



July 27, 2010

**Statement of the Association of Bermuda Insurers and Reinsurers
On
Tax issues relating to reinsurance transactions between affiliated entities
Submitted for the record of the hearing before
The Select Revenue Measures Subcommittee, House Committee on House Ways and Means
On
July 14, 2010**

The membership of the Association of Bermuda Insurers and Reinsurers (“ABIR”) consists of 22 global insurers and reinsurers that are domiciled in Bermuda. ABIR appreciates the opportunity to submit comments for the record of the July 14, 2010 hearing before the Select Revenue Measures Subcommittee of the House Committee on Ways and Means, regarding legislative proposals to disallow deductions for certain reinsurance premiums with respect to U.S. risks paid to affiliates, *viz.*, HR 3424, introduced by Subcommittee Chairman Richard Neal (D-MA), as well as a similar proposal in the Obama Administration’s FY 2011 Budget.

Near the end of the July 14, 2010 hearing, Subcommittee member Rep. Kendrick Meek (D-FL) expressed the view that staff should undertake to ascertain “the accuracy of the testimony” from both the invited witnesses and members of the subcommittee. In this regard, this statement focuses primarily on the testimony of the only private sector witnesses at the hearing – two representatives of a small group of U.S.-owned property and casualty (“P&C”) insurers seeking to change the law to their advantage.¹ ABIR respectfully submits that this testimony was riddled with assertions that are not supported by credible evidence. Before the Subcommittee finalizes any decision with respect to this issue, we are hopeful that the information in this statement will be considered.

As pointed out in the testimony of Stephen E. Shay, Deputy Assistant Secretary (International Tax Affairs), U.S. Department of the Treasury, there is considerable evidence that foreign affiliate reinsurance serves important non-tax business purposes. That evidence includes the extensive use of affiliate reinsurance within U.S. insurance groups such as the W.R. Berkley and Chubb groups of insurance companies. Thus, there is no apparent basis for singling out the global reinsurance industry by enactment of tax legislation that would penalize the U.S. operations of foreign insurance and reinsurance companies, including those based in Bermuda. Particularly in view of continuing weakness in the global capital markets, it seems counter-intuitive to consider any legislative proposal that would limit the availability of foreign sources of insurance capital (as would occur under either of the proposals discussed at the

¹ This contingent of U.S. P&C companies call themselves “The Coalition for a Domestic Insurance Industry,” but does not speak for the majority of the U.S. P&C industry: The major insurance trade associations are neutral on the proposal and the market share of the companies included in this group (based on statutory data) accounts for only approximately 21% of U.S. industry net premiums written and about 19% of industry direct premiums written. The two witnesses were the CEO of W.R. Berkley Corporation and the COO of The Chubb Corporation; the 11 other members of the coalition are: AMBAC Financial Group; Inc; American Financial Group; Berkshire Hathaway Inc.; EMC Insurance Companies; The Hartford Financial Services Group, Inc.; Liberty Mutual Group, Inc. (and its subsidiary Safeco Corporation); Markel Corporation; MBIA Inc.; Scottsdale Insurance Company; The Travelers Companies, Inc.; and Zenith Insurance Company.

hearing). Any effort to increase the taxes on international insurance carriers will be counterproductive because it will result in increased costs for U.S. consumers.

