

"Aint It Great!"

What the AIG Situation Means Predictions for 2009

{This article was written, but not published due to conflicts with AIG, long before the issues of AIG bonuses; divestitures of divisions; resignation of Liddy; Defections of Kelley and the opening statements of Hank Greenburg's trial with AIG and the Government.

It predicted Hank Greenberg would actively pursue a company affiliation to compete with AIG. He did Iron Shore in Bermuda, where he sent Billions of AIG stock certificates to escape court order.

It predicted Kelly would build a large competitor with defections from AIG which he has.

It predicted that the \$85 Billion was wrong and that the number would swell to in-excess of \$250 billion, which it has.

It predicted Federal intervention in Insurance Regulation, which is now beginning.

It is one of the primary reasons for founding Broker's Path, an independent Consulting firm dedicated to Agents and Brokers that does not and will not be involved in Merger & Acquisition Consultancy}

By
Dan Romain

Disclaimer: *This article may contain adult content inappropriate for Insurance Practitioners unless you have been previously employed in AIG's claims department (all three of you).*

There I sat, snowed-in, processing oxygen, watching a dumpster fire we call Seahawk football, sipping my Hales Pale Ale (a Seattle micro-brew) occasionally flicking a drop on the woodstove to watch it sizzle when suddenly a shrill "DAN" rang out. My usually tranquil wife occupying her time was balancing the checkbook. She discovered Prince Charming had forgotten to enter a check.

It's a character flaw, but it got me to thinking...

If my wife couldn't account for \$152 dollars and I was cleared of all wrongdoing, heads would roll at the local branch of DB Cooper Savings and Loan. What would she do if they misplaced a billion times more than that? That really got me to thinking **About Insurance Giant, AIG.**

So I did a little research, quite a bit actually.

Nothing in Google, Zippo in AM Best, nada in NASDAQ, not a peep from Fitch, same for S&P, not word-one from the GAO and mum's the word at the Fed. There's no hint in the Congressional record, no such luck with the Treasury, and no one home at the usual places most of us look for news about the exact amount the Treasury has "loaned" AIG.

You'd think you could just ask, what with those being your dollars and all....

Both AIG and the Treasury refuse to disclose how or how much of the money was spent, so Bloomberg.com eventually asked a judge. The Court held that the Treasury and AIG had protections outside the scope of the Freedom of Information Act. Say what? The bank (you) has no right to know how they're spending the money?! ***That is so cool!*** (Note to self: Buy a troubled insurance company that recently bought some sort of thrift or bank and step towards the teller with a coy demeanor. Then distribute the cash to your crony executives fast...and a pittance or two for yourself of course. What 'Joe the Plumber' doesn't know won't hurt him).

Alas, I eventually found the exact number.

The actual number is \$152.2 billion as reported in the New York Bureau Report, filed on November 10th as required by law, after the Treasury re-papered the original deal. AIG's insurance subsidiaries are regulated by New York Insurance Superintendent Eric Dinallo and the Federal Office of Thrift oversees the AIG holding company, if you are curious.

Next, I thought I'd try to find all the sell-off deals AIG has transacted since 'you' bought the company in mid-September.

If you recall, that was the deal. They'd sell stuff, lots of profitable stuff, \$60 Billion in stuff to be precise which is sort'a not-so precise; because that was precisely the deal before the Treasury doubled-down (and then some) with an additional house loan of \$90.2 Billion ***after realizing there was no way in hell AIG could sell that much stuff!***



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What's that you say? You found something? AIG sold an energy unit in Switzerland which they sold to an investment bank in Abu Dhabi? That's it? Hey, wait a minute. You forgot all about the mondo deal. They sold some oil storage tanks in Nebraska run by something called Tenaska. Who cares if an AIG spokesman described it as a "relatively small transaction"; it's a start! So, what if these two deals only offset 203 minutes of AIG's \$58.6 billion dollars in losses since January 2008! (Trust the math folks). They're trying!

