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Article abstract

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ACE, XL, MID OCEAN AND MRM AND THE BERMUDA MARKET

by Dan R. Anderson

ABSTRACT

This article discusses the development of four key organizations in the Bermuda market, ACE, XL, Mid Ocean and Mutual Risk Management Ltd. Several common factors among these four corporations, which have contributed to their considerable success, are examined. Several of those factors are becoming defining characteristics of modern risk financing groups. These four organizations have been instrumental in transforming Bermuda into one of the world's leading risk financing markets. The article concludes with a discussion of future challenges for these four groups and Bermuda market.

RÉSUMÉ

Cet article traite de l'évolution de quatre compagnies opérant sur le marché des Bermudes à savoir ACE, XL, Mid Ocean et Mutual Risk Management Ltd. L'auteur examine plusieurs facteurs qui leur sont communs et qui sont associés à leur immense succès, plusieurs d'entre eux étant des caractéristiques significatives au sein des groupes œuvrant actuellement dans le financement des risques. Ces quatre compagnies ont contribué à la transformation du marché des Bermudes, le classant comme l'un des chefs de file mondiaux dans le financement des risques. L'auteur conclut par une réflexion sur les défis futurs auxquels seront confrontés ces quatre organismes ainsi que le marché des Bermudes.

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INTRODUCTION

The College of Insurance, under the direction of President Ellen Thrower, provides a faculty development program which places their faculty with businesses in the risk management and insurance industry. The main purpose of the program is to allow professors to better understand the "real world" of risk management and insurance, in order to improve teaching and research efforts. The program is generously supported by the companies accepting the faculty placements by paying all the travel and living expenses of the faculty member as well as a stipend.

Over my 26 years of teaching and conducting research, my interests have focused on catastrophe liability (environmental, asbestos, nuclear) and property (hurricanes, earthquakes, floods, tornadoes) damages, compensation programs and risk financing schemes. These interests have led me to follow, at least from a distance, developments in the Bermuda insurance market particularly over the last decade. Because of my combined interests in liability and property catastrophe risk management and insurance and the Bermuda market, arrangement were made for me to spend one week at each of the following organizations: ACE Limited (ACE), EXEL Limited (XL), Mid Ocean Reinsurance Company Limited (Mid Ocean), and Mutual Risk Management Limited (MRM). Robert Clements, Chairman of the Board of Trustees of The College of Insurance, and a key figure in the development of ACE, XL and Mid Ocean was largely responsible for setting up my program with these four organizations.

As part of my development program, Mr. Clements suggested that I write a paper with a general common theme across the combined experience of the four risk organizations. Those of you who know Mr. Clements with his professorial tendencies will not be surprised by his suggested "required" assignment to me. Indeed, in my program, I am essentially in the role of the student although, hopefully, at some sort of advanced level.

I certainly was blessed with a plethora of resources to accomplish my twin objectives, namely, one, to learn as much as possible about each organization in a oneweek period and two, to complete Mr. Clements' written assignment. Prior to my visit, I requested and received from each group a great deal of written material (annual reports, 10Ks, prospectives, policy forms, promotional and descriptive material, among others). All this material was reviewed before my one week stay at each respective company. During the specific weekly visits, I was able to interview virtually all the top

management people in each of the organizations. I was given insider status, i.e., all questions were answered openly and candidly. Receiving insider information greatly increase my level of understanding of the intricacies of the various organizations and the nuances of managerial thinking. Of course, any confidential information I received was obviously assumed to be kept confidential by me.

As I digested the written material and conducted the interviews, I began to notice a number of similarities between the various organizations. These similarities were particularly apparent among ACE, XL and Mid Ocean. Not surprising, since MRM is a service based and not a risk taking organization, the similarities were not nearly as numerous, still some general commonalties existed across all four organizations. As I noticed the similarities among the four groups, I thought that a discussion focusing on the theme of these commonalties might produce an intriguing basis for my paper. I do not mean to suggest that the organizations are identical; there are obvious and important differences. But in my paper, I am focusing on common factors in their development and operations. It also seemed important to discuss these common factors within the framework of the changing Bermuda insurance market over the last decade. Each of these organizations, ACE, XL, Mid Ocean, and MRM have been instrumental to various degrees in bringing about these changes.

Finally, much can be learned from examining these common factors and the impact of the groups in transforming the Bermuda insurance market. Possibly the most obvious commonality among the groups is that they have all been very successful. Understanding why they have been successful can provide a model and benchmark for the operation of successful risk financing and management groups. In addition, all the groups are relatively young, ACE (10+ years), XL (10+ years), Mid Ocean (3+ years), and MRM (18+ years) and represent the new modern risk financing and servicing organization.

COMMON FACTORS

The following discussion of common factors will include more observations on ACE, XL, and Mid Ocean than on MRM. ACE, XL, and Mid Ocean are all risk taking organizations so comparisons among them are more readily made. Since MRM is a service organization, a number of factors discussed below will naturally

have no relevance to MRM. Yet, as will be seen, certain general management factors do have a common basis across all four organizations.

☐ Formation

The formation of ACE, XL, Mid Ocean, and MRM all required a spark of genius and a bit of courage. There seems little debate that the genius behind ACE's and XL's formation was Robert Clements of Marsh and McLennan. The fatherson combination of Francis and Rob Mulderig certainly was the driving force behind MRM. Both Robert Clements and Robert Newhouse were closely involved with Mid Ocean's formation, although a cartoon caricature in Newhouse's office depicts Clements with the following captioned thought "and now on to the next idea."