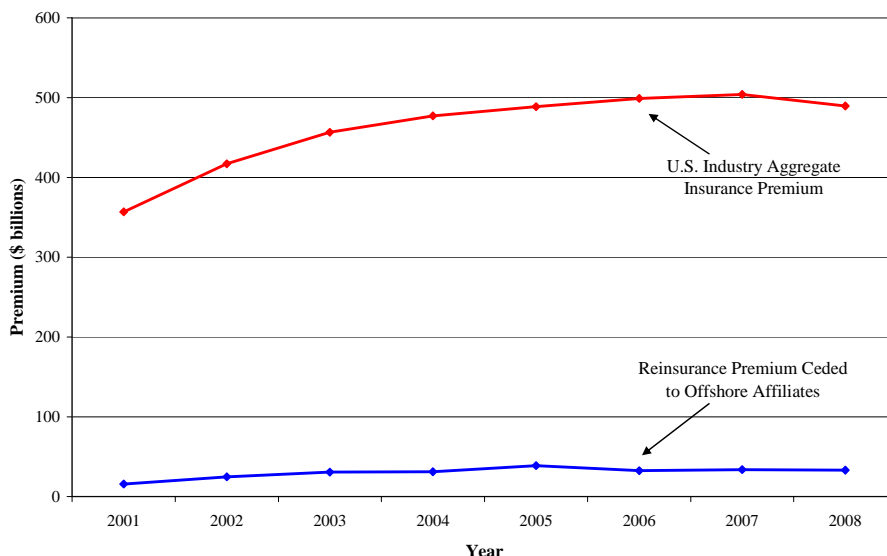
For ease of reference, points of clarification are presented in the numbered headings of each section below, in the order in which issues were raised during the hearing. Each heading is followed by a brief statement of the underlying factual basis or analysis.

TREASURY WITNESS

1. Regarding Mr. Larson’s citation of the staff of Joint Committee on Taxation’s conclusion that “between 2001 and 2008, while the total U.S. premiums to offshore reinsurers grew by 56 percent, the premiums to affiliated entities grew by 108.8 percent,” it is important to put the growth of premiums ceded to offshore affiliates into perspective. The data simply does not support the view that the U.S. P&C industry suffers from unfair foreign competition.

The growth of the onshore U.S. P&C insurance industry has dwarfed the growth of offshore affiliate reinsurance. As Deputy Assistant Secretary Shay correctly pointed out, the “data doesn’t separately break out the portion of the premiums going to offshore affiliates that are with respect to a U.S.-owned group.” A more fundamental problem with the comparison of growth rates is that a comparison of the growth rates of two quantities is misleading when the two quantities start from vastly different levels. For example, an increase from \$1 to \$2 represents a 100 percent rate of growth, but in most instances that 100% increase would be considered much less significant than the 50% increase from \$100 to \$150. As shown by the chart below, premium ceded to offshore affiliates and U.S. industry aggregate premium are substantially different in scale.

Growth in U.S. P&C Industry Aggregate Insurance Premium and Offshore Affiliate Reinsurance Premium, 2001-2008



Data Sources: Highline US Insurance P&C database and Reinsurance Association of America

While premiums ceded to offshore affiliates grew by \$17.3 billion from 2001 to 2008, industry aggregate premiums grew by \$132.8 billion. The *percentage* rate of growth for premiums ceded to offshore affiliates was higher largely because they started from a very small base! Moreover, nearly all

the growth in premiums ceded to offshore affiliates occurred during the two-year period from 2001 to 2003, when premiums increased by \$14.8 billion (while U.S. industry aggregate insurance premiums increased by almost \$100 billion). The increases in premiums during this two-year period occurred against the backdrop of capacity shortages within the U.S. P&C insurance market, and consequent high insurance prices, caused by losses from the 9/11 terrorist attack and adverse loss development in liability business. Increasing affiliate reinsurance allowed foreign-based insurance groups to quickly deploy insurance writing capacity into the U.S. market in response to these market conditions. Without this ability, these insurance enterprises might have had to cancel substantial amounts of U.S. insurance business. By contrast, over the subsequent five-year period from 2003 to 2008 premiums ceded to offshore affiliates increased by a total of only \$2.5 billion (while U.S. industry aggregate insurance premiums increased by \$32.9 billion). The time pattern of growth in premiums over this period is not consistent with the story that the U.S. industry is moving offshore due to a tax advantage – or indeed that it is moving offshore at all.

