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Executive Summary

On December 10, 2008, the Chairman of the Senate Finance Committee, Max Baucus (D-MT) released a Staff Discussion Draft of a proposal to permanently disallow deductions for certain reinsurance premiums with respect to U.S. property and casualty ("P&C") risks paid to affiliates (the "Staff Discussion Draft"). This document responds to a request for comments on the Staff Discussion Draft.

The U.S. P&C industry is not disappearing offshore

Both U.S.–based P&C companies and foreign-owned U.S. insurers use affiliate reinsurance for the same valid business purposes. The market for reinsurance is a global one, and Bermuda is a major reinsurance center that is fully compliant with international standards of transparency and exchange of information. As for concerns about protecting the U.S. P&C industry from foreign competitors, putting aside the current turmoil in the financial markets that has affected all participants, in recent years U.S.-based P&C insurers have earned record profits and their businesses have grown dramatically.

Negative impact on U.S. consumers

Ultimately, U.S. consumers would suffer due to the negative effects of the Staff Discussion Draft on the availability and affordability of P&C insurance in the United States. The proposed treatment would deliver a competitive *advantage* to U.S.-based insurance groups by imposing disproportionately higher taxes on their foreign-owned competitors who enter into reinsurance arrangements that are typical within related groups of insurance companies.

Discriminatory tax increase

Essentially, the Staff Discussion Draft amounts to a gross basis tax on ceded premium in excess of an arbitrary limitation—this occurs because the tax deduction for the ceded premium is disallowed *and* no tax deduction is permitted for the losses ceded to the offshore affiliate. Although the United States normally respects the sovereign rights of other countries to design their own tax systems, the Staff Discussion Draft appears to be aimed at foreign reinsurers that happen to be headquartered in jurisdictions with statutory corporate tax rates that are lower than the U.S. rate (which category would include all other industrialized countries with the exception of Japan).

No discernable tax policy rationale

The structure of the proposed statutory regime highlights the absence of any reasonable tax policy basis for denying a deduction in the circumstances prescribed by the Staff Discussion Draft. The view that current law confers some type of advantage on foreign-owned U.S. P&C groups ignores *the entire tax picture:* When a U.S. company cedes insurance to a foreign reinsurer (related or unrelated), it receives a ceding commission that reflects compensation for all components of income from the ceded insurance, including investment income. This ceding commission is fully taxable in the United States, and the U.S. company also is subject to a 1% Federal excise tax on gross premiums ceded—without regard to whether the business is profitable (the FET can be waived by treaty, but that is not the case for Bermuda-based reinsurers.)

A false analogy to earnings stripping. The proposal appears to be based on the notion that affiliate reinsurance presents "earnings stripping" opportunities, a misapprehension about the purpose of the existing rules that target the use of interest payments on related-party debt to "strip" operating profits out of the United States. Unlike a debt transaction, an affiliate reinsurance transaction involves the transfer of risk and attendant loss potential to the related party. Thus, the proposal would alter the tax consequences of affiliate reinsurance arrangements that clearly meet the definition of "true insurance" developed by a longstanding body of case law and that satisfy applicable accounting standards and the requirements of insurance regulators. The Staff Discussion Draft then departs from the earnings stripping model by failing to condition its application on the presence of profits, and by disallowing deductions with respect to a U.S. subsidiary's core business.

Absence of transfer pricing concerns. Both affiliate and nonaffiliated reinsurance transactions are respected for U.S. tax purposes. The only legitimate inquiry for U.S. tax policy makers is whether an affiliate reinsurance arrangement has an adequate "transfer price," *i.e.*, whether a reinsurer's U.S. affiliate is properly compensated for entering into the arrangement. The Staff Discussion Draft, however, would limit the deductibility of premiums paid to non-U.S. affiliates for reinsurance even if the premium levels comply with transfer pricing rules. No evidence of transfer pricing abuses has been presented, and for several reasons, the reinsurance industry presents less concern from a transfer-pricing compliance perspective than is present in other economic sectors where comparable transactions are difficult to identify. The IRS has far more information available to evaluate reinsurance transactions than is available to evaluate affiliate transactions in many other industries. Moreover, in addition to the requirements of the U.S. tax law, affiliate reinsurance is subject to regulatory oversight that ensures that these contracts are priced in an arm's length manner.

Disregard of legitimate business arrangements. The Staff Discussion Draft is deficient because it fails to temper the draconian impact of the proposal by incorporating an exception for an active trade or business. Such an exception is an important touchstone of anti-abuse rules generally, and is included to ensure that the provisions will operate in accordance with sound tax policy and avoid application to transactions that do not present tax policy concerns.

Violates treaties and poses risk of international retaliation

The disallowance of otherwise allowable deductions for reinsurance premiums paid to affiliates is a breach of the non-discrimination provisions found in the Tax Treaty with Bermuda Regarding Insurance Enterprises and Mutual Assistance, and virtually every other U.S. tax treaty, because the disallowance is directed only at foreign insurance groups. Furthermore, there is a concern that the novel approach of the Staff Discussion Draft will lead our international trading partners to reciprocate with anti-affiliate reinsurance regulations of their own.

Consider need for tax reform as an alternative

In view of the Staff Discussion Draft's failure to address a legitimate tax policy concern, ABIR concluded that legislative efforts to improve the competitiveness of U.S. P&C companies would be better spent on reform of the current U.S. corporate tax regime, rather than on seeking to impose a disproportionate tax burden on the U.S. subsidiaries of foreign-based insurance groups.

The Association of Bermuda Insurers and Reinsurers
Comments on the
Senate Finance Committee (Majority) Staff Discussion Draft
Proposal to Disallow Deductions for "Excess Non-taxed Reinsurance Premiums" Paid to Foreign Affiliates
February 25, 2009

The Association of Bermuda Insurers and Reinsurers ("ABIR") appreciates the opportunity to comment on the Senate Finance Committee Staff Discussion Draft of a proposal to disallow deductions for "excess non-taxed reinsurance premiums" with respect to U.S. risks paid to affiliates, released by Chairman Max Baucus on December 10, 2008 (the "Staff Discussion Draft"). ABIR's membership consists of 23 global insurers and reinsurers domiciled in Bermuda.

A contingent of U.S. property and casualty ("P&C") insurers[1] has sought "protection" from competition by lobbying for the enactment of discriminatory tax legislation that would penalize the U.S. operations of foreign-owned insurance and reinsurance companies, including those based in Bermuda. The Staff Discussion Draft would effectuate this goal by giving U.S. P&C insurers headquartered in the United States a competitive advantage relative to U.S. P&C companies that engage in affiliate reinsurance transactions with their foreign parents. For Bermuda companies that already bear a 1% Federal excise tax ("FET") on gross reinsurance premiums, the impact of this proposal would be the same as increasing the FET on "excess" reinsurance premiums (as defined by the Staff Discussion Draft) to more than 20%.[2]

To summarize ABIR's comments, the Staff Discussion Draft fails to identify a single tax policy concern that warrants legislative action. There is no evidence that foreign affiliate reinsurance presents transfer-pricing issues or is otherwise inconsistent with U.S. tax norms, and there is considerable evidence that these transactions serve important non-tax business purposes. Moreover, it does not appear that the U.S. P&C industry suffers from foreign competition. Thus, there is no apparent basis for singling out the global reinsurance industry for the draconian treatment proposed by the Staff Discussion Draft. Particularly in view of the historic economic 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 the Staff Discussion Draft).

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[1] This group of U.S. P&C companies is referred to herein as the "Berkley Coalition," after William R. Berkley, Chairman of the Board and CEO of W. R. Berkley Corporation, the executive who testified before the Senate Finance Committee in September 2007, on behalf of this group.

[2] The Background Memorandum released with the Staff Discussion Draft acknowledges that an actual increase in the current FET would breach international trade agreements.

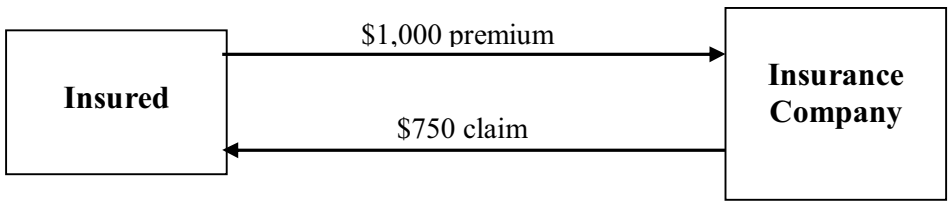
Section I of these comments provides background information regarding the current state of the reinsurance market, including explanations of the economics of insurance and reinsurance transactions, affiliate reinsurance arrangements, and the Bermuda market in particular. Section II surveys the potential for negative economic consequences if the proposal in the Staff Discussion Draft were enacted. Finally, section III analyzes the impact of the Staff Discussion Draft, and the tax policy implications of the proposed legislation. ABIR looks forward to working with Chairman Baucus and his staff to address the tax policy issues presented in these comments, and is hopeful that the views of its member companies will be considered before any decision with respect to this issue is finalized. ABIR stands ready to provide any additional information about the concerns raised in these comments.

I. Background Regarding the Current State of the Reinsurance Market

A. The Reinsurance Business Model

1. Insurance Transactions

An insurance policy is a financial transaction in which risk is transferred from the insured to the insurance company. In exchange for payment of an insurance premium, the insurance company promises to compensate the insured if a specified, fortuitous event occurs (*e.g.*, property damage from an accident or a natural disaster). The payments of claims on insurance policies are often referred to as loss payments or losses. The diagram below illustrates a simple example in which the insured pays the insurance company a $1,000 premium for a P&C policy providing cover for a particular risk, and the insurance company must ultimately pay a $750 claim on that policy. Of course, at the time the policy is entered into the magnitude of the loss is not yet known, and in the case of major natural catastrophes such as hurricanes losses may well exceed the premiums paid.



Source of Income or Loss with Respect to an Insurance Policy. Insured losses may not be paid until some time after the loss was actually incurred. This time lag may occur because the insured has not yet discovered the loss, the loss has yet to be reported to the insurance company, claims adjusters have not yet determined the amount of the loss, or final determination of the loss is the subject of legal proceedings. Nevertheless, from the time an insurance policy is issued until the time the last of the losses on that policy are paid, the insurance company must hold sufficient investment assets to pay the ultimate losses. The insurance company thus has two

sources of gross income associated with an insurance policy: premiums received from the policyholder and investment income from assets held to ensure that the policyholder's claims can be paid. The insurance company's expenses include the loss payments themselves and the costs of obtaining and administering the policy, including underwriting expenses and loss adjustment expenses.