The courage of all these individuals is easily demonstrated. In the case of ACE and XL, virtually the world insurance markets had dropped out of the excess liability and D&O markets because of huge losses. ACE and XL were swimming against the world currents not unlike entering a burning building while everyone else was evacuating. While "necessity is the mother of invention," accepting large blocks of risk when no one else is requires a certain fortitude level. The situation was very similar for catastrophe reinsurance markets following Hurricane Andrew when Mid Ocean was formed. Many were leaving as Mid Ocean was starting operations. Roberto Mendoza of J.P. Morgan should also get credit for the courage to financially back ACE, XL, and Mid Ocean.

In MRM's case, no one was leaving the field because it had not been invented yet. MRM created the rent a captive idea and was the first to deploy it. To be the first one in and create an area obviously also requires a spark of genius and a certain amount of courage.

☐ Adequate Capital

No factor is more important to the successful operation and continuation of a risk taking operation than adequate capital. It provides policyholder security, stability of coverages and premiums, and covers fluctuations in underwriting, investments and loss reserving. The author assumes that when ACE, XL, and Mid Ocean were formed with the following amounts of capital, that they were the most capitalized of any new insurers that had ever been formed to date.

ACE	$201,000,000
XL	$410,000,000
Mid Ocean	$359,000,000

Adequate capital is particularly important in high severity low frequency risk areas like excess liability, excess D&O, and catastrophe reinsurance. Having a large block of initial capital allowed ACE, XL, and Mid Ocean to all come out of the blocks running. Deterioration of statutory (even though ACE, XL, and Mid Ocean were not subject to U.S. statutory accounting rules) reported capital levels resulting from premium growth is not a problem when an insurer starts with a large amount of capital. Finally, in the very early years, ACE and XL, through mandatory stock purchases and premium reserves required of policyholders, helped to guarantee that the capital would stay with the organization and not flee at the next soft market.

☐ Unencumbered Capital or No Long Tail

Possibly no other development has caused more havoc in the propertyliability insurance industry than asbestos and environmental damages and liabilities. These are extremely long tail risks. Court interpretations of insurance contracts associated with these risks have resulted in substantial amounts of these damages and liabilities being paid by the insurance industry. Because of the large amount of money involved, litigation between policyholders and insurers regarding these long tail risks has been unprecedented. I speak from authority as I have written numerous articles on this subject.

I remember lecturing to my students even before ACE and XL were formed that an entrepreneurial risk taker (note I was a professor not an entrepreneurial risk taker) could make a lot of money by starting an insurance company and competing with old insurers that were encumbered by long tail liabilities (possibly I received my ideas telepathically from Clements). By definition a new insurer, if structured properly, has no tail it takes time to grow or develop a tail. In this time, a new insurer has a substantial competitive advantage over old insurers having long tail liabilities. Interestingly, even Mid Ocean and MRM, which by the nature of their business have little, if any, long tail exposure, mention in their annual reports that their capital is unencumbered by asbestos and environmental liabilities.

☐ Large Net Lines of Capacity

ACE, XL and Mid Ocean are characterized as being providers of large net lines of capacity. This factor guarantees stability of coverage and capacity over multiyear periods. Particularly with ACE and XL, prior to their formation, capacity and stability in the excess liability and D&O markets were largely dependent on annual reinsurance treaties. Risk managers and insurers knew their capacity in the current year, but if the reinsurance market contracted the next year, that capacity could be eroded. Writing large net lines of capacity breaks this dependency link with the reinsurance markets and promotes longer term stability. Of course, large net lines of capacity require adequate capital levels which were present at ACE, XL and Mid Ocean as discussed above.

☐ Long Term Relationships

A central management philosophy of all four organizations I visited was their emphasis on long term relationships with customers. ACE and XL pride themselves with 90% plus renewal rates by publishing them in their annual reports. Renewal rates are not as readily measurable with Mid Ocean and MRM, but discussions with company officials indicated that there was a high percentage of repeat and long term customers.

Shopping and switching insurers causes a great deal of instability and inefficiency in the insurance markets. All four organizations increased stability and efficiency by having long term relationships as a central management tenant. Capital requirements, policy forms, pricing stability, regular customer contacts, and other techniques discussed in this paper all helped to support the concept of building and maintaining long term customer relationships.

☐ Customer Satisfaction, Contract and Service

All four organizations were emphasizing Total Quality Management (TQM) long before it became fashionable in the insurance industry. A central tenant of TQM is listening to your customers, focusing on their needs, and providing top quality service to customers. Focus on customer satisfaction and service dovetails with an emphasis on long term relationships indeed it is required to maintain long term relationships.

From the first days at ACE and XL, annual meetings with customers in Bermuda were required, and are still part of management philosophy today. Every year ACE and XL underwriters meet

facetoface with risk managers and usually their brokers in Bermuda. These annual pilgrimages, as I have heard them referred to, allow underwriters and policyholders to meet, to discuss differences, to explain changes, that is to communicate. Prior to ACE and XL it was common to have the broker serve more as an intermediary: the broker would meet with the risk manager, the broker would meet with the underwriter, but the risk manager and the underwriter would not necessarily meet. While the new arrangements with ACE and XL may have been somewhat threatening to the broker, it is obvious that annual meetings led to better customer communication, service and satisfaction.

In talking with Mid Ocean officials, their extensive travel schedule to meet with their customers and markets was emphasized. Indeed this extensive travel schedule was even mentioned in their annual reports, a point which I can never remember seeing in previous annual reports of insurers and reinsurers. While the reinsurance business has historically been closely based on personal relationships, the concentration of reinsurance markets in the London area made maintaining these relationships more convenient. Mid Ocean officials typically find it necessary to travel to their customers rather than their customers coming to Bermuda. While requiring some effort, the importance of regular customer contact is maintained as part of management philosophy.

Maintaining customer service, contact and satisfaction is more obvious at MRM as it is a service based operation. Yet in learning about MRM's operation, it was clear that a great deal of emphasis was put on maintaining strong relationships with brokers who are the link to MRM's principal customer base, corporate risk managers. Indeed the 1995 Annual Report stated that MRM's "greatest challenge is to continue to recruit and train marketing people who can effectively sell our program through brokers to potential clients."

