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Submitted for the Record of the Hearing on Reinsurance
Before the Subcommittee on Select Revenue Measures
Of the House Committee on Ways and Means

July 14, 2010

I appreciate the opportunity to present these comments to the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means in connection with the Subcommittee's hearing on tax issues relating to reinsurance. I am a managing director of Horst Frisch Incorporated, an economics consulting firm. My career has focused on the economic analysis of international tax issues through academic research, policy analysis while at the Treasury Department, and in my consulting practice while working with multinational corporations and the tax authorities of various governments. For the record, a number of my corporate clients have an interest in the tax treatment of cross-border reinsurance transactions between affiliated insurance companies.

My comments focus on the standard for determining what constitutes "excess" reinsurance premium ceded to affiliates. The analysis presented below can be boiled down essentially to three points. First, U.S.-based insurance groups make extensive use of affiliate reinsurance for non-tax risk management purposes. Second, the standard established under HR 3424 for determining what may constitute "excess" affiliate reinsurance – the "industry fraction" – is inconsistent with the widespread use of affiliate reinsurance within U.S.-based groups. Third, the industry fraction is an arbitrary standard that makes no allowance for the important non-tax economic motivations for reinsurance transactions between affiliated insurance companies.

In his testimony before the Subcommittee, Treasury Deputy Assistant Secretary Stephen E. Shay acknowledged the important role that reinsurance plays within groups of affiliated reinsurance companies when he stated that "... reinsurance remains an important tool among affiliates that can be used to transfer premiums and associated risk within an affiliated group, in order to efficiently allocate capital for regulatory and other business purposes..." The non-tax economic benefits derived from affiliate reinsurance explain why such reinsurance is used extensively within groups of affiliated U.S. insurance companies, as demonstrated by the data presented in the table below. Note that the analysis presented in this table includes only companies that are part of insurance groups that are ultimately U.S. owned, so there would generally be no U.S. income tax effect from these reinsurance transactions. And yet, as the table shows, nearly half (48 percent) of these U.S. companies cede to affiliates¹ most of the premiums they receive from their unrelated customers.

¹ Ceded reinsurance premiums are measured net of reinsurance premiums assumed from affiliates.

Affiliate Reinsurance within U.S. Property-Casualty Insurance Groups

Distribution of U.S. P&C Companies by Net Premiums Ceded to Affiliated Reinsurers as a Percent of Gross Premiums

<u>Net Premiums Ceded to Affiliates/Gross Premiums</u>	<u>Number of Companies</u>	<u>Percent of All Companies</u>
>= 0%	711	100%
> 10%	426	60%
> 20%	397	56%
> 30%	375	53%
> 40%	360	51%
> 50%	340	48%
> 60%	309	43%
> 70%	289	41%
> 80%	255	36%
> 90%	214	30%

- Notes:
- (1) The sample includes only companies that belong to a U.S.-owned insurance group that has at least \$500 million in gross written premiums (GWP) in 2009. To eliminate inactive companies, companies with less than \$10 million in annual GWP were excluded from the sample.
 - (2) Foreign-controlled U.S. companies were excluded from the sample.
 - (3) Net premiums ceded to affiliates equals reinsurance premiums ceded to affiliates less reinsurance premiums assumed from affiliates. Gross premiums are defined here as direct insurance premiums written plus written assumed reinsurance premiums from unrelated insurance companies
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The aggregate flow of premiums between affiliates within these U.S. insurance groups is substantial: a net flow of premiums of about \$125 billion dollars from companies that cede affiliate reinsurance to the affiliates that assume it. This flow represents well over 50 percent of the gross premiums the ceding insurers received from their unrelated customers.

HR 3424 establishes the U.S. industry average use of reinsurance from unaffiliated reinsurers by line of business – the so-called industry fractions – as the standard for determining what constitutes “excess” affiliate reinsurance. Calculating industry fractions using recent data, I find that the average across all lines of business in recent years was generally only about 12 percent, and for some lines of business in some years the industry fraction was effectively zero. Under this standard, levels of affiliate reinsurance that are common within U.S.-based insurance groups would be treated as “excess” affiliate reinsurance.

By using reinsurance from unaffiliated reinsurers as the benchmark for affiliate reinsurance, HR 3424 implicitly treats the two types of reinsurance as if they were perfect substitutes. Although they are used for similar risk management purposes, the two types of reinsurance are not perfect substitutes. Reinsurance from an affiliated reinsurer can involve lower transaction costs than reinsurance from an unaffiliated reinsurer, because the interests of affiliated companies are more closely aligned, and therefore there is greater trust between the parties and more complete sharing of relevant information. Consequently, it can be efficient for an affiliated group of insurance companies to manage risk to a large extent within the group, using affiliate reinsurance as a key tool, and to use unaffiliated reinsurers in a more limited capacity to deal with risks that cannot be adequately managed within the group. The natural result is that many insurance groups make far greater use of reinsurance between affiliates than external reinsurance.

The structure of the “premium limitation” mechanism under HR 3424 appears also to be predicated on the notion that affiliate and non-affiliate reinsurance are perfect substitutes. Under this mechanism, each dollar of reinsurance premium ceded to an unaffiliated reinsurer can reduce by a dollar the amount of affiliate reinsurance premium that is deductible. The effect is to confront a group of affiliated insurance companies with an unappealing trade-off: the efficient use of external reinsurance to shift risk out of the group may constrain the ability to efficiently manage risk among the affiliated companies within the group.

Finally, the industry fractions can vary over time and across lines of business in seemingly arbitrary ways. For example, the industry fractions for some lines of business have varied by double-digit percentages from one year to another. Such variations could be caused by a single large transaction, such as a major loss portfolio transfer, changes in market structure caused by mergers and acquisitions, or other factors that have nothing to do with the business purposes motivating affiliate reinsurance.