
Insurance Executive Review

Market Commentary on Current Developments within the P&C Insurance Industry

CONGRESS AND THE REINSURANCE MARKET TAX LOOPHOLE ... TARGET BERMUDA!

In our Newsletters we have primarily focused on the U.S. primary property and casualty markets but in this edition we are turning our attention to the reinsurance business which traditionally has been a global business. A material portion of the insurance risks written by US domiciled primary insurers will find its way to reinsurance companies who take a share of these risks for a portion of the premiums collected. Reinsurers are essential to the private and public insurance markets as it provides access to risk capacity beyond the individual carrier's ability to retain those risks for their own account. Some risks present a severity exposure (i.e. high single risk value), an aggregation exposure (i.e. repeated frequency of risk events) or a catastrophe exposure (i.e. multiple risks exposed to a single event). Therefore, the insurance market needs a mechanism to share risks that might otherwise compromise the financial resources of the entity. In recent years insurers have sometimes turned to more sophisticated risk sharing products such as "Catastrophe Bonds" or "Side-Car" facilities but for the purpose of this paper we will focus on the more conventional reinsurance approach.

THE REINSURANCE MARKET

The reinsurance market supporting the US commercial and homeowner risk market comprises over 4,900 organizations located worldwide in 106 jurisdictions outside the United States as recently reported by the Reinsurance Association of America (RAA). There are also a number of reinsurers located in the US that we will look at more closely later. Those outside the US have traditionally been dominated for decades by the United Kingdom (i.e. Lloyds) and Continental Europe (i.e. Germany and Switzerland). But since the casualty market crises in 1985 Bermuda became a new world reinsurance center. It further expanded following Hurricane Andrew in 1992 but the growth exploded after the 2001 terrorist attack and the 2004-2005 hurricane seasons. The need for market capacity was clearly evident in the property catastrophe market.

The reason that Bermuda became a popular site for reinsurance operations stems from its long history in developing a robust captive insurance/reinsurance market initially for Fortune 1000 companies and then for group captives owned by unaffiliated middle market companies. Bermuda developed over time the infrastructure, communications and targeted regulatory environment that could easily accommodate this new market capacity for US risks.

In 2008 the RAA reported* that US premiums ceded to foreign jurisdictions was \$58.2 Billion virtually unchanged from 2007 and net recoverable (claims outstanding) totaled \$121.2 Billion up from \$113 Billion in 2007. Since some of these foreign reinsurers are affiliated through ownership with US domiciled companies (both primary and reinsurers), the amount of premiums flowing to unaffiliated foreign reinsurers was \$25.0 Billion in 2008 compared to \$24.6 Billion in 2007.

This suggests that 43% of cessions go to unrelated parties while 57% goes to affiliates outside the U.S. This will be an important item for discussion, as the US Congress prepares legislation that would disallow "excessive"

*Data taken from statutory statements Schedule F, Part 3 filed with the NAIC

reinsurance premiums with respect to US risks paid to affiliated insurance/reinsurance companies that are not subject to U.S. tax.

The excessive reinsurance could be gauged by the above suggesting that anything above a 43% cession of reinsurance by a U.S. insurer or reinsurer to a foreign affiliated company would be denied as an expense for federal tax purposes. This has been called “closing the offshore tax loophole” that many U.S. insurers without foreign affiliates have been advocating for several years.

THE FINANCIAL BENEFIT OF REINSURANCE

The domestic primary and reinsurance market utilize the capacity of global reinsurers as noted above to supplement their internal risk capacity that is dependent upon their capital position. Companies need to manage their risk based capital position relative to regulatory review as well as rating agency concerns. All states by statute or administrative practice (with variations) give financial statement credit for reinsurance transactions with “authorized” reinsurers. In all other cases the alien or offshore companies must post collateral to secure the transactions. The financial and tax benefit in simple terms, allows the reinsurance premiums paid to be directly deducted from revenue or earned premium while claims recoverable or paid by reinsurers reduces claims expense. Similar treatment applies to statutory solvency or Risk Based Capital tests that regulators apply to domestic insurers and reinsurers. These applications hold true whether the reinsurance is with an affiliate or unaffiliated alien company. Some US based insurers calling for a closure of the tax advantage when the US affiliate can send substantial risk premiums to a sister company offshore where modest or no corporate income tax applies in that jurisdiction. Congress sees this as a tax revenue opportunity to require, that at least for federal tax purposes, any “excessive” reinsurance cessions to an alien affiliate be reduced to some average amount. Let’s look at the top 10 Global Reinsurance Markets by Net Premiums Written in 2007 (see chart).

