https://www.wsj.com/articles/SB122156561931242905

U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up

Emergency Loan Effectively Gives Government Control of Insurer;

Historic Move Would Cap 10 Days That Reshaped U.S. Finance

By Matthew Karnitschnig , Deborah Solomon , Liam Pleven and Jon E. Hilsenrath
Sept. 16, 2008 11:59 pm ET

The U.S. government seized control of American International Group Inc. AIG -1.19% ▼ -- one of the world's biggest insurers -- in an $85 billion deal that signaled the intensity of its concerns about the danger a collapse could pose to the financial system.

The step marks a dramatic turnabout for the federal government, which had been strongly resisting overtures from AIG for an emergency loan or some intervention that would prevent the insurer from falling into bankruptcy. Just last weekend, the government essentially pulled the plug on Lehman Brothers Holdings Inc., allowing the big investment bank to go under instead of giving it financial support. This time, the government decided AIG truly was too big to fail.

Businessmen leave an American International Group office building Tuesday in New York.
ASSOCIATED PRESS

The U.S. negotiators drove a hard bargain. Under terms hammered out Tuesday night, the Fed will lend up to $85 billion to AIG, and the U.S. government will effectively get a 79.9%

equity stake in the insurer in the form of warrants called equity participation notes. The two-year loan will carry an interest rate of Libor plus 8.5 percentage points. (Libor, the London interbank offered rate, is a common short-term lending benchmark.)

The loan is secured by AIG's assets, including its profitable insurance businesses, giving the Fed some protection even if markets continue to sink. And if AIG rebounds, taxpayers could reap a big profit through the government's equity stake.

"This loan will facilitate a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy," the Fed said in a statement.

It puts the government in control of a private insurer -- a historic development, particularly considering that AIG isn't directly regulated by the federal government. The Fed took the highly unusual step using legal authority granted in the Federal Reserve Act, which allows it to lend to nonbanks under "unusual and exigent" circumstances, something it invoked when Bear Stearns Cos. was rescued in March.

As part of the deal, Treasury Secretary Henry Paulson insisted that AIG's chief executive, Robert Willumstad, step aside. Mr. Paulson personally told Mr. Willumstad the news in a phone call on Tuesday, according to a person familiar with the call.

Mr. Willumstad will be succeeded by Edward Liddy, the former head of insurer Allstate Corp. ALL **-0.66%** ▼

AIG's bailout caps a tumultuous 10 days that have remade the American financial system. In that time, the government has engineered rescues that insert it deep into the housing and insurance industries, while Wall Street has watched two of its last four big independent brokerage firms exit the scene.

The U.S. on Sept. 6 took over mortgage-lending giants Fannie Mae and Freddie Mac as they teetered near collapse. This Sunday, the U.S. refused to bail out Wall Street pillar Lehman Brothers, which filed for bankruptcy-court protection and is now being sold off in pieces. That same day, another struggling Wall Street titan, Merrill Lynch & Co., agreed to sell itself to Bank of America Corp. BAC **-1.39%** ▼

The AIG deal followed a day of high drama in Washington. The Treasury's Mr. Paulson and Federal Reserve Chairman Ben Bernanke convened in the early evening an unexpected meeting of top congressional leaders. Late in the trading day Tuesday, anticipation that the government might assist the insurer helped propel the Dow Jones Industrial Average to a 1.3% gain.

In bailing out AIG, the Federal Reserve appeared to be motivated in part by worries that Wall Street's financial crisis could begin to spill over into seemingly safe investments held by small investors, such as money-market funds that invest in AIG debt.

Indeed, on Tuesday the $62 billion Primary Fund from the Reserve, a New York money-market firm, said it "broke the buck" -- that is, its net asset value fell below the $1-a-share level that funds like this must maintain. Breaking the buck is an extremely rare occurrence. The fund was pinched by investments in bonds issued by now collapsing Lehman Brothers.

Money-market funds are supposed to be among the safest investments available. No fund in the $3.6 trillion money-market industry has lost money since 1994, when Orange County, Calif., went bankrupt. A number of money-market funds own securities issued by AIG. The firm is also a big insurer of some money-market instruments.

