identified elsewhere as the lead life insurance regulator. See, e.g., COP AIG REPORT, *supra* note 3, at 45.

¹⁹⁴ COP AIG REPORT, *supra* note 3, at 45.

¹⁹⁵ GAO AIG REPORT, *supra* note 184, at 17.

¹⁹⁶ *Id.* at 18 (reporting assessment of Texas Department of Insurance).

¹⁹⁷ COP AIG REPORT, *supra* note 3, at n.168 (“The New York Insurance Department learned of the RMBS purchases in mid-2006; they discovered them when reviewing AIG’s risk-based capital reporting. Because the RMBS were AAA-rated liquid assets at the time, New York did not raise the RMBS purchases as an issue.”).

¹⁹⁸ See GAO AIG REPORT, *supra* note 184, at n.30.

¹⁹⁹ STATE OF NEW YORK INSURANCE DEPARTMENT, CIRCULAR LETTER NO. 16 TO ALL AUTHORIZED INSURERS RE SECURITIES LENDING (July 21, 2008), available at http://www.dfs.ny.gov/insurance/circltr/2008/cl08_16.pdf. Two years later, the Department issued additional securities-lending guidance that, among other things, cautioned against overconcentration in loan-backed or structured securities. STATE OF NEW YORK INSURANCE DEPARTMENT, CIRCULAR LETTER NO. 16 TO ALL AUTHORIZED INSURERS RE PRUDENT PRACTICES FOR INSURERS ENGAGED IN SECURITIES LENDING (Oct. 15, 2010), available at http://www.dfs.ny.gov/insurance/circltr/2010/cl2010_16.htm.

²⁰⁰ See *Dinallo FCIC Testimony*, *supra* note 186, at 17–18 (reporting that review of New York life insurance companies almost uniformly revealed “modest sized programs with highly conservative investments” and that “larger programs had ample liquidity to meet redemptions under stress”).

²⁰¹ COP AIG Hearing, *supra* note 188, at 137 (statement of Michael Moriarty, Deputy Superintendent for Property and Casualty Markets, New York State Insurance Department).

²⁰² COP AIG REPORT, *supra* note 3, at n.107.

²⁰³ For a timeline of the crisis, see FEDERAL RESERVE BANK OF ST. LOUIS, THE FINANCIAL CRISIS: A TIMELINE OF EVENTS AND POLICY ACTIONS, available at <http://timeline.stlouisfed.org/index.cfm?p=timeline>.

²⁰⁴ FCIC Hearing Day 2, *supra* note 82, at 99–100 (statement of Stephen Bensinger, former CFO, AIG).

²⁰⁵ Coffey email, *supra* note 166 (reporting impressions from a meeting between Federal Reserve and Office of Thrift Supervision staff).

²⁰⁶ AIG, CURRENT REPORT ON FORM 8-K (Feb. 11, 2008) (reporting, among other things, that the company was having difficulty valuing its super-senior multisector CDS portfolio and that the company’s auditor, PricewaterhouseCoopers LLC, had “concluded that at December 31, 2007, AIG had a material weakness in its internal control over financial reporting and oversight relating to the fair valuation of the AIGFP super senior credit default swap portfolio”). “A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis.” PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, APPENDIX A TO AUDITING STANDARD NO. 5, A7, available at http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_5_Appendix_A.aspx.

²⁰⁷ FCIC Hearing Day 2, *supra* note 82, at 100 (statement of Stephen Bensinger, former CFO, AIG).

²⁰⁸ AIG 2008 10-K, *supra* note 22, at 3. Boyd points out the incongruity of AIG’s decision to declare a \$0.22 per share dividend in the second quarter of 2008. *See* BOYD, *supra* note 1, at 268 (pointing out the incongruity between AIG’s dividend policy and its need for capital). These payments were made on September 19, 2008, just days after the government rescue. AIG 2008 10-K, *supra* note 22, at 153. AIG also repurchased 37,926,059 shares during the first six months of 2008 to fulfill existing commitments. *Id.* at 295. During the summer of 2008, the company also had considered having the insurance companies join the Federal Home Loan Bank System so they could borrow money through them, but abandoned the plan upon realizing the money would have been trapped at the insurance subsidiaries. *See* GAO AIG REPORT, *supra* note 184, at 19.

²⁰⁹ *See, e.g.*, MOODY’S INVESTOR SERVICES, MOODY’S DOWNGRADES AIG (SENIOR TO AA3) AND CERTAIN SUBSIDIARIES (May 22, 2008), *available at* https://www.moody.com/research/Moodys-downgrades-AIG-senior-to-AA3-and-certain-subsidiaries--PR_156099 (noting the domestic life insurance and retirement services companies’ after-tax capital losses of greater than \$5 billion during the first two quarters of 2008 and downgrading AIG’s domestic life insurance companies to Aa2 from Aa1 because of continued exposure to RMBS, including through securities lending). The report predicted “that AIG will allocate a portion of its new capital to life insurance subsidiaries whose statutory capital has been reduced by [other-than-temporary impairment] of RMBS.” *Id.*

²¹⁰ *See, e.g.*, FEDERAL RESERVE BANK OF NEW YORK, MEMORANDUM: AIG—SUMMARY OF DRIVERS OF POTENTIAL EARNINGS, CAPITAL AND LIQUIDITY ISSUES (Aug. 14, 2008), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-08-14_Federal_Reserve_Bank_AIG_Summary_of_Drivers_of_Potential_Earnings_Capital_and_Liquidity_Issues.pdf (discussing issues such as AIG insurance companies’ investment portfolio’s concentration in structured credit products and the firm’s guaranteed investment contracts, which included rating-sensitive collateral triggers).