Aside from the three U.S. based reinsurers all but two of the remaining seven alien reinsurers have US affiliates.

**Top Ten Global Reinsurers
By Net Reinsurance Premiums Written in 2007
Dollars in Millions**

Rank	Company	NPW	Country	U.S. Affiliate
1	Munich Re	\$30,292.9	Germany	Yes
2	Swiss Re	\$27,706.6	Switzerland	Yes
3	Berkshire Hathaway	\$17,398.0	U.S.	N/A
4	Hannover Re	\$10,630.0	Germany	No
5	Lloyds	\$8,362.9	U.K.	No
6	SCOR Re	\$7,871.7	France	Yes
7	Reins Grp America	\$4,906.5	U.S.	N/A
8	Transatlantic Re	\$3,952.9	U.S.	N/A
9	Everest Re	\$3,919.4	Bermuda	Yes
10	Partner Re	\$3,757.1	Bermuda	Yes
		<u>\$118,798.0</u>		

Source: Insurance Information Institute/ RAA

These alien markets supply a substantial amount of reinsurance capacity to the US domestic carriers that could be in jeopardy for what may be less than meaningful income tax revenue on marginal portions of reinsurance deemed to be excessive. Increased costs to US corporations and small business via higher reinsurance cost pass-through is certainly possible.

REINSURANCE JURISDICTIONS

It seems clear from the above chart that Continental Europe and the U.K. are the largest domicile for global reinsurance groups then any other jurisdiction

taking on reinsurance transactions with insurance and reinsurance companies around the world. However, when we look at the cessions of reinsurance business emanating from the U.S. insurance market as shown below, we can see a very different view of where the ultimate reinsurance business transactions take place.

US Reinsurance Premiums ceded to Alien Reinsurers by Country
Affiliated and Unaffiliated Reinsurers
Dollars in Millions

Rank	Country	2005-2007						Total Reinsurance 2007
		Unaffiliated Alien Reinsurers			Affiliated Alien Reinsurers			
		2005	2006	2007	2005	2006	2007	
1	Bermuda	\$8,908	\$8,982	\$11,102	\$18,590	\$18,474	\$19,371	\$30,473
2	Switzerland	\$950	\$797	\$858	\$7,664	\$7,991	\$8,942	\$9,800
3	United Kingdom	\$4,827	\$4,630	\$4,578	\$252	\$346	\$777	\$5,355
4	Germany	\$1,529	\$2,582	\$2,569	\$9,401	\$2,005	\$1,463	\$4,032
5	Cayman Islands	\$1,780	\$1,806	\$2,023	\$646	\$435	\$409	\$2,432
6	Barbados	\$837	\$652	\$496	\$917	\$965	\$1,212	\$1,708
7	France	\$600	\$352	\$424	\$293	\$338	\$357	\$781
8	Canada	\$211	\$256	\$326	\$173	\$171	\$209	\$535
9	Turks and Caicos	\$382	\$398	\$481	N/A	N/A	N/A	\$481
10	Sweden	N/A	N/A	N/A	\$90	\$518	\$427	\$427
Total		\$23,246	\$22,214	\$24,594	\$38,816	\$32,470	\$33,786	\$58,380
% of Total		37.5%	40.6%	42.1%	62.5%	59.4%	57.9%	

Source: Insurance Information Institute/ RAA

It is interesting that although only two Bermuda reinsurers make the list of the top ten global reinsurers the Bermuda market as a whole is by far the largest writers of reinsurance from the U.S. market. Some of the Unaffiliated Alien Reinsurance is the result of decades of Bermuda captive insurers that receive reinsurance cessions from U.S. Insurers who front primary coverage for U.S. policyholders who own the offshore captives. The interesting observations are as follows:

1. The top 10 country locations capture nearly 99% of all U.S. reinsurance transactions to alien companies;
2. Data shows "initial premiums" ceded to alien reinsurers but does not reflect the ultimate risk distribution as subsequent reinsurance (called retrocession) may distribute the risks elsewhere in the world market;
3. Premium alone does not reflect the return or profitability of the business reinsured and may produce a taxable underwriting loss that would be contrary to the objective of "closing the offshore loophole";
4. It is uncertain if any meaningful risk capacity will be lost or if reinsurance rates would raise primary insurance costs to US taxpaying policyholders;
5. Affiliated offshore companies have made significant investments in US based operations (i.e. facilities, employment, and local tax revenues) that might be curtailed in the future.

