

Aig scandal

[Business](#)



[pic] THE INTERNAL CONTROLS AND FINANCIAL ACTIVITIES THAT LED TO THE BAILOUT OF OUR NATION’S LARGEST INSURANCE COMPANY By: Monte

Schwartz PREFACE Anyone who watches TV has most likely seen the American International Group (hereinafter AIG) commercial with the little boy who walks into his parent’s room while they are sleeping. When his mother asks if he had a nightmare, he says “ no” and that he’s worried about his parent’s financial future. After a twenty-second spiel about his worries, the father says, “ Buddy, we’re with AIG” and he goes, “ Oh! and walks out of the room and (assuming) back to his bedroom. [1] AIG, established as a Delaware corporation in 1921 by Maurice “ Hank” Greenburg, is primarily engaged in insurance-related and financial activities in the United States and European countries (over 130 combined total); including but not limited to home insurance, car insurance, life insurance and various investments. Imagine that this boys parents’ discover one day with their financial planners that they lost all of their investments and insurances in which they paid dearly.

The parents had agreed to make an investment so they and their children could have a secured future protection against market risks. Well, it became a reality for many Americans. This devastating loss left many taxpayers with misappropriated assets along with a burden to pay the “ bill” for the bailout of AIG. PART I: HOUSING MARKET SCANDAL: VIOLATIONS IN BUSINESS OPERATIONS To understand the accounting scandal of AIG, one must first understand its business transactions and operations leading up to the SEC investigations. In 1993, President Bill Clinton signed into law the Omnibus

Budget Reconciliation Act, commonly known as the OBRA-93 or the Deficit Reduction Act. Part XIII, is our primary focus, the Revenue Reconciliation Act which allows limitations on executive compensations by limiting the deductible for tax purposes to \$1 Million unless the compensation was earned through performance, bonuses or equity: ultimately increasing the average executives paycheck. [2] When an executive's paycheck percentage is primarily a bonus, those profits can lead to decisions that are not in the best interest, short-term and long-term, of taxpayers or shareholders.

You may think what this Act has to do with AIG, but this act is the very essence of why AIG failed as a business. AIG had paid its top executives a whopping \$165 million in bonuses after it had received bailout funds. In early 1995, the Clinton Administration issued new and revised regulations to the Community Reinvestment Act, or CRA (in which was created by the Jimmy Carter administration) which de-emphasize a lender to make subjective assessment measures in favor of strictly numerical quotas, or as others may say, racial quotas. 3] In simpler terms, private banks were compelled to provide loans to low income families and minority neighborhoods as long as the person was making some sort of income to repay the loan and did not require any initiation of a credit check. In more ways than one, this was a Federal scheme that pressured and extorted banks into loaning money to people at high-risk. The new regulations also instructed lenders to take into account how well they responded to complaints from groups such as Minority Community Activist organizations like ACORN.

In December of the same year, Henry Cisneros (herinafter Cisneros), then head of Department of Housing and Urban Development (hereinafter HUD),

moved Fanny Mae and Freddie Mac towards a requirement that 42% of the mortgages would now serve predominantly minority neighborhoods and low to moderate income families. In 2000, Andrew Cuomo (hereinafter Cuomo), Cisneros' successor, established an even more aggressive social-engineering goal by increasing the number of mortgages to 50% by method of dramatically hiking Fanny Mae's and Freddie Mac's mandates to buy mortgages to under-serve neighborhoods for the very low income. 4] Cuomo also encouraged them to strongly enter the sub-prime loan markets, which are credit-default swap markets. And who sold the credit-default swaps? AIG did, because it was an insurance on bonds. Large banks buy bonds and insurance policies so that if a company, say General Electric, should declare bankruptcy, the large bank is out on whatever premium amount it paid and receives money from whoever sold the insurance policy, which in this case was AIG since AIG was the biggest underwriter of credit-default swaps. 5] Take for instance, as an example, General Electric (GE)[6]. There are only two (2) reasons as to why a bank would purchase credit-default swaps. Either they do not want to provide the full credit amount as it may be a risk or they are looking to hide something, like a cash transaction. Suppose that Bank A wants to better its business relationship with GE and so GE asks for \$70 million on credit. The bank, in return, speaks to their senior credit manager that the maximum they can provide is \$50 million, due to risk exposure.

