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# The AIG Liquidity Crisis and Its Impact on the Insurance Market

## An Advisen Briefing

**Essence:** *Liabilities incurred under sophisticated financial instruments ravaged American International Group. As AIG teetered on the verge of bankruptcy Monday and Tuesday, brokers were flooded with calls from nervous AIG policyholders. However, the financial strength of AIG's insurance subsidiaries was not threatened: insurance regulations insulated the insurance entities from the losses. Tuesday evening the U.S. government announced an $85 billion loan to the company, averting a collapse. Assuming AIG's customers don't abandon the company in large numbers, the long-term impact of the crisis on the insurance pricing cycle should be minimal.*

## What went wrong?

AIG is often described as an "insurance giant," but the company also derives income from businesses unrelated to traditional insurance products. The crisis at AIG is driven in large part by losses on a type of financial instrument called a credit default swap (CDS) issued by AIG Financial Services, a unit separate from the insurance businesses. A CDS operates something like an unregulated insurance contract. It provides protection against a default on assets tied to corporate debt and mortgage securities. Losses under these instruments – which at this point are accrued losses rather than paid losses – were triggered by the meltdown of the subprime mortgage market. AIG is one of the largest players in the CDS market, with almost $600 billion of gross notional exposure in "super senior" credit derivatives, including $80 billion tied to subprime mortgages.

The crisis at AIG is a "question of liquidity, not of capital," according to Rob Schimek, EVP and CFO of AIG Property Casualty Group. Although there have been few losses paid under the CDSs, contract provisions require AIG to post collateral in cash if the value of the assets underlying a CDS deteriorates. At the parent level, AIG has nearly $80 billion in shareholder equity, but most of that is locked in the company's insurance operations and cannot be liquidated to meet the collateral calls of the financial products unit. Schimek cites $26.7b in statutory policyholders' surplus for U.S. commercial lines with international commercial lines and personal lines having additional surplus. U.S. regulations prevent the parent from taking dividends from insurance subsidiaries of more 10 percent of policyholders' surplus in a given year. That is good news for AIG policyholders – the assets of the insurance companies are all but untouchable – but it means that as the demand for collateral grew, AIG found itself in a bind with few alternatives available to quickly raise the necessary cash.

AIG's need for cash reached crisis proportions just as a tidal wave of defaults under subprime mortgages was causing chaos throughout the world's financial markets. As a precursor to the AIG situation, on September 6$^{th}$ government regulators seized mortgage giants Fannie Mae and Freddie Mac. On September 14$^{th}$, a 150 year-old Wall Street institution, Lehman Brothers, declared bankruptcy and rival investment bank, Merrill Lynch, agreed to be acquired by Bank of America.

On September 11$^{th}$ S&P placed AIG Holding's credit ratings on negative watch forcing AIG to raise yet more cash. Over the weekend AIG was unable to raise enough cash to deal with these increasing obligations, and on September 15$^{th}$ the major credit rating agencies cut its ratings. The rating downgrades significantly exacerbated AIG's already dire situation, triggering contract provisions that required the company to post $14.5 billion in collateral. Since it did not have enough cash to meet the collateral demands, the company faced bankruptcy protection and Chapter 11 reorganization.

## The Fed steps in

Initially, federal officials, other regulators and AIG tried to access the capital markets to alleviate the liquidity crisis. When that failed, the government announced it would provide AIG an $85 billion loan. The Federal Reserve said in a statement that it determined that a failure of AIG could hurt the U.S. economy and financial markets already reeling from subprime losses. In return for the loan, the government will receive rights to a 79.9 percent equity stake in AIG. Warrant triggers and other loan terms are still being finalized.

AIG will pay interest at 8.5 percentage points above the three-month London Interbank Offered Rate, or about 11.4 percent. The steep interest rate gives AIG incentive to quickly sell off assets to pay back the loan. According to Schimek, AIG had intended to hold an investor meeting on September 25th to discuss the process of selling assets. The list of likely assets, according to Schimek, does not include core insurance assets. Speculation is that the first properties on the block will be the company's profitable aircraft leasing arm, its stake in reinsurer Transatlantic Holdings, and its consumer lending and variable annuities businesses.

While the company has made no comments about which assets will be sold, the magnitude of its liabilities suggests AIG may sell at least some insurance subsidiaries. The most likely U.S. candidates are those companies that are comparatively autonomous and which serve well-defined sectors such as Hartford Steam Boiler Inspection & Insurance Company (boiler & machinery specialist), 21$^{st}$ Century Insurance Company (personal automobile business in 14 states) and Audubon Insurance Company (personal and small commercial lines in 12 states). Other AIG insurance units are deeply entwined through interlocking business models and inter-company pooling arrangements that would have to be disentangled before selling the companies as discreet entities. The National Union Inter-Company Pool, for example, has nine companies including flagship commercial lines carriers National Union and American Home. These companies represent the core of AIG's presence in the property & casualty market and are unlikely to be sold except under extremely dire circumstances.

Several companies already have expressed interest in, or are seen as likely candidates for, portions of the insurance operations. C.V. Starr, a company led by former AIG CEO

Maurice “Hank” Greenberg, stated in a SEC filing on Tuesday that it was pursuing options to acquire some or all of AIG. Munich Re chief executive Nikolaus von Bomhard said in a newspaper interview that the German reinsurer is interested in a number of AIG’s assets. Acquisitive Japanese and Australian insurance groups are likely bidders for pieces of the insurance business.

## Insurance industry impact

According to an informal poll of insurance brokers, of those AIG insureds that contacted their brokers on Monday and Tuesday, about one third requested their brokers get quotes from AIG’s competitors. There was little reason for panic, however. AIG’s insurance operations are insulated from the losses in other segments of the company by insurance regulations that essentially wall off insurance company assets. The parent company was in trouble, but the insurance entities were profitable, and their balance sheets were unaffected.

Though their statutory financial statements were unchanged, A.M. Best downgraded the financial strength ratings of the domestic property & casualty subsidiaries to A (Excellent) form A+ (Superior). Edward M. Liddy, AIG’s new CEO, and other top management have been meeting with ratings agencies, some of which have moved AIG from negative outlook to developing as a result of the loan from the Fed. A.M. Best, however, has announced that it is not ready to revise its outlook. “A.M. Best believes it is premature to declare financial stability to such an extent that a change in outlook or ratings is warranted,” the rating agency stated in a press release.

Presumably the loan from the Fed will assuage the concerns of nervous policyholders and avert a wholesale exodus of AIG insurance customers. The downgrade in Best rating may encourage some insureds to diversify their programs, but it now is less likely that the company will lose a significant number of customers over the long term. If there is a massive market dislocation caused by a stampede of AIG policyholders, it will likely lead to a sudden, short term up-tick in commercial insurance rates. But if the market responds calmly, prevailing soft market conditions are likely to be unaffected. AIG’s losses under credit default swaps have no impact on statutory policyholders’ surplus, which equates to “supply” in the insurance supply-and-demand equation. The insurance industry remains overcapitalized, which barring a massive natural catastrophe should continue to exert downward pressure on rates at least through 2009.

The most significant impact of the AIG crisis would result from a sale of AIG insurance entities to companies with different business models and risk appetites. AIG has been an engine for product innovation, and was sometimes seemingly fearless in its willingness to assume risk. If AIG’s insurance operations were acquired by more conservative companies, insurance buyers would stand to lose the far-reaching benefits of the company’s innovations in the management and financing of risk, as well as the integrated delivery of global insurance solutions.

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