

CHAPTER 36

1987

An Industry of Growing Importance

An easier beginning to the year

By 1987 the rate of growth in the Bermuda market had slowed down somewhat. Renewal terms were nowhere near as difficult for clients at 1 January of that year as they had been a year before. Some property lines began to see decreases in premiums and renewal negotiations on the casualty side were easier than they had been twelve months previously because casualty underwriters were more willing to discuss renewal options than they had been before. In general the renewal process was far smoother than the previous year, which strongly suggested an imminent change in the market.

The growing importance of the industry to Bermuda

Despite moderate growth in the international insurance industry in Bermuda, there were 1232 insurance companies and 246 insurance brokers/managers registered there by 1987, which prompted Premier John Swan to acknowledge publicly that the international business sector would play an increasingly dominant role in Bermuda's economy. Speaking to the Young Members of the Bermuda Insurance Institute, Swan said—

'International business provides one third of our gross foreign exchange. This US \$185 million is now a major part of Bermuda's growth. Apart from the financial contribution, the international companies, especially the insurance companies, have provided employment for qualified Bermudians, business for the banks, accountant firms and related services. They have also contributed to the local retail and other non-insurance-related entities in the marketplace. Whilst the financial and commerce-related contributions are of great importance, the greatest benefit to Bermuda, has to be in providing appropriate employment for qualified Bermudians.'⁴⁴⁹

Kathryn McIntyre, editor of *Business Insurance*, also dubbed Bermuda 'The Guiding Light of the Insurance Industry' in 1987 because it was the only market that harboured risks, something the conventional markets were not doing in 1986.⁴⁵⁰

Bermuda government lobbies Washington for Tax Convention

Recognising the importance of the international insurance industry to the island, the Bermuda government decided to set up an aggressive campaign to lobby Washington to gain the favourable tax treatment Bermuda sought. Kathryn McIntyre reported—

⁴⁴⁹ *The Royal Gazette*, Business Week, 1987, 'International to play bigger role than ever'

⁴⁵⁰ Speech by Kathryn McIntyre, 1995

'The Bermuda government is budgeting US \$150,000 for lobbying and legal fees related to the unratified United States-Bermuda Tax Treaty (Convention). The treaty would exempt premiums paid to Bermuda-based insurers from the federal excise tax of 4 per cent on direct premiums and 1 per cent on reinsurance premiums. The treaty would also permit individuals who are members of associations or professional groups to deduct their personal expenses of attending a convention in Bermuda. The treaty's provisions would benefit Bermuda's international insurance business and its convention business.

'However, the treaty signed on July 11, 1986 ran into problems in the Senate last year when some members of Congress objected to trading tax benefits for tax information. Hearings have not yet been scheduled by the Senate Foreign Relations Committee, but hearings might be held in June or July, a committee staff member said last week. The Senate has rejected 21 treaties in its history, but only two since World War II.

'Bermuda is budgeting for lobbying costs and for legal fees for "interpretations of US law since our attorneys in Bermuda are all British-trained", said Financial Secretary Mansfield Brock. "We want to be able to consult with people who have expertise in the Tax Reform Act and US tax law generally," he explained. William Ragan of the law firm Ragan & Mason in Washington represents the Bermuda government. "We're not looking for tax advantages – we're looking for equality," Mr Brock declared.

'Barbados negotiated a federal excise tax exemption in a treaty with the United States, and Bermuda is concerned it will lose captives. But, exemption from the excise tax may not be as important in many group-owned captives in light of the provisions of the Tax Reform Act of 1986 that create new tax liabilities for shareholders of most group-owned captives," Mr Brock suggested.

'...Bermuda's Premier John Swan said recently: "We hope a point of an agreement can be reached...I believe people don't look at Bermuda as a tax haven. They look at it as a facility to accommodate business."⁴⁵¹

While Bermuda was hopeful that a resolution could be reached soon on the tax convention, United States Consul-General James Medas hinted that the ratification had to wait until the new President of the United States was elected and inaugurated. Many feared that if a Democratic President were elected the Bermuda-United States Convention would become a dead issue.

The Convention was further complicated by the fact that it was the only one the United States would have with a non-tax jurisdiction and that is why it was called a Convention and not a Treaty. In all other cases, governments negotiating a tax break would normally grant each other offsetting benefits of some kind. In addition, the clauses of the Bermuda-United States Tax Convention had to be closely scrutinised because they were not standard clauses. Bermuda had to be patient therefore and the government did the right thing in allocating more money to fighting for this Convention because it proved to be an uphill battle.

Gulf Oil Corporation Case

While the Bermuda Government was aggressively setting up ways to lobby Washington, Gulf Oil lost a tax battle with the United States Internal Revenue Service (IRS). Gulf had been looking to recover a tax deduction of US \$22 million on account of the fact that two per cent of the premiums generated by Insko, (Gulf's captive in Bermuda, wound down in November 1984) had been derived from outside sources. The court deemed that this element was of insufficient magnitude to warrant a tax exemption. On that ground, and with its focus not on the nature of purported 'economic family' relationships but on the level of unrelated business, the court disallowed the tax deduction and ruled in favour of the IRS. *The Captive Insurance Review* reported on the Gulf ruling as follows—

⁴⁵¹ *Business Insurance*, 30 March 1987, 'Bermuda government to lobby for tax treaty', by Kathryn McIntyre, p. 26

'In 1971 Gulf incorporated Insko, a wholly owned foreign subsidiary, to conduct a general insurance business. During 1974 and 1975 Gulf and its affiliates insured risks with unrelated insurance carriers who, by pre-arrangement, reinsured with Insko and ceded premiums on such reinsurance to Insko. Insko paid claims on the reinsured risks. In 1975 Insko began insuring risks of unrelated parties. Net premium income from unrelated parties represented two per cent of its total net income in 1975.

'The Commissioner of Internal Revenue determined that premium payments made by Gulf and its domestic affiliates were not deductible to the extent those payments were ceded to Insko. He also recharacterised as constructive dividends to Gulf the premiums paid by the foreign affiliates which were ceded to Insko. In addition, he recharacterised as constructive dividends to Gulf the payment of claims by Insko to Gulf and its domestic affiliates.

'It was held that the sums paid to Insko are not deductible as ordinary and necessary business expenses. It was also held, in the other matter (in) dispute, that the premiums paid by the foreign affiliates to Insko and the claims paid by Insko do not constitute constructive dividends to Gulf. Only the second decision seems to be a success for the taxpayer; that is not necessarily the case...

'...The court decided against Gulf's claim for tax deductibility of premiums paid to Insko in 1974 and 1975 not because there could be no risk transfer where a wholly owned captive was involved but because there was insufficient unrelated business (two per cent only in 1975) being written by Insko.

'The court expressly rejected IRS ruling 77-316 on its "economic family" argument. It stated that risk transfer could occur, even with a wholly owned captive, provided it wrote enough unrelated business. The focus, the court said, should be on the amount of premiums contributed by policyholders and not the capital structure of the captive.

'...In the court's view, when the aggregate premiums paid by the captive's parent group are substantially inadequate to pay the aggregate expected losses, both parent group's and unrelated policyholders', the premiums paid by the parent groups should be deductible as insurance payments. In these circumstances, risk distribution and risk transfer are present and the arrangement cannot be equated with self insurance.

'In its footnote comment the court declined to say what proportion of unrelated premiums would be enough for the parent group's premiums to be considered payments for insurance. But it did say that "if at least 50 per cent are unrelated, we cannot believe that sufficient risk transfer would not be present."

'It is a far cry from the Government brief used in the defeat of Mobil in 1985, which said "there is absolutely no insurance theory that supports the conclusion that the presence of unrelated insureds converts the relationship among affiliates into insurance."

'On the other issue before the court in the Gulf case—that of whether premiums paid by non-US parent group companies to Insko and claims paid by Insko were constructive dividends—Gulf succeeded in proving they were not.⁴⁵²

The mid 1980s proved to be a trying time for the captive markets because of the inconsistency of the IRS rulings. As a consequence, captive owners were unsure as to what constituted taxable income and what did not. Therefore many decided to shift the focus away from the tax benefits of setting up a captive to the reasons why a captive could benefit the parent company overall. In this way, no matter what the IRS might assert and decide, they could always argue the reasons why they established their captives in the first place.

More changes to the industry

The Bermuda marketplace underwent further changes, as companies continued to cease writing business, or merged with others in order to improve their underwriting results, while others expanded their businesses to take advantage of the changes. Zurich International Insurance announced in

⁴⁵² *Captive Insurance Company Review*, February 1988, 'The Gulf Tax Decision—A New Direction for Captives?' p 1-4

May that it would stop underwriting in Bermuda and 'would send its book of Bermuda handled United States-produced business back to be managed by Zurich American in Illinois. The London-produced business found its way back to the UK subsidiary, Turegum Insurance.'⁴⁵³ Skandia America Group took over Hanna Insurance Management for an undisclosed sum. 'Hanna (was) Bermuda's fifth largest captive insurance manager and handled a premium volume of US \$300 million on behalf of 84 captives in 1986.'⁴⁵⁴

Then, in the wake of the United States Risk Retention Act of 1986 and the shock waves it sent through the community, MEDMARC Ltd. became the first Bermuda captive insurer to pull out and go back to the United States. It was widely feared that many more firms would follow and that Bermuda had passed its heyday in the international insurance arena.

As a result, perspectives were shifting once more. No longer was Bermuda referred to as the world's 'third reinsurance market' in the way it once had been. *Business Insurance* reported as follows on the changing scene—

'Gone are the giant oil company captives that rushed into commercial insurance and reinsurance underwriting, only to find there were losses, not profits, in the business... Many other captives and insurance concerns that tried commercial reinsurance underwriting in Bermuda on a smaller scale also have left the island, either because they weren't making money or they believed they could make more money based in the United States or London.

'... Today in the limelight of the Bermuda market are captive insurance companies and giant policyholder-owned stock companies catering to the insurance needs of their owners. "The future is for the next five years obviously going to be the direct markets like ACE and XL," contends J. Cox.'⁴⁵⁵

The Royal Gazette reported that, according to Hugh Rosenbaum, a captive industry consultant and editor of *Captive Insurance Company Reports*, the Bermuda insurance industry was facing its most serious set of challenges since it first entered the captive insurance market.

"The challenge is clear," said Mr Rosenbaum, speaking at the opening day of the 11th Annual Captive Insurance and Reinsurance Forum. "The value of Bermuda's services has to be worth the cost. The way Bermuda companies and services are regulated must be perceived to be superior to anywhere else." He said there were few remaining tax advantages to going offshore. "This is true for almost all single-owned and most group captives."

'The challenge to Bermuda – the world's largest captive insurance centre – is threefold.

- 'The passage of the US Tax Reform Act means Bermuda-based companies' revenues can now be taxed in the same way as US companies.
- 'The passage of the Risk Retention Act means captive companies can now be formed in certain US states, the most favourable being Vermont; and
- 'Bermuda now faces a challenge from Barbados where the Barbados tax treaty with the US means Barbados-based companies do not have to pay a four per cent excise tax as Bermuda companies do.

'While Mr Rosenbaum said Bermuda registrations continue to grow, and few companies have elected to switch domiciles, he warned, "many are looking at it... One way (to improve services) would be for managers to become more involved in their clients' onshore business," he said. "Some have been doing this for some years. Others could do it more. But he ended his speech on a down note, saying: "If standards do not go up, the 'intangibles' which have helped carry Bermuda won't carry it for very long."⁴⁵⁶

⁴⁵³ *Captive Insurance Company Review*, November 1987. 'Now Trenwick leaves Bermuda', pp. 1 & 2

⁴⁵⁴ *ibid.*

⁴⁵⁵ *Business Insurance*, 30 March 1987, 'Bermuda reinsurers focus on captives', by Kathryn McIntyre' pp. 3 & 36

⁴⁵⁶ *The Royal Gazette*, 12 March 1987, 'Insurers face their biggest challenge', p. 1

Despite the negative feelings that were aroused as a result of the Tax Reform Act of 1986, a significant change to the Bermuda landscape occurred with the growth of financial reinsurers on the island. *Business Insurance* reported that at least six new reinsurers opened to specialise in financial reinsurance transactions in 1987, in addition to other Bermuda based companies that wrote financial reinsurance contracts as an adjunct to their conventional reinsurance business.

Business Insurance quoted Mr Stephen K. Lawrence, a director of Pinnacle, Bermuda's oldest specialty financial reinsurer, as follows—

"The Tax Reform Act of 1986 presents "big opportunities" for financial reinsurance companies. "Not everyone's loss development will be in line with the average," he says, and financial reinsurance can be used to better manage the insurer's tax position."⁴⁵⁷

With a view to exploiting such opportunities, a number of companies sought aggressively to underwrite financial reinsurance. Among them were Clarendon Insurance Co. (Bermuda) Ltd., headed by Francis Carter, and Independence Insurance Co., headed by Martin Slade and owned by the Samuel Group of London, which also owned Lowndes Lambert. Likewise Belvedere Insurance decided to set up a separate unit to handle financial reinsurance. Cologne Re, set up in 1983 under the direction of Graham Pewter, decided to expand, as did Forum Re under the direction of David Thurkill and Peter Wilson.