Credit Downgrade

AIG's financial crisis intensified Monday night when its credit rating was downgraded, forcing it to post $14.5 billion in collateral. The insurer has far more than that in assets that it could sell, but it could not get the cash quickly enough to satisfy the collateral demands. That explains the interest in obtaining a bridge loan to carry it through. AIG's board approved the rescue Tuesday night.

AIG's board said in a statement that the deal would "protect all AIG policyholders, address rating agency concerns and give AIG the time necessary to conduct asset sales on an orderly basis."

The final decision to help AIG came Tuesday as the federal government concluded it would be "catastrophic" to allow the insurer to fail, according to a person familiar with the matter. Over the weekend, federal officials had tried to get the private sector to pony up some funds. But when that effort failed, Fed Chairman Bernanke, New York Fed President Timothy Geithner and Treasury Secretary Paulson concluded that federal assistance was needed to avert an AIG bankruptcy, which they feared could have disastrous repercussions.

Staff from the Federal Reserve and Treasury worked on the plan through Monday night. President George W. Bush was briefed on the rescue Tuesday afternoon during a meeting of the President's Working Group on Financial Markets.

That the government would prop up AIG financially offers a stark indication of the breadth of the insurer's role in the global economy. If it were to have trouble meeting its obligations, the potential domino effect could reach around the world.

For one thing, banks and mutual funds are major holders of AIG's debt and could take a hit if the insurer were to default. In addition, AIG was a major seller of "credit-default swaps," essentially insurance against default on assets tied to corporate debt and mortgage securities. Weakness at AIG could force financial institutions in the U.S., Europe and Asia that bought these swaps to take write-downs or losses.

CRISIS ON WALL STREET

- Real Time Econ: Here Be Dragons | Fed's 'Unusual and Exigent' Clause
- Greenberg's Letter to AIG CEO Willumstad
- Wash Wire: Bush Not to Comment on Paulson Meeting
- Crisis Blog: Questions and Answers on AIG
- AIG, Lehman Shock Hits World Markets
- Old-School Banks Emerge on Top
- Complete Coverage: Wall Street in Crisis

AIG's millions of insurance policyholders appear to be considerably less at risk. That's because of how the company is structured and regulated. Its insurance policies are issued by separate subsidiaries of AIG, highly regulated units that have assets available to pay claims. In the U.S., those assets can't be shifted out of the subsidiaries without regulatory approval, and insurance is also regulated strictly abroad.

Tuesday afternoon, after the market closed, AIG put out a statement saying its basic insurance and retirement services businesses are "fully capable of meeting their obligations to policyholders." AIG said it was trying to "increase short-term liquidity in the parent company," but said that didn't "include any effort to reduce the capital of any of its subsidiaries or to tap into Asian operations for liquidity." Asia is one of AIG's largest markets.

Financial Pain

Where the company is feeling financial pain is at the corporate level, even while its insurance operations are healthy.

The urgency of federal aid came into stark relief Tuesday as other options fell off the table and pressures continued to build. On Tuesday, AIG's attempt to raise as much as $75 billion from private-sector banks failed. The banks advising the firm concluded it would be all but impossible to organize a loan of that size, making the government AIG's chief hope.

As a result of its credit downgrades, the insurer has to post $14.5 billion in collateral to bolster its credit rating. In the debt markets, AIG also has to post additional collateral to investment banks and others it trades with.

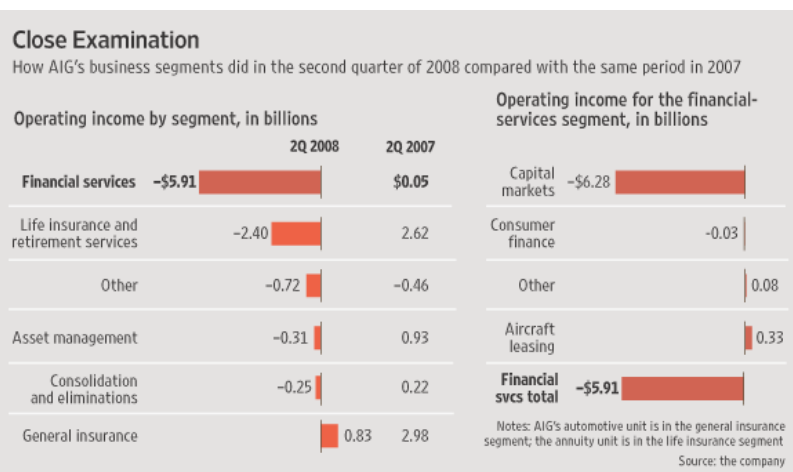
Adding to AIG's woes, investors continued to pummel the company's stock on Tuesday, pushing the share price down 21%, to $3.75. It was the third double-digit percentage decline in the past three trading days. AIG's shares are now down 94% for the year.