Loss Reserve Discounting. It is not unusual for the total underwriting and loss and loss adjustment expenses to exceed the premiums received from policyholders. An insurance business may still be profitable in this case because the insurance company receives the premium from policyholders before losses and loss adjustment expenses must be paid, and this timing difference provides a time value of money benefit to the insurance company. U.S. income tax rules permit deductions for insurer expenses, including underwriting and loss and loss adjustment expenses. A loss reserve discounting provision in the tax rules is designed to adjust for the time value benefit created by the timing difference between when losses are incurred and when they are paid. Full deduction for losses and loss adjustment expenses is allowed, but through loss reserve discounting only part of the deduction may be allowed in the year in which the losses are incurred, while the remainder is deducted in future years.

2. Reinsurance Transactions

Reinsurance is risk management effected though a contractual arrangement between insurance companies in which part or all of a risk or set of risks insured by one company (the "ceding" company) is transferred to another company (the "reinsurer"). The assumption of risk is the core function of an insurance enterprise, and capital is the key resource that allows an insurance business to function. Regulators and rating agencies require that each individual insurance company has the capital available to it to ensure (with a high probability) that the company will be able to pay claims on the risks it insures. The more efficiently an insurance group can manage risk and the utilization of capital, the lower its costs, and the more effectively it can compete.

Business Reasons for Reinsurance. Reinsurance is widely used throughout the insurance industry, and occurs between non-affiliated insurance and reinsurance companies as well as between affiliated insurance companies, both within the United States and across borders. Reinsurance is used primarily for the following reasons—

(a) Reinsurance spreads risks and provides protection against catastrophe, so that stand-alone, separately capitalized insurers are not overwhelmed by losses associated with the risks that they insure. It lowers the ceding company's net retained liability from the policies it underwrites, enabling the ceding company to underwrite more business than its own capital could support, and providing protection against catastrophic losses.

(b) Reinsurance enables a group of affiliated insurance companies to manage capital effectively by transferring premiums and associated risk.

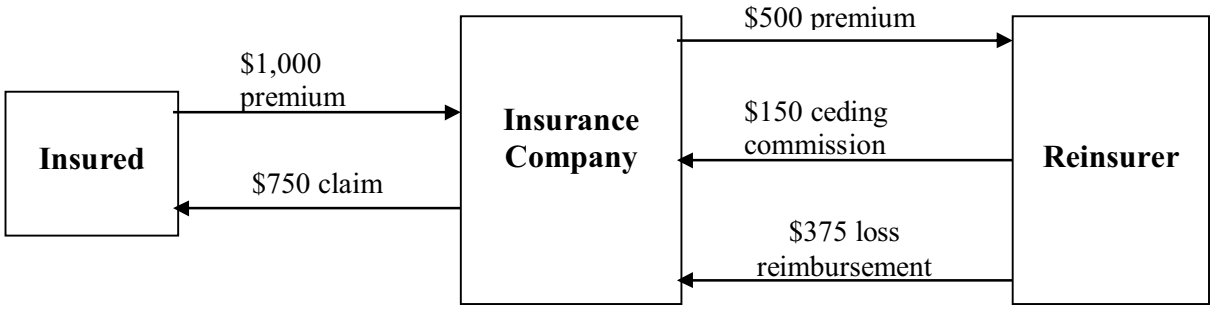
(c) There is a risk diversification benefit when a reinsurer assumes risks from multiple insurers (including affiliates); because the mix of business written by different insurers varies, the volatility of the losses from the aggregation of risks from across the different insurance companies may be lower than the volatility of the losses from the risks underwritten by an individual insurer.

(d) Reinsurance enables global companies to build capital in flagship enterprises that have the flexibility to deploy capital to sell coverage to meet market opportunities in any jurisdiction in the world in a timely fashion.

(e) Reinsurance support of a subsidiary by a parent or other affiliate can be an important factor considered by rating agencies when they evaluate whether to extend the financial strength rating of the group to the subsidiary.

Two Broad Types of Reinsurance. Reinsurance transactions fall into two broad types: proportional reinsurance and non-proportional reinsurance. Under proportional reinsurance (also known as pro rata or quota share reinsurance), the ceding company and the reinsurer share in an agreed proportion the premiums and the losses and loss adjustment expenses on policies underwritten by the ceding company. In proportional reinsurance transactions, the reinsurer typically pays the ceding company a ceding commission to compensate the ceding company for having acquired the business that is being reinsured. Under non-proportional reinsurance (also referred to as excess-of-loss reinsurance) the reinsurer agrees to reimburse the ceding company for losses in excess of a specified amount up to a specified limit.

Most reinsurance of U.S. companies by foreign affiliates is quota share reinsurance. The following diagram illustrates the payment flows if the insurance policy presented in the example above were covered by a 50-percent quota share reinsurance agreement with a 30-percent ceding commission:



Under this quota share reinsurance transaction, 50 percent of the $1,000 premium received by the insurance company from the policyholder is paid to the reinsurer, and the reinsurer pays the ceding insurance company a ceding commission equal to 30 percent of the ceded premium. The reinsurer is then obligated to reimburse the ceding insurance company for 50 percent of any losses arising under the policy.

The ceding insurance company can benefit from the quota share reinsurance in two ways, even before any losses are paid on the underlying policy. First, it receives the ceding commission from the reinsurer, to compensate for the costs of underwriting and administering the policy and provide some profit to the ceding company. For example, if the ceding company's underwriting expenses are 26 percent of the premium, then a 30-percent ceding commission would leave the ceding company a 4-percent profit margin – in the above example, $20 of profit on the $500 of ceded premium. Second, the ceding company generally gets an immediate financial statement benefit in that it does not have to maintain reserves to cover losses that have been ceded to the reinsurer.[3]

Affiliate Reinsurance. Reinsurance is used within affiliated groups of companies because it allows the group to manage risk and capital efficiently. Both U.S.-headquartered P&C companies and foreign-owned U.S. insurers use affiliate reinsurance for the same business purposes. Moreover, affiliate reinsurance is subject to regulatory approval under state insurance holding company laws (*e.g.,* in New York each such transaction has to be approved), in addition to financial accounting requirements. At the Federal level, affiliate reinsurance is subject to Internal Revenue Service ("IRS") oversight under transfer pricing statutes and regulations that require the terms and conditions of affiliate transactions to mirror the arm's length transactions of unrelated parties. Furthermore, as explained below (in the discussion of transfer-pricing in section II.C, dealing with the tax policy implications of the Staff Discussion Draft), I.R.C. §845(a)[4] provides the IRS with an enhanced tax examination tool. It is simply misleading to assert, as the Berkley Coalition does, that affiliate reinsurance is a "mere a bookkeeping entry" that moves premiums offshore.[5]

As detailed below, affiliate reinsurance provides three key benefits: (a) risk diversification from the aggregation of risks; (b) flexibility in redeploying capital to respond to changes in the market; and (c) demonstrating to rating agencies a commitment to support an affiliate and stand behind its obligations. These benefits are accomplished through valid arms-length reinsurance business transactions.—

(a) *Risk Aggregation and Diversification.* Large P&C insurance enterprises generally operate as groups of related companies. The mix of business of each company within the group may differ from that of the other companies in terms of the geographic markets and/or lines of business served. Affiliate reinsurance can be used under these circumstances to aggregate risks from the businesses of many affiliates into a smaller number of entities. Aggregation of risks from many entities into one entity can reduce the amount of capital required to support those risks because it provides a diversification benefit when the risks taken on by the various entities within the group are not perfectly correlated.

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[3] The financial statement benefit generally is available to U.S. insurance companies if the reinsurer is licensed and regulated by a U.S. authority or if the reinsurer posts collateral for its obligation in a form acceptable to the ceding company's U.S. regulator. Foreign reinsurers generally must post collateral.

[4] All references to "I.R.C. §" are to sections of the Internal Revenue Code of 1986, as amended.

[5] *See* Testimony of William R. Berkley, Chairman of the Board and CEO, W. R. Berkley Corporation, Before the Senate Finance Committee on September 26, 2007 (the "Berkley Testimony"), on page 2.

Example of risk aggregation and diversification. A simple hypothetical example illustrates this benefit. Suppose that in an insurance group there are two related companies: Company A and Company B. Company A writes principally aviation insurance, while Company B writes principally earthquake insurance. Suppose that in order to satisfy rating agencies, regulators, and/or customers, capital must be available to satisfy claims for the largest annual loss that is expected to occur once in 250 years (put differently, the company must be able to pay a level of total losses that has a 1/250 or greater probability of occurring within a year). If Company A and Company B are each capitalized separately, and there is no intercompany support as would be provided by affiliate reinsurance, then Company A must have capital sufficient to pay claims for any aviation losses with more than a 1/250 probability of occurring in a year, and Company B must have capital sufficient to pay claims for any earthquake losses with at least a 1/250 probability of occurring in a year. But aviation accidents are uncorrelated with earthquakes, so the probability that a once-in-250-years aviation loss would occur in the same year as a once-in-250-years earthquake loss is vanishingly small.[6] Consequently, if this group used affiliate reinsurance to aggregate the risks of Company A and Company B into one entity, less capital would be needed to support those risks to the once-in-250-years standard than is needed if the risks are retained separately by each company. The aggregated pool of risks is more diversified than the risks of Companies A or B operating on a standalone basis, and that lowers the volatility of the losses for the aggregated pool relative to the losses of the individual companies in the absence of affiliate reinsurance.

(b) *Flexibility in Deploying Capital Resources.* Due to shifts in market conditions, the relative profitability of insurance in different geographic markets and lines of business varies over time. P&C insurance groups operate more efficiently, and are more competitive, if they are able to respond to these shifts by redeploying capital from market segments that have become less profitable to market segments that are more profitable. Affiliate reinsurance allows more flexibility in responding to these shifts than would exist if the group were required to move capital from one entity to another, because the movement of capital generally is subject to greater regulatory hurdles.

(c) *Demonstrating Commitment to Support a Subsidiary.* An insurance company's ability to compete for business is significantly affected by the financial strength rating it obtains from rating agencies such as A.M. Best and Standard & Poor's. When evaluating a subsidiary company within an insurance group, rating agencies consider the support the subsidiary may receive from its parent and other group members to determine whether to extend the rating of the parent company to the subsidiary. An important factor in this determination is the extent of explicit contractual support that the subsidiary receives from the parent or other affiliates, including support provided via reinsurance,. In many cases, rating agencies look for substantial affiliate

[6] In fact, the probability of both events occurring in the same year is 1/62500.

reinsurance as evidence of the parent's commitment to support the subsidiary and ensure that the subsidiary's obligations to policyholders are met.

