Turning Up The Heat on AIG

BY JONATHAN R. LAING • It has been a bad week for insurance giant American International Group. Two AIG employees pleaded guilty to charges arising from New York Attorney General Eliot Spitzer's ongoing investigation of bid-rigging in the commercial-insurance market. These plea agreements raise to four the number of AIG employees caught up in the high-visibility Spitzer investigation of pricing and commission shenanigans at insurance broker Marsh & McLennan.

But of far graver moment, perhaps, was AIG's disclosure early last Monday that it had been served by a new set of subpoenas by both Spitzer and the SEC demanding key documents associated with certain "assumed reinsurance." We pointed out in a recent cover story ("Letting the Air Out," Jan. 31) that it would only be a matter of time before investigators turned their eye to the murky world of "finite-risk reinsurance" and probed how leading property and casualty insurance companies had used such transactions to burnish their own reported financial results. That appears to be the case, particularly with Spitzer's latest salvo of subpoenas leveled at AIG.

Company insiders were reportedly stunned at the specificity of the information requests, which centered on two reinsurance deals AIG reached with Berkshire Hathaway's General Re unit in late 2000 and early 2001. Moreover, if any charges of wrongdoing emerge from the probe, AIG's 79-year-old chairman and CEO Hank Greenberg could be toppled from his executive perch at a company that he has sedulously built into a financial powerhouse over four decades. That's because top management at both AIG and General Re may have been involved in both transactions, according to an industry insider.

AIG declined to discuss any details of the subpoenas. General Re has declined to comment on the reinsurance controversies.

Most thought that AIG's legal woes arising from claims of improper financial engineering were behind it until the latest subpoenas. For last November, the company settled investigations by the SEC and the DoJ into whether AIG had helped two clients outside the insurance industry—Pittsburgh banking firm PNC Financial and an Indiana cellphone distributor—boost their earnings through AIG-concocted financial schemes. AIG paid $129 million to settle the cases without admitting or denying any wrongdoing. The company also agreed to allow an independent monitor selected by the government to further scrutinize its books.

That monitor began working last week, so very likely any information giving rise to the latest subpoenas came from elsewhere.

Among other things, the last probe of AIG apparently is homing in on whether AIG employed financial hot-soace similar to what it offered PNC and Brightpoint to spew up its own financial results. Specifically, investigators are said to be looking at two reinsurance deals with General Re that allowed AIG to beef up its fourth-quarter 2000 and first-quarter 2001 reserves with a total of some $200 million in no-risk reinsurance transactions with Gen Re. In effect, investigators are looking at whether AIG borrowed the claims loss reserves from Gen Re, boosting the reserves carried on its balance sheet. AIG's offset, most likely a $200 million debt to some asset class, would be virtually undetectable in a balance sheet then bloating over $100 billion in assets.

The amount of the reserves boost may seem inconsequential to a company that at that time had nearly $25 billion in reserves against future claims losses. But at the time, security analysts following AIG were concerned that the company might be under-reserving against future claims in order to show greater-than-warranted earnings growth.

In fact, on Oct. 26, 2000, AIG stock plummeted 6%, from around 96 to around 93 after its third quarter earnings release showed a trivial $90 million drop in reserve levels from the quarter before. The stock soon righted itself. However a powerful message had been delivered to AIG management: No more reserve declines, no matter how minuscule, would be tolerated.

As a consequence, fourth-quarter reserves that year jumped some $440 million, to $24.9 billion from $24.6 billion at the end of the third quarter. Only $106 million of that increase came from organic growth in reserves while the remainder came from AIG's acquisition of Hartford Steam Boiler that quarter. That was followed by a slim rise in reserves of $228 million in the first quarter of 2001, to $25.0 billion. In fact, Wall Street fears of under-reserving at AIG were anything but misplaced. In early 2003, the stock plummeted again after AIG announced a $2.8 billion pre-tax charge against fourth-quarter 2002 results to boost the very same property and casualty reserves. And not all of this could be blamed on the impossible-to-anticipate claims losses of 9/11. The company had likely been skipping on reserves for some time.

The information giving rise to the latest AIG subpoenas was likely uncovered from the raft of information requests that the SEC and Spitzer has hit other companies with in recent months. General Re was one of the companies that had already received a subpoena, so it is not perhaps surprising to see that the two reinsurance deals were sifted from its document dump. The towering figure in the insurance industry by virtue of his longevity, aggressiveness and abilities, Hank Greenberg seems somewhat uncomfortable in the new post-Enron era of regulatory jilts against corporates. In the past, Greenberg has rolled over different state insurance commissioners like Patton's tank corp. In the mid-"Nineties, AIG was accused of creating out of whole cloth a supposedly independent reinsurance company called Coral Re so that AIG could artificially increase its capacity to write more business in the then strong market. The company slapped down the complaints of several state commissioners with ease. In a recent conference call, Greenberg groused about the new regulatory environment in which a "footfault" is treated as a "felony."

Interestingly, Greenberg laid low last week, not speaking as planned at a Merrill Lynch insurance conference on Monday or at an Executives' Club of Chicago meeting the following day. The company explained that Greenberg had a cold.

Perhaps an eventual confrontation between Greenberg and Spitzer is all but inevitable. Greenberg can't have liked how Spitzer humiliated his family by forcing the resignation of Greenberg's oldest son, Jeffrey, from the top spot at Marsh & McLennan in the wake of the recent scandal. Then there were the embarrassing guilty pleas at AIG arising from the same investigation.

These may be just preliminary bounces to a main event coming in the months ahead between Greenberg and Spitzer. It should be a hell of a fight.