KPMG

INSURANCE

Reinsurance in Bermuda

FINANCIAL SERVICES

AUDIT ▪ TAX ▪ ADVISORY

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PREFACE

Reinsurance in Bermuda is designed to provide an introduction to the reinsurance industry in Bermuda covering the main areas of regulation, company law, taxation and other related matters. It is intended to provide the basic information required by persons wishing to establish an insurance operation in Bermuda, with particular reference to captive insurance companies, and also provide an overview of the Bermuda reinsurance industry. It is not intended to be an exhaustive study.

The booklet reflects the relevant laws of the Island as of December 31, 2004. While every attempt has been made to ensure accuracy, those interested in establishing an insurance company in Bermuda are recommended to consult with their professional advisors at an early stage. Local lawyers should be consulted on legal matters and one of the professional accounting firms on accounting, auditing, taxation, regulatory and general business matters.

KPMG is structured to provide services to clients both locally and internationally, tailored to individual requirements. KPMG in Bermuda has over 50 years of experience in providing assistance to insurance companies incorporating and operating in Bermuda.

The terms insurance and reinsurance have been used inter-changeably throughout this booklet.

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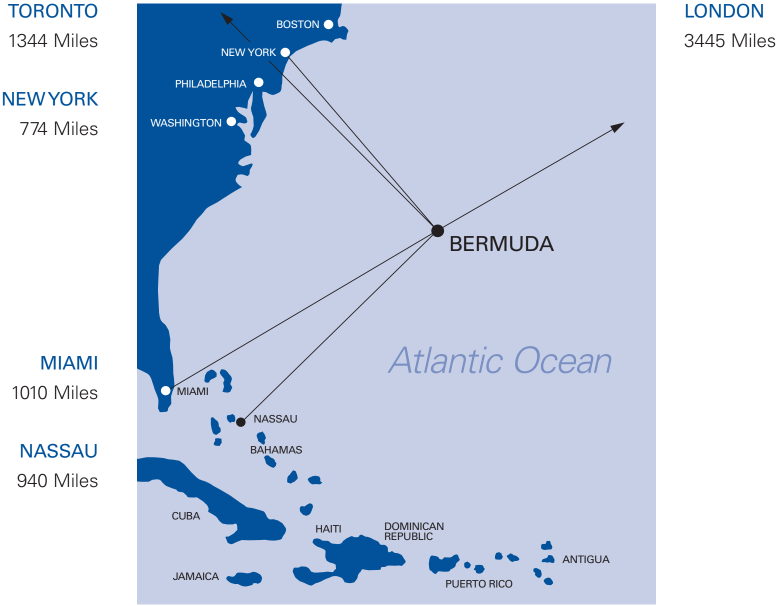
CHAPTER 1

General information on Bermuda and its economic environment

1.1 Geography and population

Bermuda is a group of islands in the western Atlantic, approximately 570 miles east of Cape Hatteras, North Carolina, and approximately 3,500 miles southwest of London, England. The main islands, connected by bridges or causeways, are about 22 miles long with an average width of between one half and one mile. The climate is generally mild and humid and frost-free. Summer temperatures range from 80° to 90° Fahrenheit (27° to 31° Centigrade) and winter temperatures from 60° to 70° Fahrenheit (16° to 21° Centigrade). The mild climate allows most sporting activities to be enjoyed all year-round, and Bermuda boasts excellent golf, scuba diving and deep-sea fishing.

Bermuda's population is approximately 64,300, with a workforce of approximately 38,000.[a] Due to the small local population, there is a shortage of skilled Bermudians in several sectors of the economy, and consequently immigration authorities allow for the employment of non-Bermudians on a work permit basis as required. Work permit holders currently comprise approximately 27 percent of the workforce and are employed in both tourism and international business.[a]



(a) Department of Statistics, Facts & Figures 2004

In general, the work permit holders in the international business arena tend to be professionally qualified accountants, lawyers, insurance underwriters, brokers, actuaries, investment professionals and bankers permitted into Bermuda to supplement the local professionals. The majority of the work permit holders within the international business sector tend to originate from the United Kingdom ("U.K."), Ireland, Canada and the United States ("U.S.").

1.2 Government and political system

Bermuda is a British Overseas Territory with effective and stable self-government. Its constitution provides for the protection of fundamental rights and freedom of the individual; for the making of laws through a legislature comprising a governor, a nominated senate, and an elected House of Assembly; for executive government by a cabinet of ministers responsible to the House of Assembly, and for an independent judiciary.

The ruling party, the Progressive Labour Party ("PLP"), was first elected into office in 1998 (and re-elected in 2003) and holds the majority of seats in the House of Assembly. The Bermuda Government has a history of working closely with Bermuda's international business community to develop laws and regulations that enhance the business environment in Bermuda and provide a stable operating environment. Both Bermuda's major political parties are fully supportive of the international business community (the United Bermuda Party forms the opposition).

1.3 Relationship with the U.K.

Bermuda was established as a British Charter Colony in 1612. Bermuda is England's oldest colony and, as a British Overseas Territory, still enjoys close ties with the U.K., whose Queen appoints the Governor as her representative in Bermuda. The U.K. retains responsibility for external affairs, defense and the police force. The Bermuda Constitution Order (effective 1968) provides for internal self-government. In common with many of the other offshore centers, Bermuda is a common law jurisdiction with ultimate right of appeal to the Privy Council in the U.K..

1.4 Relationship with the U.S. and Canada

Given its proximity to North America, Bermuda has developed close economic ties with both the U.S. and Canada. In 1970 Bermuda moved away from Sterling and adopted the Bermudian Dollar as local currency, which is at par with the U.S. Dollar, and both Bermuda and U.S. Dollars are freely accepted on the Island. The U.S. retains a Consulate in Bermuda and the U.S. has Immigration and Customs officials at Bermuda's airport.

A significant majority of the insurance companies incorporated in Bermuda are subsidiaries of, or related to, U.S. or Canadian based sponsors, associations or parent companies.

1.5 Travel to and from Bermuda

Bermuda is less than two hours by air from New York and seven hours from London. The Island is easily accessible from the U.S., Europe and elsewhere, with daily direct flights from Atlanta, Baltimore, Boston, Charlotte, New York, Newark, Philadelphia, Washington and Toronto, and several direct flights a week from London.

The Island's well-established tourism industry provides luxury hotels, a wide selection of fine dining, and an assortment of appealing recreation and entertainment activities for both leisure and business travellers.

1.6 Exchange controls

Companies incorporated and individuals resident in Bermuda are not subject to any form of currency or monetary control. They may trade and maintain bank accounts in any currency or country they desire, and they are completely free to remit, repatriate, or otherwise transfer funds.

1.7 Economy

Bermuda has a stable economy, which is demonstrated by an average annual real growth of 2.4 percent over the last decade.[b] In addition, Bermuda is one of the world's richest countries, consistently being ranked amongst the top three nations in the world for Gross Domestic Product per capita.

Bermuda's economy is dominated by two sectors; international business and tourism. Until recently tourism played the lead role in the Island's prosperity. However, over the last several years, due to increasing competition, principally from other islands in the Caribbean, Bermuda's tourism industry has declined. Conversely, international business (including the banking, investment and mutual fund industries), and particularly insurance in the aftermath of September 11th, has steadily increased. See Sections 3.1 and 3.3. Other than insurance, the leading employers by sector are the government, hotel and banking, employing approximately 17 percent, 15 percent and 10 percent of the labour force respectively.

The international business sector is dominated by the insurance industry, which has 1,267[c] incorporated insurance companies, a skilled workforce and a substantial capital and surplus base of $87.3 billion[c] at December 31, 2003. Bermuda is now viewed by many as the largest offshore insurance market and the second largest insurance market worldwide.

Bermuda's banking industry is discussed briefly in Section 1.8. For more information about the banking, investment and mutual fund industries comprising Bermuda's international business sector, please contact Neil Patterson, Partner, Alternative Investments and Banking Practice on +1 441 294 2605 or via email (npatterson@kpmg.bm).

(b) World Bank "Bermuda at a Glance" February 9, 2003

(c) All 2003 data: Bermuda Monetary Authority market statistics, available at www.bma.bm

1.8 Professional advisors

(i) Insurance managers

The majority of the insurance companies incorporated in Bermuda are managed on a day-to-day basis by insurance management companies. There are more than 40 management companies incorporated in Bermuda, registered to manage captive insurance companies and perform the duties of the principal representative on behalf of the insurance company's legal owners, who will not be resident in Bermuda.

Management companies range from full service international risk management and insurance brokerage firms, complemented with overseas resources, to smaller independent operations offering administrative and accounting services. The range of services available includes incorporation assistance, insurance feasibility studies, administration, broking, program design, insurance documentation, loss adjusting, safety and loss control, accounting and statistical records, actuarial and underwriting services and data processing facilities.

In addition, the insurance companies may outsource the management and custody of the company's investment portfolio to established investment managers and custodial banks. The investment managers operate the portfolio within pre-defined guidelines. The insurance managers will also monitor the investment management function and performance on a regular basis.

(ii) Accounting firms

The Big 4 and other smaller international accounting firms are well established in Bermuda, with the larger firms having staff complements between 150 and 200. Services offered include audit, accounting, U.S. tax advisory and compliance, actuarial, internal audit outsourcing, corporate recovery and other risk advisory services. For a detailed listing of KPMG in Bermuda's professional services, see Section 8.3.

(iii) Law firms

There are more than a dozen practicing firms, varying considerably in size and range of work undertaken, with the larger firms having staffs of over 300. Services provided include company registration and incorporation, company secretarial services, provision of resident directors and officers, litigation and other general legal services. A number of firms have expertise in insurance related matters and a few of the larger firms have offices in London, Hong Kong and the Caribbean.

(iv) Banks

There are four banks licensed to operate in Bermuda. Each offers a wide range of commercial banking facilities, together with comprehensive investment, trustee, and financial management services. They have combined assets in excess of $22 billion and together they employ approximately 3,500 staff members in Bermuda alone.[d]

(d) Department of Statistics, Facts & Figures 2004

CHAPTER 2

Advantages of Bermuda as an international finance center

2.1 Laws and guidelines

Bermuda's principal attraction is its firmly established reputation as an internationally recognized, high-quality offshore financial center. As of February 2005, there are more than 16,000[e] international businesses maintaining a presence in Bermuda. This substantial contribution to the economy is well noted and actively encouraged by the Government and the various regulatory bodies. As a result, company legislation and regulation, and in particular that pertaining to insurance companies, has been developed through a continuing partnership effort between the Government and the international business community.

The overall focus of Bermuda's regulations is towards quality of business rather than volume, which has produced one of the largest reinsurance center's in the world. This is a direct result of the combination of Bermuda's reputation for stability coupled with the Government's approach of non-interference with the activities of companies once incorporated. The majority of international businesses in Bermuda are investment holding companies, while approximately 11 percent are insurance-related companies.

As of January 1, 2002, following a KPMG report commissioned by the U.K. government, the Supervisor of Insurance's department became a function of the Bermuda Monetary Authority ("BMA"). Previously, the Supervisor of Insurance's department had been a department within the Ministry of Finance. As such, the restructuring allows Bermuda's insurance regulation to be performed by an independent and non-political body.

Additionally, under The Insurance Act, 1978 and related regulations ("The Insurance Act"), the Minister of Finance established the Insurance Advisory Committee ("IAC") which, following the restructuring, is accountable to the BMA. The IAC comprises representatives from the insurance industry, accountants, lawyers and Government regulatory agencies to advise the BMA on matters connected with the insurance industry. Various sub-committees of the IAC regularly review the law and practice of insurance in Bermuda while the IAC's Admissions Committee meet weekly to consider applications for new registrations. KPMG in Bermuda's partners are actively involved in the sub-committees of the IAC.

2.2 Taxation and fee structure

(i) Taxation

Bermuda's taxation system is "consumption based" meaning that the prices of goods and services available on the Island include import duty taxes. Import

(e) www.bermuda-online.org

duties range from 4 percent to 33 percent depending on the type of good. There are no taxes on profits, dividends or income for companies or individuals, nor are there any capital gains or inheritance taxes.