☐ Maintenance of Broker Relations

When ACE and XL were formed it would have been easy to have coverage placed direct, that is, without going through a broker. Since the policyholders and owners of ACE and XL were the same corporations, an intermediary seemed unnecessary. Yet, the broker distribution system was left in place, and this turned out to be a wise decision.

The idea person behind ACE and XL, namely Robert Clements, was, of course, a broker, indeed the President of the largest brokerage firm, Marsh and McLennan. His purpose in establishing ACE

and XL was to provide coverage for his customers, but certainly not to put himself out of business in the process. In addition, the failure of the initial ACE/XL ownercorporations to use brokers may have lead to difficulties in placing other coverages not provided by ACE and XL. And, of course, brokers provide numerous other services besides just placing insurance policies.

As ACE and XL expanded their customer base to market to nonowners, the broker distribution system was obviously needed. Also, as they added coverages beyond excess general and D&O liability, its broker system helped to market these products.

With Mid Ocean and MRM, maintenance of broker relations was a nonissue. Mid Ocean's customers were not owners of Mid Ocean and the reinsurance business has traditionally employed a brokerage distribution system. MRM's customers were also nonowners and MRM was dependent on brokers who are the links to their principal customer base.

☐ MultiYear Products

ACE and XL were among the first (possible the first) insurers to develop true multiyear contracts. The ACE and XL excess general liability policies are actually perpetual policies (subject to annual review), with annual aggregate limits, that remain in effect until canceled. XL has been even more active with its MAXL programs and the recent formation of Risk Solutions with CIGNA. Multiyear products are a natural outgrowth of an emphasis on long term relationships with customers. A stable long term relation between an insurer and its policyholder, is in effect, an informal multiyear contract. Providing multiyear policies can be considered as merely a formal recognition of a committed long term relationship.

Multiyear contracts, like long term relationships, produce efficiencies and advantages for both the policyholder and insurer. The policyholder receives more stability in coverages and pricing. The insurer is less vulnerable to policyholders who shop and switch insurers. Efficiencies in the underwriting process benefits both insurers and policyholders. Once a prospective policyholder has been underwritten in the first year, subsequent year underwritings are less time consuming and costly. I recall one risk manager telling me that 40 percent of his (her) time is spent in the renewal process. Multiyear contracts substantially reduce the time and costs involved in the renewal process.

Multiyear contracts are a developing trend. Other insurers are developing multiyear contracts (e.g., Swiss Re's Beta program). I expect that more and more insurers and policyholders will enter into such arrangements. ACE and XL's early entry into multiyear contracts is but another example of their leadership in the development of modern risk financing products.

☐ Underwriting and Pricing

An inescapable observation I made at all three risk taking organizations, ACE, XL and Mid Ocean, is that careful underwriting and adequate pricing were the fundamental bedrock of their operating strategy. While proper underwriting and pricing must be the central focus of a wellrun insurance company, this basic tenant is often forgotten in the insurance markets. Witness the soft market periods shortly before ACE, XL and Mid Ocean were formed. Actually all three were formed in hard markets, but these were immediately preceded by extremely soft markets.

Throughout all my interviews at and readings associated with ACE, XL and Mid Ocean, underwriting and pricing were continuously stressed. Strong underwriting and pricing philosophies have been backed by quality people. XL's top two management executives, Brian O'Hara and Robert Cooney, were underwriters before they joined XL in its early days (O'Hara actually was XL's first employee). While John Cox, ACE's first president, and Michael Butt, CEO of Mid Ocean, have more general management backgrounds, they brought in top underwriting people, Bill Loschert at ACE and Henry Keeling at Mid Ocean, to head up underwriting operations when these organizations were getting off the ground.

☐ Loss Reserving

Proper loss reserving is another characteristic of a wellrun insurance organization. Loss reserving becomes particularly critical in long tail lines like excess general and D&O liability which are the core products of ACE and XL. From the first days, XL has used IBNR loss reserving techniques based on BornhuetterFerguson modeling techniques. Due to management differences, ACE's employment of IBNR reserving techniques was delayed until the early 1990s. Both organizations loss reserving methods were tested when the breast implant litigation hit in the mid1990s. Due to its early start, XL faired better without any significant increases in their combined ratios due to loss reserve adjustments. While ACE has absorbed its breast implant claims, it did suffer a high combined

ratio of 149% in 1992, due to a $200 million loss reserve increase associated with breast implant claims.

Mid Ocean's core business, property catastrophe reinsurance, is not considered a long tail line, but losses can take time to develop as is evidenced by the Northridge, California earthquake in June 1994. Still, a considerable amount of emphasis is put on adequate reserving as is indicated by an annual loss reserving report prepared by Mid Ocean's actuary, Guy Whitehead. Interestingly, despite being principally in the property catastrophe reinsurance business, Mid Ocean carried a healthy IBNR loss reserve of $258 million at the end of fiscal year 1995 (10/31/95).

□ Policy Forms

The development of the occurrence first reported form by the organizers of ACE and XL is another example of the touch of genius exhibited by these firms. I believe Bob Clements is credited as being the principal author of this form.

Enormous asbestos and environmental liability insurance losses have been (are being) incurred when old occurrence policies have been (are being) triggered to pay claims. It became clear in the mid1980s that existing occurrence forms were not a viable product for insuring modern long tail liability risks. It took the formation of ACE and XL and their occurrence first reported forms to produce a solution for modern long tail risks.

