

TAXING OUR CREDULITY: REFUTING THE TOP TEN MYTHS ABOUT OVERSEAS REINSURERS

Thirteen US insurance companies want to impose a special punitive tax on some of their competitors – foreign-based companies providing reinsurance to US affiliates. This tax increase on overseas reinsurers is the centerpiece of legislation (HR 3424) introduced by Rep. Richard Neal (D-MA).

Much about this legislation – and how it is being presented by its proponents – is thoroughly misleading. Contrary to what supporters of HR 3424 want you to believe, this bill is:

Not Supported by President Obama: In a news release announcing his bill, Rep. Neal claims that “affiliate reinsurance was... a platform issue for candidate Obama last year.” In fact, the Obama administration has not taken a position on this discriminatory tax, and the President’s FY 2010 budget did not include any provision affecting affiliate reinsurance.

Only Supported by a Small Sector of the Insurance Industry: Although the 13 companies account for only about 20 percent of the premiums written in the US, they call themselves “The Coalition for a Domestic Insurance Industry.” A better name would be “the Berkley Coalition,” since the group’s principal spokesperson is William R. Berkley, chairman of the W. R. Berkley Corporation.

Not Based on an Economic Analysis: The Berkley Coalition is circulating a lengthy document purporting to refute an analysis of the impact of its proposed tax increase on overseas reinsurers that was prepared by the preeminent authority on the global insurance industry, Professor J. David Cummins of the Wharton School at the University of Pennsylvania, with the respected economics consulting firm, the Brattle Group of Cambridge, Mass. But the Berkley Coalition’s document isn’t an economic analysis. It isn’t signed by an economist, tax attorney or other respected authorities. And, instead of indisputable facts and economic analyses, it is sprinkled with phrases like “should not” that represent wishful thinking, not economic forecasting.

Opponents of the HR 3424 represent a wide range of consumer, governmental and business interests. The legislation imposes an unnecessary and costly tariff on the companies that help spread insurance risks globally and unduly harms American consumers and businesses.

Only a handful of large and profitable insurance companies stand to benefit from this bill, at the expense of competition and security.

Nearly 40 independent experts, state government officials, business owners, and associations have publicly filed opposition letters to this tax proposal. Additionally, the Brattle Group, an economic research firm has published a study pointing out the potential harmful economic consequences of this legislation.

For more information, please visit www.keepinsurancecompetitive.com

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SINCE THE BERKLEY COALITION REFUSES TO FACE THE FACTS, WE WILL. HERE ARE THEIR TOP TEN MYTHS:

Myth #1: “This legislation (HR 3424) is essential to close a tax loophole.”

Foreign-owned reinsurers don’t enjoy any US tax loopholes. Right now, the US subsidiaries of these companies are subject to the same income tax laws as their US-based competitors. If the foreign-owned companies obtain reinsurance from companies with which they’re affiliated, they face the same tax consequences as if they reinsured with unaffiliated reinsurers that are based in the US. **There is no differential or preferential treatment.**

In order to close the non-existent “tax loophole,” the Berkley Coalition wants the Congress to deny foreign-owned insurers some or all of their deductions for the premiums they pay for reinsurance from foreign companies. In spite of what the Berkley Coalition’s letter says, the “ceding commission” on these transactions is fully taxable, and the companies are also subject to a one percent federal excise tax on the gross premiums on the policies for which they obtain reinsurance (unless waived by US bilateral treaties).

To compound the misstatements, the Berkley Coalition asserts that the current treatment of foreign-based insurers somehow “costs the Treasury billions of dollars in tax revenues annually.” The absence of any figure for how much tax revenue is lost is a dead giveaway for the lack of any basis for this statement. Moreover, the staff of the Joint Committee on Taxation has never published a revenue estimate for Rep. Neal’s proposal.

Myth #2: The tax increase in HR 3424 on overseas reinsurers “should not adversely affect ... pricing in the insurance market.”

Just saying that raising taxes on some insurance companies won’t affect the prices of their products doesn’t make it true. On the contrary, the economic analysis co-authored by the preeminent academic authority on the global insurance industry, Professor David Cummins of the University of Pennsylvania’s Wharton School, estimates that **Rep. Neal’s proposed tax increase on overseas reinsurers would cause American consumers to pay \$10 to \$12 billion more for their current insurance coverage.** That is why the stakeholders who are most concerned about pricing (such as the Risk and Insurance Management Society, the Consumer Federation of the Southeast, the Florida (CFO’s) Office of Insurance Consumer Advocate, and insurance regulators from Louisiana, South Carolina and Mississippi) have all strongly and publicly opposed Rep. Neal’s tax increase.

The Berkley Coalition misleadingly claims that “the target of the bill – affiliate reinsurance – plays little if any role in providing catastrophic coverage.” In fact, prices are particularly likely to increase in areas that are vulnerable to natural disasters – especially in states like California, Florida, Texas, and others. Here’s why:

Overseas reinsurance companies are the largest providers of US property catastrophe reinsurance. These companies also provide catastrophe-exposed insurance via US subsidiaries. If their affiliate reinsurance is taxed at a higher rate, foreign reinsurance companies will substitute non-affiliate reinsurance to the extent possible. As the available supply of reinsurance shrinks, prices will rise. Thus, Professor Cummins and the

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Brattle Group estimate that **Rep. Neal's tax increase will cost Florida home insurance customers \$66 million more for premiums.**

Myth #3: The tax increase in HR 3424 "should not adversely affect capacity..."

