CHAPTER 48

1999
The Year of Worst Performance

Global market ills have little effect on Bermuda

By the time 1999 rolled around, the global insurance industry was in serious trouble. Premiums and interest rates had hit rock bottom. Global growth was stagnant and the industry had too much capital, which meant that it had excess capacity. And when there is excess capacity, insurers are forced to lower their premiums if they want to maintain their volume or grow. 1999 was the tip of the iceberg for the insurance industry's paradox in trying to justify its existence. It was also the year when the industry faced one of its worst crises with the year 2000 exposure (Y2K) bearing down on it in less than a year at a time when it had very low premium income to sustain such a large potential loss. In an article entitled 'Capital Punishment', *The Economist* commented on the state of the market—

> 'The insurance industry is in trouble. The main reason is that it has too much capital. Shareholders should ask firms to give it back to them.
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> '...None of these ills is new. For some years, both primary non-life insurers (who underwrite property and casualty policies) and reinsurers (who insure insurers) have been charging less and less, often far too little, for the risks they take on. Commercial lines such as marine and aviation have been worst affected. But few major types of insurance have escaped. Some risks are now being underwritten in the London market, a world insurance centre, for half the prices paid only a few years ago. Premium rates in America are down by 17% from 1994, even though the value of insurers risks has shot up.
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> 'If such reckless underwriting has not yet produced more profit warnings, share-price collapses and distress sales, it is largely thanks to cosmetic book-keeping. Insurers have been propping up accounting profits by releasing claims reserves from their balance sheets. Douglas Leatherdale, boss of the St Paul, America's eight-largest non-life insurer and fifth-largest reinsurer, reckons that without such face-lifts, the American non-life industry, as a whole, would have made losses in 1997, instead of the 9% return on equity that it claimed. But reserves last only so long – and they are starting to run out. From now, big losses will hit the companies' bottom lines.'[774]

Despite the continued dire global insurance market conditions, the Bermuda insurance industry continued to grow, albeit modestly. Figures released by the Registrars office for 1999 and reported by *The Royal Gazette* attested to this fact—

> '...New figures released by the Registrar of Companies ...show Bermuda's market growth came at the high end, and was characterised by developments with larger companies.
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> 'As was anticipated internationally, competitive pricing pressures continued although to a lessening extent, but the statistics reflect a Bermuda market that continues to resist pressure to chase rates downward. The focus has been on maintaining strong balance sheets and managing company assets with a conservative investment philosophy. This is reflected in a thirteen per cent increase in total assets from US $116.4 billion to 131.6 billion and a six per cent rise in capital and surplus from US $51.2 billion to US $54.4 billion.

[774] *The Economist*.com Business, 14 January 1999, 'Capital punishment'

'Overall gross premiums written grew to just over US $30 billion and net premiums increased twelve per cent from US $21.2 billion in 1998 to US $23.8 billion.

'Underwriting restraint and continued security remained a strong focus of the Bermuda markets as the latest statistics point to an industry-wide premium to capital and surplus ratio of .44 to one.

'It is also apparent from the statistics that the Island's captive insurance business, as reflected by Bermuda's Class 1 and Class 2 companies suffered from a contraction in the volume of business written in 1999.

'This was due in part to the re-registration of some of these companies into Class 3, and buyers continuing to seek out cheap commercial capacity that was prevalent in the traditional markets as an alternative to insuring their captives. The combined net premiums written of these two classes declined to US $3.8 billion, while their combined assets finished the year at approximately US $39.4 billion, up nine per cent from 1998.

'Another significant aspect of the Bermuda market in 1999 was the growth of the Class 3 sector of the market. Under Bermuda's multi-licence system of regulation, Class 3 companies include finite risk reinsurers, rent-a-captives, agency captives, commercial carriers and captives deriving more than 20 per cent of net premiums from unrelated risks.

'During 1999, the capital and surplus of Bermuda's class 3 companies rose by US $2.3 billion to finish at US $24.3 billion up ten per cent on the US $22 billion recorded in this category in 1998.

'The balance sheets of Bermuda's Class 4 excess liability and property catastrophe reinsurers were impressive, even with the high frequency and severity of catastrophic events in recent years.

'Total assets increased by nine per cent to US $23.6 billion from US $27.1 billion in 1998, while capital and surplus declined slightly to US $10.2 billion from the 1998 figure of US $11 billion. Gross premiums written increased by SD 1.6 billion, up 59 per cent from the US $2.9 billion written in the previous year, and net premiums rose 43 per cent to US $3.3 billion. This growth reflects the initiatives of certain companies to expand geographic coverage and diversify products.

'As a whole Bermuda's Class 4 insurers remain some of the best-capitalised companies in the world with a premium to capital surplus ratio of 0.32 to one.

'Assets for long-term insurers moved 114 per cent higher to US $9 billion, from US $4.2 billion in 1998, and capital and surplus for this category rose 111 per cent from US $0.9 billion to US $1.9 billion. Net premiums written increased 25 per cent to US $3 billion from US $2.4 billion in the previous year.

'Registrar of Companies, Jeremy Cox said: "Bermuda's insurers continue to grow at a modest rate and appear committed to expansion, while maintaining underwriting discipline. The Bermuda market even through challenging conditions has demonstrated an ability to shift resources strategically to benefit from opportunities that may exist in other major markets."

'...(Newly appointed) Chairman of the Insurance Advisory Committee, Robert Steinhoff, described the Bermuda insurance industry as, "a market which continues to out-perform competitive markets. Bermuda's insurers with their strong balance sheets, are well positioned to capitalise on the improving rates currently being experienced in the global reinsurance market."'[775]

Bermudian Business then reported the following about the Bermuda insurance market—

'The United Kingdom's National Audit Office (NAO) has singled out Bermuda's shared regulatory approach to the supervision of insurance as a model for other United Kingdom overseas territories.

'...(Newly appointed Chairman of the Insurance Advisory Committee Robert) Steinhoff describes the Bermuda insurance market as the "world's insurance laboratory"..."The Bermuda model is seen to have a unique regulatory framework that provides for innovation and attracts both financial and intellectual capital from the world insurance and capital markets, says Steinhoff. "The Insurance Amendment Act

[775] *The Royal Gazette*, 19 February 2001, 'Insurance market keeps on going', by Sue Stuart

1995 introduced a risk-based regulatory system, which has proven to be very successful and is a key reason why Bermuda is on the cutting edge of capital and risk management techniques and creative solutions."'[776]

Lloyd's underwriting agency Venton comes to Bermuda

Once again, another Lloyd's underwriting agency sought refuge in the Bermuda international insurance industry, away from the continued deteriorating results within its own group. Jeremy Venton, founder of the Venton underwriting agency formed Venton Underwriters (Bermuda) Ltd., to write US $50 million in short-tail United States reinsurance. Venton retained the services of RSA Services Ltd. to operate in Bermuda as reported by *Insurance Day* magazine—

'To build Venton's local operations, including hiring staff and raising the image of the company. ...RSA President Robin Spencer-Arscott, former Chairman of Aon's Bermuda operations, said his company has been hired for an initial period of six months to consult with the operating subsidiary.

'...Underwriting responsibilities in Bermuda are being handled by Venton founder and former Lloyd's underwriter Jeremy Venton, who is President and CEO of Venton Underwriters (Bermuda). Mr Spencer-Arscott says Venton plans to write US $50 million of premium income out of Bermuda over the next 12 months. Its main target is the lower northeast coast of the US.

'VHL was acquired last year by Underwriters Re of California for about US $190 million in cash. Underwriters Re, which is the reinsurance unit of Alleghany Corp, also assumed about US $123 million in letter-of-credit obligations that support Venton's Lloyd's corporate member, Venton Underwriting.'[777]

Consolidation, securitisation, and Y2K, buzz words of 1999

Nearly 600 delegates attended the World Insurance Forum held at the Southampton Princess to hear the panel debate about the future of the industry, with so many consolidations, and where the whole securitisation concept was heading. *The Royal Gazette* reported on the forum as follows—

'...XL Capital President and CEO Brian O'Hara said companies are going to have to go big to meet the needs of their large, global clients. Size is necessary in order to service such clients.

'Aon Corp. Chairman, President and CEO Pat Ryan said globalisation is forcing the acquisitions. "Scale is absolutely critical in globalisation through acquisition," he said. "We think the strategy is sound," Mr Ryan said. "It's in the execution, the cultural clashes in cross-border mergers that's the challenge."

'Swiss Re America Chairman, President and CEO Heidi Hutter said companies should not pursue acquisitions just to be larger. There must be compelling reasons to grow. "Scale in and of itself is not a virtue," she said. "The compelling reason to buy and grow in the insurance industry is done on the rationale that there is a diversification of risk and that you have to have the capacity to do the deals."'[778]

Despite Hutter's view, it was the view of *Insurance Day* magazine that—

'merger and acquisition activity in the US property/casualty (p/c) will continue at a high level during 1999, but only if there are several large-scale deals will true consolidation and capacity rationalisation occur. According to Alain Karaoglan, analyst at Donaldson, Lufkin & Jenrette, too much capital is still chasing too little business in the US p/c sector and recent mergers and acquisitions (M&As) have had no substantial impact. Merger and acquisition activity is at the same high level, but it will only start consolidating the industry if a large company starts merging with another large one. "We need the first

[776] *Bermudian Business*, Summer 1999, 'The "insurance lab" Bermuda cited as a model for other territories', pp. 28 & 30

[777] *Insurance Day*, 5 January 1999, Issue No.561, 'Bermuda underwriting unit planned by Venton', by Kevin Stevenson, p. 1

[778] *The Royal Gazette*, 18 February 1999, 'Growing pains: Top insurers debate the merits of mergers', by Ahmed ElAmin, pp. 17 & 19

catalyst, then others will follow," he said. During 1998, some 37 M&A transactions occurred in the domestic US p/c market, amounting to US $42 billion in volume terms, including Berkshire Hathaway's US $22.3billion acquisition of General Re last June. This compares with 29 M&A transactions amounting to US $9.3 billion in 1997, DLJ analysis shows. Despite this increase, Mr Karaoglan said recently announced deals, such as ACE's acquisition of CIGNA's p/c business, and XL Capital's purchase of Nac Re, had just been moving capacity around. "We need the big companies to merge together especially in commercial lines…We need more of the Travelers/Aetna type merger, where they decreased their market share because they rationalised the business. This would make a healthier environment," he said. In his outlook for 1999, Mr Karaoglan points out that even though the number and volume of M&A transactions have been increasing, the US p/c industry is still very fragmented. "There are around 1,100 organisations selling p/c products in the US, of which around 130 are publicly-traded companies. As a result, competition is intense and prices remain under pressure, as there are too many products and lines of business," he said.'[779]

The other hot topic at the World Insurance forum centred on securitisation, investment banks and capital markets, as reported by *The Royal Gazette*—

'Aon Corp. Chairman, President and CEO Pat Ryan said, " it is clear banks can sell life insurance. In other areas with commercial banks and investment banks it has been a mixed bag. It works or it doesn't work in some cases. Personally I believe in cross selling. Cross selling is going to create organic growth, but I have yet to see successful cross selling. It will be done. I don't know who will do it effectively."

'Scor Chairman and chief executive officer Jacques Blondeau said it's going to be difficult to find synergies between insurance companies and banks. He believes instead technology such as the Internet is going to give more choice to more customers.

'…Ms. Hutter (of Swiss Re America) said she believes convergence is going to be a major force in the marketplace. Insurance is really a swap of taking in a fixed premium and paying out a variable claim. The industry is now growing beyond taking in a simple hazard risk and looking at other factors. More and more reinsurers are developing products that allow participants in capital risk. "Integrated risk management is really happening," she said. "We are looking at all the components of risk. Asset liability management is already happening."

