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Zurich Foreign Affiliated Reinsurance Comments

February 27, 2009

Mr. Russ Sullivan
Democratic Staff Director
Senate Finance Committee
219 Dirksen Office Building
Washington, DC 20510

Dear Mr. Sullivan:

Zurich

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On behalf of Zurich Financial Services, an insurance-based financial services provider with a global network of subsidiaries and offices in North America, Europe, Asia Pacific and Latin America, we thank you for the opportunity to provide comments on the Senate Finance Committee "Staff Discussion Draft" proposal to modify tax treatment of foreign affiliate reinsurance premiums. Below we discuss our grave concerns that this proposed discrimination against U.S. insurers with foreign parents will:

- Dramatically increase system-wide risk in the United States
- Impair the availability of property and casualty insurance; and
- Increase the cost of insurance for those U.S. businesses and local governments that are the most difficult to insure.

About Zurich Financial Services

Zurich is a globally diversified financial services provider serving customers in over 170 countries. Founded in 1872, the Group is headquartered in Zurich, Switzerland and employs approximately 58,000 people globally. Zurich is very proud of its history as one of the first foreign insurers to enter the U.S. market—almost 100 years ago in 1912.

Zurich American Insurance Company is a New York corporation with its headquarters in Schaumburg, Illinois. Zurich employs more than 10,000 people in offices in more than thirty states with major centers of employment in the metropolitan areas of Chicago, New York City, Kansas City, Omaha, Baltimore and Orlando. We distribute a wide array of insurance products to small and mid-sized businesses, farm businesses, local governments and Fortune 500 companies.

Zurich's U.S. insurance group is the fourth largest commercial property and casualty insurer in the United States by gross written premium. Zurich is the second largest writer of commercial general liability insurance which includes coverages that, among many other risks, protect U.S. manufacturers, importers and retailers against product liability losses. Zurich protects many U.S. construction projects throughout the country as the third largest fidelity and surety insurer and second largest commercial general liability insurer. Zurich is the largest insurer of franchised automobile dealers and the third largest commercial automobile insurer. Zurich protects hundreds of thousands of U.S. employees and their employers as the third largest workers compensation insurer. Zurich assumes a substantial amount of California earthquake exposure Importantly, Zurich also has made an enormous commitment to the U.S. Gulf region as the second largest commercial property insurer in Florida and Louisiana and third largest commercial property insurer in Texas.

The Proposal

The Proposal would disallow an income tax deduction for the cost of reinsurance provided by a U.S. insurer's foreign parent or other foreign affiliate to the extent that the U.S. insurer purchases affiliated and non-affiliated reinsurance for any particular line of insurance in an amount that exceeds the industry average purchase of non-affiliated reinsurance during a period two years prior.

The Internal Revenue Service today has appropriate tools to address any concerns that may exist with respect to deductions taken for affiliated reinsurance. Every year insurers purchase tens of billions of dollars of non-affiliated foreign reinsurance through an active market about which there are many available statistics. The IRS has broad authority to measure affiliate reinsurance transactions against this active market and challenge any transaction that does not appear to reflect arms length pricing. Moreover, the IRS is empowered to impose substantial penalties for non-compliance with its transfer pricing rules. Should there be some legitimate concern about the deductibility of foreign affiliate reinsurance costs, the IRS is well equipped with notice procedures to warn taxpayers that it will impose heightened scrutiny and to publish notice of any abusive structures.

Moreover, state insurance regulators review and approve all significant agreements with affiliates – including foreign affiliate reinsurance agreements. Those reviews ensure that, among other things, the transaction transfers risk, is priced appropriately (i.e., as an arms length transaction) and is otherwise reasonable.

Affiliate reinsurance that complies with existing transfer pricing rules is not some form of earnings stripping, as some of the rhetoric around this issue may suggest. Such affiliated reinsurance – just like non-affiliated reinsurance – transfers substantial risk of loss to the reinsurer in exchange for a premium. Any affiliated reinsurance agreement that does not is in plain violation of existing transfer pricing rules. The proponents of a change to existing rules ignore the billions of dollars in claims payments that flow every year from foreign parents to their U.S. affiliates under foreign affiliate reinsurance – clear evidence that the present discussion is not about income tax parity but about differing capabilities for capital risk management.

