

# Top insurance company mired in allegations of accounting fraud

Joseph Kay  
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On March 14, Maurice “Hank” Greenberg resigned his position as CEO of American International Group (AIG) amidst allegations of fraud and accounting manipulations at the world’s largest insurer. In an attempt to contain an escalating scandal, the company fired two more top executives on March 21, including the chief financial officer, Howard Smith.

Though not a household name, AIG is the 10th-largest corporation in the United States. It has close ties to the political establishment, counting on its board of directors William Cohen, the former defense secretary in the Clinton administration, and Richard Holbrooke, the former US ambassador to the United Nations.

Greenberg, who remains the chairman of the board of directors, has long been considered the titan of the insurance industry. In 1987, Ronald Reagan offered him the number-two position at the Central Intelligence Agency, presumably because of his international connections, particularly in Southeast Asia. He declined the nomination. Because of its enormous size and international reach, the investment firm Payne Webber wrote in 2000, “We have come to view AIG as almost the equivalent of a sovereign corporate nation, with its own diplomatic ties, economy, and head of state.”

The evidence of fraud—including recent revelations as well as information that has come to light over the past year—suggests that AIG arranged deals to manipulate financial figures, both its own and those of other companies. It is yet another indication of the vast extent of the fraud perpetrated by the highest levels of the American corporate and financial elite.

The incident that led most directly to the current crisis involved a transaction in the fall of 2000 between AIG and General Re, a unit of Berkshire Hathaway, the investment group run by billionaire investor Warren Buffett. At issue is whether AIG used the transaction to help paper over recent financial difficulties by an accounting sleight of hand.

As an insurer, AIG sells plans to corporations or individuals. In return for payment of premiums, AIG assumes the risk of financial loss resulting from particular events. To pay off claims that are filed, AIG must maintain a reserve of cash sufficient to cover the claims it can expect to pay out during a given period. Investors look closely at an insurer’s level of reserves, because low reserves indicate that the insurer is susceptible to a financial crisis if it receives a number of large claims from its clients in a short period of time.

According to investigations led by New York Attorney General Eliot Spitzer, in the fall of 2000 AIG’s reserves were too low. To deal with this problem, the company sought the aid of General Re, a reinsurance company. A reinsurance company insures the insurers—that is, it sells insurance plans to insurance companies that

are seeking to offload some of the risk they have acquired from corporations and individuals. Normally, therefore, an insurance company will pay General Re or another reinsurance company to cover potential losses the insurance company might face.

In the deal negotiated in 2000, however, General Re and AIG switched roles. General Re agreed to pay AIG a \$500 million premium, and in return AIG assumed the risk from a number of policies General Re had sold to other companies. This by itself would not have been illegal. However, according to investigators, the policies General Re handed over to AIG had little or no risk: The claims that AIG would have to pay out over time would almost certainly equal the same premium of \$500 million.

The result of the deal, therefore, was that AIG received \$500 million from General Re, money that it would eventually have to pay back without risk of having to pay more. General Re received a substantial fee from AIG. Similar arrangements are generally categorized as loans on financial statements—AIG received an amount of cash that it would later have to pay back plus interest (the fee to General Re). However, because of differences in accounting rules, to categorize the \$500 million as a loan would reduce the company’s income, something that AIG was loath to do.

Instead, according to investigators, AIG categorized the deal as a normal insurance contract, and the \$500 million was counted as income that went toward reserves to pay future claims. AIG reported a fourth-quarter increase in reserves of more than \$100 million for 2000.

Accounting regulations set by the Federal Accounting Standards Board stipulate that any such transaction that does not involve a significant amount of risk must be considered a loan, though the definition of “significant” has never been clearly set out. If, in fact, the risk of the deal was negligible, then AIG could be subject to civil prosecution and fines.

Scott Black, president of Delphi Management, Inc., which invests in AIG, noted, “The real issue is there is no transparency. They set up the reserves and they can make any number they want to each quarter.... It’s not possible to know the positions and the risk.”

Why would General Re agree to the deal? In addition to the fee that AIG agreed to pay for the transaction, AIG was one of General Re’s most important customers for reinsurance. It was therefore helping out an important client.

Greenberg was apparently directly involved in the deal, as evidenced in internal e-mails. The *Wall Street Journal* quotes one person knowledgeable about the evidence as saying, “The e-mails were pretty explicit on Hank’s motivation to boost reserves.”

Allegations such as these—that insurance companies carry out

transactions designed to help companies massage financial statements—are not new. Indeed, in the past, AIG has been the target of allegations that it helped other companies in a similar way to how General Re helped AIG, in particular through the sale of so-called “finite risk insurance,” a type of policy that regulators charge can be manipulated.