²¹¹ AIG, CURRENT REPORT ON FORM 8-K (JUNE 16, 2008) (announcing appointment of Willumstad as CEO on June 15, 2008).

²¹² COP AIG Hearing, *supra* note 188, at 76 (statement of Robert Willumstad, former CEO, AIG).

²¹³ Financial Crisis Inquiry Comm’n Staff Interview of Robert Willumstad, former CEO, AIG (starting at approximately 1:02), *available at* <http://fcic.law.stanford.edu/resource/interviews#W>.

²¹⁴ COP AIG Hearing, *supra* note 188, at 90 (statement of Robert Willumstad). In a July 8, 2008, meeting with Geithner, Willumstad had not raised liquidity concerns. *See* GAO AIG REPORT, *supra* note 184, at 14.

²¹⁵ COP AIG Hearing, *supra* note 188, at 90 (statement of Robert Willumstad).

²¹⁶ The GAO reports a number of internal FRBNY communications and memoranda about the developing problems at AIG, including communications to Geithner, starting on October 25, 2007, and continuing into September 2008. *See* GAO AIG REPORT, *supra* note 184, at 14, 18–19.

²¹⁷ American International Group, *Press Release, AIG Reports Second Quarter 2008 Results* (Aug. 6, 2008), *available at* http://www.aig.com/Chartis/internet/US/en/080608_tcm3171-443239.pdf.

²¹⁸ *See, e.g.*, MOODY’S, RATING ACTION: MOODY’S REITERATES NEGATIVE OUTLOOK ON AIG; US LIFE OPS NEGATIVE (Aug. 7, 2008), *available at* https://www.moody.com/research/Moodys-reiterates-negative-outlook-on-AIG-US-life-ops-negative--PR_160748 (reiterating negative outlook for AIG and its domestic life-insurance companies). Moody’s changed the outlook for the domestic life-insurance and retirement-services subsidiaries to negative to “reflect[] their weakened capital position as a result of persistent” losses related to RMBS). *Id.*

²¹⁹ CHOLNOKY ET AL., *supra* note 171, at 1.

²²⁰ *See* Mahoney Interview, *supra* note 174, at 2 (discussing likely effects of a downgrade).

²²¹ *See* GAO AIG REPORT, *supra* note 184, at 14. GAO references an FRBNY memorandum that “states that AIG’s liquidity position is precarious and that borrowing through [the] Primary Dealer Credit Facility could allow [the] company to unwind its positions in [an] orderly manner while satisfying immediate liquidity demands.” *Id.*

²²² *See* COP AIG REPORT, *supra* note 3, at 61.

²²³ Ian Katz & Hugh Son, *AIG Was Unprepared for Financial Crisis, Former Top Lawyer Says*, BLOOMBERG (Mar. 13, 2010), *available at* <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aYq7MDFtelkc> (reporting remarks Buffett made in a Bloomberg Television interview).

²²⁴ COP AIG Hearing, *supra* note 188, at 126 (statement of Rodney Clark, Managing Director, Standard & Poor’s Financial Services LLC).

²²⁵ *See* GAO AIG REPORT, *supra* note 184, at 22. *See also* COP AIG REPORT, *supra* note 3, at 61 (reporting that AIG had \$8 billion in cash, or two weeks’ worth of liquidity).

²²⁶ *See* GAO AIG REPORT, *supra* note 184, at 22. At the time, that section provided the following:

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal Reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank; *Provided*, That before discounting any such note, draft, or bill of exchange for an individual, partnership, or corporation the Federal Reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.

12 U.S.C. § 343 (2007). Section 13(3) was subsequently modified by the Dodd-Frank Act in a manner that would have precluded its use for an AIG-like targeted rescue of a single company. Dodd-Frank, *supra* note 7, at § 1101.

²²⁷ Dinallo explained the plan as follows:

AIG sought to have certain of its property casualty companies exchange municipal bonds they owned for stock in AIG Life Holdings (U.S.), Inc. and AIG Retirement Services, Inc. (the “Life Company Stock”), intermediate holding company subsidiaries of AIG which own substantial operating insurance companies, and for other assets including certain real estate interests and other investments. AIG would then seek to post these municipal bonds with the Federal Reserve Bank of New York in exchange for cash.

Senate AIG Hearing, *supra* note 5, at 61 (statement of Eric Dinallo).

