

Actuarial Accounting: A Cautionary Report

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The Story of the AIG Accounting Scandal

- The Companies
- The Participants
- Regulatory Scrutiny Intensifies
- The Prosecution Case
- The Defense Case
- Relevant Laws and Regulations
- The Fate of the Participants

The Companies

AIG Overview

- Was world's largest insurance and financial services company
- Had 93,000 employees
- Had business in 130 countries

	<u>2007</u>	<u>2008</u>
■ Net Income	\$6.2 B	-\$99.3 B
■ Total Revenues	\$110.1 B	\$11.1 B
■ Shareholder's equity	\$95.8 B	\$52.7 B

GenRe Overview

- One of World's largest reinsurers
- Established 1921
- Headquartered in Connecticut
- Owned by Warren Buffet's Berkshire Hathaway
- Led by Ronald Ferguson, FCAS, until he retired in 2002
- Written Premium:
 - \$6.0 B (2007)
 - \$6.0 B (2008)

The Participants

Hank Greenburg, CEO of AIG

- Born 1925
- Admitted to NY Bar in 1953
- Joined AIG in 1962
- Named CEO in 1968
- Led AIG for 38 years
- Stepped down March 21, 2005



Ron Ferguson, CEO of Gen Re

- Born 1942
- Fellow of CAS
- Co-developer of B-F method
- Joined Gen Re in 1966
- Named CEO in 1987
- 1998 Berkshire Hathaway acquired Gen Re
- Retired 2002



Christopher Garand, SVP and Chief Underwriter of Gen Re

- Born 1947 in Melbourne
- Two-year stint in US Army
- First job with ISO in Manhattan
- American Re
 - Became Fellow of CAS
 - Promoted to Chief Actuary
 - Head of Treaty Pricing Unit
- Gen Re
 - Enterprise Risk Manager
 - SVP and Chief Underwriter
- Retired 2005



Elizabeth Monrad, CFO of Gen Re

- Wellesley College
- MIT Sloan School of Management
- CPA
- 12 years at Coopers & Lybrand
- Insurance professional woman of the year (1999)



Others

Robert Graham, JD

- SVP and Assistant General Counsel at GenRe until 2005



Christian Milton

- VP of AIG's Reinsurance until 2005



Others

Richard Napier

- SVP responsible for GenRe relationship with AIG



John Houldsworth

- CEO of Cologne Re Dublin (CRD)



Eliot Spitzer, JD

- Born 1959
- Former Attorney General of NY
- Notable prosecutions:
 - Mutual fund scandals (2003)
 - Insurer bid rigging (2004)
 - AIG accounting scandal (2005)
- Elected Governor of NY (2006)



Regulatory Scrutiny Intensifies

How AIG Came under Scrutiny

- 2001 – SEC learns that AIG has assisted a client company in bolstering its balance sheet through a bogus insurance transaction
 - investigation ensues
- 2003 – SEC and Justice Department settle with AIG
 - \$10 Million Civil Penalty
 - Independent consultant retained
- 2004 – Federal Grand Jury begins investigation of AIG's income smoothing products
- 2004 – Bid rigging complaint filed by Spitzer against AIG and others

AIG Admits to Improper Accounting

- February 9, 2005 – 2004 earnings released
- March 30, 2005 – AIG discloses that reinsurance deal with GenRe should have been accounted for as a *deposit*
- May 31, 2005 – Restatement amounted to reduction in 2004 net income of \$1.32 Billion

The State Authorities Attack

- May 27, 2005 – Spitzer files civil suit against AIG
- Alleges AIG "engaged in misleading accounting and financial reporting, projecting an unduly positive picture of AIG's underwriting performance for the investing public."
 - In particular, engaged in "**two sham insurance transactions**" that gave investors the impression the company had larger reserves for claims than it did.
 - Other wrongdoing

Greenberg Fires Back

- "For the attorney general to use his office to prosecute, and persecute, people in the press for political gain is wholly against our legal principles," said Greenberg in an interview. "It's outrageous." ...
- "It's simple: He's running for another office," Greenberg said. "It has nothing to do with right or wrong."
- CNBC's Charles Gasparino reports that in an interview he previously conducted, Greenberg called Spitzer "a thug."