Finally, if Bermuda-based insurance groups had a large tax advantage over U.S.-based groups, one would expect the Bermuda groups to steadily increase their U.S. market share. The following chart presents the market share of Bermuda-owned U.S. insurance groups among the largest 50 U.S. insurance groups (as measured by premiums received from third-party customers). You will note that between 2004 and 2009 the market share of Bermuda-owned groups within the top 50 did not change – it remained at six percent.²

Top 50 U.S. Property-Casualty Insurance Groups

Market Share of Bermuda-Owned U.S. Insurance Groups Has Not Grown

(\$ billions)

	<u>2004</u>	<u>2009</u>
Total Premiums of Top 50 Groups	393.1	393.8
Bermuda-Owned	23.7	23.5
<i>Bermuda-Owned as % of Total</i>	6.0%	6.0%

Note: Premiums equal direct premiums plus reinsurance premiums assumed from unaffiliated insurers. Insurance groups are ranked by this measure of premiums to determine the top 50 groups in each year.

Data source: Highline Insurance Analyst Pro

² While these figures are limited to the largest 50 U.S. insurance groups, data from other sources confirm that in aggregate U.S. subsidiaries of Bermuda insurance groups have experienced little premium growth over the past five years. Independent insurance industry analysts Dowling & Partners recently reported data tabulations showing that in aggregate the premiums received by U.S. subsidiaries of Bermuda insurers equaled \$29.3 billion in 2004 and \$29.8 billion in 2009.

The data flatly contradicts claims that Bermuda-based companies are threatening to take over the U.S. P&C insurance market.

2. Subcommittee Chairman Neal asked Deputy Assistant Secretary Shay why the Administration proposed to disallow deductions “rather than further tightening the existing transfer pricing rules or just increasing the excise tax.” It should be noted that the relevant proposals would have the effect of an increase in the 1% Federal Excise Tax (“FET”) applicable to affiliate reinsurance transactions, but it seems clear that an actual increase would breach international trade agreements.

In 1994, Treasury’s Assistant Secretary for tax policy (Leslie B. Samuels) provided a response to this question in a letter to the Reinsurance Association of America. As stated in that letter, there was a "reservation from the national treatment obligation" [of the United States] that permitted the FET to continue at its current rate [of 1%]; however, the letter noted that "future increases would be subject to trade discipline." Similarly, the Background Memorandum released by Chairman Max Baucus on December 10, 2008 in connection with the Senate Finance Committee Staff Discussion Draft of a proposal similar to H.R. 3424 acknowledges that an actual increase in the current FET would breach international trade agreements. To the best of ABIR’s knowledge, this conclusion is still accurate. Note that the FET can be waived by treaty, but Bermuda-based reinsurers do not benefit from such a waiver.

The tax imposed by H.R. 3424 is a gross-basis premium tax, because no deduction is permitted for losses. It is thus essentially equivalent to the FET, except that its effective rate on so-called excess premiums would be substantially higher, on the order of 25% rather than 1%.

3. There was much discussion at the hearing about targeting “excess” affiliate reinsurance, but little analysis of the appropriate benchmark: Domestic use of affiliate reinsurance should be used to benchmark “excessiveness,” instead of H.R. 3424’s apples-to-oranges comparison that looks to unaffiliated reinsurance

Both the Administration’s proposal and H.R. 3424 depart from the “interest” earnings stripping model of current law in a major way by failing to condition application on the actual presence of profits and by permanently disallowing deductions. Under the benchmark used under the present law rules applicable to interest, there is a safe harbor based on debt-equity ratios in typical capital structures that excuses most corporations from any potential disallowance. Nevertheless, when a Subcommittee member posed a question regarding whether there is any comparable safe harbor for “typical” reinsurance arrangements; *viz.*, domestic use of affiliate reinsurance, the Treasury representative denied the appropriateness of the suggested benchmark on the grounds that affiliate reinsurance presents a “structural problem” because reinsurance premiums are not taxed. Yet that is the very issue that an earnings stripping rule is designed to address: the fact that U.S. tax is not imposed on a deductible payment! In practice, the standard established by HR 3424 would arbitrarily rule out most cross-border affiliate reinsurance for foreign-owned U.S. insurers by referring to the average level of unaffiliated reinsurance in particular lines of business. This is clearly inappropriate for several reasons: Industry consolidation means that there is little use of third-party reinsurance in some lines of business; the average use of unaffiliated reinsurance can mask substantial variation across different companies; and the average level of reinsurance by unaffiliated reinsurers is simply the wrong benchmark given that affiliate reinsurance is extensively used within insurance groups for legitimate non-tax business purposes.