An Example of High Levels of Related-Party Reinsurance Within a U.S. Insurance Group: The W.R. Berkley Group

2007 Data -- In $ Thousands

Company Name	Gross Premiums(1)	Net Premiums Ceded to Affiliates(2)	Net Premiums Ceded to Affiliates/ Gross Premiums
Acadia Insurance Company	309,647	309,647	100.0%
Berkley Regional Specialty Ins Co	16,067	16,067	100.0%
Continental Western Insurance Co	623,300	623,300	100.0%
Firemens Ins Co of Washington DC	233,198	233,198	100.0%
Tri State Insurance Co of Minnesota	11,259	11,259	100.0%
Union Standard Lloyds	16,291	16,291	100.0%
Union Insurance Company	212,948	212,947	100.0%
Gemini Insurance Company	181,345	180,726	99.7%
Preferred Employers Insurance Co	95,743	85,778	89.6%
Starnet Insurance Co	134,943	119,798	88.8%
Midwest Employers Casualty Co	341,518	296,238	86.7%
Key Risk Insurance Company	155,059	131,807	85.0%
Clermont Ins Co	7,593	6,031	79.4%
Great Divide Insurance Co	93,379	69,151	74.1%
Admiral Indemnity Co	59,770	32,562	54.5%
Riverport Ins Co	58,884	31,864	54.1%
Carolina Casualty Insurance Co	382,202	18,394	4.8%
American Mining Insurance Co Inc	33,346	0	0.0%
Admiral Insurance Company	578,184	(36,435)	-6.3%
Nautilus Insurance Company	412,981	(76,851)	-18.6%
Berkley Ins Co	702,532	(908,131)	-129.3%
Berkley Regional Insurance Company	95,607	(1,424,832)	-1490.3%

Source: Tabulations of data from the Highline Data U.S. P&C Insurance database.

Notes: (1) Gross premiums are defined here as premiums received from customers for policies of insurance plus premiums received from unaffiliated insurance companies for policies of reinsurance.
(2) Net premiums ceded to affiliates equals reinsurance premiums ceded to affiliates less reinsurance premiums assumed from affiliates.

Affiliate Reinsurance Among Domestic Groups Underscores the Business Purpose. Generally, U.S. insurance groups do not obtain a Federal income tax benefit from the use of affiliate reinsurance. Nevertheless, U.S. insurers use a large amount of affiliate transactions to pool insurance premium and risk. In fact, U.S.-based groups also enter into reinsurance arrangements with foreign affiliates, despite the application of the anti-deferral rules of Subpart F. The frequency with which affiliate reinsurance is used within U.S.-headquartered P&C groups underscores the underlying business reasons for entering into reinsurance arrangements. As just one example, the table immediately above presents data on the use of affiliate reinsurance within the W.R. Berkley group of related insurance companies. The W.R. Berkley group makes extensive use of affiliate reinsurance: 16 of 22 companies in the group cede to affiliates most of the premiums they receive from their customers.

Affiliated Reinsurance is More Common than Unaffiliated Reinsurance Due to Non-Tax Economic Factors U.S. P&C insurance industry data from 2007 indicate that premiums ceded to unaffiliated reinsurers by U.S. insurance companies averaged only approximately 12 percent of ceding company gross premiums. The following table presents data on the level of reinsurance obtained from affiliates by U.S. companies that are members of *U.S.*-controlled insurance groups.[7] Consistent with the results shown above for the W.R. Berkley group, and in contrast to the results for unaffiliated reinsurance, this table demonstrates that high levels of affiliate reinsurance are quite common within U.S. insurance groups – over one third of companies ceded 80 percent or more of the premiums they receive from their customers (net of reinsurance assumed from affiliates) to affiliated reinsurers, and nearly one half of the companies ceded 40 percent or more to affiliates.

In one sense the table below understates the prevalence of affiliate reinsurance within U.S.-based insurance groups because the data include companies on both sides of the affiliate reinsurance transaction: the companies that cede premiums to affiliates and most of the affiliates that receive the ceded premium.[8] In aggregate across the U.S. industry, affiliate reinsurance shifts large amounts of premiums and risk among affiliates within U.S.-based insurance groups.[9] Clearly U.S.-based insurance groups use affiliate reinsurance far more extensively than they use unaffiliated reinsurance, even though there is no discernible tax motivation for these affiliate reinsurance transactions.

[7] Only companies that are members of U.S. groups with at least $500 million of gross premiums were included in this analysis. Groups with gross premiums under this threshold are much smaller than most multinational insurance groups.

[8] There is a portion of the ceded premium of U.S.-based insurance groups that goes to offshore affiliates that is not included in the data.

[9] In 2007, U.S. companies that ceded reinsurance premiums to affiliates (net of premiums assumed from affiliates) transferred over $125 billion of premiums to affiliates net of the premiums they assumed from affiliates. This $125 billion of ceded premium was over 50 percent of the gross third-party business those companies wrote in 2007.

Related-Party Reinsurance within U.S. Property-Casualty Insurance Groups (1)

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

Foreign-Controlled Companies Excluded (2)

Net Premiums Ceded to Affiliates/Gross Premiums (3)	Number of Companies	Percent of All Companies
>= 0%	744	100.0%
> 10%	443	59.5%
> 20%	413	55.5%
> 30%	388	52.2%
> 40%	361	48.5%
> 50%	341	45.8%
> 60%	317	42.6%
> 70%	289	38.8%
> 80%	268	36.0%
> 90%	219	29.4%

Source: Tabulations of data from the Highline Data U.S. P&C Insurance database
Notes: (1) Data include only companies belonging to a U.S. insurance group with at least $500 million in gross written premiums. To eliminate substantially inactive companies, individual companies within a group were excluded from the analysis if the individual company had less than $10 million in gross written premiums.
(2) Foreign control is defined here as 50 percent or greater control of the company by foreign persons.
(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.

Affiliate reinsurance is more extensive than reinsurance from non-affiliates because of asymmetries of information between buyers and sellers, and the costs of writing, monitoring and enforcing contracts. Economists have long understood these factors to be key reasons that some economic activities are more efficiently conducted within a corporate group than between unrelated parties. In insurance and reinsurance transactions, the buyer often has better information than the seller about the risk to be insured or reinsured. This leads to two types of problems in insurance markets: moral hazard and adverse selection. Moral hazard exists when the presence of insurance affects the behavior of the insured. For example, someone with auto theft insurance may be less careful about locking his car because the insurance company bears some of the loss if the car is stolen. Adverse selection occurs when the insured has better information about its risk than the insurance company, and so the insurance company may end up attracting riskier business than it had bargained for. Moral hazard and adverse selection are understood to be key reasons that insurance markets are incomplete, meaning that it is often not possible to insure completely against a risk.

Moral hazard and adverse selection problems exist in reinsurance transactions between unrelated parties because the insurer often has better information about the risks it insures than the reinsurer to whom it cedes those risks. For example, an insurance company may be less stringent in its underwriting if it is ceding most of the risk it insures to a reinsurer and making its profit through ceding commissions. Reinsurers seek to address these problems in part through

contractual provisions that specify underwriting standards and by monitoring the insurer's underwriting activities, but these remedies can be imperfect and costly to implement. Because these remedies are imperfect, unrelated reinsurers also typically seek to align the incentives of the insurer with the reinsurer's interests by requiring the insurer to retain a significant amount of risk so that the insurer shares in the consequences of poor underwriting and risk selection. The desire to align incentives limits the amount of reinsurance that unrelated reinsurers are willing to provide to an insurance company.

The problems created by information asymmetries generally do not exist when reinsurance is between related parties because the incentives of the reinsurer and the insurer are already aligned when they are commonly owned or controlled.

Affiliate Reinsurance Involves Real Risk Transfer. Affiliate reinsurance involves the real transfer of risk from one legal entity to another, with the attendant transfer of losses and the tax consequences of those losses. This has at times resulted in the ceding of hugely unprofitable business out of the United States to non-U.S. insurers, because no reinsurer knows at the time it writes business which policies or lines of business will turn out to be profitable and which will not. Publicly available data (in the table below) show that cross-border affiliate reinsurance frequently results in the realization of large losses outside the United States, where *no one gets the benefit of a U.S. tax deduction for those losses*. The table shows the loss ratio for business ceded to reinsurers by U.S. subsidiaries of certain ABIR member companies.[10] The loss ratio equals the losses ceded to reinsurers divided by the premium ceded to reinsurers. For example, a loss ratio of 100% means that for each dollar of premium the reinsurer received from the U.S. ceding company, the reinsurer ended up having to reimburse the ceding company for one dollar of losses. In many cases, in addition to the losses, the reinsurer paid the U.S. ceding company a substantial ceding commission. For example, if the ceding commission rate was 30 percent, and the loss ratio turned out to be 100 percent, then for each dollar of premium received by the reinsurer, the reinsurer would have to pay to the ceding company one dollar for reimbursement of losses plus an additional 30 cents ceding commission. It is evident from the table that there were many years in which the reinsurers did not make out well under their reinsurance arrangements with U.S. affiliates because the total of loss payments plus ceding commissions far exceeded the premiums they received from U.S. affiliates. Conversely, during those same years, U.S. affiliates earned higher taxable income (or posted lower tax losses) than would have been the case in the absence of affiliate reinsurance.

[10] This data includes reinsurance from both affiliated and unaffiliated reinsurers, but the majority of the reinsurance obtained is in most cases from offshore affiliates.

U.S. Subsidiaries of Certain ABIR Members:
Loss Ratio of Business Ceded to Reinsurers
1999 - 2007

Company	1999	2000	2001	2002	2003	2004	2005	2006	2007
Allied World Assurance Co.	N/A	N/A	64.1%	36.9%	54.7%	103.8%	96.4%	69.1%	63.5%
Arch Capital Group	N/A	N/A	154.5%	81.6%	57.4%	59.7%	77.4%	61.9%	60.8%
Argonaut Group	162.1%	89.5%	134.6%	40.0%	34.6%	59.3%	86.4%	69.4%	61.8%
Aspen Insurance	54.5%	73.2%	136.3%	70.1%	46.7%	53.3%	285.8%	34.5%	33.5%
Axis Capital Group	N/A	N/A	N/A	105.4%	51.4%	96.6%	116.8%	54.4%	61.5%
Endurance Group	N/A	N/A	N/A	N/A	80.8%	67.3%	86.9%	62.0%	53.4%
PartnerRe Group	136.1%	829.0%	923.6%	6.8%	1.9%	59.0%	81.1%	58.7%	59.1%
Platinum Underwriters	N/A	N/A	N/A	N/A	57.2%	110.3%	132.6%	64.8%	71.3%
Renaissance Re Group	92.1%	88.2%	83.5%	45.2%	30.4%	61.9%	61.0%	61.4%	57.2%
XL Capital	123.7%	111.6%	161.7%	73.8%	60.7%	61.5%	92.3%	60.8%	70.5%

Source: Tabulations of data from the Highline Data U.S. P&C Insurance database
Note: N/A indicates data was unavailable or no premiums were ceded to reinsurers

Given the magnitude of the reinsured losses in some years, it is not credible to suggest (as the Berkley Coalition has done) that foreign-owned P&C companies "cherry pick" profitable business and reinsure it with an offshore affiliate. Reinsurance contracts are entered into before losses are realized, and it is not possible at that point to determine which policies or lines of business will turn out to be profitable and which will not.