²²⁸ See email from Patricia Mosser, Federal Reserve Bank of New York, to Alejandro LaTorre, Federal Reserve System (Sept. 13, 2008), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-09-13%20FRBNY%20Email%20re%20AIG-Board%20Call.pdf (summarizing the Federal Reserve’s call with AIG and noting that AIG had proposed to use the securities from the property and casualty companies as collateral for a loan from the Federal Reserve and that “they do not appear to have explored the possibility of borrowing against these assets in the private sector”).

²²⁹ See *COP AIG Hearing*, *supra* note 188, at 133 (statement of Michael Moriarty, Deputy Superintendent, New York State Insurance Department); *Senate AIG Hearing*, *supra* note 5, at 61 (statement of Eric Dinallo).

²³⁰ See Press Release: Governor Paterson Announces New York Will Facilitate Financing Plan for World’s Largest Insurance Provider (Sept. 15, 2008), *available at* http://www.governor.ny.gov/archive/paterson/press/press_0915082.html (quoting Governor Paterson as saying, “AIG’s insurance companies are financially strong, and the Insurance Department will continue to ensure that they remain strong”).

²³¹ *Senate AIG Hearing*, *supra* note 5, at 62 (statement of Eric Dinallo) (explaining that, by the morning of Tuesday, September 16, the state insurance plan was no longer under consideration).

²³² See *COP AIG REPORT*, *supra* note 3, at 63.

²³³ *COP AIG Hearing*, *supra* note 188, at 108–9 (statement of Robert Willumstad).

²³⁴ *Id.* at 109.

²³⁵ See *COP AIG REPORT*, *supra* note 3, at 65–66.

²³⁶ See *COP AIG Hearing*, *supra* note 188, at 112 (statement of Robert Willumstad) (“Mr. Geithner stayed, I’d say for about 10 or 15 minutes. I remember his last words before leaving were that there would be no government assistance and that this had to be a private solution.”).

²³⁷ AIG 2008 10-K, *supra* note 22, at 4.

²³⁸ See *id.*

²³⁹ GAO AIG REPORT, *supra* note 184, at 34.

²⁴⁰ *Id.* at 35. See also *COP AIG REPORT*, *supra* note 3, at 167 (“[T]here was a difference of opinion between the private bankers and the government about the value of the collateral provided by the stock of AIG’s insurance and related subsidiaries.”). COP notes, however, that the assets that the private consortium was looking at could have been different than those FRBNY relied upon and that “the Federal Reserve was entitled to take into account the impact of its intervention on the value of the collateral it was taking.” *Id.* at 267. It appears, however, that FRBNY was still assessing whether the loan was adequately securitized *after* it made the loan. See GAO AIG REPORT, *supra* note 184, at 43 (reporting that FRBNY had “two main objectives during that first week: to understand the company’s liquidity position” and “to verify that the Revolving Credit Facility was secured and that AIG’s draws against it did not exceed the value of posted collateral”).

²⁴¹ FCIC Staff Interview with Mark Feldman, JPMorgan Chase (June 16, 2010) (at approximately 55:30), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-audio/2010-06-16%20FCIC%20staff%20audiotape%20of%20interview%20with%20Mark%20Feldman,%20JPMorgan%20Chase.mp3 (explaining that this “was an assessment that JPMorgan, Morgan Stanley, [and] Goldman Sachs, working alongside the company and representatives of the Fed and the Treasury, all came to”). Feldman went on to explain that “the value of the company was probably insufficient to provide sufficient collateral where you could raise the magnitude of the loan that was being potentially required.” *Id.* at approximately 1:00:30.

²⁴² AIG 2008 10-K, *supra* note 22, at 4–5.

²⁴³ Bd. of Governors of the Fed. Reserve Sys., Press Release (Sept. 16, 2008), *available at* <http://www.federalreserve.gov/newsevents/press/other/20080916a.htm>.

²⁴⁴ *Id.*

²⁴⁵ *Id.*

²⁴⁶ *Id.*

²⁴⁷ Sjostrom, *supra* note 1, offers a detailed description of the bailout.

²⁴⁸ For example, on September 14, 2008, FRBNY staff distributed to Geithner and others a memorandum discussing the pros and cons of a loan to AIG. *See* Email from Alejandro LaTorre to Adam Ashcraft et al. (Sept. 14, 2008), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-09-14%20FRBNY%20Alejandro%20LaTorre%20e-mail%20message%20to%20Timothy%20Geithner.pdf.

²⁴⁹ SIGTARP AIG REPORT, *supra* note 3, at 28.

²⁵⁰ COP AIG Hearing, *supra* note 188, at 103 (statement of Thomas Baxter, General Counsel, FRBNY). *But see* GAO AIG REPORT, *supra* note 184, at 123 (finding that the loan terms were “considerably more onerous than the contemplated private deal”). Understanding the basis for the decision is made more difficult by the fact that the Federal Reserve Board of Governors, which voted to approve the loan to AIG, did not receive a formal analysis in support of the staff’s recommendation. *See id.* at 31.

