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Why Has AIG Had So Many Problems?

In September 2005, this column questioned the culture and operations of AIG, suggesting that its response to financial restatements would only lead to future problems. The context of this discussion, titled "AIG Remediation Emphasizes Compliance, but not Ethics," was a massive restated reduction in reported income for the previous five years of more than 10%. Specific problems noted at the time were: (1) creation of a special-purpose entity to improperly convert underwriting losses to investment losses, (2) improper recording of reinsurance transactions, (3) improper "top-level" adjustments and covered call transactions, and (4) unsupported "top-level" adjustment of loss reserves.

As noted in the column, the promises by AIG management to improve compliance and ethics resulting from that restatement scandal appeared to cover only relationships with regulators and not to implement ethics strategies as a best business practice. As the then-new CEO Martin Sullivan's letter to shareowners noted under the caption Regulatory Matters: "We value our reputation...the ethical leadership we exercise...the processes we are implementing and the values we are reinforcing and changes we are making to increase transparency and build a constructive relationship with regulators will make AIG a stronger and better company."

Because AIG's establishment of better compliance and ethics programs was triggered by regulators such as the Securities & Exchange Commission (SEC) and the requirements of the Sarbanes-Oxley Act, AIG seemed to be embracing a more ethical structure only because of legal requirements and not as a series of practices that guided its daily business operations.

Interestingly, in November 2005, AIG announced a second restatement of its financial statements for this same period. This time, it corrected "errors in the way it accounted for, among other things, certain types of derivatives contracts." *The Wall Street Journal* noted at the time that "the problem appears to be similar to the one at the heart of mortgage company Fannie Mae's [then] recent irregularities." Settlement in February 2006 of these issues with New York State authorities as well as the SEC and Department of Justice resulted in payment of $1.6 billion. The Fitch credit rating agency subsequently raised its appraisal of AIG's soundness to AA.

In late 2006, AIG agreed to pay $126 million to settle Department of Justice and SEC accusations that it sold products that helped companies inflate their earnings, and, in May 2007, a corporate risk manager was convicted of fraud for using an AIG product to manipulate reported earnings. In February 2008, a jury found five executives guilty of conspiracy, securities fraud, and making false statements to the SEC. They face penalties up to life imprisonment. Four of the convicted executives were with General Re Corp., the reinsurance counterparty to AIG.

Concerns about the collateralized debt obligation (CDO) product, which was based in some cases on subprime as well as regular mortgages, began to surface during mid-2007. But when reporting 2007 second-quarter earnings, AIG's CEO Sullivan was "comfortable with our exposure to the U.S. residential mortgage market." AIG's stock price held in the high $60s, but hindsight has proved this optimistic forecast to be wrong in a big way.

According to "Behind AIG's Fall, Risk Models Failed to Pass Real-World Test" (*The Wall Street Journal*, November 3, 2008), AIG began selling credit default swaps (CDS) in 1998. These unusual financial products are essentially equivalent to an insurance contract, but they use euphemistic language to avoid their being regulated by state insurance commissioners. Around 2004, the CDS market was expanded to include guarantees on CDOs that were backed by mortgage bonds, auto loans, or credit-card receivables.

According to the *WSJ* article, Gary Gorton, then a Wharton economics professor, gathered vast amounts of historical data and built computer models (modified Binomial Expansion Technique, or BET) to forecast the future. Since credit defaults had been miniscule, AIG came to believe that "if anybody paid you to take on these risks [of credit default], it was free money." Gorton's academic papers have been cited in speeches by Federal Reserve Chairman Ben Bernanke. Omitted from the BET model's risk analysis, however, was consideration of potential write-downs of the value of the underlying assets that would trigger requirements for payment of additional collateral to trading partners. For his services, the professor was said to earn as much as $1 million per year.

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The first recognition of market weakness in CDS products occurred with the recognition of $352 million of unrealized losses in AIG's third-quarter results reported November 7, 2007. Because of large calls for additional collateral, PricewaterhouseCoopers (PWC) reviewed the September 30 valuation placed on the swaps and, apparently, the amount of write-down. AIG's stock price was then in the mid to high $50s. In December, PWC advised Sullivan that AIG "might have a material weakness in its risk management." In a December 5, 2007, SEC report on Form 8-K, AIG reported on an investor conference that estimated the October and November decline in the value of its derivative securities portfolio was $2.6 billion but reiterated its belief that "it is highly unlikely that AIG will be required to make payments with respect to these derivatives."

On February 11, 2008, AIG filed another report on Form 8-K to note deficiencies in the BET model and to present modified loss estimates for previously reported 2007 results. The next day, an AIG press release announced it "continues to believe that the mark-to-market unrealized losses on the super senior credit default swap portfolio of AIG Financial Products Corp. (AIGFP) are not indicative of the losses AIGFP may realize over time. Based upon its most current analyses, AIG believes that any losses AIGFP may realize over time as a result of meeting its obligations under these derivatives will not be material to AIG." The stock price, however, declined quickly from the mid-$50s at the end of January to the mid-$40s at the time of the announcement.

