Chapter 17

Chaos

When AIG's new CEO, Martin J. Sullivan, first met with senior management in March 2005, he cheered colleagues on by saying: "Don't forget to have fun."[1] In contrast, Greenberg's CEO speeches to managers struck a disciplinary note, stressing things like risk analysis, control, and accountability. That command-and-control culture was on its way out, and nothing would replace it, as AIG became "directionless."[2]

As the old culture at AIG began to fade, Sullivan reported two accomplishments to the board: "keeping the management team together and losing very few customers."[3] Despite the low bar, at a mid-2005 board meeting, Zarb, acting chairman, declared that AIG's management, led by Sullivan, was doing "one hell of a good job."[4] Zarb cited how management was working with PricewaterhouseCoopers (PwC) to upgrade internal controls and improving its relationships with regulators in unspecified ways. For himself, Zarb trumpeted that he had been meeting with institutional investors, including the AFL-CIO.

Meanwhile, Paul Weiss was negotiating with Spitzer about radical corporate governance reforms at AIG.[5] The terms endorsed Greenberg's early retirement and how the board had already added three new outside directors. The deal contemplated a host of other requirements, ranging from numerous new board committees to new approaches to internal controls. A pivotal requirement, also later contained in the settlement with the SEC, called for the board to hire a special advisor to identify additional outside director nominees and to advise the board about "best practices and governance issues."[6]

The board retained Arthur Levitt, who had been chairman of the Securities and Exchange Commission (SEC) when the Enron-era debacles festered. Levitt, who had hired Zarb to run Nasdaq a decade earlier,[7] would spearhead a project for radical change at AIG. Levitt's job was to review AIG's corporate governance profile and recommend "reforms." Levitt believed in having a powerful group of outside directors control corporations as best for the public interest, rather than having strong managers run them.[8]

Under Zarb, the board began making changes almost immediately. Among first steps was increasing further the number and role of outside directors, ultimately resulting in an AIG board with only two management directors amid a dozen or more outsiders. To further dilute the power of management in the boardroom, AIG opted to separate the identity of the board chairman from the chief executive. That meant having two coequal leaders in the boardroom, initially Zarb and Sullivan, until Zarb nominated another of his old friends, Robert B. Willumstad, formerly an executive at Citigroup, to join AIG's board and succeed him as chairman.[9]

In his report, reprinted in Figure 17.1, Levitt began by congratulating Zarb for his "courageous leadership," and then recommended every corporate governance device that advocates and experts who shared his views then championed, which AIG's board embraced in full.[10] Levitt endorsed changes the board made, especially stripping the chief executive of power as well as holding "executive sessions" of the board that excluded any management directors. Levitt also recommended eliminating the executive committee, which he said was "often a symbol of board cronyism"; mandating retirement of directors at age 73; and barring any former chief executive from serving on AIG's board.

Arthur Levitt
43 Owenoke Park
Westport, Connecticut 06880

March 21, 2006

Board of Directors
American International Group, Inc.
70 Pine Street
New York, N.Y. 10270

Dear Members of the Board:

After nearly eight months of coordinated efforts by AIG's board and management, I wish to comment upon the progress of our efforts to develop governance standards that will be responsive to investor concerns. I say "our" because under Frank Zarb's courageous leadership—and prior to my retention as a special advisor to the board—the board of AIG had already commenced the process of implementing important reforms, including: the separation of the roles of Chairman and CEO as well as an intense effort to recruit strong, independent directors. My role has been to work with the board and its Nominating and Corporate Governance Committee and AIG senior management to continue and accelerate the pace of change with the ultimate goal of making AIG a company whose governance, transparency, and ethical standards are second to none.

An essential foundation for sound governance is a strong and engaged board that approaches its important role as a steward for shareholders with a sense of mission and commitment. Its members must have a determination to work with and assist management through constructive skepticism, not "nit-picking" interference. Guided by this belief in a strong board, we have canvassed the views of directors, shareholders, governance experts, and shareholder activists for recommendations.

Fortunately, changes in the make-up of the board since the beginning of 2005 have added the fresh perspective of a group of experienced professionals, who can provide management insights and guidance drawn from the wealth of their experience. I am confident that this diversified and multi-faceted group will be supportive of management, while creating a healthy environment of constructive criticism, when desirable.

