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Client Alert

Bermuda's Class of 2005

By Sharon E. Sonnett

Hurricanes Katrina and Rita dramatically impacted the balance sheets of many insurers and reinsurers this year. This impairment negatively affects the insurance market by causing premium rates to rise and by reducing the number of available insurers with enough capacity to support the demand for property catastrophe insurance policies. At the same time, catastrophes provide a unique window of opportunity for well-capitalized start up insurers to make a windfall profit within their first year of operation. This is particularly true for companies in Bermuda that specialize in reinsurance. A lot of people are wondering how many new Bermuda-based reinsurance companies will be up and running by January 1, 2006, and how successful they will be a year from now.

Bermuda, a U.K. territory and island approximately 570 miles east of North Carolina, historically was known as a tourist vacation spot. However, because of its advantageous tax system and relatively relaxed regulatory standards, Bermuda is an ideal location for reinsurance companies. Over the last three decades, it has developed into a global leader in insurance and reinsurance. 8% of the world's reinsurance is written by Bermuda-based companies, and $5 billion of the estimated $40-$50 billion total losses from Katrina will be addressed by the Bermuda market.

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It's no wonder then that new Bermuda-based reinsurers are being announced in the press lately, virtually every week. For example, Jeffrey Greenberg, Marsh & McLennan's former chairman, has set up a new reinsurance company that is funded by Aquiline Capital Partners, a private equity firm for which he is raising money with the help of his partners from Venturian Capital. Private investors led by ACE Ltd.'s former vice chairman, Don Kramer, have announced plans to set up a new company with an estimated starting capital of at least $750 million. Former Lloyd's of London underwriter Richard Brindle and Capital Z Financial Services Partners are working to raise up to $1 billion to form a new company, to be called Lancashire, to write marine and energy and other risks. And there are others, including Harbor Point Limited, sponsored by Chubb Corporation, and Amlin Bermuda, sponsored by Amlin P.L.C.

This won't be the first time that new players have appeared in response to catastrophes. In fact, the anticipated Class of 2005 will be the fourth wave of catastrophe-induced reinsurers. A look at the performance of some of these classes, and the difference in the market conditions today, may shed some light on how many more new reinsurers there will be and how well they will do.

In 1985, several reinsurers set up shop in Bermuda in response to the excess liability coverage crisis in the U.S. Two of these companies—ACE Ltd., formed by Marsh & McLennan, and XL Capital Ltd.—have grown exponentially over the last 20 years and remain leading players in Bermuda today. Their net income for 2004 each was $1.1 billion.

The second class of reinsurers appeared in 1992 following Hurricane Andrew, which cost the insurance industry more than $20 billion. Eight new Bermuda-based catastrophe reinsurance companies were formed in less than a year, with an unprecedented $4 billion in starting capital, including Partner Re Ltd., Renaissance Re Holdings Ltd., Tempest Reinsurance Ltd., Cat Ltd., Global Capital Reinsurance Ltd., IPC Re Ltd., Mid Ocean Reinsurance Ltd., and La Salle Re Holdings Ltd.

Sharon E. Sonnett is a senior associate in Milbank's Reinsurance and Insurance Group. Few firms can match Milbank's experience, knowledge and worldwide resources in resolving disputes concerning reinsurance and significant insurance issues in both the property/casualty and life/health fields. Our ability to service clients globally and our in-depth expertise—in trial and appellate cases, as well as mediation and arbitration proceedings—make Milbank the choice of satisfied clients around the world.

The World Trade Center attacks on September 11, 2001 cost $40 billion, and another eight new major reinsurance companies formed in Bermuda shortly thereafter, including Endurance Specialty Holdings Ltd., Allied World Assurance Holdings, Ltd., Aspen Insurance Holdings Ltd., Arch Capital Group Ltd., Axis Capital Ltd., Montpelier Re Holdings Ltd, Olympus Re Holdings, Limited, and Da Vinci Reinsurance.

The earliest classes were mono-line companies, concentrating primarily on the coverage needed as a result of the catastrophe at hand. For example, the Class of 1992 focused primarily on property catastrophe coverage. The Class of 2001, however, focused less on property, and more on casualty (e.g., aviation and Directors and Officers) and non-traditional lines of coverage. The Class of 2001 also began with an unparalleled amount of start up capital, allowing themselves greater capacity and ability to compete with well established companies.

By 2004, every member of the Class of 2001 was A rated despite being only three years old and, together, reported a combined earned premium of $9.5 billion. Members of the earlier class also achieved high ratings relatively quickly. However, five members of the Class of 1993 have been acquired by other players in the market, including Cat Ltd. and Tempest Re (acquired by ACE Ltd.), Global Capital Re and Mid Ocean (acquired by XL Re), and La Salle Re (acquired by Endurance). While the remaining three companies are A rated, only one—Partner Re—has enjoyed increasing profitability over the last few years, reporting $492 million net income in 2004, compared to $142 million in 2000. The other two reported a decrease in net income in 2004 compared to 2003. IPC Re's 2004 net income was $139 million, and $261 million in 2003. Renaissance Re's 2004 net income was $133 million, and $606 million in 2003.

Can the Class of 2005 fare as well as its predecessors? There is speculation that while there may be a few success stories, there won't be as many as before. A major reason for the previous classes' success is the fact that there was little competition for new start ups. As a result of the catastrophe at hand, the capacity (of existing companies) to write new business dramatically decreases. Thus, if an insurer or reinsurer could no longer underwrite a hurricane or terrorism risk, one of the new start ups would step in and do so.

Today's market conditions are different. Many existing companies have raised an incredible amount of new capital in the last couple months. According to Bear Sterns, the following six reinsurers have raised $3.37 billion: ACE ($1.3 billion), Montpelier ($600 million), Endurance ($600 million), PXRE ($460 million), Axis ($250 million) and Platinum Underwriters (a spin off The St. Paul's reinsurance operations, which incorporated in April 2002 - $162 million). The Securities and Exchange Commission has also announced that it would relax certain securities regulations to make it easier to raise capital.

Based on this activity, new reinsurers may find that having a clean balance sheet may not necessarily provide an overwhelming advantage in the market. The more companies there are competing for business, the less likely that premium rates will rise as high as they did after Andrew and September 11, 2001. On the other hand, many of the existing companies are on A.M. Best's watch list with negative implications, including Aspen, Alliance, Renaissance, Partner, IPC, XL and Montpelier. Olympus recently was downgraded to B+, and Renaissance to A. A downgrade could reduce their capacity because many clients insist on a certain type of A rating.

New companies will probably also need to raise more start up capital than ever before. Some speculate that private equity won't be as much of a resource for the much needed capital. Kenneth LeStrange, President and CEO of Endurance, stated at this year's Hawksmere Reinsurance Congress that a "potential barrier" to successful start ups is the need for more capital than in previous classes, and that private equity firms might decide "to sit this [class] out." LeStrange went on to state that hedge funds would likely be the predominant source for new venture capital.

Another factor to a successful start up is the company's underwriting performance. The Class of 2005 will probably follow the Class of 2001 and offer multiple lines of coverage. However, these new reinsurers should keep in mind that less focus on property catastrophe will probably mean less expertise in writing other lines, such as marine and aviation. Weak underwriting discipline may not be as much of an issue in a hard market. However, it is something to consider once the market softens, which will happen inevitably given the cyclical nature of the insurance industry.

Will there be a Class of 2005 in Bermuda? Probably. Will it be as successful as the previous classes? We will see.

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