Cayman Islands

SPECIAL REPORT OF

THE AUDITOR GENERAL

on the

Cayman Islands Government's
Property Insurance Settlement - Post Ivan

Cayman Islands Audit Office

February 2007

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Auditor General's Report

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Executive Summary

1.01 Grand Cayman suffered extensive damage during the passage of hurricane Ivan over the Cayman Islands on September 11 and 12, 2004. The Cayman Islands Government ("CIG" or "the Government") experienced significant damage and loss of assets due to the savage hurricane. These assets were insured with a local insurance firm, Cayman General Insurance ("CGI" or "the Company").

1.02 The Company claimed to have experienced financial difficulties and stated that it was unable to meet all of its insurance claims obligations stemming from hurricane Ivan. As such, the Company approached the Government and expressed its inability to honour the full amount of its insurance claim. This commenced a series of discussion with senior Government officials, including Cabinet members and senior management of the Company with the aim of coming to a reasonable agreement.

1.03 The exact insurance claim was never calculated, but the Company and the Government reached a settlement position of $70 million from an initial estimate, established by the loss adjusters to be $108 million. A written agreement between the Company and the Government was finalised on 21 April 2005 with the Government receiving $50 million in cash and a 24% shareholding (240,000 shares out of 1,000,000 shares) in Cayman General Insurance for the balance of the $20 million of the $70 million 'settlement position.' This meant that the cost of the Government's shareholding in CGI was between $83.33 and $241.66 per share.

1.04 Subsequent to this transaction, an established Insurance company purchased a controlling interest (51%) in Cayman General Insurance for $8 million in November 2005. This meant that this company paid $15.69 per share, which is between 5 and 15 times less per share than what the Government secured with CGI.

1.05 My Office had some concerns with this insurance settlement transaction generally and especially in the method of the exact determination of the insurance settlement amount and the foregoing of $20 million or more of that settlement for 24% shareholding of the Company, when another company acquired a much more strategic portion of CGI for a substantially lesser sum.

1.06 Based upon my review, I have concluded that the Government did not receive good value for money for the insurance transaction. I estimate that the shares which were given to the Government for a consideration of between $20 million and $58 million are currently worth less than $3 million. This is based on our own calculation, the independent auditor's estimated fair value and in comparison to the subsequent purchase of shares by another insurance company.

1.07 I also wanted to determine if the Risk Management Unit of Government, responsible for adequately insuring all of Government's assets, have been able to learn from this unfortunate hurricane event and have been able to manage their risks properly going forward. My conclusion is that although the Government has diversified its coverage and therefore may not be in a similar situation regarding property insurance, it has not done a valuation of its property assets since 2000, although one was scheduled to be done in October 2004. As a result, the Government is running a risk of being significantly under insured.

1.08 This Report has been discussed with senior officials of CGI and CNC and their lawyers.

1.09 The Report has also been presented to the Lands and Survey Department which has also provided comments on behalf of the CIG in relation to the post Ivan insurance coverage policy.

1.10 My Office initially submitted this Report to the Financial Secretary on December 5, 2006 for him to provide feedback. A second request was sent on January 3, 2007. With no response forthcoming, we re-submitted our request to the Financial Secretary for feedback and comments on January 19, 2007. Based on this third request, the Financial Secretary stated that he would provide a reply by January 26, 2007. However, even the self imposed deadline was not met and we did not receive any feedback on the promised date. On February 5, 2007, two months after the initial request we sent a final reminder to the Financial Secretary for comments. These were received on February 7, 2007 and are attached as **Appendix 1** to this Report.

Audit Objectives

1.11 My Office performed an audit of the Government's property insurance settlement claim and the acquisition of the 24% shareholding in Cayman General Insurance. The main questions asked at the start of this audit were:

- What was the precise amount of the Government's insurance claim and what was the final cash settlement?
- What were the circumstances surrounding the eventual acquisition of a 24% share of Cayman General Insurance by the Government?
- Did the Government receive good value for money from the entire insurance transaction?
- What are the current circumstances regarding the Government's insurance of its physical assets?

Scope and Methodology

1.12 During the audit, we looked at the sequence of events from the submission of the property insurance claim to its eventual settlement. Interviews were conducted with persons involved with the transactions to gather relevant evidence and relevant documents were requested and reviewed when available and shared.

1.13 Financial data of Cayman General Insurance for the accounting years ended 30 September 2002, 2003, 2004 and 2005 have been reviewed and key ratios utilised to provide an indication of the value of CGI and the reasonableness of the consideration forgone for the shareholding received. Relevant supporting documents such as the share certificates and the signed agreement were also obtained to corroborate the information collected.

1.14 Share price was benchmarked with the subsequent sale of CGI shares to Sagicor, to provide some indication as to the cost of CGI's shares and whether Government received good value for the shares obtained.

Circumstances Surrounding Government's Acquisition of Shares

Negotiations between the Government and CGI

2.01 The Government had property insurance claims arising from the damage and destruction caused by hurricane Ivan against CGI under Property Insurance Policy No. 13AR04040273. Immediately after the hurricane, the destruction of Government's assets was communicated to its Insurance Broker (Willis) and CGI. The Government then started a process of assessing and compiling a list of damaged assets to provide the basis on which the insurance claim would be prepared. This detailed compilation of damaged assets was aborted and a series of negotiations commenced in order to arrive at an early settlement as it was felt that the normal claim adjustment process would be an expensive and protracted exercise. Given the extent of the damage, it was estimated by those concerned that the settlement through this route could take between eighteen and thirty-six months.