The 2008 first-quarter results for AIG announced May 9 were even more painful: a net loss of $7.8 billion. Finally, Sullivan admitted that "the severity of the unrealized valuation losses and decline in value of our investments were beyond our expectations." Nevertheless, AIG proceeded to increase dividends to shareowners by 10%, a cash outflow of $2.2 billion on an annual basis. The stock price remained above $40. Later in May, investor confidence in management seemed to remain strong, as $20 billion in stock and fixed income securities were issued. Robert Willumstad, AIG's chairman, was named CEO to replace Martin Sullivan on June 15 when the stock price reached the low $30s.

Although the second-quarter loss reported on August 7 was "only" $5.8 billion, less than the historic first quarter, the stock price drifted into the low $20s and below. After the sales of Bear Stearns to JP Morgan Chase in February and of Countrywide Financial to Bank of America, historic events in the financial markets erupted in September. These included the government takeovers of Fannie Mae and Freddie Mac, the purchase of Merrill Lynch by Bank of America, the FDIC's seizure of

Washington Mutual, and change to a bank holding company of Goldman Sachs and Morgan Stanley. As a significant provider of CDS for almost every large financial institution worldwide, AIG came under increasing pressure to raise capital and provide collateral.

During the weekend of September 13, 2008, the Federal Reserve provided AIG with an $85 billion credit facility in exchange for equity warrants for 80% of the company. The stock price sank from the low teens to the low single digits, and Edward Liddy, formerly CEO at Allstate, was engaged as chairman and CEO. AIG borrowed an additional $37.8 billion in October. On October 3, Congress passed the $700 billion Emergency Economic Stabilization Act.

A variety of factors appear to be responsible for the many problems at AIG, which had a major role in bringing the world's credit markets to the brink of disaster. One cause is the role of internal auditing. An analysis of the charter of the AIG audit committee in comparison with that of other financial institutions shows less involvement with internal auditing. For example, the AIG audit committee charter doesn't specifically require that the committee receive and review significant internal audit findings, and it doesn't provide for meeting privately with the chief audit executive, doesn't require review of the internal audit charter, and doesn't specifically mention regular oversight of ethics and compliance processes.

As an example of AIG's possibly ineffective internal auditing, a *WSJ* report of a Congressional hearing noted that an AIG internal auditor had raised concerns about being excluded from conversations at AIG's credit default swap business concerning valuations of derivatives because he had "grave concerns" that the organization was in a "potentially material liability position." The head of the CDS unit was quoted as telling the auditor he wasn't included because he "would pollute the process." The auditor resigned shortly thereafter and wrote to the audit committee.

Another factor contributing to the problems at AIG was weak controls, caused in some cases by a substandard ethical climate. Minutes of meetings from the AIG audit committee describe PWC discussions of potential conclusions that material weaknesses existed in internal control. Meetings were held on January 15, February 7, February 26, and March 11. Comments that indicated the relationship of AIG's ethical culture to the valuation problem include:

- "Control functions are not included in the ongoing [valuation] process and lose the ability to participate in discussions of the issues."
- "Reviews [of year-end valuations] by Enterprise Risk Management and Internal Auditing are being conducted concurrently with the PWC audit."
- "AIGFP's culture needs to change."
- "[It is important to] foster an environment where communications with respect to risk and control issues are elevated quickly, candidly and on a timely basis, and following up on known areas of concern before issues arise."

The *WSJ*'s "Behind AIG's Fall" story reports Gorton, since wooed away from Wharton to Yale, laments "how problems in one sector caused investors to question value all across the board," and "there doesn't seem to be a fundamental reason why."

Come, come, Dr. Gorton, you know the reason. It's the old ethical principle of TRUST. When investors or any group don't trust the validity of information they are told, of course they are going to react negatively. You can't fool people forever by presenting complicated models based on poorly thought-out assumptions and estimates. Trust is essential to the functioning of markets. Remember the old saying about computers—GIGO? Yes, garbage in, garbage out still applies, even to the modified Binomial Expansion Technique!

As the AIG bailout package has been reworked and expanded to $150 billion as these words are written, Congress is questioning whether AIG's word can be trusted. Spending on an AIG "training" session at an Arizona resort drew widespread criticism, and it was reported that the CEO of AIG's CDS business was kept on as a consultant even after he had "resigned" under fire.

One hopes that, sooner rather than later, AIG will finally learn the value of establishing and maintaining an effective control environment, including integrity and ethical values, as well as an independent and effective internal audit function. This time, taxpayers are on the hook for the cost of failures! ■

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