AIG's cash squeeze is driven in large part by losses in a unit separate from its traditional insurance businesses. That financial-products unit, which has been a part of AIG for years, sold the credit-default swap contracts designed to protect investors against default in an array of assets, including subprime mortgages.

But as the housing market has crumbled, the value of those contracts has dropped sharply, driving $18 billion in losses over the past three quarters and forcing AIG to put up billions of dollars in collateral. AIG raised $20 billion earlier this year. But the ongoing demands are straining the holding company's resources.

That strain contributed to the ratings downgrades on Monday. Those downgrades, in turn, ratcheted up the pressure on the company to come up with more cash, quickly.

Most insurance companies don't have financial-products units like these. But over nearly four decades, former CEO, Maurice R. "Hank" Greenberg built AIG into a firm that resembled no other. He transformed its insurance business, both by expanding abroad -- notably in China, where AIG has its roots -- and by buying up other firms.



Mr. Greenberg pushed into areas that have little to do with bread-and-butter businesses like selling life insurance or protecting companies against property losses. In 1990, for instance, he bought International Lease Finance Corp., which leases planes to airlines.

In 2005, Mr. Greenberg stepped down amid an accounting scandal. But Mr. Greenberg, who is fighting civil charges related to the scandal and has denied wrongdoing, didn't fade from the scene. He still heads a firm that is AIG's largest shareholder, and on Tuesday, he sent a letter to current CEO, Mr. Willumstad, saying he was "ready to offer any assistance that I can."

'I'll Do It'

Now, however, Mr. Willumstad himself will be leaving, after having been asked to step aside by the Treasury's Mr. Paulson. Mr. Willumstad, who recently took over as AIG's chief executive to try to turn around the firm, was surprised by the request. "If that's what you want, I'll do it," he said to Mr. Paulson, according to a person familiar with the call. AIG's board was unhappy with the decision but felt it had no choice but to go along, as the only other option was bankruptcy.

The fate of a corporate chief executive is normally the province of a board of directors. The decision by the Treasure Secretary to essentially oust Mr. Willumstad underscores further the magnitude of the government's intervention.

Mr. Willumstad's departure marks the end of a brief, tumultuous run. He joined AIG as a director in early 2006, after leaving the No. 2 post at Citigroup Inc., and became AIG's chairman later that year. In June, as AIG was reeling from record losses, the board forced out Mr. Willumstad's predecessor and gave him the top job. He had planned to unveil his own strategy for AIG on Sept. 25.

By tapping Mr. Liddy as AIG's next CEO, the government is turning to someone with deep experience in the insurance industry, having served as chief executive of Allstate from 1999 to 2006. He stepped down as chairman earlier this year. Allstate is a different type of insurer than AIG, focusing on selling car and home insurance to Americans, whereas AIG sells an array of insurance policies to individuals and businesses world-wide.

Mr. Liddy also has experience pulling apart empires, having helped dismantle Sears, Roebuck & Co. (from which Allstate was spun off) in the 1990s. Before joining Sears, Mr. Liddy worked under Donald Rumsfeld at drug maker G.D. Searle & Co. Mr. Liddy is on the board at Goldman Sachs Group, GS -1.29% ▼ the investment bank that Mr. Paulson led before becoming Treasury Secretary.

As confidence in AIG declined recently, the amount of money it felt compelled to raise to calm its constituents continued to rise. Over the weekend, the figure was $40 billion. That climbed to $75 billion on Monday and, according to a person close to the company, rose further on Tuesday.

—Diya Gullapalli, Serena Ng, Damian Paletta and Ashby Jones contributed to this article.

Write to Matthew Karnitschnig at matthew.karnitschnig@wsj.com, Deborah Solomon at deborah.solomon@wsj.com, Liam Pleven at liam.pleven@wsj.com and Jon E. Hilsenrath at jon.hilsenrath@wsj.com