2.02 In my opinion, this decision to not finalize an initial claim by the Government against CGI was not in keeping with good business practice. Without a solid evaluation of how much damage it had sustained to its property, it was impossible for the Government to make sound business decisions on what, if any, concessions should have made on its claims. In addition, the lack of a final evaluation makes an analysis of the value received by the Government in this transaction extremely difficult. It meant that there is substantial confusion about what exactly was the loss suffered by the Government as a result of hurricane Ivan. Without a firm loss number, it is impossible to say with any precision what the Government "gave up" during the course of its negotiations with CGI and ultimately whether the Government received fair value for its insurance claim.

2.03 The original, unofficial amount for the estimate of settlement established by the adjusters was $108 million. This is based on the loss adjustor's preliminary assessment of the damages sustained by various Government properties and was not formally concluded on as the subsequent negotiations precluded the adjusters from completing their detailed assessment. However, based on the normal process of claims adjustment, it could be expected that this preliminary value may have been reduced due to review by the insurance adjusters. CGI's estimates that claim settlements are usually half of the initial estimate of settlement.

2.04 In our discussions with senior officials of CGI, we were informed that the Government's settlement was the single largest individual loss that CGI faced. Although

CGI had reinsurance, it was having difficulty honouring the full amount of the Government's claim due to high pay out anticipated from the multitude of other insurance claims, the high risk carried on a single event and its financial position.

2.05 The Company indicated that the total of its initial adjuster's estimate as a result of hurricane Ivan exceeded its assets and re-insurance by about $85 Million. In the Company's view, it was faced with the following options:

- Liquidate CGI. It was felt that this option would not be palatable and could jeopardize Cayman's reputation. It would also result in claimants, including Government, receiving potentially less by way of settlement than through a more orderly arrangement.

- Cayman National Corporation (CNC), the parent company, to assist with a capital injection. CNC assessed that the maximum of its assistance would be of the order of $40 million and these funds would come from shareholders equity approximately halving the equity of the CNC Group. CNC assessed that any further contribution from the CNC Group or its shareholders was not viable. This option would also require a negotiated settlement with the major claimant (the Government). This was felt the most viable solution available to CGI.

As a result, CGI approached the Government to highlight its daunting financial position and the possible negative implications that would arise if the Company were to go into receivership. This resulted in a series of negotiations between CGI and the Government with the intention of arriving at an early settlement and a closure of the claim relating to this insurance policy. This settlement would take away the uncertainty for CGI, of dealing with the loss adjuster's initial estimate.

2.06 Negotiations between the CGI and the Government commenced in February 2005 and concluded in April 2005. In the final agreement of Compromise and Settlement, it was agreed by the two parties that the Government did have claims against CGI for property damages and that the minimum value of these claims was $70 million.

2.07 However, as stated previously, it is very unclear as to what the actual total value of the property claim was. Although both parties agreed that the claim had a minimum value of $70 Million, no evidence was provided to support that figure. However, it is my opinion that the value for the property claim would have been somewhere between the initial adjuster's estimate ($108 Million) and the agreed value ($70 Million). I have used these two figures as a high and low value of the amount of insurance loss in the subsequent analysis.

2.08 In the Agreement of Compromise and Settlement, CGI agreed to pay the Government a cash settlement of \$50 million. Based on our discussions with senior officials involved in the negotiations, there was considerable discussion about how much cash could have been paid to the Government. CGI officials indicated that based on its assets and re-insurance, it could afford to pay no more than \$50 million in cash to the Government. Negotiations between CGI and Government continued and various options were explored, which led to a short listing of the following two options:

- The Government accepting a settlement of \$50 million in cash within 30 days.
- The Government accepting \$50 million in cash and a 24% shareholding in Cayman General Insurance.

2.09 The final outcome from the negotiations was the second option; a cash settlement of \$50 million and a 24% shareholding in Cayman General Insurance.

2.10 Members of the Government's negotiation team comprised the Cayman Islands Leader of Government Business and two official cabinet members. These individuals were appointed to negotiate on behalf of the Government.

2.11 Most of these negotiations took place privately. The Audit Office has requested minutes, notes and any other relevant documents relating to these meetings. However we were informed that no formal minutes were taken during the negotiation meetings. As a result, we were unable to review any documentation on these negotiations. Our understanding of the process is based on the final agreement and on interviews with the various members of the negotiation team.

2.12 In my opinion, this lack of documentation for a negotiation of this magnitude was extremely unfortunate. Although the exact amounts of the transactions and the concessions made by the Government will never be known with any certainty since a final insurance claim was never produced, it was clear from the onset that the negotiations were predicated on the premise that the Government would be asked to make substantial concessions on its property claims and that this negotiation could involve considerable sums of money. In fact, it is clear to me that the Government's concession on its claim was a minimum of \$20 Million and could have been as high as \$58 Million (based on the original estimate). To not have kept clear records of the actions that led up to these concessions seems to flout the fundamentals of accountability and transparency that should have accompanied this transaction.

