

Why the world's biggest insurance company is still getting taxpayer funds

by Los Angeles Times

To understand why federal officials keep pumping astronomical sums of money into companies such as insurance giant American International Group Inc., it might help to take a high-altitude view of the situation. Say from 30,000 feet, up where jet airliners fly.

AIG is not just the largest insurance company in the world, with about 74 million customers -- more than the populations of California, Illinois and Florida combined -- but also owner of a company called International Lease Finance Corp.

Century City-based International Lease Finance is the world's largest aircraft leasing business; it owns about 1,000 commercial jet aircraft, including planes flown by nearly every major airline.

If the once highflying AIG filed for bankruptcy protection, it could pull down International Lease Finance too -- with punishing repercussions for an airline industry already staggering under the weight of other economic problems.

"If somehow it can't be sold or can't be sold in an orderly way, it would send a real chill through the industry," said Richard Aboulaflia, an aviation analyst for Teal Group Corp.

When the government ponied up \$30 billion more for AIG last week -- on top of \$150 billion previously committed -- the rationale was that it was "too big to fail." The same claim is made for other government rescue efforts, notably banking giant Citigroup Inc.

Failure of these companies would indeed hurt millions of ordinary Americans in direct and indirect ways, while sending further shock waves through the global economy. But that hasn't tempered any angry reaction from lawmakers and ordinary Americans alike.

"It effectively has the world financial system by the throat," Sen. Christopher J. Dodd (D-Conn.), chairman of the Senate Banking Committee, complained about AIG.

Yet federal policymakers keep pouring out tax dollars. Why? Because they are concerned about what would happen if the bailouts stopped. And the feared consequences fall into two categories: what officials know would happen, and what they don't know.

Some of the consequences of letting a giant fall can be foreseen, permitting officials to make at least educated guesses about whether they would outweigh the cost of continued aid.

Even more worrying are the consequences that can't be fully understood in advance.

AIG, Citigroup and other companies in their class have grown so large and diverse -- with their fingers in so many pies and their involvement so complex and hard to figure out -- that having one of them melt down could be like having an accident at a nuclear power plant: Bad under any circumstances, but would it be a Three Mile Island or a Chernobyl?

Rolling the dice on possibilities like that is something policymakers and politicians shy from. Bailouts seem like the fail-safe course.

With AIG, one thing that lies in the realm of the fairly predictable is what failure would mean for its healthy subsidiaries. For example, although AIG's life insurance companies remain well-capitalized and capable of paying their obligations, a bankruptcy could lead to a rush of customers seeking to cash out their policies, potentially destabilizing those companies, said Joe Paduda, a principal at insurance consulting firm Health Strategy Associates.

Also, many longtime holders of AIG life insurance policies might find them hard to replace. Age, changes in their health or other factors could make them uninsurable -- or only at sharply higher costs.

AIG is the world's largest property casualty insurer as well, and the largest provider of retirement savings for primary and secondary school teachers and healthcare workers. It has 71 U.S.-based insurance companies and 176 other financial services subsidiaries worldwide.

Having the parent company go down could create problems for all these companies, as well as for their customers.

"When individuals take a step back, they can see if AIG fails, it will in all likelihood impact them and people they know -- and the impact could be significant," said Paduda, a former AIG employee. "Putting the funds into AIG is a really bad option. The only problem is it's the best of the options on the table."

That's what federal officials believed when they stepped in again last week to help steady AIG as it reported a

\$61.7-billion loss in the last three months of 2008 -- the largest quarterly loss in U.S. corporate history. The goal is to keep the company afloat until it can sell its subsidiaries -- something that has become increasingly difficult as potential buyers struggle to raise cash amid the global recession.

Much the same calculation lay behind the Treasury Department's move Feb. 27 to increase the government's stake in teetering Citigroup.

Even the Fed's normally unflappable chairman, Ben S. Bernanke, said he was angry that AIG had put the nation, and the economy, in a bind.

"We had no choice but to try to stabilize the system because of the implications that the failure would have had for the broad economic system," he told the Senate Budget Committee in testimony that was almost plaintive in its appeal for understanding. "We really had no choice."