Employee costs consist of a payroll tax, work permit costs and any extra benefits provided. The payroll tax is 13.5 percent, of which the employer is entitled to recover up to 4.75 percent of the 13.5 percent tax from each employee. The cost of a work permit is $559 per non-Bermudian employee initially and $559 annually for each work permit renewal thereafter.

(ii) Fee structure

Insurance companies pay an annual registration fee, which ranges from $3,635 to $27,825 depending on the company's authorized share capital (see table below), and a licensing fee under The Insurance Act, which, depending on the class of the insurance company's license (see Section 5.3), is between $880 and $25,000 both initially and annually thereafter.

Share capital	Annual fee
≤ $12,000	$1,780
> $12,001 and/≤ $120,000	$3,635
> $120,001 and/≤ $1,200,000	$5,610
> $1,200,001 and/≤ $12,000,000	$7,475
> $12,000,001 and/≤ $100,000,000	$9,345
> $100,000,001 and/≤ $500,000,000	$16,695
> $500,000,000	$27,825

The annual registration fee is payable in January of each year. The initial annual fee is halved, if incorporation occurs after August 31 in a particular year.

Under current Bermuda law, insurance companies are not required to pay taxes in Bermuda on either income or capital gains. Insurance companies can apply for, and automatically receive, an undertaking from the Bermuda Government that, in the event of income or capital gains taxes being imposed, they will be exempt from such taxes until the year 2016. It is anticipated that this will be extended in due course.

2.3 Summary of the advantages of Bermuda as a jurisdiction

- **Political stability** – both of the major political parties in Bermuda are committed to supporting and developing the international business sector and the Island's political stability has earned the confidence of foreign investors. "Standard & Poor's Rating Services has affirmed its "AA" long-term and "A1+" short-term foreign and local currency sovereign credit ratings on Bermuda, reflecting the country's record of prudent economic management."[f]

(f) Bermuda Insurance Update, 2004 Vol. 1, page 11 (www.bermuda-insurance.org)

- **Infrastructure** – Bermuda has an established infrastructure of law firms, Big 4 accounting firms, international insurance managers and insurance brokers and professional reinsurance companies.

- **Established jurisdiction** – Bermuda is regarded as one of the pioneers of the offshore insurance industry and has firmly established a reputation as an internationally recognized, high-quality offshore financial center.

- **Expertise** – Bermuda is also renowned for underwriting expertise and innovation, developing a reputation for identifying new insurance solutions and alternative forms of risk financing. Bermuda is also acknowledged as having a high quality capital base for traditional reinsurance. Bermuda based professional advisors have highly skilled and trained workforces with significant experience in the insurance industry.

- **Regulation** – Bermuda's insurance regulation through a consultative process between government and the insurance industry has proved to be a successful model, which other jurisdictions have used as the basis for establishing their own regulatory systems.

- **Excellent communications** – the Island's telecommunications and technology infrastructure provides advanced service to the Island, enabling Bermuda to accommodate rapidly growing global electronic commerce and communication services.

- **Sensible tax structure** – the "consumption based" tax system means there are no taxes on profits, dividends or capital gains for companies or individuals.

- **Geographic location** – the Island is easy for business travelers to access via international flights to and from major destinations in the U.S., Canada and U.K..

- **Reinsurance market** – the presence of professional reinsurance companies in Bermuda provides an accessible reinsurance "after-market" for the captive insurance companies.

- **Broker and intermediary presence** – the significant presence of brokers and other insurance intermediaries in Bermuda contributes to the expertise and the accessibility of the reinsurance "after-market".

- **Fee structure** – compared to other jurisdictions, the set-up costs are relatively inexpensive and the process of obtaining a license is relatively fast.

CHAPTER 3

The insurance industry in Bermuda

3.1 Overview

Bermuda's insurance industry is now viewed by many as one of the largest markets worldwide. As of December 31, 2003, the industry comprised 1,267 insurance companies, a capital and surplus base of $87.3 billion and gross premiums written of $94.7 billion for the year then ended.[g] The 1,267 companies comprise a wide range of the insurance market, including captive insurance companies, professional reinsurance companies, structured risk, property catastrophe reinsurers and insurance brokers. Bermuda has also managed to remain at the forefront of innovative new insurance products, quickly responding to the market's needs.

Bermuda first made its name as an insurance market for the establishment of captives. However, the Bermuda insurance market has matured from just a captive market into a recognized market for alternative risk options and traditional excess reinsurance with a growing number of commercial insurers and professional reinsurers formed to meet needs which have not been adequately met by the other global insurance markets.

Bermuda's insurance regulations ensure that companies operating in Bermuda do so responsibly, and maintain appropriate margins of solvency and liquidity. The operating structures permissible include various rent-a-captive structures and alternative risk transfer companies. The Insurance Act allows insurers in Bermuda to engage in other commercial activities and engage in transformer activities allowing a risk to be written as an insurance contract in one instance and as a financial derivative contract in another. The Insurance Act allows parties to enter into designated investment contracts such as derivatives and swaps. The success of this design is illustrated by the fact that a significant percentage of all financial reinsurance companies and rent-a-captive companies are based in Bermuda.

With the onset of a hardening insurance market, it was noticeable that during the soft insurance market during late 2001 to mid 2003, the number of new insurance incorporations in Bermuda continued at a record pace. In 2004 there were 77 new incorporations (2003: 89; 2002: 96).[h] These included rent-a-captive facilities, structured risk reinsurers, traditional reinsurers and direct insurers. Although the majority of owners and sponsors continue to be U.S. based, there were a number of new incorporations emanating from Europe and South America.

(g) All 2003 data: Bermuda Monetary Authority market statistics, available at www.bma.bm

(h) 2003 data: Bermuda Insurance Update, 2004 Vol. 1, page 2 (www.bermuda-insurance.org)
2002 and 2001 data: Bermuda Monetary Authority, Report and Accounts 2003

Bermuda's acknowledged professional expertise, good security and sensible regulatory regime continue to attract entrepreneurial companies that seek to exploit niche insurance products and other gaps in the insurance and reinsurance markets. Over the last few years, Bermuda has seen activity in three new areas; life and annuity reinsurance, financial guaranty reinsurance and the securitization of risk, demonstrating the continual evolution of this dynamic reinsurance marketplace.

Following the terrorist attacks on September 11, 2001, Bermuda was the chosen jurisdiction for billions of dollars of new capital for a new wave of Class 4 companies (writers of direct excess liability and/ or catastrophe reinsurance risks), creating additional capacity, subsequent to the global underwriting capacity contraction, and an increased demand for reinsurance products. Post September 11, 2001, capitalized companies providing such capacity include: Allied World Assurance Company, Ltd ("AWAC"), Arch Capital Group Ltd ("Arch"), AXIS Capital Holdings Limited ("AXIS"), Endurance Specialty Holdings Ltd ("Endurance"), Goshawk Reinsurance Limited (renamed Rosemont Reinsurance Ltd. ("Rosemont") as of April 30, 2004), Montpelier Re Holdings Ltd ("Montpelier") and Quanta Capital Holdings Ltd ("Quanta"). Standard & Poor's reported that over half of the new capital raised post September 11, 2001 came to Bermuda, evidencing Bermuda's status as the premier offshore insurance location. Furthermore, other existing Bermuda based reinsurers (including ACE Limited ("ACE"), IPC Holdings, Ltd, PXRE Group Ltd and XL Capital Ltd ("XL")), raised additional capital to enable them to write more business after September 11, 2001. The impact of the September 11, 2001 terrorist attacks on the Bermuda insurance industry is discussed further in Section 3.3.

In 2003, gross written premium volume rose 49 percent to $94.7 billion from $63.7 billion in 2002 and net written premiums increased by 62 percent to $84.1 billion in 2003 from $51.8 billion in 2002. Total assets increased by 16 percent to $236.0 billion in 2003 from $204.0 billion in 2002 and capital and surplus increased by 15 percent to $87.3 billion in 2003 from $75.6 billion in 2002. This provides a net premium written to capital and surplus ratio of 0.96 to 1 in 2003, compared to 0.69 to 1 in 2002, below a ratio of 1 to 1 which confirms the strong security of the Bermuda marketplace as a whole.[i]

3.2 Composition of the Bermuda insurance market

(i) Captives

Bermuda has long been recognized as the domicile of choice for the world's captive insurance industry with approximately 29 percent of captive insurers worldwide. The following table shows Bermuda's domination in the captive insurance marketplace.

(i) All 2003 data: Bermuda Monetary Authority market statistics as available on www.bma.bm

Captive jurisdiction	Estimated number of captives[j]
Bermuda (Note 1)	1,330
Vermont	700
Cayman	644
Guernsey	383
British Virgin Islands	307
Luxembourg	260
Barbados	248
Ireland	205
Isle of Man	173
Turks and Caicos	159
Total of Top 10 domiciles	4,409
All other domiciles	821
Total captives	5,230

Note 1 – Captive Insurance Companies Association estimated figure. Different to 1,267 international insurance companies in Bermuda as reported by BMA (see Section 3.1) due to the above listing being as of May 2005.

In the early 1960's, the captive concept was born in Bermuda with the original concept emphasizing tax-driven structures. These companies were predominantly "pure captives" set up to write the related insurance risks of their owners, and typically featured low levels of capitalization and limited risk programs. By the mid-1970's, captives began writing an increasing share of business from third parties in order to help establish the legitimacy of the captive, and preserve its tax benefits. By the early 1980's, the Bermuda markets had expanded to include many captives with greater levels of capitalization, which were established to write programs featuring primarily unrelated risks, or which had diversified into such programs in pursuit of perceived tax advantages.

Into the 21st century, the number of pure captives incorporated in Bermuda each year continues at a steady pace with parent companies constantly looking for alternative risk management strategies where commercial insurance is either unavailable or uneconomical.

Recently, a growing number of companies have used a Private Act of Bermuda Legislature ("Private Act"), which enables a company to be incorporated under its own Act of Parliament. Pursuant to the Private Act, a company may create a segregated account for each policyholder, in which it will segregate premiums and investment income for each policy and shall keep such funds separate, separately identifiable and independent from all other segregated and unsegregated funds of the company. The Private Act generally provides that, notwithstanding the provision of any other written law to the contrary, the segregated accounts are not charged with any liability arising from any other business of the company.

(j) www.captiveassociation.com – Domicile Review

In August 2000, the Segregated Accounts Companies Act 2000 (the "Segregated Accounts Act") was approved by the Bermuda Legislative, and became operative on November 1, 2000. The Segregated Accounts Act established a system of registration so that Segregated Accounts companies may be created speedily and with the flexibility necessary to respond to the needs of international business.

Over the last two decades, Bermuda has expanded into other insurance markets that complement the captives and expands the facilities available to them. These other markets are summarized as follows:

(ii) Excess of loss liability insurers

In the mid 1980's, a new phenomenon developed in Bermuda as the U.S. commercial market was beginning to show poor underwriting results, there was a major cutback by commercial insurers in higher-risk areas such as general liability lines. Consequently, many insureds found themselves unable to obtain liability insurance at an affordable or at any cost. Bermuda responded to this crisis in 1986 and 1987 with the creation of ACE and XL. These two companies formed a new type of insurer in Bermuda, a professional reinsurance company dealing with third party clients as well as underwriting the business of their sponsoring companies. They strived to provide innovative solutions, many of which had been initially created in the alternate risk transfer market. The new wave of Class 4 companies (see Sections 3.1 and 3.3) are also writing excess of loss business.

(iii) Property catastrophe reinsurers

Hurricane Andrew in 1992 resulted in insured losses in excess of $26.5 billion making it the largest single loss event until September 11, 2001, and devastated much of the world catastrophe reinsurance market. This led to an opportunity to use the advantages of Bermuda to create a new class of reinsurer to specifically address the capacity shortage that followed Andrew. Within a year, eight new companies were formed, bringing a total of $4 billion in new capital to the market. Estimates indicate that this amounted to a 50 percent increase in global catastrophe insurance and reinsurance capacity.[k]

The core product these companies offer is excess of loss reinsurance for property damage incurred from one catastrophic event. All Bermuda property catastrophe companies have substantial exposures in the U.S., which represents about one half the world's premium volume. Other important areas are Japan, the United Kingdom, continental Europe and Australasia. A major factor in Bermuda's success is the quality and commitment of the investors and management involved.

