

Coral Re: AIG's \$1-Billion Secret

Rolling Thunder

It's two o'clock tomorrow morning when you come up with a scheme that's so good you decide to call Hank Greenberg, AIG's chairman and chief executive officer.

Greenberg, of course, is the most powerful guy in the insurance business, and his toughness is the stuff of legend. He doesn't just demand good results, he insists upon them. He tells his minions that they'd better make an underwriting profit—or else—and that they'd better show growth, too. To say that folks are scared of Greenberg is an understatement. Many in the insurance industry are too terrified to talk about him “on the record.” Off the record, however, they generally describe him as an overbearing tyrant, but a brilliant overbearing tyrant who sure knows how to run an insurance company.

As you dial Greenberg's number, it occurs to you that he's probably sound asleep.

“Hi Hank,” you say cheerfully when he answers the phone. “Hope I'm not disturbing you.”

“What time is it?” Greenberg asks tiredly.

“Never too late for business. Listen, some buddies and I want to start a reinsurance company in Barbados, but we don't have any money. So we thought that with your help Sanwa Bank might give us a \$50-million non-recourse loan—”

“It's two o'clock in the morning!” Greenberg says as he starts to wake up.

“I know. Anyway, we want to take the \$50 million and form this reinsurance company. Then AIG will cede it \$1 billion in premium, just as you did with Coral Reinsurance. And, oh yes, we'd like to be guaranteed a profit.”

“What do you think you're doing waking me up at—”

“Hold your horses, Hank,” you say, annoyed at Greenberg's cranky attitude. “We'll also need a cheap stop-loss, so we'd like you to call the boys at Munich Re and arrange it.”

“What the hell is this all about?” demands Greenberg, clearly furious.

“Here's the payoff. Since my buddies and I are guaranteed a profit with no risk, you can do what you want with this reinsurance company. Use it for surplus relief, portfolio transfers, or something far



Hank Greenberg declines to answer questions about Coral Reinsurance.

more complex than I can dream up. After all, legally speaking, it won't be an affiliate of AIG.”

“!#!@* !#! *#@!!!”

“Look, Hank, why don't you sleep on it and I'll call you in the morning.”

Click.

While the deal proposed to Hank Greenberg in this conversation may sound preposterous, it isn't exactly unprecedented. Our March issue included an article about Coral Reinsurance Company, a Barbados reinsurer that was formed on December 17, 1987, to reinsure certain AIG business. AIG's “interest in creating” Coral was clearly stated in a “confidential private placement memorandum.” The National Union pool planned to cede premium to this newly-formed “reinsurance facility,” thereby allowing AIG “to write more U.S. premiums” than it would otherwise have been able to, given its level of surplus.

Coral, which is managed by an AIG subsidiary, started with \$52 million of capital. In its first 14 days of operation it received \$474 million of reinsurance premiums from AIG. By year two it owed AIG almost \$1 billion.

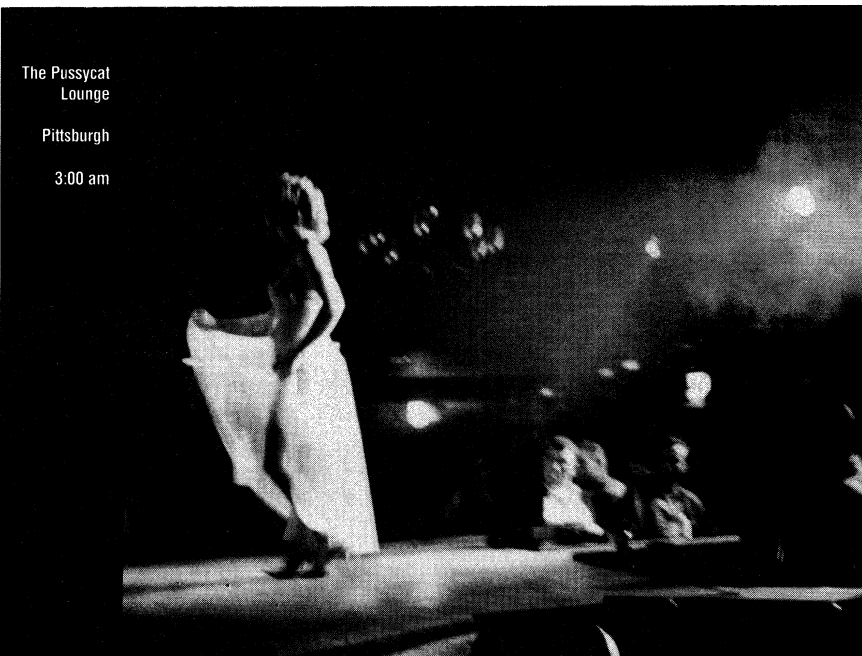
While the sheer size of these numbers makes Coral hard to ignore, it's the strangeness of the entire transaction that makes Coral particularly noteworthy. You may recall that the deal, a private placement underwritten by Goldman Sachs, was structured so that it was a *sure thing* for the dozen or so “investors” who were allowed to participate. It worked like this: the Chicago branch of Sanwa Bank made \$52 million of non-recourse loans to the investors, who then capitalized Coral with \$52 million. Coral, in turn, took this \$52 million of “capital” and bought a \$52 million certificate of deposit from Sanwa Bank. A “pledge and security agreement” between the investors and Sanwa sums it up nicely: “This certificate of deposit both constitutes the capital of Coral and is the ultimate funding source of [Sanwa Bank] for the [non-recourse loans.]” The investors' payoff came in the form of dividends that they received from Coral, a portion of which was used to pay the interest owed to Sanwa Bank. The bottom line: an investor made about \$25,000 in the first year and \$45,000 in each subsequent year—with no risk.