The Agreement

2.13 On 21 April 2005 the Government entered into an agreement with Cayman General Insurance and Cayman National Corporation Limited for a minimum value of $70 million of the CIG property insurance claim, comprising cash payments totalling $50 million and a 24% shareholding in CGI.

2.14 The terms of the agreement included the following:

- Within 30 days of the execution of the agreement, CGI will pay the Government $50 million of which $15 million had already been paid in October and November 2004. The balance of $35 million was received on 26 May 2005.

- CNC agreed to transfer shares amounting to 24% (240,000) of the issued share capital (1,000,000) of CGI to the Government and procure the registration of such transfer in the books of CGI on or before 01 June 2005.

- On completion, CNC delivers to the Government duly executed transfers of the shares together with the share certificates. These shares were transferred on 10 May 2005 and the certificates delivered to the Government.

- The shares shall be transferred together with the right from time to time to appoint two persons to serve as directors of CGI and CNC will take all necessary steps to ensure that such right can be effectively exercised from time to time.

- The parties agree to keep the terms and conditions of the Agreement confidential and will not disclose its terms and conditions to anyone other than their respective professional business, accounting and legal advisors (who will similarly keep the terms and conditions of this Agreement confidential) except as required by law.

2.15 The Agreement was signed by Stuart Dack and Danny Scott for Cayman General Insurance Co Ltd and by Stuart Dack and Truman Bodden for Cayman National Corporation Ltd. The Financial Secretary signed on behalf of the Government.

Confidentiality Clause

2.16 As noted above, the agreement had a confidentiality clause. This confidentiality clause required that both sides, including the Government, not disclose the details of the terms and conditions of the agreement to anyone other than to its various advisors.

2.17 Readers will note that I have not abided by this section of the agreement. I do so for the following reasons:

- I believe that my Office is not covered on the terminology of the wording of the agreement. I am not a "professional business, accounting and legal advisor" for the Government. Although my Office does provide accounting advice to the Government on occasion, both the Constitution of the Cayman Islands and the Public Management and Finance Law (from which the mandate of my Office is drawn) ensure that my Office maintains a required degree of independence from Government operations.

- More specifically, Section 59 (c) of the Public Management and Finance Law allows me to conduct investigations into the economy, efficiency and effectiveness with which any ministry, portfolio, the Office of the Complaints Commissioner, statutory authority or Government company has used its resources in discharging its function.

- Most importantly and beyond any specific wording of the Public Management and Finance Law or any other legislation, I believe that it is critical for the openness and transparency of Government operations that the Office of the Auditor General not be restricted in any way in regards to which items it may report to the Legislative Assembly and the people of the Cayman Islands. If confidentiality clauses such as this one were to have the ability to restrict the right of my Office to review such transactions, I believe that the Legislative Assembly and the people of the Cayman Islands would be ill served.

2.18 The Audit Office is extremely concerned about Government signing any contracts with confidentiality clauses. One of the Government's strategic policies is to have openness and transparency in its operations. In my opinion, the inclusion of confidentiality clause in contracts is fundamentally inconsistent with these principles and the principles enshrined in the Public Management and Finance Law. In the final analysis, I believe the government made a business transaction based on what it perceived to be the best interest of both the Government and the finance industry of the Cayman Islands. As a result, it claimed much less in insurance proceeds than it was entitled to. In making such an agreement, I believe that the Government has an obligation to be open and accountable for its decisions in this matter. A confidentiality clause seeks to make this and similar transactions less accountable and I believe that they have no place in Government agreements except in the very limited case of national security.

2.19 I thereby call on the Public Accounts Committee and indeed all the members of the Legislative Assembly to make a clear resolution that confidentiality clauses not be allowed in agreements signed by the Government except when there is a clear and pressing need to do so in the interest of national security.

2.20 I communicated with the Attorney General's Office on this matter and it was noted that the requirement of *"Clause 9* (of the Agreement) *would not bind the office of the Auditor General which is an independent office, protected by the Constitution and the Law (Public Management and Finance Law (2003 Revision) and which has mandatory and directory obligations which are set out in the Law which include the power to conduct investigations, demand and request information and the grant of access to government entities and statutory bodies. Most notably, the office of the Auditor General has a significant reporting obligation under section 60 of the Law which may tend to conflict with the intent of the Clause 9 of the Agreement."*

Remediation Costs

2.21 Our investigation also revealed that there was another element to the property insurance claim. After the insurance settlement agreement was signed, the Government was levied $5.5 million by CGI for remediation works which CIG requested CGI to negotiate on their behalf. Remediation works was carried out on Government properties immediately after the hurricane and consisted of clean up and sanitation services and attempts to minimise additional damage through waterproofing or temporarily fixing of such items as roofs and windows.

2.22 Of this amount, $5 million was budgeted for by Government in the 2005/06 budget and the actual payments were made to CGI in two instalments in November ($2,835,809) and December ($2,164,191) 2005. The Audit Office has not seen any contract or formal agreement for this remediation works to substantiate this amount and to whose responsibility this would have fallen to. After negotiations with CGI, the Financial Secretary authorised these two payments and stated that he had invoices to support a portion of these costs. The Audit Office is unclear as to if the remaining $500,000 will be paid by Government to CGI.

2.23 The payment of $5 million to CGI in effect reduces the overall insurance cash position of Government to $45 million. Normally, riders on insurance policies would cover expenses of this nature and it is likely that this remediation expense could have been reduced by Government. However, it is still reasonable to state that the overall consideration received by the Government in regard to its property settlement was $50 million.

