



AEAI/RLMS International Conference
October 15-18, 1989
Monte - Carlo

Please respond to

TUESDAY, OCTOBER 17, 1989

SESSION NR 9

ALTERNATIVE RISK FINANCING MARKETS

PHILIP F. PETRONIS



Omer Leroy
UNILEVER
Conference Co-Chairman



Hugh Loader
Tetra Pak
Conference Co-Chairman

SPECIAL PURPOSE INSURANCE COMPANIES

"A RECIPE FOR SUCCESS"

IT IS MY PLEASURE TO TALK TO YOU ABOUT SPECIAL PURPOSE INSURANCE COMPANIES -- AND IN PARTICULAR ACE AND X.L. AS YOU PROBABLY KNOW, BOTH COMPANIES WERE FORMED, CONCEIVED AND ORIGINATED BY MARSH & MCLENNAN, WITH ASSISTANCE FROM MORGAN GUARANTY BANK IN RAISING CAPITAL AND CAYHILL, GORDON IN DRAFTING A NEW POLICY FORM. WHILE OTHER SPECIAL PURPOSE COMPANIES HAVE SINCE APPEARED ON THE SCENE -- THERE IS A-E-I-A, CODA AND SCUUL, TO NAME JUST THREE -- NONE HAVE ENJOYED THE REMARKABLE SUCCESS OF ACE AND X.L.

BOTH COMPANIES PROVIDE A MARKET FOR EXCESS LIABILITY AND DIRECTORS AND OFFICERS LIABILITY INSURANCE. ACE NOW HAS OVER \$1 BILLION DOLLARS IN SURPLUS AND WRITES ABOUT \$230 MILLION IN ANNUAL PREMIUM FOR 375 INSUREDS.

IT PROVIDES \$150 MILLION IN EXCESS LIABILITY INSURANCE AND UP TO \$50 MILLION OF D AND O LIMITS. X.L. HAS OVER THREE QUARTERS OF A BILLION DOLLARS IN SURPLUS AND WRITES \$340 MILLION IN ANNUAL PREMIUM FOR NEARLY 500 INSURED. IT PROVIDES \$75 MILLION IN EXCESS LIABILITY LIMITS, TYPICALLY IN A LAYER THAT RESTS BELOW ACE'S LIMITS AND \$25 MILLION IN D AND O LIMITS. YOU MIGHT BE SURPRISED TO KNOW THAT ACE AND X.L.'S PREMIUM VOLUME WOULD MAKE THEM THE THIRD AND FOURTH LARGEST SURPLUS LINES UNDERWRITERS IN THE UNITED STATES, BEHIND LEXINGTON AND SCOTTSDALE. I THINK THAT'S A REMARKABLE PERFORMANCE CONSIDERING THAT BOTH COMPANIES WERE STARTED FROM SCRATCH JUST FOUR YEARS AGO. OF COURSE AN IMPORTANT PART OF THAT SUCCESS HAS BEEN THE LEADERSHIP AND UNDERWRITING TALENT AT BOTH THE COMPANIES -- LED BY JOHN COX AND BILL LOSCHERT AT ACE AND IAN HEAP, BRIAN O'HARA AND NOW MIKE KIEVNEY AT X.L.

MARSH, MCLENNAN USED ITS OWN SPECIAL RECIPE WHEN CREATING ACE AND X.L. -- ONE WHICH WE CONTINUE TO USE FOR OTHER SPECIAL PURPOSE COMPANIES. ONE OF MY DUTIES AT MARSH IS MAKING SURE THIS RECIPE IS FOLLOWED AND ALL THE INGREDIENTS ARE PRESENT ON NEW OPPORTUNITIES FOR NEW SPECIAL PURPOSE COMPANIES. I BELIEVE THIS RECIPE

.../3

WAS KEY TO THE SUCCESS OF ACE AND X.L. AND IS UNIVERSAL ENOUGH TO APPLY TO ANY SPECIAL PURPOSE COMPANIES CONTEMPLATED FOR EUROPE. BUT LIKE MY GRANDMOTHER'S RECIPE FOR BREAD, ITS SUCCESS LIES AS MUCH IN THE BAKER'S ART AS IN THE INGREDIENTS. THE ART I CANNOT EASILY CONVEY, IT COMES FROM THE CUMULATIVE EXPERIENCE AND EXPERTISE OF OUR FIRM - AND WE PROVIDE IT WHEN WE ARE WORKING FOR YOU. THE RECIPE, HOWEVER, I CAN SHARE AND WILL DO SO WITH THE HOPE YOU FIND IT HELPFUL IN UNDERSTANDING THE SUCCESS OF THESE COMPANIES.