One doesn't have to be Bernard Baruch to know that banks usually don't

make non-recourse loans to people who want to form reinsurance companies in Barbados, much less people who want to form reinsurance companies that will have 9-to-1 premium-to-surplus ratios, as did Coral. On the other hand, suppose that AIG had a long-standing relationship with Sanwa Bank in Japan, and suppose that AIG, with a wink and a nod, told Sanwa Bank that it thought Coral was creditworthy. In such a situation, Sanwa Bank just might decide to make the sort of loan that bankers generally shy away from.

Exactly what Greenberg and AIG did or didn't do is a subject for speculation, since AIG steadfastly refuses to discuss the matter, other than to say that it doesn't own Coral and that it deals with it on an arms-length basis. But questions remain. What was AIG up to when it created Coral? Why did it cede it \$1.6 billion in premium over seven years? What will be the result of insurance regulators' examination of AIG's relationship with Coral (which was first reported last year in a dandy *Business Insurance* article by Douglas McLeod)?

Based on the Coral prospectus, copies of reinsurance treaties, financial statements, and other documents we've obtained, it appears that AIG's goal in creating Coral was to have an *unaffiliated* offshore company over which it had de facto control. From a regulatory point of view it was crucial that Coral not be a subsidiary of AIG. If AIG owned Coral, then ceding it premiums would be like



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Coral Reinsurance Company, Ltd.—The Deal Hank Greenberg Doesn't Want You to See

AIG set up Coral in such a manner that the company was not an "affiliate." Coral began business on December 17, 1987, yet had \$474 million of "outstanding losses" by year end 14 days later—all ceded to it by AIG. "Outstanding losses" (loss reserves) soon topped the \$1 billion mark even though Coral only had a \$52-million sliver of capital.

	1993	1992	1991	1990	1989	1988	1987
Assets							
Cash	\$39,196,617	\$33,388,688	\$41,667,670	\$75,605,554	\$63,189,951	\$123,432,681	\$63,997,383
Bonds	917,483,270	879,042,401	974,184,478	937,100,376	973,106,694	746,862,421	432,923,782
Premiums Receivable	135,648	0	18,058,516	17,556,465	1,788,989	116,113,316	12,307,741
Other	32,792,694	32,750,377	40,798,153	39,485,763	42,670,430	33,940,483	19,759,539
Total assets	<u>989,608,229</u>	<u>945,181,466</u>	<u>1,074,708,817</u>	<u>1,069,748,158</u>	<u>1,080,756,064</u>	<u>1,020,348,901</u>	<u>528,988,445</u>
Liabilities							
Outstanding Losses	967,998,760	884,728,120	1,009,866,399	1,011,968,187	1,016,201,591	957,338,408	474,055,383
Funds withheld from reinsurer	0	38,297,676	36,450,000	0	0	0	0
Other	6,568,321	7,106,381	13,287,686	5,022,969	11,774,688	9,784,030	1,764,802
Total liabilities	<u>974,567,081</u>	<u>930,132,177</u>	<u>1,059,604,085</u>	<u>1,016,991,156</u>	<u>1,027,976,279</u>	<u>967,122,438</u>	<u>475,820,185</u>
Share capital	15,000,000	15,000,000	15,000,000	52,680,000	52,680,000	52,680,000	52,680,000
Retained earnings	41,418	49,289	104,732	77,002	99,785	546,463	488,260
Shareholders' equity	<u>\$15,041,418</u>	<u>\$15,049,289</u>	<u>\$15,104,732</u>	<u>\$52,757,002</u>	<u>\$52,779,785</u>	<u>\$53,226,463</u>	<u>\$53,168,260</u>

shifting money from one pocket to the other, and that, of course, wouldn't accomplish AIG's stated goal of reducing its premium-to-surplus ratio.

