Accounting for the Abuses at AIG

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When accounting problems at American International Group surfaced last winter, it looked like a small matter next to the corporation-busting scandals of the Enron era. Even after AIG issued a statement March 30 detailing the issues, it said only $1.77 billion in shareholder value was threatened -- not so much for a multinational company then valued at more than $81 billion.

But AIG directors acted as if the company's very survival was at stake, removing Maurice Greenberg as CEO and later forcing him to step down as chairman. According to press reports, the tipping point came when directors and regulators learned that documents may have been removed from an AIG building or destroyed. New York Attorney General Eliot Spitzer then threatened criminal charges against AIG itself. No major financial firm had survived such a blow.

But there were other problems. The stock price was plummeting as investors worried about what else would be uncovered, how the management purge would affect the future, and whether a tainted AIG would lose customers.

The heart of the problem: No one can be sure how big the scandal will grow, because it involves business relationships, insurance products and accounting practices so arcane that few people understand them -- including a controversial product known as "finite insurance." "This is an obscure product that seems to have been used in ways other than what it was intended for," says Stephen H. Shore, professor of insurance and risk management at Wharton.

The investigation began last year when Spitzer's office started to look at practices about which most outside the industry have little or no knowledge. At issue is a deal between AIG and General Re, a reinsurer owned by Warren Buffett's Berkshire Hathaway. Investigators are looking at whether the deal was used to improperly bolster AIG's balance sheet in order to shore up the company's stock price. Investigators plan to interview Buffett, but there has so far been no indication he colluded on anything improper. Some press reports have said he asked associates whether the deal was being handled according to the rules and received assurances that it was.

The Role of Reinsurers

Business between insurers like AIG and reinsurers like General Re are everyday matters. "Reinsurance is just insurance for insurance companies," says Shore. "It's basically pooling insurance on a larger level," adds Alexander Muermann, professor of insurance and risk management at Wharton.

A customer -- typically a company -- might want insurance to cover a catastrophic loss, such as damage from a hurricane or terrorist attack. An insurance company like AIG writes the policy, charges a fee, or premium, and promises to pay the claim if the event occurs. But, Muermann says, the cost of the claim may be more risk than the insurer wants to shoulder by itself, so the insurer takes out a policy with one or more reinsurance companies. If the event occurs, the reinsurers pay the insurer, who pays the customer. By spreading risk among more participants, reinsurance allows insurance companies to remove risk from their books so they can write bigger policies - or more policies - than they otherwise could. Reinsurance also helps an insurer diversify its risk across a wider geographical area, despite rules that might limit its

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direct business to certain states, Muermann says, adding that reinsurance thus has a legitimate and valuable role in the industry.

But the reinsurance industry has spawned a number of specialty products that can be abused, including finite insurance. While this custom-tailored contract can take many forms, it commonly involves a limited period and a very large premium. An insurer, such as reinsurer General Re, writes a finite policy for a corporate client or another insurance company that covers potential claims up to a set limit. Over a given period, such as three years, the client pays premiums that altogether come close to the maximum coverage. If there has been no claim by the end of this period, the insurer returns all or most of the premium to the client.

The insurer receives a fee and, since the premiums are so large, does not risk severe loss. By paying such large premiums, the client effectively bears nearly all the cost of a catastrophic event by itself. But by spreading the premiums over several years, the client avoids taking the hit all at once. Hence, finite insurance can be used to smooth out the client's financial results. "If you suffer a loss today," says Shore, "these contracts seem to help you smooth that loss over time." This is not necessarily bad, he adds, because it's generally good for a company to avoid huge, concentrated losses.

However, there is a question about the accounting for finite policies. "Whether it's an attempt to trick people or not depends on how you are using it," Shore notes. "The question is: To what extent is this *not* insurance? To get paid a dollar today in exchange for a dollar tomorrow ... that's not insurance."

Finite policies are, in many respects, loans. "It's understood that, over time, the insurance company is going to repay those premiums," Muermann says. "So you can understand it as a loan." Such a product gives insurers flexibility that can improve efficiency in the insurance market, he adds.

