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## To What Degree Were AIG's Operating Insurance Subsidiaries Sound?

### Summary

Aside from the mortgage insurers, the P&C subsidiaries were basically sound, though with some issues such as capital stacking, affiliated assets, etc., as mentioned below. The non-mortgage P&C subsidiaries didn't have a great 2008, but they would have survived as standalone entities.

The life and mortgage subsidiaries are another matter. Without the help of the US Government, many of them would have failed. Even now, given the levels of affiliated assets, capital stacking, deferred tax assets, etc., they are not in great shape now should there be another surprise. Profitability is likely to be lower in the future than in the banner years of the middle of the 2000s decade.

### Introduction

When the economic history books get written about the crisis at the end of the 2000s decade, the difficult analyses will involve Fannie, Freddie, Lehman, AIG, and the large banks that failed. The degree of leverage employed, both explicit and implicit, will be quite a tale, as will the abandonment of underwriting standards.

This piece is meant to deal with the company that I view as the most complex, and the most levered – AIG. There have been many attempts to explain the problems at AIG, with most of the attention paid to AIG Financial Products. This analysis is meant to be complementary to those analyses, because I will focus on AIG's regulated US Life and P&C subsidiaries. I have gone through the Statutory books for these subsidiaries, and there is an interesting tale to be told. (A better story than [how I got the Statutory](#) data, even.)

### Flashing back

Several incidents shaped my perception of AIG over the years. Working there in the domestic life companies from 1989-92, I heard the AIG mantras:

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- 15% return on average equity is the golden rule of AIG. Subsidiaries and divisions that cannot meet that will be eliminated.
- We exit business lines that cannot meet our return goals.
- Keeping the AAA rating is of utmost importance.
- Our accounting should be conservative.
- Keep expenses low.
- Few people make it past five years at AIG, but if you can survive that long, you will be a lifer, and you will be rewarded.
- We didn't take over The Equitable because we couldn't get to the 15% target. That said, the takeover team scared them away, and into the arms of AXA (another accounting nightmare I suspect).

I took the rules seriously. I ended up closing two lines of business that could not meet return goals, and found two centimillion-dollar reserve errors. There were several products that never made it to market because they could not meet the 15% return goal.

But there was the rest of the story:

- "Dealing with auditors is bloodsport."
- "I drop my deficiency reserves in the Atlantic Ocean." (via reinsurance)
- "I like the pension and annuity businesses because they give some bulk to our balance sheet." (Reputedly M.R. Greenberg said this to a colleague of mine. We scratched our heads over that one, because it was so anti-AIG philosophy.)
- Heavy reliance on surplus relief reinsurance in order to front statutory earnings into the present, and reduce capital needs.
- My boss found two centimillion-dollar reserve errors also.
- "Dealing with reinsurers is bloodsport. Never give them an even break."
- Clever use of transfer pricing to get money out of blocked currencies.
- Arrogant guys at AIG Financial Products that would hardly acknowledge you as part of the same team at conferences.
- And, a \$1 billion GAAP reserve understatement at Alico Japan in 1992.

There was AIG in theory, and in practice. I was a young actuary at the time, and relatively idealistic, but it was easy to get cynical in a highly politicized office environment, where almost everything was a fight. Thus my view of AIG was always colored by the hidden leverage, the large losses that never seemed to derail the company as a whole, and the bare-knuckled approach to business.

I could not live with my conscience while I worked there, so I sought greener pastures from year one there – it took two long years to get the right position. Two very hard years.

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Fourteen years later, I had dinner with a well-regarded sell side analyst while visiting P&C companies with him in Ohio. The management teams we talked with thought we were twins separated at birth. Our views were very similar, except on AIG. He asked me why I didn't like AIG – it was so cheap. I told him the story that I have told you, and one more thing: when I worked for AIG, there was virtually no debt. By 2006, the degree of financial leverage was four times higher than when I worked there. The 15% ROE was intact, but the return on assets had dropped like a stone, and leverage from debt made up the difference.

I told him AIG was not the great company that it once was. It was far more leveraged, and the ratings agencies were behind on their evaluations.

### **To the Statutory Statements**

The statutory statements record the life of an insurance operating subsidiary. The regulators require insurance companies to publicly disclose far more data than the banks do to their regulators.