As part of our dialogue, the board has adopted, or in some cases modified in an acceptable fashion, and then adopted, substantially all of my recommendations and initiated a number of corporate governance measures on their own.
These include:

- Each regularly scheduled board meeting will be accompanied by an executive session of outside directors, presided over by the Chairman of the Board
- An emphasis on providing timely and relevant information to members of the board and the development of a focused program on director orientation

Figure 17.1 Arthur Levitt Governance Letter

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- A mandatory retirement age of 73 for all directors
- The elimination of the executive committee, often a symbol of board cronyism
- Strengthening the board's focus and independence by limiting the number of boards on which a director can serve; requiring attendance at a minimum of 75 percent of board and committee meetings; improving the process of self-assessment of the board, of committees, and of individual members; and providing that no former CEO can serve as a director of the company
- Reinforcing, recognizing, and detailing the critical functions of the Chairman of the Board who will be selected from among the directors and who will receive additional compensation for his or her vital services
- Evaluating the amount and form of compensation payable to directors in a way that will further align their interests with shareholders

Additional responsibilities:

- A commitment by the board to full, fair, and transparent disclosure of executive compensation, a critical element of sound governance
- A series of important guidelines on charitable giving and improved reporting of charitable and political contributions

One subject merits a separate and specific comment - the topic of shareholder participation in the nomination and election of directors. As you know, companies, regulators, academics, and shareholder advocates have been actively exploring and debating different approaches to afford shareholders with a more meaningful role in the election process. The guidelines recognize the benefits of a dialogue between the Nominating and Corporate Governance Committee and shareholders in the selection of nominees. Moreover, I recommended and the board has adopted, the so called "Pfizer Paradigm" under which, in an uncontested election, if a nominee for director receives a greater number of votes "withheld" from his or her election than votes in favor of it, that nominee must submit his or her resignation to the Nominating and Corporate Governance Committee for its review.

I believe that this will be a reasonable and potent weapon for shareholders to exercise oversight of directors. For a number of reasons, I did not now recommend the adoption of a majority voting system or shareholder access to the company's proxy statement. Clearly this is a very important subject to be thoughtfully revisited in a dialogue between investors, management and the board.

Figure 17.1 (*Continued*)

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"Now" is a small, but critical word in my conclusion on this topic. Do not forget that corporate governance principles are neither engraved in stone tablets for the ages nor written in erasable ink. Governance is an evolutionary process and should take into account changing best practices, new challenges—whether technological or financial—and the strengths and weaknesses of management and of the board itself. Indeed, what may appear to be a superb governance regime will almost certainly not stand the test of time.

That is why periodic reviews and testing of guidelines as to their function in the "real" world are critical. Governance standards must be adapted to the genius and the unique culture of each company.

Nevertheless, while today's wisdom may quickly become tomorrow's foolishness, there are some enduring principles for good corporate governance in the modern corporation: the role of managers as custodians acting on behalf of shareholders, the commitment to full and fair disclosure, and compensation plans that fairly reward the creation of real value for the company and its shareholders.

In sum, the remarkable transformation of AIG's board of directors and of its corporate culture is proof of what is possible in today's corporate environment of chastened investors, active shareholder advocates, interested media, and careful regulators. The events of the past few years have created a culture in which the good governance practices adopted by the AIG board are both demanded and praised. In addition, it has put a premium on a certain type of leader - thoughtful, ethical, tough-minded and determined. The AIG board is fortunate to have Frank Zarb as its Chairman, a man whose decency and respect for the public interest is reflected by his constant advocacy of the significant corporate governance changes that have been implemented.

I also wish to acknowledge the vital contribution of M. Bernard Aidinoff, the Chairman of AIG's Nominating and Corporate Governance Committee. The timely participation of the board and management in the implementation of broad and far reaching change would not have been possible without Bernie's insight, wisdom and knowledge of AIG.

I am gratified to have been part of this extraordinary exercise in leadership, responsibility, and respect for the public interest.