Only four of the original eight companies formed in 1992 and 1993 remain as stand-alone operations with the other four having been acquired by either ACE, Endurance or XL. The new wave of Class 4 companies (see Sections 3.1 and 3.3) are also writing property catastrophe business.

(k) All Hurricane Andrew data sourced from: The Bottom Line, No. 38, May/June 2003

(iv) Structured risk reinsurers

The basic economics of insurance is predicated on "the law of large numbers", whereby an insured with good loss experience is partially funding the poor loss experience of another insured. Structured risk reinsurance is one type of insurance product that allows an insured to participate in the economic results of their own risk.

Structured risk reinsurance transfers a finite amount of risk to the reinsurer, coupled with a profit sharing relationship with the insured. The premise is that the insured will fund most of its expected losses and will share in any profit generated from favorable experience but does have coverage for worse than expected losses. As the risk transferred is limited, the cost to the insured tends to be lower than traditional insurance. Also, multi-year contracts can protect against price volatility by contractually determining premiums, and additional premiums and returns of premium depending on various loss experience scenarios, on policy inception. Reinsurance contracts written by these companies are typically specific to the needs of each client and can be designed to provide coverage for an extremely broad range of underlying risks.

(v) Specialty

There are numerous insurance companies in Bermuda providing other specialty coverages such as residual value, satellite, political risk, strike, and protection and indemnity to name a few. An example of Bermuda's leadership in specialty insurance needs is the formation of new insurance companies in response to the Oil Pollutions Act 1990 in the United States, issuing Certificates of Financial Responsibility.

(vi) Financial guaranty

Financial guaranty reinsurance grew during the late 1990's. Financial guaranty insurance strengthens corporate and government bond issuances by providing unconditional and irrevocable guarantees that an investor will receive all principal and interest payments on a timely basis. Bermuda based financial reinsurer's include ACE's financial guaranty business (ACE Guaranty Corp. and ACE Capital Re International Ltd.), RAM Reinsurance Company Limited and Channel Reinsurance Ltd, a company incorporated during 2004 sponsored by RenaissanceRe Holdings Ltd, PartnerRe Ltd, Koch Financial Corporation and MBIA Inc.

(vii) Brokers

Bermuda's brokerage community has grown significantly along with the rest of the Island's insurance industry. In many cases this growth is driven by insurance companies which only accept business from non-United States brokers.

3.3 Impact of the September 11, 2001 terrorist attacks on global reinsurance capacity and the Bermuda insurance industry[l]

According to industry sources, capital available to write property and casualty insurance and reinsurance was impaired by an estimated $243 billion to $263 billion in potential and realized underwriting and investment losses during

(l) Source of Section 3.3: Quanta Capital Holdings Ltd S-1 Registration Statement as filed with Securities and Exchange Commission. Source of "Estimated factors contributing to capital reduction" table: Sigma, A.M. Best and Insurance Services Office.

2001 and 2002. This represented 35 percent to 38 percent of the approximately $700 billion in available capital at December 31, 2000, as reported by industry sources. The table below shows the estimated factors contributing to the reduction in the insurance industry's capital:

Estimated factors contributing to capital reduction	Notes	Amount ($ in billions)
World Trade Center losses	1	$ 30 to 40
Estimated reserve deficiencies	2	78
Investment losses	3	100 to 110
Net realized investment losses	3	35
Total potential losses		$ 243 to 263

Note 1 – The terrorist attacks of September 11, 2001 were the single largest insured catastrophe in insurance industry history, with estimated losses of $30 billion to $40 billion, according to A.M. Best. Also during 2002 and 2003, several insurance companies either exited or significantly reduced their future premiums written in certain lines, further reducing the industry's available underwriting capacity.

Note 2 – According to A.M. Best, the insurance industry in total was deficient in its reserving for asbestos and environment-related claims ("A&E") by approximately $53 billion as of December 31, 2001. A.M. Best also expects the industry to ultimately incur more than $121 billion in net A&E losses. Additionally, deficiencies are expected to be greater and more widespread in the commercial market, where A.M. Best estimates core loss reserve shortfalls to be approximately $25 billion, excluding A&E, at December 31, 2002. Several major insurance companies have recently taken significant asbestos-related charges to earnings and A.M. Best estimates insurers will take additional A&E, professional liability and other property and casualty charges to earnings by December 31, 2003.

Note 3 – The general decline in global equity markets, credit losses and high profile Chapter 11 insolvencies during 2001 and 2002, have created significant investment losses and capital impairment for insurers and reinsurers. Sigma estimates a decline of $100 to $110 billion in non-U.S. capital during 2001 and first half of 2002 due to the unfavorable investment environment, while the Insurance Services Office estimates U.S. realized and unrealized investment losses during 2001 and 2002 to be $35 billion. Additionally, the low interest rate environment has reduced the investment returns of insurers and reinsurers.

The result of the above factors was that during 2002, many property and casualty insurers and reinsurers were downgraded, including many of the world's leading reinsurers.

3.4 Post September 11, 2001 Class 4 companies

As a result of the factors outlined in Section 3.3, several new Bermuda reinsurers were established to provide additional capacity in the global reinsurance market. Companies such as Arch, AWAC, AXIS, Endurance, Montpelier, Rosemont, and Quanta have all been capitalized and commenced underwriting, backed with experienced management teams, post the September 11, 2001 terrorist attacks. Most of these new reinsurers have subsequently conducted Initial Public Offerings in the U.S.. In addition, many existing Bermuda reinsurance companies also raised further capital following the attacks.

The following table sets out the business written and the main sponsors of these new Class 4 reinsurers:

Company	Business written	Sponsors
Arch	Casualty, property, specialty, property catastrophe, marine and aviation, non-traditional insurance	Warburg Pincus and Hellman & Friedman
AWAC	Property catastrophe, casualty, property and other specialty lines	AIG, Chubb and an investment fund managed by Goldman Sachs
AXIS	Insurance: Marine, energy, aviation, commercial property, specialty Reinsurance: Property catastrophe, property, marine	Trident II (private equity fund managed by MMC Capital), private equity funds managed by JP Morgan Partners, Thomas H. Lee Partners, The Blackstone Group, Credit Suisse First Boston
Endurance	Property catastrophe, casualty, property, excess workers' compensation, aviation and space, other specialty lines	Zurich, Aon, Thomas H. Lee Partners, Texas Pacific Group, Capital Z, Perry Capital, GIC Special Investments, General Motors Asset Management, Lightyear Capital, CSFB Merchant Banking, Golden Gate Capital, Reservoir Capital and TIAA-CREF
Montpelier	Property catastrophe, other property, Lloyd's syndicate business, specialty other including aviation and marine	White Mountains, Benfield Group
Rosemont	Marine, property, retrocession	Goshawk Insurance Holdings, U.K. based insurance company
Quanta	Insurance: marine and aviation, professional liability, environmental liability, structured insurance and property Reinsurance: marine, property, casualty, professional, structured reinsurance	Private Offering: shares sold to qualified institutional buyers, accredited investors and non-U.S. persons

3.5 Bermuda based SEC registrants in the insurance industry

The table below outlines Bermuda based insurance and reinsurance companies listed on the New York Stock Exchange or NASDAQ, together with their ticker symbol, their net premiums earned for the year ended December 31, 2004 and their shareholders' equity as of December 31, 2004.

Company	Symbol	Net premiums earned (Note 1) ($ in millions)	Shareholders' equity (Note 1) ($ in millions)
Non-life companies (Note 2):			
ACE Limited	ACE	$ 11,136	$ 9,836
American Safety Insurance Holdings, Ltd	ASI	136	109
Arch Capital Group Ltd	ACGL	2,916	2,242
Aspen Insurance Holdings Limited	AHL	1,233	1,482
AXIS Capital Holdings Limited	AXS	2,028	3,238
Endurance Specialty Holdings Ltd	ENH	1,633	1,862
Everest Re Group Ltd	RE	4,425	3,713
IPC Holdings, Ltd	IPCR	355	1,668
Max Re Capital Ltd	MXRE	918	937
Montpelier Re Holdings Ltd	MRH	788	1,752
PartnerRe Ltd	PRE	3,734	3,352
Platinum Underwriters Holdings Ltd	PTP	1,448	1,133
PXRE Group Ltd	PXT	308	697
Quanta Capital Holdings Ltd	QNTA	237	431
RenaissanceRe Holdings Ltd	RNR	1,338	2,644
White Mountains Insurance Group, Ltd.	WTM	3,821	3,884
XL Capital Ltd	XL	8,550	7,739
Life and Annuity companies:			
Scottish Re Group Limited	SCT	$ 587	$ 863

Notes

1. Net premiums earned are for the year ended December 31, 2004 and shareholders' equity is as of December 31, 2004 reported in accordance with U.S. GAAP for all of the companies listed in the table.

2. Note that some of the companies listed under "Non-life companies" do write varying amounts of life reinsurance business. However, these companies are predominantly non-life companies writing excess of loss liability reinsurance, property and casualty insurance and reinsurance, property catastrophe reinsurance and structured risk business.

The previous table detailing Bermuda based insurance and reinsurance companies listed on the New York Stock Exchange or NASDAQ does not include other large and significant insurance and reinsurance companies based in Bermuda, which are either privately held or listed on the U.K. Stock Exchange.

The table below lists examples of such companies, however, it should be noted that this list is only for illustrative purposes and is not intended to present an exhaustive analysis.

Company	Notes	Net premiums earned ($ in millions)	Shareholders' equity ($ in millions)
Allied World Assurance Company, Ltd.	1	$ 1,326	$ 2,139
Alea Group Holdings (Bermuda) Ltd.	2	1,182	706
Catlin Group Limited	3	1,161	971
OIL group of companies	4	521	1,760

Notes

1. Net premiums earned are for the year ended December 31, 2004 and shareholders' equity is as of December 31, 2004 reported in accordance with U.S. GAAP.

2. Net premiums earned are for the year ended December 31, 2004 and shareholders' equity is as of December 31, 2004 reported in accordance with U.K. GAAP. Alea Group Holdings (Bermuda) Ltd. is listed on the U.K. Stock Exchange.

3. Net premiums earned are for the year ended December 31, 2004 and shareholders' equity is as of December 31, 2004 reported in accordance with U.S. GAAP. Catlin Group Limited is listed on the U.K. Stock Exchange.

4. Net premiums earned represents the aggregated amounts reported by Oil Insurance Limited ("OIL") (year ended December 31, 2004), Oil Casualty Insurance Ltd. ("OCIL") (year ended November 30, 2004) and sEnergy Insurance Ltd. ("sEnergy") (year ended June 30, 2004). Shareholders' equity represents the aggregated amounts reported by OIL, OCIL and sEnergy as of their respective year-end dates. Net premiums earned and shareholders' equity for OIL and OCIL are reported in accordance with U.S. GAAP. Net premiums earned and shareholders' equity for sEnergy are reported in accordance with statutory accounting principles, however, sEnergy's shareholders' equity as of June 30, 2004 included in the above aggregated amount has been adjusted to exclude an amount of $327 million recorded in shareholders' equity under statutory accounting principles which would not be recorded under U.S. GAAP.

3.6 Current issues impacting our clients in the Bermuda insurance industry

The following are a catalogue of the recent events and issues which we have observed impacting our clients in the Bermuda insurance industry. These events and issues are listed in alphabetical order:

(i) Asbestos and environmental-related claims

The insurance and reinsurance industry has been affected by reserve deficiencies resulting from the "third wave" of asbestos and environmental-related claims and as a result there have been significant reserve increases by certain market participants.

(ii) Audit of Internal Controls over Financial Reporting

Under Section 404 of the Sarbanes-Oxley Act 2002, as of December 31, 2004 or December 31, 2005 all SEC registrants will be subject to an audit of their internal controls over financial reporting including the controls in place at significant service organizations used by the company. The audit opinion on the company's internal controls over financial reporting will be filed with the SEC as part of the company's Form 10-K.