While we are certainly willing and available to discuss the technical tax issues raised by the Proposal, Staff is absolutely correct that the immediate focus must be to understand the extent to which the Proposal would damage the United States economy. With confidence, we submit that this Proposal will dramatically increase system-wide risk in the United States, increase cost to insurance purchasers and impair the availability of insurance for those U.S. businesses and local governments that are the most difficult to insure.

U.S. Insurance Capital Shows Signs of Serious Stress

U.S. newspapers and trade publications have catalogued an array of events and statistics that clearly show that insurance capital – like capital committed to other financial sectors – has experienced significant stress during the last year. For example:

> **State Farm Florida** – Florida's largest private property insurer has announced that it plans to stop writing property insurance in the state because of the company's deteriorating capital position.
>
> **Catastrophe Bond Downgrades** – Willow Re (reinsuring Allstate's New York area windstorm exposures), Newton Re (reinsuring Catlin's U.S. windstorm and earthquake exposures) and Ajax Re (reinsuring Aspen's California earthquake exposures) have each been downgraded because of the failure of Lehman Brothers – with Willow Re reportedly in technical default.
>
> **Florida Hurricane Catastrophe Fund** – The FHCF reinsures state-run Citizens Property Insurance Corporation and over 200 private insurers in a total amount of $29 billion per year (and over $50 billion on a multi-year basis) against residential hurricane loss. The Fund's financial advisors have concluded that the Fund could reasonably expect to actually fund only $11 billion of its obligations following a major hurricane.
>
> **Texas Windstorm Insurance Association** - TWIA, the Texas state-run wind pool, exhausted its hurricane trust fund as well as a $1.5 billion program of private reinsurance as a result of Hurricanes Gustav and Ike. TWIA is now searching for ways to "reload" its capacity for the 2009 hurricane season.

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Insurance Linked Securities – After a record year of $7.6 billion in new catastrophe bond capacity for 2007, 2008 saw a 64% decrease in new catastrophe bond issuances. Likewise, capacity from sidecar transactions (which typically involve a capital market match of traditional reinsurance capacity) fell more than 80% during that same time period.

Massive Capital Erosion – As a consequence of the financial market crisis, global and U.S. insurers are estimated to have suffered an average reduction of shareholders' equity in excess of 20% due to changes in unrealized losses and outright realized losses on their investment portfolios. Given the current state of equity markets it will be very difficult for insurers to replenish their capital through new rights issues.

The financial crisis has caused significant stress also for a number of insurance companies. Most notable was the decision of the U.S. government to fund a $150 billion bailout of AIG under the "Systemically Significant Failing Institution" program. Similarly, Hartford, the fifth largest commercial property and casualty insurer in the United States, has applied for up to $3.4 billion of TARP money after having already received a $2.5 billion capital injection from the German insurer Allianz.

Diversification through Reinsurance

Against this deteriorating picture, it is essential to understand the importance of capital diversification. Diversification through global insurance capital delivers stability, durability and lower costs to consumers. In fact, broad diversification of risk is the central thesis underlying the insurance mechanism. That is, by assuming and mingling a wide array of uncorrelated risks, insurers turn individual volatility into portfolio stability. The broader the spread of individual risk, the greater the predictability and stability of the overall portfolio.

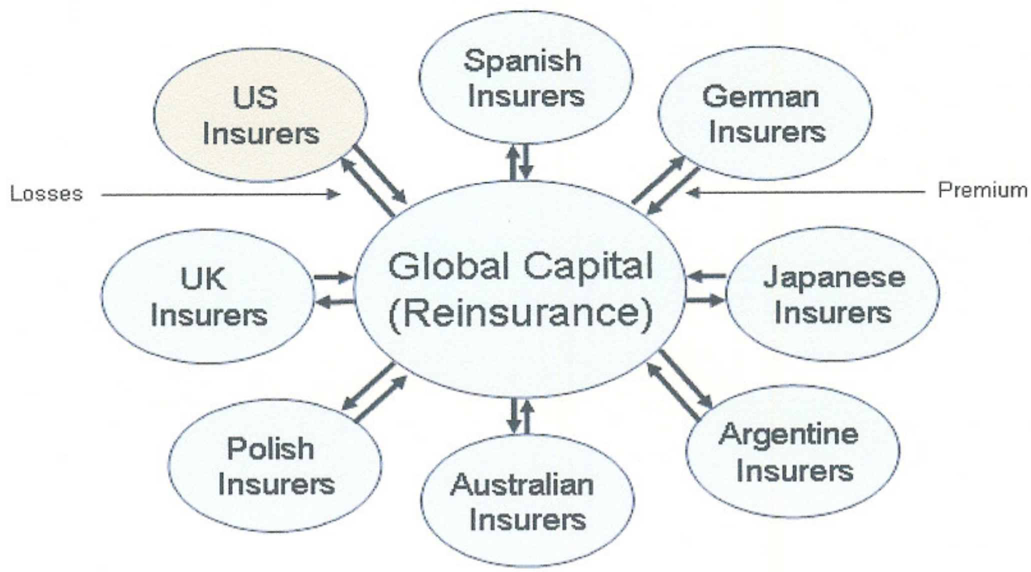
In most instances, a single retail insurer's risk portfolio is insufficiently broad to achieve satisfactory diversification. Such an insurer must mingle its own risks with those risks assumed by other insurers – especially those other insurers that are not assuming risks correlated with its own. As a practical matter, this inter-company mingling of risks occurs within the international reinsurance marketplace.