Beyond the more or less predictable consequences of letting a company like AIG go down are the murkier possibilities known as "systemic risks" -- most of them arising from AIG's rush in recent decades into all sorts of highly speculative businesses that were a huge departure from the staid world of insurance.

Some experts say what these ventures have done is make an AIG or a Citigroup that's "too interconnected to fail." And it's not just the size that would matter. AIG's interconnectedness with other companies, markets and economies is so huge and convoluted that it's almost impossible to foresee what all the consequences of collapse would be.

The prime example of this problem is about \$500 billion in unregulated credit default swaps held by AIG. Those complex financial instruments are essentially insurance policies taken out on mortgage-backed securities and other assets. The swaps were designed to pay out money to buyers who got caught in exactly the type of financial crisis taking place right now.

In essence, AIG was committed to insuring hundreds of billions, if not trillions, of dollars in investments. When the housing market crashed and the economy nose-dived, those investments tanked as well. And AIG was liable for the losses -- a liability so large that it is now overwhelming the rest of the company, including the still-profitable parts.

What's worse, because credit default swaps were unregulated and the layers of transactions so arcane that they are difficult to understand clearly, the true cost is essentially impossible to measure with certainty. Once the dominoes began to fall, no one knew where the process would end.

"People don't know the exposure, so as a result there's a huge premium on fear and the unknown," said Kent Smetters, associate professor of insurance and risk management at the University of Pennsylvania's Wharton School.

Such fear is contagious and has the potential to sow panic in parts of the economy entirely unconnected to AIG.

Many analysts see an example of what can happen in Lehman Bros. Holdings Inc., the big Wall Street financial house that was allowed to crash in September. Lehman's bankruptcy triggered a severe market downturn as the ramifications of the collapse of the company's huge and diversified portfolio rippled through the financial system.

Many analysts think that Lehman's failure set off the severe financial crisis and credit crunch now plaguing the global economy. After seeing that effect, government officials didn't feel like taking a chance with AIG and Citigroup.

"AIG is a huge, complex, global insurance company, attached to a very complicated investment bank hedge fund . . . that was allowed to build up without any adult supervision, with inadequate capital against the risks they were taking, putting your government in a terribly difficult position," Treasury Secretary Timothy F. Geithner said.

Geithner was involved in the decision to launch the government rescue in September, and said the worsening financial crisis meant an AIG failure now "would cause enormous damage" to the economy.

The Lehman experience weighs heavily in that calculation.

Lehman was the largest underwriter of bonds backed by home mortgages, and the effect of its collapse went well beyond Wall Street. In California, for example, the \$500-million construction of the Ritz-Carlton Rancho Mirage hotel was halted because Lehman was the major lender for the project. And San Mateo County lost \$150 million because Lehman debt was part of its investment pool.

The Dow Jones industrial average fell 504 points on news of Lehman's bankruptcy. A day later, a large money market mutual fund dropped below the standard \$1 a share because of Lehman's losses.

When AIG was teetering two days after Lehman's collapse, Bush administration officials feared a chain reaction. The Federal Reserve stepped in with \$85 billion in loans to finance AIG's liquidation in exchange for 80% of the company, the first of four infusions of government money.

Lehman was much smaller than AIG, which has more than four times as many employees and had nearly twice as much in total assets -- \$1.1 trillion -- at the end of 2007. AIG operates in more than 130 countries.

AIG also is more connected to other companies throughout the economy.

"If you had an institution and you had protection against credit default from AIG, your bank gave you credit for that," said Russell Walker, a risk management professor at Northwestern University. "When that's gone, the banks would pull back."

The failure of AIG could cause a series of defaults at other financial institutions, he said. In a way, AIG was like a master valve in the system with its credit default insurance, Walker said. Taking away that valve could cause chaos.

It is this fear of chaos, even more than concern over the measurable costs of an AIG going under, that has kept the government from halting the bailout.

"The biggest effects and the most troubling effects -- like what you saw in Lehman, but I think they would have been bigger in this case -- would have been on broader confidence in the financial system," Geithner told the Senate Finance Committee last week.

"The world has gotten dramatically worse since September of 2008. . . . And therefore the consequences of allowing a disorderly failure of AIG would be at least as damaging today."

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