PART FIVE
1990–1999

CHAPTER 39

1990
A Challenging Decade

Mixed beginnings

After the turbulent social environment that prevailed in Bermuda throughout the 1960s, 70s, and 80s, and the dramatic changes to the international insurance industry, the whole island seemed to be holding its breath as it moved into the 1990s. No one wanted to try to guess what the new decade would bring. All they hoped was that the island should find some sort of balance for everyone.

The year began with Premier John Swan being knighted by the Queen for all his services to Bermuda but not all signs were as auspicious. They were mixed. The government's announcement of a new education system raised doubt as to where the island was heading. Many opposed the mega-school concept and feared what the demise of parish schools would do to middle school students. A telephone poll taken by *The Royal Gazette* showed 75.5 per cent of respondents as being opposed to the single central school called Cedar Bridge. In direct response, and in protest against the new policy, Warwick Academy, one of the premier public schools on the island, announced that it was going to become a private institution. The Berkeley Institute, also one of the premier schools on the island, refused to become a comprehensive middle school and was eventually converted into a central high school along with Cedar Bridge. Later in the year, Saltus, one of the premier private schools on the island, announced that it would become coeducational, after 102 years of being only for boys.

By contrast, on the political front, 13 April 1990, US President George Bush Sr. and British Prime Minister Margaret Thatcher decided to hold a summit conference in Bermuda to discuss the ending of the Cold War with the Soviet Union, the troubles arising in the Persian Gulf and any other pressing issues of the day. Bermuda rolled out the red carpet and the summit went off without a hitch.

Shortly thereafter and for the first time, the Bermuda court systems tried and convicted a criminal on the basis of DNA evidence. A referendum was held on capital punishment. Of those registered, only 30 per cent voted, 79 per cent were in favour of retention. This was ironic because Britain no longer had capital punishment and so its continuance in Bermuda would in all likelihood be overruled by Britain anyway.

On the financial side, the international insurance industry, especially those who insured risks in Europe, faced great uncertainty because of four unexpected winter storms in succession, that caused over US $12 billion in damage between January and February of 1990, starting with winter storm Daria and finishing with winter storm Herta. Then the United States market was hit by freak Colorado storms in July, which cost the industry some US $1.7 billion. The new decade began with catastrophes that seemed to be setting the stage for more to come. To make matters worse the industry was deeply mired in a soft market. With losses coming in and premium levels inadequate, the beginning of 1990 suggested that the decade would see huge challenges for the global insurance industry.

United States Oil Pollution Act

As a direct consequence of the *Exxon Valdez* oil spill, the United States enacted the Oil Pollution Act of 1990. With few exceptions this act required that all vessels over 300 tons carrying oil into United States waters must have Certificates of Financial Responsibility (COFRs) from the Coast Guard. 'COFRs are instruments backed by approved independent guarantors effectively guaranteeing the statutory financial liabilities of each ship.'[520]

This set ship owners scrambling for guarantees that would meet the Coast Guard's new requirement for oil spill liability protection, because the Protection & Indemnity Clubs refused to provide these first party guarantees to the United States Coast Guard. The Bermuda market saw an opportunity and two separate companies First Line and Shoreline Mutual were formed in late 1994.

The Bermuda market responds to growing interest

With the Bermuda market gaining more international credibility on one hand as well as attracting some bad press on the other, many of the local insurers thought it was time to formalise the marketing campaign for the industry and so a Marketing Committee was formed by the Insurance Advisory Committee with the aim of promoting Bermuda as an international insurance centre. Its main objectives were to increase the number of insurance companies located in Bermuda, to increase the premium written by Bermuda companies, and to increase the number of business visits to the island made each year.

Shortly thereafter the International Business Forum (IBF) was founded at the specific request of the Premier, Sir John Swan, and the Finance Minister Dr David Saul. This was as a direct result of the private sector and Government leaders attending the World Economic Forum in Davos, Switzerland, to represent Bermuda's interests to that erstwhile group of business and Country leaders. The IBF was formed as an economic "think tank" addressing the infrastructure and policy decisions for the stable growth of international business in Bermuda. It was to determine exactly where the international business industry in Bermuda should be headed over the coming decade and how the current impetus could be maintained…

> 'The forum comprises the Premier, the Finance Minister, the Labour and Home Affairs Minister, the leaders of Bermuda's banks, representatives from the legal community, accounting firms, and insurance companies, plus selected large company representatives. As head of the forum, Mr (David) Lines, also a senior partner at the accounting firm Cooper & Lines, says it is vital to portray Bermuda as a destination for international business, just as it is for tourism.'[521]

Fidentia scandal is over at last

After thirteen long years the Fidentia scandal was finally brought to a close in 1990 (as previously discussed in 1984). Despite the bad press generated by this high profile case, Bermuda managed to come out of it relatively unscathed. On 23 March the *Bermuda Sun* reported—

> 'Owners and directors of the notorious Fidentia Marine Insurance Company have been summoned to attend the final general meeting of their company a week from today. They will be asked to approve, in the words of the official jargon reserved for such occasions, an "account laid before them showing the manner in which the winding-up has been conducted and the property of the company disposed of." More importantly to historians of Bermuda's international business industry the Fidentia members will

[520] *Bermudian Business*, Premier Issue, Insurance Special, Spring 1996, 'Breaking with tradition Bermuda leads way in innovative new regulations', p. 26

[521] *Bottom Line*, May 1992, 'Raised Expectations, The Offshore Financial Sector Challenges Tourism for Primacy', by Robin McPhee, p. 24

be officiating at the funeral of a company once involved in an international reinsurance scandal of epic proportions.

'The Fidentia affair, as the unfolding saga was quickly dubbed by the world's press, began in 1970 at Lloyd's of London in the mind of one Raymond Brooks, an ambitious marine underwriter. It ended almost 13 years later with a Lloyd's Committee of Enquiry recommending Mr Brooks be suspended from the market and that Lloyd's members James and Richard Pearman receive notices of censure – official slaps on the wrists – for refusing to appear and give evidence before the Committee.

'Fidentia was set up by Raymond Brooks and his partner Terence Dooley to underwrite reinsurance treaties for Lloyd's syndicates and international companies. By 1982, it was handling annual premiums of nearly £3 million, 75 per cent of which was coming from the syndicates, and was reckoned to have built up profits of almost £6 million.

'The problem was that the reinsurance premiums came from the very syndicates, which relied on Raymond Brooks and Terence Dooley to supply them with supposedly impartial underwriting services in a supposedly fiduciary capacity. However, the underwriters channelled millions of dollars of business to Fidentia without disclosing their interest in the Bermuda reinsurers to the Lloyd's syndicates.

'Initially, their ownership of Fidentia was through a British company. Later, when Fidentia was handling higher premium volumes, it was 'sold' to a Bermuda holding company owned by a Bermuda discretionary trust. Its trustees were Conyers Dill and Pearman lawyers James and Richard Pearman, and its beneficiaries were Messrs Brooks and Dooley and their families.

'By the early eighties, conflicts of interest and incestuous corporate relationships were fast becoming taboo at Lloyd's. And on December 15, 1982, a Committee of Enquiry was formed to investigate the Bermuda reinsurer. In a two–part report, the Lloyd's Committee said that Brooks and Dooley had deliberately concealed from investigators the fact that they had secretly benefited from the trust. Instead of revealing their personal stakes in Fidentia's profits from syndicate business, the enquiry alleged the underwriters created the false impression that Fidentia had made a loss—a deception the committee condemned as "highly discreditable".

'The two men were found "guilty of substantial misconduct" under Lloyd's regulations and expelled from the market. As members of Lloyd's and individuals expected to abide by its rules, James and Richard Pearman were asked to appear before the Committee. They refused, steadfastly maintaining that their professional obligations as members of the Bermuda Bar took priority. As a result, they were judged to have acted in a manner "detrimental" to the Society of Lloyd's and were reprimanded for having "failed and declined" to give oral evidence to the Committee. They were ordered to pay legal costs of £1500. That was in 1984.