Reinsurance is often described as insurance for insurance companies. To use a simple example, suppose an insurer that only does business in Florida writes a portfolio of risks that would result in $50 million of loss following a major hurricane. Suppose another insurer that writes only in California would lose $50 million to a major earthquake. Should each insurer decide to hold all of its risk to itself both insurers face a relatively volatile exposure: Each insurer could lose $50 million – or could lose nothing – depending on chance.

Should those two insurers swap some of their uncorrelated risks, both will enjoy a more stable and predicable portfolio. Suppose that each insurer agrees to trade 30% of its possible losses with the other insurer. In this way, if there were a major hurricane the Florida insurer would lose $35 million and the California insurer would lose $15 million. Similarly, if there were a major earthquake the California insurer would lose $35 million and the Florida insurer would lose $15 million. By diversifying the uncorrelated risks of hurricane and earthquake, each insurer enjoys a more stable portfolio. The possibility of a loss may have increased for each insurer, but the amount of those losses are more manageable and the frequency more predictable. As a result, these insurers' regulators may require each to hold only $35 million of capital against the possibility of a catastrophe loss rather than $50 million. The insurers pass this capital efficiency on to their policyholders in the form of lower insurance rates.

As you may imagine, if this example were expanded to include hundreds of insurers and dozens of types of exposures, each participating insurer would enjoy a substantially more predictable and stable portfolio. Of course, a direct insurer that deals with tens or hundreds of thousands of insurance customers does not have the capability or capacity to network with hundreds of other competing insurers in order to swap risks in this manner. Instead, direct insurers rely on reinsurance capital to effectively create these networks of risk exchange.

In order to facilitate the orderly spread of insurance risk across the globe, reinsurers hold capital that can be dedicated to those risks. Insurers from many countries and with a wide array of exposures pay premiums to reinsurers in exchange for a promise that the reinsurer will pay some portion of the losses to affected insurers should there be a catastrophe or other insurable loss event.



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This global reinsurance network provides a number of well accepted benefits:

> **Stability** – Because global insurance capital is well diversified across multiple unrelated exposure portfolios, investors and policyholders can expect stable results even if one or more of those exposure portfolios performs poorly.
>
> **Durability** – Insurance operates on the statistical expectation that insured exposures are not correlated (i.e., all possible loss scenarios will not happen at the same time). For example, a globally diversified pool of capital can survive a large California earthquake loss because there is no reason to believe that a Japanese earthquake or European winter storm will occur at the same time.
>
> **Lower Costs to Consumers** – Global risk diversification produces insurance of high quality (that is, financially more secure). Moreover, capital can be stretched farther because the risk managed within a diversified portfolio is smaller than the sum of the individual risks. Accordingly, the insurance buyer enjoys lower prices for higher quality protection.

Affiliate Reinsurance

Foreign affiliate reinsurance works in the very same way as non-affiliated reinsurance. Each local affiliate pays a premium to its parent insurer in exchange for a promise from the parent to pay the affiliate for some portion of the affiliate's losses. The only difference between affiliate reinsurance and non-affiliate reinsurance is that affiliate reinsurance is processed through an "in-house" global risk distribution network.