Sincerely,

Arthur Levitt

cc: Eric N. Litzky
Vice President—Corporate Governance
and Special Counsel and Secretary to
the Board of Directors

Figure 17.1 (*Continued*)

None of these changes had anything particularly to do with AIG or its needs. In fact, Levitt chose his recommended reforms after consulting shareholder advocates, corporate governance experts and selected directors[11]—but not AIG's management, employees, or largest shareholders.[12] The ideas were the off-the-rack notions of "good governance" then in fashion. Consider the recommendation to eliminate the executive committee, which Levitt supported by saying they are "often a symbol of board cronyism." At AIG, the executive committee in 2004 had consisted of Greenberg and four outside directors, including Aidinoff and Zarb. Its purpose was to enable AIG to operate nimbly in between full scheduled board meetings. There was nothing of cronyism about it, symbolic or otherwise. Abolishing it would simply make AIG slower and cost it lucrative opportunities.

Splitting the functions of CEO from board chairman had become fashionable, too. It was backed by the same rationale for adding outside directors, a desire to check the boardroom power of the CEO. This maneuver was slower to catch on, and probably with good reason. As an empirical matter, like board independence, most evidence shows that companies that split these functions do not perform better than those which keep the roles united.[13] Splitting the functions can also cause corporate schizophrenia and a sense that no one is in charge—exactly what would soon happen at AIG.

Age limits were another rage during this period, with some 40 percent of Fortune 1000 companies adopting them in response to urgings from governance gurus such as the California Public Employees' Retirement System (CalPERS). But a company that forbids older people from serving on its board ordains the exclusion of talent from its reach. At AIG, Levitt's 73-year-old cap would have compelled early retirement of such luminaries as Freeman, Manton, Roberts, and Stempel. More broadly, age limits would bar many venerated businesspeople from serving as directors, such as Warren E. Buffett at Berkshire Hathaway (who vociferously opposes age limits) or John C. Bogle at Vanguard (who was forced to retire at age 70 despite founding and leading that successful company that had invented the index fund). Age limits for directors at AIG also contradicted the company's long-standing nondiscrimination policy, which had prohibited discrimination on the basis of any demographic factor, whether race, religion, national origin, gender, or age.

Levitt said his goal was "making AIG a company whose governance, transparency, and ethical standards are second to none." Referencing the AIG board's embrace of his ideas throughout 2005, Levitt wrote:

> In sum, the remarkable transformation of AIG's board of directors and of its corporate culture is proof of what is possible in today's corporate environment of chastened investors, active shareholder advocates, interested media, and careful regulators. The events of the past few years have created a culture in which the good governance practices adopted by the AIG board are both demanded and praised.

That passage would prove to be a regrettable one, akin to the captain of a ship celebrating the arrangement of the deck chairs when the ship is sinking. The passage did correctly note a link between board-level governance changes and corporate culture. Zarb boasted, in September 2006, on the occasion of Willumstad becoming chairman, that he and the board had "[o]ver the past 18 months transformed the company in many ways, most particularly in the area of corporate governance, composition of the Board of Directors, transparency, regulatory compliance and the installation of a new management team."[14]

When PwC and the new management team scoured AIG's internal controls in April and May 2005, they confirmed the effectiveness of internal control systems governing its financial products division.[15] AIG's risk management systems were likewise strong. As part of AIG's transformation, significant changes were made to its internal control and risk management systems, particularly as applied to the financial products division. Moreover, at the end of 2005, Chuck Lucas, the former New York Fed executive whom Greenberg had recruited a decade earlier to implement state-of-the-art risk management systems at AIG, left the company.

The internal control and risk management systems that AIG had maintained over its Financial Products (FP) division served several purposes. Above all, they were intended to promote AIG's creed of accountability under the profit center model, which entailed careful management of risk and calibrated product pricing. In particular, the systems at FP were designed to assure that no transaction ever jeopardized AIG's AAA credit rating. The rating enabled FP to operate profitably in the volatile world of financial products because it assured counterparties of its ability to make good on its obligations. AIG's AAA credit rating, a rare competitive advantage in corporate America, permitted AIG to provide its customers needed comfort cheaply without having to use costlier sources of security such as posting collateral or pledging assets.

