ace group

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February 27, 2009

The Honorable Max Baucus
Chairman
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Charles Grassley
Ranking Member
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Charles B. Rangel
Chairman
House Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Richard Neal
Chairman
Select Revenue Measures Subcommittee
House Ways and Means Committee
1136 Longworth House Office Building
Washington, D.C. 20515

The Honorable Dave Camp
Ranking Member
House Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Senate Finance Committee Staff Discussion - Draft of Proposal to Modify Tax Treatment of Certain Reinsurance Transactions ("Staff Discussion Draft")

Dear Sirs:

On behalf of the ACE Group of Companies ("ACE"), please let me express my appreciation for the opportunity to comment upon the draft proposal for major modifications to the law governing inter-company reinsurance. ACE is a truly global insurer writing over $19 billion in premium from companies located in over sixty countries. ACE employs almost 9,000 people in the United States, and its United States companies generated approximately $10 billion in premiums in 2008. ACE's United States operations are primarily the result of the acquisition of distressed, unprofitable U.S. companies. Over the past decade, ACE has grown the U.S. operations of these acquired companies, has increased the number of U.S. based employees and has become a profitable, very substantial taxpayer to the United States Treasury. In addition, most of ACE's international subsidiaries, including those throughout Europe, Latin America and most of Asia, are owned by ACE's U.S. holding company and therefore, they too, are included in our U.S. tax base. Our ultimate holding company, incorporated in Switzerland, owns several other insurance companies, including several resident in Bermuda.

As set forth in detail below, the Staff Discussion Draft prohibits a foreign owned U.S. subsidiary from utilizing affiliated reinsurance, an essential tool to run a global insurance company such as ACE. Like all insurers with multi-jurisdictional activities, ACE manages its capital with the benefit of reinsurance, which is purchased from third-party reinsurers around the world (primarily), and purchased from affiliated companies (secondarily). While we will use the terms "capital management" and "spreading of risk" to describe the benefits of affiliate reinsurance, what we practically mean by this is the ability to use contractual reinsurance (as opposed to cumbersome capital infusions) to pool and then access capital from subsidiaries around the globe. Contractual affiliate reinsurance allows us to deploy capital immediately to write business we otherwise would not be able to write. This is because the amount of risk insurers can take on any one account or in the aggregate for all risks is a function of how much capital is available. If we had to maintain full capital in every place we take risk, our ability to take on significant levels of risk would be severely constrained. This restraint of foreign owned insurers would have a very real negative impact on the U.S. insurance market at the worst possible time. In addition, since the restriction applies only to foreign owned insurers operating in the U.S., there is a high probability that foreign governments will object and retaliate.

Our comments on the Staff Discussion Draft will focus on the nature of the (real or abstract) problems being addressed, concerns regarding the proposed solution to such problems, and the implications of attempting to address such problems with such seeming solutions. In addition to our primary concern that the proposal eliminates an essential risk and capital management tool for foreign insurance groups, we will also address, 1) whether there is in fact a competition problem; 2) whether there is a tax avoidance problem; 3) whether the proposed limitation of affiliate reinsurance set forth in the draft works as intended; 4) whether the proposed solution violates tax and trade treaties; 5) whether the solution will have negative consequences for consumers and 6) whether the proposal is especially ill-conceived given the current economic crisis and capital scarcity. The Staff Discussion Draft proposes a solution to a perceived problem that fails to distinguish appropriate uses of affiliate reinsurance based on necessary business needs from what may be excessive uses of affiliate reinsurance by some. The effect of this failure is a proposal that, if adopted, will have unintended consequences for consumers and free trade principles.

1. The Facts: Affiliated Reinsurance is a Capital Management Tool That Strengthens Financial Security and Risk Management

The U.S. insurance market is the largest in the world and requires substantial risk-taking capacity from foreign insurance and reinsurance markets. The foreign insurance industry absorbs a substantial portion of the economic losses when insured catastrophic events occur in the U.S. Events such as the 9/11 tragedy and Hurricanes Katrina and Ike, among many others, have all resulted in substantial loss payments to domestic policyholders. Examples include loss payments arising out of 9/11(international insurers paid 64%), the 2005 hurricanes (47% paid by overseas insurers) and Hurricane Ike where overseas reinsurers make up 78% of the Texas market. This global support of the catastrophe market is critical because it results in massive losses, which are not tax deductible in the U.S., being spread around the world rather than being concentrated in the U.S.