²⁵¹ *See* GAO AIG REPORT, *supra* note 184, at 128 (“FRBNY and AIG both told us they understood at the time the Revolving Credit Facility was established that it was only an interim solution and that additional assistance, or restructuring of the assistance, would be required.”). In addition to the AIG-specific assistance programs, AIG benefited from broadly available relief programs. For example, the Commercial Paper Funding Facility (CPFF), which was announced on October 7, 2008, enabled eligible issuers to sell three-month, unsecured commercial paper to a special-purpose vehicle funded by the Federal Reserve. Participating AIG entities borrowed more than \$15 billion in the first month under the CPFF. *See* AIG, QUARTERLY REPORT FOR THIRD QUARTER OF 2008 ON FORM 10-Q (Nov. 10, 2008), at 53.

²⁵² *See* Sjostrom, *supra* note 1, at 968 (“Notwithstanding the bailout, AIG’s securities lending program continued to impair its liquidity.”).

²⁵³ COP AIG Hearing, *supra* note 188, at 137 (statement of Michael Moriarty, Deputy Superintendent, New York Department of Insurance).

²⁵⁴ *See* Mahoney Interview, *supra* note 174, at 5.

²⁵⁵ AIG 2008 10-K, *supra* note 22, at 166.

²⁵⁶ BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: SECURITIES BORROWING FACILITY FOR AMERICAN INTERNATIONAL GROUP, INC., 2 (undated), *available at* <http://www.federalreserve.gov/monetarypolicy/files/129aigsecborrowfacility.pdf>.

²⁵⁷ *Id.* at n.1.

²⁵⁸ *Id.* at 1.

²⁵⁹ *See, e.g.*, Mahoney Interview, *supra* note 174, at 5 (explaining that AIG insurance companies could not retain the RMBS, as volatile and as prone to credit-rating downgrades and defaults as they were).

²⁶⁰ AIG, AIG Reports Third Quarter 2008 Results (Nov. 10, 2008), *available at* http://www.aig.com/Chartis/internet/US/en/AIG%203Q08%20Press%20Release_tcm3171-443258.pdf.

²⁶¹ *Id.* at 3.

²⁶² *See* Department of the Treasury, Press Release: Treasury to Invest in AIG Restructuring under the Emergency Economic Stabilization Act (Nov. 10, 2008), *available at* <http://www.treasury.gov/press-center/press-releases/Pages/hp1261.aspx>. *See also* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343. AIG was the only recipient of aid under TARP’s Systemically Significant Failing Institutions Program, which was later renamed the “AIG Investment Program.” *See* COP AIG REPORT, *supra* note 3, at 181.

²⁶³ For a description of Maiden Lane II, see COP AIG REPORT, *supra* note 3, at 85–87 and Bd. of Governors of the Fed. Reserve Sys., American International Group (AIG), Maiden Lane II and III, *available at* www.federalreserve.gov/newsevents/reform_aig.htm (last visited Oct. 19, 2013).

²⁶⁴ See COP AIG REPORT, *supra* note 3, at 87–89.

²⁶⁵ By the end of 2008, the securities-lending program was down to \$2.9 billion, which was all in the foreign securities-lending program. AIG, AIG Reports Fourth Quarter and Full Year 2008 Loss 4 (Mar. 2, 2009), *available at* http://library.corporate-ir.net/library/76/761/76115/items/326705/87A66DC4-EE74-41DB-B73A-5FFA80472A43_4Q08_Press_Release.pdf.

²⁶⁶ The Congressional Oversight Panel pointed out, “in many cases AIG was undercollateralized in relation to the securities lending counterparties, who thus returned securities with a greater market value than the collateral that was returned to them.” COP AIG REPORT, *supra* note 3, at 110. Given the market conditions at the time, the securities likely would not have been easy to sell. As the fact that many counterparties had already redeemed illustrates, cash was at a premium during the fall of 2008.

²⁶⁷ On February 28, 2012, the last of the Maiden Lane II assets were sold. The FRBNY’s \$19.5 billion loan to Maiden Lane II was repaid, and the FRBNY received an additional \$2.8 billion. FRBNY, Press Release: New York Fed Sells Remainder of Maiden Lane II Securities; Approximately \$2.8 Billion Net Gain Generated for U.S. Public from the Portfolio (Feb. 28, 2012), *available at* <http://www.newyorkfed.org/newsevents/news/markets/2012/an120228.html>. The gain, of course, must be assessed in light of the risk taken on by the FRBNY when it funded Maiden Lane II and other investment opportunities at the time.

²⁶⁸ For a description of Maiden Lane III, see COP AIG REPORT, *supra* note 3, at 91–94, and Bd. of Governors of the Fed. Reserve Sys., American International Group (AIG), Maiden Lane II and III, *available at* www.federalreserve.gov/newsevents/reform_aig.htm (last visited Oct. 19, 2013).

²⁶⁹ See, e.g., Steven M. Davidoff, *Understanding the A.I.G. Dispute*, N.Y. TIMES, Jan. 20, 2010, *available at* http://dealbook.nytimes.com/2010/01/20/understanding-the-aig-dispute/?_r=0. For a discussion of payments to AIGFP’s CDS counterparties, see generally SIGTARP AIG REPORT, *supra* note 3. As the Congressional Oversight Panel noted, however, the securities-lending counterparties received payments of “comparable” size, yet “much less attention has been paid to payouts to securities lending counterparties.” COP AIG REPORT, *supra* note 3, at 103–4. Likewise, the fact that the people at the center of AIG’s securities-lending program retained their jobs throughout the crisis and beyond has received little attention. BOYD, *supra* note 1, at 302–3 is an exception.

