

Treasure Island or Paradise Lost? The New Bermuda Insurance Market

Essence: Bermuda has transformed the dynamics of global insurance. It has become an advantageous location for conducting a full spectrum of commercial insurance and reinsurance business. But will the opportunistic new entrants be able to capture the market share they need?

Perhaps nothing is more representative of the dynamic and unsettled state of the global insurance industry than the emergence of 21 square miles of volcanic rock in the middle of the Atlantic as the world's third largest insurance market. Home to over 16,000 insurance and reinsurance companies representing over \$132 billion in assets, Bermuda has been transformed from one of many offshore captive insurance havens to the domicile of choice for an elite new breed of international insurer and reinsurer. For more than 25 years the island has been the epicenter of the seismic activity that has reshaped the insurance competitive landscape including the widespread acceptance of captives as viable alternatives to commercial insurance, the evolution of finite risk insurance and reinsurance solutions, and the introduction of highly focused companies to address capacity shortages in excess liability insurance and catastrophe reinsurance. In the aftermath of September 11 and the collapse of Enron, the engines of change are once again revving on this tiny island as yet another wave of companies are launched to seize the opportunities presented by a market convulsing under the strain of unprecedented catastrophes, disoriented by the emergence of terrifying new risks and bloodied by more than a decade of cut-throat competition.

The initial appeal of Bermuda was low taxes, a favorable regulatory environment, and a stable and business-friendly government that went out of its way to attract and retain insurance business. Those features remain attractive, even if some of the initial tax benefits have evaporated, and now are augmented by a highly developed insurance infrastructure and international recognition as a credible and desirable address for conducting business. Innovative companies such as Marsh, AIG, and KKR have learned to leverage Bermuda's infrastructure and regulatory flexibility to rapidly deploy capital to respond to emerging opportunities and market inefficiencies. A powerful new risk capital machine, fueled by forward-thinking players in the insurance industry and the capital markets, emerged in the mid-1980s when ACE and XL were launched to capitalize on a dearth of high excess liability capacity. It demonstrated just how profoundly and how rapidly it can reshape the market when, in the mid-1990s, over \$6 billion was funneled

into new reinsurers to meet the demand for catastrophe treaty coverage following Hurricane Andrew and the Northridge earthquake.

Now the machine is churning out a diverse mix of new insurers and reinsurers to capitalize on the lack of capacity for exposures deemed high-risk in the wake of the September 11 terrorist attacks, and to take advantage of rising insurance and reinsurance premiums throughout most commercial lines of business. Since September 11 approximately \$12.5 billion has flowed onto the island to support start-up operations and to increase the capacity of existing companies.

Among the recent entrants are:

Alea Group Holdings. Former Swiss reinsurer re-domiciled in Bermuda with a \$250 million capital infusion from owner Kohlberg Kravis Roberts & Co., bringing its total capital and surplus to more than \$600 million. Writing a broad array of treaty reinsurance intended to benefit from the stronger pricing in many lines.

Allied World Assurance Company, Ltd. Formed to write a worldwide portfolio of commercial property and casualty insurance and reinsurance, property catastrophe reinsurance, and certain specialty lines. Capitalized at \$1.5 billion. Major shareholders include AIG, Chubb, and GS Capital partners.

Arch Worldwide Insurance and Reinsurance Group. Insurance/reinsurance subsidiary of \$1+ billion Arch Capital Group. Anticipates writing over \$500 million annualized gross reinsurance premium in 2002 across a number of classes.

AXIS Specialty Ltd. Specialty insurer created specifically to address capacity shortages resulting from September 11, principally property, catastrophe, aviation and marine insurance, as well as specialty sub-lines in primary property, marine, aviation, and space insurance. Formed by Marsh & McLennan and capitalized at \$1.7 billion.

Endurance Specialty Insurance Ltd. Specialty insurer/reinsurer focused on six lines of business: property insurance and per risk reinsurance, property catastrophe reinsurance, excess workers' compensation reinsurance, aviation liability insurance, directors & officers insurance, and excess general liability insurance. Founded by a consortium of investors including Aon Corporation, Zurich Financial Services, and Capital Z Financial Services Fund II. Recently raised \$1.2 billion through a private placement.

Montpelier Re. Property reinsurer formed by White Mountain Insurance Group and Benfield Group. Initially capitalized at approximately \$1 billion.

Primus Guaranty. New credit risk specialty insurer formed by an investment group led XL Capital. Capitalized at approximately \$150 million.

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Talbot Holdings Ltd. New holding company formed by executives of the former Alleghany Underwriting Ltd. in conjunction with New York-based venture group Black Diamond Capital LLC. The initial acquisition of the holding company was Alleghany Underwriting, which will operate a new syndicate at Lloyds of London writing principally marine and aviation business.

The diversity among this group differentiates it from prior waves of new formations that were largely clustered around specific products or solutions such as property catastrophe reinsurance or finite risk. This is due to the current firming in the market that benefits many different sectors, but it also is reflective of the maturing of the Bermuda market itself. With the emergence of ACE Limited, XL Capital Ltd., PartnerRe Ltd. and others as international insurance and reinsurance powerhouses, Bermuda has thoroughly dispelled any stigma associated with the “offshore” label, and now is a respected location for conducting all manner of commercial insurance and reinsurance business.