B. The Bermuda Market

The market for reinsurance is a global market, and Bermuda is a major reinsurance center.[11] Bermuda offers a flexible and responsive regulatory regime that makes it an attractive location to base start-up companies. Many start-up insurers were established in Bermuda in recent years to meet shortfalls in coverage in U.S. *and* European markets. In turn, the development of industry expertise in Bermuda resulted in the buildup of infrastructure, including personnel with key insurance and reinsurance expertise. Bermuda reinsurers deploy capital around the world via direct writing through brokers, capitalization of subsidiaries, and other channels. Geographically, Bermuda is well suited for access by major U.S. and European reinsurers.

1. ***Bermuda reinsurers were created to fill market voids and meet U.S. and worldwide capacity demands.***

In recent years the U.S. insurance market has been buffeted by huge catastrophes that strained the ability of the global insurance industry to provide sufficient capital to fund insurance

[11] Based on net reinsurance premiums written data from Standard and Poor's 2007 Global Reinsurance Highlights report, Bermuda ($16.5 billion) ranks among the top four reinsurance domiciles, along with the United States ($42.0 billion); Germany ($43.0 billion); and Switzerland ($20.3) billion.

risk for U.S. consumers. Foreign reinsurance companies – including to a great degree those that are domiciled in Bermuda – have played a critical role in covering claims and making capital available to help underwrite risk in the United States. (Appendix A surveys the Recent History of the U.S. Insurance Market and the Role of Bermuda Insurers in Meeting U.S. Business and Consumer Needs.) The U.S. insurance market could not provide adequate coverage to Americans without the availability of foreign reinsurance capital.

Ease of Entry. P&C insurance carriers were established via the streamlined Bermuda licensing process in order to meet U.S. customer needs quickly. This could never have been accomplished in as timely a fashion under the U.S. state regulatory system that is comprised of multiple jurisdictions with expensive and slow moving regulatory structures. For example, under the regulatory process in Bermuda, a company can obtain approval of a license in as little as 60 days. In recent history, the major catastrophic events in the United States were hurricanes and the World Trade Center attack on 9/11/01. Each of these events caused major losses of reinsurer capital that reduced their capacity to offer reinsurance in the world reinsurance marketplace. Reinsurance capacity reductions almost inevitably lead to increases in reinsurance (and insurance) prices. In response, after each such event, new entrants were able to establish insurance companies in time to take part in the following January 1st reinsurance policy renewal process. The rapid entry of new capacity into the global reinsurance market helped to dampen the impact of these catastrophes on reinsurance and insurance prices. Such quick access to market would have been (and continues to be) impossible in the United States.

Compliance with International Standards of Transparency and Exchange of Information. Bermuda has a tax information exchange agreement in force with the United States covering the exchange of information with respect to criminal and civil tax matters. Indeed, in a quote published by Reuters on November 29, 2008, Jeffrey Owens, director of the Centre for Tax Policy Administration at the Organisation for Economic Cooperation and Development ("OECD"), cited Bermuda as one of only seven "offshore centres" that is fully compliant with OECD transparency standards. Moreover, Bermuda does not have statutory bank or business secrecy laws. As recently as January 12, 2009, Premier Ewart Brown, Deputy Premier Paula Cox, and the U.S. Consul General (Gregory Slayton) signed a "Treaty on Mutual Legal Assistance in Criminal Matters," a treaty between Bermuda and the United States that will allow authorities in both countries to request and obtain assistance from each other in criminal investigations and prosecutions and related proceedings. At that signing, the U.S. Consul General stated that "the US and Bermuda already have an excellent working relationship on law enforcement matters and this treaty will help formalise [sic] and solidify that relationship by creating a direct channel of contact between prosecutors in each country."[12]

2. *Bermuda carriers have performed as a "shock absorber" meeting U.S. economic needs.*

Over the years, periodic "supply shocks" have temporarily reduced capacity in the insurance and reinsurance markets, leading to reduced supply and higher prices for insurance and reinsurance. One supply shock was caused by the 9/11 attacks, which resulted in the largest

[12] January 13, 2009 edition of *The Royal Gazette*, Hamilton Bermuda.

insured loss known to that date; another occurred when many insurers and reinsurers found that losses associated with risks they had insured during the 1990s through 2000 were much larger than the related reserves. During the 2004-2005 period, eight U.S. hurricanes in two years devastated Florida, Louisiana and Mississippi (with Hurricane Katrina alone generating $45 billion in insured losses). These events reduced the capital in the industry and the willingness of U.S. insurers to take on catastrophic risks. Demand for property catastrophe reinsurance increased as many U.S. insurance companies sought to reduce their exposure to catastrophe losses. As a result, nine new Bermuda-based insurers were created to meet increased demand. Over the 2001-2008 period, Bermuda reinsurers made over $30 billion in economic contributions to the United States in catastrophe claim payments for terrorism and natural disaster events.

Over the years, Bermuda reinsurance companies have specialized in providing low-frequency, high-severity risk reinsurance in the U.S. market to cover natural disasters, and are now the largest providers of U.S. property catastrophe reinsurance protection: 22 of the top 35 reinsurers protecting Florida risk are Bermuda companies; Bermuda carriers provide 67% of the reinsurance to Florida based home insurers (together all international reinsurers provide 93% of the Florida private residential reinsurance market); 66% of the reinsurance purchased by the Texas Windstorm Insurance Association (TWIA); together all international reinsurers provide 89% of the TWIA reinsurance coverage); and 39% of the reinsurance purchased by the California Earthquake Authority (CEA; together all international reinsurers provide 94% of the CEA coverage).

3. ABIR members generate income from more than 100 countries worldwide

It is important to note that Bermuda insurance companies participate in the global market, reinsuring policies for related and unrelated companies around the world. The following chart sets forth information from a survey of Bermuda insurance groups, showing for each group the geographic distribution of premiums written, divided between North America, Europe, and the rest of the world.[13] This demonstrates the broad geographic distribution of the business conducted by Bermuda insurers.

[13] Note that there may be some inconsistencies across companies in the chart in how premiums were assigned to regions. In some cases the assignment appears to be based on the location of the insured while in others it appears to be based on the location of the underwriting activity.

Global Business of Certain Bermuda Insurance Groups
2007 Written Premium by Region

Rank by Earned Premium	Company	North America	Europe	Rest of The World
	Allied Word Assurance Company Holdings	13%	16%	71%
	Amlin Bermuda Ltd	39%	48%	13%
3	Arch Capital Group	69%	18%	13%
6	Aspen Insurance Holdings	74%	15%	11%
	Associated Electric and Gas Insurance Services Ltd	61%	39%	0%
4	Axis Capital Holdings	47%	27%	26%
5	Catlin Group Ltd	2%	89%	9%
7	Endurance Specialty Holdings	54%	9%	37%
8	Everest Reinsurance	59%	34%	7%
	Flagstone Reinsurance holdings	53%	15%	32%
	Harbor Point Ltd	43%	7%	50%
	Hiscox Ltd	38%	38%	24%
	IPC Holdings Ltd	0%	2%	98%
	Lancashire Insurance Company	44%	6%	50%
	Max Capital Group	55%	45%	0%
	Montpelier Re Holdings	52%	13%	35%
2	PartnerRe Ltd	42%	45%	13%
9	Renaissance Holdings Ltd	88%	6%	6%
	Tokio Millennium Re	0%	0%	100%
	Validus Holdings Ltd	38%	7%	55%
1	XL Capital Ltd	44%	43%	13%

Source: Bermudian Business Magazine April/May 2008

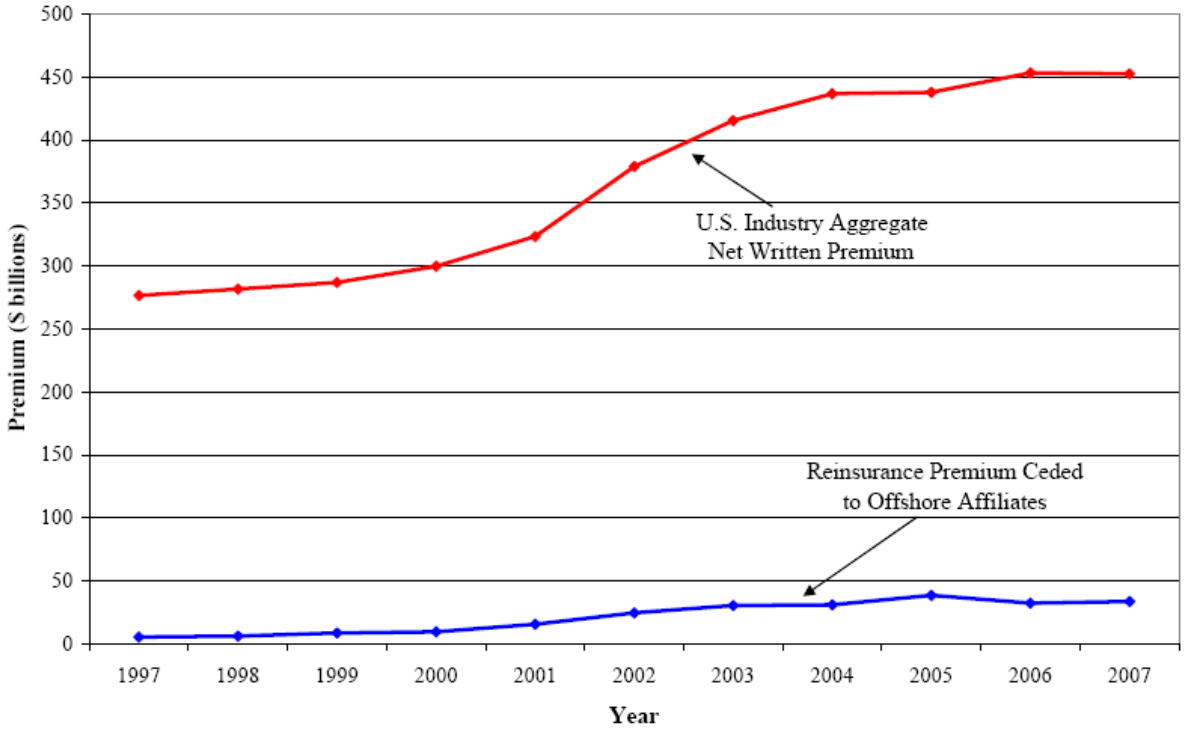
C. The U.S. P&C Industry Has Continued to Thrive

Echoing the claims of the Berkley Coalition,[14] the Technical Explanation of the Staff Discussion Draft cites "a tax-induced competitive disadvantage for U.S. insurers and reinsurers." This claim is flatly contradicted by the facts. In recent years, putting aside the current turmoil in the financial markets that has affected all market participants, U.S.-based P&C insurers have earned record profits and their business has grown dramatically. By all measures (including comparative profitability, stock price, and return on equity) the domestic insurance industry has

[14] *See* the Berkley Testimony on page 1 ("This unfair tax advantage…could threaten the future of our domestic insurance industry.")