²⁷⁰ Andrew Ross Sorkin & Mary Williams Walsh, *A.I.G. Reports Loss of \$61.7 Billion as U.S. Gives More Aid*, N.Y. TIMES (Mar. 2, 2009), *available at* <http://www.nytimes.com/2009/03/03/business/03aig.html?pagewanted=all>.

²⁷¹ AIG 2008 10-K, *supra* note 22, at 65.

²⁷² COP AIG REPORT, *supra* note 3, at 94.

²⁷³ See *id.* at 94–97.

²⁷⁴ Sandy Praeger, Kansas Insur. Comm’r and Pres., NAIC, Letter to the Editor, WALL ST. J., Sept. 26, 2008 [hereinafter Praeger WALL ST. J. Letter]. See also COP AIG Hearing, *supra* note 188, at 145 (statement of Michael Moriarty, Deputy Superintendent for Property and Casualty Markets, New York State Insurance Department) (“We do not believe that the existing policyholders of the AIG property and casualty companies for sure or even the life insurance companies would have suffered any losses should there—would there have been a bankruptcy of the AIG holding company system. . . . The life insurance subsidiaries would have suffered significant losses and the cushion, which we call surplus, which is effectively capital between assets and liabilities, would have taken a severe hit, but we still think it would have been positive.”). State regulators also argued that AIG’s securities-lending problems would not have spilled over to its counterparties. See, e.g., *id.* at 140 (“Whatever the AIG insurance companies’ losses on securities lending, those losses should not have created serious problems for other financial institutions, which were protected by the fact that they held and could keep the securities they borrowed if AIG could not return the collateral they provided.”).

²⁷⁵ Ario Statement, *supra* note 25, at 4.

²⁷⁶ Dinallo FCIC Testimony, *supra* note 186, at 14–15.

²⁷⁷ Bernanke Letter, *supra* note 3, *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/TBTF/Chairman%20Bernanke%20Follow%20Up.pdf (arguing that “even if the Federal Reserve had been able to fund Lehman to the extent of its available unencumbered assets, this volume of unsecured claims and total claims illustrate that Lehman’s collateral available to secure such a loan would likely have been insufficient”).

²⁷⁸ *Id.* at 13. The fact that AIG’s near-bankruptcy came after Lehman’s filing was another key distinction between the two. FRBNY’s general counsel explained it this way:

When AIG came for a decision the day after Lehman’s bankruptcy . . . many neighborhoods were on fire and burning embers filled the air. This is the principal reason why the Federal Reserve needed to take action with AIG. In the unique time and context of September 2008, it would have been unconscionable to allow another major blaze when you had a reasonable alternative.

COP AIG Hearing, supra note 188, at 41 (statement of Thomas Baxter, General Counsel, FRBNY).

²⁷⁹ Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve’s Response to the Financial Crisis, Lecture 21 (Mar. 27, 2012), *available at* <http://www.federalreserve.gov/newsevents/files/chairman-bernanke-lecture3-20120327.pdf>.

²⁸⁰ *See* About AIG: Pre-September 2008: The AIG Crisis, *available at* http://www.aigcorporate.com/aboutaig/pre_september_2008.html (last visited Oct. 19, 2013) (“It is important to reiterate that throughout the crisis, AIG’s insurance businesses were—and continue to be—healthy and well capitalized. The losses that occurred as a result of AIGFP’s actions have no direct impact on AIG policyholders. AIG’s insurance companies are closely regulated, and their reserves are protected with adequate assets to meet policyholder obligations.”).

²⁸¹ NATIONAL ASSOCIATION OF INSURANCE COMM’RS, THE UNITED STATES INSURANCE FINANCIAL SOLVENCY FRAMEWORK 4 (2010) [hereinafter NAIC SOLVENCY FRAMEWORK], *available at* http://www.naic.org/documents/committees_e_us_solvency_framework.pdf. *See also* Ario Statement, *supra* note 25, at 3 (explaining that the core governing principle for insurance regulators is “the requirement that insurers hold conservative reserves to ensure that they can honor their obligations to policyholders and claimants”).

²⁸² *See* NAIC SOLVENCY FRAMEWORK, *supra* note 281, at 2 (“Ultimate regulatory responsibility for insurer insolvency rests with each state insurance department and the state insurance Commissioner (sometimes also known as the Administrator, Director or Superintendent of Insurance). State insurance departments are assisted by the NAIC, which is a voluntary organization of the Commissioners of the state insurance departments.”).

²⁸³ NAIC, RISK-BASED CAPITAL: GENERAL OVERVIEW 1 (July 15, 2009) [hereinafter NAIC RBC OVERVIEW], *available at* http://www.naic.org/documents/committees_e_capad_RBCoverview.pdf.