THE CHUBB CORPORATION EXECUTIVE

4. Referring to foreign-owned insurance companies, John J. Degnan, Vice-Chairman and Chief Operating Officer of The Chubb Corporation (“Mr. Degnan”) stated “Literally with a simple keystroke, they're able to avoid U.S. income tax by reinsuring their U.S. business written onshore in our country with their own foreign affiliates.” Contrary to Mr. Degnan’s statement, affiliate reinsurance is not a mere “keystroke” or bookkeeping entry; it involves the real economic transfer of risk between two separately incorporated entities, pursuant to legally binding contracts.

In addition to the requirements of the U.S. tax law, arm’s length pricing is mandated and enforced by the review and regulatory approval required of all other affiliate reinsurance transactions under state insurance holding company laws (*e.g.*, in New York each such transaction has to be approved by regulators). Moreover, ample evidence from publicly available data demonstrates that affiliate reinsurance has resulted at times in the ceding of hugely unprofitable business to non-U.S. reinsurers – it is impossible for P&C insurers to know what their losses will be at the time policies are written. Members of Mr. Degnan’s coalition persist in portraying this as ceding profits when it is really about ceding risk.

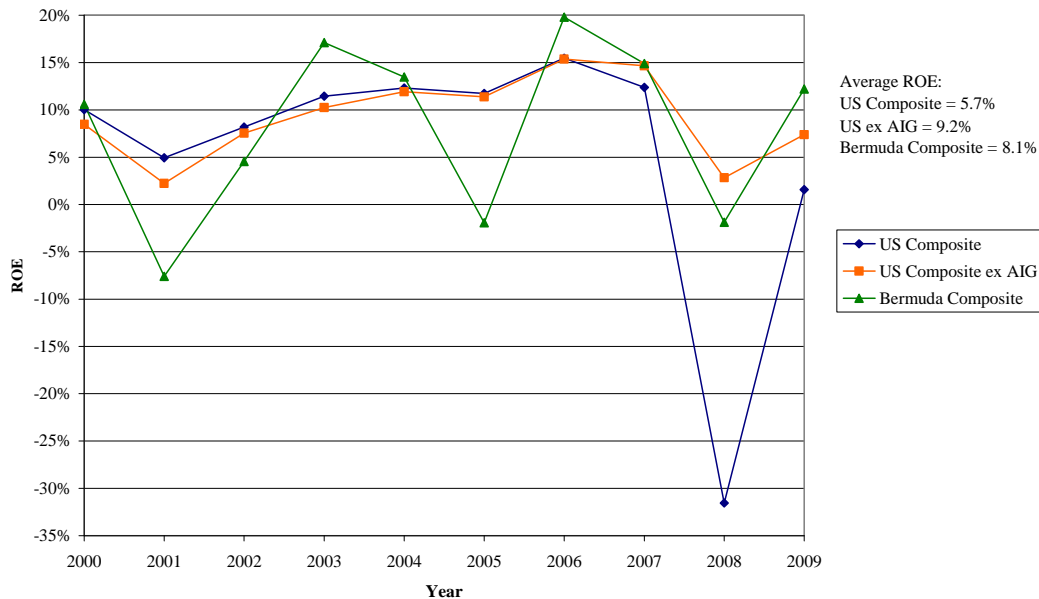
5. Mr. Degnan purported to demonstrate that Bermuda-based companies have an after-tax profitability advantage over U.S. companies by presenting a chart that contained misleading information.