The beauty of the occurrence first reported form is that only one policy period and limit for a given insured and risk situation can be triggered; and once a policy period passes it cannot be triggered in the future. Under a regular occurrence form, one insured and one risk situation can trigger multiple policy years. In addition, since the occurrence of bodily injuries and property damages trigger a policy period, the discovery or finding of past injuries or damages can trigger past policy periods and policies. Insurers literally can never close their books on a policy period and the associated policies, as so many insurers have found out to their dismay.

The occurrence first reported form requires that the circumstances of the risk situation (or the injury or damage in products cases) begin after the inception date or beginning (also retroactive date) of the first policy period. The policy period that is triggered is that policy period when the incident (loss, claim) is first reported. Once a policy period passes without a report, it cannot be triggered. This policy form also encourages policyholders to stay with ACE

and XL as the retroactive date stays constant at the inception or beginning date of the first policy period (note this supports emphasis on long term relationships). If a policyholder leaves ACE or XL, the retroactive date of the subsequent policy will move forward unless backdated by the subsequent insurer. If the policyholder switched they would have the option of exercising the extended reporting period endorsement for an additional premium, but ACE and XL officials indicated that the few policyholders which have left tend not to exercise this option.

☐ Efficiency

In an era of downsizing or rightsizing, it can be said that ACE and XL started out down or rightsized. It was constantly stressed at both organizations that their expense ratios of around 15% gave them a 1015 percent spread or advantage over the rest of the insurance industry (with a few exceptions like AIG). ACE and XL started with immediate cost efficiencies and have maintained those efficiencies. The total number of employees at ACE in the summer of 1996 was only 95 and at XL it was only 116.

Older existing insurers have (had) large middle managements and bureaucracies. In these organizations work often has (had) to be created to keep these large numbers of employees busy. Only recently have those large numbers of employees been trimmed down.

ACE and XL started with just a handful of employees. As additional work was required, additional employees were added. Indeed ACE and XL embodied the value added concept before it became a trend. Employees were only added as they were needed to accomplish work tasks. Their value added was readily apparent as the required work tasks existed before the employees were hired. The employees automatically added value by accomplishing the required work tasks when hired. In this fashion, the chance of having an employee with nothing to do is minimized in that if there was nothing to do, then the employee would not be hired in the first place.

A key factor in keeping expense ratios low arose from the manner in which ACE and XL set up their distribution systems. In 19851986, the majority of competing insurers had agency contracts with their sales force of agents. These agency contracts called for substantial financial and organizational support from insurers which, of course, increased expense ratios. In setting up their distribution systems, ACE and XL followed the example of AIG and Lloyd's of London which used brokers, but without agency contracts and their accompanying costs.

Another concept relating to increased effectiveness that ACE and XL developed from the first days was receiving the entire premium at the inception of the policy. It is such a simple yet novel idea that is not practiced by the rest of the insurance industry. Receiving premiums at the inception of the policy means no accounts receivables, no invoices, and no agents' balances. Better cash flow for the insurer is produced and a stronger financial condition results.

☐ Claims

An attitude prevalent at all three risk taking organizations was that they were all in the business to pay claims. As one executive remarked, "Ultimately what is an insurance company in business for but to pay claims? What our customers are buying is financial security to pay claims promptly and efficiently." Remarkably there were few, if any, examples of antagonism between ACE, XL and Mid Ocean and their policyholders regarding claims. XL has the enviable record of having had only two claim disputes, both involving the same insured, go all the way to an arbitration decision, despite the fact that they had paid out over $1 billion in claims. Only $25 million in defense costs have been paid out to settle these $1 billion in claim payments. The ratio of 2.5 percent is extremely low compared to industry standards. I found this fact to be particularly refreshing, given that I have written a number of papers on insurance coverage litigation between policyholders and insurers in the asbestos and environmental areas.

Another key factor in the claims area is that ACE, XL and Mid Ocean have all shown the ability to pay claims. Particularly with ACE and XL, in the early years, questions were asked, "What happens when the next asbestos type situation comes along?" The question was answered when the next asbestos type situation did develop namely, breast implant litigation. Since core customers, or large corporations, manufactured breast implants, both ACE and XL had multiple insureds involved. Multiple insureds meant that the potential existed for numerous policies and limits beings triggered. While the exact payments by ACE and XL for breast implant claims is confidential, it can safely be surmised that these payments were in the hundreds of millions of dollars. While these claim payments were not painless (ACE's $200 million reserve increase in 1994 has been previously mentioned), they were paid, they were paid promptly with relatively little dispute, and they were paid without a material adverse financial effect on ACE or XL.

While breast implant claims developed several years after ACE and XL were incorporated, Mid Ocean had only been in business a little over a year when the January 1994, Northridge, California earthquake occurred. The Northridge earthquake, as measured by insured losses of $12.5 billion, produced the second largest catastrophe in U.S. history. Interestingly, the largest U.S. catastrophe, Hurricane Andrew, in August 1992, with insured losses of $15.5 billion, was the catalyst that led to the formation of Mid Ocean. As with ACE and XL, Mid Ocean was able to absorb incurred losses of approximately $95 million from the Northridge earthquake, without a material adverse financial effect on the organization.

■ FAVORABLE CONDITIONS

The management individuals of ACE, XL, Mid Ocean and MRM did a number of things right as is evident by the discussion in the previous section. Yet conditions were also favorable for the formation and development of these four groups. On the other hand, management decisions had an influence on the conditions in which they would operate, and, more importantly, they took advantage of these favorable conditions. In this section of the paper, three sets of conditions will be discussed along with my observations on how these conditions were favorable for the formation and development of ACE, XL, Mid Ocean and MRM.