Insurance holding companies own their subsidiaries, and survive by receiving dividends from the subsidiaries, or borrowing against them. Operating subsidiaries receive cash from holding companies when opportunities are good, and dividend back when there aren't as many opportunities.

The ability to dividend back is controlled by statutory accounting principles, risk-based capital rules, and also by the state regulators. This places insurance holding companies in a tough spot; they need dividends from some operating subsidiaries to survive, particularly during times when credit is not available on favorable terms, if at all.

The key question I went off to answer is **to what degree were AIG's operating subsidiaries sound?** We all know that AIG Financial Products was a basket case, but perhaps the rest of the operating companies were in good shape. The answer to this question is mixed, and I will attempt to explain where there are weaknesses and strengths. Sneak Preview: the weaknesses outweigh the strengths.

Given my prior experience with AIG, I expected to find question marks in the area of reinsurance. I did find some, but it wasn't the biggest area of problems. I'll try to take the problems in order of importance.

### **The Securities Lending Fiasco**

Most, if not all life insurance companies engage in securities lending to some degree. AIG did it in a big way, involving almost all of their life subsidiaries. When a life insurer lends out its bonds, they receive back safe liquid collateral equal to 100-102% of the par value of what they lent out. Most companies leave well enough alone at that point. After all, you still receive the income on the bonds you lent out, plus securities lending fees. The borrower receives the income on his collateral, less securities lending fees. The borrower sells the bonds he borrowed, hoping to buy them back cheaper.

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So far, so good, but AIG added a wrinkle to the game. The safe liquid collateral was a slack asset to them. Why not replace it with equally safe and liquid assets that offered considerably more yield, like bonds backed by AAA-rated subprime or Alt-A mortgage collateral? After all, AIG was already writing financial reinsurance through default swaps on such mortgages, why not add to a winning bet?

They did so in a big way:

Subsidiary	Realized sec lending losses	2007YE Surplus	RSLL / 2007YE Surplus	It took an amazing amount of skill to lose 76% of the surplus of the affected life companies. One company, American General L&A IC, lost more than double its surplus. Wow. Why did this turn out so wrong? The assets were mismatched to the liabilities in two ways: 1) The mortgages had longer lives than the securities lending transactions. Even if there were no credit issues, there was no way to assure that the mortgage bonds
American General L&A IC	(977)	471	-207%	
AIG LIC	(871)	440	-198%	
AIG Annuity IC	(7,110)	3,729	-191%	
Am Int LIC of NY	(771)	553	-139%	
First SunAmerica LIC	(653)	501	-130%	
The Variable Annuity LIC	(3,562)	2,838	-126%	
American General LIC	(3,790)	5,704	-66%	
SunAmerica LIC	(2,281)	4,716	-48%	
AIG SunAmerica LAC	(424)	1,151	-37%	
Merit LIC	(50)	705	-7%	
American Life IC (Alico)	(470)	6,718	-7%	
Delaware American LIC	(1)	24	-4%	
Life Companies Total	(20,960)	27,550	-76%	

would be worth the same at the beginning and end of the transaction.

2) Though AAA-rated, they were not credit risk-free. Non-prime mortgages were made to borrowers of lower quality. Of their own, they wouldn't be investment grade, much less AAA, without credit support. That credit support came through subordination. Other investors would take the first X% of losses before the AAA bondholders would take any losses. That X-factor was set too low. In order to maintain a AAA rating, the X-factor not only has to be high enough that losses don't harm the AAA investors, it has to be high enough that other investors would think that it would be almost impossible for losses to harm the AAA investors.