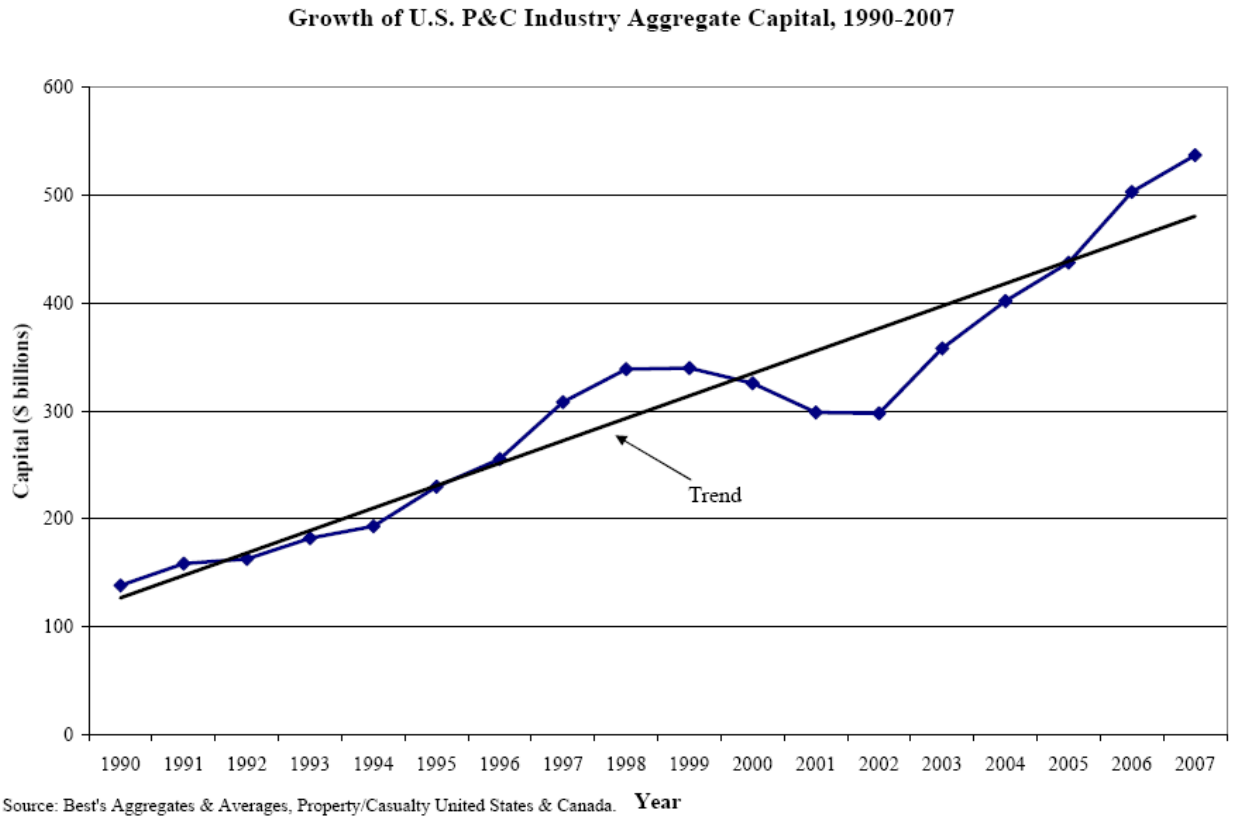
thrived. The following charts show the historical growth of the U.S. industry's aggregate net written premium, relative to the growth of affiliate offshore reinsurance premiums, and the growth of aggregate capital in the U.S. P&C industry.

Growth in U.S. P&C Industry Aggregate Net Written Premium and Offshore Affiliate Reinsurance Premium, 1997-2007



Data Sources: Best's Aggregates & Averages, Property/Casualty United States & Canada (various editions) and Reinsurance Association of America, Offshore Reinsurance in the U.S. Market (various

The high level of profits in the industry, the growth of the capital base of U.S. insurance companies, and the increase in offshore reinsurance were largely due to cyclical factors and "supply shocks" that resulted in a reduction in the U.S. P&C industry's aggregate capital during the period from about 1999 to 2001. Since that time high prices and high profitability have generally prevailed within the U.S. industry. While offshore affiliate reinsurance grew rapidly along with the rest of the industry from 2000 to 2003, offshore affiliate reinsurance saw only modest growth from 2003 to 2007.



"Surplus lines" insurance is a specialty commercial line of business that is largely outside the scope of state rate and form regulation; Large commercial risks are generally written in this line of business. The chart immediately below shows that only three of the top ten U.S. Surplus Lines insurers are ultimately foreign owned. These three carriers have 25% of the market, although 17% of that lies with a U.K. institution – Lloyd's.

U.S. Surplus Lines—Top 10 Groups (2007)

Ranked by 2007 direct premiums written, AM Best, Best Review, September 2008					
Company	**Direct Premium Written**	**Market Share**	**Parent Company Location**		
1. AIG	**$8.3 Billion**	**22.2%**	**U.S.**		
2. Lloyd's	**$6.4 Billion**	**17.0%**	**United Kingdom**		
3. Zurich	**$1.6 Billion**	**4.4%**	**Switzerland**		
4. Nationwide	**$1.4 Billion**	**3.9%**	**U.S.**		
5. ACE INA	**$1.2 Billion**	**3.3%**	**Switzerland**		
6. WR Berkley	**$1.2 Billion**	**3.1%**	**U.S.**		
7. Markel	**$1.1 Billion**	**3.0%**	**U.S.**		
8. Alleghany	**$1.0 Billion**	**2.6%**	**U.S.**		
9. Berkshire Hathaway	**$0.9 Billion**	**2.5%**	**U.S.**		
10. CNA	**$0.8 Billion**	**2.0%**	**U.S.**		

II. The Potential for Negative Economic Impacts

A. The Current Financial Crisis

> *"Foreign reinsurers with domestic subsidiaries fill a need in both the US and global insurance markets, and are critical to the economy's continued health and vitality. Over the past few decades, these entities have stepped in to fill a void when domestic insurers did not respond to US insurance buyers' needs."* Janice Ochenkowski, managing director, Jones Lange LaSalle., Inc., president Risk and Insurance Management Society, Inc. ("RIMS"), Dec. 8, 2009 AM Best, *Best Review* magazine.

The U.S. insurance market is dependent on domestic and foreign participants that have enough capital to meet the U.S. insurance market's aggregate capacity needs. Thus, even as the Berkley Coalition rails against the use of foreign insurance capital obtained through transactions with affiliates, it promotes the Staff Discussion Draft that would preserve the ability to utilize foreign sources of insurance capital to fund the domestic insurance needs of U.S.-based companies.[15] Thus far the P&C insurance industry has been relatively insulated from the capital markets crisis; however, the impact of the Staff Discussion Draft may well be to undermine the strength of this financial sector.

> *"With the current US financial market turmoil -- including the U.S. government takeover of the country's largest insurer – this is a dangerous proposal that fundamentally limits capital available to US insurance companies and their consumers, and puts a straightjacket on continued foreign insurer assistance to the US market*. " Nancy McLernon, President and CEO of the Organization for International Investment (OFII), an association of U.S. subsidiaries of companies headquartered abroad.[16]

B. Impact on U.S. consumers

U.S. policyholder groups have urged opposition to proposals such as the Staff Discussion Draft because of the effect on the availability and affordability of insurance. "Ultimately, the U.S. consumers will suffer if this proposal is approved," so stated the Coalition for Competitive Insurance Rates in its letter to Senator Max Baucus, Chair of the Senate Finance Committee, last fall.[17] The signers of that letter included major U.S. business and consumer organizations, including the Risk and Insurance Management Society ("RIMS"), the Florida Consumer Action Network, the National Risk Retention Association, the Organization for International Investment, the CEA – the European Insurance and Reinsurance Federation – and ABIR.

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[15] The Berkley Testimony at page 9 ("offshore groups reinsuring risks for unaffiliated U.S. insurers should not be affected by the legislation.").

[16] *See* the ABIR and the Organization for International Investment (OFII) press release, published in 2008 TNT 184-48 "*Groups Say Reinsurance Bill Reduced Insurance Capacity, Increase Prices.*" (Release Date: September 19, 2008)

[17] *Id.* (referenced in the ABIR and OFII press release).

"RIMS opposes any legislation that would result in negative implications for the global reinsurance marketplace and US businesses that rely on this market. It is RIMS belief that a free and fair marketplace fosters a healthy and competitive climate for reinsurance while at the same time assures more available and affordable property and casualty insurance." Terry Fleming, member of RIMS Board of Directors, director of the Division of risk management for Montgomery County, Maryland (September 8, 2009 Press Release on the Neal bill).

"We urge you to be wary about proposed revenue raising amendments that promise the US government more tax revenue at the expense of non-US reinsurers. We believe that this action will increase reinsurance costs for Florida consumers and reduce the capacity from non US reinsurers --thus increase insurance costs for Floridians."
Bill Newton, on behalf of 30,000 members of the Florida Consumer Action Network (FCAN)

The direct consequence of limiting the utilization of affiliate reinsurance would be a reduction in the supply of insurance and reinsurance capacity in the U.S. market, and the resulting decline in competition in the U.S. market would invariably lead to greater difficulty in obtaining some kinds of insurance coverage.

