World Financial Earthquake and the Nationalization of AIG

By

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Lehman Brothers bankruptcy on 15th September 2008 caused "The Mother of all Mondays" as called by the Wall Street Journal; the US financial earthquake triggered the world and so much so that Moscow Stock Exchange had to shut down for four days. On 16th September AIG's share melted from one year high of $80 to intra-day low of $1.25, whereas for the same period, market capitalization of its stock dropped from $ 185 to merely $5.5 billion. Worried with insurers non ability to honor the financial commitments it had made through millions of contracts and its massive worldwide implications, on 17th September the Federal Reserve nationalized the largest insurer in the world by injecting $85 Billion in exchange of 79.9% stake. Thus AIG escaped filing for bankruptcy protection, but became the biggest victim in this sub-prime mortgage triggered credit crisis, which on 7th September had forced Federal Reserve to takeover mortgage giants Fannie Mae and Freddie Mac and that Merrill Lynch avoided Lehman's fate by being bought by Bank of America.

It can be argued that the seeds for this man made earthquake were planted when the Federal Reserve, lead by Alan Greenspan decided to lower interest rates all the way down to 1 percent in 2003 in an effort to counter potential deflation. The banks could not sustain this low rate and got heavily engaged in financial derivatives on the back of credit default insurance and also exporting the high yield securities in international markets. Regulators turned a blind eye as in their view; on the one hand this was helping the low income people to buy houses, and on the other reducing the migration of investments from a weak Dollar to strong Euro and British Pound. They were not able to predict that this joy ride will be of limited period and that the capitalism triumphed all over the world will proceed to eat itself.

At the root cause of this crisis, were the sub-prime mortgages which carried the highest default risk. Though the focus of this article is AIG, it is best to first explain the much talked about, but less understood mortgage business. Prime mortgages are the traditional and still most prevalent type of loans. These go to borrowers with good credit who make traditional down payment and fully document their income. Sub-prime mortgages are extended to applicants deemed the least worthy because of low credit scores or uncertain income prospects, both of which reflect the highest default risk. According to Susan M. Wachter, professor of real estate and finance at Wharton School of Management, the looser credit standards brought a mortgage boom in 2005 when sub-prime mortgages made up 22% of new loans compared to 8% in 2003. These loans had 30 years term but with annual rate adjustments after the first two to three years and carried repayment penalties making it prohibitively expensive for borrowers to refinance when their payments got too high. Buyers got these mortgages at attractive down payments on the initial low rate, without being aware that they might not be able to shoulder the higher payments when the rate adjusted upward. The apparent blunder the lending institutions made was to offer a loss-leader price in the early years of a loan in order to get borrowers into the market, in the hope that they would make up the difference in later years. They attempted to enforce the higher price in the future through the use of prepayment penalties which did not work said Watcher.

As to the providers of these financing, Wharton Study explains that the mortgage-backed securities are created by assembling thousands of loans into bundles and creating a series of bonds that pass borrowers' principal and interest payments on to the bond owners. Typically, there is a series of bonds of increasing degrees of risk reflecting the borrowers' credit worthiness. The riskier bonds pay the highest yields but are the first to lose value if borrowers fall behind in payments. Many of these lenders bought credit insurance from institution such as AIG and besides taking a share on their own account passed the risk on to investors around the world, who were eager to buy these securities since the yield offered in Treasury Bonds was producing a negative return after adding the inflation. The sub-prime market mushroomed from $240 billion in 2003 to $912 billion in 2005 and as per Panmure Gordon & Co. findings; the AIG's US Regulatory filing included a $441 billion notional exposure of its super senior credit default swap portfolio as of June 30, 2008.

Investors who bought securities backed by sub-prime loans apparently did not understand the risks either, said Wachter. "Mortgage originators had powerful incentives to originate loans, regardless of quality: every mortgage that was successfully originated and sold to an investor produced a fee for the originator." These firms often assured investors that loans met minimum standards, and they often promised to make good in case of unexpectedly large number of defaults. But they did not have the capital to honor those promises except insurance.