The Federal Authorities Attack

Feb 2, 2006 – SEC files complaint in US District Court against AIG

- "This case is **not about the violation of technical accounting rules**. It involves the deliberate or extremely reckless efforts by senior corporate officers of a facilitator company (Gen Re) to **aid and abet** senior management of an issuer (AIG) in structuring transactions having no economic substance, that were **designed solely for the unlawful purpose of achieving a specific, and false, accounting effect on the issuer's financial statements.**"

SEC Settlement

- Feb 9, 2006 – SEC and Justice Department settlement with AIG
 - Total settlement in excess of \$1.6 billion
 - Related to alleged improper accounting, bid rigging and practices involving workers comp funds
 - CEO and CFO replaced

Federal Criminal Action

- Federal criminal charges filed against certain officers at AIG and Gen Re
- Alleged violation of 16 counts of the criminal code
 - Conspiracy (1 count)
 - Securities fraud (7 counts)
 - False statements to SEC (5 counts)
 - Mail fraud (3 counts)

Plea Bargained

- Richard Napier
SVP, Gen Re



- John Houldsworth
CEO, CRD



- Witnesses for the
Prosecution

The Prosecution Case

The Setting

- Oct 26, 2000 – AIG announced that premiums increased in Q3, but reserves fell by \$59 million
- Oct 26, 2000 – AIG share price dropped from \$99.37 to \$93.31 on NYSE (6%)
- October 31, 2000 – Greenberg called Ferguson

The Phone Call (Napier)

Greenberg asked Ferguson to temporarily transfer loss reserves to AIG:

- Amount of \$200 to \$500 million
- To occur by year end 2000
- To last 6 to 9 months
- AIG should incur no losses (i.e., the deal should be riskless)

Initial Steps

- Richard Napier
Gen Re point person



- Christian Milton
AIG point person



Initial Steps

- Parties agree to deal:
 - Gen Re to transfer loss reserves to AIG in exchange for a payment of premium
 - Two separate contracts transfer loss reserves:
 - \$250 million in 2000 with cap of \$300 million
 - \$250 million in 2001 with cap of \$300 million
 - Gen Re "obligated" to pay AIG "premium" of \$500 million (\$250 million per contract)
 - Gen Re to receive \$5 million for doing the deal
 - Contract to last 24 months

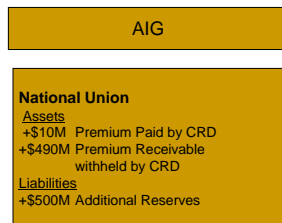
Issues with the Deal

- Accounting problem:
 - Deposit or Reinsurance accounting?
 - AIG used reinsurance accounting
 - Gen Re used deposit accounting
- The “North American problem”:
 - Statutory reporting requires disclosure of premium and reserves related to each reinsurance transaction
 - GenRe’s foreign subsidiary (CRD) not required to file US reports

Other Issues with the Deal

- A paper trail had to be created to appear that Gen Re proposed the deal
- Gen Re had to appear to be on the hook for \$500 million in “premium” without actually paying it
- AIG had to pay Gen Re’s \$5 million fee for doing the deal without attracting the attention of regulators

The Loss Portfolio Transfer How AIG accounted for the Deal



Impact on AIG's Loss Reserves

	Reported	LPT Contracts	Actual
4Q 2000	+\$106 M	-\$250 M	-\$144 M
1Q 2001	+\$63 M	-\$250 M	-\$187 M