'Mr O'Hara (of XL) said convergence is happening with sophisticated and big corporate clients. Insurers and reinsurers have the ability to do a better job of taking advantage of convergence than the investment banks since they better understand risk. Companies like Lehman Brothers and Goldman Sachs which have set up Bermuda based operations to transform reinsurance risk into the capital markets are going into an area they don't really understand. "The investment banks don't take real risks," he said. "They play with other people's money…Those coming into our business are naïve about the risks."'[780]

The *Bermuda Market Digest* added the following about the topic of convergence discussed at the World Insurance Forum—

'…(Rolf) Huppi, (Chairman and CEO of Zurich Financial Services) who said those who feel convergence is a temporary phenomenon are making a "big mistake…Survey after survey shows that the typical customer trusts a bank more than an insurer because of bad experiences over claims or deceptive sales practices. The reality is that we have a very bad image in the eyes of the public and the banks are fully aware of this." Huppi said that with newly-formed entities such as Citigroup, ING, Fortis, and Credit Suisse/Winterthur, there is an increasing commitment to one-stop shopping. "In the corporate sector, the banks have been very creative in providing risk management advice and execution to cover all aspects of risk in the profit and loss statement and balance sheet. Hence all the derivative operations, which have been started up by insurers including ourselves," said Huppi. "The investment banks consider insurance securitisation to be an area

[779] *Insurance Day*, 23 February 1999, 'Merger activity to stay high in US p/c sector', by Claire Wilkinson, p. 3

[780] *The Royal Gazette*, 18 February 1999, 'Growing pains: Top insurers debate the merits of mergers', by Ahmed ElAmin, pp. 17 & 19

offering great potential to disintermediate of woefully inefficient profit and loss and balance sheets. Although only a few billion [dollars] of deals have been done to date, any quick uptick in rates will result in them jumping in more aggressively." Huppi said the real question to be asked is: "What does the customer want? It may not be what we wish to sell. He has choices and would clearly prefer providers of solutions rather than products – products he can buy on demand via the Internet these days. Convergence gives access to huge customer bases which, if approached intelligently, can be exploited at a much lower cost."'[781]

The thrust of the World Insurance Forum was evident as more and more companies formed alliances in 1999 to try to show growth. Leading the pack of company alliance was the announcement by State Farm and Renaissance Re that they were joining forces to set up a new reinsurer. *Insurance Day* reported on the alliance as follows—

'Bermuda-based Renaissance Re Holdings has joined up with the largest US writer of property insurance, State Farm, to form a new reinsurer which will provide US $3 billion of capacity for the most severe property catastrophe risks outside the US.

'Jay Nichols, VP of RenRe's operating subsidiary, property catastrophe reinsurer Renaissance Reinsurance, confirmed that the new company has already received approval by Bermuda's Registrar of Companies and that papers to incorporate as a Class 3 reinsurer will be filed this week....

'The new reinsurer, to be called Top Layer Reinsurance, will be financed with a US $50 million letter of credit from each company, in addition to US $1.25 million in cash—US $625,000 each—and a US $2.9 billion stop loss reinsurance cover from State Farm Mutual, the parent of State Farm Fire and Casualty. "Neither company would do this on our own, but it's a great opportunity to come together and offer a product for which we expect good demand," said Mr Nichols. "It utilises and diversifies State Farm's capital capacity and our underwriting capacity."

'Top Layer will provide clients with limits of up to US $500 million for protection against the most severe and as a result most infrequent natural catastrophes including earthquake, flood and wind. The trigger for each insured will vary depending upon cover being provided.

'Target markets for the product are the UK, continental Europe, the Far East and the Pacific Basin, including Japan, New Zealand and Australia.

'Mr Nichols says he expects Top Layer Re to price business at a minimum rate on line of about one per cent, and possibly as high as two to three per cent. He declined to estimate first-year premium volume targets.

'...Mr Nichols said underwriting and administration will be carried out by RenRe staff in Bermuda. He expects Top Layer Re's competition will be Berkshire Hathaway's National Indemnity, in addition to the cat bonds now being sold in the capital markets.

'Cat bonds have become increasingly popular in recent years, because they offer new capacity with large limits and high security. However, Nichols says he expects Top Layer Re to be more competitive by eliminating costs associated with bringing cat bonds to market. "All targets are based upon exposure," said Mr Nichols. "We're going to be careful, and make sure we do it right and fully evaluate exposures before putting coverage in place. All programmes are going to be underwritten with sophisticated modelling techniques, which is RenRe's hallmark."'[782]

The second major merger came with the news that XL acquired NAC Re as reported by the *Bermuda Market Digest*—

'XL Capital's acquisition of Connecticut-based NAC Re completes the fast-growing group's reinsurance development strategy, according to company President and CEO Brian O'Hara.

781 *Bermuda Market Digest*, March 1999, Vol 3, 'Convergence here to stay, says Huppi', pp 1 & 8

782 *Insurance Day*, 6 January 1999, Issue No. 562, US $3 billion backing for latest Bermudian reinsurer', by Kevin Stevenson p. 1

'The merger also creates the world's largest broker-market reinsurance operations from a dedicated capital standpoint with a combined capital base of about US $5.6 billion, of which US $3 billion is dedicated to reinsurance alone.

'XL also believes the acquisition provides a very good platform to generate future growth once the market starts to turn, which it believes will happen in the foreseeable future. And NAC Re will also play a significant role for XL's insurance strategy in the US—the largest insurance and reinsurance market in the world, according to O'Hara.

'XL and NAC Re last month (February) announced they had signed a definitive agreement whereby XL and NAC Re will merge in an all-stock transaction valued at US $1.25 billion—US $1.05 billion in shares issued to NAC Re shareholders and US $200 million in debt to be assumed by XL....

'At year-end 1998 the combined XL/NAC Re organisation would have assets of US $23.3 billion, US $2.3 billion of revenues, shareholders equity of US $5.6 billion and market capitalisation of US $8 billion. XL had revenues of US $1.22 billion in 1998.

'"We've had a reinsurance development strategy that was significantly enhanced last year with the Mid Ocean merger," says O'Hara. "But what was lacking with the Mid Ocean merger was an onshore, mostly casualty liability-oriented reinsurance platform. Bringing NAC Re into the fold completes our reinsurance strategy so that we have a very healthy spread of both short-tail property cat business in Bermuda and long-tail liability reinsurance businesses in the US."

'...O'Hara says NAC Re will also play an important part in XL's onshore insurance strategy through its Greenwich Insurance subsidiary, which is licensed in all 50 US states and the District of Columbia. NAC Re also has a network of 13 direct facultative offices in the US...

'"This is a great fit," says O'Hara. "There's no overlap in terms of business plans, especially in the US, and it's a great fit from a cultural standpoint. They are very dedicated to underwriting quality and profitability, as we are at XL. There's also no long-tail associated with the business as NAC Re was formed at the same time as XL. We have good lineage without any past-tail problems. It's the kind of transaction we've been looking for over the past two years. We think this has great synergy, that one and one is going to be more than two—we hope for at least three or four."'[783]

However, the biggest news of the year came with the announcement that ACE had acquired CIGNA Corporation. When ACE decided to buy the domestic property and casualty business including run-off business from CIGNA, it catapulted itself into a whole new league. *Bermudian Business* commented on the ACE/CIGNA acquisition as follows—

'As one New York based insurance company analyst says: "ACE is now a very big force on a global scale." ACE Chairman, President and CEO Brain Duperreault says: "This is an extraordinary event by any measure." Under the agreement, ACE will acquire CIGNA's domestic property and casualty insurance operations, including its run-off business. ACE will also purchase CIGNA's international property and casualty insurance companies and branches, including most of the accident and health business written through those companies. "The acquisition is one of the very few truly global franchises in our core business of property and casualty insurance and represents a quantum leap for ACE," says Duperreault. "This transaction significantly strengthens ACE's position as a premier player in each of the world's major insurance markets, including the US, with a business that is diversified by industry, market and type. This transforms ACE into one of only a handful of truly international property and casualty insurance concerns and provides a tremendous platform for future growth."

'For ACE, the deal delivers a position in the top-20 in the US property and casualty market, a significant presence in all major insurance markets worldwide, and expanded products and services in its core property and casualty business...Upon completion of the transaction, ACE will have approximately US $30 billion in assets and will employ more than 9,000 people in 47 countries worldwide, including 90

[783] *Bermuda Market Digest*, March 1999, Vol. 3, 'XL Capital acquires NAC Re', p.1, 14 & 15

offices in the US alone. ACE currently has 650 employees, primarily in Bermuda, the US and UK. "This acquisition frankly gives us global scale and scope, and moves us rapidly towards where we want to be as a global company," he (Duperreault) says. "Creating such a company is not easy, but in this one transaction we get a very consistent corporate and management culture that fits in well with ACE. It's a great platform to grow."

'...The combined net premiums written of ACE and CIGNA business being acquired would have been US $4 billion for the year ended 1998—quadruple ACE's net premiums written of US $883 million for that period...Under the agreement, ACE will acquire Brandywine Holdings, the holding company CIGNA formed in 1996 to act as a run-off operation for the group's asbestos and pollution liabilities. As part of the move, CIGNA also strengthened reserves for the future claims.

'Soon after the deal was announced, ACE disclosed it had purchased US $1.25 billion of reinsurance cover for the run-off business from National Indemnity, a reinsurance subsidiary of Berkshire Hathaway. ACE will pay for the cover through CIGNA's ongoing property and casualty operations, which were kept separate from Brandywine....'[784]

Speaking about the acquisition of CIGNA, ACE Chairman and CEO, Brian Duperreault said, all companies have good and bad points. Fully aware of the inherent problems of CIGNA, Duperreault said the good far outweighed the bad. CIGNA had a wonderful international franchise – second only to AIG in the world and because of its marketshare Duperreault felt the opportunity to buy a company with such extensive worldwide marketshare is very rare and virtually impossible to duplicate.

After pondering the implications of the acquisition, ACE approached CIGNA about buying its very profitable international business without the United States business. However ACE was told the only way they could buy the international business was to purchase the domestic business as well because the two businesses were not going to be split. ACE reluctantly agreed but Duperreault said in hindsight it was the best decision he made because CIGNA was heavily involved with healthcare business. At the time, Medicare was experiencing problems in the United States so people were looking to get private healthcare coverage and CIGNA was providing that to them.

To make the domestic operations more profitable, ACE cut the United States staff by one third. They also got rid of the middle market business and all other businesses that they did not feel were profitable enough to retain. Within six months of reorganising the company, CIGNA started to show a profit and had become one of the most profitable companies there is. Duperreault recalled people often say there is a fine line between insanity and genius. Within one year of acquiring CIGNA, Duperreault went from being called insane to a genius as CIGNA was earning six times what they paid for it.[785]

According to Robert Hartwig, Senior VP & Chief Economist of the Insurance Information Institute, ACE's acquisition of CIGNA is one of the few major acquisitions within the property and casualty industry that has worked out. ACE is still employing thousands of people in Philadelphia who may have been out of work had ACE not bought the company.