(a) *The Role of Reinsurance and the Need for Capital Management and Risk-Spreading in order to maximize the amount of insurance one can write*

All insurance groups utilize affiliate reinsurance as a way to pool risks and manage them more efficiently; this allows companies to write additional business when and where it is needed. In fact, the Coalition members lobbying in support of the Staff Discussion Draft all use affiliate reinsurance extensively for these very reasons. High levels of affiliate reinsurance are quite common within U.S. insurance groups. Based on 2007 data on the Coalition, 56% of their U.S. affiliates cede *more than half* their premiums to affiliated companies. The prevalence of affiliate reinsurance within U.S. based groups underscores the underlying business purpose for such transactions. In fact, the 2007 Form 10-K for the WR Berkley Corporation tells us why they do this: "Our structure allows us to capitalize on the benefits of economies of scale through centralized capital, investment and reinsurance management . . ."

Such pools of capital are quite important to the maintenance of capital efficiency, which allows insurance groups to centralize capital in one place and then deploy it where it is needed or wanted. It can be used quickly to provide the capital needed to respond to business opportunities. It allows a local subsidiary to write business that may exceed that subsidiary's local management risk tolerance because the subsidiary is supported by the larger capital base afforded by affiliate reinsurance. It allows a group to more centrally manage a portfolio of risks that in the aggregate may be more diverse than what would be written by the subsidiary on its own. Affiliate reinsurance creates cost-effective risk taking which allows more insurance to be sold at a better price. To illustrate, ACE writes property insurance in over 60 countries; for any one risk we limit our exposure on average to approximately 20M. ACE then reinsures much of the business we write around the world using third-party and affiliate reinsurance so that our net exposure on any risk is below 5M. By aggregating risks from many entities into one entity, we can reduce the amount of capital required to support those risks because it provides a diversification benefit. To go back to our illustration, we know that each of the 20M property risks we wrote around the world will not all suffer a loss in the same year---since the aggregated risks that are pooled are more diversified than the risks of any one company, the volatility is lower for the pool than for any single company which lowers the amount of capital we need to hold to support the same level of risk. If ACE had to fully capitalize every risk in every place we write business, our costs would rise dramatically and our costs to customers would likewise have to rise.

Wherever capital is managed in this way, the risk and its associated capital move from one place to another. Very often, they cross borders. When the insurer group is a domestic one, the pool is often a domestic pool where the capital and risk move across state borders from one usually smaller affiliate to a larger, often, "flagship" affiliate. Conversely, when the insurer group is a foreign one, the pool is usually a foreign one and the capital and risk moves between companies in different countries, again, often being centralized in one of the "flagship" companies. There is nothing sinister about this process; it is done for excellent risk management reasons. Nonetheless, in any particular country, one could argue that such capital management amounts to "tax avoidance" in some abstract sense of the phrase. Whenever one is dealing with cross-border transactions, it is tempting to ignore the "other side of the coin" and bemoan the exit of cash. When one does this, of course, one ignores (a) the receipt of a valuable commodity, in this case, secure insurance coverage, and (b) the fact that one's country is the beneficiary of equally important trades that go in the opposite direction. This kind of myopic thinking is what the Coalition has sponsored.

This leads immediately to an obvious paradox: Preventing foreign-owned U.S. insurance companies from utilizing affiliate reinsurance while preserving it for U.S.-owned insurers is clearly unfair. Yet this is the essential thrust of the Staff Discussion Draft. Furthermore, the practical effect will be to decrease competition, raise the cost of capital for foreign-owned U.S. insurers, and increase insurance prices for U.S. consumers.

(b) *Is Affiliate Reinsurance a Competition Problem?*

The Coalition members have relentlessly argued that they are at a terrible competitive disadvantage because of affiliated reinsurance used by foreign companies to pool capital that comes from reinsurance arrangements with their American subsidiaries. This assertion, which appears to us to be the core rationale for the Staff Discussion Draft, needs to be examined objectively.

To begin with, the Coalition members are doing quite well. In recent years, putting aside the current market turmoil in the financial markets that has impacted all market participants, U.S. based P&C insurers have earned record profits and their business has grown dramatically. This is especially true for the members of the Coalition advocating for passage of the Staff Discussion Draft, in main part based on claims of a competitive disadvantage. When objective indicators are compared, -- whether profitability, market capitalization and valuation, stock price or return on equity -- the Coalition members are thriving. Travelers is now the largest property-casualty company in the country, measured by market capitalization. It has been profitable before and during the current financial crisis.

Likewise, Chubb. Berkeley is an even greater success story, returning gigantic value to shareholders over the years. Hartford has fallen on hard times, but those hard times have nothing to do with its property-casualty insurance businesses (which remain highly profitable) and everything to do with market-related investment losses and life insurance. We understand that mere success is not absolute proof of the absence of a competitive disadvantage. But it is certainly a start in understanding the nature, scope, and ultimate significance of any such claimed disadvantage.