Bob Cooney establishes XL underwriting office in Bermuda

While the financial reinsurers began their push to expand their business, XL was about to start underwriting in Bermuda. Bob Cooney was an underwriter at Trenwick America, who had been redomesticated to the United States from Bermuda, and when he heard about the XL concept he was ecstatic and wanted to get in on the action. When he learned that XL did not have people, nor enough money (XL had only raised US \$400 million at the time), Cooney did some research and produced a paper, setting forth how he could envisage Trenwick providing the underwriting services to the new company. He gave this to Angus Robinson and Brian O'Hara. After all, Trenwick still had an office in Bermuda, albeit a scaled down one, which was primarily handling the rent-a-captive business, so he reasoned that it would not be a big step for Trenwick to provide the underwriting services.

Cooney even volunteered to coordinate the project himself. He believed that with his experience as a management consultant for a few years, he would be able to handle the project. Sometime later Angus called Cooney into the office and told him he had good and bad news. The good news was that Trenwick had been awarded the underwriting contract for XL. The bad news was that Cooney had to be on an airplane the next morning and that there were 150 underwriting submissions waiting for him to review! Cooney was excited and elated. What problem? He looked on this as the opportunity that he had been awaiting for a long time. The next morning he left Connecticut, never to look back.

When Cooney arrived on the island Giles North, who ran National Brokerage Association (NBA), the wholesale broker operation for Marsh & McLennan in Bermuda, asked him how he intended to price the US \$75 million excess of US \$25 million layer, which was the void XL had been created to fill. At the time it was extremely rare for clients to have had a loss exceeding US \$25 million, so Cooney was faced with a real quandary. He had no real loss experience upon which to base his pricing. And if he based the pricing on the primary carriers, those companies which provided insurance up to the US \$25 million attachment point, then the whole purpose for which the company was created would be defeated, because the very reason for creating XL in the first place

⁴⁵⁷ *Business Insurance*, 30 March 1987, 'Financial reinsurers multiply in Bermuda', by Kathryn J. McIntyre, pp. 48-49, 132

was that the market had been trying to charge exorbitant prices. He could not use the current market pricing as a guide and in any case a US \$75 million net line was unheard of in those days. So Cooney went about finding the best solution that he could.⁴⁵⁸

According to North, the pricing was quite simplistic in the beginning because they came up with a structure to price those accounts that were already with ACE with limits of US \$100 million excess of US \$100 as double the ACE premium for XL to write US \$75 million excess of US \$25 million. John Cox of ACE was initially involved with the underwriting of accounts for XL and helped them to establish the rating base. XL also had a policy that it would not attach below US \$50 million for pharmaceutical accounts and therefore the price for this class of business for a US \$50 million excess of US \$50 million was the same as a US \$100 million excess of US \$100 million.

Not only were ACE and XL introducing net line underwriting, they were also introducing the occurrence integration policy, a claims made policy with occurrence reporting, a totally radical innovation at the time. Because the United States market looked askance at occurrence policies as a result of bad experiences with asbestosis, pollution and workers' compensation, in an increasingly adverse tort environment, many United States insurers were trying to force their clients to accept claims made policies. Many of them were moving away from the occurrence policy because they now understood that it could leave them open to unquantifiable losses, which would prevent them from ever being able to close out their policy years.

Many clients were unhappy with the claims made policy because it seemed that suddenly insurers were restricting their coverage. The occurrence policy allowed them to be lax about loss reporting. Unlike the claims made policy, which requires a client to notify the insurer of a claim before closing out the policy year, an occurrence policy is open ended. The loss has only to occur within the policy period, no matter how long it took to manifest itself, so a client was comfortable with this type of coverage because he felt he was purchasing sleep-easy insurance for those losses that were out there but about which he knew nothing.

The founders of ACE and XL, knowing the dangers of the occurrence policy and not wanting to appear Draconian by introducing a claims made policy, came up instead with a variant that was somewhere in between the claims made and occurrence policies, and called an 'occurrence integration policy'. This was actually a claims made policy with occurrence reporting.

Years later many said it was the introduction of this hybrid policy that thwarted the attempt of domestic insurers to coerce all their policyholders into claims made policies. More and more clients came to Bermuda because they believed that here they would get coverage designed more to their own satisfaction.

Cooney was the only underwriter based in Bermuda, but others came down to help him. Tom Thorsteinson was running TGIC, Trenwick's rent-a-captive facility, and Cooney also pulled him in to help him out. Marjory Smith was eventually hired and was followed by others in due course.

Originally XL hired Marsh & McLennan in Barbados to manage the back office operations, because technically XL was a Barbados based company, in deference to the favourable tax treaty that Barbados had with the United States and the lower stamp duties. The team was initially run from the Sandy Lane Hotel, with Bruce Connell as the coordinator.⁴⁵⁹

After Marsh hired Trenwick to do the underwriting for XL, Bob Clements formed a very high opinion of Brian O'Hara. Cooney called him and told him he thought that O'Hara for his part would be interested in joining XL. Clements replied that he was not sure how to go about having O'Hara considered for the job. He did not want to appear to be luring away Trenwick's staff when

⁴⁵⁸ Interview with Bob Cooney, 13 March 2002

⁴⁵⁹ *ibid.*

he owed them a debt of gratitude for their work in getting XL established. So he decided to employ an executive search firm to act as an unbiased third party in selecting the candidates for XL.

None the less Clements invited O'Hara and his wife, Nancy, to have dinner with him in a restaurant in Greenwich. That night there was a massive snowstorm. Nancy O'Hara's babysitter couldn't make it through the snow. The O'Hara's had only just moved into a new home and didn't know a soul around but Brian O'Hara was determined not to miss his chance with Clements. So he went to the house of the complete strangers next door and asked if they could baby sit. The neighbours agreed. The O'Hara's drove off through the snow and arrived only five minutes late for their meeting with Clements and his wife.

Perhaps Clements remembered this determination when he subsequently invited O'Hara to join XL. At first O'Hara wanted to be CEO but Clements thought he would ultimately do better with some seasoning under a more experienced executive and that meanwhile the company would benefit if O'Hara could focus entirely on the challenge of being the Chief Underwriting Officer. He suggested to O'Hara that he would get him a CEO old enough that he would not stand in his way but who would make his work easier at the start by enabling him to concentrate on building up the underwriting portfolio.⁴⁶⁰

Thus Brian O'Hara became the first XL employee. 'The company's board of directors at the time numbered 68, with each investor supplying a director to monitor its investment. O'Hara was interviewed for the job by all of them, simultaneously. His face, as he recalls the experience, reveals mixed emotions. "It was an interesting episode," he says. "It was only the second board meeting, in Barbados. I went in late, and the meeting ran until three in the morning. It was difficult to bring into symphonic harmony a fractious group of that size."⁴⁶¹

All back office operations, including policy issuance and accounting, were handled out of Barbados, while underwriting meetings were held in Bermuda, because it was easier for clients to get to Bermuda than it was for them to go to Barbados.

XL then hired the Chicago Underwriting Group (CHUG) to act as the Directors and Officers (D&O) consultant. Jim Ansaldi was the original underwriter who was the underwriting consultant.⁴⁶²

Cooney recalled that the first two years of operations were somewhat chaotic. The market was such that clients were willing to pay steep prices for a new form (the occurrence integrated form, which was more restrictive than an occurrence form but broader than a claims made form). Additionally, in the first six months all customers were required to buy shares in the company. Most did so willingly because they saw this as a way to get much needed insurance and so categorised the purchase of shares as a part of their premium.

In order to become policyholders of XL, accounts were required to pay surcharges, in effect entrance fees, additional to the annual premiums. A low hazard account, such as a hotel, was required to pay, in addition to the annual premium, a surcharge equal to the amount of one year's annual premium. A high hazard account, such as a pharmaceutical or chemical company, was required to pay, likewise in addition to the annual premium, a surcharge in the amount of twice the annual premium. To become sponsors, clients were required to pay in a different range of surcharges on top of the annual premiums, namely US \$5 million from a soft account and US \$10 million from a high hazard account.⁴⁶³

⁴⁶⁰ Interview with Bob Clements, 10 December 2002

⁴⁶¹ *Bermudian Business*, Premier Issue, Insurance Special, Spring 1996, 'XL's risk pays off', by Roger Crombie, pp. 30–36

⁴⁶² Interview with Bob Cooney, 13 March 2002

⁴⁶³ *ibid.*

Trenwick leaves Bermuda

In the fall XL dropped its reserve premium requirements from 100 per cent to 25 per cent of the total premium paid, thereby increasing the number and diversity of submissions and likewise the need for full time employees, so much so that in November XL offered jobs to the Trenwick consultants and they all agreed to come on board. Within a few days of five of Trenwick's senior managers announcing that they were leaving to join XL, the Connecticut based Trenwick Group announced that it was selling its Bermuda subsidiaries.

According to *The Captive Insurance Company Review*, "Trenwick says its decision to leave Bermuda was the result of a corporate policy decision rather than any dissatisfaction with Trenwick's Bermuda operations. The loss of senior staff is said to have no bearing on the decision."⁴⁶⁴ XL hired the entire Trenwick staff that was left in Bermuda.⁴⁶⁵ In general Angus Robinson and Brian O'Hara were responsible for bringing a highly professional and dedicated team of underwriters to XL.

XL and ACE also did not escape the effects of the Tax Reform Act of 1986. In the summer of 1987 they were forced to change their corporate structure by buying back shares from non-sponsor shareholders because of the new Related Person Insurance Income (RPII) tax that had been introduced. They did this so that non-sponsor shareholders would not have to pay RPII tax on their shares.

Bermuda insurers play a dominant role in D&O coverage

The Bermuda international insurance industry received another boost, despite the Tax Reform Act, the Risk Retention Act and the United States/Barbados treaty, when it began to play a dominant role in Directors and Officers (D&O) coverage for both American and Canadian companies. The reason for the explosive growth in Bermuda was attributed to the capacity crunch in 1985 and 1986, which severely restricted the availability of D&O coverage. So much so that prominent board members resigned from boards because companies could not offer them the protection they required.

The Royal Gazette reported how the Bermuda international insurance industry benefited from the D&O crisis—

'Bermuda-managed ACE Insurance Ltd. rank(ed) first in terms of premiums among insurers providing the United States market with excess D&O coverage, according to a report by Chicago based actuaries and consultants, the Wyatt Company. And Bermuda based Directors & Officers Ltd. (DOLI) was the second largest primary D&O insurer with 16.6 per cent of the total—primary and excess—United States D&O premium volume....

'Wyatt's tenth annual *Directors and Officers & Fiduciary Liability Survey Report 1987*, also showed a dramatic shift by United States and Canadian companies away from traditional commercial insurers to policyholder-owned facilities domiciled in offshore jurisdictions such as Bermuda and Barbados. According to the 188-page report, the traditional insurance markets provided 50.2 per cent total D&O coverage, with the remaining 49.8 per cent coming from other sources.

'Among significant changes within the D&O primary insurance market was:

- The emergence of new policyholder formed alternative markets of considerable note, including DOLI (utilities), BICL and FIRL (banks), Sargasso (life insurers) and CODA (large industrials).

'Among significant changes in the excess insurance markets was:

- The rise of alternative markets to a place of prominence, with 25 per cent of policies. Principal among these insurers are ACE, XL, DOLI, Electric Insurance Mutual, BICL and CODA.

⁴⁶⁴ *Captive Insurance Company Review*, November 1987, 'Now Trenwick leaves Bermuda', pp. 1 & 2

⁴⁶⁵ Interview with Bob Cooney, 13 March 2002

'Listed in the report were Bermuda-based or managed/operated insurers:

- ACE Insurance, which provide(d) excess of \$25 million to virtually all types of big business;
- Bankers Insurance Company Ltd. (BICL) for large banks with assets over \$2 billion;
- Corporate Officers and Directors (CODA) most companies except financial, nuke-utility, stockbroker, etc.
- Directors & Officers Liability Insurance Ltd (DOLI), primary facility for utilities;
- Financial Institutions Reserves Ltd. (FIRL), for large regional banks;
- Oil Casualty Insurance Ltd, an affiliate of OIL;
- Sargasso Mutual Insurance Co., for mutual life insurance companies
- Schools College & University Underwriters Ltd. (SCUUL), educator's liability market

'The Wyatt report noted that policyholder-owned insurers now hold 27.4 per cent of the primary market and 49.8 per cent of the excess D&O market based on premium volume.'⁴⁶⁶

Autumn storms

The autumn of 1987 saw history made in Bermuda when Hurricane Emily took the island by surprise and quickly swept through it causing extensive damage. Over seventy people were injured and millions of dollars of property damage were reported. The reported bill for Bermuda's insurers as a result of Emily was close to US \$50 million, more than double what the Premier thought the damage would be and a good US \$15 million more than the island's largest domestic insurer Bermuda Fire and Marine had estimated. The excess over estimates was a result of the extensive damage to the island's larger hotels, including Club Med, Elbow Beach, Marriott Castle Harbour and Trust House Forte Hotels, as well as claims for loss of business.

Europe was not spared the wrath of Mother Nature either when autumn storms ripped through at a cost of US \$4.3 billion.