Reaction from Analysts

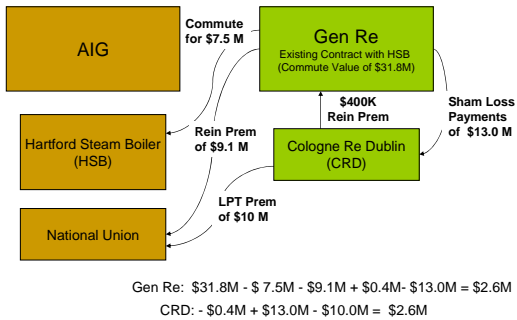
- “We think this quarter was a good example of AIG doing what it does best: growing fast and making the numbers...As important was the change in reserves: AIG added \$106 million to reserves...”
- “Finally AIG put to rest a minor controversy from last quarter by adding \$106 million to reserves...”

How CRD Paid \$10M in Premium without Really Paying

Leverage existing contract, in which Gen Re holds \$31.8M payable to AIG

- Gen Re pays only \$7.5M to commute an existing contract with AIG's Hartford Steam Boiler (HSB)
- Gen Re pays National Union \$9.1M in premium to reinsure the HSB losses that were just commuted
- CRD pays \$0.4M in premiums to Gen Re for a “sham” reinsurance contract and receives a loss payment of \$13M shortly after ink dries
- CRD pays LPT “premium” of \$10M to AIG
- Gen Re / CRD left with \$5.2M to cover the fee

The "Round Trip of Cash"



Prosecution Evidence

Napier's Trial Testimony

- Under secret side deal, AIG paid Gen Re \$5 million fee, and did not actually pay the \$10 million in premium specified in written contract
- He, Ferguson, and Monrad discussed draft contract as a no-risk deal
- Ferguson discussed terms of contract with Greenberg, including that AIG would bear no risk

Houldworth Trial Testimony

- Sent to Ferguson email on 11-15-2000, with draft LPT contract, stating “[Gen Re] will not transfer any losses under this deal”
 - Ferguson’s former secretary identifies his handwriting on email
- AIG did not ask Gen Re for information necessary to perform actuarial analysis of risk

Recorded Evidence

11-14-2000 (recorded):

- Houldworth: There is clearly no risk transfer. You know there is no money changing hands.
- Monrad: [AIG] may have a tough time getting the accounting they want out of the deal that they want to do... They are not looking for real risk...



Recorded Evidence

12-08-2000 (recorded):

- Monrad: We told AIG that there would not be symmetrical accounting here.
- Houldworth: Okay, fine.
- Monrad: We told them that was one of the aspects of the deal they would have to digest.



Evidence of Ferguson's Knowledge

12-11-00 (recorded):

- Houldsworth: We're going to ask . . . Ron [Ferguson] to sign off on the reputational risk. I think it's Ron's deal so he's the one that ought to.
- Garand: Yep.
- Houldsworth: I mean he's effectively done that by being involved but we may as well follow the rules.
- Garand: Sure. Make him sign in blood.
- Houldsworth: Well, I don't care what he signs in as long as I know it's him.



Other Evidence

12-22-2000 (email)

- "[T]he AIG project continues. It is now a two step loss portfolio deal between [CRD] and National Union. . . . Our group will book the transaction as a deposit. How AIG books it is between them, their accountants and God; there is no undertaking by them to have the transaction reviewed by their regulators. Ron [Ferguson] et al. have been advised of, and have accepted, the potential reputational risk that US regulators (insurance and securities) may attack the transaction and our part in it."

- Robert Graham



Other Evidence

3-7-01 (recorded):

- Graham: We [GenRe] aren't going to pay them [AIG] the fee [premium] yet. You know, **we don't intend to pay them until we get the cash.** If they turn around and start kicking up a fuss, **I don't think they really want this made public,** this transaction. I would be very surprised. There's a whole pile of things.



