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AIG crisis could be the tip of an insurance iceberg

The company's situation reflects problems throughout the life insurance industry as investments suffer. Further strain could bring about a second financial crisis.

By Ralph Vartabedian and Tom Hamburger

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Reporting from Washington and Los Angeles — When insurance giant American International Group Inc. imploded last fall, the firm's problems were quickly blamed not on its core insurance business but on an obscure operation that traded exotic mortgage securities.

But as the economic crisis deepens, it has become clear that AIG's problems extend across most of its business lines, including its massive life insurance and retirement services operations, which reported a staggering \$18-billion quarterly loss this month.

The company's situation is emblematic of problems across the life insurance industry, which is suffering deep losses on investments that underlie policies for millions of American families.

So far, some of the biggest companies have suffered sharp drops in their stock prices, and many of them are asking for federal assistance.

Industry conditions last year were the worst in memory and are expected to grow deeper this year amid credit rating downgrades, declining revenue and investment losses, according to credit rating firm A.M. Best Co.

The worst-case scenario is that a second financial crisis is looming if these life insurance companies come under too much stress.

"It was essentially a house of cards at AIG," said Donn Vickrey, a forensic accountant and co-founder of Gradient Analytics in Scottsdale, Ariz. "I would characterize other life insurers as suffering varying degrees of risk."

The financial problems, Vickrey said, may not be as serious as the disaster that swept over some parts of the banking industry, but insurers have not been subject to the same level of scrutiny as banks, and some experts say much remains unknown about their condition.

When the life insurance industry ultimately stabilizes, the financial landscape will be different, along with the once-dominant AIG.

Unfair advantage?

Two key pieces of AIG's life insurance and retirement products operations are Los Angeles-based SunAmerica Inc., which sells retirement annuities, and Houston-based American General Life.

Last fall, AIG tried to sell off its life insurance and retirement products units with the idea of preserving its core business of property and casualty insurance.

But by March 2, AIG retirement services chief Jay Wintrob wrote to employees in an internal message that the sales were more or less on the back burner.

Wintrob is now considering a consolidation of SunAmerica and American General. Both operations say they are well capitalized and have many times the minimum required level of reserves to meet their obligations to their 17 million customers.

Credit rating agencies have cut their assessments of the firms, though they remain well above levels that would indicate vulnerability.

The companies' survival is due to a unique advantage: AIG is the only insurance company that is a major recipient of taxpayer bailout funds. The company has received commitments from the Treasury Department for \$70 billion and lines of credit for tens of billions more.

"With the support and cooperation of the U.S. Treasury and Federal Reserve, AIG now has a new set of tools to reduce its debt, strengthen its capital base and enhance the value of its core business," Wintrob wrote in his message to employees.

Without that lifeline, all of AIG's operations -- and the welfare of its customers -- could be in a lot more trouble, according to securities analysts, insurance industry experts and credit rating agencies.

Other insurers are now asking the federal government for bailout packages, arguing that AIG has an unfair competitive advantage.

The Treasury Department and various oversight boards are uncertain how much of the taxpayer assistance went to AIG's retirement and life insurance operations. But credit rating firms say that without that assistance, there would have been a substantial downgrade to AIG's ratings.

Its current ratings reflect "our view that the U.S. Treasury and the Federal Reserve will continue their financial support of and commitment to AIG," said Kevin Ahern, an analyst who follows the company for Standard & Poor's Rating Services.

Ahern said the federal bailout of AIG kept the credit rating for AIG's holding company six notches higher than it would be otherwise, and without that support the company's credit would sink below investment grade.

AIG's loss of \$18 billion in its life insurance and retirement businesses in the fourth quarter was about the same amount that the company lost in its financial services operation, which was trading in credit default swaps and other risky instruments.

The losses for the retirement and life insurance operations came on the falling value of investments that were being furiously sold and marked down as the stock market collapsed last year. The company said that if not for those investment losses, the operations would have been profitable.

SunAmerica, which has operations in Century City and Woodland Hills, sells variable annuities, which are retirement policies that provide a stream of payments, generally based on how well securities markets perform. The company has assets of \$158 billion and nearly 6 million customers.

But those policies often have embedded guarantees, meaning that benefits can only drop so low before the company has to take a hit, said Joseph Belth, a nationally known insurance expert and retired Indiana University professor.

"Different variables have different embedded guarantees," Belth said. "But they all have one thing in common: The company takes on a risk if there is a dramatic decline in the stock market. And they no doubt never dreamed of the kind of stock market collapse like we have had.

"It seems to me that if AIG had not gotten the federal money, they would have had to declare bankruptcy," Belth said.

Belth said in a bankruptcy, state regulators would continue to operate the subsidiaries and maintain existing insurance policies.

'More aggressive'

Critics say the company brought some of its troubles on itself by engaging in risky securities practices. In some cases, it was betting against its own long-term interests.

"AIG investments were more aggressive, relative to other insurers, across all of their business, including life and casualty insurance," said Paul Newsome, an insurance analyst at investment banking firm Sandler O'Neill & Partners.

In a statement, AIG disputed that, saying their products carry about the average amount of risk for the industry.

"This claim is misleading and inaccurate," AIG spokesman John Pluhowski said. "The company has maintained a generally conservative, middle-of-the-road stance on living benefits for many years."

But other analysts go much further in criticizing the company's practices.

Overall, AIG made "the most egregious investment decisions I have ever seen," Vickrey said. "It was extremely high risk with very high levels of leverage and insufficient hedging."

AIG, along with others, began offering in recent years specialized variable annuities with guaranteed minimum death benefits, Vickrey said. The assumptions underlying these contracts turned out to be wildly optimistic, he said.

As a result, AIG is on the hook to deliver guaranteed benefits despite the fact that, even if it had invested prudently, it would not have earned a sufficient return to make good on the obligation, he added.

Sen. Richard C. Shelby of Alabama, the senior Republican on the Senate Banking Committee, said AIG's life insurance companies also played a very risky game of lending out long-term securities and investing cash collateral for those loans in securities backed by subprime mortgages.

When the mortgage market collapsed, AIG life insurance firms took a \$21-billion loss, Shelby said at a Senate hearing this month. Only because those AIG life insurers were able to tap \$17 billion in federal assistance were they able to meet policyholder claims, he said.

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