The chart was presented as a comparison of the return on average equity (“ROE”) of U.S. P&C insurance companies to that of a composite of Bermuda insurance companies. Although few details of the calculations underlying the numbers were offered, which makes it difficult to directly assess the reliability of the comparison, the details that can be discerned are troubling.

First, the results shown on the Degnan ROE chart were adjusted to remove the impact of catastrophe losses. *This invalidates the comparison because Bermuda-based groups write more catastrophe exposed business than the typical U.S.-based insurance group.* The greater catastrophe exposure can be expected to generate more volatile results: large losses from catastrophes in some years are expected to be offset by high returns in other years. Removing catastrophe losses in effect keeps the upside for the Bermuda insurers of writing this high-risk business while assuming away the downside.

Second, Degnan’s chart further distorts the comparison by using a different scale for the vertical axis of the Bermuda and U.S. company graphs. This deceptive practice makes any ROE level on the Bermuda company graph look five to ten percentage points higher than the *exact same* ROE on the U.S. company graph. Third, the data and analysis for the Bermuda and U.S. industry ROE figures in Degnan’s chart appear to come from different sources, raising questions about comparability. Finally, the chart covers an extremely limited number of years, a period that conveniently excludes the catastrophic losses and turbulent results from early in the decade.

Rate of Return on Average Equity ("ROE") for US and Bermuda Insurers



The above chart presents an ROE comparison in which consistent data sources and methodology were used in the calculations for the Bermuda-based and U.S.-based insurers³ and a full decade of data was used. The Bermuda composite is an aggregate of Bermuda-based insurance groups with U.S. subsidiaries,⁴ while the U.S. composite is an aggregate of the one dozen largest publicly traded U.S.-based P&C insurance writers.⁵ The chart presents results for the U.S. composite including and excluding AIG. The results excluding AIG provide a more reliable basis for comparison given the unique circumstances surrounding AIG in 2008 and 2009.⁶ These results contradict those presented in Mr. Degan's misleading chart: There is no evidence of an after-tax profitability advantage for Bermuda-based insurance groups over their U.S. competitors. In fact, when AIG is excluded from the analysis,⁷ overall the U.S.-based groups earned a higher average ROE than the Bermuda groups. In addition, the above chart demonstrates the greater volatility of the results for the Bermuda groups, and how excluding catastrophic losses (e.g., the large losses in 2001 and 2005) would distort the comparison.

6. Mr. Degan quoted a Bermuda Insurance Executive out of context, by incorrectly implying that the quote referred to tax matters when the statement was made in reference to a practice both U.S. insurers and foreign insurers engage in to manage excess capital.

³Nearly all the data was drawn from the Thomson Financial Worldscope database. In a few cases, the Thomson data was supplemented with data from Standard & Poor's Compustat Global database. The ROE is measured as net income as a percent of the average of beginning and end of year shareholder's equity.

⁴ The Bermuda composite includes ABIR members having U.S. subsidiaries that wrote more than a *de minimis* amount of premiums plus White Mountains Insurance Group Ltd.

⁵ The U.S. composite consists of the following corporate groups: AIG, Allstate, American Financial Group, Assurant, Berkshire Hathaway, Chubb, Cincinnati Financial, CAN, Hartford, Progressive, Travelers, and W.R. Berkley

⁶ AIG booked approximately \$100 billion of net losses in 2008, which would have bankrupted the company but for federal government intervention. Those massive losses were largely attributable to AIG's credit default swap business and not to its traditional insurance businesses.

⁷ Or if 2008 is excluded from the analysis.

Mr. Degnan stated that “the head of the Bermuda Reinsurance Association, Mr. Kading, said publicly that the advantage they get from reduced taxes goes to the bottom line and the shareholders, not to the policyholders.” Mr. Kading’s quote noted that in 2007 Bermuda companies were purchasing large amounts of shares and thus returning capital to shareholders. That is what both U.S. insurers and foreign insurers do to manage excess capital—they return the capital to shareholders. Mr. Kading’s quote is inaccurately described in Mr. Degnan’s testimony as a direct statement about tax issues.