Conceptually, the argument about a competition issue starts from the presumption that a tax differential among countries is itself, a source of competitive difficulties. This premise would appear to apply equally well to the markets for computer chips or potato chips, as to insurance. Different countries adopt tax regimes with a full understanding that there may be competitive effects from those taxes in the context of an increasingly worldwide economy. Does this mean that the US must suppress the purchase of goods and services marketed by companies located in foreign jurisdictions with a lower tax rate? Of course not.

The Coalition seems to be suggesting that insurance is different because insurance companies have the easy ability to "move" their assets and profits all over the world without much trouble. In practical reality, though, it is not so easy. There are innumerable legal, financial and prudential reasons why insurers cannot abuse the system in this way, and these obstacles result in a practical reality in which there is very little abuse. Local jurisdictions (including every one of the 50 states and nearly every country in the world) require certain levels of local capital. Those jurisdictions also control the capital "credit" the local companies can receive for reinsurance, if any. Many jurisdictions limit reinsurance in general or affiliate reinsurance in particular. In addition, there are premium taxes on reinsurance, based on the gross amount of the premium and those premium taxes are effectively higher for lower tax jurisdictions (via treaties). This gross premium tax needs to be compared to a corporate income tax on profit which is a small fraction of the premium amount---historically never more than a few percentage points. In a market where reinsurers frequently pay more in claims than they get in premium, a one percent tax on gross proceeds is a significant tax. Finally, since the idea of affiliated reinsurance is risk dispersion and capital management, it would be irresponsible to elevate taxation issues to a dominant position, compared to the risk management considerations centered on dispersal of risk and capital flexibility.

So where, in the real world, is the material competitive disadvantage faced by the Coalition? Which insurer is recklessly using affiliated reinsurance to build an oligopolistic pricing advantage over Travelers or Hartford or Berkley? Where in the insurance industry is there a competitive disadvantage for American companies that is meaningfully different from that faced down by many, if not most, American industries as they compete in a global economy? The Coalition does not answer any of these questions. We believe that this is because there are no good enough answers, answers worthy of a new experimental tax regime with broadly predictable, but ultimately unknowable, consequences.

The bottom line is that the perceived "competitive disadvantage" is largely an abstract one that has no everyday consequence for the insurers supporting the Staff Discussion Draft, does not fundamentally disrupt the insurance markets, and should not be the rationale for major tax surgery. This does not rule out the possibility of adoption of reasonable parameters for affiliated reinsurance levels in order to prevent abuse that might conceivably happen in the future. (More on this below) But it does mean that using the tax code in order to impose confiscatory restrictions on the free flow of capital is an idea that, whatever its other merits or demerits, make no sense as a response to competition issues.

(c) *Does Affiliate Reinsurance Pose a Major Tax Avoidance Problem?*

Clearly it could. But does it actually? We believe that, by and large, insurers use affiliate reinsurance for reasonable capital and risk management purposes, and not as a way of avoiding taxes. No doubt there have been abusers who have reinsured excessive amounts of exposure to tax-favored jurisdictions. But we have not seen evidence that this is widespread. And tools far simpler and more sensible than the Staff Discussion Draft can be used to prevent abuse.

The tax issue for affiliated reinsurance is really an "earnings stripping" concern. The fear is that companies can export the vast majority of their earnings by contractual undertakings between companies that are commonly controlled. However, such exporting of reinsurance premium is, in reality, exporting of risk, which if underwritten successfully, carries potential profits (net of arms-length ceding commission) with it. Insurers who use excessive affiliate reinsurance are betting that the reinsurance will in fact turn a profit – i.e., that there will be no major hurricane that year, etc. If they lose the bet, they will have exported tax deductible losses, not profits, to the ultimate benefit of the US Treasury and detriment of themselves.

The suggestion that foreign-owned U.S. insurers are avoiding U.S. taxes by reinsuring risks abroad ignores that the fundamental purpose of reinsurance is the transfer of risk. A reinsurance transaction transfers not only premium and potential profits but also claims and losses. Unlike the issuance of debt and the guaranteed payment of interest, affiliate reinsurance transfers both premium and risk to a foreign related party. Importantly, the amount of loss that ultimately may be borne by the foreign related reinsurer is not known at the time the transaction is entered into. If the reinsurance transaction ultimately results in losses in excess of premiums, the U.S. Treasury benefits because the U.S. subsidiary who wrote the business receives no U.S. tax deduction for losses that have been ceded to the foreign reinsurer. In addition, when the U.S. subsidiary reinsures to a foreign reinsurer it receives a ceding commission – typically 20%-30% of the gross premium. The U.S. subsidiary pays U.S. tax on this ceding commission, whether or not there turns out to be any profit. Further, absent a tax treaty waiver, foreign reinsurance premiums are subject to a 1% federal excise tax on the gross amount of the premium – again regardless of whether the business is ultimately profitable or not.

