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Revised government plan buys AIG some more time

Bailout 2.0 features more generous loan terms, purchase of credit default swaps; 'breathing room'

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The revised federal plan to keep American International Group afloat gives the company "breathing room" while it negotiates asset sales to pay off its original $85 billion bridge loan, chief executive Edward Liddy said today.

"We've worked hard to fashion a very comprehensive plan in order to put AIG on much more solid footing," Mr. Liddy said in conference call with investors.

The call came after AIG reported a $24.7 billion third-quarter loss—the largest in company history—and announced that it had renegotiated the terms of its federal bailout.

Under the revised terms of the "solution" (as AIG executives referred to it), the Federal Reserve will buy $40 billion in AIG preferred shares via the Treasury's Troubled Asset Relief Program for an 80% stake in the company.

The government will also replace the onerous $85 billion bridge loan it had extended to AIG with a $60 billion loan that entails less burdensome terms.

In addition, the Fed will provide $50 billion to create two separate entities that will buy AIG's distressed securities and backstop the insurer's securities lending program, eliminating the current securities lending facility AIG had in place with the Fed.

"For us to emerge successfully from this crisis, we cannot continue to hemorrhage money in the two areas of credit default swaps and securities lending." Mr. Liddy said. "We need to stop that, and we need to stop that now."

As of last week, AIG had borrowed about $75 billion for those two areas. AIG's ongoing exposure to credit default swaps will now amount to any changes in the market value of its swaps prior to the creation of the new entity, as well as its $5 billion investment in that entity. The insurer's ongoing exposure to securities lending will total any changes in the market value of its securities lending program prior to the creation of the entity, plus its AIG's $1 billion investment in the new entity. Mr. Liddy did not give a timetable for the creation of the new entities.

"The new package is better targeted to the root cause of the problem, the credit default swaps," said John Ward, chief executive of Cincinnatus Partners, a private equity firm specializing in the insurance industry. "Whether the plan will need to be modified again, only time will tell."

The program's success hinges on whether AIG's counterparties are willing to sell the insurer's collateralized debt obligation exposure to the new entity at prices below par.

Mr. Liddy emphasized during the conference call that the terms of the agreement could change in the future. The revised deal, he said, "is not fixed in concrete forever."

Morningstar analyst Bill Bergman said he would not be surprised if the Fed and AIG renegotiated the terms of the bailout again, especially when the new administration enters office in January.

“We are in an evolving marketplace, and the fact that they have changed things already a few times shows that this is not the be-all [and] end-all,” he added.

But for now, the revised progam will give AIG some leeway to continue to look for buyers of its assets, Mr. Liddy said.

The company said it has not changed its initial plan to sell all AIG subsidiaries, except for the insurer’s domestic property and casualty business, its foreign general insurance business and a majority stake in its China-based American International Assurance Co.

That asset sale has taken longer than expected because of constricted capital markets and balance-sheet pressures on possible suitors.

“We have a smart, disciplined competitive process for selling assets,” Mr. Liddy said. “The announcement today gives us more flexibility and more time. We have great confidence in our ability to sell these remarkable assets.”

He said that almost a hundred potential buyers had expressed interest in the assets, and the company may announce a few deals by the end of the year.

“This gives [AIG] more time and allows for better pricing on those assets,” said Morningstar’s Mr. Bergman. “There is less pressure to do the sales right away.”

Although AIG’s insurance subsidiaries remain well-capitalized, they have faced increased scrutiny given the problems at the holding company.

“All the AIG subsidiaries have been under immense competitive pressure since the [original] bailout was announced,” said Donald Light, an insurance analyst with Celent. “I think that’s going to continue until the situation is stabilized at the holding company, and that hasn’t happened yet…. But if this bailout works, it’s a huge plus for the overall success of AIG going forward.”

The company’s general insurance business lost $899 million in the third quarter, compared with a profit of $2.51 billion in the third quarter of 2007. Like other insurers, AIG saw big catastrophe losses related to hurricanes Gustav and Ike, which cost it $1.39 billion in the quarter.

AIG commercial insurance’s account retention decreased 6.5% from September 2007 to September 2008, and “modestly” from October 2007 to October 2008. It had seen turnover of about 5% among the 700 members of senior management in the commercial insurance business since the turmoil began, said Kristian Moor, AIG executive vice president of domestic general insurance and president and chief executive of AIG’s property/casualty group.

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