The continuing Mentor saga

Mentor's never-ending saga dragged on through the mud, as liquidators Charles Kempe and Michael Arnold fought hard to keep the venue for the trial in Louisiana, despite the fact of Mentor had been based in Bermuda. *The Captive Insurance Review* reported as follows—

'The latest argument involves defendants named in the US \$700 million suit filed in New Orleans jointly requesting dismissal of the action and being rounded on by Mentor's liquidators for doing so.

'The liquidators are Charles Kempe and Michael Arnold. The defendants are of course, Mentor's parents, Ocean Drilling & Exploration (ODECO), several Mentor directors and Bermuda-based Pinnacle Reinsurance Company.

'Defendants want the case heard in Bermuda. Louisiana, they say, represents a forum shopping exercise by the liquidators, the transparent purpose of which is to take advantage of the triple damages available under the Racketeer Influenced and Corrupt Organization act.

'The liquidators have argued that if the case is heard in Bermuda, they will not be able to compel vital US -based witnesses to attend; such as:

- The former Mentor president Herman Shwide

⁴⁶⁶ *The Royal Gazette*, 27 July 1987, 'Bermuda insurers play a dominant role in D&O insurance coverage', p. 32

- Mentor actuary John Swift, said to be the repository of a wealth of information about the company's finances during its decline
- Various staff of Mentor's bankers who the liquidators hope will prove that ODECO got unsecured bank credit for Mentor in return for implied or explicit agreement (who knows which?) that ODECO could honour Mentor's debts
- Lawyers at the New York law firm of Wilson, Elser, Moskowitz, Edelman & Dicker, who gave Douglas Higley the legal opinion that Pinnacle's reinsurance contracts with the company represented a real transfer of risk.
- The D&O insurer of ODECO, an AIG unit, which is trying to get its policy null and void on the same grounds that the liquidators have used for their suit.⁴⁶⁷

Roger Scotton reported the following about Pinnacle in the *Bermuda Sun* —

'Mentor's liquidators Charles Kempe and Michael Arnold are unlikely to be losing sleep over their work. To them and no doubt to liquidators elsewhere winding up the affairs of an insolvent company is just a job, albeit one that involves an occasional court case. But at least one of the companies named in the liquidators' 10-month-old Mentor suit is losing a good deal more sleep. Bermuda-based Pinnacle Reinsurance reckons to have seen an unprecedented drop of US \$117 million in its business since the action started last March. And it claims the island's reputation as an offshore insurance centre is suffering untold damage because of the 'mere pendency' of the suit.

'Pinnacle's director Steve Lawrence says his firm is effectively fighting Bermuda's battle as well as its own. He claims that the liquidators' case threatens to set precedents that will undermine the industry and weaken the case for setting up companies here.

"There is no doubt that Bermuda's reputation is suffering as a result of this action," said Mr Lawrence this week. "And if the court in New Orleans accepts the argument put to it by Mentor's parent which says that the liquidators have no legal standing to bring the action, then Bermuda is going to look even worse."

'Yet his views are not attracting widespread domestic support. In fact Brian Hall, who heads leading insurance management company Johnson and Higgins, thinks that Bermuda's reputation has... probably benefited from the actions of its regulators over the Mentor affair. And Bermuda Insurance Association chief Stuart Grayston says the island's reputation is not now suffering any more than it has suffered already as a consequence of Mentor's collapse.

"Some of what's been happening seems a bit heavy handed, but I think it is all part of our growing up process and we just have to get to the bottom of this thing as quickly as possible."⁴⁶⁸

Charles Kempe, one of Mentor's chief liquidators and also a Bermudian, went on record with Roger Scotton, in the course of an interview for the *Bermuda Sun*, to defend his decision to try the Mentor case in Louisiana.

'... "Insolvency work is a fact of commercial life in large jurisdictions and having contracts drawn up under Bermuda law does not immune the parties against tort litigation in other jurisdictions," says Mr Kempe who last week agreed to give his first public interview since starting the suit, but studiously avoided saying anything that could be construed as commenting on the merits of the Mentor action. "Business in the Western world increasingly crosses national boundaries and it is impossible to conceive that anyone would be allowed to insulate himself in one jurisdiction against his actions in another."

'He rejects criticisms that he has succeeded in removing the gloss from Bermuda's shiny image as an attractive business domicile and argues that, if anything, his work has the opposite effect and boosts investor confidence in the island. He sees the Mentor suit as an opportunity for Bermuda to refine and improve its business infrastructure not taint it.

⁴⁶⁷ *Captive Insurance Company Review*, November 1987, 'Mentor liquidators fight for Louisiana trial', pp. 3 & 4

⁴⁶⁸ *Bermuda Sun*, 18 January 1987, 'Pinnacle fighting Bermuda's battle', by Roger Scotton

“We cannot afford to be regarded as a centre where activities can be carried on that are counter named elsewhere. In the end, Bermuda’s capabilities will only be improved by cases of international insolvencies.”⁴⁹

Where captives went wrong

On 26 October 1987 Kathryn McIntyre of *Business Insurance* wrote the following article entitled ‘Captives found trouble writing unrelated risks’, which helped to explain what went wrong with the captive insurance industry in Bermuda—

‘A logical step from success as a captive insurance company appeared to be writing commercial insurance or reinsurance for unrelated parties. It didn’t work out that way for most captives.

‘Created to underwrite the risks of their parent or affiliated companies, captives generally were very successful as long as they stuck to the business they knew and could control. When they went into full-fledged commercial insurance and reinsurance underwriting in the late 1970s and early 1980s, most captives failed miserably.

‘These new commercial companies, mostly based in Bermuda, often did not attract the experienced underwriters needed to select risks successfully. Also, the business offered to these new entrants was often substandard.

‘Worst of all, even captives that had recruited good underwriters were underwriting a large volume of business at the beginning of the most competitive insurance cycle in the history of the insurance business. Even the best business ultimately produced underwriting losses.

‘There are however some captives that survived and are still underwriting commercial insurance. The largest—GTE Reinsurance Co. Ltd. in Bermuda. Among the captives that eventually dropped out of commercial underwriting either due to large losses or other reasons are:

—Walton Insurance Co. Ltd., a subsidiary of Phillips Petroleum Co., which started writing commercial reinsurance in 1974. Walton withdrew from commercial underwriting in January 1983 after suffering large losses. Phillips took a US \$65 million after tax charge in 1982 and pumped US \$55 million into the company in October 1983....

—Mentor Insurance Ltd., a subsidiary of Ocean Drilling & Exploration Co., which started writing unrelated business in the 1970s, and stopped in January 1985. Mentor was ordered into liquidation by the Bermuda Supreme Court in March 1986. The insurer’s insolvency could be as large as US \$505.6 million, according to liquidators. The liquidators are suing ODECO and others, seeking to cover the insolvency, and are predicting they will be able to begin paying claims in 1992.

—Cambridge Reinsurance Co. Ltd., a subsidiary of National Sea Products in Nova Scotia, which stopped writing in April 1984. Cambridge Re, which filed for liquidation in April 1985, is insolvent by almost US \$64 million, its liquidators say.

—Insko Ltd., a subsidiary of Gulf Corp., which in 1977 hired former Lloyd’s of London Deputy Chairman Leslie Dew to expand its unrelated risk underwriting, stopped writing in November 1984, after the merger of Gulf with Standard Oil Co. of California....

—Ancon Insurance Co. Ltd., a subsidiary of Exxon Corp., which stopped writing in October 1984 after Exxon determined that five years of underwriting unrelated risks did not produce the anticipated profit. The company is now being managed by Johnson & Higgins.

—Horizon Insurance Co. Ltd., a subsidiary of Cargill Inc., which started writing commercial insurance in 1978 and stopped all unrelated reinsurance underwriting in September 1985.

⁴⁹ *Bermuda Sun*, 26 August 1987, ‘A chat with Mr Mentor’, by Roger Scotton

‘—Transcon Insurance Ltd., a subsidiary of Ford Motor Co., which started writing unrelated risks in 1974, greatly curtailed its unrelated risk underwriting in 1979, re-entered on a selective basis, and then completely withdrew in December 1985. It is being managed by J&H.

‘—Arion Insurance Co. Ltd., a subsidiary of Canadian Pacific Steamship Co., which announced in January that it had stopped underwriting in Bermuda, after deciding to purchase a 6.2 per cent ownership in The Charter Reinsurance Co. Ltd. in London.’⁴⁷⁰

Hoechst Celanese explosion

At the end of the year Hopewell International, Fred Reiss’ pool, which was set up in the 1970s was dealt a severe blow when the Pampa refinery of Hoechst Celanese blew up in November. *The Captive Insurance Review* reported that the damage ‘... to its 775-acre plant at Pampa, and for subsequent business interruption is set to produce the largest ever industrial fire claim. The plant was insured through Elwood Insurance, a Hoechst Celanese captive in Bermuda, and subsequently reinsured with Hopewell International, the Reiss captive pool.’⁴⁷¹

Anna Summers, one of Reiss’s early employees, recalled how the claim was eventually settled for US \$507 million but marked the beginning of the end for Hopewell Insurance. Swiss Re had been Hopewell’s major reinsurer and was always there to provide additional capacity whenever they could not fill their treaty but this time the cost may have been a bit too high even for Swiss Re.⁴⁷²

And yet, a time of hope

Despite plenty of dramas and disappointments, Bermuda’s economy received a much-needed boost from the international sector by the end of 1987 and ended the year on a positive note, with several major insurance developments in the works. Business people kept coming to test the new insurance capacity that had developed on the island and proceeded to make it work. Statistics from the Department of Tourism showed a record number of visitors with the vast majority of them being from the business sector. Perhaps at last the international insurance industry was becoming that much needed other pillar of the economy in which so many on the island had placed their trust and hope.

⁴⁷⁰ *Business Insurance*, 26 October 1987, ‘Captives found trouble writing unrelated risks’, by Kathryn McIntyre, p. 99

⁴⁷¹ *ibid.* April 1988, ‘Reiss Group goes to Swiss Re’, pp. 1–2

⁴⁷² Interview with Anna Summers and Debbie Reiss, 7 March 2002

CHAPTER 37

1988

Shifts and Turns, Triumph and Tragedy, but Hopes of Better Times Ahead

New skylines

The dark cloud, which had obscured the true makeup and legitimacy of the Bermuda international insurance industry, began to move away by 1988. According to the *Archer Report* there were 1600 insurance related companies and over 4800 other international companies operating in Bermuda. Of these approximately 260 had a physical presence on the island.⁴⁷³

The Bermuda international insurance industry made a fundamental shift in the way business was transacted on the island. Growth in the captive industry slowed down as a result of the softening commercial property and casualty insurance market, the growth of other domiciles and the passage of the 1986 Tax Reform act.

However those on the commercial property/casualty insurance and reinsurance side of Bermuda did exceedingly well. The new excess liability facilities, ACE and XL, wrote a tremendous amount of business and the financial reinsurance sector grew significantly. Commercial reinsurers on the island were also ecstatic because they were reporting profits. However, in the minds of all the company CEOs on the island was the looming threat of the London and the United States insurance markets. Kathryn McIntyre of *Business Insurance* wrote an article entitled, 'Commercial markets celebrate successes on April 16, 1988' which demonstrated the plight that Bermuda insurers were facing.

'Despite geographic separation from world insurance centres—775 miles from New York and 3,445 miles from London—Bermuda-based commercial insurers and reinsurers know their fate is inexorably tied to trends in the large insurance centres of the world.

'...But even in the face of a changing market cycle, that threatens to reduce the amount of business that is underwritten in Bermuda, there's optimism.

"Bermuda is an innovator," says Nick Cochrane, director of GHC Financial Institutions Insurance Services Ltd., a Gibbs Hartley Cooper Unit that has recently entered a joint venture in Bermuda to broker international insurance. "If you miss one cycle, there will be another. The market here is going to be something new and different."

"Bermuda holds claim as the only offshore insurance center that is home to diverse commercial insurance and reinsurance underwriters as well as captive insurers."⁴⁷⁴

⁴⁷³ Brian Hall speech to the Paget Lions Club, 22 August 1990

⁴⁷⁴ *Business Insurance*, 16 April 1988, 'Commercial markets celebrate successes', by Kathryn J. McIntyre, p. 22

The success of the Bermuda insurance industry was becoming evident to the local infrastructure also, because there was a spurt of new office construction in the city of Hamilton. Five new office buildings were constructed, including one that was to house ACE and Bermuda Fire and Marine, the domestic insurer. The partnership between ACE and Bermuda Fire and Marine marked the first time a domestic and an international insurer partnered to construct a building.

According to Cyril Rance, its chief executive, Bermuda Fire and Marine was having problems finding assets to meet its commitments. Meanwhile, across the street from its headquarters, the company owned a property that was rapidly falling into disrepair. Rance was receiving letters from the neighbours, complaining about rats coming from the building that his company owned. Thinking ahead, Rance had plans drawn up by the architectural firm of Onions Bouchard for a new office complex to replace the dilapidated building. His problem was that he had no money with which to fund such a massive project.

Then one day when Rance had gone to see John Cox and Bill Pimm of ACE to discuss some entirely unrelated projects with them he suddenly, out of the blue, said "Look John, I've got a site that needs developing and you've got the money to help me. Can we strike a deal?"