Transfer of risk solely within the in-house risk distribution network of even the most well diversified insurers is rarely sufficient. Accordingly, insurers that enter into foreign affiliate reinsurance or similar agreements (which undoubtedly includes almost every U.S. or foreign insurer that has an affiliate in more than one country) also purchase substantial amounts of unaffiliated reinsurance to achieve optimal risk diversification. Whether a particular reinsurance agreement is in-house or external, the objective of the transaction is to achieve the same stability, durability and consumer cost benefits.

The Proposal will Reduce Insurance Capital Capacity

The advent of global risk diversification has proven to be one of society's greatest risk management assets. We see nothing but danger in turning away from the current robust spreading of insurance-related risk. Population in this country's catastrophe-prone areas continues to grow, exposing trillions of dollars of value to the ravages of hurricanes and earthquakes. Our economy marches toward new energy sources, innovative environmentally sensitive products and vastly complex supply chains. U.S. homeowners, businesses and local governments increasingly depend on stable insurance capital to support these changes.

That stability is already threatened. According to Aon's recently published Reinsurance Market Outlook, the global insurance industry has lost more than 20% of its capital during 2008 due to the adverse impact of the global financial crisis:

Figure 3: Change in Insurer Capital

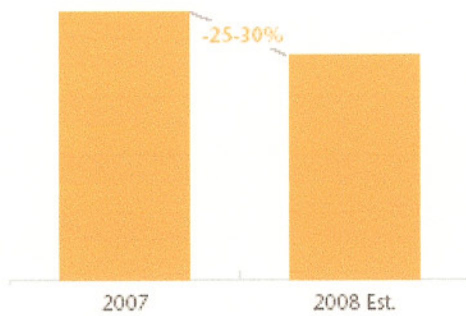
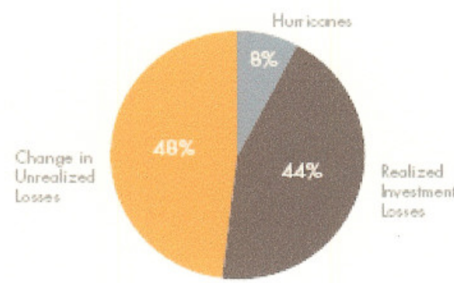


Figure 4: Insurer Loss Drivers



The Proposal would forcefully direct foreign insurance groups with affiliates in the United States to withdraw available parental capital from the U.S.'s most difficult exposures. U.S. affiliates of foreign parents already purchase many billions of dollars of the world's limited non-affiliated reinsurance capacity. Clearly, the Proposal would put upward pressure on pricing of the remaining non-affiliated reinsurance – ultimately driving up costs for U.S. businesses, homeowners and local governments.

The Proposal's severe penalization of effective worldwide diversification of insurance risk also creates a less stable insurance market. For example, the Proposal would impede:

> **<u>Capital Agility</u> -** As many years of experience prove, reinsurance demand increases markedly during the period following capital depletion resulting from a major hurricane, earthquake or terrorism event. More recent experience has shown how investment losses can similarly cause the need for an insurer to quickly replace depleted capital with reinsurance.
>
> Under a global capital management model, a parent can immediately replace depleted capital of an affiliate on predictable terms. For example, should an affiliate suffer large East Coast hurricane losses, the parent can quickly increase reinsurance to the affiliate in order to replenish capital without being subject to price or capacity volatility of external reinsurance or the capital markets. This capital agility and stability (i.e., the ability to respond to capital market changes by exporting risk from the United States) clearly benefits U.S. insurance purchasers with the promise of a quicker return to stable retail insurance availability and pricing. The Proposal would economically outlaw this sort of capital resilience and instead leave U.S. insurance consumers with little refuge from the volatility that follows major capital depleting events.

Credit Risk Management – When an insurer turns to the reinsurance market to mingle its risks with those of others it assumes counterparty risk. That is, there is some risk that the reinsurer with which it contracts will not be able to make good on its obligations. In order to manage credit risk, a prudent insurer limits the amount of reinsurance it places with any one reinsurer. However, there are a limited number of highly secure reinsurers and, certainly, a finite amount of reinsurance capacity each reinsurer may offer.

Affiliate reinsurance is essential to manage reinsurance credit risk. In the current economic crisis, management of counterparty risk is more important than ever. If a U.S. insurer has access to "in-house" global diversification, that insurer has a ready ability to spread counterparty risk by tapping into the group's own internal risk-spreading capabilities. Moreover, the affiliate-parent relationship allows superior information exchange and transparency into financial management and controls unavailable in third-party reinsurance transactions.