□ Location in Bermuda

The location in Bermuda was ideal for the formation and development of ACE, XL, Mid Ocean and MRM. Of primary importance is the fact that Bermuda regulations allowed these organizations, particularly ACE, XL and Mid Ocean, to be established and to begin operations in a relatively short period of time with a minimum of bureaucratic red tape. Bermuda originally began in the insurance business in the 1960s as a location with an infrastructure to support captives solely owned by and operated for a parent corporation. The original motivation focused on the tax advantages, i.e., the premium paid to the captive was a tax deductible business expense and the earnings of the captive were not taxed in Bermuda.

The loss of the tax advantage of premium deductibility in the late 1970s lead solely owned captives to write outside business in

the hope of regaining the premium expense as a tax deductible item. Association captives and industry captives or mutuals also developed in the mid to late 1970s, both for tax reasons and as a response to the hard market in the mid 1970s. Finally, the early to mid 1980s found a number of these expanded captive groups getting into financial difficulties (e.g., Mentor Insurance) associated with the soft market and cash flow underwriting.

Bermuda originally was developed for sole owned, industry and association captives, as described above, not for risk taking organizations like ACE, XL and Mid Ocean. To my knowledge, ACE and XL were the first insurance organizations in Bermuda in which large corporations from totally different industries capitalized and formed an insurance organization to essentially write insurance to themselves.

While the Bermuda insurance infrastructure was not originally built for ACE, XL and Mid Ocean type organizations, it turned out to be perfect for their formation and development. All were set up in a relatively short period of time, which was not unusual under Bermuda's regulatory system. Had these organizations been forced to contend with the regulatory requirements of the 50 states, their formation would have been much more costly, time consuming and inflexible. For instance, the American Excess Insurance Association (American Slip), a competitor of ACE and XL, which was set up in the United States, took nine years to get licensed in all the states. In addition, the acceptance of the ACE and XL occurrence first reported forms by state insurance commissioners in 19851986 would in all likelihood have been very difficult to accomplish.

For insurers specializing in excess liability and property catastrophe reinsurance with large net lines, the principal management objective, certainly in the early years, is capital accumulation. The ultimate measure of an insurer's ability to pay large claims is the size of the insurer's capital and surplus account. While the regulatory system, rather than the absence of an income tax, was the principal motivation for the formation of ACE, XL and Mid Ocean in Bermuda, maximum capital accumulation by these organizations over the years was possible in Bermuda because of its absence of an income tax. The U.S. tax system, or those for most other countries for that matter, would have severely hampered the objective of capital accumulation. The capital and surplus positions of ACE, XL and Mid Ocean respectively, at the end of 1995 are $1,443 million, $2,006 million, and $969 million. The 1995 premiums to surplus ratios for these three organizations are, at .29:1, .35:1, and .45:1,

respectively, compared to industry standards, incredibly low. In a very short period of time, 10 years for ACE and XL and three years for Mid Ocean, these organizations have accumulated sufficient capital to be the major players in world markets in their respective fields.

Bermuda as a favorable place for the formation and development of MRM is more obvious. Bermuda has been and is the principal captive insurance market in the world. As originator of the first rent a captive programs, it made logical sense for MRM to set up in Bermuda. Yet like ACE, XL and Mid Ocean, MRM's formation and development were supported by Bermuda's favorable regulatory environment. In addition, the tax free status also allowed MRM to accumulate an impressive capital and surplus position of $163 million at the end of 1995.

□ Timing

There is an old saying, "Timing is Everything." While not everything, timing factors definitely played a role in the successful formation and development of ACE, XL and Mid Ocean. In 198586, the time was right for ACE and XL as capacity in the excess liability and D&O liability markets for large corporations had contracted considerably or had dried up all together. To say that there was a strong demand at the time for their products relative to the limited supply is an understatement. As mentioned in the previous section, being in Bermuda also helped in the timing as ACE and XL could get off the ground quickly. Had ACE or XL taken 23 years to organize and begin operations, the window of opportunity would have been lost as markets started to soften in 1988.

The problems at Lloyd's of London helped all three risk taking organizations. Lloyd's was traditionally the leading provider of what were to become ACE's, XL's and Mid Ocean's core markets, excess liability, D&O liability, and property catastrophe reinsurance. Not only did Lloyd's of London's problems remove market capacity which gave greater opportunities for ACE, XL and Mid Ocean, a major competitor was severely limited in its operation during the formative years of these groups.

Both ACE and XL had the good fortune of not having a big claim hit in the early years. An explosion at a chemical or oil facility with large associated liability losses in the first couple years at ACE and/or XL could have proved troublesome in their overall development. It might be noted that the ACE and XL liability form insulated them in the early years from gradual accumulative type

claims like breast implants. While Mid Ocean faced the Northridge earthquake in its second year of operation, it was not the Big One predicted for Los Angeles or San Francisco.

ACE, XL and Mid Ocean all began operations in hard markets. Indeed, it was the hard markets that gave the impetus for the formation of these organizations. Hard markets allow insurers to charge higher premiums and strengthened underwriting profits. For new insurers, higher premiums and profits are particularly advantageous and important for capital accumulations.

ACE and XL essentially had the excess and D&O liability markets in Bermuda to themselves for almost eight years. This was particularly true of the layers at which ACE was writing. Other insurers seemed reluctant to enter this market and compete with ACE, although XL faced some competition. It seemed that many insurers wanted to wait and see how ACE and XL did before deciding to enter the market themselves. The lack of competition meant that ACE and XL could pretty much dictate prices and conditions which lead to favorable underwriting results. Lack of competition also bolstered ACE and XL's emphasis on long term relationships as policyholders had relatively few other choices. It was not until 1993 and the entry of AIG's Starr Excess into the Bermuda markets that XL and particularly ACE had to worry about significant competition. By that time, they were financially strong and well established.

The markets seemed to have caught on by the time Mid Ocean was formed. Even though Mid Ocean was the first property catastrophe reinsurer formed in Bermuda in November 1992, seven new cat reinsurers were established in 1993. Total capital flowing into Bermuda over this 14 month period for property catastrophe reinsurance was $4.5 billion. If imitation is the finest form of flattery, certainly Mid Ocean enjoyed a good bit of flattery.