Without the AAA rating, however, AIG would have to vouch for its financial strength in those more costly ways. The costs of operating FP absent the AAA rating were so high, Greenberg had always said, that a rating downgrade would prompt withdrawal from the business. But the new AIG seemed unaware of the role that its AAA rating played. Rating agencies stripped AIG of the AAA rating during the second quarter of 2005, thanks to Spitzer's actions, Greenberg's departure and new management's accounting restatement. AIG described resulting risks in a routine regulatory filing, noting adverse effects on FP's operations and competitive position.[16] Yet instead of curtailing FP or shutting it down, AIG's new management dramatically expanded it.[17]

AIG's internal systems were also intended to assure that FP hedged its exposure in these transactions. For any risk it took, managers would find an offsetting position to mitigate it. AIG would profit from the difference between what it charged for protection and what it paid to hedge. Hedging must be done in advance, usually when a position is created, rather than after the risk environment changes, when hedging becomes more costly or unavailable. Careful hedging was a factor that supported AIG's AAA rating, a feature of its business model for which the rating agencies gave credit. After Greenberg left, FP abandoned this hedging principle, committing to cover increasing volumes of unhedged risk, adding up to $80 billion.[18]

The third purpose of AIG's traditional controls and risk management systems was to keep the professionals at FP—who were bright, ambitious, well-paid risk takers—on a short leash. The contracts FP wrote had to be carefully vetted and limited to terms that AIG's senior managers could understand. An important example concerned credit default swaps, which could be complex, but were based on a relatively simple idea: they were akin to insurance policies covering customers against the risk that a third-party borrower would default in repaying obligations. FP historically offered customers such contracts only after scrutinizing the borrower's ability to repay. It limited commitments to the most creditworthy borrowers, such as blue-chip American corporations or European banks whose credit was also rated AAA.

More tangible examples of AIG's transformation concerned the board's new practice of giving employment contracts to executives, including Sullivan and chief financial officer (CFO) Steve Bensinger, a practice AIG had never followed in the past, preferring that managers not be given security that could impair performance.[19] Historically, every AIG employee was an "employee at will," from the CEO to underwriter trainees. Further, after SICO halted its historical practice of providing performance-based compensation in the form of AIG shares that could not be sold until retirement, AIG adopted new bonus policies that moved from that long-term orientation toward short-term results, including at FP.[20]

AIG's new corporate culture, defined by diminished internal control and risk management, a detached outside board, and short-term incentives set the stage for the debacle that followed. In April 2005, after Greenberg's departure from AIG, FP began writing credit default swaps on increasingly risky pools of mortgage-related debt, called "subprime," and increased the scale of this commitment throughout the year. These were pools of loans taken by homebuyers with relatively poor credit histories. Though such loans had an increased risk of default, those who sold pools of such loans, led by investment banks such as Goldman Sachs, sliced them into groupings with varying degrees of risk. FP backstopped the groupings that Goldman and other deal designers called "super senior," denoting that the risk of default was remote. In contrast, Goldman and others who had hand-picked the loans bet that the pools would default, leaving AIG on the hook. In many cases, it appears that customers misrepresented the quality of the pools—what AIG was told were "super senior" were bottom of the barrel at the time.[21]

During 2005, FP's portfolio steadily transformed from high to low quality, early on containing a small fraction of subprime mortgage pools (perhaps 2 to 10 percent, depending on classification) to eventually consisting of almost all subprime (90 to 95 percent).[22] FP wrote more mortgage-related swaps in the last nine months of 2005 than in the previous seven years combined.[23]

By June 2007, AIG had written nearly $80 billion of swaps on the riskiest mortgage pools, quintupling its 2005 position, all unhedged.

Many swaps required AIG to hand over cash if AIG were downgraded from AAA or the prevailing value of covered contracts declined, not merely pay only on default. In market parlance, this allowed customers to make "collateral calls" on AIG and required AIG to "post collateral" in response.

A financial crisis was brewing due to a combination of forces, including: (1) U.S. policy overstimulated appetites for home ownership and kept interest rates low for too long; (2) regulation of financial institutions was poor, as commercial banks fed the appetite for home ownership with generous mortgages while investment banks churned demand with complex financial products and increasing leverage; (3) rating agencies failed to analyze many financial products adequately and the lack of trading in such products on organized markets made them difficult to value; and (4) regulators at the SEC failed to monitor the leverage of many financial institutions, whose debt levels rose to as much as 30 to 40 times capital and, in AIG's case, regulators at the Office of Thrift Supervision, which had authority because AIG owned a savings and loan association, simply ignored any signs of trouble.[24]

During 2007, the U.S. housing market began to falter, leading to a cascade of economic problems that precipitated a global financial crisis.[25] Problems included rising mortgage default rates, falling home values, failures of various funds that concentrated in mortgages, and bankruptcies of many subprime mortgage lenders. Mortgage-related assets began to decline in value. From mid-2007 to late 2008, these problems gathered momentum and spread worldwide. For AIG, the events first produced collateral calls against it in late July 2007 and ultimately drained it of liquidity one year later.

