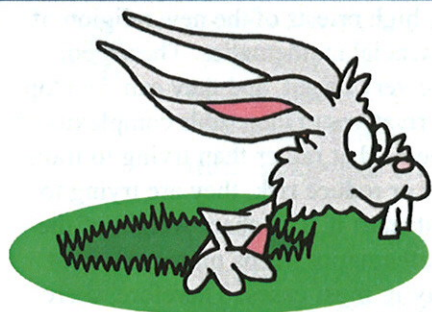




Down the Rabbit Hole

An Underwriter Looks at AIG

by Joseph J. Launie, Ph.D., CPCU, FACFE

To an underwriter who has been around the property and casualty business for 52 years, the situation at AIG Financial Products is easily as strange as the Wonderland Alice found when she fell down the rabbit hole at the bottom of the garden. Rather than hesitate, let us take T.S. Eliot's advice: "Do not ask what is it, let us go and make our visit." There may be some lessons here for management.

Insurance underwriting is not rocket science. You write business and accept exposures limited by the size of your surplus. You can gain more capacity through reinsurance, but that is it. You do not bet the company on the business you are writing.

I bored legions of MBA finance students in my seminars by telling them, "If the CEO does not understand what the mathematical wizards are doing in some corner of the company, then the company is out of control." Boring, trite, but true.

It is interesting that AIG Financial Products' troubles came after Hank Greenberg left AIG. Somehow I cannot see an underwriter from Financial Products standing in front of Hank's desk and saying, "Mr. Greenberg, we have this great deal over in Financial

Products. It is making us millions of dollars. Of course, if we have a bad day, we could lose \$13 billion on one risk, but we have that hedged." Hank would have thrown him out of the

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window. It has been reported that Mr. Greenberg told the Financial Products people that if they threatened his AAA credit rating, he would be after them with a pitchfork. They did not threaten it; they trashed it.

To use a casino example, the property and liability underwriters were apparently sitting at the \$5 tables while the Financial Products underwriters were

betting the company on every hand. Financial guarantee insurance is an insurance product and should be subject to the same rules. It does not appear that they were followed.

The underwriters at Lloyd's are fairly bold risk takers. They write a wide variety of business. One line they do not write is financial guarantee insurance. Lloyd's lost millions on that line during the last depression in the 1930s, and it is forbidden to this day.

The late Karl Borch, one of the leading risk theorists in the world, wrote an article forty years ago in which he showed that every insurance company eventually faces ruin. His argument was quite simple. If you take each year as an iteration, with an infinite number of years, sooner or later the results for the firm's overall book of business will end up way out in the upper tail of the

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loss distribution, where ruin lives. Size is irrelevant, as State Farm's Property Company showed when, after eschewing reinsurance, the company got nailed in Hurricane Andrew for many billions of dollars. While it was at the threshold of ruin, it was bailed out by other companies in the group.

Another warning was the Long Term Capital Hedge Fund debacle. Long Term Capital was a hedge fund which

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included three Nobel Prize winners in finance in its management. They were pretty smart people. LTC went down the tubes for well over a billion dollars and had to be bailed out by the government for fear of causing instability in the capital markets. Does this sound familiar?

A hedge fund is the most misnamed institution since the Ministry of Truth in Orwell's 1984. The name seems to connote risk reduction when it is really an engine for risk creation using astounding amounts of leverage.

It appears that the Financial Products people ignored the warnings of history, disdained the discipline of underwriting only within your capacity, and raced into the fog at 30 knots like the Titanic, ignoring the icebergs until they found one. AIG Financial Products rushed in where central banks feared to tread. It guaranteed transactions in the most volatile, unregulated segment of the financial markets. In retrospect, it could have succeeded only if that sector had no problems.

The vast network of derivatives created by the securitization of mortgages and other debt was based upon the shaky premise that the asset values collateralizing those debt instruments would continue on a monotonic upward path. When the upward path leveled off and started down, the entire structure collapsed. The only entity left to attempt to hold the crumbling edifice together was AIG Financial Products. Not being a central bank, it proved unequal to the task.