Whereas in the past U.S. and European companies formed specialized Bermuda-based subsidiaries to benefit from the tax and regulatory advantages, the tables now have turned with Bermudan companies now acquiring non-Bermudan subsidiaries to provide direct access to markets throughout the world. This includes syndicates of the venerable, but troubled, Lloyds of London, of which 16% of the underwriting capacity now is controlled by Bermudan companies. Not only have Bermuda-based companies grown in scope and status to become leaders in the global market, established major players such as the Willis Group have relocated their headquarters to the island. Newer insurance holding companies such as Arch Capital have set up shop in Bermuda to use the island as a base for building diversified global insurance enterprises.

Bermuda has transformed the dynamics of global insurance. The relative ease with which new companies can be formed in the country have made the worldwide insurance market more efficient, and the success of upstarts like ACE Ltd. and XL Capital make it all the easier to raise large sums of money for new Bermuda insurance ventures. Insurers launch new subsidiaries and joint ventures to seize opportunities in underserved markets (Allied World), and brokers form new risk assumption vehicles to provide continuity of coverage when capacity dries up in traditional markets (AXIS Specialty). Many of the most recent crop of companies are joint ventures among major brokers and insurers (Endurance Specialty, Montpelier Re), addressing the symbiotic needs for underwriting opportunity and capacity for difficult-to-place lines of business. The speed at which these new ventures can be launched has increased significantly, with some of the post-September 11 companies financed and operational within a matter of weeks. This increased efficiency virtually guarantees flatter insurance market cycles as capital is very rapidly channeled into any segment promising higher-than-average returns.

Bermuda insurance and reinsurance companies are not necessarily built to last as independent operations. Frequently launched to address a particular short-term opportunity, they often are acquired by larger insurance entities soon after they achieve

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credible mass and stability. While reminiscent of the “built to flip” model that plagued the dot com boom, this has proven to be a viable new business model that has effectively addressed the short-term pricing and capacity issues that periodically beset the insurance market. Though there have been a number of missteps and falters, and some companies have elected to discontinue business, there have been no major failures among the companies formed since the mid-1980s. An impressive number achieved critical mass, boasting solid business plans, adequate capital, and seasoned management, and can be deemed to have served the purpose for which they were created (including producing a solid return for their original investors).

Success is far from assured for the new kids on the block, however. The more diversified new players, hoping to reap the benefits of a firming market, find themselves going head-to-head with established companies reluctant to yield market share. The effect is to stifle the rate increases all agree are necessary to return the industry to health. While the new players have the benefits of flexibility and clean balance sheets, many are experiencing disadvantages resulting from lack of brand recognition, lower ratings than many established competitors, hastily-assembled underwriting teams, inadequate systems and, in a few cases, mediocre management as the barrel is scraped to the bottom to find the talent to run the large number of new companies. New insurers focusing on specialized opportunities, particularly those filling the gaps left by insurers and reinsurers spooked by the frightening new risk landscape following September 11 and the collapse of Enron, may have a better opportunity to quickly gain traction.

However, it remains to be proven that they can profitably underwrite these hazardous exposures, and the niches may prove to be short-lived as traditional insurers and reinsurers reassess their initial reflexive reactions and loosen recently imposed underwriting restrictions. In any event, at a conservative .8-to-1 premium to surplus ratio, this new capital supports \$10 billion in premium in a market that is stagnant, not demonstrably short on capacity and with knowledgeable customers ready to turn to alternative risk financing solutions if insurance and reinsurance rates rise too much. In short, it will be enormously challenging for the new crop of Bermuda companies to replicate the successes of their predecessors.

Wrapping-Up

New Bermuda-domiciled companies enjoy pricing advantages due to a lack of prior liabilities needing to be funded, lower tax rates, fewer regulatory limitations on investment activities, and more favorable accounting practices. Many of them also have the advantages of powerful investors that not only can contribute enormous sums of capital, but also can provide instant market credibility, a stronger basis for attracting top talent, and, in some cases, an instant flow of business. These companies are entering the market at a seemingly fortuitous time as rates are rising across the board in commercial insurance and reinsurance, and capacity is being withdrawn by traditional players from lines of business that may be successfully written by savvy underwriters. Bermuda’s

reputation as an “insurance laboratory” and the track record of success of large companies formed since the mid-1980s seems to bode well for these new players.

However, there are significant differences between this new crop and their predecessors that suggest that success is far from assured. Previous waves of new entrants were focused on clear market inefficiencies and systemic gaps caused by regulatory or accounting practices. The newer companies typically are competing head-to-head with traditional players (in some cases their own parents!) that have demonstrated an unwillingness to yield market share, even when the result is a ruinous price war.

Ultimately, the pricing advantages offered by Bermuda may permit these companies to prevail against their old-line competitors (though there already are signs that the U.S. Congress may take action to help level the playing field), but success will come only after another round of bloody competition that undoubtedly will produce casualties among both the new and the traditional companies. One has to wonder if the opportunistic investors in the new wave of Bermuda companies have the will to hang tough through the inevitable hand-to-hand combat for market share that is now looming on the horizon.

Business Impact: While Bermuda companies may relieve some of the capacity shortages that arose in the aftermath of September 11, much of the new capital is earmarked to take advantage of rising rates in more traditional lines. The impact likely will be to curtail the current hardening market. In the long run, the ability to rapidly funnel capital into the global insurance market will result in heightened competition and flatter market cycles.

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