"Should not" is a wish, not an economic analysis. Based on analysis of financial data collected by the National Association of Insurance Commissioners on more than 700 large US property and casualty firms over a ten-year period, **the Brattle Group study concludes that the tax increase would reduce the supply of reinsurance in the US by \$19 to \$22 billion.**

Myth #4: Foreign-based reinsurers currently enjoy "a significant competitive tax advantage."

The Berkley Coalition's letter purports to prove that Bermuda-based insurance companies have a higher after-tax rate of return on their average equity than US companies. But there is no evidence of this. In fact, when the problem-plagued US insurer AIG is excluded from the analysis, the US-based companies earned a higher average rate of return on equity than the Bermuda-based companies.

As for the Berkley Coalition's remedy for the non-existent problems that it cites, their proposed tax increase is equivalent to increasing the federal excise tax on the overseas reinsurers to about 26 percent of gross premiums. This is more than 11 times the historic average level of income tax paid by US property and casualty insurance companies. **This would be protectionism,- not a level playing field.**

Myth #5: "The unfair competitive tax advantage ... already has caused a significant portion of the capital base of the P&C industry to move offshore..."

On the contrary, **the US property and casualty insurance industry is healthy and competitive - and it is not disappearing offshore.** Yes, there is turmoil in the financial markets. It is affecting domestic and foreign companies. It extends beyond insurance and has nothing to do with supposed tax advantages for foreign companies.

Before the financial crisis, US property and casualty insurers enjoyed record profits. They markedly expanded their capital base and premium volume. Between 2001 and 2007, the US property and casualty insurance companies' surplus (an insurance industry financial measure approximately equivalent to equity capital) grew by more than \$235 billion - an 80 percent increase.

Myth #6: "Related party reinsurance serves different purposes than third-party reinsurance."

Affiliate reinsurance and third-party reinsurance both serve the same purpose - efficient management of risk. That is why US companies ceded more than \$125 billion of premiums to affiliates in 2007. Indeed, 16 of the 22 companies in the W. R. Berkley group reinsure with affiliates most of the premiums they receive from their customers.

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Myth #7: Because crop insurance rates are set by the federal government, the tax increase on reinsurers in HR 3424 “should have little or no impact on the crop insurance market.”

While the federal government provides some support for the crop insurance program, crop insurance companies still remain exposed to substantial risks. This is why all Standard Reinsurance Agreement Holders in this sector cede a portion of their risks to commercial reinsurers. For instance, crop insurer Agro National’s statement against the Neal bill concluded that **“Increasing costs in this way would likely increase the general upward pressure on reinsurance rates.”** Members of Congress who are concerned about the declining number of companies providing crop insurance should be alarmed about the proposed tax increase. In the 1980s, more than 60 companies participated in the federal crop insurance program, but today there are only 15 (down from 16 just last year), and four of these companies write approximately three-quarters of the business.

Myth #8: HR 3424 is consistent with US treaty obligations.

Rep. Neal’s legislation would violate US treaty obligations in several important ways. The Berkley Coalition claims the legislation does not “materially disadvantage” foreign groups relative to domestic insurers in writing coverage of US-based risks. In fact, the proposed disallowance of deductions would result in double taxation of reinsurance premiums ceded by a foreign-owned US insurer to a foreign affiliate in a high-tax country such as Germany. This, in turn, could result in a confiscatory tax on premiums that is 8 to 10 times the average tax that US-based companies pay. This and other elements of the legislation would violate the non-discrimination clauses in many tax treaties.

Myth #9: “The legislation merely prevents foreign insurers from stripping their US income to tax havens and restores a level competitive playing field.”

The existing “earnings stripping” rules target the use of interest payments on related-party debt to “strip” operating profits out of the US. The proposed tax increase on overseas reinsurers differs in three ways: First, it targets the overseas insurers’ US subsidiaries core businesses. Second, reinsurance transfers risks and losses to related parties in transactions that clearly meet the definition of “true insurance.” Third, the proposal differs from the “earnings stripping” model by failing to condition its application on the actual presence of profits.

Myth #10: “Closing the affiliate reinsurance loophole is important to help maintain the current market for state and local bonds.”

Offshore reinsurance poses no threat to the market for state and local bonds. The US property and casualty insurance’s equity capital grew by 80 percent from 2001 until the beginning of the financial crisis, while offshore affiliate reinsurance increased at an average rate of less than two percent per year from 2003 through 2008. The \$33 billion in offshore affiliate reinsurance in 2008 pales in comparison to the \$2.3 trillion in state and local debt currently outstanding. Whatever difficulties state and local governments may have with bond issues have nothing to do with offshore affiliate reinsurance.