(iii) Disciplined underwriting

Disciplined technical underwriting is becoming increasingly important to make underwriting profits rather than relying on investment income for profitability. Investors, shareholders and the sponsors of captives should expect management to focus on implementing a disciplined approach to quality underwriting which should include: a rigorous risk analysis (supported by relevant historical loss data and future trends); a proven underwriting team; information systems capable of producing timely and relevant data; a strong control environment; and profitability expectations.

(iv) FIN 46

In December 2003, the Financial Accounting Standards Board in the United States issued Interpretation No. 46 (revised December 2003) "Consolidation of Variable Interest Entities" ("FIN 46-R"). Variable interest entities ("VIE's") are entities that have insufficient equity and / or their equity investors lack one or more of the specified essential characteristics of a controlling financial interest. FIN 46-R is a broad reaching interpretation and such VIE's may include guarantees, forward contracts, derivatives, service contracts, leases and certain equity investments.

If the entity is deemed to be a VIE, the entity with the majority of the variable interest in expected losses is the primary beneficiary of the VIE and is required under FIN 46-R to consolidate the VIE. If no entity has the majority of the expected losses then the entity with the majority of the variable interest in the expected returns is deemed to be the primary beneficiary. Special provisions in FIN 46-R apply to enterprises that fully or partially applied FIN 46 prior to the issuance of FIN 46-R. FIN 46-R applies to financial statements of public entities that have interests in VIEs or potential VIEs commonly referred to as special-purpose entities for periods ending after December 15, 2003.

FIN 46-R applies to all public entities for all other types of VIEs in financial statements for periods ending after March 15, 2004. Application by small business issuers to entities other than special-purpose entities and by non-public entities to all types of entities is required at various dates in 2004 and 2005. The Canadian accounting guideline, AcG-15, Consolidation of Variable Interest Entities, is substantially equivalent to FIN 46-R and is applicable for public entities with annual or interim periods beginning on or after November 1, 2004. Non-public entities need not apply AcG-15 until annual or interim periods beginning on or after November 1, 2005.

(v) Market cycles

The continuing hard market through 2004, possibly with the exception of certain property and casualty rates, has actively encouraged the incorporation of more captives as premiums have risen in certain insurance lines of business. In some cases the premium increases have been substantial and policy terms have been observed to becoming increasingly restrictive. With softening rates in 2005 many commentators consider consolidation in this industry a possibility.

(vi) Increased scrutiny by management and audit committees

Following a number of high profile business failures and bankruptcies during the past few years, there has been a noticeable increase in the involvement of, and oversight by, senior management and audit committees. An increasing number of non-public entities are establishing audit committees and companies have increased their needs for internal audit services, both in terms of hiring their own specialists and the number of projects outsourced to the Big 4 accounting firms.

For further information on KPMG's Audit Committee Institute, please visit www.us.kpmg.com/auditcommittee.

(vii) Lines of business

There have been general increases in certain insurance lines written by our captive clients, both existing captives and newly incorporated captives. For example, more captives are writing Directors & Officers liability, Professional Liability and Medical Malpractice risks because the commercial market pricing has risen rapidly following recent business failures. In addition, several primary insurers have exited the Medical Malpractice market.

(viii) Regulatory developments

The SEC has established the Public Company Accounting Oversight Board ("PCAOB") to govern public company accounting in response to the high profile business failures and bankruptcies during the past few years as discussed in item 6. The PCAOB's remit includes the ability to request information from and request access to the audit firm's work papers, which the audit firm must comply with by law.

In 2003, the BMA participated in the Offshore Financial Center Assessment Program conducted by the International Monetary Fund (the "IMF"). The IMF's report, which assesses the regulation and supervision of the financial sector (including insurance) in Bermuda against international best practices, is to be published by the Bermuda Government in 2005. The Minister of Finance has announced that Bermuda will face further regulatory changes when the IMF's 2003 report is published.

(ix) Credit risk

Reinsurance contracts do not relieve ceding companies from their obligations to policyholders and the failure of their reinsurers to honor obligations can result in cedants suffering losses. The issue of reinsurance recoverability has become more pronounced recently as a result of the credit rating downgrades of numerous market participants, as discussed in Section 3.3. There also appears to have been a further increase in the number of reinsurers challenging the underlying coverage and terms of contracts.

Accordingly, ceding companies should actively perform an extensive due diligence inquiry of each reinsurer it places business with. This should include evaluating each reinsurer's financial condition, clarifying coverage and terms, and monitoring the concentration of credit risk arising from similar geographic regions, activities or economic characteristics of its reinsurers to minimize exposure to significant losses from reinsurer insolvencies or defaults. This evaluation should continue after the contract has been executed and focus on the strategic commutation or novation of contracts with reinsurers where the evaluation of each reinsurer's financial position falls below a certain pre-determined level.

(x) Start-ups

As discussed in Sections 3.1, 3.3 and 3.4, following the September 11, 2001 terrorist attacks several new Class 4 reinsurance companies were established to provide additional capacity in the global reinsurance market. The Bermuda reinsurance market also experienced a similar influx of new start-up reinsurance companies following Hurricane Andrew in 1992, as discussed in Section 3.2 (iii). Many of the post-Hurricane Andrew reinsurance companies have subsequently been acquired by other Bermuda based reinsurers e.g. Mid Ocean, LaSalle and Tempest were acquired by XL, Endurance and ACE respectively. As the reinsurance market softens, and the founding investors and sponsors of the post-September 11, 2001 start-ups seek exit strategies, it may well be the case that the Bermuda reinsurance industry will again experience a period of consolidation through merger and acquisition activity.

CHAPTER 4

Establishing a captive insurance business in Bermuda

4.1 What is a captive?

The term "captive insurance company" has come to be used to describe an increasingly diverse range of companies. The characteristics common to these different types of company are usually that:

- it is owned through a common interest which is not normally engaged primarily in the insurance industry; and
- the risks are related in some way to the risks of the shareholders, or third-party risks which the shareholders control.

Captive insurance companies were initially formed to insure the risks of their parent, fellow subsidiaries and associated companies, however the industry has now grown in scope. Captives currently registered in Bermuda include the following types:

- Single-parent captives, underwriting risks only of related-group companies;
- Senior or diversified captives, underwriting risks of unrelated companies in addition to group business;
- Association captives, formed by members of a common industry or trade association in order to share the risks of that industry or association among its members;
- Agent captives, sponsored by one or more independent agents to write high-quality risks that they control. These programs may be both agent-responsive and insured-responsive whereby, both the agents and the insured may benefit from profits based on their contributions;
- Captive pools, formed for the exchange of insurance business among captives in order to spread their risks and enhance their participation in non-related business;
- Rent-a-captives, owned by unrelated parties, which provide captive facilities to others for a fee. Often used by companies whose insurance programs are too small to justify incorporating their own captive;
- P&I Clubs, where captives write protection and indemnity and other risks for their members in the shipping industry.

In the early years of a captive's existence in order to build up the capital base, the captive typically:

- Cedes most of the risk to the conventional reinsurance market, thereby reducing the captive exposure; or

- Limits the proportion, or amount, of risk ceded to the captive by the "fronting company."[m]

The captive will normally carry greater proportions of risk as time progresses and net assets build up. The captive normally assumes primary coverage, with excess coverage being purchased in the conventional reinsurance market. In some cases, the captive may insure only the policy deductibles, which have been applied by the parent's conventional insurers.

Alternatively, captives may be formed purely to handle excess layers. A captive may be either a direct writer or reinsurance company. As a reinsurer, the captive assumes business from a direct insurer, normally referred to as the fronting company. Common types of policies written by captives are workers compensation, general liability, auto, property damage/business interruption, directors' and officers' liability, products liability and professional indemnity.

4.2 Reasons for establishing a captive

Captives are established for a variety of reasons, the most important of which are:

- **Improved risk management** – the formation of a captive provides an opportunity to focus on improving loss control within an organization.

- **Cost savings** – the price of insurance coverage purchased in the conventional insurance market includes a portion of the insurer's acquisition costs, overheads and profits and can represent a significant portion of the premium. In addition, the company may be paying a higher premium due to poor loss experience generally within the company's industry, even though the company may itself have good loss experience. Although establishing a captive does not avoid all these costs, it should reduce them, and if the captive's own loss experience is no worse, and claim handling costs are no greater, than the average of the conventional insurer's business, there may be substantial underwriting profits available to the captive.

- **Access to the reinsurance market** – a captive can gain direct access to the international reinsurance market. This may be less expensive than conventional direct excess cover, and the captive may also earn ceding commissions.

- **Unavailability of coverage** – the insurance industry is subject to considerable cyclical changes. Excess capacity leads to increased competition, resulting in decreased premium rates and poor underwriting results, which in turn cause a market reaction resulting in dramatic increases in premium rates and restrictions in the availability of some types of coverage. Cover may then only be available at unrealistically high premium rates. Captives can provide more stable rates than are available in the conventional market. A recent example of high premium rates in the conventional market resulting in increased captive participation is Directors & Officers Liability and certain Professional Liability lines.

(m) A fronting company (or fronting insurer) is a primary insurance carrier, which issues a policy on a risk for, and at the request of, one or more other insurers (e.g. the captive insurance company) with the intent of passing the entire risk, or part thereof, by way of reinsurance to the other insurer(s). Such an arrangement in referred to as fronting.

- **Cover for otherwise uninsurable risks** – captives can provide coverage in areas such as new or potentially hazardous products, hazardous waste or environmental pollution, where protection is unavailable in the conventional market or unavailable at affordable or reasonable cost.

- **Profit centre** – by establishing a subsidiary captive insurance company, the premiums paid to the captive, the investment income earned by the captive less the losses paid by the captive represent profit retained by the captive, which can be remitted back to the sponsor by way of dividend. Accordingly, the captive can be established as a profit centre and the profit created by the captive is retained by the sponsors of the captive rather than paid to a conventional and unrelated third party insurance company.

4.3 Feasibility study

The initial step prior to forming a captive is producing a feasibility study to consider and compare the financial and non-financial advantages and disadvantages of all the options available. The feasibility study will assist management determine whether the captive model is the optimal solution to achieving their risk management objectives and, if so, how that captive should be structured.

The feasibility study should include a review of the group's existing insurance cover, premium costs, loss history, values at risk, existing accident prevention measures and possible reinsurance costs. KPMG's multi-disciplined team of accounting, tax and actuarial professionals can consider all aspects of captive formation and structure. Feasibility studies are also services offered by brokers and management companies.

4.4 Incorporation

There are two steps involved in establishing an insurance company in Bermuda; (i) incorporation of the company and (ii) obtaining an insurance license.

The majority of companies in Bermuda are incorporated by registration under The Companies Act 1981 ("the Companies Act"). This is a relatively simple process, commencing with an advertisement in the official government gazette setting out the proposed name of the company, its principal objectives, and the fact that it is to be exempted from Bermudian ownership. Thereafter, application for incorporation is made to the Minister of Finance.

The application must include; the name, address, occupation and nationality of the majority shareholder and the nature of the business the company intends to carry on. Bank references on the majority shareholder of the proposed company must be submitted with the application, or, if the majority shareholder is a company, the latest annual report must be enclosed with the application. This information is treated in the strictest confidence and emphasis is placed on background checks to ensure reputable persons back the incorporated company.

The procedure for incorporation is relatively straightforward and can be accomplished by a brief visit to a Bermuda law firm. The incorporation process normally takes from approximately three to six weeks from the time the lawyers in Bermuda have received all relevant information on the company and the proposed majority shareholder's bank references.

Bermuda companies fall into two principal categories:

- Companies incorporated by Bermudians to trade locally in Bermuda; and
- Companies incorporated by non-Bermudians for the purpose of conducting business outside Bermuda from a principal place of business in Bermuda. These "exempted companies" are so called because they are exempted from those provisions of Bermuda law which require at least 60 per cent of the equity to be beneficially owned by Bermudians. Significantly all captives established in Bermuda fall into this category.

To qualify as an exempted company, an insurer must be registered under the Companies Act and state in its memorandum that it is an exempted company, or be incorporated by virtue of a Private Act declaring it to be an exempted company for the purposes of the Companies Act.

