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Risk Managers Speak Out on the AIG Liquidity Crisis

An Advisen Special Report sponsored by Anderson Kill & Olick, P.C.



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Executive summary

Most commercial insurance buyers claim to be confident in the financial strength of American International Group (AIG) insurance companies following an \$85 billion loan by the federal government to the parent company to stave off bankruptcy. Nonetheless, two thirds of AIG commercial lines policyholders plan to get quotes from AIG's competitors when their policies renew. Areas of concern include reputational damage, uncertainty about the future ownership of the insurance companies and the possibility of AIG losing key individuals or underwriting teams during the current turmoil. AIG is under intense pressure from competitors, but there is no consensus among insurance buyers as to how the situation will influence market capacity and the pricing cycle. One likely outcome is that AIG will compete vigorously to retain business, potentially intensifying price competition in an already-soft insurance market.

Key Findings:

- **68% are "very confident" or "somewhat confident" in AIG security**
- **71% will consider alternatives to AIG at renewal**
- **Less than 1% of brokers recommended replacing AIG**
- **35% believe the AIG crisis will cause the soft market to bottom out**

Introduction

After teetering on the edge of bankruptcy, the American International Group was rescued by an \$85 billion loan from the United States government on September 16th. The losses leading AIG to the brink of disaster were from AIG Financial Products, a unit separate from AIG's insurance operations. Although the balance sheets of the insurance companies were unaffected, nervous policyholders flooded their brokers with calls. Some demanded that AIG be replaced immediately on their programs.

In order to understand how the liquidity crisis at AIG has been perceived by insurance buyers and what affect it may have on the insurance market, Advisen surveyed risk managers and other buyers of commercial insurance. The goal of the survey was to gauge the impact of AIG's highly

publicized financial crisis on insurance buying decisions and to quantify its impact on commercial property & casualty market capacity and pricing.

In general, insurance buyers are wary but calm. While a majority of survey respondents who are AIG insureds indicated they plan to get quotes from AIG's competitors at renewal, few said they plan to replace AIG mid-term, and less than eight percent said they are highly concerned about the financial security of the AIG insurance companies. In written comments, some AIG policyholders expressed anger at AIG executive management, but many also voiced support for the insurance companies.

The AIG liquidity crisis

AIG's troubles began in a unit called AIG Financial Products, which traded in a type of financial instrument called a credit default swap (CDS). A CDS protects against a default on assets tied to corporate debt and mortgage securities. Losses to AIG's portfolio of CDSs were triggered by the meltdown of the subprime mortgage market.

No losses have been paid under the CDSs, but AIG is required to post collateral in cash if the value of the assets underlying the CDSs deteriorates. At the parent level, AIG had nearly \$80 billion in shareholder equity, but most of that is locked in the insurance operations and could not be liquidated to meet the collateral needs of the financial products unit. As defaults mounted in the subprime mortgage market, AIG was required to post collateral for CDSs protecting securities tied to pools of subprime mortgages. The company had difficulty raising enough cash to meet the collateral calls.

On September 11th, S&P placed AIG's credit ratings on negative watch, triggering contract provisions requiring the company to post yet more collateral. On September 15th, the major credit rating agencies cut AIG's ratings. This event made it necessary for the company to post a further \$14.5 billion in collateral. Unable to do so, AIG faced bankruptcy protection and Chapter 11 reorganization. AIG turned to the government for help.

Initially, U.S. federal officials and other regulators tried to access the capital markets to raise cash. When that failed, the government announced it would provide AIG an \$85 billion loan. In return for the loan, the government has rights to a 79.9 percent equity stake in AIG. AIG's interest payments are set at about 11.4 percent. Consequently, the company is motivated to quickly sell assets to pay back the loan. First to be sold will be domestic personal auto, International Lease Finance Corporation (aircraft leasing), AIG's domestic life and retirement services and certain foreign life operating units. AIG insists that it will retain its core commercial property & casualty insurance operations, but it nonetheless may be forced to sell at least some U.S. property & casualty insurance subsidiaries if it is otherwise unable to raise sufficient cash.