'Since then, the company has been in runoff and nearly a thousand Lloyd's members have received a significant part of the sums they claimed were owed to them by Fidentia and its operators. The Pearmans are also relieved that they will soon be able to close the Fidentia file for the last time. "It's been something of a burden for us and has required a lot of very tedious work," says James Pearman. "But over the last couple of years and with the help of Mr Brooks, we've been able to settle just about everything and I think the creditors are satisfied with that."

'The Pearmans' decision to stand up to the London establishment and the attendant publicity, which kept their names in the headlines through much of 1984, was said to have benefited their legal practice. But would they act in the same way to protect clients if a Fidentia-type situation arose tomorrow? "Oh yes," says James Pearman. "No question of it. But you have to remember that the Fidentia thing was a result of attitudes changing at Lloyd's and that we had no reason to suspect anything at the time the business came to us." Richard Pearman holds similar views. He too will be "quite glad to see the back of Fidentia", but he takes a harder, less forgiving view of the market's handling of the episode. "It's all behind us now but I can't help feeling that Lloyd's did treat us rather badly at the time," he says.

'Despite Fidentia and certain misgivings about the possibility of conflicts of interest arising again in the future, both lawyers are still members of Lloyd's. "I suppose it's possible that there's a chance we might face that sort of enquiry again but I'm inclined to thinks there's less likelihood of it happening now, so I've no plans to resign my membership," says Richard Pearman. "After all things have pretty much settled down at Lloyd's now."'[522]

Major changes at XL

While the Bermuda international insurance industry built a marketing force to promote Bermuda and the whole Fidentia affair was coming to a close, the industry received a much needed boost to its reputation when Barbados-based XL decided to consolidate its offices and move to Bermuda.

Speaking to *The Royal Gazette* Michael Kevany, the CEO of XL, said—

> 'No question, this move to Bermuda is an expression of confidence in facilities you (Bermuda) have, potentially even better qualified work force and closeness to the United States, all of which makes it easy to do business offshore. There are many pluses in Bermuda that makes it a natural. Costs are a little higher in terms of pure costs, but with the savings in communications and transportation costs to Barbados, the costs will probably end up the same.'[523]

Shortly thereafter XL announced that it was going to fill a major gap that had opened in the global insurance market. H.S. Weavers, the large Lloyd's syndicate, and the largest provider of United States casualty risks, had announced it would no longer accept new business. Weavers had been forced to this decision when the British Government ordered its sister company, Walbrook Insurance, to stop writing new business because it did not have the necessary reserves to pay for claims. Walbrook provided 55 per cent of Weaver's security. At the same time, Weaver's parent company, London United Investments, suspended trading its shares on the London International Stock Exchange.

Despite these dire conditions Weavers declared its intention to stay in business. However brokers were worried about its future and began to look for alternatives. Anglo-American, which provided the remaining 45 per cent of Weaver's security, was interested in buying the troubled insurer but that was still not enough to allay the concerns about Weaver's security. XL decided to step in and help clients who had previously purchased coverage from Weavers, by reducing its own attachment point from US $25 million to US $15 million. However it would offer this only to clients who already purchased coverage from XL in excess of US $25 million and only to certain classes of business. The policy was also to be written separately from the coverage the insured had already bought from XL.

At the news of Walbrook's inability to continue providing security for Weavers, local insurance company Bermuda Fire and Marine found itself in trouble. It had already lost some US $7 million in 1987. Consequently, Bermuda Fire and Marine combined with Sun Alliance and London Insurance to reinsure losses of between US $32 million and US $50 million, starting from 31 December 1995.

It was also in 1990 that XL made some major changes to the way it operated when it decided to reduce its board members from 68 and to expand into Dublin, Ireland, as reported by *Bermudian Business* magazine. 'The policy reserve premium was eliminated altogether in 1990, the year excess liability limits were increased to US $100 million from US $75 million. The move of all operations to Bermuda was completed in that year, and a Dublin subsidiary, XL Europe Insurance, was formed.'[524]

[522] *Bermuda Sun*, 23 March 1990, Fidentia 'Affair' is over at last…,' by Roger Scotton, pp. 16 & 17

[523] *The Royal Gazette*, 6 May 1989, 'Barbados' loss is now Bermuda's "Xlent" gain', p. 1

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

Aneco pulls out of property and marine market in London

Then Bermuda suffered a setback when Aneco announced in August that it was pulling out of the property and marine catastrophe reinsurance market in London, after suffering heavy losses from Hurricane Hugo. There were to be no changes to its Bermuda office as a result of these losses.

The *Bermuda Sun* reported on Aneco's decision as follows—

'The company, which handles up to US $7 million a year in property and catastrophe excess of loss premiums from Lloyd's and from London companies, says that the London market business has proved unprofitable and that Aneco cannot afford to jeopardize its more lucrative, captive reinsurance portfolio, which it regards as its primary book.

'The decision to withdraw, which follows Aneco's move last year to expand its property and catastrophe writings for 1990, was taken at an Aneco board meeting last month. It was based on a policy edict from Mark Hardy, the Chairman and majority shareholder of Aneco parent, Forum Reinsurance Group (Bermuda) Ltd., who is keen to steer Aneco into what he considers to be more lucrative lines of business.

'Bruce Jones, VP of Aneco, explained that they had to make the decision to withdraw because the cost of reinsurance was so prohibitive that it was not cost effective for them to continue to write more business. He said that London brokers were not too happy with their decision but accepted that it was a business decision that needed to be made.

'Jones added that the London market property and marine catastrophe business, which is to be runoff in-house, comprised almost 35% of Aneco's total book. In 1989 Aneco wrote about US $20 million in gross premiums, up from US $18 million in 1988. Gross premiums from captive reinsurance totalled US $11 million last year, making Aneco Bermuda's largest underwriter of captive business.

'But Jones says Hurricane Hugo alone has left Aneco with at least a US $12 million gross loss exposure. "It may even go as high as US $14 million. But we've got US $20 million in protections so our estimate is that we're probably going to be looking at a net loss of US $1 million to US $1.5 million from Hugo. Though this business represents only 35% of our book, it's 35% that was slowly killing us and we felt that the cost of staying in it was just too high. By taking this action, we're hoping to avoid having red ink on Aneco's 1990 financials."

'Even without Hugo, Aneco was increasingly concerned at the low level of profits from what it regarded as high-risk business. "We weren't making much out of it, even in a non-catastrophe year," says Mr Jones. "The final straw," he says, "came when Mr Crawley's plan to form a new company to acquire the Aneco business was scrapped last month. Aneco had been hoping to restructure, but was then suddenly faced with having to decide what it wanted to do with this business. Our decision was not to renew it and to concentrate instead on building up our captive book in Bermuda."'[525]

On 7 September 1990 Mark Hardy, Chairman of Aneco's parent, Forum Re, announced that he was closing down Aneco Reinsurance Underwriting because of the defection of his senior staff to the newly created Sphere Drake Underwriting Management (Bermuda) Ltd—a competitor set up by former Aneco President Jonathan Crawley. The news of Aneco's closure marked the 'end of the biggest captive underwriting facility of its kind in Bermuda', according to Roger Scotton, writing in the *Bermuda Sun*.[526]

Brian Hall voices concern on government spending

As Bermuda was beginning to make new strides in the global insurance industry, the increase in government spending caused many to be concerned as to where the funds would come from. In a

[525] *Bermuda Sun*, 24 August 1990, 'US $7 million catastrophe book is killing us says Aneco'

[526] ibid, 7 September 1990, 'Hardy shuts down Aneco', by Roger Scotton p. 11

speech, Johnson and Higgins President Brian Hall voiced concern over the increased government spending because he felt that it was negatively impacting international business in Bermuda.