4.5 Obtaining an insurance license

The second step in establishing an insurance company in Bermuda is obtaining an insurance license. This procedure is performed by completing the "Insurance License Application" Form together with details of the companies Business Plan (see Section 4.11), which are submitted to the BMA, who will seek advice from the Insurance Admissions Committee, a sub-committee of the IAC. The "Insurance License Application" Form includes details of the background of the company (including its shareholders), the business purpose for setting up the insurance company, the capitalization of the company, a detailed analysis of the lines of business that the company will write, the name of the insurance managers, the registered office of the company, the name of the loss reserve specialist, the financial projections and assumptions used therein, and the name of the auditors. The focus of the application is whether the applicant is a fit and proper body to be engaged in insurance business and whether the applicant has, or has available, adequate knowledge and expertise.

4.6 Minimum capital requirements

The minimum share capital of an exempted company cannot be less than the equivalent of $12,000 Bermuda Dollars. However, a company which writes general insurance (non-life insurance) is required to have a minimum authorized and issued share capital of at least $120,000, all of which must, prior to the company's registration as an insurer, be fully paid in cash or marketable securities.
For details of capital and solvency requirements for insurers, see Section 5.4.

4.7 Memorandum of association and bye-laws

A copy of the Company's Memorandum of Association must accompany the application for registration of the company under the Companies Act.

The bye-laws must provide for the holding of an annual general meeting in each year, an audit of the accounts of the company once in every year, the transfer and transmission of shares, and the quorum for general meetings. Note that under the Companies Act, the directors of an insurance company can waive the preparation and presentation of financial statements prepared in accordance with generally accepted accounting principles. However, the directors are not able to waive the preparation and presentation of statutory financial statements for an insurance company registered under The Insurance Act.

In addition, the bye-laws may regulate such matters as the allotment of shares, the payment for shares, the declaration and payment of dividends, the duties and responsibilities of the company's officers, and the conduct of the affairs of the company generally.

At the meeting of the provisional directors (i.e., the subscribers to the Memorandum of Association) the bye-laws are presented and approved for presentation to the statutory meeting of the shareholders where they are confirmed. The administration of every company is regulated by bye-laws.

4.8 Accounting and audit requirements

The company's accounting year-end date can be chosen or changed to coincide with the accounting date of the parent company or sponsoring group of companies. Any change of accounting date requires the consent of the BMA.

The Companies Act requires every exempted company to appoint an independent auditor and that audited financial statements, prepared in accordance with generally accepted accounting principles, will be placed before the shareholders at each annual general meeting. However, such appointment and presentation can be either waived or deferred for up to 90 days as agreed upon by the shareholders.

Every insurer is required to appoint an independent approved firm of auditors to report on the Statutory Financial Statements and Return. The reporting auditors are usually the same firm as that reporting to the shareholders.

4.9 Annual returns and meetings

Every company must hold an annual general meeting of its members in each calendar year in Bermuda. There is a requirement that the accounts be forwarded to the shareholders prior to the annual general meeting, and insurance companies are required to file a statutory return with the Registrar of Companies on an annual basis. For details of the components of the annual return, see Appendix 1.

4.10 Registration under The Insurance Act

Insurance companies must also register under The Insurance Act. Again, the process is not complicated and is usually done in conjunction with local lawyers or insurance management companies. At the time of registration, the company must appoint a resident "principal representative", a position normally filled by the local insurance management company. The application for registration requires information on intended underwriting, together with projected premium volumes, underwriting results, and capital and surplus levels for the first two years of operation.

The registered office of the company must be in Bermuda and the shareholders' register and the accounting records must be kept there.

4.11 Business plan

A detailed plan with financial projections is considered by the regulatory authorities to be an important part of the application for registration, and will form the basis for assessment of the adequacy of the financial resources of the applicant. There is no prescribed format, but the following serves as a useful guideline:

- Class and source of business;
- Fronting company, limits and premiums (provide accounts if appropriate);
- Deductible/excess/retention levels;
- Reinsurer(s) names, limits and premiums (provide accounts if appropriate);
- Stop loss or excess protection;
- Types of policies (standard, claims made/occurrence);
- Past history of book(s) of business;
- Feasibility study and three year projection;
- Names of any intermediaries involved;
- Progression of gross premiums to earned premiums;
- Financial investment (including related party loans) and dividend policies;
- Proportion of unrelated business;
- Underwriting resources and guidelines;
- Commission structure;
- Marketing strategy.

KPMG is experienced in the preparation of such business plans and is able to assist in this regard.

4.12 Directors, officers and offices

A Bermuda company is required to have a quorum of directors ordinarily resident in Bermuda, and these directors are usually provided by a partner of the local law firms or by executives of the leading banks and insurance management companies, see Section 5.1.

Every company must have either a President and a Vice President or a Chairman and a Deputy Chairman. These officers are elected from the Board of Directors each year as soon as practicable after the annual general meeting. In addition, a company must have a Secretary (who in certain circumstances cannot also be a director) and may appoint a resident representative. Other officers, such as a Treasurer and an Assistant Secretary are optional.

Every insurer must appoint a principal representative, resident in Bermuda, who is responsible for retaining custody of the statutory accounting records and submitting the annual Statutory Financial Return. The principal representative of an insurer must be a person approved by the BMA. It is the responsibility of the principal representative to ensure that the captive continues to comply with regulations of The Insurance Act. In the event of the captive being non-compliant with the regulations, it is the responsibility of the principal representative to inform the BMA within thirty days and take corrective action to ensure the captive returns to being compliant with the regulations.

Every insurer is also required to maintain a principal office in Bermuda, which may be the office of a director or management company, and tends not to be the registered office of the company. Certain minimum records are required to be maintained at the principal office including financial statements, minutes of meetings, general ledger, books of account, premium registers and loss registers.

4.13 Staffing

Government immigration policy allows Bermuda companies to employ non-Bermudians when qualified Bermudians are not available to fill the vacancy. Accordingly, many insurance companies, both management companies and professional reinsurance companies, staff their executive and technical positions with non-Bermudians until Bermudians can be trained for those positions. The employer applies for work permits for its resident non-Bermudian employees.

4.14 Costs

The following estimates, expressed in United States Dollars, are based on a small sized Class 2 captive. Costs increase with size and complexity.

Estimated start-up costs (including the first year's government fees)

	Range	
	Low	High
Lawyers' fees for incorporation	$ 5,000	$ 10,000
Feasibility study	5,000	20,000
Other disbursements	2,000	5,000
Registration fee – Companies Act*	5,610	5,610
Registration fee – Insurance Act	1,500	1,500
	$ 19,110	$ 42,110

Estimated annual operating costs

	Range	
	Low	High
Lawyers', secretarial and directors' fees	$ 5,000	$ 10,000
Manager's fees	25,000	75,000
Registration fee – Companies Act*	5,610	5,610
Registration fee – Insurance Act	1,500	1,500
Audit fee	15,000	30,000
Actuarial fees	10,000	30,000
Other (telephone, bank charges etc.)	1,000	5,000
	$ 63,110	$ 157,110

* The amount of the registration fee is determined by the company's share capital, see Section 2.2.

CHAPTER 5

Regulations and ongoing obligations

5.1 Compliance with legislation

Bermuda insurance companies are subject to the provisions of The Insurance Act and The Companies Act. Bermuda's statute law on companies is embodied in The Companies Act. Nearly all companies are incorporated by registration, although incorporation pursuant to a Private Act is also available and must be used where the general statute law will not accommodate the proposed structure, internal organization or method of operation of the entity. This feature of Bermuda law is not commonly found in other jurisdictions.

(i) Directors

The first board of directors is elected at the statutory meeting of the shareholders and the term of office of a director generally runs from one annual general meeting to the next. However, the bye-laws may provide for longer terms and retirement by rotation. There is no need for directors to hold qualifying shares.

There is generally no objection to shareholders' and directors' meetings being held outside Bermuda, provided that copies of the minutes are forwarded to the company secretary in Bermuda for inclusion in the official minute book. However, it is generally accepted that, if captive companies continually hold meetings outside Bermuda, the company's principal representative and the resident directors reserve the right to attend such meetings wherever they may be held.

The Companies Act requires that an exempted company must have two individuals ordinarily resident in Bermuda, who serve either:

- one as secretary and one as resident representative; or
- one as secretary and one as director; or
- both as directors.

(ii) Investments

Except for restrictions on its ability to invest and deal in Bermuda real property (i.e. land in Bermuda), an exempted company is free to acquire, hold and deal in all types of investments.

(iii) Dividends

A company may not declare or pay a dividend if the directors have reasonable grounds for believing that the company is, or will after the payment, be unable to pay its liabilities as they fall due or the realizable value of the company's assets will fall below the aggregate of its liabilities, its issued share capital and share premium accounts.

5.2 The Insurance Act

The conduct of insurance business is regulated by The Insurance Act. The Insurance Act continues to offer relative freedom to captives and is designed to minimize unnecessary restrictions and Government involvement for companies that are not considered to have a problem in meeting their commitments to their policyholders. Commercial insurers and excess reinsurers are generally subject to more regulation than captives. Sections 5.3 to 5.6 summarize the main provisions of The Insurance Act.

5.3 The multi-license system

A company must be registered under The Insurance Act before it can carry on insurance business. Bermuda's registration system is described as a multi-license system and every insurer must obtain a Class of License, which depends on the lines of business the company intends to write and its business plan, see Section 5.4. A summary of the requirements for each Class (1, 2, 3, 4 and Long-Term) is provided in Appendix 1.

5.4 Statutory requirements

A registered insurer is expected to maintain a minimum paid up capital, minimum statutory capital and surplus and a minimum liquidity ratio. The scope requirements are set out in The Insurance Act and the main elements are:

(i) Minimum paid up capital

Minimum paid up capital for an insurance company writing property and casualty as a Class 1, Class 2 or Class 3 insurer is $120,000 and $250,000 for a long-term (life insurance) company. Minimum paid up capital for an insurance company writing excess liability or property catastrophe reinsurance business as a Class 4 insurer is $1,000,000. This is summarized in Appendix 1.

(ii) Minimum capital and surplus

A Bermuda Insurer is required to maintain minimum capital and surplus representing the minimum solvency margin benchmarks. An insurer's capital and surplus must not fall below this amount. The minimum solvency margin requirements represent the greater of the minimum capital and surplus, the premium test and the loss test. The basis of these tests is set out in Appendix 1.

Fixed capital for statutory purposes can be established, with the permission of the BMA, through use of instruments such as letters of credit, loan stock, subordinated debentures or guarantees. To be approved, such instruments need to be subordinate to all insurance obligations and not repayable or redeemable if doing so would mean that the insurer did not meet its minimum capital and surplus requirement.

(iii) Minimum liquidity ratio and relevant assets

An insurer of general business is required to maintain "relevant assets" (liquid assets) equal to at least 75 percent of "relevant liabilities". For these purposes, relevant assets are generally most assets except:

- Investments in, and non-insurance advances to, subsidiaries and affiliates
- Unquoted equity investments
- Real estate, both land and buildings

(iv) Dividend restrictions and restrictions on the reduction of statutory capital

A Class 3 or Class 4 insurer falling below the minimum solvency margin is required to file with the BMA, within 30 days of becoming aware of this condition, a revised business plan setting out how the shortfall is to be rectified and such companies will be prohibited from paying dividends until they are in compliance.

A Class 4 company whose capital and surplus falls below $75 million is required to file with the BMA within 45 days of becoming aware of this condition:

- Unaudited interim statutory financial statements;
- General business solvency certificate;
- An actuary's report as of the same date of the unaudited interim statutory financial statements; and
- A revised business plan.

A Class 4 insurer, prior to declaring a dividend in any financial year, which exceeds 25 percent of its capital and surplus, is required to have two directors and its principal representative file affidavits stating that the insurer will remain in compliance with its solvency margin after the payment of the dividend.

Any insurer, prior to reducing its capital by more than 15 percent has to obtain the approval of the BMA.

5.5 Financial reporting and regulatory returns

(i) Generally accepted accounting principles

Company law requires that proper books and records of account be maintained. Captive insurance companies will typically use the accounting systems of the insurance management company.