The crucial point here is that a solution to the mainly theoretical risk of excessive affiliate reinsurance needs to consider what the actual issue is, and not be driven by extraneous rhetoric. The issue is the exporting of taxable income ("earnings stripping"), and such exporting is already somewhat suppressed by the real need for risk management, the excise tax on gross premiums and the taxation of ceding commissions. Moreover, the US Treasury already faces earnings stripping issues in many different contexts, such as the use of domestic debt by overseas companies. The notion that intra-company transactions pose income-export risks is nothing new, and in the real world there is nothing extraordinary about intra-company transactions in the insurance industry. In other areas where such risks have arisen, Congress and/or the IRS have crafted solutions that are tailored in a practical way to the problem being posed. Generally, these rules and regulations place limits on the amount of earnings that may be exported while striking a balance between concerns about tax base erosion and legitimate non-tax reasons for the transactions at issue. This being so, the solution for an affiliate reinsurance income-exporting problem, if one is needed, is to place sensible parameters on the amount of income exporting that can go on.

One might think that the Staff Discussion Draft does this, and that certainly is its stated intention. But it does not in fact do this. It blends together concepts of third-party and affiliated reinsurance in applying a formula that mandates that if one uses a great deal of third-party reinsurance, one can use little or no affiliate reinsurance. As will be seen below, this is the great difficulty with the Staff Discussion Draft – it does not regulate affiliate reinsurance per se, but regulates it in a way that creates a false tension between affiliate and third-party reinsurance.

We understand that this odd regulatory mechanism was developed because of the difficulty in calculating a reasonably precise level for fair and proper usage of affiliate reinsurance. Therefore, the drafters of the proposal used U.S. companies' average levels of <u>third-party</u> reinsurance; an arithmetically precise, but unfortunately entirely meaningless average, as a "cap". This all was done because no one attempted to develop, on rational grounds with evidence, a specific "right number" for <u>affiliate</u> reinsurance.

In other circumstances involving the potential unfair exporting of taxable income, rules have been adopted establishing workable limitations that (a) protect the Treasury from abuse, and (b) permit transactions within a range of reason to facilitate the valid purposes of global trade. For example, the "interest earnings stripping" rules of existing Internal Revenue Code Section 163(j) contain a safe-harbor mechanism (i.e., the debt-equity ratio of 1.5 to 1) that was intended to represent a ratio that was greater than the median debt-equity ratio for U.S. corporations.[1] The purpose of the safe harbor mechanism is to provide a relatively easy to compute initial screen to determine if a particular taxpayer might be engaging in excessive use of debt. For affiliate reinsurance, a reasonable safe harbor threshold would be one that the majority of similarly situated U.S.-based companies would satisfy. This would be in keeping with the manner in which the safe-harbor for the interest earnings stripping rules was determined. As shown in the table below, which is based on publicly available data, more than half of all U.S. insurance companies that are members of large U.S.-based insurance groups cede between 30% to 40% of their gross premium to affiliates. More than 45% of such companies cede more than 50% of their gross premium to affiliates.

[1] See H.R. Rep. No. 101-386, 101st Cong., 1st Sess. (1989).

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Affiliate Reinsurance of Large US Property & Casualty Groups (1)		
Based on 2007 Data		
Distribution of U.S. P&C Companies by Premiums Ceded to Related Reinsurers as a Percent of Gross Premiums		
% of Premiums Ceded To Affiliates	**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%

(1) Data exclude companies that are not part of a US Group with at least $500 million in gross written premiums, have less than $10 million in gross written premiums, and have 50% or more foreign ownership.

Furthermore, with respect to the members of the Coalition for a Domestic Insurance Industry, more than half of their U.S. insurance subsidiaries cede more than 50% of their gross premium to affiliates. Therefore, based on industry data, a more reasonable safe harbor threshold measure would be affiliate reinsurance of 50% of gross written premium. However, establishing an appropriate safe harbor threshold only addresses one of the many flaws with the Staff Discussion Draft.[2] For, if the only change to the Staff Discussion Draft were to move the cap up to 50% of gross written premium, those foreign-owned U.S. subsidiaries that cede more than 50% of their gross premium to affiliates would suffer, with respect to the "excess" premium, a disallowance of gross reinsurance premium without any recognition for the losses that are associated with such reinsurance. Such an approach is still confiscatory and discriminatory, as it would prevent those foreign-owned U.S. insurers from doing what many U.S.-owned insurance companies do.