OUR FIRST RULE IS TO NEVER PROCEED WITH A SPECIAL PURPOSE COMPANY WITHOUT FIRST EXHAUSTING ALL EFFORTS TO SOLVE THE PROBLEM IN THE COMMERCIAL MARKET.

THERE ARE A NUMBER OF REASONS FOR THIS:

IN SETTING UP A SPECIAL PURPOSE COMPANY, A GROUP SEEKS TO REPLACE THE COMMERCIAL MARKETPLACE. IF THE MARKETPLACE, WITH ITS FINANCIAL STRENGTH AND SPREAD OF RISK, IS PREPARED TO AGGRESSIVELY COMPETE ON THE BUSINESS, THEN A SPECIAL PURPOSE COMPANY HAS LITTLE CHANCE OF SURVIVAL.

.../4

THERE ARE MANY INSUREDS OR GROUPS OF INSUREDS WHICH MAY PERCEIVE THE MARKET AS UNRESPONSIVE TO THEIR NEEDS. IT IS OUR JOB AS BROKERS TO ANTICIPATE THIS CONDITION, UNDERSTAND THE PARTICULARS AND REPRESENT IT EFFECTIVELY TO THE MARKET. HOWEVER, IT IS QUITE ONE THING TO HAVE THIS PERCEPTION, WHETHER ACCURATE OR NOT, AND QUITE ANOTHER TO CLEAR THE HURDLES OF STARTING UP AN ALTERNATIVE COMPANY. THESE HURDLES, -- A COMMITMENT OF CAPITAL, START-UP AND OPERATING COSTS, NOT TO MENTION THE POSSIBILITY OF A PREMIUM WHICH IS THE SAME OR HIGHER THAN THE MARKET -- ARE OFTEN GROSSLY UNDERESTIMATED. THESE ARE FORMIDABLE BARRIERS AND IF THE MARKET CAN SOLVE THE PROBLEM, IT SHOULD BE THE PREFERRED CHOICE.

OF COURSE IT IS SOMETIMES SAID A SPECIAL PURPOSE COMPANY FORCED THE MARKET TO BECOME COMPETITIVE AND RESPOND TO THE PROBLEM. BUT OFTEN AS NOT, THIS IS THE ANGUISHED CRY OF A SPECIAL PURPOSE COMPANY THAT IS STRUGGLING IN A COMPETITIVE MARKET. IN THIS CASE, HAVING ALREADY BEGUN, THE BEST OPTION IS TO RIDE OUT THE SOFT MARKET AND HOPE THE COMPETITION WILL VANISH WITH THE NEXT HARD MARKET.

THE SECOND INGREDIENT IN OUR RECIPE CALLS FOR DESIGNING THE FACILITY FOR THE LONG-TERM. IF THE PROBLEM IS SHORT-TERM AND WILL GO AWAY WITH THE NEXT MARKET CYCLE, IT PROBABLY WILL NOT JUSTIFY THE START-UP COSTS OR SURVIVE THE NEXT SOFT MARKET.

THIS INGREDIENT MAY BE VARIED BY A SKILLED COOK BUT IT SHOULD BE DONE KNOWINGLY. FOR EXAMPLE, WE HAVE DESIGNED A FACILITY WHICH IS NOT INTENDED TO LAST THROUGH THE LONG-RUN. IT IS A GROUP FUNDING FACILITY CALLED QUAKE DEDICATED SOLELY TO PROPERTY DAMAGE AND BUSINESS INTERRUPTION RESULTING FROM A CALIFORNIA EARTHQUAKE. SHOULD SUCH AN EVENT OCCUR, IT IS EXPECTED THAT THE LOSSES WILL DEplete THE FUND. ON THE OTHER HAND, IF THERE IS NOT A CALIFORNIA EARTHQUAKE WITHIN A PRE-DETERMINED 10 YEAR PERIOD, THEN THE COMPANY IS INTENDED TO SELF-DESTRUCT AT THE END OF THE TERM WITH THE FUND RETURNED TO THE POLICYHOLDERS. AS YOU WILL NOTE, THIS IS A UNIQUE SITUATION THAT JUSTIFIED A DEVIATION IN THE RECIPE.