²⁸⁴ *See, e.g.*, AIG 2008 10-K, *supra* note 22, at 18 (“In the U.S., the Risk-Based Capital (RBC) formula is designed to measure the adequacy of an insurer’s statutory surplus in relation to the risks inherent in its business. Thus, inadequately capitalized general and life insurance companies may be identified. The U.S. RBC formula develops a risk-adjusted target level of statutory surplus by applying certain factors to various asset, premium and reserve items. Higher factors are applied to more risky items and lower factors are applied to less risky items. Thus, the target level of statutory surplus varies not only as a result of the insurer’s size, but also based on the risk profile of the insurer’s operations.”).

²⁸⁵ AIG, 2010 Annual Report on Form 10-K, at 22.

²⁸⁶ For a general discussion of risk-based capital, *see* NAIC RBC OVERVIEW, *supra* note 283. *See also* GENERAL ACCOUNTING OFFICE, RISK-BASED CAPITAL: REGULATORY AND INDUSTRY APPROACHES TO CAPITAL AND RISK 163–65 (July 1998), *available at* <http://www.gao.gov/assets/160/156259.pdf> (discussing adequate risk-based capital determinations for life insurers).

²⁸⁷ NAIC RBC OVERVIEW, *supra* note 283, at 4.

²⁸⁸ *Id.* at 5. (“This situation can occur while the insurer still has a positive level of capital and surplus; although a number of companies that trigger this action level are technically insolvent (liabilities exceed assets).”).

²⁸⁹ *Id.* at 4.

²⁹⁰ *Id.* at 5.

²⁹¹ *Id.*

²⁹² *See* NAIC SOLVENCY FRAMEWORK, *supra* note 281, at 19–20 (noting that “broad authority for determining if an insurer is considered to be in a hazardous financial condition is an important part of the US system” and describing broad corrective and preventive measures that regulators can take).

²⁹³ *See, e.g.*, *Dinallo FCIC Testimony, supra* note 186, at 3 (“While there is no question that the insurance subsidiaries would have had losses from the program, the losses were manageable and would not have made the insurance subsidiaries *as a group* insolvent.”) (emphasis added).

²⁹⁴ *The Impact of the Dodd-Frank Act: What It Means to Be a Systemically Important Financial Institution: Hearing Before the Financial Institutions and Consumer Credit Subcomm. of the House Comm. on Financial Services*, 112th Cong., 2nd Sess. 51 (2012) (statement of Professor Scott E. Harrington).

²⁹⁵ See *supra* notes 227–231 and 242 and accompanying text.

²⁹⁶ See AIG 2008 10-K, *supra* note 22, at 18 (“The statutory surplus of each of AIG’s AIG Property Casualty Group and U.S.-based Life Insurance subsidiaries exceeded their RBC minimum required levels as of December 31, 2008.”). There was still room for improvement. See *COP AIG Hearing*, *supra* note 188, at 180 (addendum to Statement of Robert Benmosche, AIG President and Chief Executive Officer) (citing as an accomplishment in early 2009 “strengthening [the] capital base” of AIG’s insurance subsidiaries).

²⁹⁷ See, e.g., GAO, Troubled Asset Relief Program: Status of Government Assistance Provided to AIG 77 (Sept. 2009), available at <http://www.gao.gov/assets/300/295521.pdf> (“[W]ithout capital contributions, adjusted capital would not have been adequate to cover losses in 2008.”).

²⁹⁸ See, e.g., *Dinallo FCIC Testimony*, *supra* note 186, at 17 (“[E]ven if there had been a run on the securities lending program with no federal rescue, our detailed analysis indicated that the AIG life insurance companies would have been solvent. Certainly, there would have been losses, with some companies hurt more than others. But we believe that there would have been sufficient assets in the companies and in the parent to maintain the solvency of all the companies.”). See also *COP AIG REPORT*, *supra* note 3, at 57 (“The regulators have stated that, had it not been for the ‘run’ by securities lending counterparties, caused by the public liquidity crunch at AIGFP, the insurance subsidiaries would have been able to gradually wind down the program without significant assistance from the parent.”) (citations omitted).

²⁹⁹ David J. Merkel, To What Degree Were AIG’s Operating Insurance Subsidiaries Sound? 13 (Apr. 28, 2009) available at <http://alephblog.com/wp-content/uploads/2009/04/To%20What%20Degree%20Were%20AIG%E2%80%99s%20Operating%20Subsidiaries%20Sound.pdf>.

³⁰⁰ *COP AIG REPORT*, *supra* note 3, at 135 (citing FRBNY and Treasury briefing with panel and with panel staff) (Apr. 12, 2010).

³⁰¹ *COP AIG REPORT*, *supra* note 3, at n.445. See also *id.* at 153 (concluding that “there is at least some concern that a number of the insurance subsidiaries may have been less solvent than generally believed at the time—as seen by the amount of government assistance they received to recapitalize and meet their obligations”).

³⁰² AIG 2008 10-K, *supra* note 22, at 297.

³⁰³ *Id.* at 298.