At the same time, a securities lending program operated by AIG insurance subsidiaries added liquidity pressure. Consistent with industry practice, AIG insurance subsidiaries historically had lent securities to borrowers in exchange for cash collateral, which would be invested in short-term/low-risk investments to gain a few hundredths of a percent in interest (each hundredth called a "basis point"). After Greenberg left AIG, company employees without proper oversight decided that the goal of these programs was to earn not merely a few basis points but as many as 30, an increase of substantial magnitude that led to making investments in longer-term, riskier assets, including mortgage-backed securities.[26]

In 2007, AIG began to face a growing gap between its duty to return that cash collateral to counterparties and the fair value of the mortgage securities the subsidiaries bought with it.[27] The combination of this gap and the escalating collateral calls facing FP squeezed AIG's liquidity. True, it had abundant net assets, but in businesses whose sale would require many months to close and whose prices were temporarily depressed by the financial crisis.

An early sign of coming turmoil occurred on July 26, 2007, when Goldman submitted its first collateral call to FP, seeking $1.8 billion based on asserted value declines. Later, AIG's top management would deny being aware of this. If true, that underscores that a radical transformation had occurred, in which the new board and executives went through the motions of internal controls instead of insisting, as Greenberg had, on substantive accountability in fact. During Greenberg's tenure, he would have learned of such a colossal matter promptly or else heads immediately would have rolled. Inexplicably, senior AIG management and some top FP executives later testified to being unaware, until July 2007, that FP's contracts required posting collateral based on value declines. Yet the company's routine regulatory filings, signed by senior managers, specifically disclosed information about the terms of these contracts, including the need to post collateral in certain situations.[28] Such discord reveals how the dismantling of AIG's risk management system exposed the company to staggering losses.

How much collateral AIG was required to post for customers depended on the exact value of the securities the contracts covered. But these securities had become hard to value and did not trade on an organized market. Instead, participating firms—including Goldman Sachs and FP—prepared models to estimate value, called "marks," which varied widely. Firms developed reputations for establishing high or low marks, with Goldman well known for quoting the lowest. This led to disagreements: Goldman presented low marks to FP, seeking greater collateral; FP responded by pointing to high marks. In the case of Goldman's July 26, 2007 collateral call, FP's managers were able to resist to an extent, negotiating for a reduction in the amount to $450 million, which it posted on August 10. But this began a series of skirmishes between Goldman and FP about valuation and collateral requirements that would last for most of the next year and result in AIG posting billions in cash collateral to Goldman and others, culminating in total illiquidity.

Obscuring these perilous developments, during the second half of 2007, FP and AIG management made public statements that omitted mention of the mounting risk. At AIG's earnings conference call hosted by Sullivan on August 9, 2007, Joseph Cassano, then head of FP, infamously declared: "It is hard for us, without being flippant, to even see a scenario within any kind of realm or reason that would see us losing $1 in any of those transactions."[29] On the same call, Robert Lewis, AIG's chief risk officer, responsible for risk management at FP, said: "It would take declines in housing values to reach depression proportions, along with default frequencies never experienced, before AAA and AA investments would be impaired."[30]

The company's new internal control and risk systems apparently impaired information flow from the division to corporate headquarters. A recently hired AIG internal auditor, Joseph St. Denis, a former SEC accountant, grew concerned in September 2007 when FP received a large collateral call. St. Denis wondered about the valuations FP assigned to the securities it covered. But as St. Denis tried to investigate, Cassano reportedly discouraged him and blocked his access to report up the corporate chain to AIG's senior management or its board. St. Denis grew so frustrated that he resigned in October 2007.[31]

These and other problems were apparently also missed by the special monitor that AIG had installed several years earlier when settling the SEC's case over the PNC matter. The monitor, James Cole, a lawyer at Bryan Cave and later Deputy Attorney General in the Justice Department in charge of the President's Corporate Fraud Task Force, was charged with overseeing internal controls and compliance programs.[32] Cole spent 2005, 2006, and 2007 filing periodic confidential reports about AIG on such topics, for which AIG paid some $20 million.[33] Given the monitor's powers and cost, one would have expected those reports to call the brewing problems to the attention of AIG's board or senior management but that apparently did not occur.[34]

In disclosing interim financial results on November 7, 2007, AIG declared that management "continues to believe that it is highly unlikely that [FP] will be required to make payments with respect to its [financial products]."[35] On a November 8, 2007, conference call, Sullivan said: "While U.S. residential mortgage and credit market conditions adversely affected our results, our active and strong risk management processes helped contain the exposure." Goldman, of course, did not give up, demanding on November 23, 2007, that AIG post another $3 billion in collateral. FP agreed to post half that.

