Client Advisory

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The AIG Crisis and Bailout: What It Means For Policyholders

Recent events involving American International Group ("AIG"), the world's largest insurer, have given commercial policyholders cause for concern, both in assessing their coverage under historical policies and when they consider purchasing AIG coverage going forward. While the immediate crisis has been averted, and AIG's core insurance companies appear to be in good financial condition, the situation is fluid and requires close monitoring by policyholders.

AIG's crisis is attributed to credit-default swaps, transactions involving business units other than AIG's core insurance companies. A number of factors, including downgrades by credit ratings and the market-wide credit crunch, caused AIG's stock price to fall dramatically in the week of September 15, 2008. In order to stave off an imminent bankruptcy filing by AIG, the Federal Reserve agreed to lend up to $85 billion dollars to AIG over a two year period, at an interest rate of 8.5 percentage points above the three-month London Interbank Offered Rate, which would have been roughly 11.4% at the time the announcement was made. As conditions to this unprecedented loan, AIG pledged almost 80% of its equity, agreed to new management selected by the Federal Reserve, and agreed to allow the Federal Reserve to veto potential asset sales as AIG works to raise capital to pay off the loan. The superintendents of insurance in New York and Pennsylvania have announced that they will take an active role in the disposition of any insurance units of AIG, although AIG's new management has indicated reluctance to sell its insurance units. Reportedly, a group of AIG shareholders are attempting to raise sufficient capital to cancel the deal, or at the very least pay back the loan in the short term. However, details of the Federal Reserve deal have not been made public, and therefore much remains uncertain.

WHAT WILL AIG LOOK LIKE GOING FORWARD?

Given its size and market position, there is little doubt that AIG's insurance business will remain a dominant part of the market. AIG issued a statement on September 18 stating that it does not plan to sell its commercial insurance businesses, which always have been financially strong, and appear to continue to be so. This plan is logical from AIG's perspective, given that its core business historically has been commercial insurance and its new Chief Executive Officer, Edward Liddy, is a former CEO of Allstate Insurance Company, another major property and casualty insurer. Of course, uncertainties in the U.S. economy generally may affect these plans, and the Federal Reserve may retain some degree of control over what assets AIG sells to pay off the loan. Furthermore, AIG's plans to avoid selling its insurance assets may be in tension with its stated goal of repaying the federal government loan quickly, as the commercial insurance lines may be among its most marketable assets. Therefore, whether or not AIG will be able to repay the loan, yet avoid a sale of any of its insurance assets, remains to be seen.

ARE THERE LIKELY TO BE REGULATORY CHANGES IN INSURANCE?

Even prior to AIG's recent difficulties, policymakers on Capitol Hill were considering federal oversight of insurance. The AIG crisis and bailout will likely energize that effort. Any action by Congress would likely involve amendments to the McCarran-Ferguson Act, under which regulation of insurance is largely the province of state insurance departments. Comprehensive federal regulation of insurance is unlikely, but some restrictions on permissible activities and investments may be forthcoming. As the current financial stresses seem to be the result of investments in certain types of risky securities and derivatives, such as credit derivative swaps, it is possible that we will see leg-

islation aimed at preventing insurance companies' involvement in such transactions. That type of incremental restriction on the way insurers do business is more likely than broad changes such as the creation of a national insurance commissioner position, but attitudes in Congress are hard to predict.

WILL RECENT EVENTS INVOLVING AIG AFFECT THE PRICE OF INSURANCE GOING FORWARD?

It is also possible that we will see greater regulation, both on the federal and state level, of how dominant one insurer is allowed to become. AIG has become so large, and has such a commanding role in the commercial insurance market, that its failure would have had far-reaching consequences for the Untied States economy. In the future, state and federal regulators may be hesitant to allow such concentrations of insurance assets in one company as we have seen with AIG, and may press for a wider distribution of risk.

WHAT DOES THIS MEAN FOR COMMERCIAL POLICYHOLDERS?

Because the federal loan may have prevented a bankruptcy filing on the part of the AIG parent company, it was undoubtedly good news for AIG policyholders. Even assuming that the underlying financials of AIG's member insurance companies are sound, a rushed effort to sell assets to raise capital would have been disruptive and unsettling for the markets. And to the extent this deal allowed AIG to avoid insolvency or rehabilitation proceedings, it is a huge benefit to policyholders because such proceedings usually take years to resolve and often pay only pennies on the dollar.

Although AIG says that it has no plans to sell its commercial insurance subsidiaries, the possibility remains that some of them may be sold over the next two years as AIG attempts to repay the loan. If this happens, and management changes, new management or ownership may adopt new claims handling and reporting requirements, or embark on new strategies in litigation or negotiations with policyholders.

The loan also creates incentives for AIG that may have direct or indirect effects on policyholders. AIG has every interest, if it attempts to sell off its subsidiaries, in maximizing the value of those entities. Accordingly, AIG may aggressively attempt to settle claims at below their reserve value, or failing that, to deny claims it would otherwise pay, if only to buy time for a sale to be consummated, particularly in the case of very large exposures. Given the slow pace at which complex commercial litigation progresses, a denial of a significant claim by AIG, forcing a policyholder into coverage litigation, could easily push payment of that claim beyond the two-year period of the loan, and allow AIG time to sell the subsidiary at a higher price. Policyholders need to be vigilant, and consult with counsel if in doubt, to ensure that they are treated fairly in the handling of their claims.

It is possible that AIG will have an incentive to price its insurance products aggressively as it attempts to improve its balance sheets, and as a result may offer competitive pricing or favorable coverage extensions in the short-term. On the other hand, if policyholders lose confidence in AIG and significant numbers choose to place their business elsewhere, AIG may find itself unable to repay the federal government loan and/or to conduct its normal business operations. If this were to happen, it would clearly be a bad result for the commercial insurance market, and hence for policyholders. AIG today is so large that its removal from the marketplace would not only lessen competition and lead to price increases, but there would be doubts that the remaining insurers in the marketplace would have sufficient capacity to meet the needs of U.S. policyholders.

In any event, regardless of pricing, policyholders should be cautious about placing too much of their insurance programs with any one carrier. No matter what action state and federal regulators may take, commercial policyholders should try to diversify their insurance program and spread risk among a number of financially sound insurance companies. Policyholders need to consult with brokers, review the ratings from the various rating bureaus, and consult with counsel as needed.

CONCLUSION

The situation with AIG remains a moving target, and details of the Federal Reserve loan continue to be disclosed. For the short-term, the fact that any liquidation or receivership proceedings have been avoided is decidedly advantageous to policyholders. To the extent the federal government loan provides AIG the time to rearrange and sell its portfolio, its insurance operations should remain stable and solvent. Whether they remain part of AIG, however, is another matter entirely, and accordingly both policyholders and potential policyholders need to consult with brokers and experienced insurance counsel both to assess their current insurance situation and looking ahead.

For more information, please contact one of the following attorneys in Kelley Drye's Insurance Recovery Practice Group, each of whom regularly represents policyholder clients in disputes with AIG and other commercial insurers, as well as providing counseling to clients regarding their insurance programs:

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