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The Financial Crisis and AIG: What Now?

By John H. Mathias, Jr. and Edward P. McKenna

The U.S. government's unprecedented bailout of American International Group Inc., or AIG, raises many still unanswered questions that should be of continuing interest and concern to policyholders of AIG's insurance company subsidiaries. We know that the "general" terms of the proposed $85 billion loan approved by the Federal Reserve for AIG would give the government a 79.9% stake in the company, but we do not know the specifics of how AIG, now effectively managed by the federal government, intends to pay back this gigantic loan.

Will AIG sell off assets? Which ones? Will it sell its insurance company subsidiaries? If so, how might these prospective sales affect existing policyholders? Will the $85 billion loan be enough, or does AIG still face a substantial risk that its opaque exposures to massive financial risks will bring it down? This situation bears careful watching by all concerned.

AIG'S Liquidity Crisis

AIG is a holding company which, through its subsidiaries, sells a wide range of insurance products (commercial, property, personal, and casualty) and also provides significant financial and asset management services. It has over 250 subsidiaries operating in 130 countries and jurisdictions. Within the United States, AIG has 71 state-regulated insurance entities — including large insurers such as American Home Assurance Co. and National Union Fire Insurance Co. of Pittsburgh, Pa.

These insurance subsidiaries are governed by the laws of the states where they operate, with more state regulatory control concentrated in the states where they are domiciled. Accordingly, the subsidiaries are subject to state regulation independent from the AIG parent holding company's other non-insurance financial and asset management service businesses.

AIG's current distress has not been caused by any of its still profitable insurance subsidiaries but by a severe liquidity crisis in its financial products unit. Not only had AIG heavily invested in mortgage-related securities and bonds that were vastly overvalued, it also frequently dealt in "credit default swaps," a form of credit insurance which exposed it to huge risks in the event of bond defaults. The more devalued these bonds became in a difficult economy, the more defaults occurred, and the more payouts AIG became obligated to make.

As investors became worried about the sufficiency of AIG's capital to meet its ever increasing current obligations, its stock price dropped dramatically, and it faced looming market downgrades. The financial website TheDeal.com estimated in a Sept. 17 article by George White and Peter Moreira that AIG "insured more than $441 billion of fixed-income investments held by the world's leading institutions, including $57.8 billion in paper related to subprime mortgages."

Because a bankruptcy filing might wipe out billions in pension funds, mutual funds and other stock investments, the Federal Reserve Board concluded in a press release earlier this month that "a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance."

The Different Case of the Subsidiaries

In contrast to their holding company parent, AIG's insurance company subsidiaries appear relatively profitable and stable. CNNMoney.com reported earlier this month that AIG's general insurance business generated $2.2 billion in profits this year. The AIG insurance company subsidiaries generating these profits are subject to regulation by state insurance departments charged with responsibility for protecting policyholders and assuring that these subsidiaries maintain sufficient capital and cash reserves to fund expected payouts on all the policies they have issued. Without state regulatory approval, the parent holding company cannot lawfully gain access to the assets or cash reserves of its insurance company subsidiaries.

In an effort to clear up much of the initial confusion concerning how the AIG parent company's financial distress might impact AIG insurance company policyholders, the president of the National Association of Insurance Commissioners ("NAIC") assured the public that AIG's "insurance subsidiaries are solvent and able to pay their obligations," according to a press release put out by the association. The statement continued: "In fact, it will likely be the insurance subsidiaries — or their valuable blocks of business and high-quality assets — that will be sold in an attempt to return the AIG parent company to a more stable financial position."

A Chapter 11 filing by the AIG holding company parent, even if made, would not have included its insurance company subsidiaries, which are not subject to federal bankruptcy laws. Instead, individual state insurance departments have a "cradle-to-grave" relationship with AIG insurance company subsidiaries in the state of their domicile and are equipped with a "toolbox" of regulatory devices to monitor for potential insolvency, including audits, financial reporting requirements, capital/surplus requirements and extensive on-site examinations.

What If the Worst Happens?

