Statement of the Association of Bermuda Insurers and Reinsurers

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Informational Hearing -- Offshore Reinsurance
United States Senate Finance Committee

September 26, 2007

My name is Donald Kramer, I am Chairman and CEO of Ariel Reinsurance Company, and I am pleased to speak to you today on behalf of the 23 members of the Association of Bermuda Insurers and Reinsurers (ABIR). I am an American citizen with a Bermuda work permit allowing me to live and work in Bermuda. I have been the CEO of Ariel Re since it was created late in 2005 in the wake of the estimated $70 billion in U.S. insured losses following the Hurricane trio of Katrina, Rita and Wilma. In 1993, I was the original CEO of Tempest Re, a Bermuda reinsurer created following Florida's devastating Hurricane Andrew. As with the 2005 hurricanes, in 1992 following Andrew, United States' homeowners and businesses were finding it difficult to find property insurance as the insurance market adjusted to the unprecedented size and scope of that hurricane. As a result, I now have experience with two Bermuda start-up reinsurers formed to meet U.S. market needs. I also have experience running a U.S. reinsurance company.

We welcome this opportunity to discuss the importance of reinsurance to the insurance industry and the American consumer. Insurance has become a global business. And reinsurance across borders plays a vital role in the efficient operation of the global insurance market. Bermuda is one of the world's leading insurance centers—along with New York, London, and Zurich—and is recognized worldwide for particular expertise in reinsurance.

The Importance of Reinsurance

Businesses, homeowners and others seek property and casualty insurance to protect themselves against the substantial risks they face. That protection needs to be sold at rates which reflect the actual risk insured. Reinsurance allows the insurance industry to transfer risk, helping to make this coverage more affordable. Reinsurance facilitates the efficient operation of the global insurance market by moving risk to insurance centers with special underwriting expertise. Reinsurance also allows capital to be pooled so that a reinsurer can quickly respond to changing market conditions by making that capital available to sell and support insurance coverage in varying locations or for classes of business where the market need is greatest.

Reinsurance is used extensively within the U.S. property-casualty industry. A substantial percentage of U.S. insurance companies cede more than half of the gross premiums they write to reinsurers. Affiliate reinsurance is used routinely within U.S.-based insurance company groups, for valid non-tax business reasons. Affiliate reinsurance provides an efficient way for a related group of companies to pool risks and manage them more efficiently. It enables affiliates to write additional business without having to raise additional capital, and permits affiliates to underwrite larger risks than their capital would otherwise allow. Insurance rating agencies recognize the value of affiliate reinsurance, and often take it into account when analyzing the claims-paying rating to be assigned to the U.S. affiliate.

The Basic Reinsurance Transaction

Reinsurance is a contractual arrangement that transfers risk. The insurance company that issued an insurance policy and now seeks to transfer its risk is known as the ceding company, while the company that assumes the insurance risk is the reinsurer. In the cross-border context, the ceding company may be a U.S. company, and the reinsurer a non-U.S. company. Through reinsurance, the parties agree to share premiums, losses, and loss expenses arising out of the original insurance covered by their agreement.

When an insurance company cedes business to a reinsurer, the ceding company pays a premium to the reinsurer, while the reinsurer generally pays the ceding company a commission. This commission, known as a ceding commission, compensates the ceding company for its acquisition and operating costs and reflects the anticipated profitability of the business – the more profitable the business is expected to be, the higher the ceding commission the primary insurer will demand and the reinsurer will be willing to pay. The ceding commission is generally paid in the same year premiums are received from the policyholder and paid over to the reinsurer. The ceding commission is taxable as income to the ceding company, which is subject to the same U.S. tax on its worldwide income as any other U.S. firm would be.