To which Cox responded, "Let's see what you've got." Rance then laid the plans out on the table and went through them step by step. Cox remained quiet throughout the presentation, but when Rance ended, Cox said, "Leave it to me."

It may be of interest to note in passing that this was the second building John Cox agreed to underwrite in Bermuda. The first, in 1982, when Cox was CEO of INA, was settled on a handshake with Brian Hall and Richard E. Meyer, when Cox agreed to partner with Johnson & Higgins in the construction of Victoria Hall. This building opened in 1985 and housed the operations of Johnson & Higgins and of INA, subsequently CIGNA.

The following week Rance received a call from Cox, telling him that he liked what he had seen and that he would be interested in pursuing a partnership with Bermuda Fire and Marine. Rance was pleased and proud when he got the call from Cox because he felt that he had reached a landmark agreement, one that would work to the benefit of ACE and of his own company, while at the same time getting rid of an eyesore on the edge of Front Street.

After many meetings, ACE agreed to put up most of the money in exchange for the land from Bermuda Fire and Marine. To thank ACE for its support, Bermuda Fire and Marine gave ACE the right to put their name on the building and to choose the space they wanted within it. The partnership worked out well for both companies as it set a trend of international companies upgrading the look of office space in Bermuda while at the same time helping the local economy by providing construction work.⁴⁷⁵

Educating Bermuda about the International Insurance Industry

Despite the growing importance of the international insurance industry in the context of the global insurance industry overall, there were still many in Bermuda who were not even aware of its significance.

Brian Hall, president of Johnson and Higgins (Bermuda), was surprised one day when a friend at the Bermuda Telephone Company (BTC) admitted that he had not the least idea of what "international business" really meant. So surprised was Hall by this that he sent a letter to Premier John Swan, suggesting more ought to be known about Bermuda's second largest industry, one that, according to government's own consultant, Dr Brian Archer, spent more than US \$232 million in

⁴⁷⁵ Telephone interview with Cyril Rance, 25 March 2003

Bermuda annually and generated some 6000 jobs. From that letter was born the concept of the *Bermuda International Business Industry Plan*, to heighten the public awareness of the insurance industry.

Hall decided that after over 40 years, of Bermuda's executives travelling their road show round the world and selling the Bermuda concept abroad, it was high time for a home run, time to put the show on the domestic stage, and to enlighten those in Bermuda who were benefiting from international business on the island but did not even know it. The spotlight would be on the vital role that international business played in the Bermuda economy and the degrees to which local and international companies were truly interdependent.

As a result, and under the leadership of Hall, the *International Business Industry Week*, which included a trade show and exposition at the Number One Shed and Harbour Room in Hamilton, was launched on 18 January 1988. A committee compiled a 60-page guide to international business for secondary schools. Robin Spencer-Arscott, President of Frank B. Hall and a member of IBI, thought that the image of the industry was richly enhanced by a new public awareness of Bermudians in key positions, among them Joe Johnson of AIG, Stuart Grayston, Brian Hall, and Andrew Carr.⁴⁷⁶

Improved communications infrastructure

Donald Lines, chief general manager of the Bank of Bermuda told *The Royal Gazette*— 'Probably the biggest reason why new international business comes to Bermuda... is because of our sophisticated communications system. Even our telephone system is state of the art.... We are probably one of the few places in the world that is totally digitalised. In New York City, you can't telephone across town without running into difficulties. But in Bermuda the communications system is very sophisticated. What you have got now is a very curious situation. The bigger we get, the more we use this electronic medium—and the more we make it impossible for others to compete with us.... We have developed an immense network of communications here, which is growing rapidly. We have actually linked the rest of the world from Bermuda, by computers and dedicated lines. We are also developing some extraordinary facilities that bring us along with the other major centres in the world. So we can actually compete on equal terms with somebody in New York City, or London, if it physically can be done.'⁴⁷⁷

Med America

Despite the Tax Reform Act of 1986, yet another company, called Med America International Insurance Ltd., a new captive of Med America Health Systems Corporation of Dayton, Ohio, decided to establish in Bermuda in 1988. *The Captive Insurance Company Review* reported on the reason why Med America decided to set up its new captive in Bermuda, to write its malpractice and professional liability risks and its wholly owned 722-bed subsidiary, Miami Valley Hospital of Dayton.

'One of the old principles of captive formation influenced the parent company: direct access to the reinsurance market secured over 50 per cent reductions in the company's reinsurance costs. That consideration obviously overran the absence of tax advantages in Bermuda—not terribly important for a non-profit making company.'⁴⁷⁸

⁴⁷⁶ *The Royal Gazette*, International Business, 21 January 1988, 'The mass marketing of international business', p. 8

⁴⁷⁷ *ibid.* 'Why Bermuda? Top businessmen explain success', p. 15

⁴⁷⁸ *Captive Insurance Company Review*, February 1988, 'New Malpractice Captive for Bermuda', p. 11

Bermuda was still able to maintain a competitive edge over other offshore domiciles despite the United States Internal Revenue Service tax threats as reported by *The Captive Insurance Company Review*—

‘Mr Felix Kloman, a principal in actuaries Tillinghast, Nelson, and Warren, told participants at the annual captive forum in Bermuda in March that the country could retain its leadership as long as both the government and exempt(ed) companies continually looked ahead and remained flexible...Kloman says Bermuda continues to be successful because “its regulations are still better adapted to multinationals’ needs than the USA’s.”⁴⁷⁹

Moves to bring the Mentor case back to Bermuda

The Mentor trial was on its way back to Bermuda. *The Captive Insurance Company Review* reported on the trial in Louisiana as follows—

‘The massive fraud lawsuit filed against the parent and officers of the failed Mentor Insurance Ltd., by Mentor liquidators may be headed to a Bermuda court following its dismissal in April by a New Orleans federal judge.

‘US District Judge Marcel Livaudais Jr, has dismissed the liquidators lawsuit against Ocean Drilling & Exploration Co (ODECO)—Mentor’s ultimate parent— and 10 other defendants on the grounds that the Bermuda Supreme Court— which appointed Mentor’s liquidators in 1985 —would be a more convenient forum for the 25-month old litigation.’⁴⁸⁰

Many people involved in Bermuda’s international insurance industry viewed this as a major victory and precedent for the future, offering as it did a shield against further encroachments on the Bermuda international insurance scene by the law courts of the United States.

Reiss Group sold to Swiss Re

The Reiss Group, the first company to make ‘captives’ a household name in the insurance industry, was sold to Swiss Re Corporation, thus marking the end of what had once been in its own right a cornerstone of the industry. Sixty two year old Fred Reiss, whose health was beginning to fail, decided he would no longer carry on struggling to fill his reinsurance treaties regardless of the disruption and damage caused by the Hoechst Celanese explosion and fire. Instead he decided to sell his company to Swiss Re, so that he could take early retirement from the industry.⁴⁸¹

In April 1988 *The Captive Insurance Review* reported on the sale to Swiss Re ‘...Fred M. Reiss has agreed to the acquisition by Swiss Re of his Bermuda-based consulting and management business, though he is expected to retain control and ownership of Transnational Ltd., a Cayman-based underwriting manager...The Reiss organization is one of the original and one of the largest managers of captive insurance companies. Its main operations are in the United States, the United Kingdom, Bermuda and Grand Cayman. It advises on risk engineering, underwriting and reinsurance for more than 150 captive insurance companies which it manages for large international commercial firms.’⁴⁸²

One month later *The Captive Insurance Company Review* further reported that, ‘The Reiss captive management group, sold recently to Swiss Re, is to be reorganized under a Bermuda-based holding company to be called International Risk Management Group Ltd. Former Vice Chairman Arthur Deters, has been chosen to lead the new organization.’⁴⁸³

⁴⁷⁹ *ibid.* April 1988, ‘Bermuda still in the lead’, pp. 3 & 20

⁴⁸⁰ *Captive Insurance Company Review*, May 1988, ‘Mentor headed for Bermuda Trial’, p. 7

⁴⁸¹ Interview with Anna Summers and Debbie Reiss, 7 March 2002

⁴⁸² *Captive Insurance Company Review*, April 1988, ‘Reiss Group goes to Swiss Re’, pp. 1–2

⁴⁸³ *Captive Insurance Company Review*, May 1988, ‘Reiss’ New Name’, p. 13

However, not all of Reiss' empire was sold to Swiss Re. As reported by the *Bermuda Sun*, '...Reiss is expected to retain control and ownership of Cayman based Transnational—a commercial market reinsurer formed in 1975—and Transnational House, an office and hotel building in the Caymans. Transnational was one of the founding shareholders of another Cayman company called United Insurance Company which, in turn, owns the Universal Insurance Company of Ireland, a firm headquartered in Shannon. It is understood that these and several other companies not directly connected to the Reiss Organization are unlikely to form a part of the sale to Swiss.'⁴⁸⁴

Reiss was expected to remain in Bermuda and to act in the capacity of chairman of the group.

Aneco taken over by Forum Re

After Forum Re's hostile bid to take over Aneco Re was rejected by the Aneco board, Forum Re came back with a much higher offer for the company. As a result, 'the Board of Aneco, whose operating subsidiary Aneco Reinsurance Underwriting is Bermuda's largest captive reinsurer, has unanimously recommended acceptance of Forum Investment's US \$7 million bid for controlling interest. The decision was revealed just after Aneco announced that its underwriting income increased nearly 400 per cent to US \$1.9 million in 1987.'⁴⁸⁵

Nuclear Mutual and Nuclear Electric move out of Bermuda

Despite the effects of the Tax Reform Act of 1986, some companies decided to remain in Bermuda and some decided to incorporate in Bermuda for the first time. There were others who thought the changes in the Tax Reform Act were far too much for them to bear and therefore left the island.

Nuclear Mutual and Nuclear Electric—the two nuclear power captives—decided that the tax savings by redomesticating onshore in the United States outweighed any advantages they would receive from continuing to operate in Bermuda under the provisions of the Tax Reform Act. Moreover all of their shareholders were Americans and would be liable for current year taxes on income to be derived from an offshore captive's insurance of American risks. As a result, both these captives left the island to redomesticate in the United States.

A much-needed boost from the Humana decision

On 27 July 1988 a tax ruling handed down by the United States Circuit Court of Appeals in Cincinnati provided an unexpected boost to the captive industry. The court ruled that, whereas the results of a captive subsidiary did affect the balance sheet of a parent company, they did not affect companies that were simply affiliated in the same group. Henceforth premiums paid to United States owned captives could be deducted from the tax liability of the company making the payment, provided that the payer was a sister company of the captive and not its parent. This ruling overturned the 'economic family' theory that had been used by the IRS in the past to deny tax deductibility of insurance payments between related companies. In so doing the Court brought to an end nine years of dispute between the Kentucky-based hospital chain, Humana, and the Internal Revenue Service (IRS).

The Bermuda international insurance industry applauded the Humana decision, but it had seen too many tax breaks coming and going in the past for it to base a strategy on yet one more ruling alone, favourable though that ruling might appear to be. The industry had no wish to depend too much on the United States as a marketplace, least of all on how that market might be demarcated from time to time by the US Courts of Appeal. Instead the industry saw clearly now that trying to

⁴⁸⁴ *Bermuda Sun*, 18 March 1988, 'Reiss deal simmering', p. 10

⁴⁸⁵ *Captive Insurance Company Review*, April 1988, 'Aneco Agrees takeover by Forum Re', p. 20

build more business on tax breaks alone would narrow to very short term prospects its hopes of future expansion. Instead it would continue to pursue new opportunities elsewhere. Bermuda began to look to the Far East.

Accountants call for tougher insurance regulations

Though Bermuda was starting to enjoy an influx of new insurers, three of the local accounting firms were concerned as to whether certain of these newcomers were following the rules of the Bermuda regulatory environment. Arthur Anderson, Ernst & Whinney and Touche Ross started to call for tighter regulation of those companies that were incorporated in Bermuda but were managed from other jurisdiction. They feared a repeat of the early 1980s, when companies such as Ajax ran into trouble and were without any management in Bermuda. The accountants were also concerned about the 'difficulties they had encountered when liquidating insurers maintain their accounts outside of Bermuda.'⁴⁸⁶

The accountants did not so much insist on fundamental regulatory requirements be enforced more rigorously, they wanted records to be kept in Bermuda and local principal representatives to be informed of what was happening to their companies overall. Some accounting firms went so far as to refuse to conduct audits on companies whose records were held overseas.

Piper Alpha oil rig explosion

One day after a beleaguered Bermuda Fire and Marine signed with London's Sun Alliance a memorandum of intent to help it with the book of business previously written by the London Weavers Agencies,⁴⁸⁷ a catastrophic event occurred in the North Sea. This loss would worsen the results of the Bermuda Fire and Marine because of its participation in Lloyd's. The XL MidOcean annual report described it as follows—

'On the afternoon of July 6, 1988, workers on the *Piper Alpha* oil platform in the North Sea, began routine maintenance on a pressure safety valve (PSV) in the condensate piping system of the rig. The valve was on the same network as a condensate injection pump, Pump A, which was also shut down for maintenance. By the end of the shift, the workers had sealed the PSV with a flange and tested it successfully. The valve was not placed back on line as the equipment needed for this operation was unavailable, and the workers agreed that they would return to this problem in the morning.