7. Contrary to the facts, Mr. Degnan suggested that the affiliate reinsurance proposals are important to help maintain the current market for state and local bonds, although there is no evidence of a legitimate threat to the market for state and local bonds.

Mr. Degnan stated that H.R. 3424 would “result in an increased demand in municipal bonds. The domestic U.S. P&C industry is the largest group investing in state and local tax exempt bonds today. Foreign insurers don't do so because they can avoid income tax... in the U.S. anyway. [If H.R. 3424 were enacted], the market for municipal bonds would likely enjoy significant growth. In fact, the amount of offshore affiliate reinsurance is tiny relative to the size of the U.S. market for state and local bonds. There is currently approximately \$2.4 trillion of state and local debt outstanding,⁸ while premium ceded to offshore affiliates in 2008 amounted to only slightly over one percent of that amount -- about \$33 billion⁹-- and a substantial portion of that premium almost certainly involved transactions within U.S.-headquartered insurance groups.¹⁰ If offshore affiliate reinsurance premiums continued to increase at the same rate as in the past five years, it would take almost 80 years before the value of those premiums reached even five percent of the *current* value of U.S. state and local bonds in circulation.

8. Chairman Neal and Mr. Degnan engaged in a colloquy that gave rise to an inference that foreign reinsurers did not fulfill their obligations under contracts that excluded losses from acts of war; lest anyone be confused about the matter, it is important to note that foreign P&C companies did bear substantial losses arising from the terrorist attacks on September 11.

MR. DEGNAN: “We tried to call our foreign reinsurers that day in London and on the continent to find out what their attitude was with respect to applying the act of war treaty exclusion because if we paid it and then they did not honor the reinsurance, we'd be bare on that risk. We couldn't get return calls.

We decided within 36 hours... we would honor each and every claim that was submitted to us. The rest of the industry followed suit and has paid someplace between \$35 and \$45 billion worth of losses, thwarting the terrorists' objective of undermining the economic stability of the Western world.”

The attacks on September 11 produced the largest insured loss known at the time, and it fell across all lines of commercial business: property, workers compensation, business interruption, commercial auto, general liability, aviation. 60% of this loss was paid by foreign insurers and reinsurers, including ABIR members that paid \$2 billion of the loss from the September 11 attacks. ABIR is not aware of any foreign reinsurers who failed to pay reinsurance claims (including a large share of the 74% of the \$3.5 billion loss Mr. Degnan’s testimony cited as Chubb’s loss).

⁸ Board of Governors of the Federal Reserve, Flow of Funds data Q1 2010.

⁹ Reinsurance Association of America, *Offshore Reinsurance in the U.S. Market: 2008 Data*.

¹⁰ Data presented in the Brattle Study show that in 2007 almost 20 percent of premium ceded to offshore affiliates was paid in transactions between companies within U.S.-headquartered insurance groups.

MR. BERKLEY

9. Contrary to the statements made on the record by Insurance Commissioners from important Gulf States, Mr. Berkley suggested that some or all of them may have changed their positions based on conversations he had with them.

With no documentation, Mr. Berkley simply asserted that he had spoken with the insurance commissioners from Louisiana and Mississippi, and single handedly changed their minds; the commissioner from Louisiana was said to have changed his view, and the one from Mississippi was said to have “reconsidered his point of view. Rather than stating a mere impression of how meetings with these insurance commissioners went, ABIR stands by the *public* opposition (in the form of letters) to H.R. 3424 evidenced by the following coastal insurance commissioners:

Louisiana Insurance Commissioner
James Donelon
Mississippi Insurance Commissioner
Mike Chaney
North Carolina State Insurance Commissioner
Wayne Goodwin
South Carolina Department of Insurance Director
Scott Richardson

10. Contrary to Mr. Berkley’s view of what is logical – based on his statement that “It fails any test of logic that a billion, \$700 million dollars of additional tax will somehow generate this enormous \$12 billion of costs, just nonsense” – there is nothing illogical about a tax having a far greater economic cost than the tax revenue it is estimated to generate.