Since the majority of the insurance companies are owned by, and many of the financial statements are consolidated into, U.S. corporations, most Bermuda insurance companies prepare their financial statements in accordance with Generally Accepted Accounting Principles ("GAAP") in the United States of America. However, since Bermuda accounting principles follow Canadian GAAP, some companies choose to prepare their financial statements under Canada/Bermuda GAAP. There are also a certain number of insurance companies who prepare financial statements in accordance with U.K. GAAP and International Financial Reporting Standards (IFRS), largely driven by where the parent company is based or the accounting standards followed by the parent company.

As previously noted, the directors can waive the preparation and presentation of GAAP financial statements since The Insurance Act only requires that statutory financial statements be prepared in accordance with the provisions of The Insurance Act and filed with the BMA. Statutory financial statements will closely mirror the GAAP financial statements with some exceptions. The most notable exceptions are:

1. Insurance contracts are treated in accordance with their legal form rather than their substance. Therefore insurance contracts which do not pass the risk transfer tests of U.S. Statement of Financial Accounting Standards No. 113 "Accounting and reporting for reinsurance of short-duration and long-duration contracts", and are treated as deposit transactions in the balance sheet under GAAP, would be recorded through the statutory income statement as insurance under The Insurance Act. This is unless the company obtains a Section 56 directive (see Section 5.6) from the BMA allowing the captive to adopt GAAP accounting in the Statutory Financial Statements. The major benefit of obtaining a Section 56 exemption in this case is that only one set of accounting records are maintained.

2. Deferred acquisition costs are expensed in the statutory income statement and not held on the statutory balance sheet.

3. Prepaid expenses are expensed in statutory surplus and not held on the statutory balance sheet.

4. Outstanding losses recoverable from reinsurers are netted against the company's outstanding loss reserves. Since both of these are balance sheet items, the statutory income statement is not affected.

5. Deferred (prepaid) reinsurance premiums are netted against the company's unearned premium reserve.

6. Deferred tax assets are expensed in a similar manner to deferred acquisition costs. Deferred tax liabilities are recorded in the statutory financial statements.

7. With the permission of the BMA, capital for statutory financial statement purposes can be established through use of instruments such as letters of credit, loan stock, subordinated debentures or guarantees, see Section 5.4. These instruments would not be treated as capital for GAAP purposes.

8. Letters of credit granted, which are outside of the insurance companies normal business operations, are recorded as a liability in the statutory financial statements. Under GAAP these would require disclosure only.

(ii) Statutory financial statements and statutory financial return

Insurers are required to prepare annual statutory financial statements and a statutory financial return in a prescribed format. These statutory financial statements must be available at the company's principal office by the filing deadlines noted in Appendix 1. The statutory financial statements are less onerous to prepare than the U.S. yellow book format, and have been designed to require minimal adjustments from normal shareholder financial statements prepared in accordance with GAAP. The statutory financial statements comprise balance sheet, income statement, statement of capital and surplus and footnotes.

(iii) Loss reserve specialist opinion

In addition to the circumstances outlined under loss reserve discounting in Section 5.5 (v), there are requirements for certain insurers to obtain a loss reserve specialist opinion by a qualified casualty actuary or loss reserve specialist as recognized by the BMA. The requirements are analyzed in Appendix 1. In certain circumstances an insurer can apply to be exempted from having to provide a loss reserve opinion.

(iv) Responsibility of the auditor

When filing a statutory return with the BMA, an audit report from the company's appointed auditors must be included. This report is addressed to the BMA and includes an opinion on whether the statutory financial statements present fairly, in all material respects, the information therein in accordance with The Insurance Act. An opinion is also included on the company's solvency declarations and statutory ratios.

(v) Loss reserve discounting

Under The Insurance Act, a company's loss reserves may only be discounted in the following situations:

- where both the loss amount and the payment dates are fixed; or
- where neither the loss amount nor payment dates are fixed but the company's approved auditor is satisfied that the loss amount and payment profile are both reasonably ascertainable.

Where reserves are discounted, a provision for adverse deviation must be included to cover uncertainties in loss amount, payment dates and interest rates. Also, where reserves have been discounted and the company does not meet its general business solvency margin on an undiscounted basis, then the discounted reserves (and the appropriateness of discounting) must be certified by an approved loss reserve specialist. Additional disclosures must also be made in the notes to the statutory financial statements when a company discounts its loss reserves.

5.6 Exemptions

The Insurance Act gives the Minister of Finance power to exempt insurers from certain of its requirements, generally referred to as Section 56 exemptions after the relevant section of The Insurance Act. Certain types of insurance companies, such as mutuals and P&I Clubs that can assess owner-members for additional premium, can be exempted from some of the provisions of The Insurance Act. Rent-a-captives also may be granted exemption from certain provisions.

5.7 Other relevant legislation and regulators

With the growth in the number of insurance companies and the increased attention to insurance companies writing third party risks and high levels of excess liability business or property catastrophe reinsurance business, both the insurance industry and the BMA have recognized the importance of insurance regulation and supervision, to protect both the public interest and the reputation of Bermuda as an insurance centre. Further to this, after extensive review, significant changes were made to The Insurance Act in 1994 and in 1995, including the creation of the multi-license system, as discussed in Section 5.3.

Additional amendments were made to The Insurance Act in 2002. The most important of these relate to an expansion of the powers of the BMA to obtain information that may be needed for regulatory purposes from insurers, insurance managers and intermediaries registered under The Insurance Act. The amendments also included provisions enabling the BMA to require insurers to commission reports from professional persons on matters relevant to the BMA's supervision. Since the BMA expects that insurers will voluntarily provide the information requested, the BMA does not expect to make frequent use of these new statutory powers.

In addition as part of the 2002 changes, the BMA agreed with the insurance industry that the BMA would begin conducting regular prudential visits to the Class 3 and 4 insurers. During these visits the BMA may discuss with senior management the company's current and proposed activities, and any questions and concerns arising from the BMA's review of the annual statutory financial return or any other reports and information requested from the insurer.

Further to the BMA's risk based approach to supervision, The Insurance Act includes a number of early warning tests, established to provide the BMA with an indication regarding insurance companies that may have potential solvency problems (e.g. the annual statutory returns include certain statutory ratios). In addition, the principal representative must report to the BMA if he has reason to believe that the company is likely to become insolvent or is in breach of any condition imposed on its operations. The Insurance Act also requires two directors of the each insurance company and the principal representative to sign an annual certification of the company's solvency.

The Insurance Act also gives the BMA statutory powers to restrict the operations of these companies or, where appropriate, to wind up or dissolve them.

CHAPTER 6

Taxation issues

6.1 Current Bermuda law exempt status

As previously mentioned, one of the factors in choosing Bermuda as a domicile is the freedom from taxes on income, capital goods and dividends. An insurance company may apply to the Government for (and receive automatically) an undertaking that in the event that taxation is introduced, it will not be applicable to that company until the year 2016. The establishment of an insurance company should be determined by its viability as an insurance operation. Tax advantages should be viewed as an incidental, although potentially important, benefit.

6.2 United States taxation

(i) Tax convention

On July 11, 1986, the governments of Bermuda and the U.S. signed a convention (the "Convention") relating to the taxation of insurance enterprises and mutual assistance in tax matters. The Convention was subsequently ratified by the U.S. Senate on October 22, 1988. The Convention was important in maintaining Bermuda's position as one of the premier offshore captive domiciles.

A significant benefit of the Convention is the inclusion of a definition of "permanent establishment". This term is defined at some length, but essentially means a regular place of business through which the business of the insurer is wholly or partly carried on. If the insurer does not carry on business through a permanent establishment, the business profits attributable to the permanent establishment will not be taxed in the U.S.

(ii) U.S. controlled foreign corporations

The U.S. Internal Revenue Code provides that any U.S. person who owns, directly or indirectly, or is considered to own through related parties, 10 percent or more of the total combined voting power of all classes of stock of a foreign corporation will be considered to be a U.S. 10 percent shareholder. In general, a foreign corporation is treated as a "controlled foreign corporation" or "CFC" only if its U.S. 10 percent shareholders collectively own more than 50 percent of the total combined voting power or total value of the foreign corporation's stock. The consequence for such U.S. 10 percent shareholders is that they must include their pro rata share of the Subpart F income of such controlled foreign corporation, whether distributed or not, in their U.S. taxable income. However, for purposes only of taking into account Subpart F insurance income, a foreign corporation will be treated as a CFC if (i) more than 25 percent of the total combined voting power or total value of its stock is owned by U.S. 10 percent shareholders, and (ii) the gross amount of premiums or other consideration in respect of Subpart F insurance income exceeds 75 percent of the gross amount of all premiums or other consideration in respect of all risk.

(iii) Related person insurance income

A different definition of "controlled foreign corporation" is applicable in the case of a foreign corporation, which earns "Related Person Insurance Income" (or "RPII"). The Internal Revenue Code defines RPII as any "insurance income" attributable to policies of insurance or reinsurance with respect to which the person (directly or indirectly) insured is a shareholder of the foreign corporation or a "related person" to such shareholder, i.e., where the foreign corporation insures its own shareholders. A corporation will be treated as a CFC if its RPII shareholders own, directly or indirectly, 25 percent or more of the total combined voting power or value of the foreign corporations' stock on any day during a taxable year. The consequence is that RPII shareholders must include their allocable share of RPII in their U.S. tax returns. The term "RPII shareholder" includes all U.S. persons who own, directly or indirectly, any number of shares of the foreign corporation. However, there are certain exceptions to the application of the RPII rules.

(iv) The domestic Section 953(d) election

Depending upon the particular facts and circumstances of a foreign insurance company, such company may be eligible to make the domestic election.

(v) U.S. Federal Excise Tax

The U.S. imposes an excise tax on insurance and reinsurance premiums paid to foreign insurers or reinsurers with respect to risks located in the U.S. The rates of tax applicable to premiums are four percent for directly-written casualty insurance premiums and one percent for life and reinsurance premiums.

KPMG in Bermuda's U.S. tax department is one of the largest and most experienced tax services groups in Bermuda. Its professionals provide compliance and advisory services to address the very unique needs of the insurance industry. For further information regarding U.S. tax, please contact Catherine Sheridan-Moore (see Appendix 4).

6.3 United Kingdom taxation

A U.K. company may be subject to taxation on the undistributed profits of certain U.K. controlled, but non-resident, companies in which it has a 10 percent or greater interest. This rule generally applies to captive insurance companies that are U.K. controlled, unless the captive pays a dividend to U.K. residents of 90 percent of the profits available. Therefore, as in the case of a U.S. controlled captive, tax planning for a U.K. controlled captive is prudent.

CHAPTER 7

Exit strategies

7.1 Why consider closure?

Insurance companies (captive or otherwise) which are in run-off (i.e. no longer writing new business) can over time create anxieties of various forms for a company's directors, managers, staff and shareholders, and even in certain circumstances, its creditors. In particular, it is likely that the costs of conducting the run-off will become increasingly disproportionate in comparison to the level of activity and size of outstanding liabilities. Accordingly, shareholders and directors will be concerned that:

- the capital tied up in the run-off entity is providing a poor return (if any);
- the company's profitability remains critically exposed to aspects outside its control such as the development of new types of claims arising on policies written many years ago, and the increasing risk of the failure of reinsurance security;
- the company's ability to maintain levels of service becomes impaired due, for example, to the loss of key staff or reliance on aging computer systems; and
- management time is being diverted from developing on-going areas of business.

In addition, staff and managers of the run-off entity will be concerned about their long-term employment prospects and possibly to some extent, the level of job satisfaction.

Creditors, on the other hand, may be concerned about the company's long-term solvency and its ability to pay claims as and when they fall due for payment in the future.

These concerns may all be capable of being addressed by a well thought out closure strategy. This would provide certainty over the level of liabilities, allow for the release of surplus capital and free up management and staff to be deployed on more profitable or rewarding ventures.

7.2 What closure options are available?

There are a number of alternative closure strategies that may be considered by an insurer, the most appropriate option, or combination of options, will depend upon the particular circumstances of the company. In particular, the strategy adopted will depend to some extent on the principal driver for the closure, the timescale, the quality of the company's records and the degree of finality required.

The early closure options currently available to be considered are:

- portfolio or whole account reinsurance;
- commutation and/or policy buy back programme;
- sale of the company;
- alternative risk transfer (ART) products; or
- scheme of arrangement.