³⁰⁴ *Id.* at 167. As in other contexts, some have pointed to the role that mark-to-market accounting played. See, e.g., *FCIC Hearing Day 2*, *supra* note 79, at 208–9 (statement of Eric Dinallo) (“Insurance companies do statutory accounting, and we can debate the wisdom, but it does permit you to take a long dated risk and match it to an asset, and basically manage yourself out of some poor decisions because you really only have to make sure that when the person, God forbid, passes away so to speak, dies, you have the asset to match against that liability. There’s a big debate I believe whether securities lending should be permitted for insurance companies because in a sense it exposes their statutory accounting to the mark to market accounting of investment banks, which is clearly what started to happen.”).

³⁰⁵ AIG 2008 10-K, *supra* note 22, at 167. See also *id.* at 202 (emphasis added).

³⁰⁶ STATE OF NEW YORK INSURANCE DEPARTMENT, REPORT OF THE FINANCIAL CONDITION OF THE AMERICAN INTERNATIONAL LIFE ASSURANCE COMPANY OF NEW YORK 22 (Jan. 30, 2009) [hereinafter AILAC REPORT], available at http://www.dfs.ny.gov/insurance/exam_rpt/60607f07.pdf (“participants in the securities lending program recorded significant capital losses”).

³⁰⁷ *Senate AIG Hearing*, *supra* note 5, at 67 (statement of Eric Dinallo).

³⁰⁸ *Id.* at 67. One of these companies, American International Life Assurance Company of New York, the capital surplus of which was \$552.6 million at the end of 2007, received \$951.8 million in capital contributions during 2008. AILAC REPORT, *supra* note 306, at 21.

³⁰⁹ AIG 2008 10-K, *supra* note 22, at 50 (“During the year ended December 31, 2008 and through February 27, 2009, AIG contributed capital totaling \$22.7 billion (\$18.0 billion of which was contributed using borrowings under the Fed Facility) to certain of its Domestic Life Insurance and Domestic Retirement Services subsidiaries to replace a portion of the capital lost as a result of net realized capital losses (primarily resulting from other-than-temporary impairment charges.)”).

³¹⁰ *FCIC Hearing Day 2*, *supra* note 82, at 228 (statement of Eric Dinallo).

³¹¹ Gensler Speech, *supra* note 2.

³¹² See, e.g., *FCIC Hearing Day 1*, *supra* note 5, at 53, 56 (statement of Michael Greenberger) (“If the exchange trading had been involved, the regulators would have known that AIG was buying these positions like crazy. The

Fed, the Treasury, the CFTC, and probably state insurance regulators would have said: What are they doing here? They're running up this phenomenal risk. . . . And in a clearing situation, the clearinghouse twice a day would have gone back to AIG and said, hey, you lost a million dollars today. Post the margin. Maybe at noon they would have done that. At five o'clock, another million.”).

³¹³ *Economic and Budget Challenges for the Short and Long Term: Hearing Before the Senate Comm. on Budget*, 111th Cong., 1st Sess. 19 (2009) (statement of Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.), available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg70993/pdf/CHRG-111shrg70993.pdf>.

³¹⁴ *Senate AIG Hearing*, *supra* note 5, at 55 (statement of Scott M. Polakoff, Acting Director, OTS).

³¹⁵ See, e.g., Praeger WALL ST. J. Letter, *supra* note 274 (arguing that “[t]he proposal to create a federal insurance regulator is a solution in search of a problem”). Ario Statement, *supra* note 25, at 3 (pointing out that other regulators were not as good as insurance regulators at regulating capital: “[t]he concept sounds simple enough—companies must practice sound risk management by setting aside funds to pay obligations down the road—but it is a concept that other segments of the financial sector have failed to enforce”); *Senate AIG Hearing*, *supra* note 5, at 57 (statement of Eric Dinallo, Superintendent, New York Department of Insurance) (“[W]hat happened at AIG demonstrates the strength and effectiveness of State insurance regulation, not the opposite.”); Jeffrey E. Thomas, *Insurance Perspectives on Federal Financial Regulatory Reform: Addressing Misunderstandings and Providing a View from a Different Paradigm*, 55 VILL. L. REV. 773, 800 (2010) (“The financial crisis and the collapse of AIG certainly suggest that something is amiss in the regulatory environment in the United States. However, that “something” is not insurance regulation.”).

³¹⁶ Professor Harrington warned of this risk. SCOTT E. HARRINGTON, INSURANCE REGULATION AND THE DODD-FRANK ACT 13 (Networks Financial Institute Policy Brief 2011) (“The history of federal deposit insurance and ‘too big to fail’ policy creates some risk that optional federal chartering could expand government guarantees of insurers’ obligations, undermining market discipline and incentives for safety and soundness, and increasing the likelihood of future federal bailouts of insurance companies.”). See also Viral V. Acharya et al., *On the Financial Regulation of Insurance Companies* § 4 (New York University Stern School of Business White Paper 2009) (recommending a federal insurance regulator and asking whether “the Federal Charter would lead to a Federal FDIC like guarantee”).

³¹⁷ GAO AIG REPORT, *supra* note 184, at 23 (reporting that the Federal Reserve had conducted an analysis “of the systemic risk AIG posed to the financial system” the weekend before Lehman’s bankruptcy in which “historical equity returns of AIG were assessed, with a conclusion that the company was not systemically important”).

