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Buffett and Greenberg: A Long Relationship

Business as Usual

BY NOAM SCHEIBER

Hank Greenberg and Warren Buffett

The recent revelations of a business relationship between companies controlled by Hank Greenberg and Warren Buffett have added an unusual twist to the events of the past year. Greenberg, having been forced out of AIG, which he spent four decades building, had set off on a second career at C.V. Starr & Company. Buffett, who helped trigger Greenberg's ouster when he shared incriminating evidence with prosecutors, had come through the scandals pretty much unscathed, but was still navigating an ongoing investigation at General Re. This was, in other words, an unlikely moment to find the two men doing business together. The fact that they are can only mean one thing: that both considered it worth their while.

C.V. Starr business is presumably lucrative, so it's little surprise that Berkshire Hathaway's National Indemnity would want to write it. For his part, it's doubtful that Greenberg would have wasted much time cursing Buffett's cooperation with the authorities. Greenberg is nothing if not a realist about the business world. He understands that you do what you need to do to protect your company, and that personal feelings don't count for much in this calculus. It's the way he always ran AIG. And it certainly characterizes his history with Buffett. Indeed, the recent deal between Starr and National Indemnity is probably best understood as a logical step in the long, unsentimental relationship between two industry legends.

The history between AIG and Berkshire dates back at least twenty-five years. In 1980, during one of their earlier encounters, AIG executives approached Buffett about a possible acquisition of GEICO, a third of which he controlled. The two sides arranged a meeting at AIG that included Buffett and Jack Byrne, then GEICO's CEO. Byrne recalls proposing a half-cash, half-stock transaction valued at $41 a share, more than the AIG representatives were willing to pay. (Greenberg says through a spokesman that he was not personally involved in the deal.) The meeting broke up cordially, and Byrne agreed to consider a counteroffer. It was only hours later that Byrne—whose decision Buffett had said he would abide by—decided he didn't really want to sell at any price.

The first public hint of tension between Greenberg and Buffett surfaced in 1986. In that year's annual letter to Berkshire shareholders, Buffett spent several paragraphs denigrating a reinsurance maneuver he termed "the lay-it-off-at-a-profit game," which he said Berkshire had never played—to its considerable disadvantage. This jab at a fairly typical AIG practice might have caught Greenberg's attention in any case. But Buffett went further: he used AIG (not by name) to illustrate the extent to which the practice had been abused. "An example of just how disparate results have been for issuing companies versus their reinsurers is provided by the 1984 financials of one of the leaders in large and unusual risks," Buffett wrote, obviously alluding to AIG. He continued:

> In that year the company wrote about $6 billion of business and kept around $2.5 billion of the premiums, or about 40%. It gave the remaining $3.5 billion to reinsurers. On the part of the business kept, the company's underwriting loss was less than $200 million—an excellent result in that year. Meanwhile, the part laid off produced a loss of over $1.5 billion for the reinsurers. Thus, the issuing company wrote at a combined ratio of well under 110 while its reinsurers, participating in precisely the same policies, came in considerably over 140. This result was not attributable to natural catastrophes; it came from

run-of-the-mill insurance losses (occurring, however, in surprising frequency and size).

Greenberg, needless to say, wasn't pleased about having his business ethics called into question. He didn't hold back when *Barron's* reporter Jon Laing later asked him about the accusation: "Buffett may be a good investor, but he's no insurance man. He has a peanut-sized book of business and only writes business in good times. He has never innovated one new product." Greenberg's pique wasn't entirely unjustified. The reinsurers had, after all, willingly offered their capacity in an attempt to make a profit.

Some CEOs' instinct in this situation might have been to write Buffett off as an enemy: someone to be eyed warily at best,

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Editor and Writer . . . . David Schiff
Production Editor . . . . Bill Lauck
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Editorial Office
Schiff's Insurance Observer
300 Central Park West, Suite 4H
New York, NY 10024
Phone: (212) 724-2000
Fax: (434) 244-4615
E-mail: David@InsuranceObserver.com
Website: InsuranceObserver.com

Publishing Headquarters
Schiff's Insurance Observer
SNL c/o Insurance Communications Co.
One SNL Plaza, P.O. Box 2056
Charlottesville, VA 22902
Phone: (434) 977-5877
Fax: (434) 984-8020
E-mail: Subscriptions@InsuranceObserver.com

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preferably from a distance. Greenberg wasn't one to let his ego get the best of him. He remained open to working with Buffett, and other AIG executives were free to do so as well. At the time, for example, the domestic property-casualty insurance market was in turmoil. Capacity was in full retreat. For many at AIG, this meant opportunity. But if the hard market was the perfect time to expand your book of business, it also meant capital was scarce. So much so that executives at AIG's American Home had trouble finding anyone to go in with them on a casualty insurance facility with a $50 million limit. Finally, Dennis Busti, then the unit's president, and Dinos Iordanou, his senior vice president, reached out to Buffett and Berkshire.