These alternative approaches are discussed in more detail in Section 7.3. Regardless of the option, or combination of options, active management of the closure, including specialist financial and legal advice will be required to ensure that the different and sometimes competing interests of shareholders, policyholders, creditors and regulators are properly and fairly addressed.

7.3 The closure options

(i) Portfolio or whole account reinsurance

This type of reinsurance can take various forms but essentially the effect is that the company reinsures all its remaining liabilities with another reinsurer. The reinsurer would typically be responsible for the handling and management of the reinsured's claims and in dealing with other pre-existing reinsurance arrangements.

Advantages

- Relatively quick to put in place as the contract wording is usually fairly straight forward and the reinsurer could undertake the necessary investigations/due diligence for premium pricing purposes in a relatively short period.

Disadvantages

- not real finality as the company:
  - must remain in existence (all existing contractual relationships and obligations remain unaffected);
  - retains a risk that the portfolio reinsurer will always be able and willing to meet its obligations under the portfolio reinsurance treaty; and
  - will by necessity be involved in any legal disputes (as writs will be served on it, or actions will be taken in its name).
- the company retains a reputational risk, since it is the reinsurer who will be performing the run-off and may do so in a manner which is inconsistent, or adversely affects, the reputation of the company (or the group);
- the cost of the reinsurance premium for the portfolio reinsurance contract may be expensive especially if the reinsurer has a different view on the adequacy of the company's loss reserves and provisions for irrecoverable reinsurance; and
- will not trigger a capital loss for tax purposes (if applicable) for the company's shareholders. Generally not an issue for Bermuda incorporated companies but may be for their foreign subsidiaries.

(ii) Commutation and/or policy buy back programme

A commutation is the termination of an insurance contract between the insurer and the insured upon payment by the insurer of a commutation payment, which is a sum agreed between the two parties, and which approximates the net present value of the total anticipated future losses under the contract. A policy buy back is effectively the extinguishment or rescission (i.e. as if it never existed) of a contract between an insurer and an insured, upon payment by the insurer of a return premium. As in a commutation the sum agreed between the two parties will approximate the net present value of the total anticipated future losses under the contract.

A feature of any commutation or policy buy back programme is that separate agreement will need to be reached with each and every insured (on the inwards book) and, unless potential reinsurance recoveries are to be abandoned, with each and every reinsurer (on the outwards book).

Advantages

- it may be possible to agree claims at lower values than would have emerged had the contracts been run-off to their natural expiry;
- the termination or extinguishment of inwards contracts through commutation or policy buy back is a full and final settlement and eliminates the potential for future deterioration in the loss reserves of those contracts; and
- as contracts are commuted (or bought back) there will be a consequent reduction in administration and the associated administration costs. A point may be reached, however, whereby additional commutations result in minimal savings as there will be a base level of costs, which will be, incurred whatever, while the company continues to exist.

Disadvantages

- in order to achieve a commutation (or policy buy back) the insured must agree to the proposed cut-off arrangement. The insured is not obliged to agree to any proposal and it is likely that it will not be possible to effect commutation agreements with all the company's insureds and therefore there will not be total finality;
- negotiations and agreement of commutation agreements can be a slow and time-consuming process. It may take several years to effect commutations of merely the major contracts;
- separate commutations will need to be effected with reinsurers. To the extent these are commuted prior to the related inwards business there is a risk that the company may become exposed on a gross basis to any escalation in inwards claims. Conversely, if the inwards contracts are commuted first, it may be difficult to agree and account for this with reinsurers; and
- the cost of negotiating and agreeing a commutation of a contract with a small level of outstanding liabilities may be greater than the cost of running it off to its natural expiration.

(iii) Sale of the company

It may be possible to sell the company, therefore providing finalization for the company's current shareholders. The liabilities in the company will not, however, be affected by the sale and so matters are not necessarily finalized for the managers or employees, unless alternative run-off management arrangements are put in place as part of the sale.

Advantages

- achieves finality for the shareholders unless guarantees or warranties are provided by them in connection with the sale;
- if a willing buyer can be found the sale may be capable of being finalized relatively quickly;
- requires no involvement or agreement with the company's policyholders or reinsurers; and
- could trigger a capital loss for tax purposes (if applicable) for the company's shareholders.

Disadvantages

- a buyer of a company in run-off would likely require a substantial discount to the net asset value;
- the sale would require regulatory approval;
- there may be adverse tax implications for the current shareholders of the company e.g. crystallization of a capital gain (if applicable); and
- there may be possible reputational risks if the new owners adopt an aggressive commutation policy and/or a harsh line on approval of claims, which creates bad feelings towards the former parent company (or group).

(iv) Sale of the business (novation)

The sale of an insurance business, not involving the sale of the company itself, must involve the novation (or possibly the reinsurance on a whole account basis) of the policies written by the company and also of the reinsurance policies taken out by the company.

A novation involves the transfer of the policy from one party (one of the original contracting parties to the policy) to a new party. The other original contracting party must, however, agree to the novation of the policy to this new party.

In Bermuda there is no statutory portfolio novation procedure available for general insurance business (as in the U.K.) and so individual consents will be required from each insured (and reinsurer). An insurance company authorized in the U.K. may, after making the requisite application to the Regulator and upon both receiving approval, and complying with the required notification procedures, novate its entire inwards book (or designated lines of business) to a new insurer without the requirement to obtain individual consents from each insured.

The company must agree a price (novation premium) with the reinsurer to which the contracts are being novated, which, as in the case of reinsurance or commutation, will typically approximate to the discounted value of the future liabilities under the contracts.

Advantages

- will achieve finality quicker than allowing the policies to run-off in the normal course, but there is no requirement for policyholders to agree and so it is likely that some policies will remain un-novated; and
- once the policies are novated there is no further liability to the company and any future deterioration in claims falls to be borne by the company to whom the polices have been novated.

Disadvantages

- there is no guarantee that all policyholders will agree to the proposed novation and so it is unlikely that finality will be achieved;
- the administrative costs of negotiating and agreeing the novations may be disproportionate in relation to underlying liabilities, especially in relation to policies with small levels of outstanding claims;
- it may be difficult to find another insurer who is willing to assume the policies by way of novation from the company, or to assume them at an economic cost; and
- separate novations of the company's outward reinsurance contracts will need to be effected. To the extent that these are not novated to the party to whom the inwards contracts have been novated there will be inevitable administrative difficulties and possible future recoverability problems.

(v) ART mechanisms

There are a variety of ART products in existence and which seek to address different needs of individual insurers. The principal categories either involve the securitization of insurance risk or the purchase of insurance receivables. In all cases, however, the company's obligations under the original policies remain with the company and what is transferred in one form or another is generally either the credit and timing risk associated with the collection of reinsurance receivables or the deterioration in loss reserves.

ART mechanisms often involve the creation of a special purchase vehicle ("SPV") which may, for instance, purchase the reinsurance receivables of the company for an agreed sum. The SPV will fund this by issuing asset backed debt securities to investors who have no recourse other than to the assets backing the securities.

Advantages

- ART products can be very flexible and be adapted to meet the individual requirements of the company;
- they do not require policyholder or reinsurer approval for the arrangements; and
- ART options provide the company with access to larger and wider finance markets.

Disadvantages

- they do not provide complete finality. In the same manner as in reinsurance arrangements the original risks remain with the company;
- ART products are a comparatively expensive alternative to traditional reinsurance; and
- ART products do not typically relieve the company of the administrative burden of processing transactions.

(vi) Scheme of Arrangement

A scheme of arrangement is a compromise of arrangement provided for by statute (Section 99 of The Companies Act) between a company and its creditors, or any class of them, and becomes legally binding on all creditors (or the particular defined class of creditor) if:

- more than 50 percent by number, representing more than 75 percent by value, of creditors (or class of creditors) voting at a meeting called to consider the proposals vote in favor of the arrangement; and
- the arrangement is sanctioned by the court and a copy of the Order is delivered to the Registrar of Companies for registration.

Once sanctioned the scheme is binding on all creditors (or creditors within the class) regardless of whether they had notice of the meeting to approve the arrangements or whether they voted in favor of it or not. The scheme is a flexible arrangement in which the company essentially enters into a new contract ("the scheme") with its scheme creditors which modifies the pre-existing contractual arrangements with those creditors.

A scheme for a solvent company, will take the form of a cut-off scheme whereby the value of all the company's (or the class) liabilities (including contingent and unquantified claims) are estimated and a once and for all dividend paid to creditors.

Advantages

- a scheme is a flexible arrangement in which the company can effectively propose whatever it wishes. It must be remembered, however, that the proposals need to be approved by creditors (or class thereof) and therefore in order to achieve the requisite majorities they must be viewed by them as favorable, or at the very least as non-prejudicial to their current position;
- it is an established and accepted procedure with a number of solvent schemes already successfully implemented; and
- provides true finality as all creditors are bound by the scheme provisions once it is sanctioned. This enables the company to avoid the risk of increases in claim reserves and irrecoverable reinsurance. It will also eliminate further administrative costs (and free up management time) once the scheme is finalized.

Disadvantages

- there is no guarantee that the scheme proposals will be accepted by creditors or sanctioned by the court. This risk can however be minimized by taking expert financial and legal advice.
- substantial preparatory work will often need to be undertaken in order that a company can reach a position in which it may successfully promote a scheme. Such work will often involve extensive research into the nature of the company's affairs and its contractual arrangements, and also enhancement to the company's policyholder and claims records; and
- a closure via a scheme mechanism is not a quick process and it is unlikely, once allowance is made for development of the scheme, voting, agreement, adjudication and payment of claims, that the process will be completed in much less than 18 months.

For further details regarding Schemes of Arrangement, see Appendix 2 or contact Malcolm Butterfield or Mike Morrison (see Appendix 4).

7.4 Options summary

	Portfolio Reinsurance	Commutation	Sale of Company	Novation	ART	Scheme
Likely to achieve finality	–	–	✓*1	–	–	✓
Likely to reduce administration costs	✓	✓	✓	✓	–	✓
Likely to be a relatively quick process	✓	–	✓	–	✓	–
Does not require agreement of all policy holders	✓	–	✓	–	✓	✓
Accelerates payments to creditors	–	✓	–	–	–	✓
Claims liabilities capped	–	✓	✓*2	✓	✓*3	✓

Notes

1. Finality achieved for existing shareholders provided no guarantees or warranties provided.

2. Claims liabilities are capped so far as impacts existing shareholders provided no guarantees or warranties given as part of the sale. The actual claim liabilities of the company are unaffected by the sale.

3. Claim liabilities may be capped (likely up to a set limit) under certain ART products.

7.5 Which option or combination of options?

Which option or combination of options is most appropriate for the company will depend upon its particular circumstances and the principal reasons driving the desire for closure. If the company wishes to achieve finality then the solvent scheme is likely to be the preferred option, as all other alternatives (other than selling the company) do not provide true finality in an acceptable timescale. It is possible that certain elements of a company's business would not be appropriately dealt with in a scheme and in such cases it may be preferable to deal with these areas of the business by, for example, novation or commutation prior to the promotion of the scheme.

The remainder of this paper considers only scheme of arrangements since this is likely to be the preferred exit route and also the one where the actual process is likely to be least well known.

CHAPTER 8

KPMG in Bermuda

8.1 Local presence

KPMG in Bermuda has 11 partners and approximately 170 staff, making us one of the largest professional services firms on the Island. We are a leading provider of audit, tax and financial advisory services.

The key to our success in the Bermuda reinsurance market is the talent of our people. We believe that the depth of our technical skills and resources, industry experience and commitment to service is unrivaled. Our management group has extensive experience in the reinsurance industry.

Our clients include professional reinsurers, SEC registrants, property catastrophe, liability and structured risk reinsurance companies, captive insurers, association captives, rent-a-captives, industry mutuals, insurance pools, P&I clubs, direct writing companies, insurance brokers, insurance managers and other specialty companies.

The business written by our clients is concentrated in property and casualty reinsurance and a large number of our captive insurance clients reinsure workers' compensation, automobile and general liability risks. Our broad experience enables us to provide services to companies whose business covers a very diverse range of insurance products including specialized lines such as product warranty, credit life, environmental liability, employment practices liability, medical malpractice, E&O, D&O, libel, loss portfolio transfers and financial reinsurance. We also have an increasing number of clients writing life and annuity business.