A report issued last fall by Fitch Ratings analyst Michael Barry noted that for such policies as these, “the primary purpose is not true risk transfer in the traditional sense, but financial statement enhancement.”

According to a *Wall Street Journal* article from March 15 (“How a Hot Insurance Product Burned AIG”), AIG became a big player in the field of finite risk insurance during the late 1990s, under the leadership of Robert Omahne, then an employee of the company. Omahne, who has since left AIG to join rival insurer ACE Ltd., said, “The culture at AIG was to make budgets. Everybody [i.e., AIG’s clients] seized on finite [insurance] as a way to make their numbers.”

One of these policies was sold in 1998 to a cell phone distributor, Brightpoint Inc. Brightpoint was allegedly looking for a way to lessen an unexpectedly large loss and turned to AIG for help. An October 18, 2004, article in *BusinessWeek* (“AIG: Why the Feds are Playing Hardball”) notes, “The insurer had just what Brightpoint needed: a retroactive insurance policy for which Brightpoint would pay monthly premiums for three years,” according to internal company documents. “During that period,” the magazine continues, “the AIG unit paid the money back in the form of insurance claims. Brightpoint recorded those payments as insurance receivables in 1998 to offset that year’s losses. The round-trip payments were cleverly disguised within a legitimate insurance policy....” In other words, Brightpoint bought “insurance” to cover losses that had already occurred, the exact opposite of how insurance normally works.

AIG ended up paying out \$10 million in fines to settle inquiries into the Brightpoint deal, while Brightpoint paid out \$600,000. In November 2004, AIG paid another \$126 million for a deal involving PNC Financial Services without admitting wrongdoing in either case. In the latter transaction, AIG allegedly helped PNC disguise its losses by shifting them to an off-balance-sheet entity.

Internal documents demonstrate that AIG was deliberately marketing policies whose main purpose was to help companies manipulate earnings. A 1997 internal document outlined a new form of “nontraditional insurance” whose main benefit would be “income statement smoothing.”

In addition to the “nontraditional insurance” deals, investigators are also looking into whether AIG set up its own Enron-style off-balance-sheet entities to hide its financial difficulties. According to a March 22 *Wall Street Journal* article, suspicions have centered on AIG’s relationship with two companies, Excess Reinsurance and Richmond Insurance. “There are signs that AIG controlled the companies, but it accounted for its business with the pair as if each was unaffiliated with it,” the *Journal* said, citing sources knowledgeable about the matter.

According to the *Journal*, “If they were affiliated, then AIG in effect was buying reinsurance from itself. That would mean that the nearly \$1.2 billion in reinsurance ‘recoverables’ that its 2003 financial statements list...are actually AIG’s own obligation.” The companies are largely unknown, but were among the 10 largest reinsurers with which AIG was doing business in 2003.

The allegations against AIG are only the most recent leveled against corporations involved in insurance and finance. In the fall of 2004, Spitzer filed civil charges against the largest insurance broker in the

country, Marsh & McLennan. At the time, Marsh was run by Hank Greenberg’s son, Jeffrey. As an insurance broker, Marsh does not sell insurance itself, but helps corporations purchase insurance from companies such as AIG and ACE Ltd. In return for fees from the companies seeking insurance, it is supposed to arbitrate a bidding process between the insurers so as to get the best insurance plans for its clients.

According to Spitzer, however, the company ran what amounted to an insurance racket. Marsh was accepting fees not only from companies seeking insurance, but from the insurers as well. In return for fees from the insurers, Marsh would send companies their way. Marsh allegedly rigged the bidding process by getting friendly insurance companies to submit artificially high bids. The high bid meant that the contract would go to another insurer; however, in return for playing the game—and creating the appearance of a competitive bidding process—the insurance company would be favored the next time around.

Two midlevel executives at AIG pled guilty for their role in the bid-rigging process. The civil charges filed against Marsh are still open. To avoid criminal charges, Jeffrey Greenberg was forced out of Marsh five months before his father resigned at AIG. The allegations of bid-ridding also involved ACE Ltd., which is run by another of Hank Greenberg’s sons, Evan. ACE has a lawsuit pending against it for allegedly providing kickbacks to Marsh.

Putnam Investments, the mutual fund investment unit of Marsh & McLennan, agreed to pay a \$110 million fine in April 2004 to settle charges that it allowed large investors to trade after market closing time, which is against regulations for mutual funds. This was part of a broader investigation led by Spitzer into the mutual fund industry.

In the summer of 2003, Citigroup and JP Morgan Chase & Co. agreed to pay a combined \$255 million to settle charges that the banks helped Enron disguise loans as revenues through a complex system involving nominally independent offshore companies. In 2002, the country’s largest banks were fined \$1.4 billion for providing false advice to their investment clients. They were publicly boosting stocks that they privately derided—in order to keep stock prices of important banking clients from falling.



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