Other Evidence



3-7-01 (recorded):

- Graham: Well, and their [AIG's] organizational approach to compliance issues has always been **pay the speeding ticket**, so, which is different than our [GenRe's] organizational approach to compliance. **So I'm pretty comfortable that our own skirts are clean but they [AIG] have issues.**

The Defense Case

Defense Case Overview

- Two days
- Five character witnesses testified
- Defendants did not testify

Defense Strategy

- Attacked reliability/credibility of Napier and Houldsworth
 - Conversations and meetings that never occurred
 - Insufficient evidence of side deals
- Also argued that
 - LPT had minimal effect on AIG financials
 - AIG share price not affected after AIG disclosure
 - Common industry practice
 - Absence of financial motive
 - Recordings were taken out of context
 - Buffet knew of and approved of LPT deal

Garand's Arguments

- Single day in meetings (Nov 20, 2000)
- Four phone calls
- Handful of emails
- No evidence that he participated in drafting the contract, chose the underlying liabilities, determined the price, or did anything
- Evidence that he assisted in commutation of reinsurance between and GenRe and AIG subsidiaries
- Involvement similar to others who were not charged



Warren Buffet's Involvement

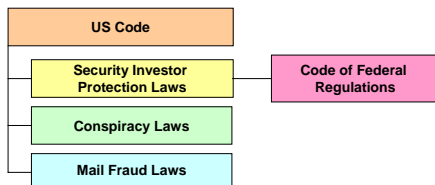
Email from Ferguson to Buffet

- "Warren, just a quick note to let you know why I hesitated a moment when you mentioned the \$5,000,000 fee on the reserve transaction. We are indeed charging a 1% fee but for some reason A.I.G. decided to split the deal in to two \$2,500,000 tranches one to be registered in 2000 and one in 2001."



Relevant Laws and Regulation

Relevant Laws & Regulations



Manipulative and deceptive devices (15 USC §78j)

Security Investor
Protection Laws

It shall be unlawful ...

- **(b)** To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange ... **any manipulative or deceptive device** or contrivance in contravention of [Rules 10b-5, 12b-20, etc.]

Rule 10b-5

Code of Federal
Regulations

Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- a) To **employ any device, scheme, or artifice to defraud**,
- b) To make any **untrue statement of a material fact** or to **omit to state** a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- c) To engage in any act, practice, or course of business which operates or would **operate as a fraud or deceit** upon any person, in connection with the purchase or sale of any security.

Rule 12b-20

Code of Federal
Regulations

Additional information

- In addition to the information expressly required to be included in a statement or report, there **shall be added such further material information**, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made **not misleading**.

Rule 13b2-1

Code of Federal
Regulations

Falsification of accounting records

- No person shall directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Securities Exchange Act.

Other Rules

- § 240.13a-1 Requirements of annual reports
- § 240.13a-13 Qrtly reports on Form 10-Q

Periodical and other reports (15 USC §78m)

(b) Form of report; books, records, and internal accounting; directives

(2) Every issuer which has a class of securities registered pursuant to section 78j of this title and every issuer which is required to file reports pursuant to section 78o (d) of this title shall—

- A. make and keep books, records, and accounts, which, in reasonable detail, **accurately and fairly reflect** the transactions and dispositions of the assets of the issuer;
- B. devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that ...transactions are recorded as necessary ... to permit preparation of financial statements in conformity with **generally accepted accounting principles** or any other criteria applicable to such statements, ...

Penalties (15 USC §78ff)

- (a) **Willful violations; false and misleading statements** Any person who willfully violates any provision of this chapter (other than section 78d-1 of this title), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who **willfully and knowingly** makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof which **statement was false or misleading with respect to any material fact**, shall upon conviction be fined not more than **\$5,000,000**, or imprisoned not more than **20 years**, or both, except that when such person is a person other than a natural person, a fine not exceeding \$25,000,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

§ 371. Conspiracy to commit offense or to defraud United States

Conspiracy
Laws

- If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined under this title or imprisoned not more than five years, or both.

§ 1341. Frauds and Swindles

Mail Fraud
Laws

Whoever, having devised or **intending to devise any scheme or artifice to defraud**, ... for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, ...or knowingly causes to be delivered by mail ...any such matter or thing, shall be fined under this title or imprisoned not more than 20 years, or both...