THIRDLY, THE COMPANY MUST BE PROPERLY CAPITALIZED. THIS IS AN ISSUE WE FEEL STRONGLY ABOUT AND ON WHICH

.../6

THERE IS EVIDENCE THAT WE DIFFER WITH MANY OF OUR COMPETITORS. THERE CANNOT BE AN INSURANCE COMPANY WITHOUT CAPITAL. OUR PREFERENCE IS FOR UP-FRONT CASH FROM THE SPONSORS AND POLICYHOLDERS. CERTAINLY THERE ARE ALTERNATIVES, SUCH AS POLICYHOLDER ASSESSMENTS, WHICH IF USED IN CAREFUL MODERATION MAY BE ACCEPTABLE. HOWEVER, WE HAVE FOUND THE REQUIREMENT OF CASH ON THE BARREL HEAD TO BE A TRUE TEST OF THE VIABILITY OF A START-UP COMPANY. PERHAPS IT COULD BE SAID THAT THE WILLINGNESS TO COMMIT ADEQUATE UP-FRONT CAPITAL IS WHAT SEPARATES POTENTIAL SPONSORS WITH A TRUE INSURANCE NEED FROM THOSE POTENTIAL SPONSORS WHO ARE SHOPPING FOR A CHEAPER INSURANCE PRODUCT. IN THE PROCESS OF SETTING UP A SPECIAL PURPOSE INSURANCE COMPANY, CAPITALIZATION REPRESENTS THE MOMENT OF TRUTH -- THE TRUE TEST OF A GROUP'S WILLINGNESS TO SUPPORT A SPECIAL PURPOSE COMPANY.

AS A FURTHER POINT ON CAPITAL, WE FIND THE BEST WAY TO RAISE IT IS THROUGH A STOCK COMPANY STRUCTURE RATHER THAN A MUTUAL COMPANY. A STOCK COMPANY ALLOWS FOR CLEARER MEANS OF DEFINING OWNERSHIP AND MAKING DISTRIBUTION OF PROFITS TO THE FOUNDING OWNERS THAN DOES A MUTUAL COMPANY.

.../7

FINALLY, AND PERHAPS THE MOST CRUCIAL ELEMENT, THE COMPANY SHOULD BE DESIGNED TO HAVE THE WIDEST POSSIBLE ACCEPTANCE. IF IT IS TO INSURE A SPECIFIC GROUP OR CLASS, IT SHOULD SEEK TO APPEAL TO THE LARGEST POSSIBLE NUMBER OF THE GROUP OR CLASS TO IMPROVE THE SPREAD OF RISK AND THE CHANCE OF SUCCESS IN RAISING ADEQUATE CAPITAL. WE BELIEVE THE BROADEST DISTRIBUTION IS OBTAINED THROUGH THE AGENCY BROKER SYSTEM AND THE COMPANY SHOULD PAY ADEQUATE COMMISSIONS TO COMPETE IN THE INSURANCE MARKET FOR PRODUCERS' BUSINESS. GENERALLY, WE DO NOT INITIATE COMPANIES THAT DO NOT DISTRIBUTE THROUGH BROKERS AND AGENTS, NOT ONLY BECAUSE OUR SHAREHOLDERS WOULD QUESTION OUR JUDGEMENT, BUT ALSO BECAUSE WE BELIEVE IN AND UNDERSTAND THE POWER OF THAT DISTRIBUTION SYSTEM.

THESE INGREDIENTS WERE ALL PRESENT IN THE RECIPE FOR ACE AND X.L. I THINK, HOWEVER, THAT INSTRUMENTAL TO THEIR SUCCESS WERE SOLUTIONS WE DEVISED TO TWO UNIQUE PROBLEMS THAT FACED THE INDUSTRY, BEYOND THE USUAL ONES OF MARKET CAPACITY AND PRICE. I AM REFERRING TO THE OCCURRENCE POLICY FORM AND THE CLAIMS SETTLEMENT PROCESS FOR U.S. EXCESS LIABILITY PLACEMENTS.