SPECIFIC REINSURANCE COMPANIES WITH ALIEN AFFILIATES

There are many U.S. based companies with affiliates in alien jurisdictions and we have data only on certain of these reinsurance operations as shown in the exhibit below. Keep in mind that this data does not include any other non-reinsurance operations such as primary retail or surplus lines operations that may be affiliated with such companies. The data does not suggest that all of the Reinsurance Ceded business went directly to their affiliated companies since we do not have information that would verify that type of transaction.

It could be misleading to assume that all reinsurance transactions were with affiliates in alien jurisdictions as has been suggested by Congressional supporters to close the purported tax loophole. The overall average in this composite at 45.8% but this data base can not distinguish between affiliated and non-affiliated reinsurance transactions. (see chart on following page).

US Reinsurance Premiums ceded to Alien Reinsurers by RAA Company

Dollars in Millions

Six Months

June 30, 2009

	Gross Written	Reinsurance Ceded	Net Written	Ceded %
Axis Specialty	\$495,926	\$268,003	\$227,923	54.0%
Endurance	\$565,981	\$323,022	\$242,959	57.1%
Everest Re	\$1,545,376	\$717,256	\$828,120	46.4%
Munich Re	\$1,469,003	\$255,393	\$1,213,610	17.4%
Odessey Re	\$992,655	\$94,542	\$898,113	9.5%
Partner re	\$560,378	\$194,483	\$365,895	34.7%
Platinum Re	\$312,899	\$18,448	\$294,451	5.9%
QBE Re	\$918,992	\$545,148	\$373,844	59.3%
Scor Re	\$309,095	\$23,111	\$285,984	7.5%
Swiss Re	\$2,938,561	\$1,847,009	\$1,091,552	62.9%
White Mountain	\$311,529	\$68,113	\$243,416	21.9%
XL Re	\$1,416,446	\$1,063,495	\$352,951	75.1%
Total	\$11,836,841	\$5,418,023	\$6,418,818	45.8%

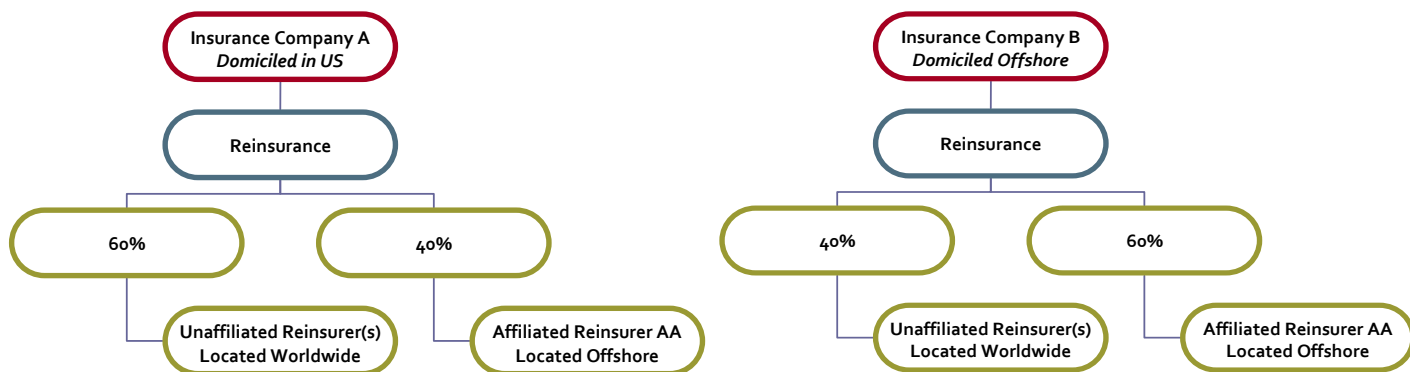
Source: Reinsurance Association of America

HOW THE CONGRESSIONAL APPROACH MIGHT FAIL TO CLOSE THE LOOPHOLE

Let us assume that Congress is successful in passing legislation that for tax purposes would reclassify related party offshore reinsurance transactions to disallow deductions for ceded premiums to affiliates above the national average for nonaffiliated cessions or 43% as noted earlier.