There were several merger and acquisitions in the property and casualty industry in 1998. Bermuda managed to complete several successful mergers and that according to Hartwig is a good story. By expanding into the United States, Bermuda companies are employing people there who are paying taxes. Therefore, indirectly Bermuda companies helped to keep people in jobs that they may not have had if the Bermuda companies had not stepped in. They have also managed to keep the tax payments to the United States government up by keeping people employed.[786]

[784] *Bermudian Business*, Spring 1999, 'CIGNA buyout puts ACE in forefront, p. 60

[785] Interview with Brian Duperreault, 2 December 2002

[786] Interview with Robert Hartwig, 1 November 2002

It was also in the fall of 1999 that Swiss Re announced that it was expanding its Bermuda focus as reported by the *Bermuda Insurance Update* newsletter—

'One of the largest reinsurers in the world can resist Bermuda no longer. Swiss Re, the world's second largest reinsurer, has decided to substantially expand its presence in the Bermuda market. Swiss Re has long recognised the value of being in Bermuda and operates several on-island companies.

'But it never had traditional, mono-line property/casualty, or multi-line underwriting resources in Bermuda. Underwriting will now take place on behalf of Swiss Re, from Bermuda, for the first time. More Bermuda companies may have to be formed to facilitate business production on the island.

'That's a new road for Swiss Re, which has typically created its Bermuda business from outside the island.'[787]

All these changes prompted mixed reviews from abroad. As reported by *Reactions* magazine, the worries of Wall Street about the diversifications of Bermuda companies ranged from expected culture clashes to the presumed inadequacy of management once faced with running such worldwide operations—

'Alan Levin, a director at Standard & Poor's (S&P) in New York said, "One of the strengths of Bermuda is a very lean management structure…That makes it difficult for these companies to supervise and control far-flung reinsurance and insurance operations around the globe. I don't know if they have the depth of management to do that."

'Several stock analysts following the Bermuda companies agree. Bermuda, once prized for its specialty risk transfer markets and captive insurance facilities, is now home to very large, broad-based insurers and reinsurers. The anti-establishment image the companies once cultivated is long gone.'[788]

Tempest Re writes first equity and catastrophe linked protection contract

The other topic, which was hotly discussed at the World Insurance Forum, was the future of securitisation, investment banks and the capital markets. Shortly thereafter, Tempest Re had a major announcement to make—:

'Tempest Re,' reported the *Bermuda Market Digest*, 'has written what it says is the market's first equity and catastrophe linked protection contract for the California State Automobile Association (CSAA) Inter-Insurance Bureau. Called "asset-linked catastrophe protection", the policy was written to protect the CSAA from the combined impact of a catastrophe, such as an earthquake, and a negative return from the CSAA's equity market investments. Also involved in putting together the transaction was reinsurance intermediary Carvill, Inc. "We have been working on combining asset and insurance protection for the last year and welcomed the opportunity to use our integrated catastrophe and financial modelling tools for CSAA," said George Rivaz, chief operating officer of Tempest Re. "We view the convergence of catastrophe protection and asset performance coverage as a natural development in the increasingly sophisticated use of reinsurance."

'James Molinelli, CSAA's President and CEO, says the association views this layer of protection as an extremely effective way to "extend our traditional reinsurance programmes and to manage two of our most significant risks in an integrated fashion."

'Asset-linked catastrophe protection manages traditional catastrophe exposures by more efficiently matching reinsurance coverage to a client's balance sheet fluctuations. In years when the equity market and surplus gains are strong, the cedant can retain more risk, whereas if the equity market is declining and the surplus is under pressure, the reinsurance programme can expand to provide additional protection for catastrophic events.'[789]

[787] *Bermuda Insurance Update*, Autumn 1999, Issue number 31, 'Swiss RE expands Bermuda focus', pp. 1 & 2

[788] *Reactions*, February 2000, 'Finding the path to success', by Russ Banham, pp. 28–31

[789] *Bermuda Market Digest*, March 1999, Vol 3, 'Tempest writes CSAA policy', pp. 1 & 16

Losses of key industry people

On the morning of 15 February 1999 the industry awoke to the tragic news that Madeline Joell, Member of Parliament and vice president of ACE, had died unexpectedly on St Valentine's Day. The front page of *The Royal Gazette* carried the headlined story. Many in the industry were shaken by the news because Madeline was one of those people who seemed to have life in the palm of her hands.

A few months later, the community was shocked again to hear of the sudden death of Kevin Stevenson, 45, founder and editor of *Bermudian Business* and President of the Bermudian Publishing Company while attending the RIMS conference in Dallas, Texas. The *Bermuda Market Digest* reported as follows—

> 'The debt owed to Kevin by the directors, employees and shareholders of the Bermudian Publishing Company, of which he was the President, cannot easily be measured. His energy was boundless and his vision was far-reaching. His intense enthusiasm for international business, insurance and Bermuda, and for those whose efforts and ideas fuel the progress of all three, suffused the pages of the *Digest*. The Bermudian Publishing Company Limited and LLP Limited intend to continue to publish *Bermuda Market Digest*, using the same team of committed professionals Kevin had assembled in Bermuda, London, and elsewhere. He would have wanted it no other way.'[790]

After just another few short months came the death of David Graham, MBE, MC, lawyer and banker, on 30 June at the age of 84. He had first come to Bermuda in the 1950s to work for Conyers Dill & Pearman (CD&P) and had been one of the original promoters who helped to get Bermuda on the map as a place for shipping companies to incorporate.

And then, but one month later again, former Premier Jack Sharpe died at the age of 77.

The OECD becomes a threat to Bermuda

Just as Bermuda was enjoying a honeymoon, with new companies setting up on the island and its larger companies, XL and ACE, establishing themselves overseas, the Organisation for Economic Co-operation and Development (OECD) dragged the island back again into the same old argument about 'tax havens'.

The United Kingdom had come under pressure to do something about the blatant practices of certain territories in the Caribbean. These were jurisdictions with which Bermuda was neither involved nor identified. Yet certain mindsets in Britain, Europe and the United States still categorised Bermuda in with them and Bermuda sought to defend itself—rescue its hard won reputation for being a sophisticated centre of international finance, before it was too late. For on 24 June 1999 the OECD put out a preliminary list of 34 countries, territories and protectorates, which it identified as 'tax havens', that might be engaged on what the OECD chose to call 'harmful tax competition'. Whether a country would appear on the final list, due the following spring, would depend on how it fared in a series of tests of its taxation system. Realising that much was to be lost if Bermuda remained on that final list, many on the island fought against the one image that the founders of the international business sector, the government, and the local business community, had always tried so hard to repudiate. They fought to make sure that Bermuda should not end up being detrimentally labelled by the OECD or any one else as 'a tax haven'.

Bermudian Business provided the following background information about the OECD—

> 'The OECD describes itself as "bringing together 29 countries sharing the principles of the market economy, pluralist democracy and respect for human rights"... The current membership of the OECD, together with the year each country joined the organisation is: Australia (1971), Belgium (1961), Czech

[790] *Bermuda Market Digest*, May 1999, Vol 3, 'Digest founder dies'

Republic (1995), Denmark (1961), Finland (1969), France (1961), Germany (1961), Greece (1961), Hungary (1996), Iceland (1961), Italy (1961), Japan (1964), Korea (1996), Luxembourg (1961), Mexico (1994), the Netherlands (1961), New Zealand (1973), Norway (1961), Poland (1996), Portugal (1961), Spain (1961), Sweden (1961), Switzerland (1961), Turkey (1961), United Kingdom (1961), United States (1961).

'...The 1960 Convention which established the OECD requires it to promote policies "designed to achieve the highest sustainable economic growth and employment and a rising standard of living of the population". This must be "achieved while maintaining financial stability inside the OECD area as well as on a world scale". The same article also requires that member countries contribute to the expansion of world trade on a multilateral and non-discriminatory basis.'[791]

If Bermuda could not persuade the OECD to leave it off the final list, then the 29 members of that organisation would apply sanctions to Bermuda, as to any other jurisdictions that were deemed to be offenders. Of special significance to Bermuda was OECD recommendation # 12, which would require the United States to consider terminating its tax treaty with Bermuda. Premier Jennifer Smith assured the public that her government was taking every precaution against the threat posed by the OECD listing. The *Bermuda Market Digest* reported on her stance as follows—

'...Premier Smith takes a sanguine view of the various demands for legislative change being mooted. "The position of my government is that we consider Bermuda to be a reputable offshore financial centre that has nothing to fear from legitimate attempts to introduce sound regulatory financial standards," she says. "While the precise implications of these complex international developments are far from static and incapable of any conclusive or authoritative assessment, I have every confidence that with the continued assistance of the international business community, Bermuda will be able to successfully meet all of these challenges."

'Smith revealed that "with the help of business partners ACE, XL, and American International, (the Bermuda) Government has set up a high level advisory committee, chaired by the Chairman of the International Business Forum", to deal with the matters. Smith's cabinet met late in April with Foreign Office representatives in Bermuda, to clarify statements in the White Paper, preparatory to a government response. The British government's Foreign & Commonwealth Office has planned a technical meeting of experts and officials on May 13, to which Bermuda will send two representatives.

'The Premier also revealed that her Government has "hired professional representation in the form of Charles Barker BSMG Worldwide, to represent Bermuda's public relations interests at a national level in the United Kingdom and Europe and Mr Harry Gutman, of KPMG Tax Consulting in Washington."

'...She added, "I am also aware that there are views and observations that Bermuda's talented businessmen and professionals have to offer. This Government will seek to meet any legitimate demands for better financial regulation head on. We will not shirk our responsibility to maintain Bermuda's reputation as a reputable financial centre. It may be true that some tax havens constitute a threat to major metropolitan countries in some way. In my mind there is no question that Bermuda makes a positive contribution to the global financial community. Companies based in Bermuda are supporting onshore business activities in a number of areas. Our insurance companies meet the reinsurance needs of companies based in North America, Europe and other global markets...Bermuda is a responsible country citizen in the global financial community. We have no reason to fear attempts to boost the integrity of the international financial regulatory structures."'[792]

Peter Hardy, acting in a support role to the Financial Secretary Walwyn Hughes at the time of the OECD initiative, recalled the negotiations as being very stressful and the most challenging period of his career. He had to go to the United States Treasury because he was dealing with a

[791] *Bermudian Business*, Fall 1999, 'Taxing Times: The OECD Papers', pp. 30–34

[792] *Bermuda Market Digest*, May 1999, Vol. 3, 'Premier: Don't push panic button', pp.1 & 8

multiplicity of issues. If Bermuda were labelled as a tax haven, it would lose the hard won Bermuda/United States Tax Convention. Therefore it had to get the United States on its side and to enlist their support in keeping its name off the OECD tax haven list. Hardy had to persuade the United States Treasury and Tax Consul that the appropriate regulations were in place and that Bermuda was not a tax haven at all.

It was an uphill battle, because everyone seemed to be convinced Bermuda was indeed a tax haven. As a consequence, Hardy fully committed himself to showing that it was not. He worked day and night to come up with supporting documents. He travelled frequently to the United States and also went to Paris with several of his ministerial colleagues, to present Bermuda's case directly to the OECD. Once there they had to prove that Bermuda was in fact the cream of the offshore financial centres. Hardy also spent a lot of time travelling back and forth to the United Kingdom, where he met with other jurisdictions, to discuss how best to meet the OECD initiative. He recalled that despite the lack of reception Bermuda had initially received from other jurisdictions, the international business community in Bermuda was very supportive. The Bermuda government also made a concerted effort to retain the Bermuda/United States Tax Convention, as negotiated by former Premier John Swan in 1988.

Eventually the Bermuda team was able to convince the United States Treasury that Bermuda was fully cooperative with the United States and Bermuda's name was removed from the tax haven list. Hardy said they had all worked so hard at this initiative because they knew that if Bermuda was black listed certain insurance companies would most certainly leave the island, with disastrous results for Bermuda, especially so in the light of declining tourism.

