**Mark-to-Market Accounting and the Demise of AIG**

American International Group, Inc. (AIG) was the world’s largest insurance company with major offices in New York, London, Paris, and Hong Kong. From 2005 to 2008, the company had a series of accounting problems. First, it was convicted of fraudulent financial reporting, and, then, of reporting mammoth unrealized losses that led to the company being taken over by the government. Throughout this period, it went through four CEOs.

On June 6, 2005, the Securities and Exchange Commission (SEC) laid charges against executives at AIG and General Re alleging that they committed securities fraud by engaging in two reinsurance sham transactions that artificially increased the loss reserves of AIG by $500 million, thereby making the financial results of AIG look better than they were in the fourth quarter of 2000 and the first quarter of 2001. According to the SEC, “The transactions were initiated by AIG to quell criticism by analysts concerning a reduction in the company’s loss reserves in the third quarter of 2000.” Billionaire Warren Buffet, who owns General Re, was not involved in the SEC suit, but Maurice Greenberg, the then CEO of AIG, was identified as an unindicted coconspirator who was aware of the sham transactions. Afterward, Greenberg was pressured to leave the company.

In February 2006, AIG agreed to pay a $1.6 billion fine, and two years later five former executives of General Re and AIG were found guilty of securities fraud. Meanwhile, AIG began replacing its CEO. In 2005, Greenberg was replaced by Martin Sullivan, who was replaced in June 2008 by Robert Willumstad after AIG recorded mammoth losses and its stock price plummeted. Willumstad was replaced three months later by Edward Liddy, after the government took over AIG.

Although its primary business is selling insurance, in 1987 AIG began to sell financial products through its subsidiary, AIG Financial Products Corp. One of its major products was a credit default swap contract designed to protect investors against defaults on fixed-income investments such as mortgage-backed securities and other mortgage-backed derivatives. However, internal controls at the subsidiary were weak. In late November 2007, AIG’s auditors PricewaterhouseCoopers raised concern with Sullivan about material weaknesses in the risk management areas. In March 2008, the office of thrift supervision said, “We are concerned that the corporate oversight of AIG Financial Products…lacks critical elements of independence, transparency, and granularity.”

Nevertheless, the subsidiary continued to sell its financial products, including credit default swap contracts on $441 billion of asset-backed securities, $57.8 billion of which related to mortgage-backed securities. When the subprime mortgage meltdown occurred in 2007, AIG began to record losses on these credit default swaps as result of FASB 157. The Financial Accounting Standards Board (FASB) issued Statement No. 157 on Fair Value Measurements in 2006 that became effective in 2007. The fair value measurement rule, referred to as the “mark-to-market” rule, requires that financial assets and liabilities be revalued to their market values each reporting period. In the case of a financial instrument, this would be at the quoted price of the instrument in an active market. As the market for subprime mortgages deteriorated, so too, did the market for financial instruments that were backed by those mortgages.

In February 2008, the unrealized losses were $4.8 billion, which were increased to $11 billion by the end of the month. In June, Sullivan resigned as CEO but was given a $15 million “golden parachute.” On September 16, AIG reported losses of $13.2 billion for the first six months of 2008. Its shares were trading at $3.14, down more than 90% from its peak of $190 billion market value at the end of 2006. The federal government decided that AIG, one of the five largest financial companies in the world, was “too big to fail,” and so it announced a bailout for the company. The government would provide a credit-liquidity facility of $85 billion, which was later increased, in return for receiving warrants that in essence gave the government a 79.9% equity interest in AIG. On September 17, AIG drew down $28 billion of the credit-liquidity facility. By October 24, it had drawn down $90.3 billion of the $122.8 billion bailout.

In testimony before the House of Representatives Committee on Oversight and Government Reform on October 7, 2008, Willumstad laid part of the blame for the company’s failure on the accounting rules that forced AIG to record unrealized losses on its credit default swaps.

However, when the market for the underlying bonds froze toward the end of 2007, accounting rules required AIG to “mark to market” the value of its swaps. But the market was not functioning. The way the accounting rules were applied in this unprecedented situation forced AIG to recognize tens of billions of dollars in accounting losses in the fourth quarter of 2007 and the first two quarters of 2008, even though, as far as I am aware, AIG has made very few payments on any of the credit default swaps it wrote and the vast majority of the securities underlying the swaps are still rated investment grade or better by the rating agencies.

So, according to Willumstad, the collapse of AIG and the subsequent bail out were the result of mark-to-market accounting. In a speech the next day, Lynn Turner, the former chief accountant of the SEC, said, “AIG is blaming its downfall on accounting rules which require it to disclose losses to its investors. That’s like blaming the thermometer, folks, for a fever.” On October 10, 2008, FASB loosened the mark-to-market accounting rule, permitting companies to forgo writing down their securities if there is no ready market for them, provided that the existence and nature of the securities is disclosed.