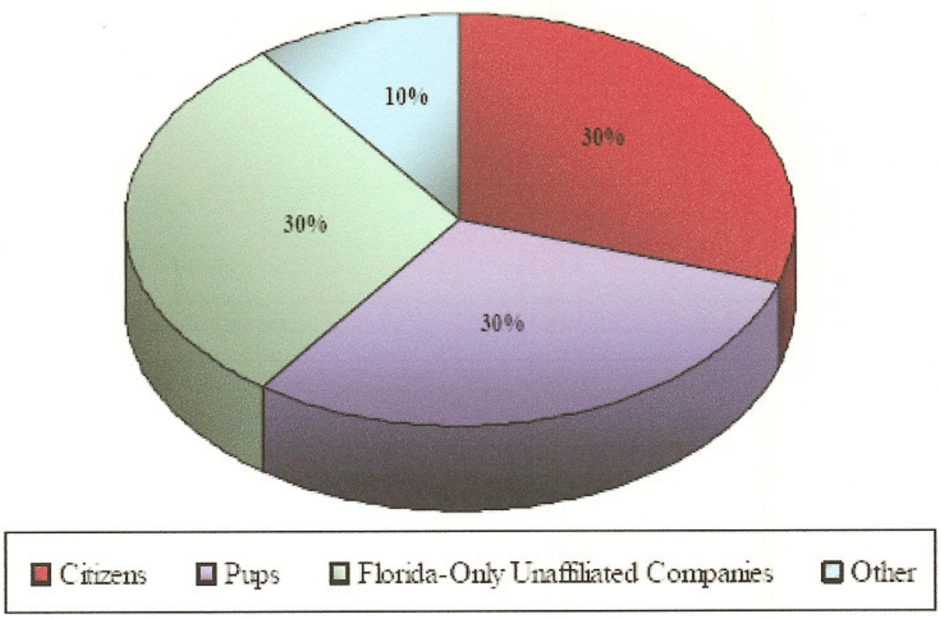
Limit Global Capacity Available to Fund Catastrophe Losses – This country's Gulf Coast and East Coast hurricane as well as Midwest and California earthquake risks require large amounts of reinsurance capacity to efficiently mingle those volatile exposures with other non-correlated natural catastrophe exposures around the globe. It should come as no surprise that many of the leading writers of U.S. catastrophe exposures have access to robust in-house global risk diversification mechanisms. Many of those same insurers also bring their global risk-spreading capabilities to other difficult exposures such as products liability, construction defect and environmental clean-up coverages. Crop insurance, identified by Staff, as well as innovative insurance products such as those supporting carbon capture technologies also require strong and well diversified capital.

The Proposal would harshly penalize U.S. insurers with foreign parents that write more of such high-severity exposures than the "average" U.S. insurer. That average would include the many U.S. insurers that completely avoid writing in hurricane or earthquake exposed areas or refuse to assume difficult liability risks. The Proposal cannot be reconciled with the often repeated public policy pronouncements at the state and federal levels that insurers must be incented to write more risks in hurricane and earthquake exposed states and to find ways to lower the cost of risk for manufacturing, construction and environmental remediation.

The economy of the United States must have access to a robust and resilient global risk-spreading capability. Insurers with deep and agile in-house global risk transfer mechanisms are reliably doing just that for the businesses and local governments of the United States.

We have a ready example of the consequences that follow a break-down in insurance risk-spreading. Following massive insurance losses from the 2004 and 2005 hurricane seasons, Florida's insurance market moved away from globally – and even nationally – diverse capital with disturbing results.

Today, only 10% of Florida's residential insurance is placed with nationally-diversified insurers with long track records of stability. The other 90% of the State's residential business is evenly split among state-managed Citizens Property Insurance Corporation, "pup" companies (Florida-only affiliates of major national insurers) and other Florida domestic insurers that write no business outside of the State. Each of these insurers are required by law to purchase hurricane reinsurance from the Florida Hurricane Catastrophe Fund. The FHCF does not transfer any of that risk into the global reinsurance market.