The *Bermuda Sun* recorded Hall as saying that Bermuda could not afford to become complacent—

> '(Bermuda was) walking a fine line with a vital but fickle sector of its economy. "We cannot become complacent," continued Mr Hall. "Government expenditures which directly impact our costs of doing business must be monitored. Unnecessary bureaucratic infrastructures must not be allowed to go unchecked and salary increases should be fair but should not lead the market. And capital projects must be carefully planned to be within our means."
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> 'The J&H chief said that Bermuda companies must strive to differentiate themselves from foreign competitors through the provision of valued added services. "We can no longer compete on price," he continued. "Companies came here years ago because Government gave them tax exemption undertakings. In the last budget, some of these undertakings were removed, albeit that levies were imposed on international companies, not taxes!"
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> 'Mr Hall was also highly critical of those Bermudians who were "out for themselves and a quick buck." The Johnson & Higgins boss, who this year announced his senior managers were temporarily forgoing a pay rise to avoid having to increase clients' fees in the wake of Government's latest budget, called for a renewed effort to create a "master plan" for the island's economic future. He said the plan should take account of the island's limited resources and its market opportunities and help position Bermuda to respond to changes while preserving its integrity and viability. "Many international businesses have conducted their own strategic planning exercises and now is the time to merge those with others to create a vision and plan to meet the challenges of the future," he told the meeting. "Bermuda is walking a fine line into the future, however these challenges have been met by many smart Bermudians in the past and, being an eternal optimist, I am confident that with the right stuff, Bermuda will take the necessary initiatives to flourish into the 21st century."'[527]

1990 sees steady growth for Bermuda

Despite setbacks in both the Bermudian and the global insurance industry, Bermuda ended 1990 with steady growth. After over five years in operation ACE announced that it was about to pay claims for the first time in its history. One of its first major payments was in settlement of the huge Piper Alpha oilrig explosion of 1988 and the second was for a bus accident in Texas. Many in the industry viewed these payments by ACE as a positive sign that the insurer was a true insurance company which paid claims and was not just set up to take in premiums.

By the end of 1990 there were 1312 international insurance companies based in Bermuda. Of these all but 100 were captives. At the end of 1990 Cyril Rance retired as President and CEO of local insurance company Bermuda Fire and Marine and handed over the reins to Glenn Titterton, who had been with the company since 1961.

In a special supplement entitled *Focus on Business, Windows of Opportunity*, Kevin Stevenson reported on Bermuda's performance in the global insurance industry as follows—

> 'While this represented an overall decline of two insurers over the previous year, it also included 51 new captives (the most of any domicile), while 53 were closed down or moved elsewhere – a natural development of a mature captive domicile according to D. Hugh Rosenbaum of Tillinghast.
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> 'The 51 new captives registered represented an increase over the 45 registered in 1981, and broke a downward trend that began in 1986 when 125 insurance companies were registered in Bermuda. While the total number of international insurers declined marginally in both 1989 and 1990, their financial

[527] *Bermuda Sun*, 24 August 1990, 'J&H President voices fears on spending', p. 11

statistics did not. Indeed gross insurance premiums rose 7.6% to US $12 billion in 1989 (last year's figures are still pending), whole net premiums rose 12% to US $9.4 billion. And by year's end, total assets were US $44.5 billion, a 15% increase over 1988. Capital and surplus rose on an even better 20.4% to US $17.4 billion. "These increases over the last year indicate the commitment of our companies to stability, their confidence in Bermuda as a captive domicile, and Bermuda's attractiveness as a domicile for larger insurance entities marketing a variety of innovative insurance products," said Pamela L. Adams, Assistant Registrar of Companies. 'Mrs. Adams noted that the ratios of net premiums to capital and surplus—a key indicator of the financial health of an insurer—remained at less than 1:1, demonstrating the "prevalent conservatism" of the Island's insurance industry.

'Without a doubt, a major contributor to the large upswing in Bermuda's annual premiums and assets has been the continued growth in financial reinsurance, which has made the Island the financial reinsurance capital with an estimated US $1 billion of deals done in 1990 according to *Captive Insurance Company Reports* (January, 1991).'[528]

[528] *The Bermudian*, April 1991, Focus on Business, Windows of Opportunity, 'Bermuda's Captive Insurance Industry: Holding its own', by Kevin Stevenson

CHAPTER 40

1991
Contrasts, Conflicts, and Some Resolutions

Captives in good health

As 1991 rolled around, Bermuda declared it had entered a recession. The rest of the world was in a state of flux as a result of the United Nations invasion of Iraq on 16 January. However for the international insurance industry this was a time of renewal.

The following article by Kevin Stevenson in *Bermudian Business* says how that came about—

> 'Despite dire predictions to the contrary, Bermuda's international insurance industry has not disappeared into the Sargasso Sea in a tidal wave of competition. Indeed, much to the chagrin of some of our competitors, international insurance – and more specifically, the captive insurance business – is alive and well and thriving in mid-Atlantic. That so many other jurisdictions around the globe are emulating Bermuda's success in this area of financial services is testimony to the vision of the captive insurance industry's founding fathers. Not only has Bermuda retained its leadership position as the captive insurance domicile capital of the world, it has done so while taking the high road – willing to share its secrets in the belief that the best will win out and that Bermuda still offers the best.'[529]

Robin McPhee of *Bottom Line* magazine added this to Stevenson's comments—

> '...Chairman of the IAC Marketing Committee, Mr Roger Gillett, is quick to reveal that despite the poor conditions and a soft market there are more captive incorporations in Bermuda in 1991 that in any of its rivals. The total number of offshore insurers registered here at the end of 1991 was 1,323. Bermuda had 64 new insurance companies formed in 1991, representing a net increase in captive formations for the first time in four years.'[530]

Verbena Daniels retires

In 1991, as the Bermuda international insurance industry worked to retain its reputation in a deteriorating global insurance marketplace, Verbena Daniels, who became known as Bermuda's First Lady of Business retired as the Registrar of Companies because of failing health. Ceicile Musson, on giving the valediction for Ms Daniels at her funeral in 1993 quoted David Saul, former Finance Minister and Premier of Bermuda as saying—

> 'From lowly clerk in the police file room to Registrar of Companies—head of an important department in the Ministry of Finance—that is the story of the career path of Verbena Daniels....It was probably inevitable that Verbena should have risen to the rank of Registrar of Companies simply because she also

[529] *The Bermudian*, April 1991, Focus on Business, Windows of Opportunity, 'Bermuda's Captive Insurance Industry: Holding its own', by Kevin Stevenson

[530] *Bottom Line*, An Economic Review, May 1992, 'Raised Expectations, The Offshore Financial Sector Challenges Tourism for Primacy', by Robin McPhee, pp. 20–26

mastered all the other intricacies of Company law and the myriad of complex detail required to police and supervise the activities of business in Bermuda. Whether it was the certification requirements for a real estate salesman or the liquidation of international corporations Verbena mastered them all.

'I, as both Financial Secretary and later as Minster of Finance, found Verbena to be a gold mine. She was invaluable. You could count on Verbena because when she spoke, you listened carefully because she knew what she was talking about.

'To her staff, she was both master teacher, understanding boss and friend. She managed to be both taskmaster and confidante. Her staff loved her—her colleagues in Government respected her, people in the business world trusted her. Her retirement party was both a sad as well as a happy occasion. Her staff knew they would miss her, in more ways than one.'[531]

Malcolm Butterfield—new Registrar of Companies

Malcolm Butterfield was the second in command to Verbena Daniels at the Registrar of Companies office in the early 1980s but, not being one to settle for second place, he took a gamble and decided to venture on his own. He wanted to show his own talents without being overshadowed by a boss. Therefore, in 1985 Butterfield formed Betterley Risk Consultants (Bermuda) Ltd. He spent nearly six years as head of this firm until his old boss, Verbena Daniels, announced her intention to retire.

Daniel's announcement put Butterfield in a quandary because it forced him to decide whether he wanted to continue as an entrepreneur or go back into the department. After attending the RIMS conference in 1990 and seeing that the industry was gearing up for a major push, Butterfield decided he would give up his consultancy firm and become Bermuda's new Registrar of Companies—a move he would never regret, for it propelled him into the spotlight during a time when Bermuda was reaching yet another peak in its insurance cycle.

When he became the new Registrar of Companies, having previously served under Daniels for a little more than a year; Butterfield had no idea that the industry was about to grow so much in less than two years. He thought it was at a crossroads because offshore jurisdictions were seen in a bad light. Bermuda in particular was looked down upon because of the Mentor liquidation, the bad business that had been coming out of London, and the perception that Bermuda wrote anything and everything during the captive third party business explosion. He needed to do something to help Bermuda get back on the map as a more credible jurisdiction. With this background in mind, Butterfield and Bermuda faced two serious challenges among others.[532]

The first challenge was that Bermuda had no working relationship with the Kansas headquartered National Association of Insurance Commissioners (NAIC), the US regulatory body that was starting to play a significant role in offshore regulations. Butterfield set out to establish a working relationship with this body.

