Response on Offshore Reinsurance Tax

To the Editor:

In response to our article on the impact of affiliate-reinsurance tax proposals on the U.S. insurance market ("Evaluating the Impact of an Offshore Reinsurance Tax," *Tax Notes*, Feb. 9, 2017, p. 1421), Mr. Talisman offered to "set the record straight." ("Stem the Migration: Close Offshore Reinsurance Loophole," *Tax Notes*, Sept. 18, 2017, p. 1583.) However, his narrow tax-focused argument neglects several important facts that underlie our economic analysis. Mr. Talisman claims to seek "fairness" when in reality U.S. consumers will suffer higher premiums while owners of domestic reinsurance companies will benefit.

Affiliate Reinsurance Provides Capacity

In reality, all large global reinsurers — whether Gen Re based in the United States, Swiss Re based in Switzerland, or Munich Re based in Germany — write business that is diversified both by product line and geography. They sell insurance through local subsidiaries or on a cross border basis. This diversification by product and geography provides not only financial strength but also efficiency. All global reinsurers manage capital as efficiently as they can — keeping minimum local regulatory capital and using affiliate reinsurance to support group members.

Reinsurers use affiliate reinsurance to pool global risks back to their respective home country. For Gen Re, this is the United States; for Munich Re, it is Germany; and for Swiss Re, it is Switzerland. This centralized capital pool allows the reinsurer to more efficiently buy needed non-affiliate reinsurance. It also allows these reinsurers to provide more affordable coverage to consumers because central management of capital for reinsurers is more efficient. Mr. Talisman's article attributes the use of affiliate reinsurance solely to tax avoidance, when in reality, affiliate reinsurance plays a critical risk management role in the industry. Artificially impeding foreign-owned groups from using this risk and capital management tool for the U.S. risks they insure will reduce U.S. insurance capacity and raise consumer prices.

Affiliate Reinsurance Transfers Risk

Mr. Talisman mischaracterizes affiliate insurance as a mere bookkeeping entry involving no additional underwriting capacity. In doing so, he ignores the fact that affiliate reinsurance is a fundamental tool used by all insurance groups, both domestic and foreign, to manage their group-level and insurer-level risk. In particular, the reinsurance ceded from a U.S. affiliate to a foreign affiliate completely transfers those U.S. risks abroad.

This risk transfer is real and undergoes scrutiny from U.S. state insurance regulators, just like the risk transfer from a U.S. insurer to a non-affiliated foreign reinsurer. The data show that foreign firms cede $35 billion in insurance premiums to offshore affiliates annually. This risk transfer supports the U.S. economy, because non-U.S. reinsurance capital supports insurance policy claims and so reduces U.S. economic dislocations caused by large loss events.

Unlike non-affiliate reinsurance, affiliate reinsurance is particularly potent in mitigating the informational problems (moral hazard and adverse selection) between the insured and the insurer. In fact, U.S. insurance groups make extensive use of affiliate reinsurance within the United States. Our statistical analyses further confirm that affiliate reinsurance, non-affiliate reinsurance, and capital have different costs and benefits, and are far from perfect substitutes for each other. Mr. Talisman provides no methods or empirical analyses to calculate the impacts on consumers and insurers. In contrast, we use two decades of data from the U.S. insurance industry, to statistically measure the impacts on consumers of the proposed tax on the industry.

The Reinsurance Industry Is Global

Like many industries, the reinsurance industry has become increasingly global during the last two decades, thanks to a number of factors including business reasons, regulations, and taxes. U.K., Swiss, German, and Bermudan reinsurers have in recent years provided substantial risk-taking capacity that benefits the U.S. economy. Mr. Talisman's argument narrowly focuses on the purported tax-driven migration of U.S. insurance capital abroad, missing the broader perspective that the global spread of risk is essential to the efficient operation of insurance and reinsurance markets. As pointed out in a 2014 study by the Federal Insurance Office, Bermuda reinsurers only rose to prominence following Hurricane Andrew's devastation of Florida in 1992 and subsequent natural disasters as a number of new reinsurers were organized there to respond to the cyclical needs of the global reinsurance market. Bermuda's relatively quick regulatory approval to launch operations, proximity to the United States, and, over time, substantial concentration of capital and reinsurance-related resources all foster Bermuda's ability to serve the U.S. market.

Over the last two decades some of the largest and oldest reinsurance groups in the world, such as Munich Re, Swiss Re, and Zurich Re from Europe, QBE from Australia, and Tokyo Marine from Japan, also expanded their presence in the United States to more effectively diversify risks globally. These foreign reinsurers cover U.S. risk via various organizational structures (U.S. subsidiaries and/or branches) and transactional structures (primary insurance, affiliate and non-affiliate reinsurance). As noted above, this risk diversification reduces the total amount of capital needed to support their global business, thus making insurance more cost effective to U.S. consumers.

'Excess Capital' in the Reinsurance Industry

Mr. Talisman correctly states that recently there has been excess capital in the reinsurance market. This has resulted in falling reinsurance prices over the last decade. The prevalence of this capital is inversely correlated with the relatively limited catastrophic losses in the United States since Superstorm Sandy in 2012.

Yet, as the spate of natural disasters this year has reminded us, insurance is a cyclical business. With loss estimates exceeding $100 billion for two earthquakes in Mexico and three major hurricanes in the Atlantic, it is a good thing this "excess" capital Mr. Talisman references is there to pay these catastrophic losses. According to the insurance ratings company AM Best, reinsurance prices could increase next year and reinsurer credit ratings could be under pressure due to the growing frequency of intense storms in the Caribbean. Time and time again, in various markets, from emerging market debt to mortgage backed securities, capital has been plentiful, until a negative event occurs, and then capital becomes scarce. This is why any credible analysis of global insurance markets cannot focus on short-term market conditions but instead must be based on many years of historical data.

Sincerely,

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Sept. 27, 2017

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