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AIG Liquidity and Access to the PDCF
Danielle Vicente September 2, 2008

AIG’s current liquidity position is precarious and asset liability management appears inadequate given the firm’s substantial off balance sheet liquidity needs. Although the insurance company has a large securities portfolio, which totals $835 billion, liquidating sufficient assets to fund their liabilities would result in substantial realized losses and potentially impact market prices. Borrowing through the Primary Dealer Credit Facility could potentially allow AIG to unwind its positions in an orderly manner while satisfying its immediate liquidity demands, although it is questionable whether such a facility is necessary for the survival of the firm.

Volatile funding

AIG is vulnerable to “runs” on a portion of its liabilities. This funding is generally susceptible to run-off risk; risk that these liabilities would not be rolled over. Although they total nearly $100 billion, these liabilities represent less than 10% of assets. As of second quarter 2008, volatile funding consists of:

- repurchase transactions- $9.7 billion
- securities lending- $75 billion
- commercial paper and extendable notes- $15 billion

Off-balance sheet commitments

The primary concern for the insurance company’s liquidity position is not volatile funding but rather its off-balance sheet commitments. Unlike liabilities on-balance sheet, the effect of these commitments on the firm’s liquidity can be difficult to forecast. In the near term, possible commitments that could strain liquidity are:

- Collateral calls in the event of a downgrade – minimum of $10.5 billion
- Contract terminations in the event of a downgrade- minimum of $4.6 billion
- Put options exercised but not yet funded- $1.5 billion
- Other commitments (such as private equity, etc.)- $17 billion

These commitments that could require funding at any moment, and if events trigger margin calls and contract terminations, it is less likely that the volatile funding will be rolled over.

Other noteworthy aspects of their liquidity

Additionally, the following short term liabilities come due within the next year:

- Guaranteed investment contracts- $9.4 billion
- Current portion of long term debt- $28 billion

AIG has available $4 billion in revolving credit facilities. However, it is unclear whether $3 billion has already been designated to support put options.
What are the main concerns of AIG’s current liquidity position?

Liability runs: not just a banking problem

AIG is an active securities lender; the firm takes a large portion of its securities and lends them to institutions and investors who pledge collateral against these securities. AIG then takes the collateral and invests it in assets with longer durations in order to earn a spread. This is possible because the liabilities due to the investors are normally rolled over. Currently, AIG’s assets associated with securities lending are experiencing losses, and are valued at $59.5 billion, less than the $75.1 billion in liabilities.

Potential liquidity need: Securities lending contracts range in maturity from one day to six months. Given the current operating environment, roll over risk is substantial, and could mirror a run on deposits. Therefore, AIG’s potential overnight liquidity needs for securities lending varies, but is limited to $75 billion.

Collateral calls: in the long run, we’re all dead

AIG sold $80 billion of multi-sector CDO protection (notional). The ultimate economic losses on the book are difficult to determine at this time. Both independent analysts and AIG’s management have continually increased their estimates, however, management doubts the current estimated losses will materialize. Nevertheless, as unrealized losses grow, margin calls will require the firm to post additional collateral. This CDS book has recorded losses of $26.1 billion to date and AIG has posted $16.5 billion of collateral.

If the firm is downgraded by one notch by a single rating agency, collateral postings of $10.5 billion would be required for Guaranteed Investment Agreements and other financial derivatives. The collateral call would increase to $13.3 billion both S&P and Moody’s downgrade AIG.¹

Potential liquidity need: Margin calls on this CDS book can create an immediate funding need that requires AIG to sell assets under duress.

Contract terminations: downgrades hinder liquidity

If the firm is downgraded by one notch by a single rating agency, $4.6 billion of the CDS written on multi-sector CDOs would be terminated. Terminations would increase to $ 5.4 billion if both agencies downgrade AIG.

The settlement of these CDSs contracts would imply a full cash outflow. Goldman’s equity report points out that protection written on CDOs are often settled physically; meaning that AIG would actually purchase these debt securities at par. So a contract with

¹These estimates were calculated before Fitch announced its review of AIG’s ratings. If all three agencies downgrade the firm, the collateral calls and contract terminations will increase.
a $100 loss may imply a cash outflow of $1000 to purchase the security, now valued at $900 on the market.

Additionally, AIG is has $8.2 billion of CDS contracts that require the firm to maintain a certain level of over-collateralization. Should the firm not comply with these provisions, the contracts would also be terminated.

Potential liquidity need: Contract settlements on this CDS book imply a large cash outflow when combined with the margin calls.

Commitments that could come back to bite them

AIG sold $11.3 billion of put options that may require the firm to buy CDOs backed by CMBS and hold them from three to six years. The firm has committed liquidity lines of $3 billion to support some of these options, but of the $1.6 billion that have experienced default triggers, only $100 million has been funded and the remaining $1.5 billion. The unrealized loss in the second quarter in this portfolio is $800 million.

Potential liquidity need: In addition to the $1.5 billion in unfunded options that have been exercised, cash will be needed to support the remaining unexercized options.

What are the perspectives of the ratings agencies?

All three major rating agencies have placed AIG on watch for downgrades. S&P is not focused on liquidity concerns as of yet, but rather earnings volatility. They seem to delay any action until the third quarter, in hopes that management will find some way to deal with the potential losses and poor operating performance of the subsidiaries. Moody’s expects that management will “actively address potential liquidity and capital needs.” Fitch was the last of the agencies to put the firm under review.

In general, rating methodologies for insurance firms have not incorporated analysis of liquidity in the way we analyze bank liquidity. Insurance company liquidity considerations have been focused on cash flow ratios, total investments, committed bank lines, leverage and interest coverage.

Market sentiment believes the rating agencies will require more capital of AIG to maintain its current ratings, especially as the firm is expected to make additional contributions to some subsidiaries. At year end 2006, S&P believed financial leverage would remain around 20% or less. Today, financial leverage stands at 32.4%. The firm’s capital structure was 81% equity in 2007 and is now less than 70% equity due to hybrid instruments.
How do analysts see AIG?

Market sentiment is against buying credit or equity related to AIG. Review reports by Goldman, Lehman, Citigroup, and analysts seem concerned with the extent of losses in the CDS and investment portfolios, rating agency actions on the firm, and the subsequent impacts on capital. Additionally, they worry about downgrades on AAA MBS assets that are currently benefiting from subordination, and the consequences it will have on AIG subsidiaries.

Goldman was especially concerned over liquidity. Their analyst believes AIG management and rating agencies are denial about the extent of economic losses that is expected and hint that management is not prepared to deal with the magnitude of challenges facing the firm.