Yes, I know...the **Hartford Steam Boiler** deal they just announced. There's a term-sheet in play and, who knows, maybe obscenely profitably **HSB** will be sold for much needed surplus. If so, I'm taking the "under" on the proposed purchase price. With indexed claw-back provisions I'll be surprised if it turns-out to be 50% of what they announced. \$1.5 Billion is 1% of what Hank Paulson (not the other Hank who I predict will have something to *give* AIG before this is all over...a run for their money!) 'gave' AIG.

Now the WTO (World Toilet Organization: I swear-to-God this is true! `worldtoilet.org`) estimates there's 3 billion toilets in the world (not counting a certain someone's back deck) that flush on average 25-times a times a day (public use must really skew the number, I suspect). If true, then the world flushes as much as Uncle Sam did on AIG last year!

But here's a less garish comparison:

(Totals reported in Billions)

EPA	\$8
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Congress	5
Executive Branch	17
Judicial Branch	7
Commerce	9
Homeland Security	44
State Department	25
Dep't of Energy	23
Big three Bailout	13 (?)
Red Sox box seats	1.999,999,999
<u>AIG CEO W-2</u>	<u>1</u>
Total:	\$152

Basically everything we call "The Federal Government" less Social Security, Defense, and the Treasury is what we've committed to AIG in the past 90-days and we can't get football's B.C.S. fixed once-and-for-all! What's up with that? I had to roll a potato with my nose down Main-street just to find out how much actually went to AIG!

AIG has had lots of "showings" from all kinds of interested buyers. Mysteriously, there's not a lot of interest in AIG platforms these days, except of course, the highly coveted and obscenely profitable Chinese operation which AIG isn't too anxious to sell by the way. (Which is exactly why China Life will be bought for 1/2 its enterprise value!) Perhaps the recent talk that Munich



Re might buy Hartford Steam Boiler (HSB) for between \$1.2 and \$1.5 billion will transact later this spring? I hope so! And, if so...that's nearly 1% of the total bailout AIG has received, thank you very much! If they peddle the China operations that would really make a dent, but then I wonder...will they endorse the check over to you or hang-on to it to replace evaporating surplus? Even if they do, aren't HSB and China AIG intensely profitable?

But, we know that the longer time passes without a major deal, the harder it is for AIG to maintain the value of the businesses it is trying to sell, as well as those it is trying to preserve.

Maybe that's why, out-of-retirement, Liddy recently said that the sell-off of assets is being "re-thought".

"Re-thought?"

Re-think this. Liddy just said, "We might have to go back to the Treasury for more assistance"

What?

We, well...you know; "the collective we" shell-out a gazillion and you sell-off some stuff and life as we know it moves on...**THAT WAS THE DEAL!**

Well, the good thing is that there's some Treasury oversight. Which sort of annoyed PricewaterhouseCoopers and several other 'hired guns' that mind the store, because they all had sections of their contracts **blacked-out** or omitted entirely. (No, I'm not kidding.) The documents look like a Watergate flash-back. I've seen them and, but for duct-tape, my head would have exploded. (I personally have complete confidence in PWC as the only guys to call-out AIG. PricewaterhouseCoopers called it before it all 'hit the fan'.) But come' on! Blacked-out contracts?!

Well, at least they've got that going for them....which is nice.

AIG doesn't seem to be worried about surplus. Not in the way Liberty Mutual's CEO (the last Kelly in this month's trilogy) is worried, that's for sure:

"AIG has intensified its efforts to increase market share, or at least preserve it," Kelly said. "It's fair to say they are doing some very stupid things in the market. AIG is focused more on government and capital and is "paying little attention to what is actually going on in the trenches," Kelly said.

As rumors go, I'm told this remark got Kelly tossed-off Liddy's Christmas card list. Believe what you want. As for me, I've always thought Kelly had "street-cred". I'm a huge fan of Liberty Mutual.