☐ Stock Insurer with a Mutual Concept

The formation of ACE and XL is a testament for the combining of a stock insurer with a mutual concept. The mutual concept arose from having the original buyers and sellers, i.e., the risk managers and the risk takers (insurers), being comprised of the same group. This mutuality overcame a number of potential difficulties in the formation and in the early years of ACE and XL. Potential areas of conflict between risk managers and insurers, such as the premium charged, the policy form, underwriting requirements, reserving, and claim payments are greatly reduced when the risk managers' corporations form and manage the insurer to write insurance themselves.

For instance, it is silly for the risk manager to argue for unreasonable premium reductions; premiums should be set at adequate levels. If they are too high, they can be reduced in the future and/or the profits of the insurer, which is owned by the policyholders, will be increased. Premiums due at the inception of the policy are probably only possible under a mutual concept. A policy form should be developed that is sustainable. Loss situations, like those that occurred under the old occurrence forms, would just adversely affect the insurer in the future. There is no need to manipulate loss reserves because their development, whether favorable or unfavorable, will just come back to affect the insurer, which again is owned by the policyholders.

Regarding service, just as much service as is needed is developed it makes no sense to build in inefficiencies as it just ends up costing the owners extra money. The emphasis on customer satisfaction and service is automatic because the customerpolicyholders are satisfying themselves. The concept of regular contacts, meetings and long term relationships naturally occur when the policyholders/owners get together for the board of directors' meeting for their own insurance company.

On the other hand, establishing ACE and XL as stock insurers allowed the original investors/owners, who were also the original policyholders to profit if the organizations were successful. Had they been set up as mutual insurers, profits would be distributed through dividends to both the original owners/policyholders as well as future owners/policyholders. It might be noted that a minority of the original investors/owners thought all profits should be distributed as dividends to policyholders. Finally, establishing ACE and XL as stock insurers allowed these organizations to be taken public. Going public, of course, would not have been possible for a mutual insurer, absent a demutualization plan being accomplished.

■ CHALLENGES FOR THE FUTURE

While the preceding sections portray an extremely favorable and successful performance by ACE, XL, and Mid Ocean and MRM, the future is not without its challenges and potential problems. In this section I will present my observations on key challenges and potential problems in the future.

Soft Markets and Increased Competition

Most of the individuals I interviewed at ACE, XL, Mid Ocean and MRM, spoke of the increased softening of insurance markets. For the three risk taking groups, soft markets mean slower premium growth, lower profits, and increased pressure to lessen underwriting standards and reduce premiums to respond to competition. For MRM, soft markets generally impede captive growth which adversely effects their business.

I have mentioned previously that all of the three risk taking organizations have prided themselves on their high underwriting standards and responsible pricing. Maintaining these underwriting and pricing philosophies is becoming increasingly difficult.

The arrival of Starr Excess in Bermuda in 1993, the U.S. domestic market with a capacity of $100 million, the revival of the Lloyd's market, and large world reinsurers (Swiss Re, Munich Re, Zurich Re) were all mentioned frequently as providing increased competition for ACE and XL. ACE, in particular, may have difficulties adjusting to soft markets and competition. At its excess liability insurance layers, ACE has enjoyed relatively little competition over the years. The current market conditions represent a relatively new set of challenges for ACE underwriters and management. XL has also encountered increased competition but since they have historically written at lower, more competitive layers than ACE, it may not be such a new experience for them. Of course, XL with its decision to increase capacity from $100 million to $150 million, and invading ACE's layers so to speak, is also a contributing factor to the increased competition faced by ACE.

While property catastrophe reinsurance markets are softening, on a relative basis, it does not seem to be as severe as in the excess liability markets. The period following Hurricane Andrew in August 1992 saw a substantial increase in catastrophe reinsurance rates. There appears to be more room or margin for softening in the property catastrophe reinsurance markets. Officials at Mid Ocean did mention though that the softening of rates cannot go on indefinitely without materially affecting its underwriting and pricing strategies.

Public Companies

All four organizations have gone public: ACE in 1993, XL in 1991, Mid Ocean in 1993, and MRM in 1991. Part of the motivation for going public derived from the success that all four organi-

zations have had as measured by profit margins and accumulation of capital. Of course, going public increases the pressure to maintain these performance levels.

Being public makes the effects of the soft market more noticeable. That is, soft markets tend to lower premium growth rates and profit margins, which makes it more difficult to produce the growth and rate of return on equity desired by shareholders. While not altering the fundamental philosophy of their underwriting and pricing strategies, officials at the three risk taking organizations mentioned the added pressure of being a public company when attempting to maintain their rates of return in softening insurance markets.

Diversification

The combination of accumulation of significant amounts of capital, coupled with the pressure for maintaining rates of return demanded of a public company, has led all four companies into a diversification strategy. ACE, XL, Mid Ocean and MRM all had excess amounts of capital to support their core business areas. This excess capital, along with the demands for adequate rates of return, lead to diversification into other noncore business areas. In addition, as has been discussed, growth rates and profit margins in the core areas were under pressure from softening insurance markets.

Since 1994, ACE has diversified into the areas of aviation insurance, satellite insurance, excess property coverages, financial lines and property catastrophe reinsurance. These areas are all characterized as high severitylow frequency risk situations. This risk characteristic dovetails naturally with their core business areas of excess liability and D&O liability which also are high severitylow frequency areas. The excess property area is also a nice fit with their existing excess liability and D&O policyholders, i.e., these policyholders become a natural group of potential customers for property insurance.