Meanwhile, on November 29, 2007, PwC met with AIG's senior executives to discuss risk management problems it perceived to be growing at FP. During the meeting, PwC raised questions about a contradictory quality of AIG's operations. FP had come to recognize that the mortgage securities market was very risky and had ceased doing new business in it. But AIG's securities lending business increasingly invested the cash it received from borrowers of its securities in subprime mortgage pools. The questions PwC raised struck at the heart of AIG's new approach to corporate governance, internal control and risk management. Apparently, nothing was done.

Two months later, on February 6, 2008, PwC reported these festering problems to Willumstad, AIG's board chairman. PwC's appraisal, reprinted in Figure 17.2, was chilling, highlighting a pervasive problem at the new AIG: an appreciation of risk and risk management, once the company's defining spirit, had seeped out of its corporate culture.[36] PwC declared that AIG lacked leadership. Before detailing scathing criticism of Sullivan, Bensinger, and Lewis, PwC stressed that it was the board's job to select and remove corporate officers, referencing the normal practice, which contrasted, of course, with what PwC had done at the March 2005 AIG board meeting when the firm all but demanded Greenberg's resignation.

The auditors' blistering late 2007 critique of Sullivan stated that "some of [his] weaknesses [include] a difficulty in holding people accountable for internal control related matters, making difficult decisions, experience with large scale change, and lacking in execution skills." Their blistering critique of Bensinger stressed that those were "among [his] weaknesses as well," citing an example of the resulting problems: the imminent crisis concerning credit default swaps. Even the chief risk officer, who had been with AIG for many years, received a stinging review, PwC concluding that he lacked core skills of risk analysis and management. In short, the auditors told Willumstad, these officers were in over their heads and desperately needed help.

American International Group, Inc.,
Meeting Notes
February 6, 2008

Auditor 2 (A2) and Auditor 1 (AI)

On February 6th, 2008 A2 and A1 met with Bob W. to discuss the status of our material weakness consideration and our views as to remediation steps that the Company might want to consider. Below is a summary of the topics discussed.

We informed Bob that we had thought over nite about whether steps that AIG might take between today (Feb 6th) and the filing of the 10K might change our MW [material weakness] views and concluded that while steps that AIG might take during that time period will be helpful to the ultimate remediation, that implementing these steps at this point would not be enough to remediate the material weakness that exists at December 21, 2007. Bob understood this answer and indicated that AIG [would take] the necessary remediation steps regardless of the MW or not.

Bob then asked for our views as to possible remediation steps. We indicated that we had gathered our thoughts into two buckets—non people changes and people considerations. Below are the items that we shared with Bob.

Non People Changes

1. We indicated that the Board and the Company needed to address the reporting lines for ERM [Enterprise Risk Management]
2. ERM's interaction with the Finance Committee and how the Committee will oversee ERM needs to be addressed [as] to date, the primary focus of the Finance committee has not been on ERM, despite its charter
3. We indicated that the Company needed to review risk, transaction and other limits across the Company
4. We indicated that the Company should consider direct reporting (versus the dual reporting that has not been working consistently across the company) in ERM and Finance—we discussed that dual reporting—done substantively could be an alternative and agreed that this path should not necessarily be closed.
5. We indicated that the Board and management should consider separate compensation programs for control functions (ERM and Finance) that are non stock and non EPS driven
6. The Company should ensure that business units should also be incented on internal controls and compensation programs should be adjusted as appropriate.
7. We indicated that the FP compensation plan should be revisited to incent investments in internal controls.
8. We indicated that the Company needs to define its overall risk appetite
9. We suggested that the Company should form a operations and control Comprehensive Program into this Committee

Figure 17.2 PwC Auditor Notes

10. We suggested that the Company form a senior risk committee of the company
11. We suggested that the Company form a valuation control group in ERM that monitored valuation across the enterprise
12. We suggested that the outstanding issue with the ILFC CFO and controller be addressed
13. We indicated that the urgency and rigor with respect to remediating the remaining SD's need to be increased

People Considerations

As it relates to people, we indicated that among the skill sets that AIG needs include leadership, execution skills, change management skills, the ability to hold people accountable and experience in dealing with large scale improvement and change effots.