Against all odds, Liberty made a few bucks last quarter after hitting the “delete” button on a billion dollars in CPA recommendations. They didn’t borrow a penny from you to do it either. They bought underwriting-obsessed Safeco too. Something tells me Kelly’s not going to hold his nose and follow AIG into the Stygian Pit. We know Chubb won’t and Fireman’s

Fund/Alliance was just upgraded to a higher form of life by S&P and AM Best. Hartford’s stock had a nice bounce after some Alliance cash the other day. Those ratings may be worth gold (literally) in six months if they can hold onto them! What do these well-run outfits think they know?

Donn Vickery, a forensic analyst (CPA Columbo type) with Gradient Analytics thinks he knows what happened at AIG: “You don’t just lose \$120 billion overnight” he is quoted as saying in the New York Times. Mr. Vickery believes AIG must have already accumulated tens of billions of dollars worth of losses by mid-September when it came close to collapse. But “**Those losses do not show up in the company’s financial filings.” he reports.**

Huh?

I just think that is so weird how we call them “financial statements” when ***they don’t actually state the financials!***

(Note to self: Go to the bank, hand the Teller a pop-cycle wrapper with some ink-bled numbers scribbled on the parts that aren’t sticky and tell them you’d like ***to have \$152.2 billion dollars!!***)

It’s rumored that an AM Best SWAT team sleeps on the rich Corinthian leather at AIG Plaza in New York. Imagine one morning being one of those guys, all serious and analytical, walking past the AIG receptionist and noticing a headline in the *Insurance Journal* on the coffee table: “AIG is slashing renewal rates by 60%”!

Unfortunately, S&P, Fitch and Best metrics don’t contemplate snap-quick implications in terms of weeks. If the long-tail exposures AIG is binding percolate for a few years (by definition) before the claims start to come, then I guess AIG lives to fight another day. That is, until “that” day comes.

Ohhh...don’t you worry American Agents and Brokers across these fruited plains. That day is coming alright. It’s right around the corner. By February some nit-wit in Congress will go “Huh?” There will be a passing press release. Somebody will hold a hearing and the issue will fall off the page until July. Then, sometime around then you’ll be shown a movie. Have you ever seen the film clip: “Bambi meets Godzilla”?

What is going to happen when (not if) all these drastically priced risks start tendering claims and if (hopefully not) AIG is in no position to pay? Will Harry or Barney or Barry or Nancy let

AIG fail then? Even if that admission of failure were to happen, don't we (you and I) owe claimants? Oh, I forgot. That's right. The state guarantee funds and a bankruptcy court rummage sale will cover those bets. They ought'a fetch a pretty penny by then! What happens if/when \$300,000 (most states) of guarantee funds protecting policyholders doesn't feed the bulldog? ***Could that be a problem?!!!***

What a great time to be an Agent!

No really...faaabolous!

If you ask me, it's a great time to contact your E&O carrier and ask them to help you craft a written statement that is delivered to all clients at renewal regardless who the carrier is. Have Producers document in your system the conversation they had, in addition to the notice. And, if you elected not to purchase insolvency coverage due to price, make certain every stockholder signs-off on that decision!

Sarcasm aside

There is another \$10+ billion of losses AIG has brought forth in the past week (December 13th) that never made its way onto the financial statements. They say this. Others say that. But \$10 billion is, well, sort of a lot. To put it in context, it's almost 10-times the proposed Hartford Steam Boiler sale!

Core Values

AIG's core insurance platforms were rock solid.

AIG Financial Products (AIGFP) was a one paragraph afterthought in AIG's most recent 20-page annual report. I'm serious...one paragraph. This paragraph you're reading actually has seven less words in it than the one you'd read in AIG's financials. Seven words including this sentence. That's it!

AIGFP had 370 employees on the 14th floor and took, are you ready for this, over 3.4 billion dollars in compensation and bonuses! AIG in total employed 160,000 when all hell broke loose. It's probably not of any concern that TurboTax Tim Geithner, who oversaw the business practices of AIG's credit default swaps, never said a word, never raised his hand, never mentioned it to anyone, and was never in doubt to get promoted to oversee not just financial division, but every bank in America!

Think about what I just said.

AIG created a mythical "thing" that would cover off-color loans and investments if they went bad, but they couldn't call them "insurance (which they are) because there would have been oversight. So, they changed the name to "swap" and you want to know why? I'll tell you why.