The second challenge was the huge threat presented by the Fronting Model Act. Robin Zuill explained this as follows—

'The NAIC was proposing to draft language to limit fronted reinsurance programmes. The Reinsurance Task Force of the NAIC, nervous about highly publicized reinsurance company insolvencies, took its first steps in late 1990 to develop legislation to effectively ban the practice of fronting, upon which most Bermuda captives relied. Fronting is commonly used to pass insurance business from the parent company to the captive whether in an onshore jurisdiction or one offshore, like Bermuda. Most Bermuda captive insurance companies are owned by corporations or associations in the United States, which use captives to insure their risks.

[531] Valediction to Verbena Daniels by Ceicile N. Musson

[532] Interview with Malcolm Butterfield, 12 March 2002

'Typically, the United States owners of Bermuda captives use a separate United States insurance (licensed) company as a go-between or "front" when dealing with their captives. The captive owner buys insurance from the fronting company, which then passes all or most of the business on to the captive in Bermuda.

'Most captives pay fees to the licensed "front" company, which issues the actual insurance policy, handles claims investigations and other administrative matters in the United States mainland, and generally acts as the captive's agent in the United States.'[533]

In Butterfield's first two years in office he worked to help Bermuda become recognised for what it had achieved and he marketed the island as a leading offshore jurisdiction that knew how to regulate insurance companies and could operate effectively and efficiently. Butterfield also became a significant player in representing Bermuda's interests in the drafting of the Fronting Model Act to make sure that it became a document friendly to the Bermuda insurance industry rather than an adversarial one.

Butterfield said the original drafts of the Fronting Model Act were punitive. Although the proposals were originally put forward to stop fraudulent fronting arrangements and to create greater transparency, the original language went too far. As a matter of fact, captive owners argued that the captives were probably better managed than insurance companies because they were directed by the people who owned them. Butterfield believes that his experience in both the public and private sector gave him the skills to become known as the 'businessman's regulator' because he could relate to their needs whilst still putting the necessary regulation in place.[534]

Kevin Stevenson published an interview with Butterfield for *The Bermudian*—

'My mission (he said) is, in part, to maintain that well-established partnership (between the government and the insurance industry), which has contributed to our success as an insurance jurisdiction. It also is to assist as a regulator in the further globalisation of international financial markets.' He saw the mission as one of helping the Bermuda market to continue to remain 'responsive, innovative and creative' in its approach to business. As Butterfield put it, the Government 'looks at every application based upon its merits. There are no hard and fast rules about what we do and don't accept. People come to see us and if their application is out of order, we act accordingly.' Mr Butterfield points to both financial reinsurance and excess liability insurance as classic examples of the Bermuda market being 'responsive and flexible' to business plans for 'alternative insurance'. Introduced in the mid to late 1980s, both examples are flourishing well, with the largest three companies representing these niche markets—ACE Insurance, X.L. Insurance and Centre Re—boasting upwards of US $5 billion in assets. Their combined annual gross premiums almost match Bermuda's billion-dollar Gross Domestic Product. So successful have these companies become that other domiciles are enviously looking Bermuda's way, much the same way they did the captive insurance industry.

'One has to remember that Bermuda as an international centre is not only successful as a captive insurance domicile, but also as an international insurance market, as ACE, XL, and Centre Re testify to,' Mr Butterfield said...There, of course, remains the danger that Bermuda's 'responsive flexibility' approach could lead to failures such as the billion dollar Mentor insolvency, which stands as mute testimony to the folly of the so-called captives writing non-related business willy-nilly as some did in the late 1970s and early 1980s. 'I don't think any regulatory authority can stop this sort of thing,' said Mr Butterfield. 'I think insolvencies and failures are a part of the insurance industry in a free market environment. There will continue to be failures, and this shows our regulations work. Our track record compares favourably to other jurisdictions in this area.'[535]

[533] *Bottom Line*, International Business, November 1992, 'Bermuda's Frontman', by Robin Zuill pp. 59, 77, 78

[534] Interview with Malcolm Butterfield, 12 March 2002

[535] *The Bermudian*, Focus on Business, April 1991, 'Malcolm Butterfield in the hot seat', by Kevin Stevenson

Malcolm Butterfield was given much credit for his role in gaining the trust of the NAIC, as demonstrated by these comments made by Brian Hall to *Bottom Line*—

> 'Brian Hall, Chairman of the Insurance Advisory Committees and President of the largest manager of captives in the world, Johnson & Higgins, says it is Mr Butterfield's involvement that has helped increase the NAIC's awareness of Bermuda's contribution to the captive industry and its approach to regulation. Mr Hall says few Bermuda captives have collapsed and fronting played little to no part in those disasters. Bermuda, with 1,323 captive insurance companies according to the 1991 statistics is, far and away the leading domicile for this type of business. Already this year, despite a poor insurance market, there have been 36 new incorporations to the end of August with a total of 31 removals.'[536]

Two catastrophes impact insurance industry

In addition to the many changes affecting the global economy there came two catastrophes, one that some say changed worldwide weather patterns, the eruption of Mt. Pinatubo in the Philippines, and a second which became one of the ten worst insurance catastrophes on record, Cyclone Mireille in Japan.

The explosion of Pinatubo on 15 June was the largest volcanic eruption the world had known in nearly a century. In addition to the widespread destruction that the volcano wrought on the island of Luzon, the impact was felt throughout the region and around the world. A continuing local hazard derived from the millions of tons of ash and rock that blanketed the flanks of Pinatubo and created dangerous rivers of mud during the annual rainy seasons. Massive infusions of dust and gases into the upper atmosphere increased the levels of stratospheric aerosols to more than 20 times the normal. This caused global cooling of five degrees Celsius and weakened the protective ozone layer in the upper atmosphere for more than a year after the eruption. The blast caused a shift in North Atlantic wind patterns that resulted in a warmer than usual winter in Europe for 1991-92 and that has led to some speculation as to whether the long term impact on worldwide patterns can be known in full even now.[537]

A second catastrophe came in September. Cyclone Mireille was the worst typhoon to hit Japan in more than thirty years. It swept through for five days and intensified by interacting as part of a group of three cyclones to strike Japan during the month. So devastating was Mireille that it was to be known as a super cyclone and its name was retired from the cyclone list, never to be used again. Its cost to the insurance industry was a phenomenal US $7.14 billion.

Bermuda Fire and Marine Ltd. controversy

Bermuda suffered a catastrophe of its own when its largest domestic insurer made drastic structural changes in an effort to remain viable. After the disastrous results of the H.S. Weavers line slip in London, Bermuda's largest and oldest domestic insurer, Bermuda Fire and Marine Ltd., sold its profitable domestic business in 1991 to a newly created company called BF&M Ltd., while retaining its international business. Bermuda Fire and Marine was later to go into liquidation. Eyebrows were raised with the announcement of the creation of BF&M when it was discovered that the same people that ran Bermuda Fire and Marine also ran BF&M. This change in operational structure set off a great debate across the global insurance marketplace as to the credibility of Bermuda when it came to insolvencies.

[536] *Bottom Line*, International Business, November 1992, 'Bermuda's Frontman', by Robin Zuill, pp. 59, 77, 78

[537] NASA Goddard Space Flight Center GSFC on-line News Releases, 10th anniversary of the Eruption felt around the world, www.gsfc.nasa.gov

XL goes public

After the bad headlines made by Bermuda Fire and Marine, and after nearly a decade of cautionary loss experience, the Bermuda industry finally made some positive headlines in July when XL became its first excess liability company to go public. Brian O'Hara, President and CEO, said that, 'the decision to take EXEL public – the first Bermuda company to do so – was made for many reasons, not least of which was the fact that prior to going public, the company had a board of 70 directors, 68 representing the original policyholders/shareholders who took a proprietary interest in the company. We could all see that it wasn't a well-functioning model and that we had to downsize the board," said O'Hara, adding that there were also some very compelling tax issues, "where it was not in the economic interest of shareholders to be policyholders and one way for the company to remain robust and viable was to replace the private shareholders/policyholders with public shareholders."