In the following chart we have two domestic insurers ceding reinsurance offshore to affiliated and nonaffiliated reinsurers. Company A cessions are 40% and 60% respectively and would not need to restate their federal tax return.

DIAGRAM: REINSURANCE WITH AFFILIATED AND UNAFFILIATED REINSURERS

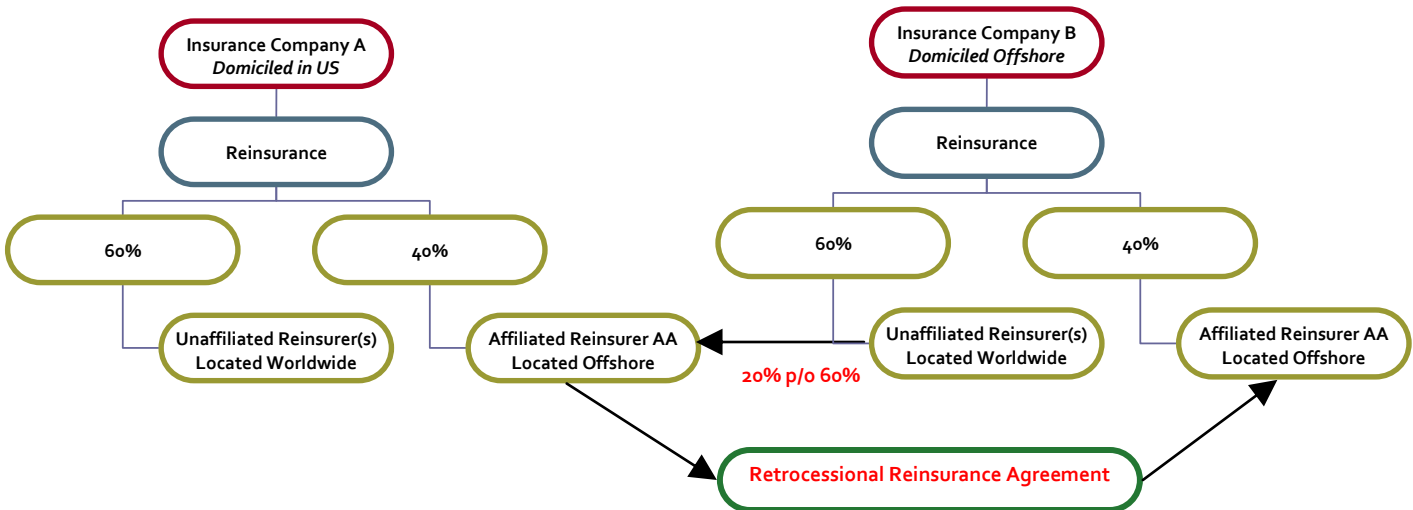


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Company B has the reverse with 60% affiliated reinsurance transactions so for federal tax purposes about 17% of the reinsurance premiums (offset by related claims and expense) would be disallowed, placing an assumed higher tax burden on Company B. Under these circumstances Company B might alter its reinsurance program

similar to the exhibit below that would keep it within the guidelines of the U.S. tax code.

DIAGRAM: REINSURANCE WITH AFFILIATED AND UNAFFILIATED REINSURERS



In the arrangement above Company B would alter its reinsurance distribution to look more like Company A so no restatement of reinsurance for tax purposes would be necessary as the affiliated reinsurance is now less than the 43% target. One or more of Company B’s unaffiliated reinsurers, which could include Reinsurer AA, could then retrocede portions of business received from Company B as reinsurance to Reinsurer BB.

From the perspective of Company A and Company B records it would be virtually impossible to understand where a given risk exposure would ultimately fall beyond the initial reinsurance transaction. It is not uncommon for reinsurers to spread some of the accumulated risks from various assumed reinsurance transactions to other reinsurers who may in turn do likewise. Reinsurance is all about balancing the individual reinsurance risk assumptions to create a spread of risks so these multiple accumulations are not compounded by being excessively subject to the same single event or occurrence.

For Congress to attempt to manage what it deems to be excessive offshore affiliated reinsurance to capture perceived lost tax revenue will easily be frustrated by the international market as well as potentially cutting off access to additional risk capital to the US insurance market.



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