Bala Nadarajah is to this day of the opinion that other jurisdictions simply do not understand the shared regulatory system that prevails in Bermuda. They do not think it possible for private and public sectors to work together without creating a conflict of interest. This concept of shared-regulation developed out of necessity because Bermuda is so small in size that it could not afford to let itself be overrun by bureaucracy. But the system, says Nadarajah, is ideally suited to Bermuda's insurance and reinsurance market, which comprises captives on the one hand and reinsurers on the other. While captives cover risks within their own economic family, reinsurance transactions are between sophisticated parties and therefore have need for the degree of bureaucratic supervision and intervention that might otherwise be requisite. If its international business sector had been designed as a bureaucracy, it would have been stifled and could not have developed the market of innovative and timely responsiveness for which it has become known around the world. Instead it devised a system that could use shared-regulation to its most effective end. The fact that this system was partly self-regulatory with full disclosure did not mean that its regulations were toothless. Quite to the contrary. Those who drafted the regulation ensured that they would have adequate sanctions and would be properly enforced.

> 'The insurance industry is Bermuda's economic lifeline and that being the case', says Bala Nadarajah, 'ensuring its credibility worldwide is of the utmost importance. The regulatory system draws its strength not only from its legislation and the regulators who enforce it but from every service provider involved with the company's operations whether its auditor, actuary, manager/principal representative, bank or lawyer and from the regulated company itself. By ensuring the credibility of each and every insurance and reinsurance company in Bermuda we thereby also ensure the credibility of the jurisdiction. It would be economic suicide for Bermuda to allow any company within its jurisdiction to malfunction and therein lies the strength of shared regulation. Why then attack a system that has worked so well saying that it is inadequate – perhaps only because it has limited bureaucracy or is it because it is different?'[793]

[793] Interview with Bala Nadarajah, 21 May 2002

Bermuda Fire and Marine trial attracts scrutiny from overseas

On the heels of the OECD initiative came the widely watched Bermuda Fire and Marine trial. Many overseas companies, analysts and news reporters were interested in the case because they expected it to set the precedent as to how Bermuda would handle the bankruptcies of local companies with international policyholders and shareholders. The *Bermuda Market Digest* reported on the trial as follows—

> 'The Bermuda Fire and Marine Case, in which law firm Conyers Dill and Pearman, auditors Cooper and Lines and five former directors are being blamed for the collapse of the insurer, has got under way in Supreme Court. The civil case, which is being heard by puisne judge Vincent Meerabux and involves some 40 lawyers, both local and overseas, began on May 4 and is expected to continue for several months. At stake are the business dealings and reputations of some of Bermuda's top business leaders and Bermuda's image as a whole.
>
> '*The Wall Street Journal* has reported that Bermuda's image as a place of "enlightened regulators and dynamic entrepreneurs" is on trial. The *Journal* said: "For Bermuda's critics, the case underscores the clubby nature of business life on this coral outcrop in the Atlantic."
>
> 'Ernst and Young, Bermuda Fire and Marine liquidators, is claiming Conyers Dill & Pearman (CD&P), Cooper and Lines, the forerunner of PricewaterhouseCoopers, and the former directors wrongfully stripped the assets from Bermuda Fire and Marine in 1991 to create BF&M Ltd. The liquidator is claiming unspecified monetary damages from the company's former directors William Cox, Donald Lines, Greg Haycock, Michael Collier and the estate of the now-deceased Charles Collis, Cooper and Lines and CD& P. All deny any wrongdoing.
>
> 'Ernst & Young is attempting to seize ownership in BF&M from current shareholders, who received a share dividend in the company in 1991 when Bermuda Fire and Maine was split in two, leaving the company with the unprofitable international business and BF&M with the profitable domestic business. Ernst and Young is arguing that through the close nature of personal relationships, CD&P and Cooper and Lines helped the directors complete what Ernst and Young alleges was an "illegal" transaction in the setting up of BF&M.
>
> 'Charles Collis was senior partner at CD&P, while his son John Collins was legal advisor to Bermuda Fire and Marine. Donald Lines was, at the time, CEO of the Bank of Bermuda and his brother, David, is senior partner at Cooper & Lines.
>
> '(Michael) Collier at the time was chief general manager of the Bank of Butterfield. The two banks, which are not named in the suit, helped to fund the creation of BF&M.
>
> 'When BF&M was created, it paid Bermuda Fire and Marine US $56 million for its domestic business with US $10 million in cash, a loan note of US $3.5 million, one million nine per cent convertible cumulative redeemable preference shares in BF&M, and 2.88 million common shares in BF&M.
>
> 'The common shares were transferred as dividends to Bermuda Fire and Marine shareholders. The US $10 million was used to pay off Bermuda Fire and Marine preference shareholders. The liquidator claims that Bermuda Fire and Marine was not financially able to make the share dividend, a fact (the liquidator) alleges was known by the directors, CD&P and Cooper and Lines.
>
> 'In 1993, Bermuda Fire and Marine went into liquidation with some US $450 million in debts, owed primarily to US insurance companies. The liquidator is arguing that the directors, CD&P and Cooper and Lines were in "breach of duty" and "recklessly indifferent" in allegedly attempting to save themselves and the Bermudian shareholders instead of upholding their legal obligation to Bermuda Fire and Marine and US creditors.
>
> 'The suit also alleges that Cooper and Lines knew Bermuda Fire was "grossly insolvent" when the firm produced a report stating it had a US $12 million surplus. Ernst and Young is also alleging that Bermuda Fire and Marine's insolvency was documented by reports from the actuarial firm Tillinghast and a 1989 report by the US National Association of Insurance Commissioners.

'Bermuda Fire and Marine's 1991 directors are arguing that based on the information before them, the full 17-member board acted in the best interests of shareholders and policyholders, including creditors. They also argue that Bermuda Fire and Marine's considerable stake in BF&M gave it a stable and continuing source of income.

'Lawyers Elizabeth Gloster and Roger Millett represent BF&M and some 800 shareholders. Robin Potts and Martin Moore represent the five former directors, Geoffrey Vos is representing CD&P, and Ian Croxford represents Cooper and Lines.

'Potts told the court the five directors could not have known about and were not responsible for the "alleged insolvency". He said he would show that the five acted honestly in carrying out their duties and there has been no attempt to defraud the liquidators. And Vos argued that CD&P and John Collis gave the correct legal advice to Bermuda Fire and Marine's board.

'Croxford said Cooper and Lines did not believe Bermuda Fire and Marine was insolvent when the separate company was created.

'...A 1994 United States Congressional Report by a subcommittee of the House Energy and Commerce Committee called the Bermuda Fire case "a prime example of outrageous irresponsibility by an offshore insurance company."'[794]

Despite the negative attention it attracted from overseas, many believed the Bermuda Fire and Marine case would actually help Bermuda to revamp its antiquated insolvency laws. Dedrie Stark of the *Bottom Line* reported on the implications of the case on Bermuda's insolvency laws as follows—

'The current push to overhaul Bermuda's insolvency laws could be just the right antidote to calm the potentially poisonous publicity that could stream from the Bermuda Fire and Marine court case. Any positive news could be helpful to mop up the damage, deserved or not, from the high profile court battle and other recent insolvencies.

'While the legislative overhaul began years ago and is not connected to the Bermuda Fire case currently being fought in the Supreme Court, such a concerted effort to tie up legislative loose ends and make laws as clear and fair as possible should be widely admired.

'...Nigel Howcroft, the head of the insolvency team at Appleby Spurling & Kempe, is the individual largely behind the project to overhaul the regulations. He is currently serving as Chairman of the 11-member Insolvency Subcommittee of the Law Reform Committee, and before this played a leading role in a BIBA subcommittee on legislative change. As far back as 1994 an arm of the Insurance Advisory Committee looked at the legislation. "I don't want to give the impression that our existing law doesn't work because it does," says Howcroft, who was born in England and worked there before coming to Bermuda in 1989. "It's just not satisfactory to be working under a system where there and in Canada are anomalies and inconsistencies and things that don't make commercial sense and probably never did."

'To sum up the problems he points to a report he wrote that has been adopted by the latest subcommittee, whose work has been publicly endorsed by Premier Jennifer Smith. It outlines the deficiencies in the relevant parts of Bermuda's Companies Act 1981 and the Companies (winding up) Rules 1982, both based on English legislation from the 1940s. Bermuda's legislation has remained unchanged while the UK has since adopted the Insolvency Act 1986 and Insolvency Rules 1986. The subcommittee meets every month to establish how different sections of this legislation could be adopted here.

'The report describes Bermuda's laws as "antique, incongruous in parts, unclear, inconsistent and generally inappropriate to suit the size and character of contemporary insolvency assignments arising in Bermuda."

'It outlines concerns of former Registrar of Companies Kymn Astwood in respect of the Registrar's powers under sections of the Insurance Act 1978. "Mainly we're tying to tidy up and modernise the legislation,"

[794] *Bermuda Market Digest*, June 1999, Vol. 3, 'Bermuda trail attracts overseas scrutiny', pp. 1 & 6

says Howcroft. "It's old fashioned and archaic and we wanted to have something more suited to the times." He would like to see the administration rehabilitation process introduced to Bermuda, a concept that Howcroft likens to a "halfway house" that would help companies in distress get back onto their feet rather than facing liquidation. It would give the companies an opportunity to find a way out of their problems whereas once you get into a liquidation, that's hardly an option," he says. "That point is sort of like the end of the line for a company. This administration process would significantly improve the likelihood that the company would come out of its problem whole."

'And this would set out a formal mechanism of what was sometimes embarked upon informally for insurance companies showing early signs of trouble.

'The second big change being considered would see courts in Bermuda more easily recognise foreign insolvencies. "It may be there won't be many cases where it has application but that is something most of the western nations are considering," Howcroft explains.

'The subcommittee is also keen for Bermuda to adopt the more detailed English model of the receivership process, to replace "somewhat limited" legislation.

'Howcroft modestly plays down the ambitious nature of the whole project, but admits it will take at least another year before the subcommittee finishes reviewing the English legislation and recommending how it should best be re-jigged to apply to Bermuda. "All these changes would have the effect of showing that Bermuda is at the forefront. It will mean having legislation that will deal with a whole range of insurance companies and other companies from the beginning of their life to the end," he says. "If we introduce the statutory mechanism to recognise foreign insolvencies, Bermuda will be recognised as giving other countries the same sort of treatment that they already give us. In that sense it will make Bermuda look good. We do have common law rules that enable us to recognise foreign insolvencies, but they're limited and it would be nice to have statutory mechanisms as England and America do."

'(Acting Registrar of Companies Jeremy Cox said) "We are constantly looking at ways to keep ourselves in the fore in terms of being a premier jurisdiction. Bermuda is very resilient. Every jurisdiction has its failures but the key is to have a jurisdiction that is respected for its regulation and for the strong entities within it." He endorsed the proposed improvements to Bermuda's insolvency laws as a good example of how the Island "constantly tries to hold itself out as a jurisdiction that could adapt to changing times. We've got a good track record of adaptations to legislation in order to keep Bermuda's reputation at the top, and this is one more way we are striving to do that," he says.'[795]

Unicover and workers compensation

The workers compensation marketplace was dealt a severe blow when Unicover, the huge workers compensation reinsurance pool in the US, suddenly came apart at the seams. Shock waves ran through the very soft workers compensation marketplace. As reported by *Business Insurance*—'...Reinsurance facilities operated by Unicover Managers Inc., a managing general underwriter, stopped accepting business earlier this year after an explosion of premium volume and the spectre of massive underwriting losses led pool reinsurers to withdraw.'[796] Companies such as Berkshire Hathaways' Cologne Reinsurance Co. led the exodus from Unicover. AIG sued on the grounds that they had transferred risks to Unicover only to find they were never accepted.