OVER THE LAST DECADE, U.S. COURTS HAVE SO BROADLY INTERPRETED THE OCCURRENCE POLICY THAT MANY INSURERS ARE UNWILLING TO WRITE IT FOR CERTAIN RISKS. ASBESTOS LIABILITY WAS A MAJOR CONTRIBUTOR TO THIS EXPANDED THEORY OF LIABILITY -- PARTICULARLY THE TRIPLE-TRIGGER COVERAGE INTERPRETATION WHICH PROVIDES AN INSURED WITH MULTIPLE POLICY LIMITS OVER A NUMBER OF YEARS ON LOSSES INSURERS FELT SHOULD BE GROUPED TOGETHER. THIS MULTIPLE LIMIT EXPOSURE LEFT INSURERS UNWILLING TO OFFER OCCURRENCE COVERAGE FOR ANY RISK WITH SIGNIFICANT LATENT DISEASE EXPOSURE. LIKEWISE, INSURERS NOW VIEW POLLUTION LIABILITY TO BE TOO BROAD FOR THEM TO INSURE. INCIDENTS WHERE POLLUTION WAS CAUSED BY DUMPING OF WASTE OVER A PERIOD OF YEARS HAVE BEEN INTERPRETED BY THE COURTS AS BOTH SUDDEN -- SINCE THE LEAKING BEGAN AT SOME INSTANT -- AND ACCIDENTAL -- SINCE ALTHOUGH THE DUMPING WAS CLEARLY INTENTIONAL, THE POLLUTION WAS NOT.

A NEW POLICY FORM WAS DEVELOPED FOR ACE AND X.L. TO ADDRESS THESE AND OTHER COVERAGE ISSUES, ENABLING THESE COMPANIES TO RESPOND TO INSUREDS' COVERAGE NEEDS WHILE AVOIDING THE PITFALLS OF THE OCCURRENCE POLICY.

.../9

THIS POLICY IS AN OCCURRENCE REPORTED FORM WITH A GUARANTEED TAIL IN THE EVENT OF NON-RENEWAL. THUS IT IS SOMEWHAT OF A CROSS BETWEEN THE OCCURRENCE AND CLAIMS MADE FORM. SINCE THE FORM OPERATES ON A STAND-ALONE BASIS, IT DOES NOT RELY ON UNDERLYING INSURANCE TO EFFECT COVERAGE. AS RESPECTS POLLUTION, IT UTILIZES TIME-BASED COVERAGE WHICH DOES NOT ATTEMPT TO DRAW A DISTINCTION BETWEEN GRADUAL OR SUDDEN AND ACCIDENTAL EVENTS.

THE OTHER UNIQUE PROBLEM WHICH WAS ADDRESSED BY ACE AND X.L. IS THE CLAIMS SETTLEMENT DISPUTE THAT CAN ARISE WHEN THERE IS A LOSS ON A LAYERED EXCESS LIABILITY PROGRAM. A TRADITIONAL U.S. MARKET PLACEMENT FOR \$200 MILLION LIMITS OF EXCESS LIABILITY MAY HAVE AS MANY AS 25 OR MORE DIFFERENT INSURERS WRITING SEPARATE LAYERS OR QUOTA SHARING LAYERS. EACH CARRIER HAS THE RIGHT TO ASSIGN ITS OWN LAWYERS AND ADJUSTERS IN THE EVENT OF A CATASTROPHE LOSS. THIS SITUATION CAN CREATE SIGNIFICANT INEFFICIENCIES AND COVERAGE DISPUTES FOR OUR CLIENTS. ACE AND X.L., BY PROVIDING A LARGE BLOCK OF LIMITS WITH A SINGLE POLICY FORM AND SOURCE OF DEFENSE PROVIDES A VASTLY SUPERIOR ALTERNATIVE -- A FACT TO WHICH ANY OF YOU WHO HAVE COLLECTED LOSSES ON A LAYERED BASIS CAN ATTEST.