Background Information on Cayman General Insurance

2.24 Cayman General Insurance Company Limited was incorporated as an ordinary resident company under the Companies Law of the Cayman Islands on February 20, 1984. Its principal activities are the writing of general (property & casualty) and health insurance in the Cayman Islands, for which it holds a Class "A" Insurers License under the Insurance Law of the Cayman Islands. The company also provides captive insurance management services through its wholly owned subsidiary, Cayman National Insurance Managers Limited.

2.25 Prior to the Government involvement in CGI, the company was 99.24% owned by Cayman National Corporation Limited (CNC). CNC is a publicly owned and traded company in the Cayman Islands. Cayman General Insurance registered office is located at the office of Cayman National Trust Company Ltd, Cayman National Building, 200 Elgin Avenue, PO Box 1790 GT, George Town, Grand Cayman, Cayman Islands.

Downgrading of CGI Rating by Insurance Rating Agency after Hurricane Ivan

2.26 According to a press release published in the Caribbean Net News on 31 December 2004, it was reported that A.M. Best Company had downgraded the financial strength rating of the company from A- (Excellent) to B- (Fair). It was further reported that A.M Best said that *"this rating downgrade reflects the magnitude of the damage caused by Hurricane Ivan and the significant amount of estimated losses affecting Cayman General's risk-adjusted capital position. This rating action also recognizes the anticipated substantial decline in Cayman General's capital base due to the accumulation of losses from Hurricane Ivan. As a result of the company not providing A.M. Best with hurricane loss information and a recapitalisation plan, AM Best based this rating action upon industry loss estimates and Cayman General's market share information. In A.M. Best opinion the company has limited access to substantial levels of additional capital that would return Cayman General to the secure rating range."*

2.27 The article also reported A.M Best Company as the world's oldest and most authoritative insurance rating and information source. The downgrading of CGI by A.M. Best and its expression of opinion on the company financial stability implies that the company might be in serious financial distress and without significant capital injection, there could be potential going concern issues.

Financial Highlights of Cayman General Insurance Company

2.28 To get a better understanding of the financial position of CGI prior to and subsequent to Government's acquisition of equity stockholding in it, we reviewed the Company's audited financial statements for the years ended 30 September 2002, 2003, 2004 and 2005. Selected results are summarized in **Table 1** below:

Table 1: CGI Financial Highlights 2002 to 2005

	2005 CI$	**2004 CI$**	**2003 CI$**	**2002 CI$**
Consolidated Statement of Income:				
Net underwriting income/(loss)	5,480,882	(42,307,241)	4,768,761	3,624,977
Other Income	1,723,836	430,650	524,019	639,507
Total Income/(loss)	7,204,718	(41,876,591)	5,292,780	4,264,484
Expenses	4,403,876	3,474,761	3,123,421	2,990,131
Net Income/(loss)	**2,800,842**	**(45,351,352)**	**2,169,359**	**1,274,353**
Consolidated Balance Sheet:				
Assets	38,662,619	255,371,394	24,414,704	28,846,810
Liabilities	30,022,423	292,225,990	16,173,780	23,209,828
Net Assets/(Liabilities)	**8,640,196**	**(36,854,596)**	**8,240,924**	**5,636,982**
Financed by:				
Shareholders' Equity/(Deficit)	**8,640,196**	**(36,854,596)**	**8,240,924**	**5,636,982**

2.29 Cayman General Insurance had a surplus of assets over liabilities of $5.6 million and $8.2 million at 30 September 2002 and 2003 respectively. As at 30 September 2004, its liabilities exceeded its assets by $36.9 million. This is due mainly to net loss (primarily from hurricane Ivan) of $45.4 million incurred for the financial year ended 30 September 2004.

2.30 Given the above financial results, in my opinion Cayman General Insurance was, as a result of the catastrophic losses of Ivan, in serious financial distress at 30 September 2004 and its ability to operate as a going concern was in question.

Recapitalisation of Cayman General Insurance

2.31 CGI was recapitalised during the financial year ended 30 September 2005. The parent company, CNC, contributed additional capital of $43.97 million with no issuance of new shares. This comprised a cash contribution of $41 million from CNC and the fair value of the 24% stake in the equity of the company passing from CNC to Government which was estimated to be $2.97 million. This resulted in the Company moving from a negative shareholders' equity position of $36.9 million at 30 September 2004 to a positive shareholders' equity balance of $8.6 million at 30 September 2005.

2.32 The share capital note to CGI's 30 September 2005 financial statements indicates that *"no shares were issued in connection with these additional capital contributions and as such amounts represent long term interest-free capital contributions to the Company which are intended to be subject to the same terms and conditions as share premium under Cayman Islands Law and which are not callable or redeemable at the option of CNC."*

Cayman General Insurance Shareholders at 30 November 2005

2.33 Following the recapitalisation of the Company, CNC sold 51% of its shareholding in CGI to Sagicor for $8 Million. This sale took effect on 30 November 2005. CGI's list of shareholders and their percentage shareholding at 30 November 2005 was as follows:

Table 2: Shareholders at 30 November 2005

	Shareholders	**Percentage Shareholding (%)**
1	Sagicor	51
2	Cayman National Corporation	25
3	Cayman Islands Government	24
		100

Did the Government Receive Good Value for the Shares?