³¹⁸ See, e.g., COP AIG REPORT, *supra* note 3, at 148 (“[T]he evidence shows that long after September 16, 2008, and indeed well into 2009, the government was still considering the possibility of some form of bankruptcy for at least part of AIG.”) (citing, *inter alia*, FRBNY and Treasury briefings with COP); GAO AIG REPORT, *supra* note 184, at 39–42 (reporting that FRBNY continued to consider bankruptcy as an option after the initial bailout).

³¹⁹ GAO AIG REPORT, *supra* note 184, at 41.

³²⁰ Sjostrom, *supra* note 1, at 979 (stating that “AIG was likely overselling the impact of its collapse in an effort to secure a bailout and avoid bankruptcy”). Sjostrom’s point about AIG’s attempts to present as grim a picture as possible is bolstered by a March 6, 2009, presentation, in which AIG listed twenty pages of reasons why the company could not be allowed to fail, ranging from the size and scope of AIG’s insurance business to the message the government would send by pulling support mid-stream from AIG. AIG, AIG: Is the Risk Systemic? (Draft not intended to be updated—Mar. 6, 2009), available at http://www.aig.com/aigweb/internet/en/files/AIG%20Systemic%20Risk2_tcm385-152209.pdf (The presentation, made for the purpose of ensuring continued government support, concluded with the statement that “[i]nsurance is the oxygen of the free enterprise system. Without the promise of protection against life’s adversities, the fundamentals of capitalism are undermined.”).

³²¹ See GAO AIG REPORT, *supra* note 184, at 36 (reporting government officials’ fear that seizures of insurance subsidiaries would follow AIG’s bankruptcy and three state insurance regulators’ statements that they would seize insurance subsidiaries). State regulators, however, told GAO that they would not have seized the subsidiaries, unless they were insolvent, which they did not believe they would have been. *Id.* at 36–37. But see David E. Wood, *If AIG Enters Bankruptcy Would Insurer Subsidiaries—and Their Policyholders—Be at Risk?*, 7 ENFORCE 10–14, available at <http://www.andersonkill.com/webpdfext/publications/wbenf/pdf/enforce-vol7-issue1.pdf> (arguing that, even if the insurance companies were solvent, “facing the prospect of an AIG creditor-led run on subsidiary assets, state regulators will be incentivized to preemptively institute delinquency proceedings to protect the assets of the AIG insurance subsidiaries”). Boyd reports, for example, that Doug Slape of the Texas Department of Insurance was

considering, in the days before the AIG bailout, whether it needed to seize the Texas AIG subsidiaries. BOYD, *supra* note 1, at 280.

³²² See COP AIG REPORT, *supra* note 3, at 117 (discussing potential for an AIG bankruptcy to trigger assessments on other insurers, if one or more subsidiaries were undercapitalized). See also Viral V. Acharya et al., *On the Financial Regulation of Insurance Companies* (New York University Stern School of Business White Paper 2009), available at <http://web-docs.stern.nyu.edu/salomon/docs/whitepaper.pdf> (“losses in A.I.G.’s insurance businesses were as large as those in A.I.G.’s Capital Markets and probably beyond the capacity of the New York and Pennsylvania State Guarantee Funds”); MERKEL, *supra* note 1 (“The US government acted for multiple reasons on AIG. Among them was to protect the other life insurers of the US from getting surcharged in order to pay for the costs going to the guarantee funds, along with systemic risk issues at AIG Financial Products (which was much bigger).”). See also PETER G. GALLANIS, NOLGHA, THE LIFE AND HEALTH INSURANCE GUARANTY SYSTEM AND THE FINANCIAL CRISIS OF 2008–2009 10 (2009) (“The theoretical maximum of assessments that may be collected across the guaranty system in a given year can be roughly calculated by applying each state’s ‘assessment cap’ to the total of the currently assessable premiums within the state, and adding those amounts for all 52 [guaranty associations]. That exercise generates a theoretical national assessment maximum for the current year of approximately \$8.8 billion, including about \$4.7 billion regarding life and annuity premiums (generally available only to cover consumer benefits for life and annuity business) and \$4.1 billion regarding health premiums (generally available only to cover health benefits).”).

³²³ See COP AIG REPORT, *supra* note 3, at 119.

³²⁴ See Department of the Treasury, Press Release: Financial Stability Oversight Council Makes First Nonbank Financial Company Designations to Address Potential Threats to Financial Stability (July 9, 2013), available at <http://www.treasury.gov/press-center/press-releases/Pages/jl2004.aspx>.

³²⁵ See DEPARTMENT OF THE TREASURY, THE FINANCIAL CRISIS FIVE YEARS LATER: RESPONSE, REFORM, AND PROGRESS 21, 23 (2013), available at <http://www.treasury.gov/connect/blog/Pages/The-Financial-Crisis-Five-Years-Later.aspx> (celebrating a “\$22.7 B positive return to taxpayers,” but acknowledging that this “represent[s] gains on a cash in/cash out basis (not including financing or administrative costs)”).