AIG's insurance operations are insulated from losses in other parts of the company by insurance regulations that essentially wall off insurance company assets. The insurance entities are profitable, and their balance sheets are unaffected. Nonetheless, A.M. Best downgraded the financial strength ratings of the domestic P&C subsidiaries to A (Excellent) from A+ (Superior). AIG's top management has met with ratings agencies, some of which subsequently moved AIG from negative outlook to developing. A.M. Best, while stating it "remains optimistic for the insurance businesses," announced that it was not ready to revise its outlook. Following an investor conference call to outline a plan to sell non-property & casualty insurance assets, A.M. Best reaffirmed its rating: "While A.M. Best is optimistic that the plan will be diligently executed, there are as yet no named buyers or post-acquisition balance sheets representing the remaining businesses, and any timing delays could have unforeseen effects, which causes A.M. Best to be unwilling to revise ratings and/or the under review status at this time." Moody's downgraded AIG's senior unsecured debt rating following the conference call, citing the reduced diversity of the revamped insurer.

The survey

On September 23rd Advisen sent 6,885 individuals identified as risk managers and buyers of commercial insurance e-mail invitations to participate in an online survey. Survey participants were directed to a website where they answered eight multiple-choice questions, as well as provided written comments and posed questions to AIG management through a process to be mediated by Advisen. At 8:00 p.m. on September 25th, the survey was closed and the website deactivated. Exactly 1,000 invitees completed the survey for a response rate of 14.5 percent.

Exhibit 1

Respondent job functions

Risk manager with insurance decision authority	76.0%
Not risk manager, but with insurance decision authority	8.1%
Member of risk management department without insurance decision authority	10.6%
Not involved in the insurance buying process	1.3%
Other	4.0%

Participating companies with identifiable revenue are evenly distributed among the “less than \$1 billion,” “\$1 billion to \$5 billion,” and “greater than \$5 billion” revenue categories. Respondents represented twelve high-level industry groups, with Industrials, Financials and Consumer Discretionary collectively comprising about half of the survey participants. The overwhelming majority of respondents are from the U.S., though insurance buyers from Canada and Europe also participated. About 84 percent of respondents have insurance decision-making authority for their companies, of which 76 percent identified themselves as risk managers. (Exhibit 1)

Summary of survey results

Less than eight percent of all survey respondents, and only about six percent of respondents from companies insured by AIG, said they are “very concerned” about the financial condition of the AIG insurance companies. About 68 percent said they are “very confident” or “somewhat confident” in the companies’ financial strength. Some respondents are concerned that AIG has suffered long-lasting damage to its reputation, but, based on written comments, many policyholders understand that the insurance companies are safeguarded by insurance company solvency regulations.

About five percent of respondents said they will consider replacing AIG before their current policy period expires. Perhaps of greater concern to AIG – and encouraging to AIG’s competitors – more than two thirds of AIG policyholders said that, as a result of the liquidity crisis, they will consider alternatives to AIG at the renewal of their policies. Although nearly 70 percent of respondents said they are “very confident” or “somewhat confident” in the financial strength of the AIG insurance subsidiaries, 52 percent of AIG policyholders gave the answer “Uncertainty over financial stability” as a reason they are considering replacing AIG. Based on written comments, other areas of concern include uncertainty about the future ownership of the insurance companies and the possibility that AIG insurance companies will lose key individuals or underwriting teams during the current turmoil.