1. On the topic of Martin Sullivan—we indicated that it is the Board's decision in terms of what to do with Martin, we indicated that if the Board chooses to stay with Martin that they needed to be assured that he was truly committed to changing the way the Company is run and managed from an internal control perspective.
2. On the topic ofBensinger, we indicated that we viewed it as important that a CFO—particularly one with Steve's responsibilities (i.e., effectively the number two person in the company) compensate the CEO's weaknesses. We indicated that we viewed some of Martin's weaknesses to be a difficulty in holding people accountable for internal control related matters, making difficult decisions, experience with large scale change, and lacking in execution skills. We indicated that Steve does not compensate these weaknesses (i.e., these are among Steve's weaknesses as well). We indicated that as an example a significant contributing factor for the current situation regarding the super senior credit default swaps is because of the lack of leadership, unwillingness to make difficult decisions regarding FP in the past and in experience in dealing with these complex matters.
3. As it relates to ERM we indicated that there are two key skill sets that we would expect an ERM head to have—the first being the ability to understand, assess and evaluate risk (i.e., risk appetite) and second the ability to build an infrastructure to manage and monitor risk throughout a company like AIG. We commented that we were not sure that Bob Lewis had these skills. We also raised concern with his willingness to speak up as was evidenced by Willumstad's questions that he asked Lewis at the Dec AC meeting where Lewis was clearly uncomfortable discussing his reporting lines. Similarly, we pointed to the lack of access that ERM has into units like AIG Investments and others and that this arose thru the MW/SD discussions and that Lewis had not aggressively addressed these issues in the past.
4. We discussed Cassano. We indicated that the decision on Joe is that of the Board but that from our perspective the culture at AIGFP had to change.

Figure 17.2 (*Continued*)

5. We indicated that the lack of leadership and involvement by the AIG FP CFO in the valuation process was concerning and that this should be reviewed and—at a minimum the Company needs someone like Elias on top of the AIGFP CFO until her true capabilities are understood.
6. We indicated that it continues to be our view that the span of control and workload that Steve and Martin have is too great and that AIG needs a fulltime CFO without many of the responsibilities that are currently under the CFO. Bob agreed with both points and indicated that while Martin may not be amenable to a COO, that a CAO might be necessary.
7. We indicated that Jerry De St Pierre was struggling to get traction in the Company and that his effectiveness should be reviewed.
8. We indicated that Roemer was a key control but that the pressure lately has been relatively high from senior management (i.e., super senior valuation process, material weakness related to super seniors, mw/sd discussions related to access and roles and responsibilities of key control functions and other matters) and that the Board should ensure that Roemer knows he has their support.

We indicated that we would continue to think of other potential steps. Bob indicated that he was going to review these matters with Martin.

No other significant items were discussed.

A1
February 13, 2008

Figure 17.2 (*Continued*)

AIG's "good governance" board had failed in discharging its most important job.

On February 11, 2008, AIG publicly disclosed PwC's concern about control weaknesses, prompting immediate credit rating downgrades and slicing 12 percent off its stock price. On February 28, AIG reported its quarterly results: a $5.3 billion loss, driven mostly by an $11 billion valuation drop in FP's portfolio. As bad as that sounded, these figures were small compared to the losses to come. The reforms initiated by Levitt and adopted by Zarb and the other AIG directors had not only "transformed AIG's culture" as they heralded, but led it to the verge of self-destruction. For that, Greenberg concluded that Levitt had acted as a supercilious regulatory zealot.

Amid this turmoil, AIG opted to seek additional capital from the public markets. It prepared an offering of securities to raise up to $30 billion in a combination of debt and common stock. Strikingly, the prospectus describing the securities and the company, first dated July 13, 2007, and supplemented on May 12, 2008, nowhere mentioned PwC's concerns about managerial qualifications or internal control and risk management defects.