To be clear, a punitive, confiscatory tax on a business activity will logically lead businesses to cease performing that activity, and hence little or no tax may be collected. But if the effectively banned business activity made possible the provision of valuable goods or services to consumers, then there is a large economic cost from the tax even though it generates no revenue. And in this case, under quite typical conditions the tax imposed by HR 3424 is confiscatory. The Brattle study consequently estimates that HR 3424 will lead foreign-based insurance groups to virtually eliminate the reinsurance they provide to their U.S. affiliates, a development that would impose substantial economic costs on consumers because it will lead to the withdrawal of a substantial amount of insurance capacity that is made possible by the support of that affiliate reinsurance. There is nothing illogical about those predictions.

11. Regarding Mr. Berkley assertion that H.R. 3424 would “not impact the ultimate cost of risk...because the ultimate risk bearer in all crop insurance in the United States is the Federal government,” actual crop insurance companies are concerned that H.R. 3424 would “adversely affect the provision of crop insurance products that protect America’s farmers.”

As pointed out by a crop insurance company (Agro National), in a February 26, 2009 letter submitted to Chairman Baucus of the Senate Finance Committee, although the Federal government provides some support for the crop insurance program, crop insurance companies still remain exposed to substantial risks. As a result, all Standard Reinsurance Agreement (SRA) holders cede a portion of their risk to commercial reinsurers. Agro National’s submission concluded that “[i]ncreasing costs [resulting from the bill] would likely increase the general upward pressure on reinsurance rate.” Moreover, precisely because the Federal government sets crop insurance rates, SRA holders would not be able to distribute the increased cost of crop reinsurance to policy holders. Thus, as stated by Agro National, the proposal

provides “incentives to exit the market” and may “reduce the number of insurance companies providing crop insurance.” To put things in perspective, in the early 1990s, over 60 companies participated in the Federal crop insurance program.¹¹ Today, there are only 16 and four of these companies write approximately 73 percent of the business.

12. During the hearing, Mr. Berkley contradicted Sean M. Shaw, the Insurance Consumer Advocate for the State of Florida, when Mr. Shaw correctly stated that Citizens Property Insurance Corporation (the state sponsored insurer) is the “largest property insurance company in the State of Florida.”

Mr. Berkley misrepresented both the status of the state sponsored insurer in Florida and the market share directly written by foreign affiliates. Mr. Berkley said that “[Citizens Property Insurance Corporation is] not the largest. State Farm is the largest”—that statement is false. In 2009 Citizens wrote about \$2.2 billion of property insurance in Florida (classified in three different lines of business, but all property). By contrast, in non-automobile lines (Citizens does not write auto insurance) State Farm wrote about \$1.0 billion in property insurance.

Regarding the market in Florida, Mr. Berkley also asserted that H.R. 3424 “won’t impact it whatsoever,” and Mr. Degnan added that “the foreign reinsurers that so vigorously oppose this bill write an infinitesimally small part of the direct commercial or homeowners market in the State of Florida.” In fact, foreign affiliates directly write 10% of home owner coverage and 40% of commercial property coverage.

13. Finally, the data flatly contradicts Mr. Berkley’s oft-repeated assertions that “the entire reinsurance industry has relocated offshore because the economics are so overwhelming.”

Reports of the demise of the U.S. reinsurance industry have been greatly exaggerated. Reinsurance Association of America data show that U.S.-owned reinsurers assumed almost \$14 billion of reinsurance premium in 2008.

¹¹ *Financial Status of the Crop Insurance Industry Hearing Before the Subcomm. on Gen. Farm Commodities & Risk Mgmt. of the H. Comm. on Agric.*, 108th Cong. 34 (2003) (statement of Ron Bricler).