In *Best's Review* magazine, Peter Nakada wrote the following—

'The Unicover controversy has generated a string of losses, complaints and legal threats over the last year, with a number of reinsurers claiming to have been treated unfairly. In particular, some reinsurers have claimed they did not receive shares of the premium proportional to the risks that they accepted from the workers' compensation pool...

[795] *Bottom Line*, October 1999, 'Taking the initiative', by Deidre Stark, pp. 58–60

[796] *Business Insurance*, 15 March 1999, 'Workers Comp pool's troubles roil market', by Douglas McLeod

'This is basically what happened in the Unicover case:

- Primary insurers originated and underwrote workers' compensation business.
- Unicover Managers Inc., renamed Cragwood Managers LLC, was the managing general underwriter in reinsuring the business on behalf of several reinsurers in a pool.
- Reinsurance brokers helped to arrange the transfer of risk from the pool to other reinsurers.
- The reinsurance brokers stepped in again, this time to arrange the transfer of risks to still more reinsurers—some of whom were the same insurers who had transferred the risk in the first place.

'A premium is paid each time the risk is transferred from one reinsurer to another, with the broker who arranges the transfer taking a significant fraction (reported to be as high as 30% of the ceded premium in some cases).

'It was arguably the reinsurers at the end of the chain who had retained most of the risk, had the least sophisticated understanding of it and were paid the least for it. Players higher up in the chain, on the other hand, took premiums but bore little risk: In essence, they were paid primarily for passing the risk on to players lower in the chain.'[797]

Business Insurance continued—

'...Who ultimately will be left holding the bag for Unicover's losses (estimated to top US $1 billion and could hit US $2 billion) is unclear: The Unicover facilities are themselves heavily reinsured by retrocessionaires (insure reinsurance companies) that include two of the original pool participants. The retrocessionaires, in turn, retroceded the business to others – including at least one original pool participant and these retrocessionaires may have retroceded the business further, leading analysts to compare the structure of the infamous London market excess-of-loss spirals of the 1980s.

'...Wherever the Unicover losses land, they should help trigger a turn in the soft workers compensation market by driving out 'naive' reinsurance capacity, analysts and industry officials predict.

'...Based on Unicover's premium volume, PaineWebber analysts estimate that about 10% of the US workers compensation marketplace ceded business to the facilities and that ceded loses and ceding commissions expenses related to Unicover will boost the entire industry's workers compensation combined ratio by five percentage points.

'...With all of the uncertainties surrounding the fate of the Unicover facilities, most reinsurance observers agree on one thing—litigation among the ceding insurers, reinsurers, underwriting managers, and even brokers involved is likely.'[798]

The first sign that the Bermuda international insurance industry was not to be spared from the unravelling of Unicover came when the London reinsurer, Odyssey Re, filed a civil racketeering suit against Bermuda based broker Stirling Cooke Brown Holdings Ltd. *Business Insurance* reported—

'The suit alleged that Stirling Cooke Brown and other managing general agents of Odyssey Re "victimised it in a series of reinsurance placements, including deals that originated with Unicover." According to the suit, units of Stirling Cooke and several MGAs engineered reinsurance placements to be relatively profitable for ceding companies but disastrous for Odyssey Re, generating loss ratios as high as 1118%. The defendants also arranged Odyssey Re's own retrocessional protections in a way that will cause losses to spiral through several retrocessionaires and back to Odyssey Re itself, the suit charges.

'Along the way, the suit alleges, Stirling Cooke and the other defendants stripped off fees and commissions totalling " well in excess" of US $15 million. Odyssey Re, meanwhile, has been left with more than US $35 million in losses, the reinsurer says.'[799]

[797] *Best's Review*, June 2000, 'Lessons from Unicover', by Peter Nakada, pp. 58 & 59

[798] *Business Insurance*, 15 March 1999, 'Workers Comp pool's troubles roil market', by Douglas McLeod

[799] ibid.

The second indication that the US workers compensation crisis had hit the Bermuda international insurance industry came when Mutual Risk's stock price fell. After experiencing explosive growth during the 1990s and defying the market trend of falling premium volumes in 1998, in September of 1999 Mutual Risk's stock fell when it issued a warning about reduced fee income from its programme business and a downturn in the Workers Compensation market. This was a signal of what was to befall Mutual Risk.

Peter Nakada of *Best's Review* also wrote that '…The Unicover incident revealed more than the mistakes of a few companies. It shines a spotlight on deficiencies in the current reinsurance system in two key areas: the way reinsurance intermediaries worked and the failure of ceding insurers and their brokers to assess and control counter party performance risk.'[800]

PXRE redomesticates to Bermuda

In what was to start a wave of redomestications that would later haunt the Island, PXRE decided to redomesticate to Bermuda. *Insurance Day* reported on this decision as follows—

> 'US reinsurer PXRE Corp unveiled a proposed reorganisation under which it will move its headquarters offshore to Bermuda and create a new reinsurance subsidiary on the island, capitalised at US $50 million. …PXRE said the move to become a Bermuda-based company would bring significant tax advantages and was designed to respond to recent competitive positions taken by Bermudian companies in the US market.
>
> 'Jim Dore, chief financial officer, said: "First of all the regulatory, tax, and financing environment is much better in Bermuda than in the US. Secondly, with a lot of Bermudian companies making acquisitions and moving into the US, it is making an uneven playing field. Bermuda is an important reinsurance market and we believe we will see increased deal flow by putting people on the ground there." Some 80% of PXRE's premiums currently come from offshore, while 30% of its current property business is ceded to Bermuda, so it made little sense to be headquartered in the US, he added.
>
> '…The move will also allow PXRE to become more creative and innovative, increasing its focus on Alternative Risk Transfer (ART) products, such as those which involve hedging of currency and interest rates. This fits in with PXRE's diversification strategy, which in recent years has seen it add casualty lines. Mr Dore underlined there would be no impact on the group's US reinsurance operations, which will continue to operate from their New Jersey base.'[801]

In October, Everest Reinsurance Holdings Inc announced it was redomesticating to Bermuda by forming a new holding company called Everest Reinsurance Group, Ltd. (ERG) with a new Bermudian reinsurer called Everest Reinsurance Bermuda (ERB) formed as a subsidiary of ERG. According to the *Bermuda Market Digest* magazine, Chairman and CEO Joseph V. Taranto explained the company's decision as follows: 'the restructuring will provide us with an opportunity to establish a new operating company in Bermuda, which has become increasingly important as an insurance and reinsurance centre. Our new holding company structure will also allow us to operate in a financially more efficient manner.'[802]

The third company to announce it was redomesticating to Bermuda was Mutual Insurance Corporation of America (MICOA). According to the *Bermuda Market Digest* magazine—

> 'Through a newly formed subsidiary, MICOA Consulting LLC, the company is now offering alternative risk transfer (ART) services to its clients. MICOA believes it is one of the first medical professional liability companies in the US to offer rent-a-captive services.

[800] *Best's Review*, June 2000, 'Lessons from Unicover', by Peter Nakada, p. 58

[801] *Insurance Day*, 8 July 1999, Issue No.644, 'PXRE for Bermuda', by Claire Wilkinson, p.1

[802] *Bermuda Market Digest*, October 1999, Vol 3, 'Everest Re to redomicile', pp. 1 & 12

'MICOA Consulting will provide alternative risk financing and other non-traditional insurance solutions. This will include insurance fronting services, reinsurance self-insurance modelling consulting services, captive management services, a rent-a-captive facility, loss control consulting services, captive underwriting services, risk management information systems and casualty actuarial services.'[803]

The common reason given for such redomestication was to allow companies to be on the same competitive footing as global companies headquartered outside the United States. The United States taxes its citizens including corporations for any income that they earn outside the United States. Some believed this tax put companies, which are headquartered within the United States, at a competitive disadvantage as compared to foreign counterparts.

It is also a well-known fact that corporate inversions were legal under United States law, which allowed disadvantaged companies with offshore affiliates to overcome those disadvantages in order to remain competitive. However as companies starting redomesticating to Bermuda when the economy was down they caught the roving eyes of politicians looking as always to curry favour with the electorate. Thus it was actually the politicians who drummed up the furore, because the companies themselves were merely following past precedents, and were not in breach of any laws.

Jeremy Cox becomes new Registrar of Companies

After Kymn Astwood announced his intention to resign as Registrar of Companies to become the President of Arrow Re, Jeremy Cox was appointed as his successor. The *Bermuda Market Digest* reported on Cox's appointment—

'...Cox has worked in the Registrar's office since 1993 and has most recently been Bermuda's Inspector of Companies...Jeremy Cox holds an undergraduate degree in finance and insurance and earned post-graduation qualification as a certified public accountant. As Inspector of Companies, he oversaw the re-registration of Bermuda's more than 1,400 insurance companies. Cox has also served on the Insurance Advisory Committee, as well as that body's marketing, regulatory and private bills subcommittees.'[804]

Jeremy Cox discussed his new role in an interview with the *Bottom Line*—

('Cox says)..."Bermuda has an important role to play and I must make every effort to ensure that our regulations keep pace with the changes and the types of companies that we regulate. That requires flexibility and the capacity to adapt in order for us to keep regulations moving one step ahead. My ultimate goal is to see that Bermuda continues to be seen as a premier off-shore jurisdiction and that there is confidence in our regulations. It's about managing change well. If a person is a good manager of change they will be a good Registrar. I do not foresee a lot of difficulty."

'...His main challenge is to make sure that companies and members of the public that use the department are treated respectfully and that the high standards of service developed under his predecessors are maintained..."Bermuda is moving forward at a good pace and we will continue to look at legislation and keep it current and consistent with international regulatory initiatives. We can't afford to take the insular view. We need to be concerned with what is going on around us. Bermuda is the world's insurance laboratory," (Cox says.)'[805]

Bermuda Commodities Exchange suspends trading

When the Bermuda Commodities Exchange (BCOE) was launched in November of 1997 to trade catastrophe-linked option contracts, there was great hope that it would revolutionise the way insurance was purchased. Unfortunately, with the continued soft market and the poor state of

[803] *Bermuda Market Digest*, October 1999, Vol 3, 'MICOA joins Bermuda ART market', pp. 1 & 12
[804] ibid. August 1999, 'Cox appointed Registrar of Companies', p. 2
[805] *Bottom Line*, Fall 1999, 'Registrar plots hi-tech path', by John Burchall, p. 14

investments, the Bermuda Commodities exchange announced some two years later that it was suspending trading. The Bermuda Market Digest reported that—

> 'The decision to suspend activities, described as a "pause to catch our breath" by BCOE secretary Mike Murphy of AIG Bermuda, came in mid-August, at a time when there was no open interest on the exchange.'[806]

UPS of America v. Commissioner of Internal Revenue

After nearly a decade of trying to clear its name with the US Internal Revenue Service, UPS was dealt a severe blow in 1999 as reported by *Best's Review*—