A robust insurance market open to as many competitors as possible is essential to consumers, and a fact understood particularly well by those in hurricane-exposed states where there has been a crisis of insurance availability and affordability and certain classes of commercial insurance have suffered from contractions in availability of coverage in the past. For example, by letter dated February 6, 2009, the Commissioner of Insurance for the State of Louisiana wrote to Chairman Baucus about the "serious insurance availability problem" faced by his and other coastal states—

"*I oppose any legislation similar to the above referenced discussion draft of the bill regarding reinsurance premiums paid to affiliates pending before the Finance Committee….This tax increase, if enacted, could increase the cost and/or decrease the availability of insurance in markets where conditions are tight-like Louisiana's market for property insurance."*

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

III. Analysis of the Staff Discussion Draft Proposal

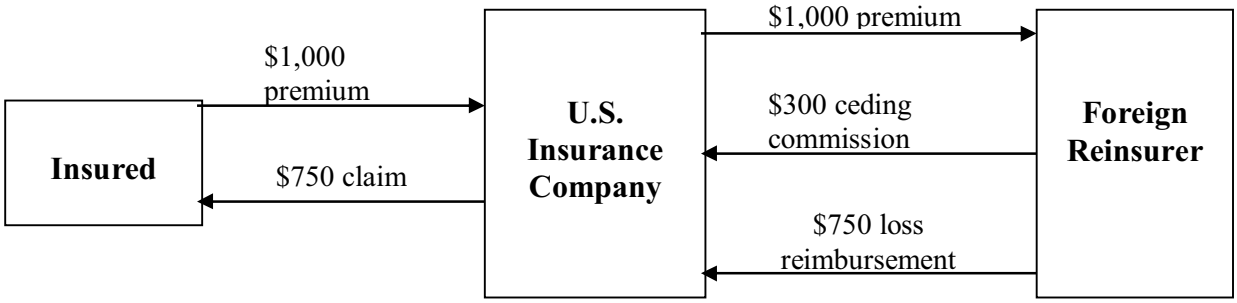
A. Current Law

Under current law, U.S. subsidiaries of foreign-based insurers are subject to the same income tax laws as their U.S.-based competitors. The assertion that current law confers an advantage on foreign-owned U.S. P&C groups focuses only on whether a U.S. tax would have been imposed on underwriting or investment income associated with risks ceded in affiliate

reinsurance transactions, *without looking at the entire tax picture*. When a U.S. company cedes insurance to a foreign reinsurer (related or unrelated), it receives a ceding commission that reflects compensation for all components of income from the ceded insurance, including investment income. This ceding commission is fully taxable in the United States. Additionally, there is one aspect of U.S. law that works to the advantage of U.S. insurers—*viz*., the 1% Federal excise tax ("FET") on gross premiums that a U.S. subsidiary is required to pay on reinsurance transactions—without regard to whether the business is profitable. (The FET can be waived by treaty, but that is not the case for Bermuda-based reinsurers.)

In cases where the reinsurance contract results in the payment of claims (such as in the World Trade Center tragedy, the Florida hurricanes of 2004, and the Katrina, Rita and Wilma events of 2005), the U.S. insurers would have generated tax losses if the reinsured risk had been retained, and these losses would have offset substantial amounts of U.S. income. Where the risks have been reinsured with *non*-U.S. affiliates, however, the US subsidiaries cannot claim these losses on their U.S. tax returns to offset their U.S. tax liability, because the risks have moved outside the United States.

The following example illustrates the total U.S. tax burden that might be borne by insurance business ceded offshore under a quota share reinsurance arrangement. Using the same facts from the example set out in the description of the reinsurance business model (I.A., above), solely for purposes of simplifying the analysis, assume that 100 percent of the premium is ceded offshore (although, in practice, quota share reinsurance transactions cede substantially less than 100 percent of the reinsured business).



Because 100 percent of the premium is ceded to the reinsurer, the insurance company ends up with no net premium income from the policy. Similarly, 100 percent of the losses are ceded to the reinsurer, so the insurance company has no deduction for losses. The U.S. insurance company needs to maintain virtually no assets to pay the claims of the insured,[18] as it is relying on the reinsurer to reimburse it for those losses, so the U.S. insurance company will have little investment income attributable to this policy. The sole U.S. income from the ceded policy is the $300 ceding commission.

[18] The insurance company would need to maintain some amount of assets to compensate for the risk that the reinsurer might default on its obligations, because the insurance company's obligation to the policyholder remains in effect, without regard to whether the reinsurer pays its obligation to the insurance company.

In arm's length quota share reinsurance transactions, it is not unusual for the ceding company profit margin (ceding commission less underwriting expenses) to equal 2 to 4 percent of the ceded premium.[19] At a 35-percent tax rate, this range of profit margins implies a U.S. income tax liability equal to approximately 1 percent of the ceded premium. Combining this income tax liability with the one-percent federal excise tax (if, as in the case of Bermuda, there is no tax treaty waiver) results in a total U.S. tax liability that is approximately equivalent to a 2-percent tax on ceded premiums.

It is difficult to make a precise comparison of a tax burden of that magnitude to the taxes paid by U.S.-based P&C insurance companies. Among other factors that complicate a comparison are timing issues that affect the economic impact of taxes on business ceded offshore versus business retained in the United States. Generally, the FET and income tax paid on ceding commission income from premiums ceded offshore is paid upfront, in the year the insurance premium is received and ceded to the reinsurer. By contrast, a substantial component of the income tax associated with insurance business retained in the United States is tax on investment income from reserves that may be earned many years after the premium is received. The tax paid in the future has a lower present value than the tax paid upfront. Also, taxes paid by U.S.-based P&C insurance companies as a percentage of their net premiums vary substantially from year to year and across companies. In recent years record profit levels have led to relatively high tax payments, but the historical average for the industry from 1990 to 2007 is tax payments equal to about 2.3% of net premiums received. To put this crude comparison in context, the difference between paying tax equal to 2.3% of premiums and tax equal to 2% of premiums is equivalent to the difference between an income tax rate of 35% and 30.4%.

B. The Staff Discussion Draft Would Result in a Confiscatory Tax Increase

The Staff Discussion Draft would permanently disallow deductions for "excess non-taxed reinsurance premiums" with respect to U.S. risks paid by "covered insurance companies" to "affiliated insurance companies" that are not subject to U.S. income taxation.[20] A "covered insurance company" would be defined as any company that is subject to tax imposed by I.R.C. §831, with all domestic members of a controlled group of corporations (as defined in I.R.C. §1563) of which a covered insurance company is a member treated as one corporation. An "affiliated corporation with respect to a covered insurance company" would include members of the same controlled group of corporations; defined for this purpose as in I.R.C. §1563(a), using a standard of "more than 25%" of the total vote or value instead of "at least 80%." The amount

[19] The range of ceding commission profit margins used here is consistent with, or more conservative than, the assumptions in several analyst reports evaluating the potential impact of H.R. 6969 on foreign-based insurance groups with U.S. affiliates. For example, see the reports from the following analysts: Dowling & Partners (IBNR Weekly, December 18, 2008); Fox-Pitt Kelton Cochran Coronia Waller (U.S. Property & Casualty Insurance Research, February 3, 2009); Credit Suisse (Equity Research, January 22, 2009); and Citigroup (Citi Investment Research, December 14, 2008). In some cases an arm's length profit margin is higher or lower than this range, depending on factors such as market conditions and the cost structure of the ceding company.

[20] The proposed statutory language in the Staff Discussion Draft is virtually identical to H.R. 6969, a bill introduced on September 18, 2008, by the Chairman of the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, Richard E. Neal (D-MA). The only substantive difference is that the "Neal Bill" defines "affiliated non-taxed reinsurance premiums" to exclude premiums paid to a controlled foreign corporation, whereas the Staff Discussion Draft limits the exclusion to cases where the premium is subpart F income.

subject to disallowance would be the excess of the reinsurance premiums paid to an affiliated corporation, over the sum of (1) the "premium limitation" for the taxable year and (2) "qualified ceding commissions" with respect to such premiums that are included in the covered company's income.

The premium limitation would be determined by multiplying the gross premiums written by a covered insurance company by the "industry fraction" for the taxable year, an amount to be determined and published by the Treasury Department on the basis of published aggregate data from annual statements of insurance companies. The numerator of the industry fraction is the aggregate reinsurance premiums paid by covered insurance companies to nonaffiliated corporations for the second preceding calendar year; and the denominator is the aggregate gross premiums written by covered insurance companies during the same period.

A foreign reinsurer that is paid a premium by a covered insurance company that would otherwise be a disqualified reinsurance premium would be given an election to be treated as a domestic corporation for U.S. income tax purposes. As a practical matter, it is unlikely that any foreign reinsurer would ever make this election, because it would subject the foreign affiliate's *worldwide* income to U.S. taxation!

Essentially, the Staff Discussion Draft amounts to a gross basis tax on ceded premium in excess of the limitation. This occurs because the tax deduction for the ceded premium is disallowed *and* no tax deduction is permitted for the losses ceded to the offshore affiliate. The following example illustrates the punitive impact of the Staff Discussion Draft under a set of reasonable assumptions.

An Example of the Punitive Impact of the Staff Discussion Draft

Line			
	Assumptions:		
1	Ceded premium in excess of premium limitation	100	
2	Ceding commission rate received for ceded premium	30%	
	Effect of Staff Discussion Draft:		Source
3	Ceding commission received by U.S. ceding company	30	line 1 x line 2
4	Disallowed premium deduction	70	line 1 - line 3
5	Resulting increase in U.S. tax (35% tax rate)	24.5	35% of line 4
6	***Increase in tax as percent of disallowed premium***	***24.5%***	line 5 / line 1
	U.S. industry averages (1990-2007) for comparison purposes:		
7	***Ratio of pre-tax income to net premiums earned***	***10.2%***	See note
8	***Ratio of income taxes paid to net premiums collected***	***2.3%***	See note

Note: Calculated from data reported in Best's Aggregates & Averages, Property/Casualty.

This additional tax is clearly confiscatory; as shown above, the tax per dollar of premium is more than double the historical average of pre-tax profits that U.S. P&C companies earn per dollar of premium, and over ten times the historical average income taxes that U.S. P&C companies have paid per dollar of premium.

C. The Staff Discussion Draft Fails to Identify Any Tax Policy Concern that Warrants Action.

Essentially, the Staff Discussion Draft is aimed at foreign reinsurers that happen to be headquartered in jurisdictions with statutory corporate tax rates that are lower than the U.S. rate. This happenstance is not and never has been a basis for denying deductions or otherwise asserting tax jurisdiction with respect to payments made to foreign affiliates that are not themselves engaged in a U.S. trade or business. The following discussion (1) provides an example that highlights the absence of any reasonable tax policy basis for the Staff Discussion Draft; (2) describes why the effort to analogize affiliate reinsurance to related-party debt transactions that are used to effect "earnings stripping" is misguided; (3) explains that transfer pricing rules provide an effective enforcement tool for affiliate reinsurance, particularly because insurance regulators provide oversight in addition to IRS enforcement; and (4) explains the basis for the concern that the Staff Discussion Draft violates U.S. tax treaties and poses a risk of international retaliation.

1. The United States normally respects the sovereign rights of other countries to design their own tax systems.

The United States does not assert its jurisdiction to tax simply because a U.S. subsidiary engages in a transaction with a foreign affiliate whose home country has a lower corporate tax rate. In analyzing whether the Staff Discussion Draft addresses an actual problem, consider an example involving the U.S. subsidiary of a foreign auto maker that is headquartered in Germany and subject to a corporate tax rate of 29.8 percent[21] in 2008. The subsidiary is engaged in manufacturing vehicles in the United States but purchases some auto parts from its foreign parent. The only legitimate inquiry for a U.S. tax policy maker is whether the auto parts are purchased for an adequate transfer price. In the absence of “transfer pricing” concerns (discussed below), there is no apparent tax policy reason to deny a deduction for the purchase price paid to the German parent corporation. In a reinsurance transaction, however, where the facts are similar to the auto manufacturing example, the Staff Discussion Draft would apply to deny all or a portion of the U.S. subsidiary’s deduction for premiums paid simply because the foreign parent is domiciled in a country that has a statutory corporate tax rate that is lower than the 35 percent U.S. rate! The United States has the *second highest corporate tax rate* among member countries in the Organization for Economic Cooperation and Development (just under

[21] The "effective" income tax rate in Germany (which includes the corporate tax, solidarity surcharge, and trade tax) varies from 27.73% to 32.98%. For 2008, the corporate tax is 15%, and the combined corporate tax and solidarity surcharge is 15.825%. The trade tax rate depends on the municipality, which leads to a range of combined "effective" tax rates of 27.73% to 32.98%.