2. The Staff Discussion Draft Has Structural Defects and Will Do More Harm Than Good

We believe that the foregoing discussion shows that there is no more than a modest problem with affiliated reinsurance that is not much different from global trade issues faced regularly by Congress and the IRS. The Staff Discussion Draft ventures into uncharted terrain with its own arithmetical calculation leading to a cap. And it enforces that cap not by taxing exported earnings above the cap amount, but by prohibiting any deduction for the cost of affiliate reinsurance above the cap. As noted, the cap is applied to a *combination* of third-party and affiliated reinsurance, apparently because the proponents of the proposal ignored other more useful market metrics. The result

[2] Those other flaws are discussed more fully below.

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is a proposal that is not only highly complicated and difficult to decipher, but also largely dysfunctional and confiscatory in its treatment of revenue as a proxy for profits whereas in the insurance business, profit is a small fraction of revenue. These effects are worth exploring in some detail.

(a) The "Cap" in the Staff Discussion Draft is Arbitrary and ignores U.S. companies' significant use of affiliate reinsurance.

The premise of the Staff Discussion Draft is that some foreign-owned U.S. insurers are using excessive amounts of affiliate reinsurance, not for legitimate business purposes but for tax avoidance. Accordingly, one would expect that the Staff Discussion Draft might compare U.S.-owned companies' and foreign-owned companies' use of affiliate reinsurance as the basis upon which to set limitations for deductibility *of affiliate reinsurance*. However, this is not the case at all. The test set forth in the draft uses U.S.-owned companies' use of *non-affiliate* reinsurance as the basis of the limitation on a foreign-owned company's deductibility of *affiliate* reinsurance For example, if the average use of non-affiliate reinsurance by U.S.-owned insurers for a particular line of business is 15%, the proposal limits the deductibility of a foreign-owned U.S. company's use of affiliate reinsurance to 15%; however, the 15% limitation is eroded by the foreign-owned U.S. company's use of both non-affiliate and affiliate reinsurance. The effect of this provision is perverse in several ways: (i) a foreign-owned U.S. insurer is penalized for its use of non-affiliate reinsurance, which is clearly not motivated by tax reasons and is essential for prudent risk management, particularly for certain highly volatile classes of business; (ii) U.S. insurers can use as much affiliate reinsurance as they want ; (iii) the "right amount" of reinsurance (and affiliated reinsurance to some degree) seems to be defined by average market behavior, rather than by any sensible standard pertaining to risk management; and (iv) each company's capital flexibility is inherently held hostage to broad trends in competitors' reinsurance buying behaviors, rather than its own risk management needs.

(b) *Eradicating the Deduction for Affiliated Reinsurance is Confiscatory rather than Revenue-Enhancing*

Although it is attempting to address a perceived problem concerning earnings-exportation, the Staff Discussion Draft enforces its limitation on affiliated reinsurance by disallowing any tax deduction for affiliated reinsurance payments that are above the calculated maximum. Deduction disallowance for amounts actually spent for business costs is a brutally blunt instrument that is not designed to enhance revenues. It is designed to destroy the possibility for the transaction itself. Thus, while the purchase of reinsurance is, even within affiliated insurance groups, a risk dispersion tool by which money is paid for coverage received – i.e., a legitimate and important business expense -- the Staff Discussion Draft does not permit the transaction and then recover the "lost" income tax. Instead, the Staff Discussion Draft technically permits the transaction, does *not* collect the "lost" revenues, and then disallows the deduction for what was paid. The result, for affiliated reinsurance transactions above the calculated threshold, is to render such transactions impossibly irrational and counterproductive. The Staff Discussion Draft in effect outlaws them.

This is illustrative of the competitive, rather than revenue-related, intentions of the Coalition. The goal is not revenue enhancement, or the elimination of unfair earnings-stripping, but rather the hamstringing of foreign insurers with U.S. operations through the outlawing of their ability to manage their capital.

Combined with the flawed calculation methodology that irrationally collects together third-party and affiliated reinsurance, this brutal sanction for going over the calculated threshold means that foreign insurers who use a lot of third-party reinsurance cannot use affiliated reinsurance (or much of it). It means that individual companies who should prudently disperse risk more widely through reinsurance to others cannot manage their capital within their organizations, and it means that such companies will be tempted to suppress their risk dispersal in the worldwide reinsurance markets in favor of preserving room for an inter-affiliate reinsurance program for their own company. Meanwhile, U.S.-based insurance groups will be entirely unaffected and can do whatever they want.

(c) *ACE as an Example*

This illogical design is particularly brutal to ACE. Our aggregate use of affiliate reinsurance for all domestically-sourced business is less than 20% - an amount that no one asserts is excessive or motivated by tax avoidance. And yet, because we practice sensible risk management by using a great deal of third-party reinsurance, we would be severely penalized by the draft formula, which would eliminate virtually all of our deductions for all affiliate reinsurance. By doing so, it would therefore eliminate the possibility of using affiliated reinsurance at all. Thus, our company is perhaps Exhibit A to demonstrate the mischief of the methodology in the Staff Discussion Draft: a company that is clearly not close to being an abuser will have its entire affiliate reinsurance capital management program wiped out. ACE's 2007 use of affiliated reinsurance in the aggregate is 18.7%--hardly the excessive amount being discussed as the problem leading to the need for this legislation. ACE's 2007 use of non-affiliated reinsurance in the aggregate is 39%, a relatively large number that reflects conservatism and a real risk dispersion.