Subsidiary	Net capital contributed / 2007 Surplus (neg = divs)	2007YE Surplus	Net capital contributed (neg = divs)
American General LIC	123%	5,704	7,004
AIG Annuity IC	167%	3,729	6,223
The Variable Annuity LIC	113%	2,838	3,213
SunAmerica LIC	57%	4,716	2,696
AGC LIC	12%	7,729	895

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American General L&A IC	185%	471	872
First SunAmerica LIC	153%	501	768
AIG LIC	167%	440	736
Am Int LIC of NY	101%	553	557
AIG SunAmerica LAC	25%	1,151	284
New Hampshire IC	19%	1,369	265
American Life IC	3%	6,718	211
Commerce and Industry IC	7%	2,688	180
UG Mortgage Indemnity Co of NC	55%	55	30
21st Century IC	0%	663	2
AIG Auto IC of NJ	0%	18	-
AIG Centennial IC	0%	335	-
AIG Excess Liability Co.	0%	1,248	-
AIG Hawaii IC	0%	65	-
AIG National IC	0%	18	-
AIG Premier IC	0%	162	-
Am Gen Property IC	0%	18	-
Am Int IC	0%	367	-
Am Int IC of Delaware	0%	45	-
Am Int Specialty Lines IC	0%	638	-
Audubon IC	0%	42	-
Delaware American LIC	0%	24	-
F book	0%	-	-
Landmark IC	0%	146	-
New Hampshire Indemnity Co	0%	102	-
Pacific Union Assurance Co	0%	67	-
UG Residential IC of NC	0%	194	-
United Guaranty IC	0%	24	-
United Guaranty Residential IC	-2%	496	(10)
Hartford Steam Boiler IAIC of CT	-26%	43	(11)
AIG Casualty Co	-5%	1,884	(103)
Hartford Steam Boiler IAIC	-22%	720	(158)
Lexington IC	-5%	4,551	(250)
Merit LIC	-38%	705	(270)
AIU IC	-33%	1,398	(463)
American Home Assurance Co	-8%	7,297	(571)
National Union Fire IC	-6%	12,157	(787)
Totals	30%	72,089	21,313

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As a result of the securities lending losses, and the troubles at AIGFP, the Fed and Treasury began the bailout of AIG. (Look at the above table to see the amount pumped in and taken out of each subsidiary on net.) Why did they indirectly bail out life insurance companies that they do not regulate including one that mainly serves foreigners (Alico), by bailing out the AIG holding company?

I can't be totally certain here, but I suggest that all major state insurance regulators should send Ben Bernanke, Tim Geithner, and Hank Paulson some really nice gifts, because had AIG's life companies failed, the state guaranty funds would have been hard pressed to come up with something north of \$10 billion by surcharging the other insurance companies doing business in each state. At a time like this, where many life insurers, particularly ones facing credit risks, and those having variable policies, where profitability has declined along with the stock market, the surcharges could have kicked additional life insurers over the edge, and who knows how big the cascade would have been.

(Note to corporate bond managers managing insurance money: this is why you don't own insurance bonds in your neck of the industry. The company you manage money for already has contingent credit exposure to all of their peers through the guaranty funds.)

AIGFP was the bigger issue, but the domestic life companies of AIG posed a separate, distinct issue that the US Government addressed, right or wrong.

### **Capital Stacking, Cross-guarantees, and Surplus Notes**

After the difficulties with securities lending, the next issue reminded me a lot of the first company I worked for: Southmark. A two-time loser in chapter 11, in their second trip of insolvency, they interlaced the capital of their subsidiaries, forcing them to do business on a thin capital base. Subsidiary A would own stock of subsidiary B, and B would own stock of A. They would both look more solvent, but would not be any more solvent. Neither "asset" could be tapped for liquidity purposes. In AIG's case, most of the capital stacking was not so crude. Most of it was operating subsidiaries owning shares in other subsidiaries, without another transaction going the other way.

Capital stacking increases leverage in a hidden way. Say Subsidiary A owns Subsidiary B. The surplus of B not only supports B's business, but also A's business. A downturn in the business of B affects not only the affairs of B, but also A, particularly so if the surplus of B is a large fraction of A's surplus.

