

The Daily Telegraph

Doubters at a Premium in Run-Up to AIG's Failure

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Published: September 18, 2009

THE third domino to fall in the chain reaction that triggered a series of systemic shocks in markets around the world a year ago this week was American International Group

While the collapse of Lehman Brothers - Search using: and the 11th-hour rescue of Merrill Lynch - dominoes one and two - were at least understood by investors, the fact that AIG had come so close to the brink that it needed an \$85bn (pounds 51.1bn) bail-out from the US government came out of nowhere.

The emergency bridging loan - in return for the government taking a 79.9pc equity stake - ended 72 hours of high tension. The loan assured markets that the US government was willing to step in where necessary - which it had not done with Lehman - but at the same time initiated questions about how things had got so out of hand at what many thought was just a simple insurance company.

As UBS credit analyst David Havens put it at the time: "Nobody really knew what it would have meant if they [AIG] would have been allowed to fail, but there was an enormous amount of systemic risk."

That no one knew what impact the failure of a company like AIG - best known in the UK as the former shirt sponsor of Manchester United - could have on the rest of the market is to a certain extent testament to the sheer hedonism that existed in the market up until last September.

"It was a big complicated company, with top ratings, and there was no reason for people to ask questions," says David Schiff, editor of Schiff's Insurance Observer, an industry newsletter. "On Wall Street, you can't make money from saying something's bad," says Schiff, who had been a critic of AIG for a number of years.

Schiff also believes that analysts were afraid of Hank Greenberg. Greenberg ran AIG for 37 years until he was ousted in 2005, but continues to be its largest shareholder through a 9.6pc stake held in a charitable

vehicle he manages. Criticising the analysts who should have spotted any troubles with AIG, Schiff adds: "They all wanted to believe - and they all took everything on faith."

Data from Bloomberg News appears to tally with Schiff's view, showing that at the time of AIG's bail-out, of 10 analysts who covered the company, four had a "buy" rating on its shares, five had "hold" ratings, while only one, Société Générale's Emmanuelle Cales, was telling investors to sell.

One of the problems with detecting AIG's troubles was the sheer breadth and complexity of its business. While known as an insurer, its troubles lay in its lesser-known derivatives business, which started life under Greenberg in 1987, and which meant that by 1997, AIG was a big name in the fledgling credit default swaps (CDS) market, basically offering insurance guarantees on derivative contracts. Fast forward another 10 years, and by 2007 AIG was also a major mover in the mortgage insurance business, just in time for the US sub-prime mortgage collapse.

The combined impact of both these forays was a stream of losses, the impact of which was intensified when auditors PricewaterhouseCoopers found in February 2008 that AIG had overstated the value of its CDSs. Later that month, AIG reported a three-month loss of \$11.12bn, its biggest ever quarterly loss as a public company at that point. From then on in, for the next seven months, things only got worse, and in spite of a change at the top - with British-born chief executive Martin Sullivan replaced in favour of former Citigroup executive Bob Willumstad - there was no radical move to decrease leverage nor reduce risk.

By September 12, as ratings agencies began to make long overdue negative calls on AIG's debt, the company needed to come up with an extra \$14.5bn capital to cover its positions. After discussions with its adviser JP Morgan on the possibility of raising money in the market, by September 16 a government bail-out was the only option for an insurance company that had \$441bn

of CDSs with other major financial institutions on its books. For that reason alone AIG was not going to be allowed to fail.

"The bottom line is that people were asleep," says **Gregg Fisher**, president of New York-based boutique asset management house **Gerstein Fisher**. "Everyone had too much faith in the system, faith which was based on reality."

Had investors woken up and done their due diligence, they might have found that a large degree of the success - and ultimate failure - of AIG was down to a small team, led by American-born Joseph Cassano, out of offices on Curzon Street in London's Mayfair.

AIG Financial Products (AIG FP) wrote more than \$500bn worth of CDS contracts in its heyday, delivering remarkable profits for the insurer and bumper pay packets for its staff, including Mr Cassano, who personally banked \$280m in the eight years until the end of 2007.

"The existence of the London-based unit was little known. Only when it was revealed as the culprit that brought down AIG did regulators realise that AIG was

as vulnerable as other companies and not properly supervised," says Ron Shelp, AIG's former head of government relations, who has written a book, *Fallen Giant*, on the history of the company.

One year on, and three further bail-outs from the US government - after AIG racked up in excess of \$99bn of losses in 2008 - the size of the US government's total facility is as much as \$182.5bn. Few, other than AIG, believe it will ever be repaid in full.

John Hall, a Wells Fargo analyst, said that without government support AIG would be out of business, while new chief executive Bob Benmosche is doing little to allay fears over when the money will be repaid. He said recently: "It's not a question of if, but when," as to when two divisions worth up to \$45bn might be spun out.

Before the bail-out, AIG's advertising tagline was: "We know risk." Unfortunately for the financial markets - and US taxpayers - that proved to be not quite true.

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