Fate of the Participants

Ron Ferguson, FCAS



Convicted of:

- Conspiracy (1 count)
- Securities fraud (7 counts)
- False statements to SEC (5 counts)
- Mail fraud (3 counts)

Sentence:

- 2 years in prison
- 2 years supervised release
- \$200,000 fine
- Personal recognizance pending appeal

Christopher Garand, FCAS



Convicted of:

- Conspiracy (1 count)
- Securities fraud (7 counts)
- False statements to SEC (5 counts)
- Mail fraud (3 counts)

Garand's Sentence



Sentence:

- 1 year & 1 day in prison
- 2 year supervised release
- \$150,000 fine

Elizabeth Monrad, CPA



Convicted of:

- Conspiracy (1 count)
- Securities fraud (7 counts)
- False statements to SEC (5 counts)
- Mail fraud (3 counts)

Gives pre-sentencing interview

Monrad's Reaction to Conviction

Monrad's response

- "I know I'm innocent"
- Plans to appeal

Misgivings

- Expected to testify but was persuaded it wasn't necessary
- She was afraid that her testimony would be used to try to harm innocent co-defendants

Buffet's ongoing involvement gave her comfort that the transaction was acceptable

Gun to the Head

- Plead and cooperate and get probation or go to trial and risk prison for the rest of your life

Monrad Sentencing Hearing

- Prosecutor refers to interview as lack of respect for judicial system
- Children, husband, colleagues address the court
- Monrad begged the judge for mercy: "My life is in your hands."
- Judge Droney's comments:
 - "There were many opportunities for her to come to her senses and shake this shady deal, but she never did."
 - The fact that she didn't benefit personally from the scheme "doesn't excuse her conduct."
 - Her involvement with the fraudulent transaction "was central to its success."
 - She knew the harm her conduct could cause.
 - "She was the financial expert for General Re in this transaction."
 - **"A message must be sent to the business and financial communities that this kind of conduct will not be tolerated."**

Monrad's Sentence

- 18 months in prison
- 2 years supervised release
- \$250,000 fine



Robert Graham, JD

Convicted of:

- Conspiracy (1 count)
- Securities fraud (7 counts)
- False statements to SEC (5 counts)
- Mail fraud (3 counts)



Sentence:

- 1 year & 1 day in prison
- \$100,000 fine

Christian Milton

Convicted of:

- Conspiracy (1 count)
- Securities fraud (7 counts)
- False statements to SEC (5 counts)
- Mail fraud (3 counts)



Sentence:

- 4 years in prison
- 2 years of supervised release
- \$200,000 fine

John Houldsworth

Plea Bargained to conspiring to commit securities fraud

Sentence:

- 2 years of probation
- \$5,000 fine
- 400 hours of community service



Richard Napier

Plea Bargained to conspiring to commit securities fraud

Sentencing:

- Two years of probation
- \$10,000 fine



Unindicted Co-conspirator

- Hank Greenberg
- "Took the 5th"



Down in Shame

- Eliot Spitzer
 - Stepped down as Governor in 2008 amid allegations of patronizing a prostitution ring



Code of Professional Conduct

PRECEPT 1. *An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession's **responsibility to the public** and to uphold the reputation of the actuarial profession.*

- **ANNOTATION 1-2.** *An Actuary shall not provide Actuarial Services for any Principal if the Actuary has reason to believe that such services **may be used to violate or evade the Law** or in a manner that would be detrimental to the reputation of the actuarial profession.*
- **ANNOTATION 1-4.** *An Actuary shall not engage in any professional conduct **involving dishonesty, fraud, deceit, or misrepresentation** or commit any act that reflects adversely on the actuarial profession.*

CAS Action

- CAS has requested ABCD to investigate whether Garand and Ferguson violated the Code of Professional Conduct