With AIG, many of the operating insurance subsidiaries [OISs] held stakes (usually common stock) in other OISs. Here's a table of those subsidiaries with the exposure to the issue:

<b>Subsidiary</b>	<b>2008YE Surplus</b>	<b>Affiliated Assets / Surplus</b>
Am Gen Property IC	18	628%
AGC LIC	5,887	171%

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UG Residential IC of NC	200	138%	Some of AIG's larger OISs have significant exposures to other subsidiaries. One minor subsidiary, Pacific Union, invested directly in AIG's common stock. That subsidiary doesn't have much business in it, and is in little danger of insolvency, but is the most egregious example of creating capital out of thin air. (I feel the same way when companies contribute common stock to Defined Benefit plans.)  Other OISs of note: 1) AGC LIC seems to be an intermediate level holding company, with little business of its own. 2) National Union is the biggest P&C company. 3) Alico is the intermediate holding company for most of the International Life business. 4) SunAmerica and American General are holding companies for the companies when they were acquired by AIG. They have significant business in themselves as well.  There are guarantees as well. Some of the larger subsidiaries, like National Union, together with AIG, guarantee a number of other domestic and international OISs.  Finally, there are surplus notes, concentrated in the mortgage guarantee subsidiaries. This
SunAmerica LIC	4,653	107%	
National Union Fire IC	11,825	90%	
American Life IC "Alico"	3,900	79%	
Audubon IC	39	77%	
American General LIC	5,185	74%	
New Hampshire IC	1,652	72%	
AIG Centennial IC	305	63%	
Hartford Steam Boiler IAIC	443	47%	
AIG Casualty Co	1,457	35%	
AIU IC	726	34%	
AIG Hawaii IC	64	27%	
AIG Excess Liability Co.	1,438	24%	
American Home Assurance Co	5,702	23%	
AIG Annuity IC	3,045	22%	
American General L&A IC	488	22%	
Commerce and Industry IC	2,678	20%	
The Variable Annuity LIC	2,841	20%	
Am Int IC	374	19%	
Am Int LIC of NY	371	19%	
AIG Premier IC	144	18%	
United Guaranty Residential IC	1,106	16%	
New Hampshire Indemnity Co	140	13%	
Hartford Steam Boiler IAIC of CT	46	11%	
Lexington IC	4,263	11%	
Pacific Union Assurance Co	20	10%	
AIG LIC	360	9%	
AIG SunAmerica LAC	1,271	8%	

is another way of creating capital out of this air. Surplus notes are considered as surplus, not debt, to the issuer, because any payment of principal or interest must be approved by the state Insurance Commissioner. Subsidiary A offers surplus notes to Subsidiary B, which sends cash back to subsidiary A. Subsidiary B gets to admit the surplus note as an asset. New surplus created, with no transfer of risk to an external party. Three of the four mortgage guarantee subsidiaries issued surplus notes to other AIG mortgage insurance-related subsidiaries totaling a little less than \$900 million.

Now, given all of the complexity and leverage from all of these arrangements, it is all the more stunning that the normally intelligent New York Insurance Department allowed for the OISs of AIG to contemplate lending \$20 billion to AIG. At the time, [I thought the idea was dubious](#). This [article from Enforce](#) (pages 17-20) gives the definitive treatment of the issue, though I disagree with one of their main conclusions. [I don't think the Federal Government would do a better job](#) regulating insurance than

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the states currently do. They have certainly not distinguished themselves in their regulation of depository institutions.

### Unrealized Capital Losses

Subsidiary	C UR CG / Surplus	2008YE Surplus	
Pacific Union Assurance Co	-385%	20	<p>The table to the left indicates current unrealized capital gains as a fraction of surplus. When I first looked at this, I thought most of these must have been from unrealized losses on bonds, but to my surprise, they are mostly losses from affiliated company stocks, which must be valued at market price or net worth.</p> <p>But as I began to dig into the losses, I found something unusual at Alico. At the end of 2007, almost the entirety of their surplus assets were composed of AIG common stock.</p> <p>Delaware regulators, please tell me, why would you allow this? It is one thing to allow this for a pup subsidiary like Pacific Union, and quite another thing for a big dog like Alico.</p> <p>For those less aware, holding affiliated stock of subsidiaries is capital stacking, which raises leverage, but owning holding company stock is</p>
AGC LIC	-360%	5887	
American Life IC "Alico"	-118%	3900	
American General LIC	-89%	5185	
SunAmerica LIC	-74%	4653	
AIG Casualty Co	-46%	1457	
AIG Annuity IC	-29%	3045	
American Home Assurance Co	-21%	5702	
The Variable Annuity LIC	-20%	2841	
Hartford Steam Boiler IAIC	-16%	443	
Commerce and Industry IC	-16%	2678	
Audubon IC	-15%	39	
AIG LIC	-15%	360	
Lexington IC	-10%	4263	
Am Int Specialty Lines IC	11%	726	
AIU IC	32%	726	
UG Residential IC of NC	34%	200	
AIG SunAmerica LAC	50%	1271	

creating capital out of thin air. When things are going good capital rises disproportionately. When things are bad, the opposite happens. We are experiencing that negative part of the cycle now.