To a layman, when you satisfy the greed of people to buy homes with as little as $2500 down, it should not have been a surprise that many of these borrowers walked away from their obligation when they lost jobs or ran out of business? DiMartino an economics writer and Duca Senior Policy Advisor in the Research Department of the Federal Reserve Bank of Dallas reported that in early 2007, investors and lenders began to realize the ramifications of credit-standard easing. Delinquency rates for 6-month-old sub- prime underwritten in 2006 were far higher than those of the same age originated in 2004. Lenders reacted to these signs by initially tightening credit standards more on riskier mortgages. In October 2007 survey of the Federal Reserve, the share of banks tightening standards on prime mortgages jumped to 41 percent, while 56 percent did so for sub-prime loans. Many non-bank lenders also imposed tougher standards or simply exited the business altogether. The stricter standards meant fewer buyers could bid on homes, affecting prices for prime and sub-prime borrowers alike. Foreclosures added to downward pressures on home prices by raising the supply of houses on the market. And after peaking in September 2005, single-family home sales fell in September 2007 to their lowest level since January 1998.

On Aug. 14, the paralysis in the capital markets led three investment funds to halt redemptions because they couldn't reasonably calculate the prices at which their shares could be valued. This event triggered widespread concern about the pricing of many new instruments, calling into question many financial firms' market values and disrupting the normal workings of the financial markets. Initially it started with Citi Bank and later took the Wall Street and some of the European and Asian markets by surprise until the triggers of this Financial Earthquake were felt worldwide on September 16, 2008.

In my view there are four parties to this crisis, the borrower, lender, insurer and the regulator. While in first and second there is a common element of greed which caused this crisis, but the role of third one being insurer by nature has to be prudent and finally, what regulator was doing when all this was happening. In the following I will deal with the role of both but in the context of AIG.

World Financial Earthquake and the Nationalization of AIG

In 1919 an American entrepreneur Cornelius Vander Starr founded under the name American Asiatic Underwriters in Shanghai. In 1927, Starr moved his office to the building below in Shanghai where in 1931 American International Assurance (AIA) Co. Ltd. was established and in 1967, American International Group, Inc. (AIG) was formed in New York

After completing my MBA in Insurance & Risk Management in 1979 from the College of Insurance (which is now part of St. Jones University), I joined AIG and was entrusted with statuary filing of returns to 50 States where 6 of Group companies were registered. At that time every line of business, personal commercial, liability, aviation, marine and engineering etc. were operating as independent profit centers. Before filing the return acid tests were conducted and I had the access to Group Actuary who had the power from Group CEO “Hank Greenberg” to overrule the President of a subsidiary. But at the same time, Greenberg had the desire to be the market leader, and therefore only in early eighties he took the industry by surprise and created new divisions to cater for Political Risk, Directors and Officers Liability, Kidnap & Ransom and Product Guarantee coverages.

Greenberg’s aim as it could be seen from AIG’s annual reports was to make the Group a flagship operation offering traditional and innovative covers in every part of the world. He established AIG’s offices even in small or newly born countries making it a truly international insurance conglomerate. In 2007 after four decades of its establishment with 245 companies and a trillion dollars in assets, presence in 130 countries, 116,000 employees, 700,000 agents and 74 million customers; it was by far the world’s largest insurer. Besides underwriting traditional lines of business, and selling annuities in countries such as Poland though it’s innovative marketing skills by appointing soap opera and ballet dancers as agents.

It was heavily engaged from aircraft leasing, mortgage financing and credit insurance as well as the vast scale asset management businesses. Sadly, in getting bigger and bigger, it deviated from the profit-centered approach on which it was founded in 2007 annual report, Martin Sullivan former CEO of AIG, while setting out the 2008 priorities said “we must remain disciplined in our underwriting refusing to chase rates down in softening markets”. But the call was too late, since in case of sub-prime mortgage, in the absence of credible data, the risk was greater and required careful underwriting, yet the Company accepted the business at cheap rates which is evident from its results that it could reinsure only 17% of the business producing a combined loss ratio of 190% in 2007. Thus, instead of being prudent, it ended up with an aggressive underwriting which resulted in accumulation of risks as opposed to spreading it through sound reinsurance strategy.