3.01 In looking at the issue of whether the Government received good value for the shares in CGI, I have looked at the problem from several points of view. Most importantly, I have compared the value of the consideration given up by the Government to the subsequent purchase of the majority of the shares in CGI by Sagicor. In addition, I have reviewed the financial statements of CGI to attempt to determine the fair value of the shares obtained as well as to compare to the fair value estimate as disclosed by CGI's independent auditors.

Subsequent purchase of CGI Shares

3.02 Subsequent to the agreement of April 2005 signed by the Government and CGI, Cayman National Corporation sold 51% of its shareholding in Cayman General Insurance to Sagicor effective 30 November 2005. The sale price for these 510,000 shares was $8 million. At this price, the cost per share is computed as $15.69.

3.03 This subsequent purchase of the shares of CGI allows for an objective analysis of whether the Government obtained good value for the shares received during the property insurance transaction. However, it should be noted that the Government did not "pay" for its shares of Cayman General Insurance. Rather, it did not receive as much money from its insurance claims as it could have. As noted previously in this report, the additional amount that the Government could have received in cash from the insurance company ranged from a low of $20 million to perhaps as high as $58 million.

3.04 In the remainder of this report, we will use the consideration of the claims not received as the "purchase" price of the shares. However, it should be noted that officials of CGI strongly disagreed with this interpretation during our discussions with them. During those discussions, CGI officials stated that the acquisition of the share was a last minute addition to the Agreement and that the intention was not to "sell" the shares for that consideration. Therefore, they felt that any analysis based on that concept was inappropriate.

3.05 I accept as a fact that the shares may have been added at the end of the negotiations and the value of $50 million in cash paid was based more on what CGI could afford to pay in cash rather than what the Government was owed. However, at the end of the day, there are only two factors that I believe are relevant to this analysis:

- The Government received less on its claim than it was entitled to. It is my conclusion that the amount received was between $20 million and $58 million less than the amount that the Government could have received as legitimate losses as a result of hurricane Ivan.

- The only other item received by the Government for this consideration was the 24% shareholding in CGI. Whether it was done as part of the negotiation or at the end is irrelevant in my opinion.

3.06 Based on a perceived value of $20 million, the Government "paid" $83.33 per share for its 240,000 shares of CGI. If the ultimate consideration given up was as high as the $58 million contemplated in the preliminary assessment, the amount "paid" per share could have been as high as $241.66.

3.07 **Therefore, the share price paid by Government was more than five times that paid by Sagicor and could have been 15 times as high.**

3.08 Another way of looking at this transaction would be to value the shares obtained from CGI based on the price paid by Sagicor in November 2005. Using the share price of $15.69 paid by Sagicor, the 24% shareholding acquired by Government is equivalent to a total stockholding value of $3.8 million as compared to the $20-$58 million forgone by Government. It must be noted that the sale of shares to Sagicor took place after CNC injected substantial additional capital of $43.97 million into CGI. Therefore, it can be reasonably concluded that, had Sagicor acquired their controlling shareholding in CGI prior to recapitalisation (as had Government) the price per share would have been significantly lower than the $15.69 per share, post recapitalisation.

3.09 Another determination on the value of the Government's shares in CGI comes from our own calculation of the share price and that of CGI's independent auditors estimation of the fair value of the Government's shareholding.

Financial Ratios and Valuation of CGI's Shares

3.10 We computed key ratios and estimated the value of CGI shares at 30 September 2002, 2003, 2004 and 2005 using the Cost Approach method of share valuation. **Table 3** below summarizes these results:

Table 3: CGI Key Ratios and Share Prices for 2002 to 2005

	2005	2004	2003	2002
Key Ratios:				
Return on Investment (ROI)	32%	(123%)	26%	23%
Earnings per Share (EPS)	$2.80	($45.35)	$2.17	$1.27
Share Valuation Method:				
Share price calculated using Cost Approach (Net Assets)	$8.64	($36.85)	$8.24	$5.64

3.11 As 2004 was an extraordinary year, given the size of the losses incurred and the huge claims made by policyholders, we used the two financial years prior to the disaster and the subsequent financial year, to provide a trend and a more objective way of assessing the value of CGI's share price.

3.12 CGI's return on investments (ROI) for 2002 and 2003 were 23% and 26% respectively. CGI had a negative return on investments of 123% in 2004 due to the huge losses incurred in that year as a result of the hurricane Ivan insurance claims. The company was restored to a positive ROI of 32% in 2005 following the recapitalisation of the company and the realisation of a net income of $2.8 million for that financial year. The earnings per share (EPS) trend is similar to that of the ROI. Except for 2004, the year of the disaster, there were continuous increases in CGI's earnings per share.

3.13 ***Share Valuation Using the Cost Approach/Net Assets*** – This method of valuation is based on the premise that a prudent valuator would pay no more for an asset than its replacement or reproduction cost. In this method we obtained the aggregate value of the company's assets and netted this amount against the estimated value of all liabilities resulting in the estimated value of shareholders equity. The estimated shareholders equity value is divided by the number of shares to derive the share price. While this figure can be used as a base value, it is fair to say that usually a company's underlying assets are worth more than their fair market value. The value of assets synergies and intangible assets such as reputation are not accounted for in this method. In addition the value of the company assets were ascertained from CGI's audited financial statements and fixed assets were stated at historical costs.