This utilization of both affiliated and non-affiliated reinsurance makes sense because ACE is predominantly a commercial underwriter of complex property and casualty risks, often with very large limits of coverage. In many lines of business, ACE purchases significant amounts of non-affiliate reinsurance to spread the risk of loss where we provide large limits covering volatile exposures. Because the Staff Discussion Draft includes our use of non-affiliate reinsurance when applying the threshold or cap, in many lines of business (if not most) we will lose the ability to deduct any affiliate reinsurance whatsoever, even where our use of affiliated reinsurance is lower than the U.S. companies' average use of third-party reinsurance (the threshold set forth in the draft). This just makes no sense.

It is worse than that, though because this effect is not limited to ACE – it is systemic. By its very structure, the proposal reserves special mistreatment for companies who, unlike their market peers, use larger than average amounts of third-party reinsurance. Often, such companies are similar to ACE: they write complex business that demands the use of substantial non-affiliate reinsurance to spread the risk of loss. Or they are similar to ACE in that they have good conservative risk management protocols that limit the amount of net exposure they take on in a given location or for a given customer. The Staff Discussion Draft penalizes such conservative risk-management. Indeed, it encourages suppression of third-party reinsurance to "have room" for an affiliate pool.

3. The Staff Discussion Draft Will Violate Treaties and Pose International Retaliation Risks

The disallowance of the otherwise allowable deduction for reinsurance premiums paid to affiliates is a breach of non-discrimination provisions found in virtually every U.S. tax treaty. The U.S. Treasury technical explanation to the current model Tax Treaty provides:

> "This article ensures that nationals….and residents of a Contracting State….. will not be subject, directly or indirectly to discriminatory taxation in the other Contracting State. Not all differences in tax treatment, either as between nationals of the two States, or between residents of the two States are violations of the prohibition against discrimination. Rather, the non-discrimination obligations of this Article apply only if the nationals or residents of the two states are comparably situated. (This Article)…. prohibits discrimination in the allowance of deductions. When a resident or an enterprise of a Contracting State pays interest, royalties or other disbursements to a resident of the other Contracting State, the first mentioned Contracting State must allow a reduction for those payments in computing the taxable profits of the resident or enterprise as if the payment had been made under the same conditions to a resident of the first-mentioned Contracting State".

Thus, the model tax treaty forbids the discriminatory disallowance of the deduction for reinsurance premiums contained in the Staff Discussion Draft. This is because the disallowance is directed only at foreign insurance groups and it clearly reduces (perhaps to zero) the ability of domestic subsidiaries to manage their capital outside the United States. In recognition of this principle, the European Insurance and Reinsurance Federation ("CEA") submitted a letter in response to the Staff Discussion Draft which 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". Indeed, the non-deductibility of reinsurance premiums constitutes a clear violation of the U.S. Double Tax Treaties which led CEA to characterize the 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.

Not only does the draft run afoul of tax treaties, but by denying a deduction to U.S. companies for certain transactions with foreign affiliates, it also departs from longstanding tax principles that taxation of related-party transactions must conform to the arms-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 international taxation norms. In fact, the arms-length standard is linked in a significant way with U.S. international trade policy. For decades the U.S. government has advocated both the expansion of free trade and the use of the arms-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 nature of the transaction, is a stark departure from the arms-length standard. In effect, if any insurer would dare risk the use of affiliated reinsurance above the calculated "cap", the draft would impose U.S. tax on gross income earned by the foreign affiliate in what amounts to extra-territorial extension of U.S. taxation. Under existing law and international norms, the U.S. does not have the right to tax U.S. affiliates on income earned by their foreign affiliates.

While the model treaty differs in various details with the actual U.S. treaties in place with Ireland, Switzerland, Germany and Bermuda, each of these treaties 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.

Furthermore, whether or not treaty obligations are considered, it seems fairly clear that the novel approach of the Staff Discussion Draft will lead our international trading partners to reciprocate with anti-reinsurance regulations of their own. Whether these will mirror the Staff Discussion Draft approach or not, no one can tell. But foreign governments would be negligent not to respond to the protectionist and discriminatory intrusions of the Staff Discussion Draft into the free flow of capital across borders. We think it highly likely that foreign government will suppress the use of affiliated reinsurance by American multi-national companies, and thereby inhibit provision of capital support for the domestic insurance industry. Even the Coalition members, who have sponsored a one-way suppression of affiliated reinsurance, will likely find that the street inevitably runs in two directions.