.../10

THERE'S NO QUESTION THAT ACE AND X.L. HAVE BEEN A GREAT SUCCESS. COMBINED, THEY HAVE AS POLICY HOLDERS MOST OF THE FORTUNE 500 BUSINESS EXCESS OF \$25 MILLION. THE COMMERCIAL MARKET NOW GENERALLY FUNCTIONS BELOW X.L. OR SERVES RISKS THAT CAN STILL OBTAIN OCCURRENCE COVERAGE IN THE MARKET. BOTH COMPANIES HAVE HAD A TREMENDOUS IMPACT ON THE MANNER IN WHICH WE SERVE OUR MAJOR RISK MANAGEMENT CLIENTS AND I EXPECT THAT THIS INFLUENCE WILL CONTINUE TO BROADEN WHEN THE MARKET NEXT TURNS.

IF YOU WILL PERMIT ME A SHORT DIGRESSION, I WOULD ALSO LIKE TO OFFER AN OPINION OR TWO ON PURE CAPTIVES. I DO SO BECAUSE I UNDERSTAND THAT SOME EUROPEAN CAPTIVE INSURANCE COMPANIES HAVE VENTURED INTO THE ARENA OF WRITING THIRD PARTY OR UNRELATED INSURANCE BUSINESS, AND ARE ALSO POOLING THEIR RISKS WITH OTHER CAPTIVES. I THINK SINGLE PARENT CAPTIVES INHERENTLY LEAD IN THAT DIRECTION BECAUSE THEY OFFER THE OPPORTUNITY TO ORGANIZE THE RISK MANAGEMENT FUNCTION AS A PROFIT CENTER, BOTH FROM AN ADMINISTRATIVE AND AN ACCOUNTING STANDPOINT. HOWEVER, AT MARSH & MCLENNAN WE THINK THIS IS A SIREN CALL THAT SHOULD BE RESISTED. IN THE U.S., DURING THE LAST HARD MARKET, IT WAS FASHIONABLE FOR CAPTIVES TO WRITE THIRD PARTY BUSINESS. THIS WAS

.../11

FUELED BY TAX RULINGS THAT ENCOURAGED DOING SO TO ENHANCE THE TAX DEDUCTIBILITY OF PREMIUMS PAID TO A CAPTIVE. AS IT HAS TURNED OUT, OUR INTERNAL REVENUE SERVICE NO LONGER ACCEPTS SUCH LOGIC AND IT DID NOT IMPROVE THE CASE FOR DEDUCTIBILITY. BUT MORE IMPORTANTLY, IT TURNED OUT TO BE A VERY BAD BET FROM A RISK TAKING STANDPOINT AND MOST INSUREDS WHO WROTE SUCH BUSINESS LOST MONEY -- AND SOME LOST CONSIDERABLE AMOUNTS.

OUR EXPERIENCE WITH SPECIAL PURPOSE COMPANIES SHOWS JUST HOW CRITICAL SPECIALIZED RESOURCES -- AND PARTICULARLY UNDERWRITING SKILL -- ARE TO SUCH A VENTURE. WHEN A CAPTIVE TAKES IN THIRD PARTY BUSINESS, IT TYPICALLY DOES SO ON A TREATY BASIS AND THEREFORE DOES NOT HAVE THE OPPORTUNITY TO UNDERWRITE IT OR REVIEW ITS QUALITY. EVEN IF A CAPTIVE HAD THAT OPPORTUNITY, IT IS UNLIKELY IT WOULD HAVE THE EXPERTISE TO DO SO. IT IS ONLY WITH THE FINEST UNDERWRITING TALENT AND RESOURCES THAT SPECIAL PURPOSE COMPANIES PROVE TO BE SUCCESSFUL OVER THE LONG-RUN.

.../12

IN OUR VIEW, PURE CAPTIVES SHOULD BE DEDICATED TO
MANAGING THEIR PARENT'S RISK AND SHOULD NOT VENTURE
INTO THIRD PARTY RISK TAKING.

THE INSURANCE MARKET IS AN EXTREMELY COMPETITIVE ARENA.
IT TAKES SIGNIFICANT EXPERTISE, RESOURCES AND CAPITAL TO
SUCCEED THERE IN THE LONG RUN. WE THINK THE PHENOMENAL
SUCCESS OF ACE AND X.L. ARE A TESTAMENT TO THE QUALITY OF
THE RECIPE USED IN THEIR MAKING. LIKE MY GRANDMOTHER'S
BREAD, THEY ARE BASED ON A RECIPE THAT WILL STAND THE
TEST OF TIME.