Improper Use of Finite Policies

But in practice, finite policies have sometimes been used improperly. In 2000 and 2001, AIG's Greenberg asked General Re to do an unusual deal involving a bundle of finite contracts General Re had written for clients. AIG took over the obligation to pay up to $500 million in claims on the contracts. At the same time, General Re passed to AIG $500 million in premiums the clients had paid. AIG paid General Re a $5 million fee for moving these contracts to AIG's books.

Last year, General Re reported the deal to investigators who were questioning a number of reinsurers about finite policies. This deal carried a red flag because it was backwards: Typically, it would be AIG seeking a finite policy to shift risk to General Re. Because the $500 million in premiums had to be paid back to General Re, AIG seemed to be losing money on the deal, not making it. So why had Greenberg asked to take over those contracts?

In accounting for the deal, AIG tallied the premiums as $500 million in revenue and applied that amount to its reserve funds used to pay potential claims. This helped satisfy shareholders who had been concerned AIG did not have enough in reserve.

The issue in this deal, as in many finite insurance contracts, is whether AIG was providing insurance coverage or receiving a loan. To be insurance, AIG would have to assume a risk of loss. An industry rule of thumb known as "10/10" says the insurer should face, at a minimum, a 10% chance of losing 10% of the policy amount for the contract to be considered insurance.

In the absence of that degree of risk, the premiums transferred from General Re to AIG, and repayable later, would be a loan. AIG would then not be able to count the $500 million in premiums as additional reserves, as it had.

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On March 30, AIG directors announced that: "Based on its review to date, AIG has concluded that the General Re transaction documentation was improper and, in light of the lack of evidence of risk transfer, these transactions should not have been recorded as insurance."

As a result, the company said it would reduce its reserve figure by $250 million and show that liabilities had increased by $245 million. However, it added, these changes would have "virtually no impact" on the company's financial condition. Bottom line: The AIG-General Re deal was an accounting gimmick to make AIG's reserves look healthier than they were -- an apparent effort to deceive regulators, analysts and shareholders.

More Cases of Questionable Accounting

The directors then surprised observers by announcing they had uncovered a number of additional cases of questionable accounting.

The most serious involved reinsurance contracts AIG had taken with a Barbados reinsurer, Union Excess, allowing AIG's risk to pass to the other company and off AIG's books. AIG found that Union did business exclusively with AIG subsidiaries, and that Union was partially owned by Starr International Company Inc. (SICO), a large AIG shareholder controlled by a board made up of current and former AIG managers. Hence, the AIG statement said, SICO could be viewed as an AIG unit, or "consolidated entity," and SICO's risks were therefore actually AIG's. As a result, AIG had to reduce its shareholders' equity by $1.1 billion.

Another case involved a Bermuda insurer, Richmond Insurance Company, that the directors found to be secretly controlled by AIG. A third concerned Capco Reinsurance Company, another Barbados insurer, and "involved an improper structure created to recharacterize underwriting losses as capital losses," the directors said. Fixing this meant listing Capco as a consolidated entity and converting $200 million in capital losses to underwriting losses.

Yet another case involved $300 million in income AIG improperly claimed for selling outside investors covered calls on bonds in AIG's portfolio. Covered calls are supposed to give their owners the option to buy bonds at a set price for a given period, but AIG used other derivatives transactions to assure it could retain the bonds.

The directors also stated that certain debts owed to AIG might be unrecoverable, resulting in after-tax charges of $300 million. And they noted that the company was revising accounting for deferred acquisition costs and other expenses involving some AIG subsidiaries, resulting in as much as $370 million in corrections.

Some of the revelations seemed eerily similar to ones raised in the Enron case, which included use of little known offshore subsidiaries to hide liabilities, although the scale of the abuse so far appears to be far smaller at AIG.

The scandal highlights one of the dilemmas of American accounting, says Catherine M. Schrand, professor of accounting at Wharton. "We have one-size-fits-all accounting for firms in this country. If the standard-setters try to make it too specific and take out all the gray areas, then they would have a problem creating financial statements that are relevant."

The degree of risk assumed by a company that takes out a finite insurance policy is difficult to measure, so it may not be absolutely clear, even to the most well intentioned accountant, whether the policy should be counted as insurance or a loan. Companies like AIG are so big, and their

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accounting so complex, that it's impossible to write regulations to prevent all abuse, Strand suggests. "They will just find another way to do it.... Flexibility gives companies the opportunity to make their financial statements better. But it also gives them the opportunity to abuse the rules."

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