They changed the name because they knew there would be no oversight! They knew Tim! And who do you think bought those mythical things? ***Have you even heard of Hedge-Funds?!!!***

When the band played, things were sweet. Hedge-Fund managers danced the night away, knowing that if they were wrong...their bets were covered! Now, not all hedge Funds were this way. I have a dear friend who runs a Hedge Fund honorably, consistently and profitably. He says he's not alone and that most Hedge-Fund operators are deeply honest. He should know, but from the outside looking-in, it just doesn't look that way to me!

The sad thing is that the melt-down of AIG in September 2008 had nothing to do with AIG's insurance operations. AIG was a very well run insurer; every Broker I know loved to hate AIG they were so good.

But, the trouble is real. RBC Capital market analyst Hank Calenti estimated that AIG's failure would cost its "swap" counterparts \$180 billion if AIG tipped-over. Michael Lewitt wrote in the New York Times about AIG:

"Its collapse would be as close to an extinction-level event that the financial markets have not seen since the Great Depression"

I'm just an Agent...

No, you're not. Not anymore.

AIG is beyond comprehension. Some say AIG's debt subordination is more than a trillion dollars and, most of them say, "mostly in the US". AIG is "Ma Bell" of the 1960's. AIG is beyond big and it's beyond comprehension. AIG has guaranteed much of the country's commercial loans won't default. Listen to what I just said. AIG has co-signed on the largest segment of the world's debt and things suck!

I just have to get you to comprehend what I just said! So, ***go to Starbucks and order a Ritalin Smoothie, drink it down and then concentrate.***

If AIG melts-down, nearly a Trillion dollars of commercial loans to US businesses will go bad. What that means is, based upon commonly held sales to debt ratios across all industries ***Six Trillion dollars of GDP could call it quits!...1/2 of the US economic output calls it a day that day!***

Did you hear me? I'm not a nut (well...we can discuss my demerits later). These are facts. Hedge funds were created to give loans and make investments stuck-up banks couldn't or wouldn't. Ergo, the debt to equity ratio of those companies is much higher by definition. Ergo,

nearly twice the higher returns hedge funds earned. Ergo, the need to 'hedge' those risks. Ergo, AIG's credit swap gizmo. Ergo, even more risky loans and so it goes and so it went.

For the first time in my fiercely capitalistic life, I don't care if the AIG bailout goes against every principle I hold dear. The AIG bailout was put in place to save the country as we know it, in one man's humble opinion, and as thus was completely justified and necessary! That means those

AIG guarantees must be paid (by you and me) or we will see 35% unemployment as certain as I'm typing this.

So how can they, the hapless government, allow the insurance operations of AIG to appear to be under-cutting their own renewals (based on Liberty's CEO) by 60%?

AIG affects everything and everybody. Because of that, AIG isn't really AIG anymore.

Its government owned and for good reason (which I hate). It's not likely to fail, because we (*We the People*) knew this going-in (well...DC did). It simply can't fail. It must not fail! And therefore, I say AIG has taken the place of the US "full faith and confidence" on those loans it guaranteed. In many ways, AIG's subordinated debt is worse (bigger) than the combined five-trillion dollars of Fannie & Freddie debt.

What's it all mean?

I can't tell you what it means as an American or as an American tax-payer. But, as an American purveyor of insurance and risk services I think there are some things I can see happening as a consequence to all of this.

As a crow on the wire, in the snow-torn northwest in early December '08, here's what I see...

- I believe there is enough dry powder (surplus and profit) to sustain a leveling, if not mildly softening marketplace for the next year in spite of all logic to the contrary. We'll see what happens after the gulf-storm season passes in June and July.
- I believe AIG will drive the market towards higher combined ratios, but the best of class will ride their modest risk portfolios towards modest profitability in spite of things. Some of them, like Zurich and Liberty will probably scoop-up some nice AIG companies on a bargain basis. That is, of course, after they scoop-up the AIG executives who know those companies inside-out. (And I still think Hank is so pissed, that Elliot came after him and then AIG sold 80% to the government, that he's going to come out of retirement and hook-up with someone or something whose sole mission is to crush whatever is left of AIG.)

