Have We Got a Deal for You

AIG's Unusual Relationship with Coral Reinsurance

You are sitting at your desk pondering various investment opportunities when Hank Greenberg calls. Greenberg, as we all know, is the tough-as-nails chief honcho at American International Group and a living legend in the insurance business. He has built AIG, of which he is only the second chairman in its 77-year history, into one of the world's great insurance organizations and one with an unrivaled international scope. The company earned $2.5 billion last year and its shares, since being sold to the public in 1969, have appreciated at a compounded annual rate of 17.7%, making Greenberg a billionaire. When Greenberg calls, you pick up the phone immediately.

"Hi Hank," you say with eagerness as well as trepidation. "It's nice to hear from you."

"Mr. Greenberg will be with you in one moment," the voice at the other end of the line responds.

When Greenberg comes on, he barks a quick hello and begins talking. "We're setting up a reinsurance company in Barbados that's going to write $500 million of business ceded by AIG. Under the reinsurance treaties, the reinsurer's loss is limited and a stop-loss arrangement will be in place so that the reinsurer is guaranteed to make money."

"Gee Hank," you say admiringly, "that's really interesting. If there's anything I can do—"

"The structure of this deal is clever. Investors won't have to put up any money. We've lined up a bank to provide financing at no risk."

"Hank, that's brilliant—"

"You can have $4-million worth of the deal," Greenberg continues. "You won't be risking a cent. Nothing but profit."

You are stunned. Hank Greenberg, the toughest man in the insurance business, is letting you in on this sweetheart deal. "God bless you, Hank," you blubber. "You're too kind. We must get together, perhaps over din—"

"Don't have time. Our people will fill you in on the details." Click.

While this conversation sounds like pure fantasy, it isn't. According to a 1987 Confidential Private Placement Memorandum, AIG *did* set up a company in Barbados and *did* allow certain "selected accredited investors" to participate in a no-risk sweetheart deal. Whether Hank Greenberg actually *talked* to the investors, who were a bunch of corporate bigwigs, is not known, and AIG has declined to comment on the matter. But it is safe to assume that Greenberg was well-versed in the details and approved the transaction.

The deal in question was the issuance of 1,000 shares of common stock, for a total of $60 million, to establish Coral Reinsurance Company Ltd., a Barbados-domiciled company that would reinsure certain risks from several of AIG's insurance companies. At year-end 1995, AIG had an estimated $800 million to $1 billion of reinsurance recoverable from Coral, making Coral a major reinsurer of AIG's business. (AIG's relationship with Coral was first reported in a 1995 *Business Insurance* article by Douglas McLeod.)

Why did AIG allow certain corporate bigwigs to make a risk-free investment in Coral Reinsurance?

AIG has claimed that it is not an owner of Coral and that it deals with the company on an arm's-length basis. Indeed, AIG's statutory filings list Coral as an *unaffiliated* reinsurer, and Coral does not appear on AIG's organization chart. There is no question, however, that AIG has a cozy relationship with Coral. Not only has its Barbados subsidiary, American International Management Company, managed Coral's operations, but AIG was responsible for Coral's genesis. The 1987 prospectus states that "AIG's interest in creating [Coral] is to create a reinsurance facility which will permit its U.S. companies to write more U.S. premiums. For a U.S.-domiciled company, a high level of statutory surplus is required to support insurance premiums in accordance with U.S. statutory requirements. The statutory requirements in Barbados are less restrictive." Implicit in this statement is the idea that by getting investors to stick $60 million into a start-up Barbados insurance company, AIG would be able to cede billions of dollars of its U.S. reserves, thereby improving its financial appearances by apparently removing this risk from its balance sheet.

It is unclear why AIG found it necessary to set up a Barbados company to do this, and why it decided to let certain investors into this deal on a risk-free basis. The investors include the Arkansas Development Finance Authority; Abeille Re; L. Donald Horne, chairman of Mennen Co.; Charles Locke, chairman of Morton Thiokol; Kenneth Pontikes, chairman of Comdisco; David Reynolds, chairman of Reynolds Metals; John Richman, chairman of Kraft; and Samuel Zell, chairman of Itel.

Under the terms of the deal, the investors were offered the opportunity to buy units of 67 shares of common stock for $4,020,000 a unit. The investors were not required to shell out one red cent, however, because Sanwa Bank would finance their investment with non-recourse loans secured solely by the investors' Coral shares. In other words, investors did not have to put up any funds or risk any money, but were nonetheless granted 100% ownership of Coral.