Rance predicts the changing nature of insurance industry

With all the changes occurring in the Bermuda insurance industry, Cyril Rance, former head of Bermuda Fire and Marine, gave the following predictions and advice in *The Bermudian*—

> 'In looking to the future, it is apparent that the insurance industry worldwide will continue to be beset with serious problems and challenges. The whole nature of the insurance market is changing. The utmost good faith and trust that did exist in the past is disappearing rapidly. The principles of insurance are not being adhered to, and the industry is poised to have real restrictive measures instigated by insurance commissioners and governmental departments unless quick action is taken by the insurance markets to change. Bermuda is once again poised to take advantage of this phenomenon if, and only if, the entire Bermuda industry pulls together in taking this real challenge which could increase Bermuda's income enormously.
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> 'This is obviously a difficult task, but in my view it can be achieved if we work hard at it. We are going to see competition from other offshore territories like we have never seen before. We must continue to have the required expertise and integrity that is going to be expected from within the industry in Bermuda. We cannot sit back and expect the business to flow into Bermuda as it has in the past. The major brokers no longer support Bermuda as they did in the past; they now have offices and personnel in almost all other offshore territories, they are obviously going to support their other offices for one reason or another, which in my view is beginning to have an effect on business that would normally come to Bermuda.
>
> 'I am satisfied that Bermuda is poised to fulfil its function during the 1990's, provided that a concerted effort is made from within Bermuda. I do not wish to be critical but I once again recommend to the industry and Government that some form of Insurance Development Council be established with representatives from the industry, the Finance Ministry, the banks, the lawyers, and the accountants to formulate all of our resources so that we can go forward meeting with those overseas clients that already have Bermuda connections, and to strive to meet new prospective clients and in addition explore the opportunities that may exist in Europe and the Far East.
>
> 'Whilst this may sound strange to some, I believe the time has now come for the Bermuda insurance industry, in cooperation with the Finance Ministry, to appoint travelling business ambassadors similar to what our older colleagues did back in the days of promoting the captive concept. These so-called business ambassadors would promote what is available and what can be achieved and at the same time build up a relationship on a one-to-one basis with the brokers, risk managers, and senior (company) executives.
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> 'It may be prudent to work closely with one or two of the better known and respected offshore domiciles. We must obtain as much feedback as we can and act as an offshore insurance centre and to always maintain that lead with new innovative concepts.'[538]

[538] *The Bermudian*, Focus on Business, April 1991, 'Is Bermuda poised to fulfil its function during the 1990's?' by Cyril Rance

It was also in 1991 that *The Bermudian* reported on the results of a survey carried out by Penn & Schoen Associates, Inc., commissioned by BIBA, which demonstrated the following—

> '...90 per cent of all respondents recognised that international business is "either extremely important or very important to the Bermuda economy." Equally important, 95 per cent of respondents said they are either very or somewhat favourable to exempted companies. "Bermudians recognise the central role exempted companies and the international business sector plays in providing for the economic health of the country," reported Penn & Schoen in its report presented in February 1991. Only five per cent of Bermudians believe the country can meet its own economic needs, while 93 per cent recognise the fact that the country must look abroad to meet its economic and material needs. Also, 94 per cent believe exempted companies help the economy, while only three per cent believe they hurt the country. This growing awareness of the importance of the international business sector can only benefit the Island. For as the industry grows within the framework of an increasing globalisation of financial services, so too does the realisation that to succeed Bermuda must remain competitive. And given Bermuda's century old ability to survive the odds, the odds are in Bermuda's favour.'[539]

A relatively quiet year-end for Bermuda

Although 1991 had proved to be a year of turbulent and eventful contrasts for the world at large, what with natural catastrophes of historic proportions, a war in Iraq, the end of the Soviet communist empire, the return of South Africa to the international community, and renewed uncertainties for global commerce, the end of that same year was for Bermuda a time of comparative quiet. It saw the passing of Bermuda's first black Government Leader, Sir Edward Richards, and so it was a time for reflection. On the other hand, despite a worldwide recession, the international insurance industry in Bermuda still managed to show modest growth, with some 1310 insurance companies and 244 insurance brokers and managers writing US $13 billion in premiums. And so it was also a time of hope.[540]

[539] ibid. 'Bermuda's Captive Insurance Industry: Holding its own', by Kevin Stevenson

[540] *International Companies 1997, Their Direct Impact on the Economy of Bermuda* by Brian Archer, Report of an independent study carried out by the Ministry of Finance, Government of Bermuda.

CHAPTER 41

1992
And the Cats Come to Bermuda

Boundaries redefined

By 1992, the international companies provided half of Bermuda's gross national product. Many were astounded by how quickly it had become such a major contributor. This contribution was to grow even larger than any of its forefathers could have ever imagined because the Bermuda market began to enjoy an amazing rate of growth, beginning in 1992, when the word 'catastrophe' took on a whole new meaning in terms of the scale of losses, both natural and man made.

At the end of 1991, there was a substantial roster of insurance companies, brokers and managers registered in Bermuda.[541] Responding to a lack of worldwide capacity for coverage, in less than two years Bermuda attracted nearly US $4 billion of new capital. As a result Bermuda wrote more than 20 per cent of the world's catastrophe reinsurance.[542] *The Bermudian* reported on the new status in the global insurance industry as follows—

> 'Exel Chairman Michael Kevany boldly asserts: "Bermuda is THE market!" And in ever growing specialty areas of insurance and reinsurance, his assertion has legitimate claim to being the truth. The boundaries of insurance are still being defined, with Bermuda having an increasing say in that definition.
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> 'Nowhere is this more evident than in the growing number of Bermuda-based insurance companies that can count in their balance sheets assets of more than a billion dollars. Put eight of the biggest entities together and you have more than US $23 billion in total assets. More important, each of these companies not only have strong financial reserves, they also employ men and women who have the courage and vision to pursue their own innovative concepts that are pushing beyond the traditional limits of their business. And rather than competing with one another, each is carving out a niche in an insurance world where barriers to innovation and creative genius are coming down.
>
> 'The growth of these companies has been nothing short of spectacular, and underscores the important role Bermuda now plays in providing innovative solutions to traditional insurance problems. As the captive insurance concept first introduced in Bermuda in the 1960s proved successful beyond all dreams, so too are the pioneering companies of the 1980s and 1990's. And their impact on the worldwide market place could be just as significant.
>
> 'Indeed, if we look at eight of the largest entities now operating out of Bermuda—American International, Centre Re, XL (Exel's operating subsidiary), ACE, OIL, Heddington, Mutual Risk Management, and Mid Ocean—four did not exist before 1985. One of them was formed just last year. OIL dates back to 1972, while American International is the grand-daddy of them all, having come to the island in 1947, and which now boasts assets in Bermuda of US $11.6 billion.
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> 'The list is hardly definitive in terms of both number and financial strength of the Bermuda insurance industry. Indeed, as the latest figures released by Bermuda's Registrar of Companies indicate, the

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[541] *Lloyd's List* magazine focus, June 1994, 'Bermuda Treasure Island – Insurers unearth capacity cache'

[542] *Historical Development of Insurance,* Chapter 1, 'Reinsurance Companies', p. 8, compiled by the Bermuda Insurance Institute

Bermuda market now boasts US $52.6 billion in total assets and US $19.7 billion in capital and surplus. By all accounts, Bermuda now has more capacity than Lloyd's of London, particularly in the excess and catastrophe markets. Gross premiums written in Bermuda during 1992 were US $15.4 billion, with net premiums written of US $11.8 billion. This compares with the entire US commercial market which has total premium volume of US $167 billion.

'These are extraordinary numbers, especially if you consider that almost half of the assets and capital are concentrated in a handful of companies.

'Other major players include a wide range of recently formed insurers who are more readily recognised by their acronyms, such as CODA, ALAS, SCUUL, not to mention the progeny of the likes of OIL which today include OCIL and TOPS. The nature of these companies range from mutuals, associations, specialty companies, to captives, all of which numbers 1,324 as of December 31, 1992….'[543]

A model regulatory environment?