Our client portfolio includes a number of the largest Bermuda reinsurance companies and a substantial number of Bermuda's major insurance pools, captive companies and industry mutuals.

8.2 KPMG International

KPMG has achieved its standing as a leading global audit, accounting and advisory services firm by delivering the highest quality service which provides significant added benefits to our clients.

For many years, KPMG has played a leading role in providing audit, accounting, tax and advisory services to the insurance sector and has developed a worldwide group of professionals with the necessary experience to serve this industry. Insurance companies are an important part of the financial services sector and KPMG has developed networks of professionals worldwide with specific skills to focus resources on the components of this sector.

KPMG professionals have in depth knowledge of local regulatory and tax matters that affect insurance companies, as well as on-going contacts with lawyers, banks and insurance managers which can be invaluable in the set-up and administration of captive insurance companies. KPMG professionals in Bermuda have access to an extensive network of colleagues globally.

We are confident that this group of professionals can provide you with the advice you need and the service you expect from one of the world's leading global professional services firms.

8.3 Professional services

The core professional services we provide to our clients include:

Audit – Our audit group provides services to clients across the Bermuda market. These companies report under U.S., Canadian, and International accounting standards. As a PCAOB registered firm, we also provide audit services to SEC registrants including reporting on Internal Control over Financial Reporting.

Tax – KPMG in Bermuda was the first firm to provide U.S. tax services in Bermuda. Today our tax department of 20 professionals, is the largest and most experienced in Bermuda and is quite possibly the largest and most experienced tax services group in the world that is dedicated to the offshore insurance industry. We provide a variety of compliance and advisory services addressing the unique needs of the offshore reinsurance industry.

Information Risk Management – In the fast moving area of information technology it is a constant challenge for companies to balance business goals with the risk of using (or not using) technology. KPMG understands the need to take advantage of technology but we also are aware of the risks involved and responsibilities to control these risks. KPMG's Informational Risk Management Group advises on risks associated with information technology. This includes audits of secure e-business infrastructure, penetration testing, control design and implementation, disaster recovery and business continuity planning.

Internal Audit – KPMG's internal audit group comprises industry and internal audit professionals. Our internal audit services help clients focus on strategic business risks and develop strategies and practical ways to manage those risks. Services range from initial risk assessment, ad-hoc audits to co-sourced or outsourced relationships. Our dedicated Bermuda group is also able to draw upon KPMG's global network of resources to deliver meaningful and pragmatic advice.

Actuarial – We have three actuaries on staff in Bermuda providing advisory and compliance services. As well as supporting our audit teams, our actuaries also assist clients with property/casualty loss reserving (including regulatory opinions); risk transfer and cash flow analysis; pricing and product design; feasibility studies and dynamic financial analysis including asset and liability management and capital adequacy.

Financial Advisory Services Limited – Our team of 20 professionals advise in specific areas of restructuring, exit strategies, run-off, commutation negotiation, schemes of arrangement and insolvency. Additionally members of the team provide forensic services to the Insurance industry.

APPENDIX 1 Highlights of Bermuda Insurance Regulations

License Category	Class 1	Class 2	Class 3	Class 4	Long Term
Type of Company	Single parent captives, risks of parent and affiliates only	Multi-owner captives and single parent captives writing up to 20 percent unrelated business	Commercial insurers and reinsurers (i.e. more than 20 percent unrelated business)	Excess liability and/or property catastrophe insurers with capital in excess of $100 million.	Life insurance and long term accident and health
Minimum Capital to Obtain License	$120,000	$120,000	$120,000	$1,000,000	$250,000
Minimum Solvency Margin Statutory Capital & Surplus must exceed the greater of: (i) Minimum Capital and Surplus	$120,000	$250,000	$1,000,000	$100,000,000	$250,000
(ii) Premium Test ■ First $6 million NPW, plus	20 percent	20 percent	20 percent	50 percent (maximum deduction for reinsurance of 25 percent of GPW)	N/A
■ Excess of $6 million NPW	10 percent	10 percent	15 percent		N/A
(iii) Loss Reserve Test (net reserves)	10 percent	10 percent	15 percent	15 percent	N/A
Liquidity Ratio	Relevant assets must exceed 75 percent of defined liabilities. (Relevant assets see Note 1 below)	Relevant assets must exceed 75 percent of defined liabilities. (Relevant assets see Note 1 below)	Relevant assets must exceed 75 percent of defined liabilities. (Relevant assets see Note 1 below)	Relevant assets must exceed 75 percent of defined liabilities. (Relevant assets see Note 1 below)	N/A
Deadline for filing annual return	6 months (on application max 9 months)	6 months (on application max 9 months)	4 months (on application max 7 months)	4 months (on application max 7 months)	4 months (on application max 7 months)
Information to be filed in annual return	Cover Sheet Solvency Certificate Declaration of Ratios Auditor's Report	Cover Sheet Solvency Certificate Declaration of Ratios Statutory Financial Statements Auditor's Report Loss Reserve Specialist Opinion (triennial)	Cover Sheet Solvency Certificate Declaration of Ratios Statutory Financial Statements Auditors' Report Loss Reserve Specialist Opinion	Cover Sheet Solvency Certificate Declaration of Ratios Statutory Financial Statements Schedule of ceded reinsurance Auditors' Report Loss Reserve Specialist Opinion	Cover Sheet Solvency Certificate Actuarial Opinion Statutory Financial Statements Auditor's Report
Loss Reserve Specialist Opinion	No requirement (annually if discounting to meet solvency margin or more than 30 percent professional liability business written)	Triennial (annual if discounting to meet solvency margin or more than 30 percent professional liability business written)	Annual	Annual	Annual opinion by life actuary
Failure to meet solvency margin	Principal representative to report to Minister within 30 days	Principal representative to report to Minister within 30 days	Cease paying dividends. Within 30 days report on how company intends to comply with solvency margin.	Cease paying dividends. Within 30 days, report on how company intends to comply with solvency margin. If capital and surplus falls below $75,000,000, additional reporting requirements.	Principal representative to report to Minister within 30 days.
Dividend Restrictions	Company must comply with minimum solvency/liquidity requirements after dividend (see above)	Company must comply with minimum solvency/ liquidity requirements after dividend (see above)	Company must comply with minimum solvency/liquidity requirements after dividend (see above)	If dividend greater than 25 percent of statutory capital and surplus, require affidavit signed by two directors and Principal Representative stating that margins still met after dividend	Dividends to shareholders must not reduce long-term fund surplus below $250,000.
Reduction of statutory capital	Approval by Minister of Finance required for any reduction in total capital of 15 percent or more below that included in previous years financial statements	Approval by Minister of Finance required for any reduction in total capital of 15 percent or more below that included in previous years financial statements	Approval by Minister of Finance required for any reduction in total capital of 15 percent or more below that included in previous years financial statements	Approval by Minister of Finance required for any reduction in total capital of 15 percent; also, affidavit signed by two directors and Principal Representative stating margins still met	Approval by Minister of Finance required for any reduction in total capital of 15 percent or more below that included in previous years financial statements

Note 1 – Relevant assets exclude investments in non-insurance advances to subsidiaries and affiliates, unquoted equity investments and real estate.

APPENDIX 2

The Scheme of Arrangement

1.1 The process to launch the scheme of arrangement ("the scheme")

It is highly recommended that the company take professional advice (preferably from the proposed scheme supervisors) early on in the planning as this will undoubtedly speed the process by identifying likely obstacles and matters that will need to be specifically addressed either prior to, or as part of, the proposed scheme. The proposed scheme supervisor will also assist in the design of the scheme and the drafting of the scheme document. KPMG has extensive experience of providing advice and assistance to companies wishing to finalize all or part of their insurance activities and in particular, have advised and acted in relation to a number of insurance company schemes of arrangement.

Stage I – Strategy and analysis

- identify and agree principal objectives;
- identify potential problem areas;
- assess adequacy of systems and personnel, quality of data, and attitude of the regulator;
- identify current costs of the operation and quantify anticipated costs of the scheme;
- review the company's business, identifying matters such as guarantees, security arrangements, reinsurance programmes, reserving methodology and claims profile; and
- perform a cost/benefit analysis.

Stage II – Pre-scheme actions

- address those aspects of the company's business that will not be included within the scheme (e.g. to be dealt with by novations and/or commutations);
- devise scheme proposals;
- prepare a mailing list of scheme creditors and potential creditors. This may involve an extensive exercise involving review of policy records and/or access to brokers' records;
- put in place systems so that a principal to principal ledger can be created;
- prepare financial information for the explanatory statement to the scheme. This may involve actuarial input for a loss reserves valuation; and
- draft scheme document.

Stage III – Voting and scheme meeting

- the Court agrees to the calling of a scheme meeting;
- the scheme documents (comprising the scheme of arrangement, explanatory statement and proxy/voting forms) are distributed to all creditors and potential creditors;
- scheme meeting held at which votes are counted and if requisite majorities are achieved, proposals are approved; and
- scheme sanctioned by court and registered with the Registrar of Companies.

Stage IV – Scheme effective

- creditors submit final claims before the bar date prescribed in the scheme; and
- creditors' claims are agreed, and any which cannot be agreed within the predetermined period will be forwarded to an independent scheme adjudicator. The adjudicator would then have a predetermined period in which to make a binding adjudication.

Stage V – Scheme payments

- agreed scheme claims (net of applicable set-off) are paid out in accordance with the scheme terms; and
- outstanding security issues are dealt with.

Stage VI – Closure

- scheme is terminated;
- liquidation of company; and
- distribution of capital to shareholders.

We would estimate that the entire process (subject to any major unforeseen circumstances) could be completed in approximately 18 to 24 months.

Throughout the entire period the company will continue to collect reinsurance recoveries. A commutation strategy with reinsurers should be considered, and at some point before closure, consideration can also be given to assigning uncollected reinsurance recoveries (including sums due from insolvent companies on which a pro rata dividend will ultimately be receivable) to another party such as a specialist debt trader.

1.2 Potential scheme issues

There are a variety of issues that will need to be considered as part of the scheme process, some which may be unique to the company and others that are likely to be applicable to most companies. Some of the likely general considerations are:

- identification of the name and address of all scheme creditors and potential creditors. This is required for the preparation of a mailing list for the distribution of the scheme document;
- preparation of a principal to principal ledger (this may also involve valuing and allocating IBNR claims to individual principals);
- commutation of reinsurance outwards balances (or some other form of agreement with reinsurers or at least major reinsurers);
- negotiation with creditors who currently have the benefit of security, such as letters of credit;
- consideration as to whether a Section 304 (U.S. Federal Bankruptcy Code) order is required to enforce the provisions of the scheme on scheme creditors located in the U.S.;
- potential set-off issues; and
- identification of any fronting or pooling arrangements, especially in those circumstances where the company does not account for the arrangements in a manner, which fully reflects the true contractual relationships between the parties.

In addition to the above issues other matters will inevitably arise. KPMG have extensive experience of schemes and have worked with many companies in resolving these and other issues and can provide advice on the most appropriate manner in which to approach these difficulties.

APPENDIX 3

Useful addresses and Web sites

Bermuda Insurance Institute
Cedarparkade, 48 Cedar Avenue, Hamilton HM 11 Bermuda
Tel: +1 441 292 9829
www.bii.bm

The Bermuda Monetary Authority
Jardine House, 33-35 Reid Street, Hamilton HM 11 Bermuda
Tel: +1 441 295 5278
www.bma.bm

Government Information Services
Global House, 43 Church Street, Hamilton HM 12 Bermuda
Tel: +1 441 292 6384
www.gov.bm

KPMG in Bermuda
www.kpmg.bm

KPMG International
www.kpmg.com

Bermuda Communications Directory
www.bermudabusiness.com

Bermuda Insurance Management Association
www.captive.com

Bermuda Insurance Market
www.bermuda-insurance.org

Bermuda International Business Association
www.biba.org

Bermuda Stock Exchange
www.bsx.com

The Bermuda Sun
www.bermudasun.org

The Royal Gazette
www.theroyalgazette.com

APPENDIX 4

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