'The next shift began at 6:00 p.m. that night, and *Piper Alpha* operations continued as normal throughout the oil platform. At 9:45 p.m., a condensate injection pump, Pump B, suddenly went off line, and the workers began a manual switchover to condensate Pump A, unaware that its system was compromised.

'The night shift workers soon heard a loud "human-like scream"—the noise of the pressurized condensate pushing through the PSV flange on the Pump A system. Flammable gas quickly filled the area and alarms were sounded. At 10:00 p.m., a massive explosion devastated the area, and ignited an oil fire at the northern end of *Piper Alpha*. By 10:20 p.m., another explosion rocketed the rig, fuelled by the reserves of oil on *Piper Alpha* and those piped to it by other rigs, and engulfed the operation in flames and toxic black smoke. Ten minutes later, a third explosion initiated the *Piper Alpha*'s disintegration into the ocean, which a fourth explosion at 11:18 p.m. aided. Finally, by 12:15 pm—less than two hours after the original explosion—most of *Piper Alpha* had collapsed into the North Sea, and the fires on board blazed over the rest of the doomed oilrig.

'167 workers died in the *Piper Alpha* disaster, including two rescuers. Later, it was reported that the two main factors contributing to this high death count were poor communication and inadequate safety

⁴⁸⁶ *Captive Insurance Company Review*, July 1988, 'Call for tighter regulation in Bermuda', p. 7

⁴⁸⁷ *ibid.* July 1988, 'Sun Alliance link with BF&M', p. 7

training... In the end, most of the 61 survivors jumped into the North Sea to safety, while the rest were saved off the platform by the few rescue vehicles able to manoeuvre amongst the explosions.

'After the disaster, Occidental Petroleum Corporation, who owned the *Piper Alpha*, shut down the pipeline, which serviced 5 other rigs, and did not resume operations in that field until 1993. This temporary shutdown cut British North Sea oil production by almost 13 per cent, resulting in billions of dollars in lost revenue alone. Insurance figures, however, called for many more millions of dollars in damages and human casualties, making the *Piper Alpha* incident the most deadly and most costly disaster in the history of offshore oil exploration.¹⁴⁸⁸

'Not only was *Piper Alpha* the worst single loss ever suffered by marine underwriters (estimated at US \$1.25 to US \$1.5 billion) but at only halfway through the calendar year it followed what was already threatening to be the worst year in marine underwriting history. The market had already sustained the impact of the Mexican storms in January, followed by the sinking of the *Rei Jin*, a brand new Japanese car carrier with full cargo, and then the total loss of the Brazilian platform *Enchova* which, prior to *Piper Alpha*, was the largest energy loss in history.¹⁴⁸⁹

The four main partners in the *Piper Alpha* joint venture included Occidental Petroleum, Texaco, Union Texas Petroleum and International Thomson, with Occidental Petroleum acting as the operator. So Occidental was to carry the bulk of the loss as it was the operator and, in the oil industry, if the operator is found to be negligent, it may be required to cover the loss in its entirety. The *Piper Alpha* platform was mainly insured through Lloyd's and this disaster brought to light the problems within their reinsurance practices, as reported by Jonathan Marland in *The Review – Worldwide Reinsurance* magazine—

'The assessment of the original loss was aided by a prompt and detailed summary of the participants and their insurance arrangements by the main placing broker, Willis Faber. Occidental Petroleum were the operators of the platform and owned 36.5 per cent of it. Union Texas Petroleum and Thompson North Sea both owned 20 per cent and Texaco had a 23.5 per cent stake. Sadly, the loss to London does not end there. The UK market has gradually become heavily oriented towards reinsurance. UK reinsurance companies are characteristically incestuous and in their hunger for premium they have been offering reinsurance facilities to overseas companies. It is this, in addition to the original loss, that makes the *Piper Alpha* disaster an unprecedented event and one which is fascinating to observe.

'The unprecedented nature of the catastrophe is easily demonstrated by the fact that up until now, the London market has never had to sustain an immediate cash payout for the direct portion of a 'mega' loss. Previous 'mega' events have been hurricanes such as Betsy and Alicia, when the London market was acting as a reinsurance one. As a result, they have paid the loss second hand, as either a proportional reinsurance or when the loss has reached the deductibles of US companies excess of loss programmes. Furthermore, because many policyholders are involved with the claims, settlements are over an extended period of time.

'...Difficulties will also be caused by the "spiral"—a problem specific to excess of loss underwriters. For a pure direct underwriter, the gross and net losses are readily quantifiable. In the current market, however, underwriters have ventured into excess of loss with gusto either to substantiate their otherwise falling direct income or as excess of loss specialist underwriters. The result is that A reinsures B, B to C, C to D, C back to A, D back to C and so on. The spiral is created by the claim progressing through excess of loss account reinsurance protections. It follows that D may be covering his own loss back again as a reinsurance of C. In the final analysis, the original claim may be \$1.25 - \$1.5 bn but the reinsurance claim could be three or more times that amount.¹⁴⁹⁰

¹⁴⁸⁸ *XL MidOcean Annual Report 1999*, 'Piper Alpha disaster', p. 36

¹⁴⁸⁹ *The Review-Worldwide Reinsurance*, October 1988, 'Piper Alpha When Disaster Strikes', by Jonathan Marland, pp. 5-7

¹⁴⁹⁰ *ibid.*

Mr Walter Scott, chairman, president and chief executive officer of ACE, cited the *Piper Alpha* North Sea oil platform disaster as an example of why Bermuda was beginning to see more referrals from major European insurance companies. Kevin Stevenson reported on the *Piper Alpha* loss as follows—

‘European businesses are becoming more aware of their increasing liability exposure, not only through their operations in the US, but also through their increasing liability exposures that exist in their own backyard.

‘Mr (Walter) Scott (President and chief executive officer of ACE) uses the *Piper Alpha* North Sea oil platform disaster as an example. A total of 167 men were killed when *Piper Alpha* blew up in 1988. Liability settlements were in the US \$1 million to US \$1.5 million range for each of the victims, “five times the statutory rate had an individual died on the docks,” said Mr Scott. “This has caused inflation in liability settlements. There is an expanding concern about the consumer and the individual in Europe. This is an export from the US.”⁴⁹¹

Centre Re formed

As the London market faced the serious consequences of *Piper Alpha*, a partnership that had first been formed back in the 1970s between two Americans out in Iran was about to change the face of financial reinsurance around the world. It would introduce the term ‘finite risk’ to the insurance industry and would revolutionise the way financial reinsurance was bought.

Steven Gluckstern and Michael Palm had been highly qualified schoolteachers who, like many others in their profession became frustrated by their lack of financial prospects. They decided to do something about it.

As a result of the Iranian revolution in 1979 the pair of them returned to the United States, where they went their separate ways until 1986. Then, far away from their schoolroom days, they came together again and conceived a plan. In a series of articles for *Bermudian* magazine Kevin Stevenson wrote about the history of Centre Re as follows—

‘Steven Gluckstern was a superintendent of schools for a small district in rural Colorado when, in 1981, he came to an important realization. “I woke up one morning and concluded that I really didn’t want to be poor for the rest of my life,” said Mr Gluckstern. “In the US it is very, very difficult for the main breadwinner in a family to make enough money to raise a family, own your own home, and give your children the type of things you want to give them.”

‘So at the age of twenty-nine, Mr Gluckstern enrolled in the MBA (Master of Business Administration) programme at Stanford University in California. “I had no idea of what I wanted to do, “says Mr Gluckstern... “I had been a teacher and administrator, and I told myself, “I want to do the opposite of teaching... and what would be the exact opposite job—to become an investment banker and go to Wall Street.”

Mr Gluckstern first signed up with investment bankers Lehman Brothers before joining a dental distribution company as its chief financial officer. It was while with the later company, where he was “selling false teeth, dental bits”, that he was approached by Warren Buffet’s organisation, Berkshire Hathaway, to see if he was interested in the reinsurance business. He initially turned down the offer, but upon reflection, accepted it. And just three years out of business school he became president of a huge reinsurance company, about which he knew absolutely nothing.

““It was like being in a Groucho Marx joke, you know, the story, ‘Why would you join a club that would have you as a member?’ I said these people must be out of their minds, I don’t even know what reinsurance is, and they want me to be president of the company.

⁴⁹¹ *Bermudian special reprint for Centre Reinsurance Holdings (Bermuda) Limited* (Articles previously appeared in January 1992 and April 1993 *Bermudian* magazine), ‘Bermuda’s Billion Dollar Club, pushing the boundaries of insurance’, by Kevin Stevenson, pp. 7–13

“It turned out they weren’t out of their minds, they were brilliant people, and I went to work for them in the beginning of 1986. I knew nothing about reinsurance, not one thing, and I went out and read everything I could possibly read. I studied as much as I could, leaving my family and moving to Philadelphia. I worked all day and read all night. I didn’t sleep for three months, but finally I put my head up for air in April, and I was beginning to get an idea of what’s happening in this business.”⁴⁹²

“But it’s an industry full of jargon, and in the very beginning I had to have an interpreter with me. I would say, ‘Excuse me for a second’, and whisper to the person next to me, ‘What does excess of loss mean?’ Literally, it was something out of a movie, but in about six months I felt that I had been grounded enough. I wrote a business plan for Centre Re, though it wasn’t then Centre Re, it was a business plan for the company I worked for. It turned out it wasn’t compatible with what my employers wanted, it really wasn’t, so after one year I quit. I walked out with my partner, Michael Palm.” (In 1986, Mr Palm joined Mr Gluckstern at Berkshire Hathaway, where they would eventually hatch the plan that would lead to Centre Re. “We didn’t know a single thing about reinsurance,” admitted Mr Palm. “We were a great pair and were evenly matched. It was a crazy year, 1986, with reinsurance prices going through the roof.”)

“By 1987 we had the plan for Centre Re, and left Berkshire Hathaway to raise money. Some people thought we were lunatics because between the two of us we had less than two years’ experience in reinsurance, yet we were trying one of the biggest start-ups in terms of capital.

“But we did have ten years of solid banking and corporate finance experience, and we brought to the table a different and arguably more sophisticated perspective.”⁴⁹³

‘Armed with this idea, both Mr Gluckstern and Mr Palm started out to raise half a billion dollars during Christmas 1986. “Consider the fact that we had eighteen months experience in the reinsurance industry between us,” says Mr Gluckstern. “But, we knew we had a great plan, and we went out and started pounding the pavement. Guy Carpenter helped us with a little seed money, and J.P. Morgan agreed to help raise the funds, and over the course of 1987, we raised the money we required.

“Fundamentally it was the right idea, the theoretical basis of the company—and this company was formed on a theoretical basis—was compelling. It wasn’t as if we said, ‘I think this idea might work.’ It was an economically rational argument. We were convinced that if you keep pounding away at people, and if you were right, people would buy the product.”

‘The theory behind Centre Re was that traditional insurance was not insurance at all. It was merely a financing mechanism, and there had to be a better way.

“Large buyers of risk at the end of the day don’t really transfer risk to anybody because no insurance company in the world is either big enough or stupid enough to keep taking losses,” says Mr Gluckstern. “In the long run buyers of insurance have got to pay their own freight. Nobody is going to take losses for free.

“And if that’s true, then the notion of charging huge risks charges is wrong (is all wrong). They shouldn’t charge a risk charge because they haven’t taken a risk. They are just going to turn around the next year and double the premium and make you buy it.

“Did the insurance company really take a risk? No, they didn’t. What they did is finance you.

“And the question is, can you do that more economically? You don’t have to buy an infinite amount of coverage, only a finite amount. And, by the way, if you don’t have any losses, we give you back your money, and if you have losses, too bad, I think I’ll go home.’

⁴⁹² *Bermudian special reprint for Centre Reinsurance Holdings (Bermuda) Limited* (Articles previously appeared in January 1992 and April 1993 *Bermudian* magazine), ‘At the Centre of it all’, by Kevin Stevenson, pp. 15–19

⁴⁹³ *op. cit.*, ‘The Silent Partner at Centre Re, an interview with Michael Palm’, by Kevin Stevenson, pp. 4–6

“This is the sort of stylised view, but that was the theory; that people in the long run have to pay their own freight.”

‘Armed with a detailed business plan, both Mr Gluckstern and Mr Palm set out to raise an unheard amount of capital—ideally almost half a billion dollars, though in the end US \$250 million was committed—to set up Centre Re. They were successful in a remarkably short period of time.’⁴⁹⁴

“I remember meeting Steven in New York and having lunch with him,” said a Bermuda insurance industry leader. “He told me he wanted to start up a new type of reinsurer and liked the idea of setting up in Bermuda. He explained that he was a schoolteacher and that he didn’t know anything about reinsurance. Then he asked me if I knew how I could raise US \$250 million.”⁴⁹⁵

“We didn’t build factories, and as a result we were able to say, ‘Hey, give us your capital and we’ll go out and sell this. If it doesn’t sell, we’ll give you back your money. We just need your money in a bank account so people think we are creditable.’ And that’s what enabled us to raise that kind of money. The amount was unheard of, but it made sense because we weren’t going out and buying bricks and mortar.”⁴⁹⁶

“As they say, the rest is history.”

