Can AIG Stay on Top?

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To the lengthening list of fallen executives, add one more: Maurice "Hank" Greenberg, legendary CEO of American International Group, was forced to step down March 14 as investigators look at whether the company used complex insurance transactions to improperly pad its bottom line.

Greenberg's departure, after a four-decade reign that turned AIG from a sleepy also-ran into the world's biggest insurer, immediately raises questions about whether the company can stay on top -- or whether shareholders will suffer, as they have in so many corporate scandals. In the first five trading sessions after the Greenberg announcement, the stock fell by 7.6%. Nonetheless, shareholders held on to most of the outsized gains earned under Greenberg. Average annual returns for the past decade have been 15.5% versus 11% for the Standard & Poor's 500.

Despite the initial jolt, AIG shares did not go into the freefall seen in many of the corporate scandals of the past few years. "I think it's going to get over this crisis," said Neil A. Doherty, professor of insurance and risk management at Wharton. "In many ways, it's been a spectacularly successful company." AIG "is going to address these issues," he added. "They are going to have the core strengths they had before."

As to Greenberg's departure as CEO, Andrew Metrick, professor of finance at Wharton, suggests that it was time "for AIG to have new leadership. But whether this means all their problems are behind them ... I think it's too early to say that.... There's just a lot we don't know about this very complicated financial institution, and we will have to see what comes out over the next 12 months under the new leadership.... There is a lot of uncertainty about whether there are other shoes to drop."

State and federal officials are looking into a "finite reinsurance" transaction four years ago between AIG and General Re Corp., a reinsurance company owned by Berkshire Hathaway Inc. The issue is whether AIG counted the transaction's value as an asset when it should have been a liability.

This type of transaction involves an exchange of an insurance liability to manage risks. For a given period, one company takes on the obligation to pay any claims against a policy issued by the other company. But any claims paid are largely considered loans that must be paid back. Accounting for these transactions is an esoteric area, with much depending on judgment calls about which insurer ultimately bears the greatest risk of loss, according to Doherty, who added: "I don't really believe there is any bright-line test here."

Lower Credit Ratings

The reinsurance investigation is just the latest of several over the past few years involving questions about possible bid rigging and price fixing, possible improper reporting of payments from AIG to a firm owned by Greenberg and some other AIG executives, and possible violations of federal securities laws.

After the company announced Greenberg was stepping down, two rating agencies lowered the company's credit rating, citing the investigations and management shake-up. As advanced news of Greenberg's ouster spread, analysts at the brokerage Raymond James & Associates commented: "The uncertainties associated

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with the potential departure of AIG's longstanding patriarch could outweigh all other issues relating to the company in the near term." Although the company has "a number of extraordinarily capable and talented executives," changes at the top often lead to other management departures and changes that can cause problems in the short run, Raymond James said, noting that AIG shares were already somewhat risky because they traded at a higher price-to-earnings ratio than those of most insurers. Similarly, an analyst at A.G. Edwards noted after Greenberg stepped down that too little was known about the reinsurance transactions to assess the potential damage from the investigation.

Despite the concerns, AIG continued to receive positive ratings from the 25 analysts polled by Bloomberg News. Their average price target over the next six to 18 months was more than $77, compared to about $61 when the survey was done March 18. And although AIG postponed release of its annual report because of the management changes, it said on March 14 that the deals in question were not likely to cause "significant changes" to those results.

Still, losing Greenberg as CEO is a noteworthy event. Greenberg joined AIG in 1960 and took over in 1968 upon the death of the company's founder. He is widely credited with guiding the company from its humble roots writing life insurance in Asia and property-casualty coverage in the U.S. into an international powerhouse with a vast array of products. Among Greenberg's strengths was a talent for identifying profitable new markets that competitors were slower to see, Doherty said. After the 9/11 attacks, for example, AIG quickly began writing terrorism policies. "Organizationally, they are very good. I think they make very clever use of reinsurance buying."

Greenberg, he said, "runs a very tight ship" and created a corporate culture that provides strong incentives to enhance the company's value. "That's going to be difficult to replace." But Greenberg is nearly 80, and investors have long realized he would not be on the scene too much longer. The stock's relatively modest drop after he stepped down reflects the fact that his departure was already priced into the shares, Doherty said. "There was a lot of discussion about succession anyway."

And it's not as if Greenberg is disappearing. He remains chairman of the board of directors, although many observers expect him to leave that post in the next few months. Nor has AIG fallen into the hands of strangers. Greenberg was replaced by vice chairman Martin J. Sullivan, formerly co-chief operating officer. Sullivan has been with AIG since 1971. While there were several other top-management changes, each position continues to be held by an AIG veteran well-trained in the Greenberg business model. "My guess is these executives would not have survived if they had not inherited a lot of his strengths," said Doherty. "The net effect of losing him," Metrick added, "is not enormous."

Executive Hubris

Nonetheless, no one can be sure what the investigations will uncover. AIG's outside auditor, PricewaterhouseCoopers LLP, is examining the company's accounting practices going back many years, and AIG has not ruled out the possibility it may have to restate past financial results. "The problem is, in these sorts of scandals once you get a whiff of something going wrong, it tends to have an impact beyond the economic effect," Doherty said. The collapse of Enron, he noted, involved a loss of value that far exceeded the value of the transactions at the heart of the scandal. "That's always the danger."

Some observers believe Greenberg would have survived but for the err-on-the-safe-side culture that has taken root in many boardrooms in the years since the Enron scandal. The same week that Greenberg stepped down, a federal jury convicted former CEO Bernard Ebbers of fraud in the $11 billion collapse of telecommunications giant WorldCom, rejecting his claim he was unaware of the company's accounting gimmickry. Chief executives, it seems, can no longer say they didn't know what their subordinates were doing.

Investigators have found that Greenberg was personally involved in setting up the General Re transaction under question. "There does seem to be ... a lot of weird stuff going on, and who knows to what extent

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Greenberg knew about it," said Metrick. Questions about AIG's accounting practices have been raised for years, and many institutional shareholders have long been bothered by Greenberg's autocratic management style and refusal to address questions about who would succeed him. In today's climate, shareholders, analysts and regulators frown on executive hubris.

Robert Holthausen, professor of accounting, finance and management at Wharton, notes that executives like Greenberg might well have survived identical troubles in the pre-Enron era, and that investors, regulators and politicians may eventually conclude that some of today's boards of directors have become a bit trigger-happy. "It's not unusual that government passes regulations in response to crises," Holthausen commented, "and then the issue is, 'Did we end up over-regulating this area?'"

Starting last November, the 2002 Sarbanes-Oxley Act has required chief executives to personally certify the accuracy of their companies' financial results, with stiff fines and even jail terms for violations. Boards of directors, too, are being held to tougher standards, and directors at several companies have recently been ordered to pay fines out of their own pockets. "I think there's some evidence to suggest boards are getting more vigilant," Holthausen said. "The issue is whether they are getting too vigilant.... They are scared to death."

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