BusinessWeek

TOP NEWS September 16, 2008, 12:01AM EST

The Unraveling of AIG

Once the gold standard in the insurance industry, AIG is the latest victim of the meltdown in the credit markets

by Nanette Byrnes

The insurance business is all about risk—understanding it, minimizing it, pricing to compensate for it. But American International Group (AIG), the biggest insurance company in the world, seems to have had very little concept of the risk it held in its own businesses.

Now, AIG has emerged as the latest victim of the meltdown in the credit markets, reeling from a seemingly endless escalation in what it could owe on transactions involving mortgage-backed securitizations. On Sept. 15, management spent the day in a desperate bid to get help covering those obligations from government sources and other institutions. As the markets closed, its stock slid to $4.76 a share, down from a 52-week high of $70 a share, representing the evaporation of $176 billion in market value in less than one year. While regulators were racing to find some kind of capital infusion that could keep the company standing, ratings agencies slashed AIG's credit rating, making it much more expensive for the insurer to do business.

AIG—a company with $110 billion in revenues last year and $1 trillion in assets—has suddenly gone from being the gold standard in its industry to fighting for survival. The sheer speed of its descent has stunned employees, customers, and many in the industry. "It's staggering to see just how much has changed in a very short time," says David Schiff, editor of *Schiff's Insurance Observer*, and a longtime critic of the company. Even more staggering are the ever-rising estimates of how much capital AIG now needs to cover its obligations. "That's a scary thing. It can be that some things are just unknowable in the high-wire finance a lot of these companies are in."

GOVERNOR PATERSON TO THE RESCUE

Indeed, it's not clear how much capital AIG will need to get itself out of this mess and survive as a global insurance powerhouse. The $20 billion in capital that AIG has raised through stock and debt offers in May isn't enough. On Sept. 15, it was given access to another $20 billion when the governor of New York state, David Paterson, in an extraordinary move, agreed to relax insurance regulations to allow it to tap its subsidiaries' liquid assets.

Even that is not enough. Paterson said he hoped the state's move would be a foundation on which the federal government could build a bigger solution, either directly or by helping other companies invest in the insurer. Within hours, *The Wall Street Journal* reported, the Federal Reserve had asked Goldman Sachs (GS) and JPMorgan (JPM) to make between $70 billion and $75 billion in loans available to the company. It's hard to know if even that number will be sufficient to cover AIG's needs. "The short answer," says Donn Vickery, an analyst at Gradient Analytics, who's been writing critical reports on the company since February, "is they took on significant risk in their subprime obligations that they didn't understand. I don't think anyone really knows the risks, and if they say they do, they're fibbing."

Since late last week, AIG had been desperately trying to stave off a downgrade by ratings agencies that might trigger further problems in its portfolio of credit default swaps, a credit derivative instrument. By the evening of Sept. 15, even with extra funding in place, that chance seemed to be slipping away. Insurance rating agency A.M. Best downgraded most of the company's subsidiaries and slashed AIG's rating to "bbb" from "a+." An hour later, Fitch Ratings had followed suit, downgrading AIG's long-term rating and the ratings of its outstanding debt.

INSURANCE 101

Late on Nov. 15, Standard & Poor's, which like *BusinessWeek* is owned by The McGraw-Hill Cos. (MHP), also cut AIG's credit rating, citing concerns about reduced flexibility in meeting additional collateral needs and increasing residential mortgage-related losses. Assuming current market conditions persist, S&P said it expects AIG to continue to pursue additional access to liquidity and the sale of certain businesses to cover potential further investment losses. "In years to come, the real story will not be the subprime crisis or some housing bubble," says Campbell Harvey, professor of finance at the Fuqua School of Business at Duke University, "it will be the spectacular failure of risk-management systems in our so-called leading financial institutions."

How AIG got into this terrible spot draws, in some ways, on the lessons of classic risk mismanagement—what Schiff calls "Insurance 101." The job of an underwriter is to spread risk around. If you write earthquake insurance, you don't write it only in California as that could leave your entire business exposed to one terrible turn of events. AIG appeared to ignore that practice when making just such a dangerous bet on subprime mortages. At least until 2005, various divisions of the company were writing subprime mortgages, selling mortgage insurance for borrowers, writing derivatives on collateralized debt obligations (CDOs) with subprime exposure, and investing premium dollars in mortgage-backed securities as well.

The mortgage insurance business, United Guarantee, started to rack up big losses last year. By early 2008, it became clear that the company's derivatives were following suit. That's when AIG's audit firm, PricewaterhouseCoopers, forced the company to change how it was accounting for the value of its derivatives. That caught the attention of Gradient's Vickery, who began to question the company's earnings quality. He went back into the company's Securities & Exchange Commission filings and chronicled the rise in the gross cumulative decline in valuation of its derivatives from $352 million as of Sept. 30, 2007, to $5.964 billion as of Nov. 30, 2007. AIG, which had already been battered by an accounting scandal that resulted in the ouster of iconic CEO Hank Greenberg, was again under the microscope as a number of analysts began to question the company's exposure to the spiraling mortgage crisis.

BREAKUP SPECULATION

Over the course of the spring, the stock fell, and by June criticism was getting closer to home. That's when former AIG director Eli Broad, and two prominent investors—Shelby Davis of Davis Selected Advisers and Bill Miller of Legg Mason (LM)—sent a letter asking the board to name an interim CEO to replace Martin Sullivan, while a search committee found a new leader for New York-based AIG. Greenberg, who still controls big chunks of stock, had sent a letter criticizing management as well.

In June, board chairman and former Citigroup (C) executive Robert Willumstad was named CEO. When the company issued its second-quarter 2008 results in August, it was up to him to announce that marked-to-market losses on its derivatives had climbed to a whopping $25 billion. Speculation began that the company might have to break itself up, or at least sell off some assets to raise capital, on top of the $20 billion raised in May. With parts of its core insurance businesses reporting weaker results—a 54% operating income decline in its property and casualty business—speculation about the sale of other parts of the business began to rise. International

Lease Finance, AIG's aircraft leasing subsidiary, was often mentioned as a possible sale candidate. American General Finance, its $29 billion consumer-finance unit, is considered another possible spinoff.

AIG management has yet to present a plan for its restructuring. Negotiations continue over a possible capital infusion from outside the firm. Investors remain skittish as the future of one of the world's biggest brands remains unclear. And nobody is quite sure if the trouble for AIG has passed, or the worst is yet to come.

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