What will be the effect of this? While it is impossible to measure at this point, governmental suppression of affiliated reinsurance around the world will clearly eliminate the most effective tool insurers have to provide cost-effective coverage for insurers. Insurance capital will become far more fragmented than it already is, lying fallow in jurisdictions where it is not needed and unable to quickly move to jurisdictions where price signals and natural catastrophes call for more capacity. By suppressing the use of affiliated reinsurance, and by making that tool available only through a convoluted arithmetical formula that depends on market levels of all reinsurance, the Staff Discussion Draft will effectively eliminate the contractual movement of capital within insurance groups, leaving insurers in a position of having to provide direct capital (equity) infusions into their subsidiaries around the world. Because such equity infusions are both cumbersome and also difficult to reverse later, the Staff Discussion Draft, in our opinion, will essentially abolish one of the sharpest, nimblest tools insurers have for providing financial security around the world.

4. **The Staff Discussion Draft Imposes a Discriminatory Tax on U.S. Companies with Foreign Parents by Disallowing Deductions Without Ever Recognizing Related Losses**.

The Staff Discussion Draft would disallow deductions for a U.S. subsidiary's cost of affiliated reinsurance but would nonetheless tax reinsurance recoveries from the foreign affiliate on the very same transactions. The draft is irreparably inconsistent in that it disallows deductions for the reinsurance premium paid, resulting in taxable income in the U.S. without allowing the corresponding incurred losses in the U.S., yet continues to recognize reinsurance recoveries on incurred losses (as if the reinsurance was deductible) as taxable income resulting in U.S. taxation a second time. As a result of this presumably deliberate inconsistent treatment, the draft effectively assesses what is in effect an additional excise tax of more than 20% on gross reinsurance premiums, which is contrary to the concept of taxation of net <u>income</u>. In addition, because the Staff Discussion Draft is effectively an additional excise tax, it violates the General Agreement on Trade and Services ("GATS"), in which the U.S. agreed not to increase excise taxes on insurance premiums. In fact, the Senate Finance Committee Staff's press release accompanying the Staff Discussion Draft acknowledges that "Congress is unable to raise the current law excise tax because it would violate international trade agreements . . ."

This is one of the main reasons why the Staff Discussion Draft is not a correction or reform, but a confiscatory scheme. If insurers continue to use affiliate reinsurance above the calculated caps, they face irrational and abusive taxation levels which are akin to taxation of revenue rather than profit. The "rates" are so high, due to the combination of deduction disallowance and taxation of reinsurance claim payments, that the transactions are rendered not just uneconomical but impossible. Presumably, this has been done because the real objective of the proposal is not taxation but competition. The proposal basically outlaws affiliated reinsurance above the cap. In doing so, it violates GATS as well as basic principles of fairness.

5. The Staff Discussion Draft will Result in Increased Prices to U.S. Policyholders

Any significant tax can be expected to affect market prices for the goods or services being taxed. This truism applies to the Staff Discussion Draft. But the pricing implications of this proposal are not simply a matter of passing on the cost of a tax to some degree as the market may bear it. The Staff Discussion Draft does not raise taxes so much as alter the financial plumbing behind the delivery of insurance coverage. As described above, it removes the most important tool for capital management, and it will have follow-on consequences as other nations react to it. By encumbering the free flow of capital to efficiently support the writing of business where it is needed, the Staff Discussion Draft will affect insurance markets in multiple ways, few of which can be defined with precision. It is an experiment – an experiment in using the tax laws to affect competition (marginally at most) by re-routing capital in a trillion dollar market. It is not worth the risk.

At its core, affiliate reinsurance is a capital management tool. The Staff Discussion Draft virtually eliminates this flow of capital support to U.S. subsidiaries of foreign parents. Faced with this restriction, U.S. subsidiaries will likely respond in one of two ways: 1) reduce the amount of U.S. business they write because the amount of capital (via affiliate reinsurance) they have supporting the business has been reduced; or, 2) dedicate more capital to their U.S. operations. In either case the consumer is hurt either through decreased insurance options, increased pricing, or both.

With respect to the first option, without the ability to utilize affiliate reinsurance, U.S. subsidiaries of foreign groups would have to reduce the amount of business they write in order to maintain the ratings of the U.S. insurance entities. This would mean less competition in the market as insurers would be capital constrained. In addition, insurers would seek to optimize their smaller capital base by trimming their portfolios and only writing business that provides the greatest risk adjusted return. Obviously, less competition would lead to increased insurance costs for consumers. This is precisely the goal of the Coalition who has been advocating for the Staff Discussion Draft. They are not trying to “level the playing field” they are trying to use tax policy to reduce competition so they can demand higher pricing.