3.14 Using the cost method of valuation, CGI's price per share at 30 September 2004 was negative \$36.85. This meant that the Company was insolvent at the time of Government's 'investment' in CGI and the shares were actually worthless considering that there were valued at substantially less than it's nominal value of \$1.00.

3.15 Except for the negative share price in 2004, the share price for CGI for the years 2002 to 2005 ranged between \$5.64 and \$8.64 as per Table 3 above. These share prices, although positive are significantly lower than that paid by Government for its 24% shareholding. As indicated earlier, with the range of \$20-\$58 million forgone, Government would have paid between \$83.33 - \$241.66 per share compared to a share price which ranged from \$5.64 to \$8.64 as computed. At these share prices of \$5.64 and \$8.64 the 240,000 shares acquired by Government would have valued at \$1.4 million and \$2.1 million indicating an over-valuation of shares of \$18.6 million and \$17.9 million when compared to the lower amount of the \$20 million forgone. However, if we were to compare these valuations to the \$58 million forgone, these shares would be overvalued by \$56.6 million and \$55.9 million.

Estimated Fair Value of CIG's 24% Shareholding in CGI per the Company's Auditors

3.16 Note 6 (ii) of CGI's audited financial statements at 30 September 2005 disclosed that the fair value of Government's 24% shareholding was estimated at \$2,970,000. Using this estimated fair value of \$2,970,000 for 240,000 shares, equates to a share price of \$12.38 per share. Based on the \$20 million settlement forgone, the Government obtained the shares in CGI for \$83.33 which is \$70.95 more than (or approximately six (6) times) the fair value per share. However, based on \$58 million settlement forgone, the shares in CGI would have been obtained for \$241.66 which is \$229.28 more than (or approximately nineteen (19) times) the fair value per share. Since cash flows were an issue for CGI, the Government could have negotiated for a larger stockholding in the Company. At a share price of \$12.38 the Government could have obtained 100% shareholding of the company for \$12.38 million, a far cry from the \$20-\$58 million forgone.

Conclusion

3.17 As an auditor, I am often required to determine a "fair" value of assets including shares held. In this case, I believe that the evidence is clear and compelling. As of the fall of 2005, the value of the Government shares of CGI was slightly less than $3 million. Given that the Government had given up a consideration of between $20 million and $58 million, it is my opinion that the Government **did not** receive value for money in this transaction. It gave up its rights to considerable additional consideration (between $20 and $58 million) and received in return shares that were worth less than $3 million in the fall of 2005. While it is acknowledged that the Government had other social and business issues to consider and that this should not be looked at as a straight financial decision, it is clear to me that the Government paid a very hefty price for what it received,

Could the Government have done Better?

Types of Shares Acquired

4.01 The Government acquired 240,000 ordinary shares in CGI and the shares have a nominal value of $1 each. These shares were authorised, issued and fully paid for. They also carry normal voting rights as is customary in a limited company. The Government has the right to appoint two directors to the board which is consistent with normal business practice. The two directors appointed to the Board of CGI by Government are Mr. Brian Pairadeau and Mr. Joseph Ebanks. In our discussions with officials of CGI, it was noted that there are normally 9 members of the Board of Directors of CGI.

4.02 There are different types of shares available for issuance by a limited company. It was noted that CGI had only ordinary shares which were authorised, issued and fully paid at the date of the acquisition. One option that the Government could have considered would have been a request for preference shares. The key advantage of these types of shares is that they have preferential rights over ordinary shares. The most common preferential rights would be the ability to receive dividends prior to any distribution to common stockholders. Generally the dividend payout is specified in advance.

Types of preference shares include:

- Preference shares can be issued as cumulative preference shares. With these types of shares, dividends not paid in any year must be made up before distributions can be made to common stockholders. With these shares the Government would still have a claim on dividends whether or not the board of directors declares a common dividend.

- Participation – These types of preference shares would have allowed the Government to share with common stockholders in dividend distributions after both preferred and common stockholders receive a specified level of dividend payment.

- Convertible preference shares – With these shares the Government would have an option of exchanging their shares for common stock at a specified ratio.

- Callable – With these shares CGI would have the option to repurchase the preferred stock at a specified price.

4.03 Preference shares would also offer better protection in the event of a bankruptcy or if the Company goes into liquidation. In bankruptcy common shareholders are ranked at the bottom after secured creditors and preference shareholders are paid.

4.04 In my opinion, an arrangement for preference shares would have been much more suitable for the situation that the Government found itself in after hurricane Ivan. In the negotiations, the Government had given up a substantial consideration. In return, it had become a shareholder in the Company. However, by taking its shares as common equity, the Government has been and will always remain a minority shareholder. As such, it has no ability to force CGI to pay a dividend even when it makes a substantial profit. In addition, there is no stock market for the shares and therefore the ability of the Government to sell the shares is limited.

4.05 However, there is a potential for insurance companies to make substantial profits as well as significant losses. This was seen in the September 2005 financials when CGI made a profit of $2.8 million. As preferred creditors, the Government could have ensured that it would receive any distribution of these profits first.