Shareholders grew anxious. On May 11, 2008, Greenberg, the company's largest individual shareholder and representing the company's largest shareholder group, detailed some concerns in a letter to the board.[37] The company was in crisis, he said, most obvious due to its financial and capital problems but more fundamental and pervasive deteriorations were occurring across all businesses. The May 2008 letter* highlighted the following changes since March 2005, besides the growing cumulative losses unprecedented in AIG's history:

- Losing AIG's unique leading positions in China and Japan.
- Eroding the leading position of AIG's Asian life operations.
- Releasing capital by converting overseas branches into subsidiaries.
- Allowing U.S. life insurance operations to stagnate.
- Increasing the number of employees by 24,000 ("the equivalent of two Army divisions," from 92,000 to 116,000).
- Bloating the expense ratio from 20 to 26.
- Bloating the loss ratio from 64 to 71.
- Therefore, bloating the combined ratio from 84 to 97.

In other words, AIG's healthy underwriting profit of 16 percent had shrunk to 3 percent and was vanishing. Gone were venerable employee-centric values and concepts such as profit centers, underwriting profit, risk analysis, expense control and long-term compensation programs. As PwC echoed, effective board oversight had disappeared along with competence among senior management. Significant costs were being incurred for legal fees, consultancy fees, and accounting fees—the latter

*The full text of this letter appears as Appendix E on this book's companion web site.

alone soaring from $35 million in 2005 to $108 million in 2008 without any obvious benefit.[38]

The board ignored Greenberg's warning letter. It sent a curt formal note in reply that did not address any of the substantive points raised. Although the note's salutation said simply "Mr. Greenberg," it read more like a form "Dear Shareholder" letter to a remote owner of a few shares than a response to the founder, former chairman and chief executive officer, and largest shareholder representative.[39]

But as later independent research reports would confirm, Greenberg's diagnosis of AIG's problems was spot on. According to a Congressional oversight report produced by Elizabeth Warren, the law professor and consumer advocate who became a Democrat U.S. senator from Massachusetts in 2012, AIG's risk management and internal control systems failed, especially in 2007 and 2008.[40] AIG's new management had overlooked the risks that FP and the securities lending group were taking. The practice of concentrating on "super senior" groupings had made managers complacent. When problems mushroomed in 2007, AIG lacked management and technical resources to address credit concerns, Warren's report concluded.

The board belatedly responded to the mounting evidence of danger in June 2008, when it requested that Sullivan resign as chief executive officer and asked Willumstad to succeed him—becoming both chairman and CEO, sensibly repudiating the Levitt-Zarb policy of separating those functions.[41] On his departure, AIG gave Sullivan a severance package worth $47 million.[42] Willumstad, who had been serving as chairman for nearly two years, held a conference call, telling investor analysts that he would conduct a strategic planning study of AIG "within 60 to 90 days, and hold an in-depth investor meeting shortly after Labor Day to lay it all out for you."[43] Pity that AIG's seasoned chairman could not complete such an exercise in a shorter period, however: before that deadline passed, the company would be nearly destroyed.

Warren's report noted discussion among experts about whether, had Greenberg remained in office, these problems would never have arisen or been solved at the outset. Insurance industry legend John J. ("Jack") Byrne, famous for turning around Fireman's Fund and GEICO, is among those convinced that AIG would have averted its fate had

Greenberg stayed on board. In an interview for a retrospective on the insurance industry from 1981 to 2011, he said:

> Hank Greenberg was the most amazing manager I ever saw. Just by dint of his personality and his fierce drive he turned AIG from a medium sized company into a giant, until the day it wasn't a giant anymore. It is quite remarkable the story of how AIG grew and grew, spread its tentacles around the world and developed enormous relationships. The end result was they forced Greenberg out and brought the company down. I continue to believe that if Hank had been there for that last five years he never would have let the risks taken on by those derivative traders get so out of hand.[44]

Comparing the history of AIG that Greenberg led to the changes wrought by the Levitt-Zarb reforms, it is hard to gainsay Byrne. Directors and senior managers seemed unaware of how AIG's previous culture defined its success and how their changes doomed it. Warren's report, after acknowledging inherent difficulties in making such "what if" judgments after the fact, quoted one comment that may be distressingly apt: former AIG in-house counsel Anastasia Kelly said that at AIG after March 2005, "no one was in charge."[45] Shortly after Labor Day in 2008, as chaos engulfed AIG, the U.S. government would take charge.