The United States requires a large amount of reinsurance capacity, a substantial part of which is supplied by non-U.S. reinsurance companies. More than half the reinsurance purchased each year by U.S. insurance companies is from non-U.S. reinsurers.[i] For certain classes of business, the non-U.S. proportion is even greater. For example, two-thirds of the reinsurance to protect insurers of homes and businesses from hurricanes and earthquakes (property catastrophe reinsurance) comes from non-U.S. reinsurers. The tragedy of September 11, 2001 highlighted the importance of non-U.S. insurance and reinsurance to the U.S. market. More than 60 percent of the World Trade Center insurance claims were paid by non-U.S. insurers and reinsurers. Hurricane Katrina also reinforced this point, since approximately 50 percent of the insurance and reinsurance claims paid for Hurricane Katrina losses came from non-U.S. reinsurers. Bermuda's carriers alone contributed 24 percent of that total.[ii]

Background on ABIR

The ABIR membership includes only the global insurers and reinsurers domiciled in Bermuda (not the captives) and our members collectively wrote at 2006 year end $56 billion in premiums with a surplus base of $67 billion.[iii] Bermuda's insurers are specialists in business that is typified by large sized, infrequent claims. This business is highly volatile and many U.S. publicly-traded insurers have shied away from it because of the problems the state regulatory system imposes on insurers trying to quickly adjust rates or coverage terms to meet new underwriting goals.

There is no one Bermuda insurer business model. According to several published reports on publicly traded companies, approximately 65 percent of our business is reinsurance; 35 percent is insurance; 57 percent is property insurance; 54 percent is North American and 28 percent is European in origin.[iv] The United States is the world's largest insurance market so it is not surprising that the majority of our business comes from North America. But ABIR members generate business income from more than 100 countries around the world. It is incorrect to describe us as a market that solely serves the United States. Although our companies are smaller than their older European and American competitors[v], Bermuda is now a major global reinsurance center. That wasn't always the case.

Reinsurance in Bermuda

In the mid-1980's, U.S. businesses and consumers faced a shortfall in liability insurance coverage. Everyone from local governments, to doctors and lawyers, to day care centers, to Fortune 1000 companies, to condominium associations, faced problems in finding and affording insurance coverage due to market shortages following unexpected losses that affected the U.S. liability insurance sector. In its scope it was the biggest insurance market crisis of the 20th century. Bermuda's ACE and XL (Bermuda's two largest insurers) were formed by businesses that pooled their resources to form new insurers that would sell specially crafted, excess liability insurance products to meet their collective insurance needs. Since Bermuda was already the home of a significant captive[vi] insurance market, the regulatory and operational infrastructure was in place to serve this new market and thus these Fortune 1000 businesses were comfortable with Bermuda as their insurers' chosen home. Most importantly, the Bermuda regulatory system allowed companies to be formed, licensed, and writing insurance in a matter of a few months, which was critical to respond to the insurance crisis in a timely manner.

The United States has experienced four such insurance market crises in the last 30 years. In each case incumbent insurers in the U.S. and Europe pulled back to rebuild their capital bases after unexpected shock losses or sustained deterioration in underwriting results. In turn, capital markets raised billions of dollars to finance the creation of new competitors to provide consumers with needed insurance coverage in light of these new market opportunities. These four waves of company formations in Bermuda followed: 1) the mid-1980's liability crisis; 2) Hurricane Andrew and the property insurance crisis of 1992-1994[vii]; 3) the World Trade Center tragedy and the ensuing financial market turmoil in 2001 and 2002; and 4) the hurricane insurance market crunch following Katrina, Rita and Wilma in 2005[viii]. In my work with Tempest Re and Ariel Re I have personal experience about the important role Bermuda insurers play in meeting the critical needs of U.S. and European businesses and consumers in two of these periods of insurance market shortages.