No Guaranteed Return on Investment

4.06 The problem with the Government having a 24% holding of the current shares of CGI is that there are no guarantees that any future earnings of CGI will flow to the Government. Unless CGI's Board of Directors declares a dividend payment, the Government will not get any income from this investment. CGI management seems to have adopted a growth strategy over the years and therefore profits are retained in the Company instead of dividend payment made. The last dividend payment made by CGI was in August 2001. Future dividend payments will be dependent upon the determination of CGI's board.

Loan Option

4.07 Another possible method of securing the consideration that the Government forgone was to enter into an agreement with CGI about recovering its losses in subsequent years of profit. This could have been done through a loan agreement where the consideration given up would have been secured through a medium to long term loan at a reasonable interest rate mutually agreed by both parties. The Audit Office inquired with Government officials about this option and was told that members of the CGI and CNC negotiation team were not in agreement with this.

The Government's Long-term Plan and Exit Strategy

4.08 The Government indicated that it does not intend to hold the Cayman General Insurance shares in the long run, but it has not yet developed an exit strategy for the disposal of these shares. CGI is not a publicly traded company and as such it could be difficult to dispose of these shares in the future. Investing in privately held companies is not one of the Government's core functions and therefore a strategy must be developed and implemented to monitor this investment and liquidate it at the appropriate time.

Conclusion

4.09 In my opinion, the Government could have done better in its negotiations with CGI to secure a superior investment deal. The outcome of the negotiations could have made provision for a guaranteed rate of return on the investment through preference shares, a loan or fix rate of return clause included in the agreement. In addition, the negotiations could have made provisions for share repurchase by CGI, thus providing a smooth exit strategy.

What has the Government Done Since Hurricane Ivan Insurance Settlement?

Diversification of Insurance Risk

5.01 Prior to the hurricane Ivan insurance claim with CGI the Government insured all its property assets with this Company. The sum insured for property insurance at that time was $353 million as detailed in **Appendix 2**. Following the Ivan experience, the Government changed its insurance risk strategy and now has adopted a participating policy approach, where a number of insurance companies are asked to participate in the policy, which spread the risk to various insurance companies. As shown in **Table 4** below, the largest participant of the policy is ACE American Insurance Company Limited; a US Company with it's headquarters based in Bermuda.

Table 4: CIG Property Insurance Policy for April 1, 2006 to March 31, 2007

	Carrier	**Program Share**
1	ACE American Insurance Co. Limited	45%
2	Royal Star (Fidelity)	35%
3	NEM West Indies Limited (NEMWIL)	10%
4	British Caymanian	5%
5	Island Heritage	5%
	Total	**100%**

5.02 This diversification of the insurance policy will reduce Government's exposure to a single insurance company's inability to honour a claim in the event of a disaster. I applaud such a move and would note that if the government had a similar strategy prior to hurricane Ivan, it would have been more likely that it would not be in a position of having to negotiate with its insurance company because that company had not provided sufficient capital and/or re-insurance to cover all its obligations. It should be noted that CGI has contended that CIG had such a strategy in place prior to Ivan but CIG was having difficulty in having their assets insured.

Valuation of Government Properties

5.03 However, I believe that the Government may still be at substantial risk in regard to its insurance cover for physical assets. The last valuation of Government properties was done in the year 2000. The Government has not done a valuation since that date although one was scheduled for October 2004. At 1 April 2006, the Government obtained property insurance for $400 million. These values were determined based on input from the Insurance Broker and attempted to include adjustments for estimated increases in property values.

5.04 With this method it is possible that the Government properties could be significantly under insured. Even worst, if there is another catastrophe such as hurricane Ivan, there would be a substantial delay in claim payment while the government and the insurers argues about the fair value of the assets and whether the Government was adequately insured or not.

5.05 If hurricane Ivan has taught the residents of the Cayman Islands anything, it is that all owners, including Government, need to continually update the value of its assets and to ensure that the insurance company agrees **before** an event that the organization is adequately insured. Therefore, I strongly recommend that the Government perform an immediate evaluation of all of its properties and to ensure that its insurance coverage is adequate. In addition, the Government should plan to do regular re-assessments to ensure that its assets are adequately insured.

Management Comments from Lands and Survey

5.06 **Lands and Survey** agrees with the Audit Office's recommendations that the Crown Estate should be re-valued for insurance purposes i.e. the reinstatement value as many of these figures appear to be inaccurate. Lands and Survey state that the Crown Estate should also be valued to assess the market value of each property for asset management purposes. This should be done annually, with physical inspections carried out at least every three years, by qualified Chartered Surveyors. The Valuation Office of the Lands & Survey Department has been advocating this for the last four years and it is only recently that they have been given the go-ahead by Risk Management Unit to now prepare a rolling program to carry out these valuations.

5.07 Lands and Survey further pointed out that CIG should be looking to have all its property records on a proper property management and asset database. At the moment data is only kept on excel spreadsheets. They are currently looking at a number of computer software systems in order to put a proposal to CIG.

Conclusion

5.08 In my opinion, the Government has learned from the Ivan settlement experience and has since adjusted its risk mitigation strategy through diversification of its insurance risk. However, I am concerned about the sum insured on these assets due to the absence of current valuations. Over-insurance of assets, will result in unnecessary expense to Government through the payment of higher insurance premium while the under insurance of assets increases Government exposure to losses in the event of a disaster. I encourage the Government to have properties valued regularly to reduce expenses and exposure to unnecessary losses in the event of a disaster.