While Bermuda was beginning to emerge once again as a credible offshore insurance jurisdiction, the United States insurance industry was in such a crisis that many were calling upon its government to do something about it. Many in the United States feared that the insurance industry was coming to the end of its line and wanted to find a solution to rescue it. Toni Mulder reported on the state of the international insurance industry in *Contingencies*—

'Congress has held over 20 hearings in the past 11 months in an attempt to assess just how the United States system of state regulation is working. In addition, Senator Howard Metzenbaum (D-OH) has released a draft bill that would impose a federal layer of regulation over existing state regulation.

'State regulators, in turn, have responded to the public's concerns by requiring states to meet minimum standards for solvency certification, requiring actuarial opinions for all companies, and strengthening many model solvency regulations—plus several other actions designed to tighten up the regulatory system and allay fears of further undetected insolvencies.

'…But none of these solutions goes to the root of the problem of regulation. Fact: There will never be enough money or enough manpower in state insurance departments to regulate solvency adequately. As Best's insolvency study showed, the six states (Pennsylvania, New York, Texas, Florida, Illinois and California) with the highest number of insolvencies are among those with the biggest regulatory coffers. An obvious conclusion is that even if one were given the budget, resources, and staff, something is missing in effective regulation. That something might well be the cooperation of the private sector

'One jurisdiction that has successfully incorporated the public and private sectors in its regulatory system is Bermuda…Bermuda's current position as the leading captive domicile owes much to the fact that it is seen as a quality jurisdiction. The quality control starts right at the formation stage with the stringent shareholder scrutiny by the Bermuda Monetary Authority and a thorough review of the business plan by the Insurance Admissions Committee (IAC)…'[544]

Mulder then pointed out the differences between Bermuda and the United States regulatory systems, while illustrating how the Bermuda regulatory system could work better for the bureaucratic United States. To this date, the United States system remains as it is and still many of its regulators and government officials look unfavourably on the Bermuda system. The Bermuda regulatory system was designed to be self-regulatory so that bureaucracy would not suffocate it; thereby

[543] *The 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

[544] *Contingencies*, January/February 1992, 'Postcard from Bermuda', by Toni E. Mulder, actuary and President of E.T. Mulder, Inc, in Washington DC

allowing Bermuda the ability to respond promptly to worldwide needs. Time and time again, this is exactly what the Bermuda regulatory system has done and continues to do today.

IRS ruling on life insurance companies

Bermuda received yet another boost in captives when in 1992 the United States Internal Revenue Service decided companies could deduct group term life insurance premiums paid to captives, because these premiums represented unrelated business.[545] This ruling set into motion the impetus of the life insurance industry in Bermuda.

Hurricane Andrew

Before 1992, Bermuda was known as the captive centre of the world and looked upon as an alternative market, until a hurricane in the Caribbean and the US devastated the international insurance industry and catapulted Bermuda to dizzying heights in the global financial marketplace. Hurricane Andrew wrought unprecedented devastation through the northwestern Bahamas, southern Florida peninsula, and south-central Louisiana. Damage in the United States was estimated to be near 25 billion, making Andrew the most expensive natural disaster in US history.[546] Brendan Noonan commented in *Best's Review* how Hurricane Andrew 'redefined the possible terms of insured losses and forced the industry to seek a new level of sophistication in modelling and managing its exposure.'[547]

It was later reported that 'until September 11, 2001, Hurricane Andrew was the world's worst "disaster of record." According to a report commissioned by the office of then Florida Governor Lawton Chiles, the devastation included 23 deaths directly attributed to the storm, 28,066 homes destroyed, 107,380 homes damaged, 82,000 businesses destroyed or damaged, 7,800 businesses closed...and 86,000 people out of work as of September 1992.'[548]

Several insurance companies in the United States went out of business as a result of Andrew. It changed the industry attitude towards catastrophes. "...prior to Andrew, the insurance industry perceived its role was to cut checks. Once having done that, the traditional perception was others would do the rebuilding.' So said industry observer William Bailey, author of the book *Andrew's Legacy: Winds of Change* and in the *Best's Review* Dennis Kelly quoted him as saying that '...with Andrew, insurers followed a whole new set of rules in dealing with customers and working with government agencies to help rebuild devastated communities... The result was only a handful of lawsuits from dissatisfied policyholders after Andrew....'[549]

This devastating hurricane in the United Status was the impetus that led to Bermuda being put on the map for attracting big business. It was the spark that enlightened the world as to how quickly Bermuda could make up for shortfalls in the insurance industry worldwide. It was also the event that brought Bermuda to the forefront to many looking for a government environment that worked in partnership with the private sector and not against it. 1992 ushered in the time of big business for Bermuda, not just from an insurance perspective but also across the board.

Bermuda Fire and Marine collapses

In November 1992 Bermuda Fire and Marine collapsed because of its participation in the H.S. Weavers underwriting pool. Those who were in possession of information as to developments at

[545] *Business Insurance*, 13 November 2000, p. 32, 'Bermuda Market, Exploring the Island's Expertise from tip to tip, Charting Bermuda's History', by Shirley Henry, Sources Bermuda Insurance Institute and Business Insurance reporters
[546] National Hurricane Center website, www.nhc.noaa.gov/1992andrew.html
[547] *Best's Review*, August 2002, 'Renaissance Man', by Brendan Noonan
[548] www.insure.com, '10 years later, Hurricane Andrew would cost twice as much', by Insure.com
[549] *Best's Review*, P/C November 1999, 'The Eyes of the Storm', by Dennis Kelly, pp 28–36

Bermuda Fire and Marine were restrained by counsel from making any public statements for nearly seven years, from late 1992 to December 1999. According to senior BF&M officials the resulting silence was filled by misinformation, uninformed comment, and all sorts of theories put about by people who knew little or nothing of the facts. One story, heavily disputed by BF&M, was published in *Lloyd's List* in 1994. In this David Marchant questioned how the collapse could have occurred in the first place—

> '...A potential "image" problem for Bermuda lies in the ongoing investigation into the collapse of Bermuda Fire and Marine in November 1992. Bermuda Fire was a domestic insurer that suffered heavy losses by expanding into the international arena through its participation in the London based H. S. Weavers underwriting pool. Questions which still have to be answered include how such a relatively tiny company was permitted to write up to 15% of the pool's business, while the world's largest reinsurer, Munich Re, only took 12% participation. The central issue, however, is the controversial sale by Bermuda Fire of its successful domestic business in 1991 to a newly formed BF&M, which was set up and run by the same people who controlled Bermuda Fire.
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> 'The break-up has been described by US creditors of Bermuda Fire as nothing more than an asset-stripping exercise that took more than US $50 million out of the company that would have otherwise been available to meet potential future claims on Bermuda Fire's deteriorating long-tail business. The 1991 directors and officers have denied any wrongdoing and claim they left behind more than enough assets to cover liabilities, although sources involved with the liquidation claim the reverse is true.
>
> 'Accounting firm Ernst & Young, the provisional liquidators of Bermuda Fire, and the United Kingdom Department of Trade and Industry are currently investigating the matter. Action against the 1991 directors and officers is considered by some to be inevitable. The implications for Bermuda are widespread because the 1991 directors and officers of Bermuda Fire who authorized the split-up are some of the island's most powerful people, including past and present government MPs, several Justices of the Peace and the heads of some of the largest local companies.'[550]

According to one BF&M source, contrary to the allegations in the Marchant story, Munich Re reinsured all of the slip participants and their exposure was absolutely enormous. Whatever the finer points of the matter, to the present day some outside analysts still feel the Bermuda Fire and Marine troubles have left a blemish on Bermuda. Alan Levin of Standard & Poor's believes that the situation was glossed over. There is an outside perception by some that local companies will be treated differently in Bermuda. As a result of Bermuda Fire and Marine there is also a latent fear that Bermuda is a regulatory sham which will protect its own at the expense of outsiders.[551] Yet there are others who believe that the matter was dealt with fairly within the Bermuda legal system and that the commercial settlement that was reached, without any admission of wrong doing, was entirely appropriate and not at all different to what would have happened in London for example.

One is left to ponder why there was such a huge scandal over the Bermuda Fire and Marine case when it was handled in the same way it would have been treated in other jurisdictions. Many companies in the United States separate their current businesses from their past liabilities. There is likewise the formation of Equitas in London. Is Bermuda the more closely scrutinised because of its many successes in the financial sector or because it is considered to be 'offshore' or simply because it is seen to be a threat?