Since 1992, XL has also diversified into property catastrophe reinsurance, excess property insurance, reinsurance, and employment practices liability insurance. XL also has written excess professional (E&O) liability since 1987. As with ACE, the excess property insurance, catastrophe reinsurance, reinsurance and excess E&O dovetail with XL's core business of excess liability. In addition, their existing policyholder base is a natural marketing opportunity for property insurance.

Mid Ocean has decreased its concentration in its core line of property catastrophe reinsurance from 65% of its overall business in 1993 to 44% in 1995. It has increasingly diversified into the reinsurance areas of other property, excess property, marine and energy, aviation and satellite.

Beginning in 1991, MRM has made a number of acquisitions. It acquired MRM Hanover Ltd., a London reinsurance broker; Paris International Ltd., a Bermuda broker; Worksafe Group, a loss control consulting firm; Shoreline Mutual, which issues guarantees for U.S. Coast Guard required Certificates of Financial Responsibility; and Dearborn Insurance company, a surplus line insurer.

These diversification strategies help to reduce overall variation in the companies' risk areas and rates of return. Assuming noncorrelation, a bad year in one area can be balanced by a good year in another; and produce increased stability.

Whenever organizations diversity beyond their core contingencies, they encounter new opportunities, but they also need to be wary of spreading themselves too thin and of the difficulties of managing and coordinating too many areas. One challenge for all four of these organizations will be to find the proper balance between the opportunities and problems of diversification.

☐ Reemergence of Lloyd's of London

The problems of Lloyd's of London in the late 1980s and early 1990s are well documented. As has been mentioned, problems at Lloyd's of London actually helped ACE, XL and Mid Ocean as Lloyd's is a major competitor in excess liability and property catastrophe reinsurance lines. Given the recent approval of the Lloyd's rescue plan, Lloyd's strength as a competitor can be expected to strengthen. In my interviews numerous references were made to Lloyd's potential competition in the future. This expected increase in competition will put further pressure on ACE, XL and Mid Ocean in their efforts to maintain market share without significantly weakening underwriting standards and pricing.

The recent lifting of the prohibition on corporate capital is a two edged sword for ACE, XL and Mid Ocean. This change allows them to invest their capital in Lloyd's as part of a diversification strategy. For instance, ACE purchased a majority interest in Methuen Limited, a Lloyd's managing agency and Mid Ocean purchased a 51% interest in the Brock Bank Group, also a Lloyd's managing agency. This will allow ACE and Mid Ocean access to

previously untapped markets and help to counterbalance the increasing competition of Lloyd's. On the other hand, this infusion of corporate capital can be expected to increase even more the overall competition from the Lloyd's of London market. For XL, which has chosen not to invest in Lloyd's, increased competition from corporate capital in Lloyd's seems to only have a downside, unless, of course, such investments turn out to be unprofitable. From my viewpoint, I do not see developments at Lloyd's of London, favorable or unfavorable, as having much, if any, effect on MRM.

☐ A More International Focus

All four organizations have taken on a more international focus. Increasing international operations naturally coordinates with diversification strategies. XL opened a Dublin Office in 1990 (XL Europe), and MRM set up a Dublin subsidiary in 1991. More recently, in 1994, ACE opened a London office and Mid Ocean established a London branch in 1995. With these new operations, ACE, XL, Mid Ocean and MRM hope to increase their penetration into the European and other international markets. For instance, in 1995, over half of Mid Ocean's property catastrophe reinsurance premiums came from outside the U.S. Onethird of ACE's new excess liability policies in 1995 were nonU.S. accounts and that comparable percentage was 41% for new D&O policies. Finally, ACE and Mid Ocean's investments in Lloyd's of London, discussed in the previous section, also support a more international focus.

As with diversification, international expansion offers risk spreading, new opportunities and potential problems. In particular, international expansion necessitates the understanding of cultural differences and individual country practices and idiosyncrasies. In organizations that pride themselves on face to face contacts with customers and markets, added pressure will be put on individuals in these groups to cover expanded areas. While modern technology will help, computer and telecommunication systems cannot replace face to face contacts without altering fundamental management philosophies.

☐ Bermuda as a World Market

Bermuda has moved from being a sleepy island which handled sole parent owned captives to a major world insurance market for excess liability (general and D&O) insurance and property catastrophe reinsurance. As is evident by the success of the organizations discussed in this paper, Bermuda has provided the necessary infras-

tructure, and regulatory and tax environment, to support these and other risk and service organizations. The 1995 Bermuda Insurance Amendment Act set up requirements to respond to new insurance developments and should provide more relevant, modern regulations. While Bermuda seems well positioned to support the continued expansion and development of risk financing and servicing markets, potential problems were mentioned in my interviews.

The favorable regulatory and tax environment is subject to political change. Concern was raised that changes in the parties running the government could alter this environment and make it less favorable to development. Company management and the Bermuda infrastructure rely both on Bermudians and nonBermudians. Bermudian employment laws require that a Bermudian has precedent over a nonBermudian for a job vacancy, assuming equal qualifications. In the companies in which I worked, the majority (usually the overwhelming majority) of employees were Bermudian. This percentage should be expected to grow in the future. In theory, all organizations could some day employ all Bermudians. The question that arises is, "Can this transition be made without adversely affecting the quality and effectiveness of the management of risk organizations and the necessary supporting infrastructures?"

Even if the transition discussed above is accomplished, it will take many years. In the interim, another potential problem mentioned was continuing to attract top management to Bermuda. It is my impression that certainly to date this has not been a problem as all the organizations had top flight management. But some of those interviewed mentioned that the high cost of living in and the cultural adjustment of many to Bermuda will make attracting quality people a continuing challenge. In addition, changes in the very favorable tax laws (particularly for nonU.S. expatriates), which currently largely offset the high cost of living, would undoubtedly have a deterrent effect to maintaining people in and attracting them to Bermuda.