Dan Duguay

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12 February 2007

Appendix 1

The Financial Secretary's comments were sought on this Report and he provided the following response:

- *The Report emphasises repeatedly that the full extent of the Government's insurance claim was not established. Whilst the negotiations were being undertaken, Government was aware of this but it took the pragmatic approach that whilst it may have been desirable to have established this figure, it was to a large extent academic – because it would have been far higher than the Company would have been able to pay;*

- *The Report states that the Government should have completed its compilations of damaged assets as the basis for making its insurance claim. The Report further states that settlement through this route could have taken between 18 and 36 months and, failure to finalise this process was not good business practice. The Government clearly took the view that in an environment in which its infrastructure needed to be repaired and rebuilt after the hurricane, it was impractical to be delay this vital rebuild and repair process by 18 to 36 months;*

- *Government's 24% shareholding in the Company should not be construed in the light of the Government accepting the shareholding as full compensation for the $20 million difference between the agreed value of the claim ($70 million) and payment made in respect of that claim ($50 million). Government's acceptance of a 24% shareholding in the Company is more accurately construed by the following three considerations: by taking a less than 50% shareholding in the Company, the Government increased the prospect of a private- sector insurance company acquiring a controlling interest in Cayman General Insurance (CGI), thereby increasing the likelihood of CGI returning to a financially successful position – a result which was subsequently realised; Government deliberately did not want to be the majority shareholder in the Company; and lastly, the shareholding, over time, would help the Government to recover the $20 million deficiency stated above; and*

- *The Report although well-intentioned does not give adequate emphasis on the truly national considerations that the Government had to take into account when the insurance settlement was being discussed and negotiated. Foremost amongst Government's considerations was the fact that if the Government did not reach a settlement figure that the Company could pay, there was a real risk of the Company failing and, even more importantly, there would be a loss of confidence in the banking entity within the CNC Group and that, in turn, would have catastrophic results for the entire Cayman Islands' economy. The Government's acceptance of a $50 million settlement was done in the national interest of the Cayman Islands. The GovernOment was resolute in its belief that although it suffered a substantial reduction in the value of its insurance claim that it received in its $50 million cash receipt, such a loss avoided a much larger national financial crisis.*

Appendix 2
Insurance Schedule of Government Properties and Contents for 2004-2005

	Department	Building Values	Contents	Total Insured Values
1	Agriculture	2,660,203	94,498	2,754,701
2	Archive	888,430	533,244	1,421,674
3	Audit Office	0	13,575	13,575
4	Broadcasting	1,118,386	196,301	1,314,687
5	Civil Aviation Authority	25,558,755	3,219,000	28,777,755
6	Cadet Corp	381,640	19,000	400,640
7	CI National Pensions	0	32,500	32,500
8	Cayman National Cultural Foundation	5,511,450	354,871	5,866,321
9	Community College	10,552,955	0	10,552,955
10	Computer Services	0	2,911,955	2,911,955
11	Cayman Islands Stock Exchange	0	363,304	363,304
12	Customs	4,577,650	118,000	4,695,650
13	District Administration	9,626,550	125,100	9,751,650
14	Department of Vehicle & Equipment Services	881,020	0	881,020
15	Education	84,964,411	400,000	85,364,411
16	Employment Relations	0	88,686	88,686
17	Environment	218,225	0	218,225
18	Environmental Health	2,940,455	0	2,940,455
19	Fire Services	3,861,060	552,691	4,413,751
20	H.E. Governor	1,268,750	0	1,268,750
21	Health services	43,336,187	7,719,877	51,056,064
22	Immigration	2,009,700	99,869	2,109,569
23	Judicial	2,639,000	87,045	2,726,045
24	Lands & Survey	21,733,941	419,986	22,153,927
25	Legal Affairs	0	507,500	507,500
26	Legislative	3,601,220	43,048	3,644,268
27	Library	1,495,785	1,382,416	2,878,201
28	Licensing	273,035	0	273,035
29	Ministry of Community Services	941,515	43,917	985,432
30	Ministry of EHRC	81,311	15,532	96,843
31	Ministry of Planning	234,465	3,414,250	3,648,715
32	Ministry of Tourism	681,200	0	681,200
33	Mosquito Research & Control Unit	764,295	30,000	794,295
34	Museum	1,146,950	279,740	1,426,690
35	National Roads Authority	0	95,619	95,619
36	Police	5,303,414	944,000	6,247,414

	Department	Building Values	Contents	Total Insured Values
37	Port Authority	29,204,220	1,192,610	30,396,830
38	Portfolio of Internal & External Affairs	0	28,000	28,000
39	Postal	5,093,270	0	5,093,270
40	Prison	12,159,700	851,844	13,011,544
41	Public Works Department	2,460,998	263,304	2,724,302
42	Schools Inspectorate	0	126,978	126,978
43	Secretariat	0	82,565	82,565
44	Social Services	4,731,226	107,871	4,839,097
45	Substance Abuse	1,407,805	23,000	1,430,805
46	Tourism Attraction Board	8,112,045	1,145,205	9,257,250
47	Turtle Farm	6,464,785	3,902,592	10,367,377
48	Youth & Sports	8,927,687	8,000	8,935,687
49	Other	3,144,876	0	3,144,876
	Total	**320,958,570**	**31,837,493**	**352,796,063**