Evaluating the Impact of an Offshore Reinsurance Tax

By Michael Cragg, Jehan deFonseka, Lawrence Powell, and Bin Zhou

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When the government raises taxes on a product, supply shrinks and the price rises. That will happen if Congress imposes special taxes on reinsurance — the backup coverage that protects U.S. families and businesses from natural and man-made disasters, according to a recent study by the economic consulting firm The Brattle Group, conducted at the request of a coalition of insurance firms and consumers.

An Old Idea, Many Times Rejected

Three times over the past decade, Congress has rejected proposals to impose a special tax on the reinsurance that foreign-owned insurance companies in the United States purchase from their offshore affiliates. The special tax was also included in seven federal budgets presented by the Obama administration.

The proposals arose from pressure from some U.S.-owned insurance groups that portray offshore affiliate reinsurance as a tax avoidance strategy. Those groups argue that the proposed tax is necessary to level the playing field and will not harm U.S. consumers.


In a new approach, the Warner-Neal bill would disallow the deduction paid by a U.S. insurer to its offshore affiliate. Yet, the losses that the reinsurer pays under the insurance contract would be tax-exempt for the U.S. insurer when it receives the payment. This asymmetric tax treatment for the U.S. insurer — non-deductible on reinsurance premiums while tax-exempt on recoveries — is called a tax “deferral” because the tax exemption on incoming reinsurance claims could offset the special tax on the premiums paid in the early years. The deferral would increase the cost of providing insurance lines in which (1) the insured risks are infrequent but highly impactful, such as earthquakes, hurricanes, class-action lawsuits, and product and medical liabilities; and (2) there is often a significant lag between the initial insurance premium payment and the recovery of the reinsurance payment, such as workers compensation and automobile liabilities. In effect, if the Warner-Neal bill is enacted, some of the increase in taxes would be passed along to consumers.

Increasing Costs and Declining Coverage

Our study of the new legislation finds that the deferred deduction of affiliate offshore reinsurance would reduce the supply of reinsurance by one-eighth, or about $18.3 billion. As a result, the supply of insurance, as measured by insurance premiums, would drop by a total of $9.3 billion, or an average of 1.4 percent. The percentage drop in some low frequency but high impact lines would be much higher. Those would include declines of 4.6 percent in earthquake insurance, 5.6 percent in ocean and marine insurance, and 5.2 percent in product liability insurance.

It is calculated as approximately $18.27 billion divided by $139.76 billion.

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When supply falls, prices rise. If the Warner-Neal bill were to go into effect, we estimate U.S. consumers would pay $5 billion more per year for their current level of coverage. That translates to an average 0.8 percent increase in the price of insurance and as much as 6 percent in some insurance lines in the states most at risk for natural and man-made disasters.

With supplies of insurance declining and prices increasing, insurance coverage would drop by an average 2.2 percent throughout the nation. The falloff would be as large as 17 percent in some lines of business. For instance, earthquake coverage would fall by 6.9 percent, ocean marine coverage by 8.3 percent, and basic commercial coverage by 2.2 percent.

The impact on the cost and availability of insurance would be even greater in some natural catastrophe-prone states. For example, we estimate that the cost of basic insurance for homeowners (Homeowners Multiple Peril) would increase by $152 million, along with a decline of insurance supply by $282 million. Similarly, the cost of basic insurance for businesses (Commercial Multiple Peril) would increase by $198 million, along with a $367 million reduced supply of insurance. Similar results for Louisiana and Texas are reported in the table below.

<table>
<thead>
<tr>
<th>Consumer Impact of the Warner-Neal Bill In Select States</th>
<th>Cost Increase (dollars in millions)</th>
<th>Supply Decline (dollars in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Homeowners Multiple Peril</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Florida</td>
<td>$152</td>
<td>$282</td>
</tr>
<tr>
<td>Louisiana</td>
<td>$8</td>
<td>$15</td>
</tr>
<tr>
<td>Texas</td>
<td>$32</td>
<td>$60</td>
</tr>
<tr>
<td><strong>Commercial Multiple Peril</strong></td>
<td></td>
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</tr>
<tr>
<td>Florida</td>
<td>$198</td>
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</tr>
<tr>
<td>Louisiana</td>
<td>$9</td>
<td>$17</td>
</tr>
<tr>
<td>Texas</td>
<td>$44</td>
<td>$81</td>
</tr>
</tbody>
</table>

While some of those percentage increases may seem low, the additional costs that consumers and companies would pay — tens or even hundreds of millions of dollars — represent substantial new financial burdens in an era of economic uncertainty.

**Offshore Reinsurance Is Indispensable**

Approximately half of the global demand for reinsurance comes from the United States. That is because our country has the world’s largest insurance market and faces unique risks from natural disasters and the U.S. legal liability system. In fact, between 1970 and 2015, the United States was involved in seven of the world’s 10 costliest natural and man-made disasters. These included Hurricane Katrina in 2005 ($49 billion), Hurricane Sandy in 2012 ($20 billion), the 9/11 terrorist attacks in 2001 ($44 billion),


In particular, during the 1990s and 2000s, the growing reinsurance sector in Bermuda played an increasingly important part in providing insurance in the aftermath of major natural disasters in the United States.

Potential Consequences of ‘Border Adjustability’

Meanwhile, Congress may consider a second, more broad-based special tax on foreign reinsurance. Border adjustment — an initiative intended to close the trade deficit and create U.S. jobs by taxing imports and subsidizing exports — has been included in the House Republicans’ comprehensive blueprint on tax reform. The unintended consequence of this proposal could be a 20 percent import tax on the export of insurance risks from insurance companies in the United States to insurers overseas.

Contrary to its intended purpose of strengthening the United States’ standing in the global marketplace, border adjustability would also shrink the supply of insurance, thereby raising its price. Although this initiative takes us into uncharted territory, we estimate that it would reduce the supply of reinsurance, with the total loss of insurance supply ranging from $15.6 billion to $69.3 billion. At the same time, costs for consumers would increase by $8.4 billion to $37.4 billion. In yet another harmful effect, the misapplication of border adjustment could also diminish the diversification benefits obtained by U.S. insurance companies transferring risks to foreign reinsurers; the increased concentration risk would cause concerns about an increased insurer insolvency threat.

By buying backup coverage from reinsurers overseas, U.S. insurers are actually enhancing our country’s competitiveness by exporting risks and importing capital. These transactions should not be lumped together with other exchanges of goods and services. That is why, in other advanced economies, financial services are excluded from similar revenue-raising, export-encouraging initiatives, often called VATs.

More Catastrophes, Less Coverage

The Warner-Neal bill coupled with the threat of border adjustment comes at a challenging historical moment. The risks of large insurance losses have been increasing over time, with all but two of the top 10 insurance losses having occurred since 2000. Part of the explanation may be extreme weather events: According to the Insurance Information Institute, catastrophe losses in the United States between 1994 and 2013 can be attributed largely to weather-related events such as hurricanes and tropical storms (41 percent), tornadoes (36 percent), and winter storms (6.4 percent).

More catastrophes and less insurance coverage can be a dangerous combination. With a growing gap between insured and uninsured losses, part of the burden would fall on the federal and state governments, and ultimately on taxpayers.

Congress should consider these economic realities as it evaluates the Warner-Neal bill and border adjustment. We must not needlessly burden U.S. families, businesses, and taxpayers.

5Our estimates ignore the potential impact from foreign exchange rate changes caused by the border adjustments. We note, however, that foreign reinsurance companies writing U.S. business will incur most of the related expenses such as claims, claim reserves, loss adjustments, and expenses, in U.S. dollars.