Now there were other areas of loss for AIG OISs, many are [detailed in this article here](#). I'm not generally a fan of insurance companies investing in anything more dangerous than investment grade bonds. My main reason for this view is the outlier types of events, like that which we are seeing now. Insurance companies should never want to be in a situation where they are suffer underwriting losses at a time where they are taking losses on the investment side as well. Most of these losses from limited partnerships (private equity and hedge funds), though unrealized, have already hit capital levels. Some will make part of the losses back, but many will not. In this environment, high risk investments are not being rewarded.

### Reinsurance

Before I start this section, a small word of warning. I am a life actuary, not a P&C actuary, so I may not get all of the nuances on reserve credits for P&C companies. I have worked on life reinsurance issues at all of the life companies that I have worked with, or consulted for, but it is not my specialty.

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Reinsurance involves a transfer of risk to another insurance carrier. To the degree that risk is transferred, a reserve credit can be set up to reflect the discounted expected value of future claim payments.

Reinsurance does carry a risk, though, if the reinsurer can't or won't pay. AIG's rather sharp handling of reinsurers in the past carries with it the risk that reinsurers will be less than sympathetic to their problems. Because of AIG's difficulties, reinsurers will be more likely to try to deny claims while AIG is weak. And like the [parable of the unjust steward](#), some AIG employees might be inclined to compromise at levels fairer to the reinsurer. After all, opportunities at AIG are ebbing, but having friends in the industry is always an aid when looking for work.

Here's a table listing the size of the net reinsurance reserve credits by subsidiary relative to the size of the surplus.

<b>Subsidiary</b>	<b>2008YE Surplus</b>	<b>Reinsurance Reserve Credit / Surplus</b>
AIG National IC	17	1300%
Am Int IC	374	1006%
Am Int Specialty Lines IC	726	742%
AIU IC	726	407%
Am Int IC of Delaware	48	319%
UG Mortgage Indemnity Co of NC	128	260%
AIG Excess Liability Co.	1,438	179%
Lexington IC	4,263	162%
AIG Hawaii IC	64	144%
Landmark IC	155	143%
American General LIC	5,185	101%
New Hampshire Indemnity Co	140	100%
United Guaranty Residential IC	1,106	97%
21st Century IC	747	96%
American Life IC "Alico"	3,900	93%
AIG Premier IC	144	92%
AIG Centennial IC	305	83%
AIG LIC	360	70%
Audubon IC	39	69%
UG Residential IC of NC	200	45%
Hartford Steam Boiler IAIC	443	41%
F book	23,314	22%
American General L&A IC	488	18%

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Delaware American LIC	25	16%	A few notes: 1) The higher the reinsurance reserve credit is relative to surplus, the greater the risk if the reinsurers can't or won't pay. 2) AIG reinsures many of their risks internally through intercompany P&C pools, but the reinsurance credits from those
SunAmerica LIC	4,653	13%	
Am Int LIC of NY	371	12%	
First SunAmerica LIC	544	6%	
AIG SunAmerica LAC	1,271	5%	
AIG Auto IC of NJ	21	2%	

agreements should net out of the net reinsurance credit figure. The reinsurance pools spread out risk within AIG, but do not reduce the risk within AIG. Plus, say an insurance commissioner trying to keep an OIS afloat in his state might take actions that keep that OIS safer, but that would push risks to other OISs in other states. 3) There is one odd entry called "F book." Five OISs share one statutory book for all of their reinsurance – National Union Fire IC, American Home Assurance Co, Commerce and Industry IC, New Hampshire IC, and AIG Casualty Co. Those OISs are 5 of the 6 largest, ranked by 2008 year-end surplus. Though large, there is not much reinsurance credit exposure there.