‘Centre Re opened its door in 1988 with “US \$250million in start up capital, itself an unheard of amount of money for a type of reinsurance about which no one seemed to know much.”’⁴⁹⁷

‘Mr Gluckstern concedes that financial reinsurance isn’t anything new. But the notion that a company would devote all its resources into this one area was unique.

“I think we were the first company, with maybe the exception of Pinnacle, that said, ‘This is what we want to do,’” says Mr Gluckstern. “People have thought about these ideas for years and years. It wasn’t anything radical or new, but insurance companies have historically dabbled in the business. And when pricing got better in the traditional business, they would take their capital elsewhere.

“Our conclusion was that the idea was compelling enough that you could have a full-time business doing this stuff, and if you did more of it than anyone else in the world, you’d go down what’s called the ‘learning curve’. You’d be the best at doing it if that’s all you did, and you’d learn more about the techniques and pitfalls, how to apply it, how to sell it.”⁴⁹⁸

‘Gluckstern and Palm followed a vision despite the doubters who thought they were insane. Perhaps they were a little insane. Most sane people would be too scared to ask for that type of money. Only the insane go where no one else will go—or so society would like us to believe. It was through their insanity that Gluckstern and Palm “managed to revolutionise the way people thought of financial or “finite” reinsurance.

“When we started Centre Re, we did so in response to what we saw as pressures and disequilibria in the industry, which could lead to structural changes. Our goal was to make Centre Re a stabilizing element, stressing continuity and stability. We said to ourselves there had to be changes because the industry couldn’t accept such volatility.”⁴⁹⁹

‘Centre Re “is a good story—we’ve built a very powerful company in a very short period of time. It’s a story about people who believed in something, who thought about it theoretically, who had the vision and who went out there and sold it to people. Then they got lucky enough for it to be right—and there’s a lot of luck to that part, that’s why it’s a good story.”’⁵⁰⁰

⁴⁹⁴ *Bermudian special reprint for Centre Reinsurance Holdings (Bermuda) Limited* (Articles previously appeared in January 1992 and April 1993 Bermudian magazine), ‘At the Centre of it all’, by Kevin Stevenson, pp. 15–19

⁴⁹⁵ *op. cit.* ‘The Silent Partner at Centre Re, an interview with Michael Palm’, by Kevin Stevenson, pp. 4–6

⁴⁹⁶ *op. cit.* ‘At the Centre of it all’, by Kevin Stevenson, pp. 15–19

⁴⁹⁷ *op. cit.* ‘The Silent Partner at Centre Re, an interview with Michael Palm’, by Kevin Stevenson, pp. 4–6

⁴⁹⁸ *op. cit.* ‘At the Centre of it all’, by Kevin Stevenson, pp. 15–19

⁴⁹⁹ *op. cit.* ‘The Silent Partner at Centre Re, an interview with Michael Palm’, by Kevin Stevenson, pp. 4–6

⁵⁰⁰ *op. cit.* ‘At the Centre of it all’, by Kevin Stevenson, pp. 15–19

'According to Alan Levin, Managing Director, Standard & Poor's, Centre Re raised the ante on Alternative Risk Transfers (ART). They were able to put US \$250 million on the table and thereby established themselves as a real player. It was unheard of to raise US \$250 million in capital before writing one piece of business. And it was because of Centre Re's bold move into ART that small players were left out of the picture. No longer could those finite risk carriers with US \$20 million sit at the same table with the mighty Centre Re.

'It was generally believed that if people were willing to put that kind of money into a business, the backers would look closely at how it was operated so many believe a large operation like Centre Re would be better managed and operated. And therefore, clients chose Centre Re over the smaller players.'⁵⁰¹

David Whiting of Swiss Re New Markets in Bermuda and formerly of Centre Re believes that because Centre Re opened the world's eyes to the benefits of financial reinsurance, many of the smaller players actually benefited from Centre Re's presence in the marketplace.

Brian Hall becomes first non-American partner at J&H

'Then to end the year, in a vote of confidence of the Bermuda Insurance marketplace, Johnson and Higgins (J&H) announced that effective January 1, 1989, Brian Hall was to become the first non-American partner of J&H. This announcement marked the appointment of the first foreigner to the firm's all-American board. Hall became one of the four top executives who joined J&H's board at the end of the year, which brought the total number of partners in the New York based group to 39. Hall was not only the first non-United States citizen to be admitted to the group's inner sanctum of controlling partners, but also the first from the captive management side of the group's largely broking and consulting-dominated business.'⁵⁰²

Scandinavian Reinsurance Company formed

In addition to the news of Centre Re's formation the insurance industry in Bermuda received another boost with the announcement that a new financial reinsurer, Scandinavian Reinsurance Company Limited, a subsidiary of Sirius Insurance Group of Stockholm, with an initial capitalization of US \$25 million had plans to form on the island. The company was headed by Jens Juul, who was the former head of GTE Reinsurance. Scandinavian Re covered financial reinsurance and reinsurance programs, including loss portfolio transfers, prospective and retrospective aggregate covers, funded excess layers and surplus relief transactions.⁵⁰³

As reported by *The Bermudian*, Scandinavian Re head Jens Juul and David Brining believed that—

'The road to success lay in offering clients intellectual products individually designed to fit particular situations. Their idea was to address the total risk management needs of a company, unlike the traditional market where brokers and ceding insurers pluck products off the shelf, set the price and send them out into the subscription market.

'Scandinavian Re's ultimate parent, the ABB Group, told Juul and Brining that if they could meet their first year's business plan the Swiss based giant would double Scandinavian Re's capital base from US \$25 million to US \$50 million at year-end.'⁵⁰⁴

⁵⁰¹ Interview with Alan Levin, Karole Dill Barkley, Olga Kalinina, Standard & Poor's, 30 October 2002

⁵⁰² *Bermuda Sun*, Business, 16 December 1988, 'J&H Partnership Deal Boost for Bermuda', p. 12

⁵⁰³ *Captive Insurance Review*, October 1988, 'Sirius sets up Bermuda Financial Reinsurer', p. 16

⁵⁰⁴ *Bermudian Business*, Summer 1998, 'The quiet success story, Scandinavian Re emerges as a major player in the finite risk arena', by Kevin Stevenson, pp. 46-51

United States/Bermuda tax convention ratified at last

In 1988 Premier John Swan still led a double life—going back and forth to Washington, without anyone in Bermuda knowing what he was doing, to try to get the Bermuda tax convention ratified. By this time George Bush Sr. was the President of the United States and Swan looked upon Bush's appointment as positive for Bermuda. President Bush had around him people like George Schultz, who was supportive of the Bermuda cause. Swan knew he had to win over members of the Treasury to get his amendments through, because James Baker, the Secretary of the Treasury, was vehemently against any amendments to the Convention.

Fortunately for Swan, Colin Powell, formerly the National Security Advisor under Reagan, had by that time become Joint Chief of Staff under Bush and was one of Swan's greatest supporters. Swan was grateful for any such support that he could find, because he was faced with formidable adversaries, not only in the United States but also back in his home country of Bermuda as well.

After years of patient diplomacy and thanks to the backing of a majority in the United States Cabinet, Swan negotiated increasing support for the revision of the United States/Bermuda Taxation Convention. Once he had advocates in Congress, they in turn began to convince others to amend the legislation so that the benefits originally intended might be realised. Many came to believe that ratification would be one of the keys to continued good relations between Bermuda and the United States.

Among Bermuda's basic requirements were that US federal excise taxes on premiums paid to Bermuda insurers should be eliminated, that businessmen should be allowed to offset expenses incurred attending conventions in Bermuda against their US tax liabilities and that US tax payers be allowed to obtain Foreign Sales Corporation tax benefits by exporting through qualifying companies in Bermuda. The most important requirement of all was that there be mutual assistance in tax matters, including the exchange of information.

However the Senate Committee raised concerns respecting the terms of the agreement. Foremost among these was the reduction of income tax on United States income earned by residents of a country that imposed no income tax within its own jurisdiction. Therefore the Committee decided that in fairness to other income paying citizens of the United States it must subject its approval of the Convention to the following reservations. First it regarded the waiver of excise taxes on insurance premiums earned by Bermuda companies insuring United States risks and noted that the other jurisdictions exempted from this tax did levy their own income taxes. This raised the question of whether it was equitable to waive the excise tax requirement for Bermuda, which had no income tax itself. However, the Committee did recognise the competitive disadvantage Bermuda would be placed under by the exemption that Barbados enjoyed in its tax treaty with the United States. It was decided to eliminate the waiver from the Barbados treaty as of 1 January 1990 and to grant Bermuda an equivalent waiver *pro tempore* until the same date, thereby putting both Bermuda and Barbados on an equal footing as far as excise taxes were concerned.

The second reservation involved the introduction of Related Persons Insurance Income (RPII) taxes, which meant that companies such as ACE and XL had to revamp their corporate structures completely so as to save their nonsponsor shareholders from heavy assessments of tax.

While so deeply involved in the Bermuda/United States tax convention, Swan still had to undertake many other projects that waited for him at home in Bermuda. Yet he knew he must keep up the momentum that was gaining in the United States as far as amendments to the convention were concerned. His level of stress was at an all time high but he said his wife was an enormous support, as were those civil servants who helped him through this long and arduous task. He does not know if he would have had the strength to carry on without their support. At times the cynicism was so great that he began to question why he bothered but he knew he had to do so if Bermuda was to prosper.

The end game began when George Schultz, Colin Powell, John Swan, and a businessman who was the guest of Swan, gathered together and planned the last stages of their campaign to get the convention modified. They decided on their course of action and went about doing what had to be done. Swan was in China later that year when a call came through about certain aspects of the amendment and he provided the answers.

Finally his efforts to win over the House of Representatives and some 300 members of the Senate began to show positive results. He started to receive indications that he was gaining support from the Senate. At the eleventh hour Senator Metzenbaum intervened. After several meetings he persuaded Rostenkowski to drop his objections and cleared the way for the passage of his amendment through Congress.

Swan was concerned that Colin Powell in particular should be at ease with the way matters were proceeding. Meanwhile, unbeknownst to Metzenbaum, Colin Powell himself had enquired as to the details of Metzenbaum's amendment and was seeking ways of getting it ratified. He found this to be outside his own authority but he knew that Schultz and the President approved of the amendments so in general things seemed to be well in hand.

Came the last hour of the last session of the 200th Congress of the United States. The Speaker declared it to be the final session. At that moment a member stood up and proposed an amendment to legislation. It was 3:40 in the morning. Senator Metzenbaum's amendment was voted through Congress. The Bermuda Tax Convention was ratified.

So 1988 ended on a high note for Bermuda. The new Convention now put Bermuda on a level footing with Barbados. *The Captive Insurance Company Reviews* reported—

'Barbados has won much offshore captive business in the past couple of years by being alone among the offshore captive havens in escaping the excise tax net through its double tax agreement. The good news for Bermuda now is that its own long-stalled no-reinsurance-excise-tax treaty with the United States is to be approved to run to the first of January 1990. The bad news for both Bermuda and Barbados is that thereafter neither will be exempt from excise tax.'⁵⁰⁵

Once Bermuda and Barbados were on an even footing, XL no longer saw any reason to be in Barbados. Bermuda was easier for clients to get to and had a favourable regulatory environment. XL moved its headquarters to Bermuda. With the ratification of the tax convention, Bermuda went from being a secondary to being a primary choice of domicile in which companies would base their headquarters.

The other interesting point about the new tax convention was that it put Bermuda on a par with Vermont. Bermuda was also helped by the Technical Corrections Act because one section of that allowed a US controlled foreign corporation in Bermuda to elect to be treated as a domestic United States corporation for tax purposes, thus avoiding liability for special excise taxes.

Roger Crombie, author of *Conyers Dill & Pearman, A History* wrote of John Swan's efforts to have the United States/Bermuda Tax Convention ratified—

'The Taxation Convention is the greatest achievement of Premier Sir John Swan's 13 years in office. The Convention allowed American companies holding business meetings or conventions in Bermuda to write off the cost of the trip in computing their US taxation. Failure to achieve this concession might have crippled Bermuda's growing convention business.

'In return, the Bermuda Government agreed to co-operate with the American authorities when they presented *prima facie* evidence of financial wrongdoing by a Bermuda-registered company. Under the agreement, so called "fishing expeditions" would not be tolerated by the Government of Bermuda. A fishing expedition occurs when authorities in one country believe that an individual or company might bear closer scrutiny, although necessary evidence of malfeasance has not yet presented itself. The

⁵⁰⁵ *Captive Insurance Company Review*, October 1988, 'USA Excise Tax Hike on way', p.16

Bermuda Government was, and is, willing to look into an allegation of wrongdoing when suitable evidence is presented.

The 1988 Convention also designated Bermuda as a country qualifying, under the 1986 Internal Revenue Code, as an FSC jurisdiction. An FSC is a Foreign Sales Corporation, a corporate vehicle designed to encourage the export of products manufactured in the United States. Exclusions from income tax, combined with allowable deductions for depreciation of assets and interest payments, enable an FSC to accumulate earnings free of taxation.⁵⁰⁶

Despite the controversy that was created as a result of the Tax Convention, it was actually this convention that some years later saved Bermuda from being labelled as a tax haven by the OECD. When it signed the convention with the United States, Bermuda also agreed to exchange information with the US government about tax evaders. The OECD looked favourably on Bermuda for having established this link with the United States and the Tax Convention became the cornerstone of the OECD negotiations.