Bermuda's Economic Contribution to the United States – Insurance Coverage and Jobs

Our economic contribution to the United States is significant. Our contribution is multi-faceted including catastrophe claims payments, other insurance and reinsurance payments and job creation. ABIR members paid approximately $2 billion in losses from the 2001 U.S. terrorist attacks, approximately $5 billion in claims from the Florida quartet of hurricanes in 2004 and approximately $17 billion in claims from the 2005 Katrina, Rita and Wilma events. Collectively in just six years, these carriers paid more than $25 billion in catastrophe claims alone to their U.S. customers. [ix]

Let's put these U.S. catastrophe insurance payments in perspective. According to an economic analysis provided to ABIR by GSP Consulting (a Pennsylvania-based economic consulting firm)[x], the Bermuda carriers' 2005 hurricane claims payments provided enough funds to rebuild 45,000 homes in Louisiana, 24,000 homes in Mississippi and 12,000 homes in Florida. Bermuda's economic contribution covered 32 percent of the home rebuilding needs in the areas affected by Katrina, Rita and Wilma. In addition, looking at claims payments for rebuilding businesses and their lost income, Bermuda's insurers paid an estimated 10 percent of the total (federal government plus insurance industry payments) business recovery assistance provided to Louisiana and Mississippi. Our funding helped return more than 9,000 employees to work in Louisiana and nearly 5,000 employees to work in Mississippi. The question you would logically ask, is where would these consumers be, where would the U.S. economy be without the significant contribution of these Bermuda insurers to the U.S. economy? The answer is that fewer people would have been able to return to their homes and the state economies would have declined further or stagnated longer.

Here's another example. Bermuda's insurers and reinsurers are also leading providers of U.S. crop insurance. According to GSP Consulting, in 2005 Bermuda insurers and reinsurers accounted for nearly 57 percent of total net premiums written in the U.S. crop insurance and reinsurance market. Iowa's farmers in 2003 reported more than $237 million in crop insurance claims. The average Bermuda company wrote $36.5 million in premium in Iowa in 2005 – enough to cover more than 3,150 farms. In total Bermuda companies may insure more than 50,000 Iowa farms. In Kansas, the average Bermuda firm may insure as many as 2,290 farms and in total there may be 36,635 farms insured through Bermuda companies. Bermuda based companies write more than $1.6 billion in crop insurance premium.

Employment Statistics

Fourteen ABIR members have U.S. subsidiary corporations to conduct additional insurance or reinsurance operations in this country. These companies are fully subject to U.S. corporate income taxation.[xi] Our membership employs 17,000 people around the world, including 1,700 in Bermuda, 9,600 in the United States and 4,700 in Europe.[xii]

U.S. employees of ABIR are distributed around the country, with large numbers located in New York, Connecticut, Pennsylvania, Georgia, Delaware and California. GSP

Consulting estimates that these employees in turn lead to the employment of an additional 95,000 people as service providers, everything from claims adjusters, to brokers, to investment managers, to risk consultants, to lawyers, accountants, actuaries, information technology managers and others. We believe ABIR members are net job creators in the U.S. economy. Protectionist tax measures targeted at these U.S. operations will likely lead to a reduction in U.S. insurance industry employment.

Why Bermuda

We are always asked: why are we in Bermuda?[xiii] Having been the CEO of one U.S. insurance company and two Bermuda companies I'm in a good position to answer that question. First and foremost, we are in Bermuda because we can quickly deploy our capital, form a company, get licensed and write insurance. No other jurisdiction does this as well as Bermuda. The insurers then deploy their capital to meet critical market needs whether in the United States, Asia, Latin America, Europe or the rest of the world. Capital is not trapped in regulatory frameworks that limit the insurer's flexibility to exit and enter markets. We are not subject to regulatory price controls nor coverage mandates.

In the mid-1980's, concurrently with the formation of ACE and XL, capital providers attempted to create a U.S. liability company called the American Slip. After three years or so of trying the company was not able to build its operations because it was unable to secure sufficient state licenses to conduct business on a countrywide basis and therefore recognizing that the market opportunity was gone, the effort was abandoned. The U.S. insurance regulatory system, with its 50 state licensing requirements, burdensome and often contradictory state rules and a focus on regulatory requirements unnecessary for a wholesale insurance market (which is targeted to sophisticated commercial insurance and reinsurance customers), is a major impediment to capital formation of insurance companies in the United States today.