[550] *Lloyd's List* magazine focus, June 1994, 'Bermuda Treasure Island Insurers unearth capacity cache, The mouse that roared at the insurance world', by David Marchant, pp. 1 & 3

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

Mid Ocean Re formed

There was at least one man for whom Hurricane Andrew came at a propitious time. That was Robert Newhouse, the partner and fellow pioneer of Bob Clements in the first generation of excess liability carriers in Bermuda. Newhouse had been retired for two years from the insurance industry when he spotted a void in the property catastrophe reinsurance marketplace. He immediately contacted Bob Clements, the mastermind behind ACE and XL, to discuss the state of the market and to try to come up with a solution; Clements and Newhouse then had several talks with Guy Carpenter, the reinsurance broking arm of Marsh & McLennan.

Sensing that their window of opportunity was about to close if they did not act quickly, Newhouse sent Clements a note, saying that he thought they ought to act at once. The chance to solve the property cat shortage was an opportunity not to be missed. Clements agreed but said he would only be interested in helping to form a property cat company if its capital was raised more conventionally than the way in which ACE and XL were capitalised. He recalled that ACE and XL had been in operation for several years and had very good loss records as they were. However, the development of both companies had been hindered by their unconventional governance structure. The need to offer sponsors a brand had left ACE with 34 directors and XL with 68. Furthermore many of the people selected for this role by their sponsors were also responsible for negotiating their own policy renewals with the two companies.

Clements insisted that they approach professional investors to raise the capital for the new company, Mid Ocean Re. Marsh & McLennan agreed this time to put up 10 per cent of the capital. Marsh's contribution to Mid Ocean not only made it easier to raise the rest of the capital for the new company but also proved to be immensely profitable. They were able to raise US $350 million for the new company in nine months. Raising the capital for a new property catastrophe reinsurer was a little more difficult than they expected because of Hurricane Andrew and the Northridge Earthquake. Investors were a little wary of the property catastrophe market. A lot of doom and gloom was circulating in the media as to a supposedly expected increase in natural catastrophes.

Clements then suggested to Newhouse that he become the Chairman of Mid Ocean because his name would lend credibility to the project. Clements said he wanted Newhouse because "he was by far the best candidate around." Newhouse accepted and they set out to staff Mid Ocean with the best names in the property cat market. They continued to work with investors.

The original consultant for Mid Ocean was Charlie Skey, an old friend of Newhouse who was a well-respected underwriter. Having Skey on board was key to the whole operation, as he was able to do the initial underwriting before Mid Ocean was staffed up. Skey then introduced Newhouse and Clements to Henry Keeling, who turned out to be a great asset to Mid Ocean as its Chief Underwriting Officer. Then they decided to look for a President to run the day-to-day operations of Mid Ocean. Newhouse and Clements were both close to Michael Butt from the Sedgwicks days and thought he would be the ideal candidate for this new position. They were actually talking to him about another position in London but then decided he would be better for the new property cat reinsurer in Bermuda. Butt agreed and the rest is history.[552]

Said Newhouse in an interview with *The Bermudian*—

> 'I saw that there was going to be a complete vacuum in property catastrophe and I went to Bob Clements, who I had worked with on ACE and XL, and told him that I thought there was a great opportunity to find a solution to the reinsurance requirements that weren't being met. This led to working with Clements and Roberto Mendoza of J.P. Morgan again and convincing the investment community that there was a real opportunity to fill a vacuum.'[553]

[552] Interview with Robert Clements, December 10, 2002

[553] *The Bermudian*, Focus on Business, January 1995, 'Prop Cat Visionary', by Kevin Stevenson pp 5 & 11

The Wall Street Journal reported on the devastating effects of Hurricane Andrew on the market as follows—

> 'Although Lloyd's is writing less reinsurance, the demand for the coverage became even stronger since Hurricane Andrew hit Florida last year. Following the hurricane, the price of catastrophe reinsurance shot up 40%, and Mr Clements was the first to grab the opportunity. Three months after the storm, Marsh & McLennan and J. P. Morgan formed Mid-Ocean Ltd. This time, investors were interested. Texas investor Richard Rainwater, Hawaii's Bishop Estate and insurance expert John Byrne put up money. Marsh and J.P. Morgan each invested about US $30 million.'[554]

Mid Ocean Re began operating in November 1992, becoming Bermuda's first property catastrophe reinsurer. It was originally set up with a capital and surplus of US $350 million. Speaking about Mid Ocean Re's entrance into the property catastrophe marketplace, Mr Newhouse was quoted by *The Bermudian* as saying—

> 'Timing is the most important thing in the world. You can be the smartest man in the world, but if your timing is wrong, they forget that quickly. In the insurance industry, timing is absolutely vital. It (Andrew) was manna from heaven as far as pricing goes, but having said that, whether it came a year later or at another time, it was going to come and wake everybody up to the basic problem of retention in the US.
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> 'Mid Ocean's lucky timing was not lost on other potential insurance industry investors. They rushed in to fill the prop cat gap and the result has been an easing in the capacity crunch, benefiting the entire industry.'[555]

The other significant aspect of the formation of Mid Ocean is that it heralded a new era for the formation of future insurance companies. Mid Ocean was born out of the marriage between established major reinsurers, brokers, and the capital markets. The mystique of forming an insurance and reinsurance company was no longer limited to those in the insurance industry and had now been opened to the capital markets, thereby making it much easier for capital to be raised to start a new company than was possible in the past.

Thorn Rosenthal, partner at Cahill Gordon and Reindel in New York, said Mid Ocean was much easier to launch than ACE and XL because of their successes. It also marked another paradigm shift in the way Bermuda was to be viewed as an insurance marketplace. However, the difference this time was that many did not want to lose out on a chance to make good returns, as had been the case for those who invested in ACE and XL, and therefore many copycats of the Mid Ocean concept were quickly formed. The entry of so many other insurers and reinsurers after the formation of Mid Ocean was a testament to the vision of Clements and Newhouse.

United Security Life Insurance Company

Bermuda faced another large insolvency in February when Bermuda's Registrar of Companies, Malcolm Butterfield, followed the lead of Trinidad and told United Security Life Insurance Company (USL) to stop writing new business. USL was headquartered in Trinidad & Tobago but had a branch office in Bermuda. It collapsed in 1992, leaving 2000 policyholders facing large losses. Not wanting to be embarrassed by such a large insolvency, which took money from many of Bermuda's working class, the government sought to know what caused the failure and to provide against a repetition. David Marchant, reporting for *Bottom Line*, quoted Walwyn Hughes, Financial Secretary of the Ministry of Finance, as saying—

[554] *The Wall Street Journal*, 31 August 1993, 'Alluring Island, New Bermuda Insurers are Draining business from London market but their catastrophe lines run some of the same risks that devastated Lloyd's, The boom on Victoria Square', by Greg Steinmetz

[555] *The Bermudian*, op.cit.

'If we didn't learn anything from the United Security Life affair then we would be pretty foolish. We've already made certain changes to the Companies Act which allow us to have a little bit of a handle on the affairs of companies which are not incorporated here, as is the case with NRIUs (Non-Resident Insurance Undertakings, discussed in 1967). Recent amendments to the Companies Act make it possible for the winding up in Bermuda of companies like NRIUs. Before, there was no way to wind up a company that wasn't registered here...We will be looking very closely at the insurance and companies' legislation which applies collectively to NRIUs because they're a separate animal and we don't have the same controls as we do with locally incorporated entities...We will be looking ourselves at things we can do legislatively to provide something which is a little more rigorous in its approach to the operation of NRIUs here, taking a look at reserves and things of that nature.'[556]

Many local insurers were very concerned about Bermuda's image being tarnished by these foreign companies controlled from a totally separate location and therefore had no vested interest in Bermuda's well being. But all was not lost because as a result of this financial smudge on Bermuda's image, local regulators and business people once again sat around the table and drafted legislation to try to prevent such an incident from occurring again.

