Swaps and Derivatives

AIG Moves into Hyperspace

Although his name appeared nowhere in AIG's annual report, Howard Sosin, a former professor who once worked at Bell Laboratories, may well have been the giant international insurance organization's highest-paid employee. According to *The Wall Street Journal*, his 1992 compensation was in the neighborhood of $40 million to $50 million.

Until recently, Sosin ran AIG Financial Products, a major player in the "swaps" and "derivatives" market. Swaps and derivatives are financial transactions where returns are tied to variables such as interest-rate, currency, stock, or commodity prices. For example, a fixed interest rate might be swapped for a floating interest rate, or a deutsche mark liability swapped for a yen liability.

According to those in the know, AIG and Sosin were willing to venture into the ionosphere of international high finance considered too risky by others: arranging swaps going out thirty years into the future. In 1992, AIG Financial Products' profit of $171.5 million represented eight percent of AIG's pretax profit.

AIG's non-insurance operations have been growing rapidly, and the Financial Services Group—which includes AIG Financial Products, International Lease Finance (which leases and markets jets), AIG Trading, and subsidiaries engaged in Swiss-based private banking, premium finance, asset management, merchant banking, and stock brokerage services—now accounts for 15.5% of AIG's pretax profit.

What interests us most about AIG Financial Products is not Mr. Sosin's eventual falling out with AIG, or even the vast amount of money involved, but the reminder that the insurance business has become the money business, and the reminder that the rewards—and the risks—of the money game are vastly different from those of the traditional insurance game. (To be technical about things, AIG Financial Products is a subsidiary of American International Group, Inc., the holding company that owns the insurance companies.)

AIG's Financial Services division has assets and liabilities of $23.5 billion and $21.2 billion, respectively—about thirty percent of American International Group's total—and at year end 1992 was "short" $1.5 billion of spot commodities.

AIG Financial Products has entered into interest rate and currency swaps and currency forward commitments with a notational principal amount of $82.4 billion. "Assuming nonperformance by the counterparties on all contracts," says AIG's annual report, "the maximum potential loss...at December 31, 1992 approximated $4.3 billion," up from $2.8 billion the previous year. This "maximum potential loss" will increase in size over the life of the swaps. Although AIG attempts to hedge its risks, there's no such thing as the perfect hedge. Still, nonperformance by all parties—which is what could cause the maximum loss—seems farfetched.

As large as these figures are in absolute terms, they must be viewed in light of American International Group's $12.8 billion of capital funds.

AIG's stock was recently trading at $88, about sixteen times earnings—a higher than average multiple. Obviously, an investor must consider AIG's top financial ratings, its strong international presence (fifty-two percent of earnings come from outside the United States) and the possibility of an improvement in insurance pricing. Considering that AIG's recent earnings growth has been fueled by its Financial Services and Life Insurance operations, and considering that financial services giants such as J. P. Morgan and Salomon trade at considerably lower multiples than does AIG (because of the perceived uncertainty of their earnings streams), one might attribute AIG's higher-than-average stock-market multiple to its insurance operations, whose earnings have been flat. In other words, in the stock market, the whole of AIG seems to be worth more than the sum of the parts.

That sounds a bit odd, at least to us. On the other hand, maybe it's worth it. ■

AIG: Big Growth in Financial Services
AIG's Pretax Profit by division ($ millions)

	General Insurance	Life Insurance	Financial Services
1987	818	319	39
1988	944	387	87
1989	1,099	453	143
1990	1,286	462	100
1991	1,263	561	216
1992	1,124	667	332
1993 – 9 Mo.	$ 995	525	285

Price, Service, Loyalty, and the Independent Agent

During a town meeting at the annual Independent Insurance Agents of America convention, a question was posed to the audience: does customer service make a difference?

That eighty-one percent of the agents answered "yes" is not surprising. That nineteen percent actually said "no" is.

Most (seventy-nine percent) agreed that "cost" is more important than "service." That was troubling because, as the agents see it, they're in the business of providing "service." Indeed, in a recent survey most agents claimed to provide better service than their competitors. But ask any insured what he thinks and he'll probably say that getting a low price is an important part of an agent's service.

The agents at the conference had a hard time coming to grips with this and looked for someone to blame. The most popular scapegoats were insurance companies and the government, although a tally of the agents revealed that eighty percent felt that their customers were "less loyal."