- I believe small regionals and Bermuda will enter the market in areas that will surprise you and they will offer terms and conditions that will amaze you. If you're a purist, it will disappoint the hell out of you!
- Carriers who cannot offer lower prices will offer coverage(s) they should be ashamed of offering, including things you haven't seen for several years.
- I believe AIG will be on the front page of every newspaper in the US by August of 2009 and it's a really bad read. On a Sunday, in August, Obama will stare tight-lipped into the camera as his Treasury Secretary (whoever the hell that guy is) explains why we can't let AIG fail.
- I predict the Fed will offer an alternative oversight function to those served by the 50 states Insurance Commissioners which will eventually render them de facto policy-holder advocacy bureaus, customer complaints, and non-admitted carrier gatekeepers for those states and little else. They will enforce behavior and standards and be relieved of their solvency roles by the Fed.
- The Fed will pursue the co-mingling of insurance and banking in the wake of TARP and subsequent bail-out/loans to insurers. Brokers who believe this will have no effect on how they do business haven't had lunch with a friend in the Securities world lately.
- I predict the trillion dollars (\$11 by my calculations) flooded into the arteries of the world economy will have its intended result...inflation. Inflation in itself will help offset the debt burden those trillions created and deflate dollar after the Euro collapses. None of us are going to like what happens next. It's why Hedge-Fund managers are buying cattle ranches and planting 'victory gardens' at their vacation homes. It's why China will say "enough".
- Gold should have fallen like, well...a metal stone as the world plummeted into economic malaise and it's traveling companion black-gold (oil) fell like, well...a stone. But it didn't. It's gone-up, and then up some more. You need to ask yourself why and then read-up on what "pre-1933" gold coin means. Like a lot of people who know a thing or two about insurance, you need to study-up on a gold policy of your own.
- Eighteen insurance companies bought goofy banks in the middle of nowhere just before the deadline to qualify for TARP consideration. They'll get cash, juice the market and keep rates lower than reason would dictate. (It's weird. Everyone was so worried about banks in insurance a decade ago. Now, they're the steroids!) That will usher-in Federal oversight which means that the Treasury and the Federal Reserve will have more to do with Carrier behavior than combined ratios. If you have appointments with Carriers (like Liberty/Safeco & Chubb and others) who refused to sell-out to TARP then call them up

and take-back every unkind word you or an out-of-control Producer ever said. They will save you. Period!

- I believe Agents and Brokers will experience a cash flow crunch in 2009; the hardest hit will be Sub-Chapter S Corps and values for firms will continue to fall as buyers retrench. (I have a separate article on this.)
- Downward pressure on EBITDA multiples, terms, conditions, earn outs, guarantees...blah, blah, blah...that effect Agency values will not stop for at least two years and, if truth be told, I tell my close friends "Five". Yes...I know. Owners tell me "they wish they sold last year" and, mark my words; the same guys will say the same thing next year too!
- Regional Brokers will re-emerge as legitimate buyers of smaller firms in their marketplaces.
- \$152.2 billion bailout for AIG is just the beginning. It will end north of \$400 billion and some of the AIG mess will be buried under a nationalized banking proposal (temporary of course) that won't make it easy to find out how big the bailout of AIG really is.
- I believe, at some point, 11 trillion dollars of "umpff" to the economy will translate into inflation and 'crash-flow' underwriting will, once again, transform into cash-flow underwriting and I think that is exactly what AIG and others think when they look at the world.
- I believe there will be ever-more consolidation of the distribution system brought-on by a significant reduction in carriers, more regulation, shrinking margins and operating pressures, and the revival of the New York Insurance Commissioner's hearings on contingent income.
- Many of you have pension or employee plans that you haven't looked at in a while with totally unrealistic investment goals. They've been hammered. If you don't totally rethink your extra-benefit approach, you're going to fund 10% of total compensation for zero results.

Call or email...

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