Task Force on Employment

To illustrate just how unprepared the Bermuda insurance industry was for the boom about to hit Bermuda, a special task force was put together in 1992 to provide a ten year projection on the insurance industry. The committee consisted of several people from the industry including Brian Hall, Monica Dobbie, Anthony Joaquin, Cyril Rance and Nick Wheeler. Based upon prior manpower statistics and their view of the industry growth at that time the committee projected that—

'The industry will see nominal growth in total population.

'There will be a gradual aging of the population.

'There will be a continued decline in the number of clerical and service related jobs (Categories 3-5), with a commensurate growth in professional and technical, and administrative and management jobs (categories 1&2).

'There will be the need to replace approx. 125 people who will retire.

'Due to cost considerations, there will be even greater commitment to automation and computer networks. This will also enable larger employers to consider the cost alternatives if retaining work product in Bermuda, or exporting via their networks.

'The principle area of revenue growth (currently defined as premium volume) will come from the Excess and Financial Reinsurance sector. Insurance Brokers will benefit from this. Based upon existing foreign regulatory conditions. Insurance Managers will remain relatively static, due to the maturity of their market – we project that a hardening market will be short-lived and will have no material effect on population. The domestic market will maintain a status quo, with a nominal downturn in sales people.'

The committee concluded that—

'The industry will only advance by 20 people over the next 10 years—brought about by an additional 52 people in Categories 1 & 2, and a further decline of 33 in the clerical category. —This is based upon a compilation of all sectors, and their projection to the year 2001. We foresee approximately 125 people retiring from the industry by 2001 and there being 374 people under 30 in that year—297 Bermudian and 77 non-Bermudian.'[557]

How mistaken they were...

[556] *Bottom Line*, International Business, November 1992, 'Could it happen again?', by David Marchant, pp. 57, 74, 76

[557] Task Force on Employment- Insurance Industry – Ten Year Projection, 30 December 1992

The 'Bermuda Angle'

This was the brainchild of Brian O'Hara, CEO of XL, and Robert Mulderig, CEO of Mutual Risk. Gavin Arton, Exel's senior VP of investor relations and corporate planning, explained that it was created to 'provide an in-depth investment think-tank for sell-side analysts and shareholders, and that it was to spotlight 'the financial stuff at the back of the annual report.'[558]

According to Rob Mulderig, one of the things the island desperately needed, after first his company Mutual Risk Management and then XL went public, was exposure to Wall Street analysts who knew little of these huge Bermuda companies. Mulderig said he was looking for a way to increase the profile of the Bermuda companies when he noticed that the Bermuda Open Golf Tournament was struggling to find sponsors. He then contacted Brian O'Hara, head of XL, to discuss the possibility of linking the Bermuda Open Golf Tournament with analysts coming to Bermuda. O'Hara liked the idea, so the two set about formalising the 'Bermuda Angle'. The Bermuda Angle Conference took place in 1992. The only publicly traded Bermuda companies were Mutual Risk Management and XL, so they were the only companies that could attend.

By 1993, ACE had become a public company and therefore was able to join the Bermuda Angle. Each year thereafter the conference has grown considerably as the number of publicly traded companies in Bermuda increased dramatically. Top analysts, from Bear Stearns, Goldman Sachs, JP Morgan and Solomon Brothers among others, flew in for one-on-one meetings with each company. After presentations, analysts quizzed CEOs and other top executives about the financial health of their firms.

The Bermudian quoted Gavin Arton as follows on the significance of the Bermuda Angle—

> 'I think these meetings are quite forthcoming... A typical presentation would be a review of the most recent financial period, a historical financial review of where the company is now, discussion about current underwriting conditions, market conditions, opportunities, challenges. They want to know how many shares outstanding we have, whether we have buy-back programme; they're interested in our balance sheet and earnings.
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> 'This is as close to a public meeting as you can have in a controlled circumstance... Invariably, it gives CEOs a chance to talk about the very big picture—to talk long-term about the opportunities for their company—with the implied sell underneath.'[559]

FASB issues Financial Accounting Standard 113 and EITF 93-6

To end the year on a note of concern, FASB issued Financial Accounting Standard 113 and EITF 93-6, which materially affected the way financial reinsurers operated. According to *Business Insurance*, EITF 93-6—

> 'Governs the reporting of insurance transactions by publicly traded insurers using generally accepted accounting principles. Among other provisions, the new rules state that a contract will be considered reinsurance only if it transfers "significant insurance risk" to the reinsurer and if it is "reasonably possible" the reinsurer will suffer a "significant loss" under the contract.
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> 'FASB's Emerging Issues Task Force—at the Securities and Exchange Commission's urging—in March proposed a rule subsequently adopted by FASB that virtually eliminates the benefits of funded catastrophe covers. Under a typical multiyear funded cover, a reinsurer places premiums into a segregated fund. A loss exceeding the amount of the fund creates a negative balance that the ceding company is obligated to repay with increased premiums, settlement adjustments or, if the ceding company cancels the contract, cancellation penalties.

[558] *The Bermudian*, Focus on Business, April 1995, 'The Bermuda Angle', by Rosemary Jones, pp B44–B45

[559] ibid.

'Under the new rule, which is known as EITF 93-6, obligations owed to reinsurers under multiyear contracts must be reported as liabilities by ceding companies while reinsurers will have to report these obligations as assets. Conversely, if a ceding company stands to make a profit under a multiyear contract because of good loss experience, that amount must be booked as an asset while the reinsurer reports it as a liability.

'Requiring ceding companies to report the amounts owed to reinsurers as liabilities effectively means that funded cat covers can no longer be used to "smooth out" balance sheet volatility over a multiyear period.[560]

Bermudian Business reported on the effects of FASB 113 as follows—

'FASB 113 requires that more specific hurdles be overcome for a contract to be considered to transfer risk than had been required under previous accounting standards. Contracts that fail the risk transfer criteria of Statement 113 must be accounted for as financing, not insurance transactions, i.e. deposits.

'In short, the reinsurer must assume significant risk and it must be reasonably possible that the reinsurer may realize a significant loss. "Reasonably possible" and "significant loss" still remain somewhat judgmental, but a "probability" of 10 to 15 per cent can be considered reasonably possible and a 10-per cent loss can be considered significant.'[561]

This standard sent ripples through the financial reinsurance market and began a change in direction for financial reinsurers, which proved detrimental for some. Many said this new ruling would kill funded cat covers unless new techniques were found to make them comply with SEC rulings. The industry came to a virtual standstill as it sought to find new ways to smooth balance sheet volatility. *Business Insurance* continued—

'The move toward more traditional reinsurance products is likely to favour the larger reinsurers,' said Michael Smith, an analyst with Lehman Bros. in New York. 'Basically what the FASB did was to hand a big victory to the large reinsurance companies because what you are going to see is a shifting of demand away from financial reinsurance towards traditional reinsurance, but traditional reinsurance requires more risk-taking and therefore requires more capital.'

'One new area that some reinsurers are beginning to look into is the use of different hedge potential losses from these more traditional reinsurance arrangements,' said Alice Schroeder, an analyst with Paulsen, Dowling Securities Inc. in Boston and until recently a FASB project manager. '...There is still a question as to whether such hedging would be permitted under FASB 113, which says all agreements must be linked with the reinsurance contract as a whole.'[562]

The industry ends 1992 with modest growth but increasing importance to GDP

After a year of many changes the industry again ended with modest growth. Many welcomed the income from international business because Tourism was not showing any improvement. Indeed the Bermuda Department of Tourism, in a bid to attract visitors to the island, introduced the '68-degree guarantee', which reduced room rates if the daily high temperature did not exceed 68 degrees during the winter months. And in the midst of trying to win back tourists, the Grotto Bay hotel workers went out on strike during the peak tourist season, which did not bode well for the image Bermuda was trying to sustain.

The importance of growth in the international business sector to the financial stability of the island became even more apparent in 1992, when income for the year from international business was level with income from tourism, as elements of the GDP.

[560] *Business Insurance*, 1 November 1993, Spotlight report, 'Financial reinsurers bounce back from accounting setback, FASB changes making financial reinsurance more traditional', by Judy Greenwald pp. 24, 28–29

[561] *Bermudian Business*, Summer 1998, 'The quiet success story, Scandinavian Re has emerged as a major player in the finite risk arena', by Kevin Stevenson, pp. 46–51

[562] *Business Insurance*, op. cit.