However, in order to satisfy the customer, the bank lends the \$70 million anyway and writes off the \$20 million difference by purchasing a credit-default swap from Bank B. The only problem is, GE believes the entire \$70 million came from Bank A. Now, Bank B was "AIG Financial Products"

(hereinafter AIGFP), a division of AIG. Bank A was Bank of America, Wells Fargo, JP Morgan Chase, etc. PART II: THE ACCOUNTING SCANDAL: VIOLATIONS OF INTERNAL CONTROL There are four (4) most common ways of distorting a company's financial condition.

They are revenue recognition, cost or expense recognition, accounting for reserves and accounting related to business combinations. [7] AIG distorted their financials via accounting for reserves. What does that mean though? In accounting, companies use reserves to cover future costs such as taxes, possible litigation and pay-off debts or other liabilities. When a company intentionally falsifies information and misleads auditors of true financial reports, these fake transactions are better known as "sham transactions".

In 2001, the Securities Exchange Commission (herein after SEC) began investigating and making allegations that AIG was providing investors, shareholders and auditors with false financial statements, showing two sham schemes where the company altered its balance sheets through bogus transactions in efforts to conceal the company's losses on investments related to the credit default swaps. By September of 2003, the SEC filed a lawsuit against a company known as Brightpoint Inc. (hereinafter Brightpoint), in which is a wholesale distributor of electronics.

Their allegations included, but not limited to, improper use of insurance policies in attempting to reduce a loss by 11.9 Million in efforts to show the public a smaller loss. As a result, Brightpoint's Financial Statements overstated their net income. The SEC found their net income overstated by 61%. [8] It was revealed later in the discovery period that AIG was involved in assisting Brightpoint to spread out their losses over a time period. This

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technique is known as “ retroactive insurance” which combined two policies into one.

The two policies were the Retroactive Coverage and a Prospective Coverage. The “ policy” was supposed to cover the cost of losses over a three-year term. The idea was to “ smooth” the financial statements so that the public did not see such an impact of losses by AIG clients. Brightpoint paid a monthly premium for this policy of \$15 Million. This tactic, while completely fraudulent, allowed Brightpoint to show an Insurance Receivable of \$11.9 Million. See, SEC v. Brightpoint (2003). Retroactive Coverage is not insurance.

It just moved cash from one place to another, which the SEC called a “ round-trip of cash”. Brightpoint deposited monies with AIG and later on, AIG would return the funds; yet mark it off in their books as if they made an Insurance Claim Payment. There was no risk being transferred. Once Auditors realized that this policy wasn’t quite an Insurance Policy, Brightpoint began making “ restatements” to their financial statements. It is obvious that there is fraud when the books require numerous “ restatements”. After the SEC had filed their lawsuit, AIG quickly made agreements to settle for \$10 Million.

This was only a civil penalty. No criminal penalties were administered by the Federal Courts for this “ Retro-active Policy”. This payment of \$10 Million resulted in AIG’s profit a mere \$100, 000. See, SEC v. Brightpoint (2003). Brightpoint was not the only company received “ assistance” from AIG around the same time frame. Another company, known as PNC Financial Services Group Inc. (hereinafter PNC), was also involved. In short, PNC was a

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Pennsylvania bank holding company. AIG helped PNC to move \$762 million of assets off of the balance sheets. 9] By now, it seems AIG was a “ pro” at distorting balance sheets. They didn’t like low net incomes and they helped others by sharing their tactics of “ distortion”. The SEC calls these “ PAGIC” transactions, since net incomes magically show profit. PNC had transferred their assets to another entity which PNC held major interest. They had created three (3) transactions which were intended to reduce their losses in regards to loans and venture capital investments by “ transferring”, according to the SEC summary findings.