In Wonderland, if someone displeased the Red Queen, she would say, "Off with his head." In the AIG Financial Products division, after it lost \$62 billion, it not only kept its head, but it got \$165 million in retention bonuses. I assume that if it had made money, it would have been given the island of Bermuda.

Why would anyone want to retain the underwriters who had just lost \$62 billion? The guys in the mailroom could probably lose \$50 billion if that is the objective. It may be similar to the character I ran across in my military intelligence days who really liked the area where he was stationed. "They can't transfer me," he confided over a drink one evening. "I have things so intertwined it would take me a year to untangle them." When I studied management at UCLA years ago, I did

not think that is how we were supposed to run things.

The Financial Products people seem to be high priests of the new religion of financial mathematics. These people are very bright, and they can develop derivatives of incredible complexity. It seems that rather than trying to transfer or reduce risk, they are trying to outsmart it. The sheer weight of the mathematics keeps management at bay in most cases. Therefore, there really is no one in charge of the division except those who are in it.

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I am certain that the huge array of financial guarantees that ultimately came unglued were backed up by stop-loss deals in several layers. The problem is that the stop-loss deals for the original derivatives were most likely other derivatives. This is like backing up the levees at New Orleans with dirt banks. It looks fine until there is a flood.

The AIG fiasco is just the most spectacular example of problems which can

(Rabbit Hole, continued opposite)

FROM NEAR AND FAR



Florida – Many storm forecasts are doing the rounds as the 2009 Atlantic hurricane season gets under way. The majority of forecasts seem to be favoring the prediction that nine to 14 named storms will form and that between one and three will become major hurricanes. The report from Colorado State University says that there is a 63 percent chance of at least one major hurricane making landfall on the United States mainland.



L'Aquila, Italy – The earthquake that rocked the town of L'Aquila in the central Italian region of Abruzzo on April 6 measured a 6.3 on the Richter scale. More than 300 people were lost, and the cost of insured losses alone was expected to reach more than \$530 million.



Washington, D.C. – According to a report published in the *National Underwriter*, there has been a significant increase in the amount of insurance fraud. The National Insurance Crime Bureau reports that during the first quarter of this year, there has been a 71 percent increase in potential fraudulent workers' compensation claims as well as a 77 percent upswing in suspicious slip-and-fall accidents. Also mentioned is a 275 percent climb in suspicious car fires.



London – The recent surge in piracy on the high seas has added momentum to the increasing costs of ship insurance. In a report published in the *National Underwriter*, Peter Townsend with AON said that ship owners might be paying as much as \$30,000 in premiums for \$3 million in kidnap and ransom coverage for one voyage through the Gulf of Aden.



Rio De Janeiro – Lloyd's of London has opened an office in Brazil. This comes one year after it was granted approval to become the country's first admitted reinsurer. Rio-based Lloyd's Brazil will enable syndicates and MGAs to offer reinsurance in Brazil.

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be found across the entire property and casualty insurance industry. The old-line approach of just writing property and casualty insurance became overshadowed by the glamour of the world of investments. The grass which looked so green in that pasture is turning out to be full of weeds.

The academic insurance community has too frequently joined in the stampede to the world of financial economics. The problem is that someone needed to stay home and mind the old-fashioned property and casualty store. It does not seem that job was well handled.

Hopefully, out of the wreckage of AIG and the other companies in similar straits will come a new commitment to

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the old practice of insurance underwriting. The insurance technicians who have spent years studying their product

lines and understand those product lines should be the underwriting leaders of the future. When choosing executives, the boards of directors should place a higher value on technical expertise and a lower value on social and marketing skills. At that point the industry can rise out of the rabbit hole into the garden itself, into a world that may be boring but is stable. RIIA

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RHA was recently voted by *Business Insurance* readers as one of the top five risk-management consulting firms in the commercial insurance industry.

RHA has seen many things change over the years and most assuredly will see more and bigger changes in the years to come, but through all of that it hopes to have provided a beacon of professionalism, stability and friendship to its clients. All of us at RHA thank you for your past, present and future support.

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