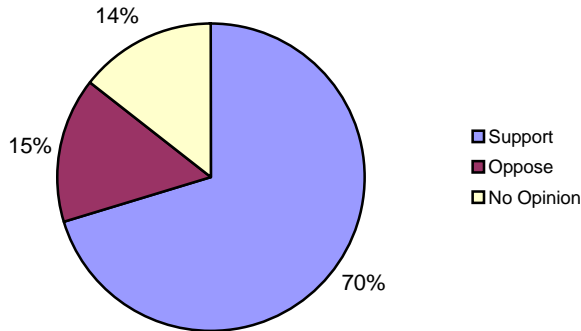
Attitude towards AIG and the government loan

Survey respondents strongly support the decision by the U.S. government to loan AIG \$85 billion. In response to the question “Do you support or oppose the announced decision by the Fed to loan AIG \$85 billion?” about 70 percent answered “Support,” with the remaining respondents equally split between “Oppose” and “No opinion.” (Exhibit 2) Some respondents noted in written

comments that they disapproved of government bailouts on principle, but believed the AIG loan was necessary for the health of the economy and the insurance industry. Several respondents suggested the loan was a good deal for taxpayers since it would likely return a profit.

Exhibit 2

Do you support or oppose the announced decision by the Fed to loan AIG \$85 billion?



Support of the loan is correlated with whether or not a respondent's company is insured by AIG. Among respondents not insured by AIG, 43 percent support the loan, and 40 percent oppose it, with the remainder choosing "No opinion."

In written comments, some survey participants were highly critical of AIG's executive management:

"While I support and appreciate the Fed's decision to make a loan, I deplore the actions of AIG executives that led to the situation."

"I am perplexed as to how and why AIG could permit greed to compromise its ethos by turning such a blind eye to managing risk resting in its portfolio."

"General crunch was mismanaged and lacked any sort of forethought by AIG's management team.... AIG's arrogance is showing full force."

While respondents were critical of AIG executives for the liquidity crisis, many are rooting for the company's success:

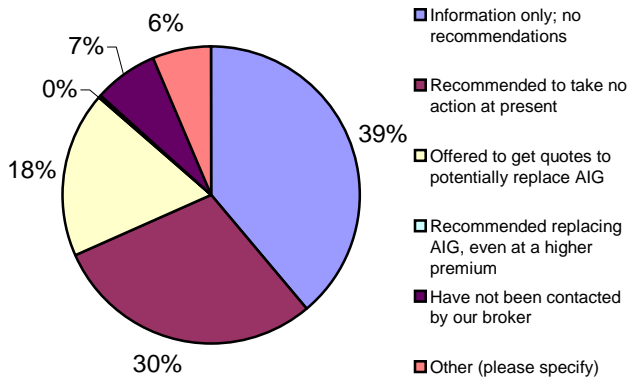
"I'm confident they will get out of this crisis."

"At the end of the day I hope AIG floats!"

"I sincerely hope that the Federal government's intervention buys the AIG parent entity time to allow them to re-take control of their future."

Exhibit 3

Since Monday, Sept. 15, which best describes the nature of the communications concerning AIG from your broker?



Broker communications and recommendations

Since September 15th, brokers had contacted all but about four percent of AIG policyholders participating in the survey. Nearly 40 percent of respondents said their broker provided information about the situation, but had not offered any recommendations as to actions. About 30 percent said their broker recommended

taking no action at the present and about 18 percent said their broker suggesting getting quotes from AIG's competitors to potentially replace AIG. Only two respondents, .02 percent of the total, said their broker recommended replacing AIG, even at a higher premium. (Exhibit 3)

Many survey participants praised their brokers for the way they handled the situation:

"Our brokers closely monitor the ongoing activity and issues and provided us with day to day information including conference calls to discuss status."

"Provided tons of info and looking into replacement cover."

"Our broker has kept us informed via conference calls and written material."

"Excellent fact based communication including offer to find alternative carriers should the need arise."

"Marsh has been great...provided multiple pieces of information and specific plans at this time."

