greenberg's Fall

BY JONATHAN R. LAING • The end came with stunning swiftness. An all-day board meeting a week ago Sunday, and a day later insurance kingpin Maurice "Hank" Greenberg was deposed as chief executive officer of American International Group after nearly four decades in the post. Martin Sullivan, co-chief operating officer, was named CEO.

The once-impregnable Greenberg was laid low by investigations by the Securities and Exchange Commission and New York Attorney General Eliot Spitzer into the possibly sham reinsurance deals reported in 1998 and early 2001 to artificially pump up AIG's policy-loss reserves and satisfy concerns of Wall Street analysts. And AIG directly had learned that Greenberg was the direct instigator of the reinsurance arrangement with Berkshire Hathaway's General Re to boost AIG's reserves by $500 million. The lineitemed of the transaction was first disclosed in a Feb. 21 Barron's article, "Turning Up the Heat on AIG."

But AIG's accounting problems with the regulators may be just beginning as is implied by an internal investigation, delay in the filing of AIG's 10K report with the SEC and talk of possible large writedowns to come at AIG. In other words, plenty of folder remains for Spitzer and the SEC.

For example, investigators are beginning to uncover material suggesting that AIG was likewise misleading two reinsurance companies it secretly controlled, Richmond Insurance Co. Ltd. of Bermuda and Union Excess, domiciled in Barbados, to improve AIG's earnings, understating results and capital position over a period of years by various finite-risk reinsurance schemes. Among other things, these companies appeared to be convenient dumping grounds for poorly performing property and casualty insurance policies to get them off AIG's books. By laying off business on these supposedly independent reinsurers, AIG was also able to write more new business than its true capital position might have otherwise permitted.

Finite reinsurance fees off the gap between when policy losses are recognized for accounting purposes and when they are actually paid out. Major insurers use reinsurance to exploit this gap by handling, say, $700 million of its policy reserves to a reinsurer in return for the later assumption, say, $1 billion of future claims.

The reverer's cost of claims will rise by only $700 million rather than by the full $1 billion, thus boosting its pretax net by $300 million. Similarly, the insurer's capital and surplus is effectively boosted by $300 million, freeing up capital to carry forward even a small percentile of its own risk. The reinsurer is hoping to be able to pay the future claims from the build-up in investment value on the $700 million in reserves and still garner a profit. The technique, known in the insurance trade as "discounting reserves," is designed to realize the time value of money. Reinsurers have to bargain hard because of the uncertainty of knowing exactly when their assumed claims will hit.

For years, AIG had been able to negotiate even more favorable deals with secretly controlled reinsurers like Richmond and Union Excess. Since, in essence, AIG may have been negotiating with corporate extensions of itself and thus was effectively on the hook to pay all the eventual claims when they rumbled in, AIG could theoretically strike any deal it wanted with its supposed shells. AIG could say, advance just $300 million in reserves on the aforementioned $1 billion in future claims, thereby pumping up its current pretax earnings and capital by an extra $400 million over the $1 billion benefit posted in the previously described transaction. A friendly reinsurer could function as a sort of slash fund allowing an insurer to delay taking reserve hits for years.

If nothing else, Richmond and Union Excess seem to boast an enviable position among AIG's offshore reinsurers. At the end of 2003 (the latest numbers available), Richmond and Union Excess accounted for nearly 1.2 billion of the policy recoverables on AIG's books out of a total of $4.6 billion from all offshore reinsurers, according to figures compiled by the insurance newsletter IBNR Weekly, owned by Dowling & Partners. At the very least, a determination that Richmond and Union Excess were AIG-controlled shells would result in the restatement of years of earnings and the removal of the near $1.2 billion reinsurance recoverable from the asset side of AIG's balance sheet. That would be a far bigger hit than a new $1.5 billion charge that the rumor mill last week was predicting for the embattled insurance company.

The key issue for regulators is establishing the nature of the control AIG exercised over Richmond and Union Excess. A spokesman from AIG disclaimed even any knowledge of the two reinsurers. Naturally, they appear nowhere in AIG's elaborate table of organization. As of press time, insurance regulators in Barbados declined to provide AIG's with any information on Union Excess, including even its address. Richmond Insurance, however, turned up in an online Bermuda insurance directory. It has just six employees and a tiny capital base of $44 million to support the $656 million in owes AIG as of the end of 2003.

However, its ties with AIG seem extensive. Richmond's office is in the AIG Bermuda headquarters building on Richmond Road. In the directory, AIG is listed not only as one of Richmond's owners along with Munich Re "and others," but also as designated as Richmond's "management company." Finally, Richmond does little or no business with any other insurer but AIG.

In many ways, the developing controversy over Richmond and Union Excess seems to be an instant replay of a drama played out a decade ago over another obscure offshore reinsurer, Coral Reinsurance Co. In 1993, insurance regulators in three states asserted that Coral Re, domiciled in Barbados, was in effect a shell company so tightly controlled by AIG that transactions between the two shouldn't be given for reinsurance purposes. AIG denied any connection but stopped writing new business with Coral Re in 1997, and Coral Re was quietly shut down in 1999. Ultimately, state regulators exacted no penalties against AIG from that 1992 decision.

The similarities between Coral Re, Richmond and Union Excess abound. Both Richmond and Coral Re started within a year of each other in the 1986 to 1987 period when AIG and the rest of the industry was still reeling from the collapse of big business with AIG, at one point being on the hook for $1 billion in AIG policy claims or recoverables. Likewise, Coral Re was managed by an AIG subsidiary and did business almost exclusively with AIG.

Lucy Komisar, a reporter for online organizations, and insurance commentator David Schiff of Schiff's Insurance Observer have come up with details of how AIG set up the supposedly independent Coral Re, AIG possibly followed the same template with Richmond and Union Excess.

Coral Re's shareholders, assembled by Goldman Sachs in 1987, were six rich guys mostly from Chicago, including real-estate mogul Sam Zell, the late Ken Pontikes, then chairman of Cominsico, and John Richman, former chairman of Kraft Foods and the Arizona Development Finance Authority. None had to put up a cent to buy the $2 million Coral Re stock at a cost of around $56 million a chartering treatment. AIG didn't have a major claim on it. AIG was a private bank and lent them all the funds on a risk-free, noncore basis. And the dividends from Coral Re were precisely culled to cover all the investors' cost of $1.4 billion in annual profit of around $45,000 on their riskless, painless investment. Also, the investors were permitted to sell their investment at any time at the original purchase price. The offering material made clear the symbiotic relationship that would exist between AIG and Coral Re.

We contacted one former Coral Re shareholder who recalled his foray into the world of reinsurance: "It was a sweet deal with no personal risk and a steady return. Then one day it went away. I vaguely remember the deal having something to do with Hank Greenberg and AIG, but I know absolutely nothing about insurance nor was I ever called upon to do anything for Coral Re. We had no committees and never received one financial statement."