Source: Citizens Property Insurance Corporation

The Florida Hurricane Catastrophe Fund projects that a single major hurricane could burden Florida residents and businesses with special assessments of nearly $2 billion per year <u>for each of the next 30 years</u>. Such extreme volatility is the direct result of the failure to embrace global risk-spreading. Wide diversification of risk – which must include fully leveraging affiliated as well as non-affiliated reinsurance capital – is essential to prevent this sort of destabilization at the national level.

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Who Pays the Price for Reduced Insurance Capacity?

In addition to the obvious increase in system-wide risk that necessarily accompanies reductions in global risk transfer, the Proposal's impact on the supply of globally diversified reinsurance would reach:

State-Sponsored Insurers – Hurricane exposed states each operate significant windpools or similar facilities that depend on global reinsurance capacity to pay claims, limit assessments and reduce volatility. The Proposal would decrease availability and drive up costs as competition for limited unaffiliated global reinsurance capacity intensifies. For example:

Texas: Hurricane Ike resulted in more than $2 billion in losses to the state-run property residual market – $1.5 billion of which was covered by the private reinsurance market.

North Carolina: The North Carolina property residual market plans purchased $700 million of reinsurance in 2007 and are looking to increase that amount to more than $2 billion for 2009.

Mississippi: Mississippi's insurer of last resort (which lost more than $700 million in 2005) currently purchases $500 million in private reinsurance.

South Carolina: South Carolina's property residual market purchased about $1.5 billion of reinsurance in 2008.

California Earthquake Authority – The country's largest earthquake insurance facility purchased $3.1 billion of private reinsurance for 2009. It would likewise face decreased availability and increased cost – translating into higher consumer costs for earthquake insurance and resulting in fewer homes insured.

Lenders – Residential and commercial mortgage lenders require that the collateral backing a mortgage (i.e., the home or commercial property) be adequately insured against catastrophe and other losses. Impairment of insurance availability and increases in system-wide risk within the insurance industry in turn increase the risk to lenders.

U.S. Insurance Customers – U.S. insurance customers would face increased insurance costs and fewer insurance choices generally. Following a major natural or financial catastrophe, U.S. business, local governments and homeowners would face much more limited availability and volatile pricing as insurers scour global capital markets for unaffiliated replacement capital.

Globally Active U.S. Companies - U.S. companies with global operations purchase comprehensive and coordinated global insurance programs executed through U.S. insurers that maintain a network of global affiliates. Because the Proposal effectively disassembles those networks, U.S. companies competing globally will face a patchwork of more costly coverages.

Federal Taxpayers – Weakened state-sponsored catastrophe insurers, such as the Texas windpool and Florida Citizens Property Insurance Corporation, are more likely to seek a Federal bailout after a major catastrophic event. More troublingly, increases in global credit risk in insurance markets and a smaller pool of replacement capital would dramatically increase the risk of systemic failure and resulting government intervention.

U.S. Insurers Operating Globally – If the United States were to violate its international agreements by shutting down international insurer group risk transfer, other countries that host affiliates of U.S. insurance groups would surely consider retaliation by likewise shutting down access of local affiliates to global risk transfer. For example, the Proposal would violate the non-discrimination provisions of the Swiss-US Tax Treaty. If enacted, there would be a "more burdensome" tax impact on Swiss-owned US companies in violation of Article 24. We would expect that the Proposal similarly violates other tax treaties.

Conclusion

We certainly appreciate Staff's desire to fully understand the ramifications of penalizing U.S. insurers with foreign parents that transfer risk to global capital through "in-house" mechanisms. Indeed, we are alarmed by the far-reaching and destabilizing implications of the Proposal. We implore you to view the Proposal through a broader public policy lens than that offered by its proponents. Is it the public policy of the United States to hold volatile insurance risks inside its borders and limit access to a deeper pool of global reinsurance capital? Or, do the homeowners, businesses and local governments of the United States benefit most from robust risk transfer mechanisms that export the nation's insurance exposures where they can be well diversified in ways that deliver greater resiliency and lower insurance costs?

As an insurer capable of diversifying insurance risks that arise from 170 countries across the globe, we are proud of our partnership with hundreds of thousands of U.S. customers and the contributions we have made and very much plan to continue to make in securing this nation's economy against insurable loss. We look forward to a continued, constructive and open working relationship on this and other policy matters before the Senate Finance Committee.

Best regards,

Michael T. Foley
CEO, Zurich North America Commercial