> 'United Parcels Service has taken a US $1.44 billion charge to cover its potential tax liability charge and will create a subsidiary insurance operation in an effort to appease the US Tax Court after an adverse ruling.
>
> 'Last month, the court found the company liable for more than US $80 million in taxes for 1983 and 1984 for the way it insured its packages. UPS has determined that its potential tax liability from 1983 to the present could total US $1.672 billion under the ruling. The US $1.44 billion charge is in addition to the US $230 million that UPS had set aside to cover any potential liability in the case.
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> 'The court ruled that UPS set up a "sham transaction" with National Union Fire Insurance Company of Pittsburgh, a unit of American International Group Inc., to front for its Bermuda-based Overseas Partners Ltd. reinsurance company. Overseas Partners is owned by stockholders of the privately held UPS, but it isn't a UPS subsidiary.
>
> 'UPS got into trouble with the court because it never declared the 25 per cent premium it charged on each US $100 of coverage beyond the US $100 value of each package. These package insurance premiums, known as excess-value charges, are considered income and, therefore are taxable, according to the court. UPS had used the money it made on these charges to settle damage claims and then sent the remaining funds to National Union Fire. After taking out expenses, National Union Fire forwarded the funds to Overseas Partners as reinsurance premiums.
>
> The method UPS used, according to Judge Robert Ruwe, meant that the insurer and reinsurer carried virtually no risk, since UPS paid all the claims. Since UPS rarely loses a package, insurance claims were small and Overseas Partners, which was established in 1983, grew quickly.
>
> 'Ruwe's ruling means that UPS may no longer reinsure with an offshore reinsurance company, said UPS spokesman Malcolm Berkley. No decision has been made whether to reinsure packages with another company or handle all of the insurance needs in the new subsidiary.
>
> 'Berkley said UPS would establish a subsidiary to insure the packages it delivers, but it won't reinsure them with Overseas Partners. He said he didn't know how the excess-value charges would be treated, whether they would be premiums paid by UPS to its new subsidiary—and thus an expense—or if they would be considered income and passed to the new subsidiary.
>
> 'UPS, Berkley said, is trying to do everything it can to satisfy the court by rearranging the way it accounts for the excess-value charges.
>
> 'One of the key elements in Ruwe's opinion, which called the original arrangement a "sham" for tax purposes, was that UPS' decision to form the offshore reinsurance company was based on tax avoidance rather than business considerations, said Mark Anderson, head of the alternative-risk tax practice of KPMG's Financial Capital Strategies unit.
>
> 'Until 1983, UPS self-insured packages it delivered. The 25-cent premium charged for each US $100 of extra coverage was considered as additional income by UPS. This resulted in millions of dollars of income on which the delivery service paid corporate tax, after deducting for claims.

[806] *Bermuda Market Digest*, September 1999, Vol 3, No. 9, 'Bermuda Commodities Exchange suspends trading', p. 1

'By shifting funds to Bermuda in 1984, UPS escaped tax on what would have been considered US $77.7 million in additional income under its old system of accounting for excess value charges. UPS contended that since Overseas Partners wasn't a subsidiary and wasn't subject to US taxation, the funds shift wasn't taxable.

'Insurers, Anderson said, should pay close attention to the judge's ruling, which means that privately held companies can't establish offshore reinsurers to escape US taxation. "They never really paid a premium...What the court got hung up on was that nothing really changed for UPS before or after the agreement..."Anderson said.'[807]

Bermudian Business magazine reported the significance of the ruling on OPL in Bermuda as follows—

'Despite the decision being appealed by UPS and (that) Overseas Partners was not a party to the suit and is not obligated to pay UPS anything, the overseas company cancelled the shippers risk policy effective September 30, 1999. This action paved the way for OPL to expand into other areas of reinsurance.'[808]

The first major indication of the change in direction for Overseas Partners Limited (OPL) came with its announcement in November of 1999, that its subsidiary, Overseas Partners Cat (OPCat), had signed an agreement with Renaissance Re to underwrite property cat reinsurance programmes. OpCat was capitalised with US $400 million. However, Renaissance Re was the exclusive underwriter for OpCat.

Bermuda Commercial Bank and State Street pilot new captive product in Bermuda

Still deriving significant income from captives, Bermuda's banks, accountants, lawyers and investment managers were developing specialist products and services for the industry. In a groundbreaking move reported by *Reinsurance* magazine—

'Bermuda Commercial Bank and State Street Global Advisors recently announced an investment programme for captive brokers and their clients. The programme is being piloted in Bermuda before being offered elsewhere and includes integrated investment management, letter of credit services, reporting and client services.'[809]

Bermudian Business magazine further reported—

'... Through the BCB (Bermuda Commercial Bank)/SSGA (State Street Global Advisors) Captive Insurance Programme...BCB's local presence and market knowledge have been combined with SSGA's sophisticated investment capabilities to take advantage of the strengths of each institution.

'This has created the ability to offer a product that includes integrated investment management, letters of credit, reporting and client service at a very competitive cost. The programme is designed to improve the level of service a manager can provide to his or her captive client, while reducing the administrative burden.'[810]

ACE and XL clash over Capital Re

ACE now found itself in a battle with none other than XL, over an issue ACE had thought to be a done deal. In the spring of the year ACE had made an all stock offer for Capital Re, whose stockholders were just about to cast their final vote on whether to accept when, out of the blue, they received a counteroffer in cash from XL.

[807] *Best's Review*, P/C, September 1999, 'Judge delivers bad news to UPS', by Rick Pullen, p. 93

[808] *Bermudian Business*, Spring 2001, 'Driving Force', by Duncan Hall, pp. 39–44

[809] *Reinsurance*, November 1999, 'Bermuda captives, A captivating island', by Tony Dowding, p. 31

[810] *Bermudian Business*, Fall 1999, 'BCB & State Street Launch New Captive Product'

Back in May, when the ACE offer was made, its nominal value on paper was US $605 million. Since then ACE stock had fallen so far that by the time the offer came to a final vote the stock on offer was worth at market value only US $375.3 million, or 38 per cent less than the stockholders of Capital Re had originally expected.

Then, just one day before the closing vote, XL came in with an all-cash offer of US $456.3 million, which set off a battle royal between the two Bermuda giants. ACE even went to court over the XL offer. Finally, at the end of October, ACE came back to the table with an offer for Capital Re of US $511.3 million in cash and stock combined. And what of XL? It seems that XL went away just as mysteriously as they had come.[811]

Bermuda Insurance Update reviewed the incident in the following light—

> 'Market observers noted that two firms vying for the same acquisition target is an example of market forces, and of how, in pursuing separate, strategic business plans, conflicts with each other can and will arise, just as in any other mature industry market. "It proves the fallacy of arguments that Bermuda companies are too close. It is expected...because of the high calibre of specialty business that ACE and XL write, that sometimes they will face off. It is just business," said Anthony Joaquin, Insurance Advisory Committee (Deputy) Chairman.'[812]

Electronic Transactions Act 1999

The enactment of this legislation signalled the dawn of a new era in Bermuda. Based primarily on the United Nations Commission on International Trade Law (UNCITRAL), the model law for e-commerce, the Electronic Transactions Act 1999 was designed to set the law firmly and clearly in place as it related to electronic transactions and the use of electronic records. Thereby it would enhance Bermuda's appeal for companies wishing to transact business over the Internet.

Since then the Bermuda government has also issued a standard for anyone conducting commercial transactions or services electronically in or from within Bermuda. This standard includes rules relating to the observation of business integrity, to "knowing your customer", and to the protection of personal data. The Act provides for penalties in the event of non-compliance."

An encouraging development came in the following year when a number of leading Bermuda insurers, along with Lloyd's, joined WISe, the Worldwide Insurance e-commerce initiative designed to provide an open, collaborative platform for worldwide e-commerce trading. WISe is open to direct insurers, reinsurers, brokers and other insurance intermediaries and is designed to reduce processing and administrative costs.[813]

Gramm-Leach-Bliley Act

This Act was heralded as the door opening opportunity for the convergence of the banking and insurance industry. Signed into effect by US President Clinton on 12 November, the Gramm-Leach-Bliley Act removed the cumbersome barriers that had in the past blocked insurers and the rest of the financial industry from entering each other's territory. Capital markets could take a renewed interest in the traditional insurance 'space'. Many capital market firms had been waiting in the wings for prices to harden before coming into the insurance game because the softer prices made their own products look too expensive. With the Gramm-Leach-Bliley Act, they now felt they were finally on their way. James Hamilton, a senior writer and authority on financial law and services said that the Gramm-Leach-Bliley Act—

> 'represents the most sweeping reform of financial services regulation in over sixty years. The landmark

[811] *Business Insurance*, 20 December 1999, 'Buying spree sets up ACE, XL showdown', by Gavin Souter, p. 16

[812] *Bermuda Insurance Update*, Winter 2000, 'Ace hold off XL for Capital Re'

[813] Christopher Garrod: *Bermuda E-Insurance: embracing the challenge*, 7 December 2000

legislation repeals Glass-Stegal Act Depression-era restrictions and permits the creation of financial services holding companies that can offer a full range of financial products under a strong regulatory regime based on the principle of functional regulation. The legislation eliminates legal barriers to affiliations among banks and securities firms, insurance companies and other financial services companies. The Act provides financial organizations with flexibility in structuring these new financial affiliations through a holding company or a financial subsidiary, with appropriate safeguards.

'According to House Banking Committee Chairman James Leach, this historic measure allows for one stop shopping for financial services, with banking, insurance and securities activities being available under one roof.'[814]

According to *Business Insurance* magazine—

'Financial services integration, however, has been accepted as a fact of life among US companies in those industries for the past several years. The 1998 US $70 billion megamerger of Citigroup and Travelers Group into Citigroup might have been the most dramatic manifestation of the trend to date. Across the country in 1999, that trend was being played out with increasing frequency in other ways as well, whether in the form of banks acquiring insurance agencies, insurance companies forming banks, or insurance buyers looking for financial alternatives to transferring risks.

'Although the move toward financial integration was well underway before the passage of S.900 (The Gramm-Leach-Bliley Financial Services Modernization Act), the law's enactment was expected to speed the pace of such activity. Industry observers anticipate that S.900 will prompt new merger and acquisition and alliance activity among banks and insurers, as those companies seek competitive advantage in the marketplace of the next century....'[815]

Pessimistic outlook for the future of insurance and reinsurance

1999 proved to be a very difficult year for the global insurance industry. Therefore analysts began to take a very pessimistic outlook on its future, as reported by *Reinsurance* magazine—

'...In considering the state of the market, rating agencies Standard & Poor's (S&P) and AM Best take a fairly pessimistic view of the short and medium-terms. "The traditional underwriting cycle has ended," AM Best proclaims. "A permanent down market of excess supply and weaker demand for traditional products has begun."

'Others describe the insurance industry as "a capital trap". AM Best expects up to a third of the 1100 property and casualty groups worldwide to "lose operating autonomy or withdraw from the market within the next five years."

'S&P's outlook on the reinsurance sector is negative for this year and next. Two trends are likely to persist throughout the year, S&P says—limited premium growth and weaker underwriting results. S&P expects US reinsurance companies to post combined ratios in the range of 105% to 106% in the next two years, as reinsurers continue to find it difficult to hold the line on pricing. Outside the US, trends are expected to be similar, with international reinsurers experiencing further rate deterioration, S&P says, not exempting Bermuda from this fairly miserable prognosis...'[816]

Adding credence to the pessimistic outlooks of the rating agencies, Herbert Haag, former President and CEO of Partner Re issued a stark warning to the world's reinsurers as reported by *Reinsurance* magazine—

[814] James Hamilton: *Gramm-Leach-Bliley Act Creates Financial Dynamic for Next Century*, CCH ©2003, CCH Incorporated. All Rights Reserved. Reprinted with permission from Financial Services Modernization: Gramm-Leach-Bliley Act of 1999: Law and Explanation

[815] *Business Insurance*, 20 December 1999, 'Financial Services gets green light', by Rodd Zolkos, p. 17

[816] *Reinsurance*, November 1999, Bermuda Market Overview, 'Reinvention keeps the island afloat', by Roger Crombie, pp. 20 & 21

'..."The survival of the industry is under threat," he predicts. "Whether reinsurance as an industry ultimately survives depends on the decisions taken in the next 12-18 months. If companies lose the support of their shareholders they will be replaced by a new financial services industry."