Japan[22]), and thus this approach would sweep in transactions with affiliates in nearly all of the major trading partners of the United States.

2. A "false" analogy to "earnings stripping"

The approach of the Staff Discussion Draft appears to be based on a misapprehension of the purpose of the earnings stripping rules of I.R.C. §163(j).[23] It is simply misleading to assert, as the Berkley Coalition has, that foreign-based groups engage in affiliate reinsurance transactions that "strip" underwriting income and investment income and thereby avoid U.S. tax. The earnings stripping rules of I.R.C. §163(j) address tax policy concerns that are not presented by affiliate reinsurance. Unlike a debt transaction that reflects a foreign parent's option to capitalize its U.S. subsidiary with debt rather than equity, an affiliate reinsurance transaction involves the transfer of risk and attendant loss potential to the related party.

The IRS had occasion to summarize the law regarding the definition of "insurance" for Federal income tax purposes in a recent private letter ruling, which document concluded that contracts reinsured by a wholly owned captive insurance subsidiary under a reinsurance contract constitute a pool of unrelated insurance risks for tax purposes and that the subsidiary would qualify as an insurance company:

> Neither the Code nor the regulations thereunder define the term "insurance" or "insurance contract." The accepted definition of "insurance for Federal income tax purposes relates back to Helvering *v.* Le Gierse, 312 U.S. 531, 539 (1941), in which the Supreme Court stated the [sic] "[h]istorically and commonly insurance involves risk-shifting and risk distributing" in "a transaction which involve[s] an actual 'insurance risk' at the time the transaction was executed." Insurance has been described as "involve[ing] a contract, whereby, for adequate consideration, one party agrees to indemnify another against loss arising from certain specified contingencies or perils[I]t is a contractual security against possible anticipated loss." Epmeier *v.* United States 199 F.2d 508, 509-510 (7th Cir. 1952). Cases analyzing "captive insurance arrangements have distilled the concept of "insurance" for federal income tax purposes to three elements, applied consistently with principles of federal income taxation: 1) involvement of an insurance risk; 2) shifting and distribution of that risk; and 3) insurance in its commonly accepted sense. *See e.g.*, AMERCO, Inc. *v.* Commissioner, 979 F.2d 162, 164-165 (9th Cir. 1992), *aff'g* 96 T.C. 18 (1991).[24]

In this regard, the Staff Discussion Draft would alter the tax consequences of affiliate reinsurance arrangements that clearly satisfy the definition of "true insurance" developed by a

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[22] Note that the Japanese government recently proposed to reduce the corporate tax burden. *See* "*Repatriation Aid for the Financial Crisis?*" Martin A. Sullivan and Lee A. Sheppard, Tax Analysts, Tax Notes Today, January 6, 2009.

[23] *Cf.* "Present Law and Analysis Relating to Selected International Tax Issues," scheduled for a Public Hearing Before the Senate Committee on Finance, prepared by the Staff of the Joint Committee on Taxation (JCT") (JCX-85-07), which includes the statement: "*Even though interest earnings stripping is not a perfect analogy to reinsurance in every detail, the effects on the U.S. tax base of an FCC that reinsures U.S. risks with its foreign parent companies or foreign related parties is the same as earnings stripping*." at page 61.

[24] *LTR* 200850011 (Release Date: September 8, 2008) (Doc 2008-26171).

longstanding body of case law. Moreover, the Staff Discussion Draft departs from the earnings stripping model by failing to condition its application on the presence of profits, and by disallowing deductions with respect to a U.S. subsidiary's core business.

There is no Question about the Status of Affiliate Reinsurance Arrangements as "True Insurance," Rather than Disguised Dividend Distributions that Strip Earnings. The use of related-party debt obligations to strip profits out of the United States is possible because of the difficulty in distinguishing debt from equity – a definitional issue that is not presented by affiliate reinsurance. The original Ways and Means Committee Report cited "the difficulties encountered in distinguishing debt from equity, and in effectively enforcing that distinction"[25] as a justification for an *interest* earnings stripping rule. Indeed, I.R.C. §163(j) was described as a "limitation on the ability to 'strip' earnings out of this country through interest payments *in lieu of dividend distributions*…." (*Emphasis added*).[26] In this regard, the "conferees [in 1989] believe[d] that a safe harbor for companies capitalized at debt-equity ratios of no greater than 1.5 to 1 would excuse many U.S. corporations with typical capital structures from any potential disallowance under [I.R.C. §163(j)].[27]" As explained below, however, in section II.D, however, the Staff Discussion Draft fails to inquire whether there is any comparable safe harbor for "typical" reinsurance arrangements; instead, the proposal uses an inappropriate benchmark in an attempt to define companies with "acceptable" levels of affiliate reinsurance.

Significantly, the "Earnings Stripping" Rules of I.R.C. §163(j) Require that There be "Profits" to Strip. These rules have no application unless interest payments to foreign affiliates exceed a prescribed percentage of a U.S. subsidiary's taxable income (adjusted to back out non-cash items and related party interest). As explained above, the Staff Discussion Draft makes no attempt to determine whether profits actually exist.

Potential for Business Disruption. As the Ways and Means Committee recognized in 1989 when it first proposed a rule for "interest" earnings stripping, "[a]bsent deductions for related party interest, the United States would collect both a corporate tax on the U.S. Corporation's profits and, in most cases, a withholding tax on dividends it pays to its [foreign] parent."[28] The effect of the I.R.C. §163(j) limitation on "excess" interest is to re-characterize the tax consequences of the method by which a foreign corporate group chooses to repatriate U.S. earnings. In sharp contrast, limiting the utilization of affiliate reinsurance, as would occur under the Staff Discussion Draft, would disrupt a U.S. subsidiary's core business by hampering the ability to manage capital and spread risks.

In Any Case, an Exception to the Proposed Anti-abuse Rule Should be Provided for an Active Trade or Business. Bermuda companies that would be affected by the Staff Discussion Draft have real business substance; they own or rent significant real estate, employ a good number of people, and operate truly active trades or businesses. The existence of an active trade or business is viewed as the touchstone for defining an exception to the scope of an anti-abuse

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[25] H.R. 101-247, 101st Cong., 1st Sess. (1989) 1241, (Report of the Committee on the Budget to accompany H.R. 3299) at 1242.
[26] *Id.*
[27] *Id.*
[28] *Id.* at 1241.

rule, which exception is normally provided to ensure that anti-abuse provisions operate in accordance with sound tax policy and avoid application to transactions that do not present tax policy concerns. As one example, the passive foreign investment company rules of I.R.C. §§1291 *et seq*. contain an exception for income derived by corporations engaged in the active conduct of an insurance business (in I.R.C. §1297(b)(2)(B)).

3. Transfer pricing considerations

I.R.C. §845 of current law gives the Secretary of the Treasury the authority, in the case of affiliate reinsurance transactions, to allocate, recharacterize, or adjust the income of the parties to the transaction if it is deemed necessary to reflect the proper amount, source, or character of that income. This authority is to be exercised in a manner similar to the authority provided under the general transfer pricing rules of I.R.C. §482; essentially, reinsurers are subject to a higher standard then any other industry. The purpose of I.R.C. §482 is to ensure the clear reflection of income, and the standard to be applied in every case is that of a taxpayer dealing with an unrelated party. This arm's length standard has been a central feature of U.S. tax policy for many years, and the United States has promoted its use worldwide. It is well-established that when affiliated parties enter into transactions, those transactions will be respected for tax purposes unless the terms do not comply with the arm's length standard or the transactions as structured lack economic substance.

Affiliate Reinsurance is Often Subject to More Oversight than Non-affiliate Reinsurance. The reinsurance industry is unlikely to present transfer-pricing compliance concerns such as those that may be present in certain economic sectors where comparable transactions are difficult to identify. In addition to the requirements of the U.S. tax law, in the case of cross-border and all other affiliate reinsurance arrangements, arm's length pricing arrangements are subject to continuing review and regulatory approval under state insurance holding company laws (*e.g.,* in New York each such transaction has to be approved).

4. The Staff Discussion Draft proposal violates treaties and poses a risk of international retaliation.

In the first instance, the Staff Discussion Draft fails to make clear whether the intent is to override conflicting tax treaties. In a technical explanation of the substantially similar Neal bill, the drafters assert that the proposal does not violate U.S. tax treaties. As explained below, however, the provision would violate the non-discrimination provision in the Bermuda tax treaty that requires "that interest, royalties and other disbursements paid by a resident of [the United States] to an enterprise of insurance of [Bermuda] shall, for purposes of determining the taxable profits of such [U.S.] resident, be deductible under the same conditions as if they had been paid to an enterprise of insurance of the [United States].[29]" Tax legislation can override a tax treaty,

[29] Paragraph 7 of Article 4 of the Tax Treaty with Bermuda Regarding Insurance Enterprises and Mutual Assistance. The treaty is actually between the United States and the United Kingdom and is titled "*Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda) relating to the Taxation of Insurance Enterprises and Mutual Assistance in Tax Matters."* In 1988 the United States and Bermuda entered into a more complete agreement for the exchange of tax information, titled *Agreement between the Government of the United*

because the provision that is later in time prevails under the Constitution and Internal Revenue Code; however, the U.S. Congress normally makes clear whether it intends to override conflicting tax treaties.

In any case, the disallowance of otherwise allowable deductions for reinsurance premiums paid to affiliates clearly would be a breach of non-discrimination provisions found in virtually every U.S. tax treaty. As an example, the U.S. Treasury Technical Explanation to the Tax Treaty with Bermuda Regarding Insurance Enterprises and Mutual Assistance provides that:

> Paragraph 7 of Article 4 "prohibits discrimination in the matter of deductions. Interest, royalties, and other disbursements paid by a resident of a Covered Jurisdiction to an enterprise of insurance of the other Covered Jurisdiction must be deductible disbursements for determining taxable profits of such resident in the first-mentioned Covered Jurisdiction as if they had been paid to an enterprise of insurance of such first-mentioned Jurisdiction. An exception to this rule applies where the provisions of paragraph 5 of Article 4, relating to associated enterprises, apply. The term "other disbursements" includes a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises.
>
> Paragraph 5 provides that no provision of the Convention shall limit the application of any internal law provisions in either Covered Jurisdiction designed to place transactions between related enterprises on an arm's-length basis. Thus, the Convention does not limit the right of the United States to apply section 482 of the Code."