Mike Murphy, of American International Company, said that John Swan was a key player in the tax convention negotiations. He looked on Swan as a true statesman who knew how to play the political game in Washington and therefore did an excellent job in winning over US senators. Murphy said that although Swan was not fully versed in the details of the convention being negotiated, he always did the right things. He knew how to leave the technical aspects to those who best understood them, while he covered the big picture issues. Swan took the time to understand the American process. He knew how to 'walk the fence post' in the United States manner.⁵⁰⁷

Premier Swan said that after the 1981 strikes in Bermuda he saw tourism begin to decline and he doubted that it would ever recover. It was this realisation that pushed him to pursue the United States Bermuda tax convention, because he could see that Bermuda needed something more than tourism if its prosperity was to be maintained. He holds that the Bermuda of today is the result of a process begun in 1983 and completed in 1988. He recognises that a moment of opportunity comes but once and that once it's gone, it's gone for good. It was with this fundamental truth in mind that he pursued the United States/Bermuda Taxation Convention until he brought matters to a favourable resolution in 1988. He concluded an interview with this writer by saying, 'A country without a vision will perish.'⁵⁰⁸

A major contributor to the Gross Domestic Product

By the end of 1988 the capital and surplus in the Bermuda insurance industry had reached US \$15 billion. Total assets exceeded US \$40 billion, with the total number of international companies on the Bermuda register at 5689. The Bermuda insurance industry was a significant contributor to the Gross Domestic Product and also made a valuable contribution to the industry worldwide.

Signs and portents

Seeing the growing importance of the international insurance industry to the island, and also the devastation that Hurricane Emily wrought upon the people of Bermuda, the government of the day commissioned a review of how the island could be better prepared for a hurricane of such magnitude in the future. The review was carried out by the Emergency Measures Organisation and concluded that the Bermuda Electric Light Company (BELCO) should bury its cables underground to prevent such island wide blackouts from occurring again.

⁵⁰⁶ Roger Crombie: *Conyers Dill & Pearman: A History*, Chapter 35, 'New Spirit', pp. 252–253

⁵⁰⁷ Interview with Mike Murphy

⁵⁰⁸ Interview with Sir John Swan, 19 November 2002

There was growing concern on the island about the widespread talk of becoming independent from Britain. Those who did not think the timing was right for this circulated a petition against Independence and some 5,000 Bermudians signed it.

On the other hand, as though to signal that the island was losing its isolation from the rest of the world and was fast becoming in its own right a fully accredited member of the global village, Bermuda's first cable company, Cablevision, began transmitting in July 1988.

Yet not even the record number of tourist coming to the island in 1987 had been enough to rescue the financially troubled Bermudiana Hotel, which finally closed its doors on 30 October 1988. This served only to emphasise the urgent need for another pillar to set alongside tourism. There were many observers who feared that the closing of the Bermudiana would not be the last of its kind.

Then, on the night of 21 December, just four days before Christmas, a world forgetful, or as yet still unlearned in the full horrors of extremist malevolence, was shaken by shock and disbelief. At 6:25 p.m. that evening Pan Am Flight 103 took off from London's Heathrow airport and headed northwest on its way to New York and Detroit. Just 38 minutes later, as the Boeing 747-121 was crossing from England into Scotland at 31,000 feet, above the little border town of Lockerbie, the aircraft was shattered by an explosion within the hold.

All 259 passengers and crew were killed as the hail of wreckage fell to earth. Sections of the aircraft, one with 60 bodies inside, landed in the streets of Lockerbie six miles below. A jet engine gouged an enormous crater. One wing fell directly on three houses, creating a fireball. Deaths on the ground brought the toll of lives to a total of 270. The crash was one of the United Kingdom's worst peacetime disasters and one of the most appalling in the history of aviation. The aftermath and implications of such an event were manifold and at times seemed unending.

When, moreover, the Lockerbie explosion was found to have been a terrorist act of mass murder, not only did it change attitudes and measures regarding security around the world but also it threatened to be the harbinger of even more unthinkable atrocities yet to come.

CHAPTER 38

1989

Perils on Land and Sea

Comings and goings

The beginning of 1989 saw continued price-cutting because of the abundance of capacity across the board in the global insurance industry. Risk managers were extremely pleased with their renewals at 1 January 1989 while insurers were relieved that the implications of the 1986 Tax Reform Act and the prospect of eroding profits kept rates from bottoming out completely.

Liability rates were fairly stable while property rates continued to fall. Renewal premiums were costing between five and twenty per cent less than they had cost a year before. Some described 1989 as the year of awakening in the insurance industry. Others said that 1990 would be the year of implementation. Within the Bermuda insurance industry, the soft market began to have a negative impact on the number of captive formations. One of the hardest hit companies in the captive industry was Hopewell, Fred Reiss's reinsurer, which suffered huge losses from the Hoechst Celanese Pampa explosion of the year before. Desperately seeking ways to rescue the deteriorating record of the company, Art Deters, President of Hopewell, announced that the company was changing its structure so that it could better handle future losses.

Bermuda also suffered another blow when the last of the captive reinsurance giants, GTE Re, announced that it would cease to write nonrelated insurance as of July 1989. Although GTE's withdrawal did nothing to hurt the Bermuda insurance industry, it did hurt Bermuda's image as a credible offshore jurisdiction. *The Royal Gazette* reported on GTE Re's closure as follows—

'The company originally known as Telect Insurance Company when it set up business in Bermuda in 1976 was one of the more prominent survivors of the late 1970s and early 1980s when the reinsurance industry was hit hard by a downturn in the worldwide market. The company had vowed in 1984 that it was here to stay and in its annual report (1987) said it was committed to the challenge of profitably managing through the forthcoming cycles.

Mr Finley, managing director of GTE, said that a decision was made on April 12 to stop writing North American business because the company was not getting satisfactory returns. Then in early June it was decided there was little point in writing any further nonrelated business.'⁵⁰⁹

Kathryn McIntyre of *Business Insurance* reported that 'there was a new aura of self esteem that pervaded Front Street, Bermuda's bustling waterfront thoroughfare, and the almost as crowded side streets of Hamilton where office buildings are in various stages of completion to house the growing insurance and reinsurance business.'⁵¹⁰

Since 1987, newly invested money and profits earned in the commercial property/casualty insurance and reinsurance business in Bermuda had exceeded US \$1.2 billion. The largest contributor to

⁵⁰⁹ *The Royal Gazette*, 17 July 1989, 'Significant blow to insurance industry', p. 17

⁵¹⁰ *Business Insurance*, 10 April 1989, 'Bermuda: Still in front, Coffers filled with cash, market exudes confidence', by Kathryn McIntyre, p. 22

that amount was ACE, with US \$1.1 billion in shareholder's equity—not a negligible statistic for a company that had been capitalised with US \$100 million only two years before. By 1989 there were 1310 insurance companies and 257 brokers/managers registered in Bermuda.

It was also in 1989 that Michael Kevany was appointed as the new chairman and chief executive officer of XL Insurance Co., Ltd of Bridgetown, Barbados and President and CEO of EXEL Ltd., the parent company of XL. Kevany succeeded Ian Heap, who was to remain as chairman of EXEL with Brian O'Hara as the President of XL.

Competition grows among financial reinsurers

The financial reinsurance marketplace in Bermuda had become a victim of its own success. Too many companies were going after the same pie within the short period of time since the formation of Centre Re. In addition the reinsurance market was beginning to soften, so that clients became more inclined to place their risks in the traditional marketplace at what they perceived to be 'value for money premiums'. As a result Bermuda's financial reinsurance market began to decline very quickly. *Business Insurance* reported as follows—

'Once a niche market for a few reinsurers that ventured to wed actuarial and banking skills to...recognize future investment income... The market is now bursting with players that offer a variety of products that can be called financial reinsurance.

'...Bermuda is home to no fewer than seven reinsurance companies with US \$406.6 million in capital and surplus that claim financial reinsurance as their specialty. Bermuda is an ideal financial reinsurance centre, permitting reinsurers to discount loss reserves for regulatory and accounting purposes. And, except for US controlled corporations, business is conducted tax-free. Among the newest entrants to the financial reinsurance market are Scandinavian Reinsurance Co. Ltd., a unit of Sirius Insurance Co., Ltd. of Stockholm, and Accord Re Ltd., in which Continental Corporation has announced it will invest.

'With all these markets vying for business, underwriters and brokers agree that competition is stiff...And financial reinsurers' profit margins are being squeezed...While financial reinsurance underwriters must sharpen their pencils today, they also spend a lot of time wearing down the lead to no avail. The so-called hit ratio—how many proposals are reviewed before a contract is written—is awful, underwriters say, considering the amount of time and effort that has to be devoted to reviewing a financial reinsurance contract.'⁵¹¹

One reason why hit ratios were so low for financial reinsurers was that a lot of the deals were very complex and involved tax issues that needed to be discussed and decided at board level. The concept was also very new and was cluttered with jargon so that many in the industry had difficulties translating the meaning of proposals to their boards. It seemed that the average hit ratio was somewhere between one in nine and one in a dozen—by no means good enough for the number of financial reinsurers that had opened on the island.

Despite the doubters and the ratios of hits to submissions, Centre Re managed to yield some impressive results as it wrote some US \$290 million in its first year of business. Centre Re's success proved to be the exception rather than the rule. *Business Insurance* explained this as follows—

'Centre Re's contracts called finite risk reinsurance, involve limiting the ultimate risk, and ultimate profit, for Centre Re. Mr Gluckstern (president and chief executive officer of Centre Re) differentiates Centre Re's finite risk reinsurance product from financial reinsurance, which traditionally has involved contracts with little or no risk transfer. Centre Re always takes an underwriting risk. Generally charging a premium of at least 50 per cent of the limits issued, Centre Re assumes not only the risk that claims will develop more quickly than projected, but also that ultimate claims will exceed the premium charged.

⁵¹¹ *Business Insurance*, 10 April 1989, 'Financial reinsurers feel competition', by Kathryn J. McIntyre, pp. 40–43

'Centre Re probably has the largest appetite for accepting real insurance risk of the financially oriented reinsurers in Bermuda, Mr Gluckstern says. "We have more capital to write risk business."⁵¹²

Insurance catastrophes that affected the global insurance industry

The end of the decade also brought with it several catastrophes that would severely damage the global insurance industry. The first major catastrophe of the year occurred on 24 March, when the oil tanker *Exxon Valdez* ran aground in Alaska's Prince William Sound. Filled to capacity with crude oil, the tanker ran aground and ruptured, spilling some ten million gallons of crude oil into the waters of the Sound. This was the largest single oil spill in US history to date and was made worse because the oil spewed into a sheltered body of water with many islands, bays and fjords. The world was able to view the damage over and over again on television, hour by hour footage of birds, marine life, shorelines and vegetation, smothered in deadly black oil.

Such was the magnitude and the cost of the *Exxon Valdez* disaster that later in the year the International Tanker Indemnity Association Ltd, the protection and indemnity club that provided pollution clean up to the major oil companies, including Exxon, considered no longer writing coverage. The Bermuda insurance market was not left unaffected. However the new insurers XL and ACE were both spared from the effect of the *Exxon Valdez* incident because neither had written the account at the time of the spill.

Hurricane and earthquake wreak havoc

As if the industry had not suffered enough from the catastrophic results of the *Exxon Valdez* spill in the early part of the year, it took another such blow when a 'category four' hurricane ravaged the coast of South Carolina. Hurricane Hugo was the worst to hit the United States since 1969, when Hurricane Camille had slammed into the Gulf Coast. Estimates of the cost of Hugo ranged from US \$7 billion to 9 billion. The historic city of Charleston suffered severely. Although most of the other areas affected were predominantly rural, some 5000 homes were destroyed and some 1200 more were left uninhabitable. The saving grace for many of the structures in the Carolinas was the number of trees, which served as a shield. However, in addition to the residential damage, there were great losses of livestock and timber.

At 20 feet the storm surge from the hurricane was the highest to hit the East Coast in the century. Hugo formed as a tropical depression on 10 September 1989, 12 days before crossing the South Carolina coast. With winds up to 160 mph it was classed as a category 5 hurricane. Shortly before midnight on 22 September, and now a category 4 with sustained winds diminished to 135 mph, Hugo crossed the South Carolina coast just north of Charleston. At 3:00 a.m., with winds of 109 mph, the eye of the hurricane passed just east of Columbia, South Carolina, 100 miles inland. By sunrise Hugo had reached Charlotte, North Carolina and, although now classified as a tropical storm, still had winds gusting to 87 mph.

Despite the devastating effects of Hurricane Hugo in the Caribbean and in the US and despite the fact that insurance rates were still very low, the claims did not shift the course of the insurance market, one way or another, from its continuing decline. However Hugo was soon followed by a massive earthquake that rocked San Francisco.