'His prediction is rooted in the strong global competition for capital and the consequent need to satisfy shareholders' expectations. "Pressure on the managers of reinsurance companies is enormous," says Mr Haag, President and Chief Executive of PartnerRe Group. "Managers have to either produce more earnings or face the prospect of their company being sold."

'Management boards have to decide either to write more business or return capital to shareholders—stark choices in a market of soft rates and overcapacity. "Companies do not want to get any smaller by returning capital to shareholders, so the pressure leads to excessive risk taking," says Mr Haag. "This creates a lack of underwriting discipline and has a ruinous effect on the industry."

'The only remedy, Mr Haag insists, is financial discipline: "Either underwrite profitably or return capital to shareholders."

'Insurance companies are not immune either. "Insurers are very influenced by the overcapacity in the reinsurance world," says Mr Haag. "The interdependence makes them as vulnerable as the reinsurers themselves." It also means the future success of the reinsurance market determines the future of the insurance market, and Mr Haag says he will not be surprised if in 10 years' time the key players in the global insurance market have been changed entirely. "Changes are going to happen very soon – almost overnight," he warns.'[817]

A catastrophic end to an already catastrophic year

Many of the major insurers in Bermuda began to feel the effects of the many natural catastrophes that occurred in the third quarter of 1999—

'Partner Re announced (that) the quarter which ended on September 30, 1999 was unusual in terms of the number and size of the natural catastrophes that occurred. Earthquakes in Turkey, Greece, Taiwan and Mexico, flooding in Central America and tropical cyclones in the US, Caribbean, Japan and Hong Kong caused much devastation and loss of life.

'For the insurance industry, the most destructive of these events—the severe earthquakes in Turkey and Taiwan, Hurricane Floyd in the US and Caribbean, and Typhoon number 18 (Bart) in Japan—are each expected to produce insured losses of US $1 billion or more, with Typhoon Bart likely to be the costliest, reaching approximately US $2 billion.

'These catastrophes significantly impacted the third quarter performance of Partner Re bringing in losses of about US $30 million after taxes and losses to ACE of approximately US $35 million after taxes.'[818]

Between December 25th and 28th, just when the global insurance industry thought it had seen the worst of the catastrophes for 1999, subtropical windstorms Lothar and Martin caused extensive damage in heavily industrialised and populated areas of Western Europe, with the most damage in France (estimated costs between US $4 billion and 6.1 billion), Switzerland and Germany. They were the worst catastrophic storms to hit Western Europe in centuries. These storms severely impacted the French insurance industry, causing many insurers and reinsurers to reassess the way they handled catastrophes, as Hurricane Andrew had forced the United States in 1992. Although the costs attributed to Lothar and Martin were miniscule compared to Andrew, the damages were concentrated in a very tight French marketplace.

These storms also caused the fourth quarter results of the majority of the Bermuda property catastrophe industry to show losses. The only company whose financials were not affected by the storms was Renaissance Re.

[817] ibid. p. 23, 'Bermuda: interview, Time to talk tough'

[818] *Bermuda Market Digest*, November 1999, Vol 3, 'Partner Re, ACE forecast Q3 catastrophe losses'

According to XL MidOcean's annual report to shareholders by Henry C.V. Keeling, President and CEO—

'...Certainly 1999 had been a testing year for all reinsurers and especially for those involved in the property catastrophe market. A series of earnings impacting relatively modest losses had occurred with a depressing degree of regularity.

'This started with the Sydney hailstorm in April and continued with the Oklahoma tornadoes in May, the Turkish earthquake in August and the Athens earthquake in September. These were followed by two windstorm losses, Hurricane Floyd which affected the Bahamas and the USA, and Typhoon Bart in Japan, and a further earthquake in Taiwan.

'...The industry was already looking at one of the highest cost catastrophe years on record when it was hit by extra-tropical cyclones Lothar and Martin in Europe on December 27 and 28 respectively.

'While the ultimate insured cost of these events is yet to be determined, market estimates put this at a total of approximately US $7 billion. 1999 represents the second worst year on record for insurance catastrophe losses (at US $28.6 billion in total, according to SIGMA) following only 1992.'[819]

Munich Re's annual review of natural catastrophes 1999 gave the following synopsis for this devastating year of catastrophes—

'The final year of the 20th century was marked by the number of loss events and their severity/ A series of large earthquakes/ December gales Anatol, Lothar, and Martin with new loss records/ No prospect of a change in their long-term trend of increasing catastrophes/ Severe storms.

'...The analysis of loss events in the last year of the 20th century produced the following picture:

'. The number of loss events registered, as having been caused by natural hazards was 755, a figure that far exceeds the previous record of 702 (1998) and the long-term average of 600. Ten of these events reached 'historical' dimensions...

'Insured losses exceeded US $22 billion. This is the second highest figure recorded in the 1990s (higher only in 1992; Hurricane Andrew cost US $17 billion). The largest losses resulted from the December gales in western and central Europe (Anatol, Lothar, and Martin), which generated losses amounting to US $5 billion—US $6 billion, followed by Typhoon Bart (Japan, September: US $3 billion), Hurricane Floyd (United States and Bahamas, September: US $2.2 billion), and a series of tornadoes in the United States (Oklahoma, May: US $1.5 billion). The hailstorm that hit Sydney in mid-April caused a loss of US $1 billion, making it the costliest weather related catastrophe in Australian insurance history. The catastrophic earthquakes in Turkey (US $1 billion) and Taiwan (US $850 million) mainly affected industrial fire insurance. Otherwise, however, the insurance sector was not badly hit.

'Economic losses totalled approximately US $100 billion, a figure exceeded only in 1995 by the Kobe earthquake. The two earthquakes in Turkey (US $12 billion) and Taiwan (US $14 billion) and the severe storms and floods in Venezuela (US $15 billion) were the principal causes.

'In 1999 at least 70,000 people were killed by natural catastrophes and perhaps even as many as 100,000. This is the highest figure since 1991. Earthquakes in August and November claimed more than 20,000 lives in Turkey. Cyclone 05 B, which raged in the Bay of Bengal at the end of October, killed as many as 30,000 in Orissa (India). The death toll in Venezuela probably exceeded 30,000 as a result of debris, avalanches and mudslides following torrential rain.

'Of the catastrophes registered by Munich Re throughout the world, windstorms were responsible for 80% of the insured losses while earthquakes accounted for 10%, floods 6%, and other events like forest fires, frost, and heat waves around 4%. In terms of numbers, too, windstorms (255) were predominant, followed by floods and other events (about 190 each). At 111, the number of geographical catastrophes (earthquakes, volcanic eruptions) is in the average range.

[819] *XL Mid Ocean Annual Report 1999*, pp. 2 & 3

'At the end of the millennium, therefore, there is no sign of any slowing, let alone reversal of the long-term loss trends. If we compare the last ten years of the 20th century with the 1960s, we will see that the number of great natural catastrophes increased by a factor of three, with economic losses—taking into account the effects of inflation—increasing by a factor of more than eight and insured losses by a factor of no less than 16.

'Although there were a number of extreme weather event—like the series of tornadoes in the United States, floods and landslides in Latin America and southeast Asia as well as the devastating December gales in western Europe—the increasingly distinct change in climate can in no way be made completely responsible for the constantly rising impact of natural catastrophes. The main role is still played by other factors, like population growth and the increase in values in large conurbations and in particular land use in highly exposed regions. This was made particularly clear by the series of avalanches in the Alps at the beginning of the year. Thousands of avalanches came down in the tourist areas of the Austrian and Swiss Alps, killing more than 100 people in February and March.

'The fact that modern industrial societies are exceptionally vulnerable to catastrophes was illustrated by the earthquakes in Turkey (7th August) and Taiwan (21st September). The earthquakes of Armenia (Columbia), Huajuapan (Mexico), Izmit and Duzce (Turkey), Athens (Greece) and Chichi (Taiwan) made 1999 the year most severely affected by earthquake catastrophes since 1976, despite major individual events like Mexico in 1985, Northridge (California) in 1994, and Kobe (Japan) in 1995. The quake area in Turkey has been known as a "seismic gap"—i.e. an area of elevated earthquake probability—since 1979. But no practical measures were taken in response to this well-founded scientific observation in spite of the fact that the area involved accounts for 40% of the country's entire industrial output. In view of the fact that a further seismic gap has been located to the south of Istanbul, long term planning and above all its uncompromising implementation is more essential than ever if a catastrophe of unforeseeable dimensions is to be avoided in Istanbul itself.

'Athens and Taiwan presented a different situation, each in distinct ways. Exposure studies for Greece had not completely ruled out the possibility of an earthquake of the strength recorded in September occurring in the Greater Athens region, but the probability was considered very low. An even greater surprise was the magnitude of 7.6 recorded in Central Taiwan. The quake hit the centre of one of the country's key industries: the Hsinchu Science-Based Industrial Park. The park was supplied with electricity by a single overhead line, which broke in a place that was difficult to access. The installed stand-by units did not have enough capacity to sustain the power supply. This had two major consequences; firstly, all the chips that were bring processed at the time were lost and, secondly, it took in some cases several weeks to restore the clean room conditions needed to continue production.

'...The major winter storm(s) of last December...primarily affected Denmark (Anatol, 3rd and 4th December), France, Germany, and Switzerland (Lothar and Martin, 26th and 27/28th December). The two gales Lothar and Martin alone claimed 140 lives; the insured losses from these two events will probably total US $4-6 billion. This is the second largest windstorm loss in Europe, following the 1990 series of winter storms—names like Daria, Vivian, and Wiebke are still familiar to many – which cost the insurance industry around US $10 bn. The overall economic losses—including damage to power and telecommunications networks and in the forestry sector—are estimated to top US $9 billion. Lothar and Martin come under the category of meteorological bombs on account of the extremely rapid increase in their intensity. Anatol, which generated record losses in Denmark and also hit parts of Great Britain, northern Germany, and Sweden (presenting the insurance industry with a bill of US $400 million in Denmark and US $100 million in the other countries affected), also developed from a very rapid intensification of the storm-generating low-pressure system.

'A "series" of extratropical storms in close succession is nothing unusual as last demonstrated by the series of eight winter storms over Europe in 1990. According to investigations carried out by Munich Re's Geoscience Research Group, the return period for a storm event in Europe with an insured loss of the same scale as Lothar (some US $3-4 billion) is around 10-15 years. The largest insured windstorm loss to date in Europe is US $4.5 billion (in 1990 values) and was caused by the gale Daria in 1990.

'1999 fits exactly into the long-term pattern of increasing losses from natural catastrophes, which the scientists at Munich Re's Geoscience Research Group already predicted in the 1980s. The International Decade for Natural Disaster Reduction (IDN), which has just come to an end, did not make any major difference in this respect in spite of all the efforts undertaken. The aim of this initiative launched by the United Nations was to combat the effects of major natural catastrophes in a more efficient way on the basis of international cooperation. And a degree of success was certainly achieved in some of the areas most affected, such as Bangladesh. Fortunately, the endeavours that have been initiated with the aim of improving disaster management, early-warning systems, and disaster mitigation, are being continued in many countries. In view of the global increase in population, urban growth and the signs of climate change with all its related effects, we cannot expect there to be any far-reaching success in the future. If, namely, meteorological extremes like torrential rain, windstorms, and heat waves continue to increase and the rise in sea levels accelerates, many densely populated regions of the world will be in immediate danger.