Thus, the U.S.-Bermuda tax treaty forbids the discriminatory disallowance of the deduction for reinsurance premiums proposed by the Staff Discussion Draft, because the disallowance is directed only at foreign insurance groups. While the Bermuda treaty differs in various details from the Model U.S. Tax Treaty and the actual U.S. Tax Treaties with such international insurance markets as the United Kingdom, Ireland, Switzerland, and Germany, each of the cited pacts contains both a prohibition against discriminatory disallowance of deductions and the preservation of each government's right to enforce compliance with the internationally accepted arms-length standard.

Not only does the Staff Discussion Draft run afoul of tax treaties, it also departs from longstanding tax principles that taxation of related-party transactions must conform to the arm's-length standard. The essence of this standard is that transactions between related parties should be treated no differently than transactions with third parties. This central principle of international taxation is widely accepted around the world, applies broadly to all industries, and provides the basis for accepted norms of international taxation. In fact, the arm's length standard is linked in a significant way to U.S. international trade policy. For decades the U.S. government has advocated both the expansion of free trade and the use of the arm's length standard as the appropriate basis for international taxation of cross-border trade. The Staff Discussion Draft, which denies an otherwise legitimate deduction to the U.S. affiliate based on the related-party

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States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda) for the Exchange of Information with Respect to Taxes.

nature of the transaction, is a stark departure from the arm's length standard. In effect, if any insurer would dare risk the use of affiliated reinsurance above the calculated "cap," the Staff Discussion Draft would impose U.S. tax on gross income earned by the foreign affiliate in what amounts to an extra-territorial extension of U.S. taxation. Under existing law and international norms, the United States does not have jurisdiction to tax U.S. affiliates on income earned by their foreign affiliates.

Furthermore, regardless of whether treaty obligations are considered, there is a concern that the novel approach of the Staff Discussion Draft will lead our international trading partners to reciprocate with anti-affiliate reinsurance regulations of their own. In recognition of this principle, ABIR understands that the European Insurance and Reinsurance Federation ("CEA") submitted a letter in response to the Staff Discussion Draft that called the proposal a "punitive, discriminatory tax on global insurance and reinsurance companies." The CEA went on to state, the "proposal(s) deviate from the non-discrimination principle and lead to double taxation." CEA characterized the Staff Discussion Draft as a violation of international business principles inconsistent with decades of U.S. tax and trade policies. CEA concluded that affected countries might retaliate with tax laws aimed at U.S. companies.

D. The "Industry Fraction" is a Meaningless, Arbitrary, and Inappropriate Benchmark for Affiliate Reinsurance

The Staff Discussion Draft in effect limits the amount of reinsurance that the U.S. subsidiary of a foreign insurance group may obtain from foreign affiliates based on the "industry fraction," which is a measure of the U.S. industry average level of reinsurance from *unaffiliated* reinsurers. As explained above in the explanation of why "affiliated reinsurance" is more common than unaffiliated reinsurance (section I.A.2), the level of unaffiliated reinsurance obtained by insurance companies does not provide an appropriate benchmark for determining the reasonableness of "affiliate reinsurance," principally because – for important non-tax economic reasons – reinsurance from affiliates is commonly used much more extensively than reinsurance from unaffiliated reinsurers.

The Higher Rate of Utilization of Reinsurance by Bermuda-owned Companies is not Surprising in View of the Volatility of the Business in which the Bermuda Market Specializes. Non-U.S. insurers in the ABIR membership cede on average 24 percent of their premiums on a global basis to *non*-affiliated reinsurers. This may be a larger amount than U.S. insurers in the Berkley Coalition, but it is not surprising that Bermuda companies cede to the non-related reinsurance market more than U.S. competitors who write safer books of business. Bermuda reinsurers write volatile coverage in the infrequent, large loss category, business that U.S. insurers have avoided because of the inherent risk.

U.S. insurers have historically used non-U.S. reinsurers because they are a better bet to fulfill a promise to pay in the event of a catastrophic event or macroeconomic changes. U.S. insurers know that catastrophic events can render reinsurers insolvent, just as they can render the insurer insolvent. The risk is compounded if the U.S. reinsurer is subject to the same large loss event that the insurer is. For example, if both the insurer and the reinsurer are subject to local losses from Florida hurricanes, they both face the risk of insolvency from the events. But if the

U.S. insurer chooses a non-U.S. reinsurer, it is more likely that the non-U.S. reinsurer will have less exposure to the events and thus will stand a better chance of surviving the catastrophic loss. This fundamental risk-management strategy explains why U.S. insurers historically have relied upon non-U.S. reinsurers for much of their reinsurance. This fact belies the suggestion that U.S. policymakers can force additional reinsurance capital onshore in the United States by changing U.S. tax policy. [Insurers that buy reinsurance would tend to shy away from the new U.S. reinsurer capital because it simply is more prudent to diversify your financial counterparties.] Also, regulators are focusing heavily on the credit risk of counterparties and are concerned about aggregation of such risk.

IV Conclusion

In view of the failure to identify a legitimate tax policy concern, legislative efforts to improve the competitiveness of U.S. P&C companies might be better served by proposals to reform the current U.S. corporate tax regime, rather than seeking to impose a disproportionate tax burden on the U.S. subsidiaries of foreign-based insurance groups.

cc: Cathy Koch, Tax Chief (Majority)
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APPENDIX A

Recent History of U.S. Insurance Market

1. **1985-1986 U.S. Business Owners Need Excess Liability Coverage . . . Bermuda Insurers Are Created to Meet the Shortfall.**

   In the mid-1980's American consumers were reeling from a shortage in liability insurance coverage as insurers dramatically increased premiums or withdrew from specialty liability classes. Day care centers, schools, small business and large businesses all find insurance coverage increasingly non-renewed and prices increased. The insurance market turmoil led to countrywide expansion of state commercial lines, joint underwriting associations, and a vigorous debate on tort reform. Nearly 100 leading businesses joined together to form two specialty liability writers based in Bermuda. Creation of a similar U.S. company failed. By 2006, three Bermuda insurers were among the top 10 writers of U.S. professional liability for directors and officers, and Bermuda carriers provided 25 percent of the primary and reinsurance market for medical malpractice.

2. **1992 Hurricane Andrew Strikes South Florida, Nine Insurance Companies Go Bankrupt and Insurers Search for Catastrophe Reinsurance as Traditional Providers Retrench . . . Eight Bermuda Catastrophe Reinsurers Are Created to Meet U.S. Coastal Market Needs.**

   Prior to Andrew the most catastrophe reinsurance any U.S. insurer sought for any single event was $100 million; following Andrew's record setting hurricane claims, insurers then sought $500 million and more in per event reinsurance coverage. Florida's insurance market was in turmoil as the largest home insurers were recapitalized, exited the state, or decided to reduce writings. Fifteen years later, Bermuda reinsurers now provide more than 40 percent of the U.S. property catastrophe reinsurance coverage.

3. **2001 World Trade Center Attack and Resulting Insurance Capacity Crises . . . Nine Bermuda Commercial Lines Insurers are Created to Meet U.S. Market Need.**

   The terrorist attacks in the U.S. produced the largest insured loss known at the time -- $35 billion -- and it fell across all lines of commercial business: property, workers compensation, business interruption, commercial auto, general liability, aviation. Nationwide commercial insurance prices rose and coverage became scarce in key urban areas. Insurers struggled to put in place new underwriting technology to measure aggregation of losses across lines of business from a single event. Congress responded with creation of the Terrorism Risk Insurance Act (TRIA). KMPG estimated that global reinsurance capital was reduced by 35 percent as a result of the terrorist attacks, the coincidental liability loss reserve adjustments, and the post attack stock market decline.

4. **2004-2005 Eight U.S. Hurricanes in Two Years Devastate Florida, Louisiana and Mississippi; Hurricane Katrina Alone Generates $45 Billion in Insured Losses . . . Nine New Bermuda Based Insurers are Created to Meet Increased Demand for U.S. Property Catastrophe Reinsurance.**

Florida was crisscrossed by four strong hurricanes in a single year. Katrina becomes the worst ever U.S. natural disaster event with insured losses of $45 billion. A major catastrophe modeling firm projected future losses from the increased storm frequency would cause average annual insurance losses to increase by 45 percent in the Gulf Coast, Florida and Southeastern U.S. Coastal insurance markets from Massachusetts to Texas experience price increases; insurance coverage was widely cancelled as insurers responded to: 1) the 2004 and 2005 losses, 2) changes in the expectation of future risk and 3) the new capital requirements imposed by rating agencies. Ten billion dollars in capital was raised for new Bermuda companies; and $11 billion was raised to bolster the capital for existing companies - both serving to meet U.S. coastal insurance market needs.

5. **Major U.S. and European Reinsurers Have Exited the Market (or merged) Since 1999 … Without the New Bermuda Reinsurers (and their U.S. Subsidiaries) the U.S. Reinsurance Market Capacity Would Have Been Substantially Diminished; the Market More Concentrated.**

   In the wake of the 9/11 terrorist attacks, leading U.S. commercial insurers which operated substantial U.S. reinsurance operations left the market citing concerns about aggregations of risk from their commercial and reinsurance businesses. Several leading European reinsurers having faltered from the combined effects of 9/11 and bad underwriting decisions left the market entirely, or closed their U.S. operations. Bermuda carriers provided 25 percent of Lloyds of London capacity.

6. **Bermuda Insurers and Reinsurers Have Paid Nearly $30 Billion in U.S. Property Catastrophe Claims in the Last Seven Years . . . The largest share of any non-U.S. market.**

   Bermuda's reinsurers are the largest providers of U.S. property catastrophe reinsurance protection. Twenty two of the top 35 private reinsurers protecting Florida risk are Bermuda companies. Bermuda carriers provide 67 percent of the reinsurance to Florida based insurers. Bermuda carriers provide 66 percent of the reinsurance purchased by the Texas Windstorm Insurance Association and 39 percent of the reinsurance purchased by the California Earthquake Authority.

7. **Top Ten Global Reinsurers Have 72% of the Market . . . Reinsurance Buyers Note Concern About Market Concentration.**

   The growth of the Bermuda reinsurers will lead to further market diversification, providing the benefits of increased competition to reinsurance buyers. Businesses that buy insurance and reinsurance oppose tax legislation that would restrict capacity from non U.S. carriers.

8. **U.S. Crop Insurance . Bermuda Companies Make the Reinsurance Market Work**

   Bermuda's carriers provide 57 percent of the insurance and reinsurance for U.S. crops; covering all types of U.S. agricultural commodities for farmers across the country.