☐ Increasing Risks of Modern Society

ACE, XL and Mid Ocean all insure risks at the excess catastrophe level. They become involved in extremely large loss situations. Modern society is providing increasingly larger risks, with the potential for mega losses. A challenge for all three of these groups will be to maintain the ability to respond to these ever increasing risks.

The toxic tort area has produced three catastrophe risk situations in the liability area: asbestos, hazardous waste and pollution (Superfund), and breast implants. ACE and XL were able to avoid the first two and were able to pay claims associated with the third. Undoubtedly mega toxic tort risks are developing today which will result in future claims. The probability of these claims hitting ACE and XL increases each year. As their policies mature their occurrence first reported forms cover longer and longer tail risks. While their policies do protect against multiple policy periods being triggered for a given insured, the problem of several policies involving multiple insureds being triggered still exists.

Both ACE and XL have made adjustments to respond to the potential of increasingly larger liability claims. In 1995, ACE reduced its excess liability limits for integrated occurrence coverage from $200 million to $100 million. In the same year, XL entered into a quota share reinsurance policy covering excess liability policies. Under the policy, XL will cede 20 percent of risks with total limits up to $100 million and 25 percent of risks with total limits in excess of $100 million. Of course, the best guarantee that ACE and XL will be able to respond to increasing losses is their substantial capital base, which has been discussed above.

Another potential problem area, the problem area frequently mentioned by ACE and XL as a worst loss situation, is an explosion at an industrial firm, like a chemical manufacturer, that produces a large loss in both the property and liability areas. If ACE or XL had written both coverages, an extremely large loss could ensue. Not surprisingly, both organizations are well aware of this situation and have set up procedures to manage their accumulations by setting maximum acceptable limits when writing both covers on a single risk.

ACE, XL and Mid Ocean are all vulnerable to the increasing magnitude of natural catastrophe losses, particularly hurricanes and earthquakes. Of course, this is Mid Ocean's core business, but ACE and XL have recently established excess property insurance programs which also makes them vulnerable to natural catastrophe losses.

Two trends point to the increasing potential for large natural catastrophe losses. One, changing weather patterns are producing increasingly severe storms, particularly hurricanes, cyclones and typhoons. While a debate exists as to whether these more severe storms are resulting from global warming or long term cyclical changes (e.g., return to a more intense hurricane period like that

which existed in 19301960), there is little debate that storm severity is increasing. Obviously, this trend portends for larger natural catastrophe losses which will produce the potential for larger claims under ACE, XL and Mid Ocean's policies.

The second trend involves the increasing property development in high risk areas, most notably coastal areas and earthquake fault zones. Population growth makes this trend inevitable. While development could be curtailed in high risk areas through strict building codes and zoning regulations, there has been little serious effort in restricting development. Besides generally increasing loss levels, this development increases the size of the mega loss scenario, i.e., Hurricane Andrew type hurricane making a direct hit on Miami, or the Big One earthquake in Los Angeles and San Francisco.

ACE, XL and Mid Ocean have all taken elaborate measures to protect themselves against increasing natural catastrophe losses. In their underwriting practices, all employ state of the art computer modeling schemes to measure loss potentials of individual risks. All three have elaborate procedures to monitor and limit their concentrations of risk within specific areas. All three have purchased reinsurance policies to help control large losses. Finally, as has been repeatedly discussed, their large capital bases allow them a substantial cushion to absorb large losses.

Ace, XL and Mid Ocean seem to be in as good a position as an insurer can to control the increasingly large loss potential of modern society while still providing coverage and paying claims. While all three organizations have expressed confidence at absorbing one extremely large loss situation, multiple events in a short period of time are a continuing worry. This is a dynamic risk area and will have to be constantly monitored in the future.

□ Developing Trends in Risk Management

Three developing trends are altering the nature of risk management and insurance markets. The first one is increasing retentions (selfinsurance, deductibles, captives) being taken by risk managers along with purchases of larger amounts of high layer, excess, catastrophe insurance. The second involves the use of financial products (e.g., derivatives, Act of God bonds, catastrophe options and futures) to finance traditional insurance risks. The third is a more holistic view of risk management which incorporates speculative risks of the organization like currency, exchange, credit and investment risks, with traditional pure risks areas fires, floods, and liability suits.

All four organizations are well positioned to handle the first trend. While primary markets may be threatened by higher retentions and more emphasis on higher layer catastrophe level insurance, this trend bolsters the business of organizations like ACE, XL and Mid Ocean which emphasize higher layercatastrophe level insurance. Since higher retentions are often handled through the captive mechanism, this trend also supports the core business of MRM. In addition, MRM's recently acquired brokerage operations deal in the area insured by organizations like ACE, XL and Mid Ocean. Finally, XL's recent Risk Solutions initiative with CIGNA should be noted. This initiative provides a sophisticated and flexible multiyear, multiline, high retention, high layer, combined aggregate program to provide overall balance sheet and earnings protection. It represents an excellent model for developing sophisticated modern risk management and financing programs.

Regarding the second trend, both ACE and XL have set up units to explore opportunities in the use of financial products. ACE established a financial lines product area to deal with and market financial products. XL has purchased a 40 percent interest in Pareto Partners to lead its development in the financial products area. While Mid Ocean and MRM have not set up separate units, developments in this area are being closely monitored by company management.

The third trend involves the meshing of the management of speculative risks with the more traditional management of pure risks into an overall management of all the organization's risks. This trend is related to the second in that financial products (hedging, swaps, derivatives, options, futures) have traditionally been products used to manage an organization's speculative risks. The effect of this trend on ACE, XL, Mid Ocean and MRM is a little harder to predict. In general, it would seem that their general high level of sophistication in risk financing, including their recent development in the financial products area, as well as their organizational flexibility, will allow them to respond accordingly as developments unfold.