Some survey participants noted that responses varied significantly by broker:

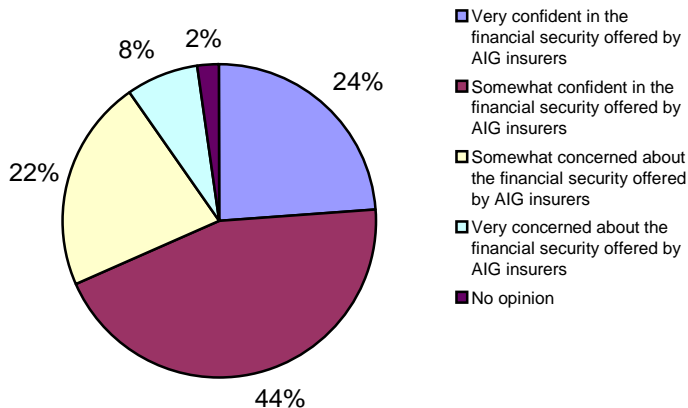
"We have four brokers placing insurance with AIG. One was silent. Two encouraged us to develop alternatives but also supported the soundness of AIG Commercial Insurance. The fourth was ready with alternatives and was suggesting cancel midterm and replace."

"Certain brokers have provided information only. Other brokers who are involved in pending renewals are obtaining quotes from other markets."

"We have two brokers. One opined it was time - when news broke - to get alternative bids. The other provided information and concurred it was appropriate to stay informed, but not necessarily time to start seeking alternative bids."

Exhibit 4.

Which best describes your attitude towards the financial strength of the AIG insurance subsidiaries?



Financial security

Most survey respondents are confident that the AIG insurance companies are financially secure. In response to the question "Which best describes your attitude towards the financial strength of the AIG insurance subsidiaries?" 68 percent of respondents said they are "very confident" or "somewhat confident" in the financial strength of the insurance companies. Only 7.5 percent said they are "very concerned." (Exhibit 4)

Insurance buyers for companies not insured by AIG are far more pessimistic about the financial security of the insurance entities than are the buyers for companies that are AIG policyholders. Twenty-six percent of non-policyholders said they are "very concerned" about the financial strength of the AIG insurance entities as compared to 7.5 percent overall. Conversely, only about 6 percent of AIG policyholders claim to be "very concerned."

By industry group, insurance buyers from financial services companies are the most upbeat about AIG's security: about 31 percent of those buyers said they are "very confident" in the financial strength of the insurance companies as compared to approximately 24 percent overall. Insurance buyers for companies in the services industry are most concerned about AIG's security with about 13 percent of respondents claiming to be "very concerned" about financial security as compared to 7.5 percent overall.

Several respondents noted the role of state insurance regulation in protecting the financial security of the insurance entities:

"The regulations and oversight of the insurance industry have worked, as intended, for the protection of policyholders. The AIG insurance companies have strong balance sheets as a result and the parent was not allowed to transfer any of those assets."

"The AIG insurance carriers are regulated by the NY and PA state insurance Depts. The carriers are solvent, financially healthy and insulated from the difficulties at the 'problem' Division. The foregoing 'basics' were lost in the all the media hype."

"The individual states have done their job and Washington has failed."

Some survey participants suggested that, while the companies may be financially secure, the damage to AIG's reputation is nonetheless significant:

"Insurance operations are stable, but the reputational damage has already been done."

"The credibility of the AIG name is lost and the insurance subsidiaries need to distance themselves from it."

"Concern also exists around to what extent the AIG brand has been damaged and how that might affect their ability to generate premium revenue going forward."

"AIG insurance will suffer due to the name and the affiliation with parent company issues."

A number of survey participants expressed concern that rash decisions by AIG customers could lead to further problems:

"If RMs start steering business away from AIG, they may cause it further financial harm and in the end have less choice."

"My feeling is that as long as clients don't start moving their business away from AIG in droves this situation will resolve itself."

"We can very quickly crater AIG's chances of survival by moving our policies from them without adequate justification. I urge AIG policyholders to act prudently, not hastily."