The deal never quite came together. "We thought their terms or conditions were more onerous than we would have thought reasonable," recalls Busti. But, during the negotiations, Buffett and his lieutenants came to two realizations: first, that the property-casualty market was too attractive to miss out on. (Both Greenberg and Buffett are famously—and shrewdly—contrarian in allocating their capital.) Second, that Busti and Iordanou were extremely talented. Buffett expressed interest in hiring them to build up his property-casualty operation and the three men spent the next few months working out the details. As one former AIG executive tells it, "What happened was Buffett did not commit the $50 million, but stole both Busti and Iordanou." "Hank wasn't too happy with me, but he let me go," says Busti of the moment he finally broke the news.

The coda to the story is that Greenberg was right to advise Busti against leaving. "I liked Warren Buffett, but the action was not up to snuff," Busti says of his tenure at Berkshire Hathaway. "I was so used to working with Hank…Warren didn't especially have the stomach for the kinds of things I was good at." Busti left Berkshire within a year and moved to Reliance National, which later failed.

One hallmark of any comparison between Greenberg and Buffett is the disparity in their reputations. Buffett is widely viewed as working in the public interest even as he amasses a personal fortune. Greenberg, by contrast, is viewed as fighting relentlessly for the interests of his company to the exclusion of almost everything else. There is a certain amount of truth to this. Buffett has taken principled public stands in favor of expensing stock options and against lowering taxes on dividend income, even though the latter could have saved him millions of dollars. For his part, Greenberg has long preferred to work on legislative matters alone rather than through industry-wide trade groups.

But the caricatures only go so far. Greenberg, for example, has lobbied aggressively on issues, like the normalization of trade relations with China, that benefit all American multinationals. In these cases, Greenberg appears driven by some combination of corporate self-interest and principle. Buffett, meanwhile, has violated some of his own ostensible principles. Though a proponent of strong corporate governance, he has, by his own admission, been a complacent director: "Over a span of forty years, I have been on nineteen public-company boards (excluding Berkshire's) and have interacted with perhaps 250 directors," he wrote in Berkshire's 2002 annual report. "Too often I was silent when management made proposals that I judged to be counter to the interests of shareholders. In those cases, collegiality trumped independence."

The two men's involvement with Salomon Brothers is instructive on this count. In 1987, Salomon was about to lose a major shareholder—the Oppenheimer family, which owned roughly fifteen percent of the company's stock and wanted to sell. Salomon couldn't afford to repurchase the stock and wanted to see it end up in friendly hands.

Salomon eventually opened up talks with Buffett. The advantage of dealing with Buffett was that he was willing to leave management intact (unlike, say, Ronald Perelman, who also expressed interest in the deal). The disadvantage was that Buffett would only put up capital on extremely favorable terms. The deal between the two sides worked like this: Salomon would repurchase its stock for about $800 million, or $38 per share. Buffett would then buy $700 million worth of a Salomon convertible preferred stock with a nine percent coupon and a conversion price of $38. This gave Buffett the same upside as if he'd bought the stock outright, but reduced his downside because of the big dividend and the preferred position. Buffett would also get two seats on the board: one for himself, the other for Charlie Munger. Several Salomon managers worried that the deal was too cushy—the dividend too high and the premium too low. "Warren had it both ways," Salomon's Chicago office head William McIntosh told Buffett biographer Roger Lowenstein after the fact.

After the terms had been negotiated, Salomon CEO John Gutfreund brought

1:45 p.m. Since 1981, **Richard Stewart** has been chairman of ***Stewart Economics,*** a consulting firm specializing in insurance and insurance regulation. Dick was a Rhodes Scholar and attorney before becoming First Assistant Counsel to New York Governor Nelson Rockefeller. He served as New York's Superintendent of Insurance from 1967-1970, and was subsequently SVP and general counsel of First National City Bank, then SVP and CFO of Chubb. Over the years, Dick has published influential tracts on insurance regulation, insurer insolvency, underwriting cycles, and insurance insolvency guarantees. He'll tell us what he's thinking about these days.

2:45 p.m. A living legend returns for a rare New York performance! **Joseph Belth,** editor of ***The Insurance Forum,*** will be making his third appearance at Schiff's Insurance Conference. Joe, whose articles, speeches, and testimony have shaken up the life-insurance industry, is the author of numerous books and journal articles and is professor emeritus of insurance at the Kelley School of Business at Indiana University. He will let us know what's bothering him.

3:45 p.m. David Schiff will have his say on the great insurance issues of the day, and discuss where he sees value and solvency (or the lack thereof).

4:30 p.m. Attendees will socialize with their fellow insurance mavens and observers, discussing the day's events and making deals over cocktails while taking in the view from the top of the New York Athletic Club.