In response to CNBC’s Maria Bartiromo’s question, on 16th September 2008; what do you think went wrong? Hank Greenberg said, I think several things; Risk Management controls either disappeared or were weakened. There was n’t attention being paid to the accumulation of risk and there was a determination to grow without the right controls in the financial sector of the business. It’s a tragedy, it did n’t have to happen. To another question, what businesses AIG should be selling that possibly could raise capital, he replied that, airline leasing company and the Transatlantic Re which are no longer necessary in AIG, you could sell part of the domestic life operation and the asset management business is not necessary for AIG. He was further asked, if he took these ideas to Bob Willumstad, the current CEO of AIG? He said I have reached out to him several times but there has been very little response.

One should not blame Willumstad, after all who wants to listen to an 80 year old man when he did not take these measures to make the Group cash rich during his own tenure. The fault also lies in the system, where for public entities; there is a need to fix the retirement age of CEO as well as Chairman of the Board. Now finally to the role of regulators; in response to a question on BBC news on 17th September that where were the regulators when all this was happening, Sir Howard Davies, former Chairman of the Financial Services Authority of UK said that there were no regulators to monitor the Group. According to him it is a weakness in American system that each company files its report to each of the State and unlike FSA there is n’t anybody to oversee the Group’s operation. Additionally, its Annual report became so complex that to examine it each of the 50 States needed to employ a team of experts and an actuary, which perhaps they could not afford and were satisfied to receive increasing amount of annual fee which was linked to the premiums. However, as reported in the Business Week issue of April 11, 2005, AIG faced an investigation into two reinsurance transactions which the Company acknowledged as improper accounting inflating reserves upto $1.7 billion.

In first quarter of 2005, the Group was served with subpoenas by state and federal regulators which caused decline in its stock by 22% as well as downgrade in rating by S&P. Earlier In fall of 2004, the insurer paid $126 million in fines to the Securities & Exchange Commission and Justice Department for deals it structured for outside clients that allegedly violated insurance accounting rules. AIG also came under the glare of New York Attorney General for its role in bid rigging with broker Marsh & McLennan which led to the ouster of Hank’s son Jeffery as CEO there. The Group admitted no wrongdoing, but two of its executives plead guilty and left the Company. In the back drop of all this development, finally AIG Board, that was notoriously clubby and close to Greenberg, says Patrick McGurn of Institutional Shareholder Services, came under shareholder’s pressure and the investigators made the directors nervous about their own ability that they even demanded Greenberg’s resignation, an unthinkable act resulting in his departure, but perhaps with his political connections, he managed a safe exit.

The matter should not have been allowed to rest on departure of Greenberg and merely on collecting of fines, rather had the New York Governor, which on 16th September offered $20 billion worth of State assets to bail out the insurer, intervened in March 2005 to team up with regulators to install independent directors and demanded from the Board for clearing up the mess before the close of 2005, the current crisis could have been avoided.

Many experts continue to criticize the US administrations' decision to single out AIG and not to rescue Lehman Brothers, Goldman Sachs and General Motors. Unlike these organizations it must be recognized that AIG was world's insurance power and if it was allowed to fail, its knock on effects would have been far reaching, resulting in stoppage of insurance coverages and halt of many airlines and shipping operations where AIG was direct insurer/ reinsurer or both. It would have been impossible for the US government to cough up trillions of dollars to pay huge losses and the crisis could have led to worldwide economic war. Needless to say that the nationalization of AIG has resulted in comfort to its policy holders as well as partner organizations.

About the Writer: He is the former Managing Director of the Karachi Stock Exchange and the Country Chief of Commercial Union Insurance plc.