Though presently stable, AIG's insurance subsidiaries are not immune from insolvency concerns. Should an AIG insurance company subsidiary (or any insurance company for that matter) be in danger of insolvency, it would be brought under the control of regulators in the state of its domicile working with state courts exercising in rem jurisdiction over any of its assets in that state.

The usual first step, which often begins while the company is still solvent, would be an informal administrative supervision that seeks to return the company to profitability conducted pursuant to detailed state statutes authorizing regulators to specify deficiencies and require compliance with remedial orders.

If administrative supervision fails, then insolvency proceedings will commence, typically taking the form of a receivership administered by the state. State receivership can take three forms: conservation, rehabilitation, or liquidation. Conservation is a judicial proceeding that seeks to maintain the status quo. Rehabilitation is a more thorough judicial proceeding where regulators formally try to reach an agreement with the insurance company on how to return it to financial stability. State insurance department regulators are expected to act in the public interest with the diverse needs of policyholders in mind. Because recovery is difficult, most receiverships end in liquidation, where the assets are distributed to creditors and policyholders.

An initiation of insolvency proceedings for an insurance company is not good news for policyholders. In liquidation proceedings, states do employ various methods for getting some return for policyholders, but the unwinding and liquidation process is slow, uncertain and painful, often dragging on for many years.

Some states, including New York, have a pre-assessment system under which insurers pay into a permanent fund. In addition, all states require insurers and insurance trade groups make payments into guaranty funds. After liquidation proceedings, all policyholders have a claim on these guaranty funds up to a per claim ceiling. Even with access to these funds, however, policyholders are unlikely to make full recoveries.

The NAIC Pledges Oversight of Any AIG Sell Offs

The NAIC, comprised of insurance commissioners from every state, has announced the formation of a task force to oversee AIG in the selling of its assets. Some of AIG's profitable insurance subsidiaries might well be on the selling block. However, AIG's new chief executive officer, Edward Liddy, recently commented that he expects to complete very shortly a list of AIG assets that will be sold with the goal of returning the company to its core strength, a focus on property and casualty insurance, and away from financial services. Nevertheless, there still are strong indications — and NAIC comments have been consistent with these indications — that some of AIG's profitable insurance businesses will be sold.

If AIG does begin to sell off its insurance businesses to raise cash to pay off its government loan, policyholders would be well advised to keep careful tabs on this situation with particular attention to what the NAIC oversight task force is doing and saying. One way to do so is simply by accessing NAIC's website, http://www.naic.org/, which contains press releases and links to other sources.

At the moment, there has been no announcement on who exactly will comprise the task force, but it is expected to be drawn heavily from the regulators of the 19 states where AIG has insurance subsidiaries domiciled. The NAIC task force has proposed to form two subgroups, one that addresses streamlining regulatory approval process by creating a standard template for change of control filings, and another that addresses special issues related to AIG's life insurance subsidiaries.

The chairman of this NAIC task force, New York Insurance Superintendent Eric Dinallo, has stated that the purpose of the task force will be "to provide constant communications between the various state, federal and international regulators . . . [and] work to ensure that policyholders are protected and that there are no allegations of unfair practices by potential buyers."

Of course, all of this is subject to change with circumstances, and Congress might soon become interested in trying to wrest this process away from state regulators, renewing the longstanding debate concerning whether there should be federal regulation of the insurance industry.

Renewal Questions?

Many policyholders have questions concerning the wisdom of renewing or buying new coverage from AIG insurance companies. For a lot of reasons, many professionals are unwilling to offer public opinions on this subject. So a healthy dose of common sense may need to enter the decision making process. Reputable insurance brokers usually do a pretty good job of ferreting out reliable information on markets and circumstances, and Aon in particular has been providing highly valuable up-to-date information to clients and the general public relevant to AIG at its so-called "Situation Room" at http://insight.aon.com/?elqPURLPage=3422. This story is not over, so stay tuned.

About the authors: John H. Mathias, Jr. is a partner at Jenner & Block and chair of the firm's insurance litigation and counseling practice; Edward P. McKenna is an associate at Jenner & Block.