Actions in response to the crisis

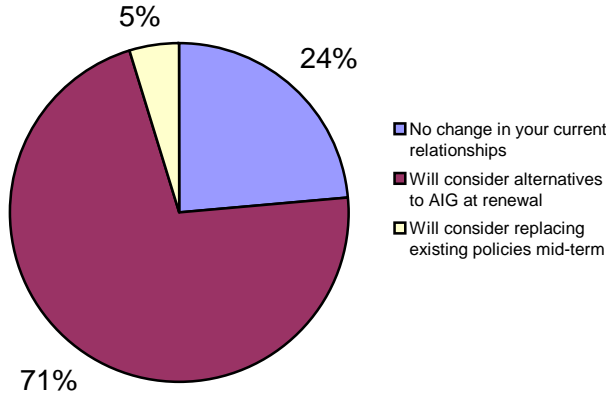
A majority of survey respondents who are AIG policyholders indicated they are "very confident" or "somewhat confident" in the financial security of the AIG insurance companies, but most, about 71 percent, nonetheless indicated they plan to get quotes from AIG's competitors at the next renewal of their companies' insurance programs. Approximately five percent said they would consider replacing policies at mid term. (Exhibit 5).

The largest AIG policyholders, those with revenue greater than \$5 billion, are more likely to seek quotes from AIG's competitors at renewal (76 percent) than are those with revenue less than \$1 billion (69 percent). However, nearly twice as many small companies as large said they are likely to replace their policies mid-term. About 78 percent of non-US companies will consider alternatives to AIG at renewal.

The most common reason given in response to a question about why they would consider replacing AIG was “Uncertainty over financial stability,” chosen by 52 percent of respondents, followed by “Uncertainty regarding future ownership” and “Ratings downgrade,” each at 35 percent. The total of the responses is greater than 100 percent because more than one choice was permitted.

Exhibit 5

If your organization buys insurance from an AIG company, how does the recent liquidity crunch at the AIG parent affect your future plans to buy from AIG?



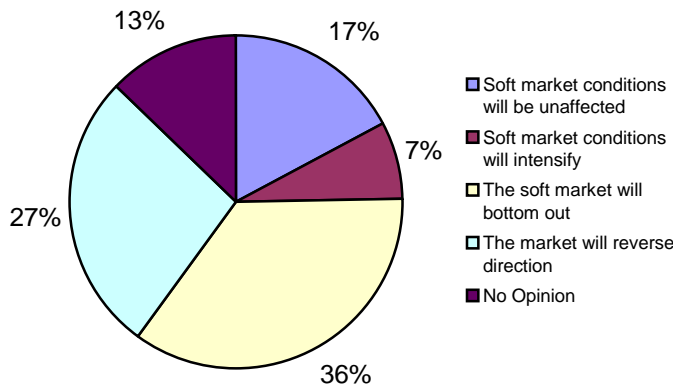
In written comments, a few respondents noted that AIG’s rating downgrades had triggered provisions in loan covenants and other contractual agreements, or expressed concern that further downgrades would trigger such provisions. Other areas of concern disclosed in the written comments include refusal of other insurers to write above AIG primary policies, AIG management distraction caused by the turmoil, uncertainty regarding long-term underwriting philosophy, and loss of trust in AIG’s management.

Some respondents noted in written comments that the

decision to get quotes from AIG competitors was driven by concerns at the senior management and board levels of their companies. “Extreme management concern due to all of the publicity,” wrote one respondent. “If we argue to keep AIG and we’re wrong, the consequences will be severe.” For the most part, however, risk managers said they are permitted to exercise their own judgment as concerns actions relative to AIG. In answer to a question about senior management response to the AIG situation, only about two percent of respondents said that senior management “insisted,” and six percent said senior management “suggested,” that they “diversify or reduce ... insurance with AIG companies.”

Exhibit 6

What affect will recent developments at AIG have on the insurance pricing cycle?