It seems that some high-priced lawyers were quite careful to make Coral appear independent of AIG. For starters, Coral was owned by investors, albeit investors who didn't have to put up any money. Although an AIG company "executed" Coral's "management and operating procedures," it did so "as directed by" Coral and its board of directors. Thus, AIG was *just following orders*.

So who was calling the shots? Coral's board included Robert Aicher, a lawyer in Chicago who was appointed by Sanwa Bank; Trevor Carmichael, a lawyer in Barbados; Martin Hole, an insurance-company executive in Barbados; J. Markham Green of New York; and Michael Laparra, the chairman of Abeille Reassurances, which was an investor in Coral and an affiliate of Abeille General Insurance Company, which AIG managed.

Did this disparate group really get together, set up a tiny Barbados reinsurer, line up non-recourse loans, hire Goldman Sachs to find investors who wanted to make a risk-free investment, arrange for Munich Re to provide \$470 million of stop-loss coverage for \$1 million, and then talk Hank Greenberg and AIG into ceding their newly-formed company \$1 billion in premium in a little over a year? And, if so, why did these folks go to all that trouble when Coral, according to its own projections, was *expected* to make a negligible amount

of money from its insurance operations? (The prospectus pegs Coral's expected return on equity at 9%—about what one could have made buying bonds at the time.)

Finally, was it merely AIG's good fortune that all this happened at a time when the insurance market had hardened and AIG was apparently in need of some cheap financial reinsurance? Between 1984 and 1987, AIG's "domestic general-brokerage" gross written premiums had grown from \$3.3 billion to \$9.1 billion, but its net written premiums—premiums less reinsurance ceded—had soared from \$1 billion to \$5.1 billion. At the same time its net retentions increased dramatically. AIG may have felt compelled to lay off a big chunk of premiums in order to keep its various leverage ratios lower. (Buying a stop-loss cover may not have done the trick. It might have reduced the company's economic risk without affecting its financial ratios.) AIG, however, may not have been eager to cede premium at a time when underlying pricing was terrific and reinsurance was expensive. It may have viewed the environment as a rare opportunity to write tons of incredibly profitable business (which it was) and thought, "Why should some shiny-suited regulator tell us how much business to write?"

Presumably, AIG could have ceded to Munich Re the \$1 billion in premium that it ceded to Coral, but Munich Re would have wanted a rate of return considerably higher than that which it could earn by merely buying bonds. Coral's

Greenberg's Greenbacks

When Jeffrey Greenberg (Hank's oldest son), left AIG last year, the news made it to the front page of *The Wall Street Journal*, and speculation about the circumstances of his departure—a feud with his father, a rivalry with his brother, etc.—was a favorite topic of conversation among folks who follow the industry. In fact, many pundits chose to ignore another scenario: that Greenberg, a dynamic 44-year-old, wanted to run his own show outside the glare of his autocratic father.

Whatever the circumstances, Greenberg's current job—chairman and chief executive officer of Marsh & McLennan Risk Capital Corp., and director of Marsh & McLennan Companies, Inc.—is nothing to sneeze at. Greenberg's contract, which makes him one of the highest paid people at Marsh & McLennan, calls for him to receive a salary of \$750,000 per year, a signing bonus of \$300,000, a deferred bonus of \$300,000, 20,000 shares of restricted stock (worth about \$1,760,000 on October 31, 1995) and options on 50,000 shares of stock. In addition, he will be eligible for annual bonuses, restricted shares, and stock options.

Is Greenberg worth it?

You decide. Trident Partnership, which is managed by Marsh & McLennan Risk Capital, recently invested \$75 million in Travelers/Aetna Group (see page 3). The investment already shows a gain of \$53 million.

Not bad for a few months work.

Coral Reinsurance Company, Ltd.—What was Hank Greenberg up to?

A mighty strange deal: According to its own projections, Coral expected to make a negligible amount of money from its insurance operations. It succeeded.