Coral would then take the investors' $60-million "investment" and place it in certificates of deposit issued by Sanwa bank. These CDs, which would be "held outside of Barbados," paid interest at the LIBOR rate for 90-day U.S. deposits. The investors were charged interest on their non-recourse loans at a rate that equaled a 37.5 basis-point spread over that which they received on their Sanwa CDs.

Once financed, Coral would receive "approximately $480 million" of reinsurance premiums from AIG. Under these reinsurance treaties, Coral's maximum loss in a given year would be $950 million, but that was then reduced to $480 million via a stop-loss agreement with Munich Reinsurance Company. "The 'stop-loss' is designed to insulate Coral from reinsurance risk in excess of the amount available from the $480 million of premiums paid annually and the investment income generated thereby," reads the prospectus. In other words, Coral would take in $480 million in reinsurance premiums and pay out $480 million in losses.

Coral's investors, however, would profit through the receipt of an annual "2% risk premium" on their "equity investment" (the $60 million that Sanwa lent them). From this 2%, the investors would pay Sanwa various fees and commissions that equaled 50% of the "risk premium" in the first year and 25% in each subsequent year.

The bottom line: an investor who purchased a $4,020,000 unit would receive an $80,400 annual "risk premium." Offsetting this would be the cost of the loan (37.5 basis points, or $15,075) and various fees and commissions ($40,200 the first year and $20,100 thereafter). The result: an investor's profit would be $25,125 in the first year and $45,225 in each subsequent year—with absolutely no risk.

Under the terms of the deal, the investors' stock could be redeemed for the price that they paid, and that is apparently what happened in early 1991. According to the *Business Insurance* article, at that same time stock was issued to several new investors, among them The Molson Companies, a Canadian brewing conglomerate. This is noteworthy because Marshall Cohen, Molson's CEO, has served on AIG's board of directors since 1992. Curiously, AIG's proxy statements have not disclosed what would appear to be a potential conflict of interest: Cohen's involvement with one of AIG's largest reinsurers, Coral Reinsurance.

It is not clear exactly what kind of business AIG was ceding to Coral, although various documents included in the prospectus give some indication. For example, a quota share replacement agreement between the National Union pool and Coral states that Coral will "accept all 'loss and premium liability' that had been previously ceded to various prior reinsurers whereby the company has or would incur a financial loss because of the inability of such prior reinsurers to pay amounts due or to become due by reason of 'financial impairment' or 'government regulation.'" Other agreements call for AIG to cede pre-1986 losses emanating from professional liability business written in Divisions 65 and 66, and 1987 accident-year losses on business written in Divisions 30, 35, 36, 65, and 66.

AIG's dealings with Coral are intriguing for numerous reasons. For starters, they have benefited AIG by allowing it to write more U.S. business without having more statutory surplus. Although AIG may have followed the letter of the law in these transactions, it appears to have sidestepped the spirit of the law (e.g., risk is not transferred unless it is ceded to a third party). On the other hand, since Coral appears to be little more than a shell over which AIG has de facto control, it seems that—absent tax or regulatory considerations—AIG was not accomplishing anything of economic substance that it couldn't have accomplished otherwise. Knowledgeable sources who preferred not to be quoted (in the words of one, "I like my job") suggested that the Coral transaction was driven by tax reasons.

Perhaps the most galling aspect of the Coral deal is that it was offered to "selected accredited investors" and not to, for example, *Emerson, Reid's Insurance Observer*. But one thing is certain: if Hank Greenberg offers to let us into his next no-risk deal, we'll gladly sign on. ■

To receive a copy of the Coral Reinsurance prospectus, send a check for $10 to "Emerson, Reid's Insurance Observer."

CONFIDENTIAL
PRIVATE PLACEMENT MEMORANDUM

MEMORANDUM NO._____
NAME ________________

1,000 Shares

CORAL REINSURANCE COMPANY LTD.

Common Stock

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"AIG's interest in creating [Coral] is to create a reinsurance facility which will permit its U.S. companies to write more U.S. premiums..."

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GOLDMAN, SACHS & CO.

DECEMBER 1, 1987

AIG claims to deal with Coral at arm's length, but the prospectus indicates otherwise.