'This acute increase in natural catastrophes represents a major challenge to the insurance industry, which is developing financial tools in an endeavour to come to terms with the threatening loss potentials...'[820]

An industry perspective on 1999

'...At the top of its game. But what does the future hold for the Bermuda market?' This, the title of an article written by Donald S. Watson, Alan M. Levin and Fred Loeloff, all of Standard & Poor's, well summarised the year from an industry perspective—

'Once again, Bermuda's insurance and reinsurance industry finds itself in challenging waters. Several powerful trends are bearing down on the sector, testing its mettle. In the past, competitive pressures and changes in the market motivated the captains of the industry to do some of their best sailing. Faced with stormy conditions, they historically managed to right the ship—usually by reshaping the industry. Will they come through again? Or has the Bermuda insurance industry met its match? The answer is not obvious, but one thing is clear. If the masterminds in the sector need a good challenge to do their best work, they are well motivated these days—because the challenges to the industry are great. True, an easy claims environment during the past several years has left insurers in Bermuda flush with cash. But the spectacular profits have attracted lots of new competitors. And the fresh faces—as well as the soft premiums—are putting pressure on top-line growth all around. Bermuda insurers have responded by going on a merger and acquisition campaign to diversify into new product lines. Will this strategy work?

'And what about Bermuda's role in the burgeoning field of alternative risk transfer (ART)? Clients are already using hybrid products that blend properties of insurance and finance to protect against risks like changes in currency values or interest rates. Increasing emphasis on shareholder value in the corporate world means that CEOs and risk managers are warming up to new types of balance sheet insurance like these. Bermuda has often been an incubator for cutting edge products. But will it keep up in this new field?

'And for the first time ever, it is not too hard to imagine some inclement weather in a political world on the home front. For now, at least, it appears unlikely that the new Progressive Labour Party (PLP) government will change the rules, which make Bermuda a hospitable place to run an insurance company. But who knows for sure?

'Standard & Poor's believes Bermuda's insurers are generally in very good financial shape. Despite lower premiums in most business lines, Bermuda's insurers have posted outstanding returns during the past several years. While most insurers have performed well since the catastrophe-ridden year of 1992, Bermuda has outperformed most other markets. Returns are generally better than those generated through most of the 1980s. And they have stayed high. Profits, while down for 1998 following an increased frequency of losses, were still extraordinary with an estimated average return on equity of 18 per cent, down modestly from the 20 per cent returns of the past few years. The reason bottom-line results have been solid despite declining top-line growth is simple: claims have been low, and investment returns have been healthy.

[820] Munich Re Press Release, 29 February 2000

'Furthermore, most of the companies have a solid capital base. And since many only began writing liability insurance after 1986, they have avoided the wave of excessive claims caused by court rulings, which forced other insurers to pay out huge sums for liabilities linked to asbestos, pollution and product risks. What's more, the favourable tax and regulatory environment in Bermuda had given insurance companies the space they need to build cash reserves and to put their entrepreneurial nature to work on innovative insurance solutions for clients,

'...Despite the obvious financial strength of Bermuda's insurers, however, all is not well on this small island. Premiums continue to decline. And the competition that is putting the downward pressure on premiums is probably not going to ease up. Capacity won't decline as long as the capital base of the industry continues to expand. Even Lloyd's, now that it is finding its strength again, is grabbing back some of the business that Bermuda took over when the London market was in trouble—just as Bermuda companies are using their cash surplus to acquire capacity at Lloyd's.

'Other sources of pressure on reinsurers include increased retention by primary companies and greater use of alternative risk transfer tools. These trends are reducing the demand for traditional insurance products. Mid-size insurers (with capital between US $500 million and US $1 billion) will feel the most heat, since primary insurers will favour the strongest reinsurers, in a "flight to quality". But for just about all insurers, big or small, combined ratios are likely to deteriorate as premiums continue to decline, and contract terms expand to increase risk exposures.

'A favourite strategy used by Bermudian companies to deal with declining premium growth has been to expand from mono-line to multi-line business models, typically through mergers and acquisitions. Standard & Poor's believes this kind of consolidation will remain the growth strategy of choice for the next few years. Organic growth, or building on existing business lines, is extremely difficult in this competitive market environment marked by an abundance of capacity and limited premium growth.

'...One question that seems to get overlooked in the rush for diversity through mergers and acquisitions is whether this strategy will actually work. The jury, of course, is still out, but if history is any guide, there are good reasons to be suspicious.

'...The chances are good that many of the mergers and alliances won't live up to expectations. And surely there will be some failures. We don't expect that all the start-ups will survive, either. But the Bermudian insurance sector has a critical mass of managerial talent, and a track record for getting through challenges like the Carnation decision, the era of naïve capacity and the passage of the Tax Reform Act in the US in 1986. Through all these events the creativity of the Island has remained intact, and the industry has been able to reinvent itself by taking advantage of its unique strengths....'[821]

Standard & Poor's further described the consequences of the end of the decade of catastrophes on the Bermuda insurance marketplace as follows—

'For most of Bermuda's (re) insurers, calendar year 1999 was a test of the island's mettle as growth opportunities over the past three years made an economic impact on each company's earnings and capital structures. Combined with downward pricing pressures, intense market conditions for most insurance segments constrained Bermuda's earning growth. The year also saw earning fall short of Wall Street's expectations, which caused the "street" to lose its love affair with Bermuda's publicly held companies. Additionally, large loss costs associated with catastrophic loss frequency, adverse development and exiting from non-profitable business lines prompted some management teams to reconsider their strategic alternatives as stand alone operations. For some (re) insurers, the "growth through acquisition" strategy prevailed in 1999 (albeit at a slower pace than the previous three years) while for others, the reverse option to sell in order to remain competitive occurred. Aside from a few (re) insurers holding their own, Bermuda's operating performance in 1999 was well below previous efforts, and reflects the increased volatility embedded now within many Bermuda (re) insurers' risk portfolios.

[821] *Bermudian Business*, Spring 1999, 'At the top of its game: But what does the future hold for the Bermuda market?' Analysis from Standard & Poor's, by Donald S. Watson, Alan M. Levin and Fred Loeloff, pp. 37–46

'Bermuda still remains the world's leading offshore financial centre as low taxation and a light, but effective, regulatory environment allows companies the freedom to do their sophisticated businesses. However, because of past diversification efforts to expand into the global markets, Bermuda's (re) insurers are no longer insulated from insurance industry trends. The inherent advantage of Bermuda is that it is a midway point between the United States and Europe allowing its licensed companies the benefit of a proven product distribution centre and offshore laboratory for customized solutions. Over the past two decades, risk management creativity through captives and alternative risk transfers (ART) mechanisms have become a standard and have been expanded more so to encompass enterprise (or holistic) risk integration. The responsibilities of corporate risk managers and chief financial officers are constantly evolving, and Bermuda provides a favourable climate for the development of strategies that encompass a client's risks as a whole, whether they are financial, operational, or insurable.

'...During 1999, Bermuda's past earnings prowess was deflated through large loss events and unprofitable business lines due to inadequate pricing, increased competition, and, expanded terms and conditions.

'...Standard & Poor's believes that although 1999 was one of the worst performing years for the Bermuda insurance market, it should not be construed as an indicator of the Island's overall or prospective earnings performance. Because of past aggressive growth and capital management policies, many are still in the middle of growing pains, and earnings stability will remain a challenge...Going forward, maintaining the momentum of the past decade will be the primary challenge for Bermuda's newly emergent global (re) insurers. However, managing these ambitions across cultural, environmental and regulatory minefields promises to separate the winners from the losers.[822]

Basically because the Bermuda insurance industry had initiated the trend of expanding overseas, it was no longer insulated from what happened outside its shores. Whatever market trends affected the global insurance industry now directly affected the Bermuda insurance industry. In a concerted effort to show growth to their shareholders by expanding overseas, the large insurance companies in Bermuda may have in fact hampered their own abilities to operate effectively and efficiently because they had become significant contributors and direct participants in the institutionalised, over regulated world they initially wanted to get away from.

1999 definitely proved to be the year of the publicly traded insurance companies in Bermuda moving from their honeymoon period with analysts to being scrutinised as truly global institutions. As we have seen, it had also proven to be a year of catastrophes both physical and notional for the international insurance industry. Many sceptics said Bermuda had seen the last of its double-digit growth and predicted that Bermuda's heyday was over. Some pushed for using other domiciles such as the Cayman Islands and Dublin as the new insurance centres of the world.

Relief, foreboding and again relief

It had been a year of tensions and transition. Despite all the vicissitudes of the marketplace, Bermuda's international business and financial sector went on growing beyond all recognition and, splendid though this was in many respects, it yet brought with it the need for constant adjustment and repositioning. But the islanders were feeling other strains of a much more general, perhaps universal, nature. In a time of chaotic and onrushing changes around the globe they sought in their own small homeland to retain something of their own traditions and culture but, in terms of social behaviour, like many other parts of the world, they had reason enough to be troubled.

Bermudians are a friendly and peaceable people. Yet the year began with *The Royal Gazette* reporting how an old lady had been beaten up and robbed in her own home by machete-wielding thugs. The Canadians had always thought well of Bermuda, with affection and respect, yet now

[822] *Bermudian Business*, Summer 2000, Deloitte & Touche Sixth annual Bermuda insurance survey 2000, with analysis by Standard & Poor's, 'Bermuda reconfiguration under pressure'

they were appalled to read in their own newspapers that the vicious murder in Bermuda of a harmless, young Canadian girl had been left unresolved and unpunished. The islanders were celebrating the victory of the PLP. A festive mood would soon give way to alarm, when the island's youth showed itself increasingly violent, as fights broke out in schools and on the football fields. Small wonder that bells were ringing the warning of growing illiteracy. Unrest and disaffection spread into every corner. Throughout the year there were threats of strikes by service professions and industry, including the police, the teachers, and the taxi drivers—these last being up in arms because funeral homes were allowed to bring in stretch limousines. Controversy broke out when a 'hotline' was set up for the denunciation of neighbours who might be breaking the work permit laws. And there were allegations of racism in respectable places. It seemed as though Bermuda might not be so friendly and peaceable after all.

Yet the year was not all doom and gloom. Great news came for journalists when a landmark legal case ruled that they did not have to reveal their sources, after former reporter David Marchant had been threatened with jail for failing to name the source of stories about Bermuda Fire and Marine. Events moved on in their various paths, as events are inclined to do. Hurricane Gert came through, flooding homes and destroying businesses on the South Shore. Yet work began at the Daniel's Heads Village in Somerset on the first new tourist development in Bermuda for 27 years. The death penalty was abolished. The island was besieged by influenza. Those who had been involved with the theatre boycott in 1959 celebrated its 40th anniversary. The year ended with a freak storm.

Meanwhile President Clinton had signed into effect a Bill that limited liability for certain potential computer-related problems that were thought to be in the offing. It was widely expected that all electronic equipment would come to a halt at midnight on 31 December, the last day of the last month of the last year of the last century of the past millennium—the moment when the closing digits of the date read 'zero zero', 'nought nought'.

There was something faintly Apocalyptic about this notion. The Bermuda financial sector closed out 1999 not knowing whether anyone or anything would survive the prop cat to end all prop cats. Was it worth fretting about the competitive domicile question if, as 1999 rolled into the year 2000, there might be no more domiciles of any kind?

None the less, there were still enough Bermudians who got together gladly, to Ring out the Old and Ring in the New, just as they had always done in years gone by. And surprisingly enough, just at the moment when they were doing that, just at the stroke of the midnight hour—

The lights did not go out. The Earth did not blow up. The sky did not fall.

People awoke next morning. And Y2K? Oh, yes...Happy New Year.