Whether internally or externally reinsured, the size of reinsurance credits relative to surplus raise risk solvency risk issues if reinsurers can't or won't pay.

### Realized Capital Losses, Excluding Securities Lending at the Life Companies

Subsidiary	Sum of 2007YE Surplus	Other Realized Capital Losses / Surplus	If the securities lending losses weren't enough, the life companies ran asset portfolios where many risks did not pan out.
First SunAmerica LIC	501	-81%	Much of that came from corporate bonds (including junk bonds), CMBS, and non-conforming RMBS. The domestic life companies pruned areas of their portfolios in order to prevent greater losses later.
The Variable Annuity LIC	2,838	-61%	
AIG Annuity IC	3,729	-49%	
Am Int LIC of NY	553	-41%	
AIG LIC	440	-39%	
American General L&A IC	471	-28%	
SunAmerica LIC	4,716	-17%	
American General LIC	5,704	-16%	
American Life IC	6,718	-11%	
Merit LIC	705	-4%	
Pacific Union Assurance Co	67	-1%	

### Deferred Tax Assets

Here is a table of deferred tax assets by OIS, for those having more than 10% of surplus in DTAs. Deferred tax assets are only valuable to the degree that you can earn income adequate to use them. The column "DTA payback" indicates the number of years of 2007 earnings (a relatively good year) that it would take to fully use the DTAs.

Now, it may no longer matter whether AIG ever pays taxes or not. It is largely "in one pocket, out of the other" with the government. But it does have some solvency and profit implications for the subsidiaries.

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Subsidiary	DTAs/ Surplus	2008YE Surplus	DTA payback
American General L&A IC	152%	488	6.24
Am Int LIC of NY	133%	371	13.22
AIG LIC	131%	360	11.91
AIG Annuity IC	117%	3,045	15.53
First SunAmerica LIC	85%	544	17.37
The Variable Annuity LIC	70%	2,841	7.08
UG Residential IC of NC	61%	200	NA
American General LIC	50%	5,185	6.66
American Life IC	43%	3,900	2.93
AIG Premier IC	37%	144	151.43
SunAmerica LIC	35%	4,653	4.94
Hartford Steam Boiler IAIC	29%	443	1.65
AIG Centennial IC	24%	305	NA
AIG Hawaii IC	23%	64	NA
AIG SunAmerica LAC	20%	1,271	4.26
United Guaranty IC	19%	52	2.60
American Home Assurance Co	19%	5,702	1.81
AIU IC	18%	726	3.66
AIG National IC	12%	17	NA
Merit LIC	12%	406	2.00

DTAs as assets earn no income, and there is nothing that can be tapped for cash in a crisis. In insolvency, they are not very useful, because acquirers can only use them in very limited ways. Therefore, having a long DTA payback period, or a high amount of DTAs as a fraction of surplus is a negative for profitability and solvency.

This will prove to be more of a difficulty if prior profitability levels are not regained, which could be particularly difficult for the equity-sensitive OISs, where fees from variable products will likely be down for a while. Also, consider that the OISs as a whole may find that 2007 was an exceptionally good year for investments and underwriting, and may not be achievable any time soon.

### Continuing profitability / Is this strictly an investment problem?

	2007 Net Income	2008 Net Income	2007 Net Operating Income	2008 Net Operating Income	Surplus Increase net of Capital Contributions and divs	Yellow Column less Realized Capital Gains
Total P&C	5,563	733	7,210	654	(353)	
Total Life	3,404	(23,218)	7,206	2,819	(29,539)	(1,840)
Total	8,967	(22,485)	14,416	3,473	(29,892)	

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	Net Underwriting Gain 2007	Net Underwriting Gain 2008	Net Investment Gain 2007	Net Investment Gain 2008
Total P&C	2,189	(1,939)	3,783	2,485

Take a look at the above two tables. For the P&C OISs, investment results were worse in 2008, but the really big swing was in underwriting, where profits were around \$4 billion lower than 2007. My summary figure for core P&C statutory earnings in 2008 is the -\$353 million highlighted in green. That is the surplus increase net of capital contributions and dividends. I.e., how much did the value of the companies fall as a result of the year operations -- \$353 million.