Moreover, Bermuda is one of the world's centers of expertise in reinsurance. If you need reinsurance you go to the markets in New York, London, Zurich and Bermuda looking for coverage. Bermuda is now the leading center of excellence with regard to property catastrophe reinsurance (reinsurance that pays for damage to homes and businesses from hurricanes and earthquakes) and catastrophe related high layers of excess liability insurance (insurance for protection against lawsuits from a variety of causes that based on the number people or businesses involved can result in hundreds of millions of dollars in claims). These are volatile classes of business and in Bermuda we developed the underwriting talent and the information technology that allows us to successfully underwrite these classes of coverage. The underwriters in Bermuda have formed a center of expertise and the synergies that flow from that community have attracted additional business activity.

As a result, Bermuda has become a principal bulwark in the financial support available to the United States for catastrophic risks. Today, Bermuda provides U.S. businesses and homeowners with 40 percent of the market capacity for property catastrophe reinsurance;

for Florida this number is 50 percent. Our ability to compete fairly to provide this capacity as efficiently as possible helps stabilize the market for these volatile exposures, ultimately reducing costs, stimulating growth and development, and helping communities rebuild when necessary.

U.S. Taxation

Under longstanding U.S. and international tax principles, a foreign-based reinsurer that derives income abroad from reinsuring risks originating in the United States is not subject to U.S. federal income tax in the United States. Cross-border reinsurance with a foreign reinsurer, whether affiliated or unaffiliated, moves the risk of loss to a non-U.S. entity. Income on premiums associated with that risk is earned and taxed abroad where the risk now resides. Similarly, any losses will be borne by the non-U.S. entity. It is well-established that when affiliated parties enter into the same economic arrangement as unaffiliated parties, the transaction will be respected for tax purposes. The U.S. Treasury has ample authority under Section 482 and the recently strengthened Section 845 to assure that cessions between affiliates are made on an arms-length basis, which is the internationally accepted standard that the United States has long championed for such cross-border transactions.

We have heard our critics say that we are in Bermuda because we want to avoid U.S. taxation. That is simply incorrect. All premiums ceded to Bermuda reinsurers or paid by U.S. businesses when they directly buy insurance from a Bermuda based insurer is subject to the U.S. insurance excise tax, a tax which is paid regardless of whether the reinsurance ultimately results in a profit or a loss. All affiliated reinsurance transactions between a U.S. insurer and its Bermuda affiliate are, of course, subject to the reinsurance excise tax. In addition, our U.S. subsidiaries pay U.S. income tax on their worldwide income.

Some have suggested that affiliate reinsurance is comparable to borrowing among affiliates. Reinsurance differs significantly from these transactions, however. Bona fide reinsurance, unlike earnings stripping, involves the true transfer of risk. Transferring risk transfers the losses as well as the gains associated with that risk. Significantly, reinsurance transactions must pass muster with State insurance regulators. Earnings stripping, by contrast, is a debt/equity problem – when capital is supplied by an affiliate, whether it takes the form of debt or equity may have little real economic consequence. The tax consequences of risk transfer, on the other hand, should follow the economics. Regulation requires the price in a reinsurance transaction to be an arm's length price; therefore, these transactions must be respected for tax purposes.

Impact on U.S. Consumers

Increasing these taxes will increase the costs for U.S. businesses and consumers. Increased taxes will increase prices and reduce the availability of coverage and competition in insurance markets, worsening capacity shortfalls and escalating insurance prices unnecessarily. Business owners in Kentucky and New York, and homeowners in

Florida, Louisiana and Mississippi will pay more for their insurance. Farmers in Iowa, Kansas, Montana and North Dakota may have trouble finding a choice of crop insurers. Increased tax obligations - simply put - directly reduce an insurance company's capital and that in turn reduces the amount of insurance coverage that can be provided by that insurer. As you know, today in the U.S., homeowners from Massachusetts to Texas are finding it difficult to buy insurance to protect against hurricanes. The Florida Consumer Action Network, which has some 30,000 members, recently sent a letter to Senators Bill Nelson and Mel Martinez. Here is an excerpt from that letter:

> *"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 increasing insurance costs for Floridians. . . . It's not a good deal and these amendments should be exposed as protectionist measures by US insurers seeking to grab more business for themselves by increasing taxes on their non-US competitors – taxes ultimately paid by Florida consumers."*
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> Bill Newton, Executive Director
> Florida Consumer Action Network represents 30,000 members. (7/6/07 letter to Sen. Bill Nelson)

A reduction in insurance coverage and an increase in prices would be noticed by U.S. businesses. You have evidence of this in the letter from the Risk and Insurance Management Society (RIMS), an association that represents insurance buyers from 81 percent of the Fortune 1000, plus about 1,000 small businesses plus local governments. Here is an excerpt from the RIMS letter:

> *"Reinsurance is an important resource used by business and insurance underwriters to control and finance risk. Many RIMS members, who represent the commercial policyholders, rely on non-US reinsurers and the robustness of this segment of the market. . . .We strongly urge you to oppose any legislation that would result in negative implications for the global reinsurance marketplace and more importantly, those US businesses who rely on this market to manage their risk exposure. . . . We would argue that targeting the non-US reinsurance market for an increase in their taxes would reduce competition and drive up prices for policyholders."*
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> Michael Liebowitz, RIMS President
> Risk and Insurance Management Society (RIMS) represents risk managers for 81 percent of the Fortune 500, plus 1,000 small businesses, local governments and public utilities. (8/6/07 letter to Sen. Max Baucus)

Protectionist measures targeting tax increases at non-U.S. insurers will have counterproductive effects in the U.S. economy – they will make insurance more expensive and harder to buy. The additional tax costs will not ultimately fall on the non-U.S. insurers themselves, but rather on U.S. citizens -- businesses and consumers in your states.

Thank you for the opportunity to present these remarks. I would be happy to answer any question if time permits.

Attachments:

RIMS Letter
FCAN Letter

For more information contact Brad Kading, Association of Bermuda Insurers and Reinsurers (ABIR) 202-783-2434; Bradley.Kading@ABIR.bm

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[i] Reinsurance Association of America, Offshore Reinsurance in the U.S. Market, 2006 data
[ii] Dowling and Partners, IBNR, various reports 2003-2005
[iii] ABIR membership survey, 2007
[iv] Deloitte Bermuda market survey, 2007
[v] Europe's largest reinsurer is five times as large as Bermuda's largest reinsurer; the largest U.S. reinsurer is two times as large as Bermuda's largest reinsurer, Standard and Poor's, Global Reinsurance Highlights, 2006
[vi] A captive insurer is an insurer largely owned by a single business enterprise to help manage its insurance risk; business and local government associations also create captives for their member companies
[vii] Hurricane Iniki also struck Hawaii in 1992 and the Northridge Earthquake struck in California in 1994
[viii] Florida's quarter of hurricanes in 2004, Ivan, Jeanne, Francis and Charley set the stage for market problems that exploded following the 2005 hurricanes
[ix] Dowling and Partners, Insurance Information Institute
[x] GSP Consulting Corporation, Pittsburgh, PA, Analysis of the Economic Impact that Bermuda Based Insurers and Reinsurers have on the United States
[xi] In addition, 14 of our members have created European business subsidiaries.
[xii] ABIR membership survey
[xiii] Bermuda's partnership with the United States goes back centuries. Bermuda is the United Kingdom's oldest colony. Bermuda today is a self-governing, overseas territory of the U.K. It is an English speaking jurisdiction with a U.S. dollar economy. The ultimate judicial appellate court is the U.K.'s Privy Council. Bermuda used to supply the U.S. with flowers, fruits and vegetables. Bermuda has played a strategic role in the U.S. revolutionary war, the U.S. Civil War and in the North Atlantic defense in two World Wars as cited both by Winston Churchill and Franklin Roosevelt.