At 5:04 p.m. on Tuesday, 17 October 1989 an earthquake measuring 7.1 on the Richter scale struck San Francisco just when approximately 62,000 fans filled Candlewick Park for the third

⁵¹² *Business Insurance*, 10 April 1989. 'Centre Re premium volume proving many sceptics wrong', by Kathryn J. McIntyre, p. 43

game of the World Series and as the homeward bound Bay Area commute moved into its heaviest flow. The earthquake only lasted 20 seconds and was centred about 60 miles south of the city itself, but it was felt as far away as San Diego and western Nevada. The worst disasters were the collapse of the elevated Cypress Street section of Interstate 880 in Oakland, the collapse of a section of the roadbed of the San Francisco-Oakland Bay Bridge, multiple building collapses in San Francisco's Marina district, and the collapse of several structures in the town of Santa Cruz, at the Pacific Garden Mall, and in other areas around the epicentral region.

Damage and business interruption estimates reached as high as US \$10 billion, with direct damage estimated at US \$6.8 billion. Over 62 people died, a remarkably low number given the time and size of the earthquake. Most casualties were caused by the collapse of the Cypress Street elevated roadway. At least 3,700 people were reported injured and over 12,000 were displaced. Over 18,000 homes were damaged and 963 were destroyed, Over 2,500 other buildings were damaged and 147 were destroyed.

Warren Buffet of Berkshire Hathaway reported to his shareholders on these two back-to-back catastrophes as follows—

'In 1989, two unusual things happened. First Hurricane Hugo generated US \$4 billion or more of insured loss, at a pace however that caused the vast damage in the Carolinas to occur slightly more than 72 hours after the equally severe damage in the Caribbean. Second, the California earthquake hit within weeks, causing insured damage that was difficult to estimate, even well after the event. Slammed by these two—or possibly three—major catastrophes, some primary insurers, and also many reinsurers that had themselves bought CAT protection, either used up their automatic second cover or became uncertain as to whether they had done so.

'At that point sellers of CAT policies had lost a huge amount of money—perhaps twice because of the reinstatements—and not taken in much in premiums. Depending upon many variables, a CAT premium might generally have run 3 per cent to 15 per cent of the amount of protection purchased...

'But because the 1989 disasters left many insurers either actually or possibly bare, and also left most CAT writers licking their wounds, there was an immediate shortage after the earthquake of much needed catastrophe coverage. Prices instantly became attractive, particularly for the reinsurance that CAT writers themselves buy.⁵¹³

Rapidly following on the California earthquake came news of a mammoth industrial explosion. At approximately 1:00 p.m. on 23 October, there was a chemical release from the polyethylene plant of the Phillips' 66 chemical complex at Pasadena, near Houston, Texas. This formed a cloud of flammable vapour that then ignited in a massive explosion. A series of more explosions and fires followed. 23 deaths were reported and between 130 and 300 people were injured. The plant was extensively damaged.

On the day prior to the incident, scheduled maintenance work began on a reactor, to clear three of the six settling legs. A specialist maintenance contractor was employed to carry out the work. A procedure was in place to isolate the leg that was being worked on. During the clearing of No. 2 settling leg a part of the plug remained lodged in the pipework. A member of the maintenance team went to the control room to seek assistance. Shortly afterwards the release occurred and some two minutes later the vapour cloud ignited.

This incident severely affected OIL Insurance, the property captive set up in Bermuda for oil companies, as it was the biggest loss it had ever suffered. The *Bermuda Sun* reported on the loss to OIL as follows—

⁵¹³ Warren Buffett: *Chairman's letter to shareholders 1989*, Copyright © 1978-2003 Berkshire Hathaway

“The Phillips explosion led to our first full-limits loss of US \$300 million, of which we are recovering US \$100 million,” OIL senior vice president Ron Massey said this week. He said the loss was still being adjusted but is likely to be in excess of US \$1 billion, including business interruption.⁵¹⁴

The *OIL Insurance Ltd. 25th Anniversary supplement 1971-1995* reported on the impact of the multiple catastrophes—

“The ‘euphoria’ of 1987 quickly evaporated in 1988 and 1989 when OIL experienced, for the first time in its history, the impact of multiple catastrophe losses involving explosions and fires at Shell Oil’s refinery in Norco, Louisiana, Occidental Petroleum’s *Piper Alpha* platform in the North Sea and Phillips Petroleum’s petrochemical plant in Pasadena, Texas (which) exhausted the entire Basic OIL 150 million limits and penetrated the Maxi OIL layer. The adverse development of the 1987 Unocal/Marathon Oil Steelhead platform loss in the Cook Inlet, Alaska and the 1989 Hurricane Hugo loss at the Amerada Hess St Croix refinery, each at about US \$117 million, while not penetrating the maxi-layer, were both significant losses. By the end of 1989, OIL’s capital and surplus had declined to US \$406 million.”⁵¹⁵

The effect of these catastrophes on the members of OIL was tremendous. Many began to raise their deductibles to escape the increases OIL imposed on its standard rates to try to recoup some of the premium dollars it had lost. OIL then decided to freeze members’ ability to raise their deductibles but only after recognising that there was a serious flaw in the Rating & Premium Plan it was currently using.

Continuing efforts to upgrade insurance education

The Bermuda international insurance industry began to see that if it wanted to continue to grow at a cost effective level it needed to set in place programmes to educate locals about the international insurance industry. It was at this time that Dr Ellen Thrower, now Executive Director and Professor at the School of Risk Management at St John’s University, in New York City, previously the College of Insurance (TCI), first came to Bermuda. Richard Meyer, Executive Vice President of Johnson & Higgins, was on the Board of TCI and asked Brian Hall to make introductions to the industry. He organised a lunch which was extremely well attended, indicating the industry’s interest and support for extended educational resources. Bermuda College principals were also in attendance. From that time, Dr Thrower has spent a lot of time developing close relations with the Bermuda insurance industry, the International Companies’ Division, the Bermuda Insurance Institute, the Bermuda Government, the Insurance Advisory Committee and the Bermuda Foundation for Insurance Studies. She also enjoys a close partnership with the Bermuda College and has a team that has been coming to the island every year since 1989.

Dr Thrower came to Bermuda to strengthen a relationship that had already been established between Bermuda and the College of Insurance before she took over. She recalled that Bermuda had reached out to the College of Insurance and said that they needed help to improve the quality of Bermudians looking to enter the insurance industry. It may be noted that in fact several companies had provided scholarships for Bermudians to attend TCI. Johnson & Higgins (Bermuda) sent two Bermudians, Kathy Bull and Thelma Trott, there in the early 1980s.

And since that visit in 1989, Dr Thrower says St John’s School of Risk Management that St John’s still recruit lots of Bermuda students. In the past, there have been Bermudian valedictorians, and Bermudian student leaders and many graduates have gone back to Bermuda to become leaders in the industry. Several of Bermuda’s industry leaders also sit on the Board of Directors of the St John’s University.⁵¹⁶

⁵¹⁴ *Bermuda Sun*, 30 March 1990, ‘\$1 billion-plus toll of deadly blaze’, p. 13

⁵¹⁵ *OIL Insurance Limited, 25th Anniversary supplement 1971-1995*, ‘The Shock Loss Years’, pp. 30-31

⁵¹⁶ Interview with Dr Ellen Thrower, 31 October 2002

Walter Scott takes over from John Cox at ACE

In October 1989 John Cox handed over the Chairmanship of ACE to Walter Scott, who had been invited to Bermuda at the recommendation of United States executive search firm after a nine-month search for a successor to Cox. Scott said it was not easy to recruit for top jobs on the island because of spousal employment problems, because of the difficulties experienced in finding suitable education for the children of expatriates, and because expatriates were unable to buy their own homes. He also instanced as a secondary consideration that some people thought Bermuda was too insular and far too small for cultural activities.

The Bermudian reported on Scott's charge in Bermuda as follows—

“The conclusion was we could run the company with less than a billion dollars in capital and surplus. But after talking to our client base, brokers and the like, the billion-dollar number became very important,” says Scott. “That separated, so to speak, the men from the boys.”⁵¹⁷

Scott's background before coming to Bermuda had been mostly in life insurance but he had no problem in adapting to the property and casualty side of the business. He said that the major difference between the two lines of business was the terminology or jargon. He also said that Cox's stature in the industry had given ACE instant credibility from its birth. Now if his own role as successor was dealing with ACE's adolescence then his charge would be to determine what ACE should be once it had grown up.

When he arrived he was pleased by the calibre of underwriters at ACE. However he was less at ease with the pricing and reserving practices of the company. Coming from the life insurance side, where actuaries are a fact of life in the underwriting process, Scott was concerned that there was no actuary on staff and immediately put the actuarial discipline into place at ACE. Once he had done so, he found that certain classes of risks were being grossly underpriced.

Scott also had to deal with the fact that ACE had never established loss reserves, a serious issue which troubled a number of ACE's board members. Because of its uniquely high attachment point and its radically new policy form, ACE found it a challenge to develop a system for determining the appropriate level of incurred but not reported losses (IBNR), so that ACE would have funds to pay for losses that later developed.

He was also confronted by the fact that ACE had 34 directors, which made it very difficult to agree on major corporate decisions. In the course of its comparatively brief history ACE had become very proficient at writing excess liability and D&O business. Scott felt that for the longer term it was essential for ACE to write a broader spectrum of speciality risks. However there were many members of the board who wanted to stay with the market segment that ACE had initially decided to write.

A worrisome outlook for Bermuda

By the end of the 1980s and as a consequence of the hard market, the global insurance industry had reached a pivotal point in its cycle. In July 1991 David Olsen, President of Johnson & Higgins, gave a speech to the World Insurance Congress. It was entitled 'Captive Insurers: their role in the Marketplace' and in it he described the state of the market as follows—

‘...Then came the 1980s. The two events that shook the insurance industry most during the last decade and laid the groundwork for the restructuring we're seeing today, were the devastating impact of the market's abrupt upswing and the resulting emergence of alternative market facilities.

⁵¹⁷ *Bermudian*, January 1996, 'ACE, The First 10 Years', by Rosemary Jones, pp. B25-B32

'For an industry that had been viewed with mild indifference at best and a certain aversion at worst, the hard market was clearly one of the worst public relations debacles in the history of insurance. It unleashed a furious consumer backlash and a public outcry against the insurance industry that reflected scepticism and disdain of dramatic proportions. Even though the market softened rather quickly, distrust of the industry remained, as well as an ongoing impetus to enact regulations to further constrain insurance companies and turn them into quasi-utilities.

'While the consumer backlash had devastating consequences in the number of regulatory initiatives it prompted in the United States, it was the growth of alternative markets that hurt commercial property/casualty insurance companies the most—because it hit them where they were most vulnerable, in a permanent loss of market share.

'The creation of large alternative markets such as ACE, XL, CODA, AEIA, PRIMEX and ERI—now ERMA, the growth of smaller group facilities and risk retention groups, and the explosion in the number of single-parent captives established during the 1980s meant significant premium volume left the commercial market—never to return.⁵¹⁸

The end of the 1980s also ushered in a worrying time for Bermuda's international insurance industry. The market was very soft and those in the international industry began travelling as far as Hong Kong to attract the next wave of business over to Bermuda.

The population of Bermuda grew disenchanted with the little they saw in their hands as a result of the bustling international insurance industry. Many still blamed the industry for the rising cost of living. Consequently in the February 1989 general election the gap between the UBP and the PLP narrowed again, with the UBP keeping 22 seats and the PLP with 18.

The Financial Times 'Survey of Bermuda' reviewed the Bermuda economy—

'These are some difficult times for Bermuda. The economy is looking shaky: a sharp fall in tourists, coupled with a steep rise in imports and domestic spending, brought the first balance of payments deficit for five years in 1988. The outlook for this year is none too bright and the rate of inflation has risen ominously.

'At the same time the ruling party, which has formed the government ever since Bermuda became a self-governing colony in 1968, suffered a severe setback in the February 1989 general election, and now has a small majority in the House of Assembly.

'On the business side the reinsurance industry, which is one of the mainstays of the Bermudian business community, is in one of its downward cycles and is, therefore, generating less income... The island lives on a knife-edge and there are some serious problems to be faced. There is acknowledged to be a growing drugs problem, and a high incidence of drug-related AIDS. The government makes strenuous efforts to crack down on drugs entering the country, but it is an impossible task to police the whole of the coastline.

'There are also underlying racial tensions. The government claims that Bermuda is one of the best-integrated societies in the world. But there is, inevitably, an undertone of resentment as the size and influence of the black population grows in an island still, to a large extent, controlled by a white minority.'⁵¹⁹

The end of the 1980s saw a notable shift, as a number of Bermudians, especially the men, left the international insurance industry, never to return. The closure of big name captives, of the companies that had been writing third party business and reinsurance in the Bermuda marketplace, left many local people without work. Where did those jobless Bermudians go? More importantly for the long term of the industry, why did they not come back to it?

⁵¹⁸ David Olsen speech to World Insurance Congress July 1991: 'Restructuring for Opportunity, Captive Insurers—Their Role in the Marketplace'

⁵¹⁹ *Financial Times*, 30 August 1989, Section II, 'Financial Times Survey', by John Edwards, p. 1

Major questions loomed unanswered as the 1980s drew to a close. Uncertainties about the health of the economy, about the state of the political environment and about conditions for the average Bermudian, left many people wondering yet again just where the island was heading as it moved on into a new decade.