Impact on insurance market

There was no broad consensus among survey participants as to how the AIG crisis would impact the insurance pricing cycle. In answer to the question “What affect will recent developments at AIG have on the insurance pricing cycle?” about 36 percent responded “The soft market will bottom out and stabilize,” while 27 percent said “The market will reverse direction; rates will increase.” Only about seven percent believe that soft market conditions will intensify, though

a number of respondents indicated they expected AIG to lower premiums to retain business. (Exhibit 6)

Some respondents are concerned that AIG's problems will spread to the rest of the market, or are a harbinger of deeper problems in the insurance market:

"I am very concerned about the future of the insurance market when a company as large and seemingly solid as AIG was so under-reserved in their riskier lines of business. I don't think we've seen the bottom yet - more to come."

"Are other top carriers exposed in the same way AIG was?"

"The foundation of the insurance business, utmost good faith and trust, has been shaken to its very core and remains suspect. Renewed confidence in the industry as a whole will take some time to recover."

Analysis and conclusions

Judging by written comments, insurance buyers generally believe that insurance regulations have protected AIG's insurance entities from the parent company's financial crisis. Most respondents are "somewhat confident" or "very confident" in the financial strength of the AIG companies. Many participants, while highly critical of the management of the parent company, voiced support for the AIG insurers and expressed confidence that the companies would survive the crisis. Nonetheless, most respondents said they planned to get quotes from AIG's competitors at renewal, and about five percent said they may cancel AIG policies mid-term.

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Survey respondents were generally complimentary about how their brokers have handled the crisis. Brokers have contacted more than 95 percent of AIG policyholders since September 15th. About 70 percent either have not made any specific recommendations as to actions, or have counseled their clients to not take any action at the present. Only two out of 1,000 respondents said their broker advised them to replace AIG, even if at a higher premium.

The insurance market appears to be responding to the AIG crisis in a calm and rational manner. The AIG insurance entities are vulnerable to competition, and responses to the survey strongly suggest they will experience erosion in market share in the short run. However, it does not appear there will be a stampede of AIG policyholders into the market looking for replacement coverage at any cost. Some buyers are concerned that the companies could be damaged by the loss of too many policyholders, defections of key personnel, or by being sold to lower rated companies, but there is a surprisingly deep reservoir of good will towards AIG – or at least a

recognition that the company plays a number of important roles in the insurance market – and commercial insurance buyers seem inclined to support the company to the degree that cautious and prudent behavior permit.

Most respondents believe, as a result of AIG's problems, the current soft market will bottom out and stabilize, or will reverse direction. Fewer than 10 percent believe soft market conditions will intensify. Based in part on these survey responses, however, it seems likely that AIG will be forced to slash premiums to retain business, which could set off a pricing war throughout the commercial insurance sector. Since most AIG policyholders are "somewhat confident" or "very confident" in the insurer's financial security, many are likely to be won back by lower premiums. AIG's competitors may be able to increase their market share at AIG's expense, but there will be a cost to winning the business.

This report was written by Dave Bradford, Executive Vice President and Editor-in-Chief, dbradford@advisen.com, 212-897-4776. Thanks to Glenn Trutner, Jim Blinn, Mason Power and Tom Ruggieri for their contributions.

Follow the AIG Liquidity Crisis on Advisen Read our Briefing: Our first 4 page brief called "The AIG Liquidity Crisis & Its Impact on the Insurance Market." This item ran in Advisen's Front Page News on September 19. Portions of that briefing are based on our exclusive conversation with AIG Property Casualty Group CFO Rob Schimek on September 18. Click on the Topical Analysis dropdown menu and choose Insurance Market.

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<and>( <and>( <any>( <phrase>(American,International,Group),AIG), <any>(rating,downgrade,cash,bankruptcy,rescue,solvency,liquidity,crisis,loan,billion)) <in>v_resourcesummary, <not> <any>( <phrase>(AP,Online),inewsnetwork, <phrase>(briefing.com)))
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- "fantastic strategists."
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