	1993	1992	1991	1990	1989	1988	1987
Earned premiums	\$121,729,484	\$124,515,335	\$233,586,035	\$65,768,557	\$133,356,416	\$442,819,366	\$474,397,488
Reinsurance premiums ceded	1,000,000	1,000,000	102,728,914	1,000,000	1,000,000	1,000,000	1,000,000
Net premiums earned	120,729,484	123,515,335	130,857,121	64,768,557	132,356,416	441,819,366	473,397,488
Loss and loss expenses	201,818,364	201,041,947	223,818,277	152,738,075	214,171,545	483,577,098	474,055,383
Underwriting expenses	5,287,337	5,515,473	955,162	5,460,070	8,266,374	17,592,142	0
Total	207,105,701	206,557,420	224,773,439	158,198,145	222,437,919	501,169,240	474,055,383
Underwriting income	(86,376,217)	(83,042,085)	(93,916,318)	(93,429,588)	(90,081,503)	(59,349,874)	(657,895)
Investment Income	88,188,530	84,651,946	95,163,339	98,826,264	95,876,225	65,043,913	1,919,228
General and administrative expense	218,651	213,556	226,066	230,388	193,077	235,039	773,073
Net income	\$1,693,662	\$1,396,306	\$1,024,953	\$5,166,286	\$5,601,645	\$5,459,000	\$488,260

investors, perhaps because they weren't risking anything, didn't have such requirements.

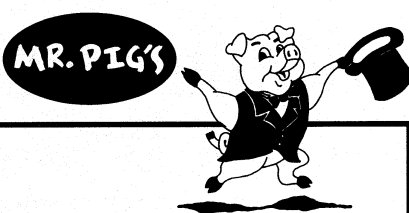
Coral also had the advantage of a favorable domicile. As its prospectus implied, a U.S. insurance company is hampered by silly old regulators who insist upon "a high level of surplus to support insurance premiums." In Barbados, where sugar cane is the main export, "the statutory requirements are less restrictive."

Barbados, in addition to its pleasant climate and lax regulations, permits insurance companies to operate free of taxes. In the U.S., however, The Tax Reform Act of 1986 requires the discounting of loss reserves, which accelerates the recognition of profits for income tax purposes, thereby increasing taxes. If, however, a U.S. insurance company were to have economic control over an "unaffiliated" Barbados insurance company through a contractual arrangement such as a reinsurance treaty, it is conceivable that it could cede premium to that Barbados insurer, shift income to the future, and postpone the payment of taxes for years. And, if the Barbados insurer would handle the transaction for next to nothing, all the better.

From AIG's point of view—although who knows what its point of view is?—it might be fortunate if a friendly Barbados company would accept \$1 billion in premium, secure the reinsurance recoverables with collateral, and pay out \$1 billion in losses *plus* the investment income earned on the ceded premium. As luck would have it, Coral, which was created by—gee whiz, who knows?—appeared in the nick of time.

It's well known that the insurance industry has a habit of setting up redundant reserves in good years and taking them down in bad years. This has the effect of "smoothing" earnings over time, which tends to placate Wall Street, where investors prize consistency. Nonetheless, property/casualty companies, because of their inherent risks and cyclicity, generally trade at a lower multiple than that of the Standard & Poor's 500 index.

Although AIG is in businesses—property/casualty insurance, life insurance, and financial services—where rapid earnings growth is almost impossible to sustain over time, its earnings



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have compounded at an 18.4% annual rate since 1985. This steady growth has certainly got the attention of Wall Street, where Greenberg is revered and AIG is the bluest of blue-chip insurance stocks. (AIG's return on equity, which averaged in the high teens in the late 1980s, has fallen to about 14% recently, which is still much better than average.) AIG's shares sell for 15.7 times this year's earnings and for 230% of book value, far higher than the average insurance company. It's impossible to say how much AIG's consistence adds to its stock multiple. Question: although Coral certainly wasn't responsible for AIG's success, did transactions with it, or with other similar companies, play a role in smoothing or increasing AIG's earnings?

Finally, if AIG did pull the strings on Coral Re, would that be wrong? While setting up complex offshore transactions with an "affiliate" that is, technically speaking, not an affiliate, might be pushing the envelope, we assume that Hank Greenberg wouldn't do something unless it passed muster with a slew of fancy lawyers and accountants.

Hank Greenberg is a genius. He is to the insurance industry what the 1927 Yankees were to baseball. He wouldn't get involved with a tiny Barbados company, no-risk investments, non-recourse loans, and \$1 billion in premiums unless he had a compelling reason.

Someday, perhaps at two o'clock in the morning, he'll tell us exactly what it was. ■

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