For the life companies, I did the same calculation, but netted out realized capital losses, which should not recur, for a core statutory loss of \$1.84 billion. I can't split that entirely into underwriting and investments, as with P&C, but taking out the realized capital gains approximates it.

My main point here is that 2008 was a bad year for AIG's OISs even without the investment losses. Not enough to take any of the main OISs into insolvency by itself, but bad still.

#### Articles and other issues

More holding company liquidity out of thin air: receiving a [\\$800 million loan from American General Finance](#), a wholly owned subsidiary, in exchange for giving the subsidiary \$600 million in capital to satisfy a debt covenant. Wonderful, American General Finance is somewhat less creditworthy to bondholders of the firm, and the AIG holding company gets cash.

AIG attempts to raise cash and reduce leverage through the sale of subsidiaries that are in relatively good shape:

- [Investment Management Businesses](#)
- [21<sup>st</sup> Century Insurance \(Personal Auto, mainly\)](#)
- [Reorganizing AIU Holdings to make it more saleable.](#)

The price talk doesn't look that great. Counting in Hartford Steam Boiler, premium prices are certainly not being realized.

In general, the simplest units to sell are the simplest ones to value. They have the easiest models for analyzing likely future free cash flows, or distributable earnings. I have said before that when a company is in a crisis, and has to sell off assets, that it makes a great deal of difference what kinds of assets they sell off. If they reach for the dirtier assets, and wish to keep the clean ones, it is usually a sign of confidence in the future. If they sell the good assets, because that is all they can do, they are just stalling for time, and hoping that a better day arrives. Hope is not a strategy, but that is what seems to be going on here.

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Now, as for [Maurice Raymond Greenberg's claim](#) that he had nothing to do with the wreck of AIG, let me simply say that he should shoulder a lot of the blame. Most of the increase in leverage occurred under his watch. AIG was a decidedly more risky investment when he left than in the late 80s, when the balance sheet had virtually no debt. He encouraged a fear-based culture that was very bottom-line oriented for the quarterly earnings estimate, even to the point of buying finite reinsurance to manipulate the results. He pushed for an aggressive culture at AIG Financial products, and he got one. He may not have been there for the worst of it, but he certainly sowed the seeds of future trouble.

## Summary

**To what degree were AIG's operating subsidiaries sound?** Answer: aside from the mortgage insurers, the P&C subsidiaries were basically sound, though with some issues such as capital stacking, affiliated assets, etc., as mentioned above. The non-mortgage P&C subsidiaries didn't have a great 2008, but they would have survived as standalone entities.

The life and mortgage subsidiaries are another matter. Without the help of the US Government, many of them would have failed. Even now, given the levels of affiliated assets, capital stacking, deferred tax assets, etc., they are not in great shape now should there be another surprise. Profitability is likely to be lower in the future than in the banner years of the middle of the 2000s decade.

The US government acted for multiple reasons on AIG. Among them was to protect the other life insurers of the US from getting surcharged in order to pay for the costs going to the guarantee funds, along with systemic risk issues at AIG Financial Products (which was much bigger).

If AIG did not have AIGFP, and no bailout from the US Government, the company as a whole would have come under severe stress, and some of the life and mortgage subsidiaries would have gone into insolvency, but the company as a whole would probably have survived.

## Investment implications

My view of AIG is this: the common stock will go out worthless, or nearly so. Preferred stakes will be compromised at best. Beyond that, I am less certain. I look at two types of debt securities and wonder, though. I am planning on doing a review of the funding agreement-backed notes, and perhaps a closer look at American General Finance notes after the first quarter is reported.

The tough part is we don't know what the government will do. If their main goal was stabilizing AIGFP, and that job is nearly complete, then if the value of AIG as subsidiaries get sold appears to not support the preferred stock, the government might walk, and not throw good money after bad. At that point, bonds of the holding company would suffer further, because the insurance commissioners will carefully watch any dividending up to the AIG holding company. They got bailed out once. They will be watching more closely from now on, because lightning doesn't often strike twice in the same place.

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My basic view is take a conservative posture on AIG securities. There are many competing interests, some political, some economic, fighting over the corpse of this once great company. Be wary of investing in the capital structure of AIG.

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