6:00 p.m. There will be an additional reception and dinner for those who want more of a good thing. The venue is the Coffee House, a convivial and somewhat worn-at-the-edges private club devoted to "agreeable, civilized conversation." Attendance is limited to 36 people.

the deal before his board. It was the first the directors had heard of it, yet one by one they signed off. Most were star-stricken with Buffett and didn't raise any objection. Finally, it came time for a board member named Hank Greenberg to weigh in. "Gee, John," Greenberg said. "The convertible preferred is an awfully attractive instrument. How much of this $700 million can I get?" Gutfreund was at a loss. It hadn't occurred to him that someone might question the terms he'd just worked out with Buffett. Maybe Hank was kidding, or speaking hypothetically. "But this is Buffett's…" Gutfreund said. If this was supposed to be a trump card, it failed. "I'll even improve the terms," Greenberg continued. "What would you take for a nonconvertible?"

And Greenberg wasn't done yet. Next he politely asked Gutfreund to quantify Buffett's value, looking for some justification for why Salomon investors, as opposed to Salomon's management, might agree to such a generous deal. Gutfreund had no answer. In fact, there really wasn't one—other than the one he had already given, which was that Buffett was Buffett. Before long he gave the floor to one of his lawyers to shut down the discussion. In the end, Salomon did the deal. Greenberg gave up his seat on the board at year's end.

Several years later, the deal would come back to haunt both men: Buffett because of the Treasury auction scandal that would engulf Salomon in the early 1990s; Greenberg because AIG was still writing Salomon's directors and officers policy at that point. Worse, not only had AIG renewed Salomon's policy in 1991, but it had allowed Buffett to rework the policy with a smaller public reimbursement cover and a much higher side A limit (that is, the portion that directly covers the directors and officers as opposed to the company itself). This left AIG on the hook for potentially enormous liability. The only mitigating factor was that Buffett minimized the claim by stabilizing Salomon during his brief tenure as chairman. Buffett also negotiated a fairly lenient civil settlement.

The 1990s saw a series of collaborations between Greenberg and Buffett. Early in the decade, AIG worked with Goldman Sachs, Johnson & Higgins, General Re (then in its pre-Buffett days) and Berkshire Hathaway to create an insurance facility for the pharmaceutical industry. Eventually it became clear that making the project profitable would require premiums of nearly $300 million—much too high to be attractive to manufacturers. In 1998, Goldman and Buffett were preparing a joint bid for the portfolio of Long-Term Capital Management, the hedge fund rocked by that summer's Russian debt default. LTCM's portfolio was loaded with derivatives and complex hedging arrangements, and the companies wanted a third partner to provide additional expertise in these areas. They turned to Greenberg and AIG, whose Financial Products subsidiary had been a pioneer in the derivatives trade back in the late 1980s. The planned bid would have involved Berkshire investing $3 billion, AIG $700 million, and Goldman $300 million to acquire the LTCM portfolio. But it came to naught when a consortium of Wall Street banks intervened to bail out the fund.

In 1994, both AIG and Berkshire Hathaway were able to parlay the troubles of auto-insurer 20th Century Industries to their advantage. 20th Century, a low-cost direct writer, had a small homeowners book of business in Los Angeles. But much of this business happened to be near the epicenter of the Northridge earthquake, which cost 20th Century more than $1 billion and impaired its capital position. Berkshire helped rescue the company by providing $400 million of earthquake coverage for a year's worth of run-off exposure at a cost of $40 million. Independent of Berkshire, AIG finished the job by injecting over $200 million into 20th Century (and buying warrants to purchase up to $200 million more of stock) for what would become a controlling position.

Suffice it to say, neither CEO seems to hesitate when the opportunity for a profitable collaboration arises. Greenberg and Buffett have always been perfectly capable of competing on one deal then turning right around and cooperating on the next one. In 2000, AIG paid $41 per share to acquire HSB Group, the parent of Hartford Steam Boiler, far higher than a Berkshire offer in the neighborhood of $31. AIG was able to "overpay" because it made the acquisition using its stock, which was then trading at almost 40 times earnings, versus the HSB purchase price of roughly twenty times earnings. As a result, the deal was immediately accretive to AIG's earnings.

Only days after September 11, Greenberg and Buffett worked together on a private-sector terrorism risk insurance program. Greenberg spokesman Howard Opinksy says the two men arranged a reinsurance facility that helped keep the airline industry flying immediately after the attacks. They soon concluded that the broader terrorism risk was too large to manage without a federal backstop.

The HSB acquisition hints at an interesting contrast. The company had boasted a steady stream of earnings over the years, something Greenberg is known to value. Buffett, on the other hand, has famously said he'd rather have a "lumpy" twenty percent return rather than a steady fifteen percent. In some sense the two men's investing styles are the flip side of their personalities.

There's more than one way to get to the top.

Noam Scheiber is a senior editor at The New Republic *magazine whose work has appeared in* The New York Times *and* New York. *He is currently at work on a biography of Hank Greenberg, which will be published by Random House. You can contact him at nschei@yahoo.com.*