PNC had then failed to account for these transfers as an asset or a loan which failed to appear on their balance sheets. This reduced their exposure to “ troubled loans and volatile assets”. (See SEC v. PNC Financial Services, Inc.) These transactions were obviously structured to benefit PNC and its interested entities by increasing the value of their net income. Recently, as of January 2010, the SEC has also filed a complaint against a company known as Gen Re (General Reinsurance Corporation) which SEC has evidence of involvement in assisting AIG and other Financial Companies in using this sham scheme.

The SEC makes allegations that Gen Re “ knowingly provided substantial assistance to both AIG and Prudential in connection with their own violations of the books and records and internal control provisions of the federal securities laws, Sections 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1932. “[10] AIG falsely reported on its financial statements increases to both loss reserves and premiums written via sham reinsurance transactions. Gen Re helped AIG’s balance sheet transactions appear as

thought AIG had an increase in loss reserves[11] by \$500 million, which obviously was far from the actuality.

The loss reserves should have been \$250 million - half of the claimed amount - according to the SEC findings. There is also another accounting scandal involving AIG and the Federal Reserve Bank of New York. The individual parties involved Hank Greenberg, the CEO and founder of AIG and Timothy Geithner, then President of the NY Fed. Bank. The party investigating was the House Oversight and Government Reform Committee (hereinafter Committee), whose senior chairman is Darrell Issa, also Republican Representative of California.

Over twenty-two (22) hearings, discovery proceedings, interrogatories were produced on behalf of the Committee towards Timothy Geithner in why the Federal Reserve ordered AIG to refrain from disclosing in the notes of the financial statements all the facts of the bailout. Geithner, in hearings, attempted to defend the bailout by suggesting that had AIG collapsed, America would face a Great Depression. This answer was something the Committee had heard numerous times before. They demanded a new answer.

Even if the case is true, that America would have faced a Great Depression, the Committee smelled a bad scene unfolding, especially since two of Geithner's closest advisors, Mark Patterson (chief of staff) and Henry Paulson Jr. (former ex-chairman of the Federal Reserve), were both ex-employees of Goldman Sachs. In AIG's bailout, Goldman Sachs had received \$13 Billion. In defense to the bailout, Timothy Geithner's general counsel had claimed that

the disclosures were unnecessary since the company's regulatory filings had offered more detailed information.

In opposition to this statement, Issa released a five-page list of derivative transactions, also known as " Schedule A"[12] which is a comparative list of notional value, total collateral and negative mark to market values, respectively. Notional value is the value of the derivatives underlying assets at spot price (current price). The total collateral posted is the total securities for the guaranteed repayment of a loan and the negative mark to market measures the fair market value of accounts, which can change overtime.

Between the three comparisons, it is clear that " Schedule A" shows little reason for the Federal Reserve Bank of New York insisted that information should be kept private. PART III: THE RESULTS: BAILOUT & BONUSES A " bailout" is the giving of financial assistance (via the Fed, therefore taxpayers) to a failing business to save it from collapse. A bailout can be through the use of cash or a loan; however it can only happen when a company faces potential bankruptcy.

With AIG's housing market scandal and accounting scandal, it faced bankruptcy because it reported an overstatement of net revenue on its annual financial statements leading investors and shareholders to believe the company was a success. AIG initially received \$85 Billion from the government as a loan, and then sometime in March 2009, they received another \$88 Billion. Now that we know what financial assistance was received, term \$173 Billion, what did AIG do with all the bailout money? Well, now we can look closer at Figure 1-1 in determine where the money has gone. 44 Million went back into the Banks of the United States. AIG paid itself

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\$600 Million. Golden Sachs received \$13 Billion and Merrill Lynch: \$7 Billion. The chart also includes bailout money that each of the 50 states received, totaling \$12 Billion, even though they were originally supposed to receive \$15 Billion. \$113 Billion went to guarantees, such as bond guarantees and securities guarantees. If you look closer, you will see that foreign banks and countries received more bailout money than the United States did. France, Germany and the United Kingdom received the bulk of the funds, a whopping \$49 Billion.