With respect to the second option--- infuse more capital into the U.S. subsidiaries -– the current marketplace makes that a very untenable option. In the present global economic downturn, not only has the cost of capital increased dramatically but it is a scarce, prized commodity. U.S. businesses must compete for this limited capital in a global economy and insurers who are forced to choose will not dedicate all of their capital to the U.S. as this would limit their ability to compete in other faster growing markets. The foreign-based insurance groups are predominantly multinational groups that have choices regarding where to deploy our capital and do so based in part on where we can achieve the greatest return on equity for our shareholders. Moreover, even in the best of times, capital injections are a long-term commitment that reduces the financial flexibility that global insurers require to be successful. Thus, the resulting reduction in capital supporting the U.S. marketplace and the less flexible capital framework presented by the Staff Discussion Draft will translate into less capacity and competition, which always hurts consumers.

Experiments in the suppression of the free flow of capital are a bad idea in the middle of a financial crisis. Insurers have generally faired better than other segments of the financial services sector due in part to insurers' risk management capabilities, including the ability to pool uncorrelated risks via affiliate reinsurance. The industry's capital management approaches are working. This geographic and economic diversification stabilizes the market, particularly following a major catastrophic event. And it allows capital to move immediately to where it is needed. However, if every subsidiary is required to operate on a stand-alone capital base, each entity would be more susceptible to being impaired by a loss event that could damage its solo capital position.

Rating agencies recognize the value of this internal group support by providing rating credit for affiliate reinsurance support. Ratings depend, in part, literally on "capital flexibility", and for good reasons. Insurers with capital flexibility are not only able to move capital to where it is needed, they are able to immediately respond to major claim events like natural catastrophes by providing contractual capital support to the affected subsidiaries. The Staff Discussion Draft makes it economically irrational for global groups to provide this internal support via affiliate reinsurance. This is clearly at odds with providing a smoothly operating, highly competitive insurance industry in which the consumer is offered broad choice at competitive prices. Erecting new barriers to the flow of capital into the U.S. insurance market is extremely ill timed given the current global capital liquidity crisis.

6. The Staff Discussion Draft Will Do Little or Nothing for Tax Revenues

Because its taxation regime is so punitive, the Staff Discussion Draft effectively outlaws, rather than taxes, affiliate reinsurance above the caps. Therefore, it will deliver no direct revenues at all.

One can argue that it will indirectly deliver some revenue by preventing the movement of earnings to other countries. In the abstract, there is some truth to this, but only if one entirely ignores the likelihood that other countries will reciprocate with reinsurance encumbrances of their own to prevent earnings from flowing in the opposite direction.

Be that as it may turn out to be, indirect incremental revenues from the Staff Discussion Draft depends entirely on (a) the assumption that the market will not react to the proposal itself by reducing the capital capacity of the American insurance market; (b) the presumption that affiliated reinsurance is profitable from an underwriting point of view; and (c) the presumption that trapping capital in the U.S. by effectively prohibiting cross-border contractual risk management within in insurance groups will allow the Treasury to enhance revenues on insurers' investment earnings.

We believe that assumptions (a) and (b) are clearly wrong. The market will react, affiliate reinsurance will be suppressed, and few or no underwriting profits will be taxed in America. With regard to assumption (c), it is possible that modest tax revenues will emerge from trapped capital, although this is clearly a matter of speculation because companies will have investment options that impose little or no tax. What is most important is the basic idea: the idea that the U.S. is raising (modest) amounts of revenue by seriously undermining the free flow of capital in the worldwide economy. It is always possible, for awhile, to raise some money by encumbering capital. Over time, however, the protectionism at the heart of such an approach inevitably suppresses trade sufficiently to make this a negative for revenue.

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The property-casualty insurance industry is weathering financial calamities quite well. This is a result of the sophisticated risk management tools we use and the innate conservatism of our investment philosophies. In the past ten years, the industry has paid for the catastrophe of 9-11-2001, the series of natural disasters in 2005 and the hurricanes of 2008, while also paying hundreds of billions of dollars for everyday claims made by companies and individuals. As those claims have been paid, capital has moved through the international financial plumbing, to fill holes where there are holes, and to seek profits where they are available.

Respectfully, we submit that the Staff Discussion Draft is an overwrought and dysfunctional reaction to a problem that is barely there. It will deliver little if any revenue, and will have seriously negative implications by haphazardly manipulating the financial plumbing for the system. If we need to do something about the risk of earnings-stripping from affiliate reinsurance, then let's do that – not this.

Sincerely,

Evan G. Greenberg

cc: Russ Sullivan, Democratic Staff Director