These countries received, rounded, 80% of the AIG foreign funds. See below figure for details of the funds AIG disbursed to large banks and foreign countries. [pic] And what about that \$165 Million "bonus" contract AIG had? Senior Judicial Analyst, Judge Andrew Napolitano states that (1) the "existence of a contract is the building block to our commercial society" and that (2) therefore, the contract to pay top executives a \$165 million cannot be broken because the "constitution prohibits the government, federal and state, from interfering with valid contracts and these contracts were valid when they were signed. [13] Much of the debate of where all of the taxpayer bailout funds come into scrutiny but that is another issue of AIG. The majority of the housing market and accounting scandals began during the Jimmy Carter administration when he enacted the CRA. Then, in the Bill Clinton administration, while he may have had good faith intentions to help the minority communities, he literally forced banks to handout loans when the applier had a high credit risk.

Then, Cuomo increased the percentage of mortgages that were required to serve minorities via credit-default swaps which AIG were the primary

underwriters. This factor, along with the sham balance sheet insurance transactions was the reason AIG nearly went bankrupt. While the bailout certainly helped AIG in avoiding bankruptcy, thousands of American citizens who file and pay annual income tax returns (the 50%), lost their investments and insurances to secure their futures all due to tax-schemers and executives who are high on themselves and want a bigger return. PART IV: AIG:

WHAT IT IS NOW Since the discovery of AIG's fraudulent behaviors in business and financial activities in 2001, the company has had to face many lawsuits from investors and shareholders; some are still pending. The CEO of AIG, Hank Greenburg as well as a few top executives were forced to resign. Some executives received a two (2) year prison term, which isn't a very long time when considering how much money was misappropriated. Just recently, Oct 2, 2012, the company revealed a new image for their name. They have changed their logo which is the cover image above.

They claim the new logo is "transparent" and "simplistic". Does a new logo change the history of a company though? In a company that had so much potential yet failed to secure the futures of the Americans who they insured, the reputation is irreparably damaged and until it repays the billions of dollars back to the government (or, taxpayers). Until then, AIG is owned by the Federal Government. ----- [1] "AIG Commercial" © 2005 < <http://www.youtube.com/watch?v=9VvGW98D3XA>> [2] Korzenik, Jeffrey D. Forbes. om "The Tax Code Encourages Big Wall Street Bonuses" Feb 2009. < http://www.forbes.com/2009/02/04/wall-street-bonuses-opinions-contributors_0204_jeffrey_korzenik.html> [3] Money Gather: "Bill Clinton <https://assignbuster.com/aig-scandal/>

Helped Cause the Housing Crisis” September 2008. [4] Morris, Dick. Take Back America. Pg 266, Harper, April 13, 2010. Print. > [5] The Big Picture. “ Credit Default Swaps are Insurance Products. It’s Time we Regulated them as Much. ” March 2012. [6] General Electric was in no way shape or form related to the AIG scandal; this is strictly an example. 7] See Pricewaterhouse Coopers LLP, 2009 Securities Litigation Study 30 (2009), available at http://10b5.pwc.com/PDF/NY-10-0559%20SEC%20LIT%20STUDY_V7%20PRINT.PDF. [8] Securities Exchange Commission v. Brightpoint Inc. , (2003) <http://www.sec.gov/litigation/complaints/comp18340.htm> [9] Securities and Exchange Commission v. PNC Financial Services Inc. <http://www.sec.gov/litigation/admin/33-8112.htm> [10] Securities and Exchange Commission v General Re Corporation, 10 CV 458, PACER [11] Loss reserves in the Insurance industry are an estimate of the value of a claim or group of claims not yet paid. [12]