The Impact Of HR 3424 On The US Insurance Market

Law360, New York (July 22, 2010) -- Congress recently conducted a hearing on H.R. 3424, legislation introduced by Rep. Richard Neal, D-Mass., that would deny deductions for certain reinsurance premiums paid by a foreign-owned U.S. insurer to an offshore affiliate. The legislation is a response to pressure from some U.S.-owned insurance groups that portray affiliate offshore reinsurance as a tax-avoidance strategy. These groups also argue that the tax is necessary to level the playing field and will not harm U.S. consumers.

We disagree. Affiliate reinsurance serves legitimate non-tax business purposes: it effectively mitigates the information asymmetry (adverse selection and moral hazard) between the insurers and reinsurers; and it allows risk and capital to be moved more quickly and easily within the insurance group in response to changing market conditions.

In fact, affiliate reinsurance is the dominant intra-corporate risk-management tool for both U.S. and foreign insurance groups. Moreover, far from "leveling the playing field," the proposed tax is confiscatory as almost all affiliate offshore reinsurance would be eliminated. Consequently, the U.S. businesses and consumers would be harmed, and no taxes would be raised directly from the legislation.

We estimate the price of insurance would increase by 2.1 — 2.4 percent, on average, or $11 — $13 billion more per year for the same coverage. At the same time, the insurance coverage would drop by 4.1 — 4.8 percent, on average. Rather than being a tax policy, this is really a disguised protectionist trade policy.

Reinsurance as a Critical Risk Management Tool

To understand why a tax on affiliate offshore reinsurance would have such a significant economic impact, we start with the role of reinsurance in effective risk management of the insurance business.

P&C insurance protects businesses, homeowners and others against a wide range of risks, including earthquakes and hurricanes, crop failure, workers' compensation claims, and general liability including class action lawsuits. The amount of insurance an individual P&C company can sell is partly a function of how much capital it maintains and how much reinsurance it procures.

Capital acts as a shock absorber for volatility — it gets depleted when times are bad and accumulates when times are good. Reinsurance, insurance for insurance companies, is a substitute for capital and an effective risk management tool used by all U.S. and foreign insurance companies.

Because reinsurance transfers the actual risk, the insurer typically does not have to maintain capital or reserves to cover the losses it cedes. The key function of reinsurance is risk-pooling and diversification: An insurer can reduce the volatility of its losses by ceding its exposure to particular risks.

A reinsurer can bear these risks more efficiently because it assumes them from a variety of sources and many of the risks (e.g., hurricanes in Florida and earthquakes in Japan) are uncorrelated. Reinsurance allows an insurer to write more insurance, or provide a higher limit of protection, than its capital assets would otherwise allow, which makes insurance more affordable. This is true whether or not the reinsurer is part of the same corporate family.

The reinsurance market is global because insurers need to be able to diversify across the widest possible geographic area (except for overages like automobile accidents where smaller geographic risk pools are often sufficient). The United States is particularly dependent on foreign reinsurance market, as it has the world's largest insurance market and faces unique risks from natural disasters and the U.S. legal liability system.

Roughly half of the $100 billion in reinsurance purchased by U.S. insurers comes from non-U.S. reinsurers. The fraction of foreign reinsurance is even higher for high-risk lines of business, such as commercial liability insurance, homeowners insurance in catastrophe-prone states, earthquake insurance and reinsurance covering extreme losses.

For example, foreign reinsurers account for two-thirds of U.S. property catastrophe reinsurance. This is also consistent with the payout experience for the 2005 hurricane trio, where more than 60 percent of the insurance payments came from foreign insurers and reinsurers.

Economics of Affiliate Reinsurance

H.R. 3424 specifically targets affiliate reinsurance the U.S. subsidiaries cede to their offshore affiliates, as its supporters claim that the purchase of reinsurance from foreign affiliates is a mere tax-avoidance strategy by U.S. subsidiaries. This is untrue, since the affiliate reinsurance is actually far more prevalent than non-affiliate reinsurance, and is used extensively by the U.S.-based insurance groups as well.

This begs the question of why the H.R. 3424 proponents themselves rely so heavily on affiliate reinsurance. The answer is that affiliate reinsurance solves real economics problems — adverse selection and moral hazard inherent in the insurance market and efficient capital allocation within an insurance group.

These problems arise because the insurer often knows more than the reinsurer about the risks it insures, and this information asymmetry creates an incentive for the insurer to transfer the worst risks to the reinsurer (adverse selection) and/or to be lax in its underwriting (one form of moral hazard). If the insurer and the reinsurer are part of the same corporate group, their incentives are better aligned.

In other words, vertical integration serves to "internalize" the costs of adverse selection and moral hazard. This is the insight of two Nobel Prize laureates (Prof. Joseph Stiglitz and George Akerlof). The benefit of vertical integration is especially important with respect to infrequent, high-loss events such as natural catastrophes, where the information asymmetry is most pronounced.

Moreover, as a tool for intercompany transfer of risks, affiliate reinsurance is central to the group structure of the insurance industry. Because of its greater flexibility, affiliate reinsurance is also less susceptible to price increases and supply restrictions over the hard-market phase of the underwriting cycle.

These benefits of affiliate reinsurance have been confirmed in the published academic studies. Our own empirical analyses, which update and extend the existing literature (described below), reaffirm the unique and different role that affiliate reinsurance plays in insurance risk management.

Because affiliate reinsurance addresses real problems in the market, U.S.-owned insurance groups use it extensively: In 2009, nearly half of U.S.-owned insurers ceded at least 40 percent of their premiums to an affiliate, and a third of them ceded at least 80 percent.

Furthermore, legislative and governmental entities such as the Joint Committee on Taxation and the Treasury explicitly recognize the use of affiliate reinsurance as an effective risk management tool and are not per se tax-avoidance schemes.

Tax Treatment of Offshore Affiliate Reinsurance

Under the current tax law, if an insurance company reinsures a portion of the risk, the insurer may deduct the amount of premiums paid for reinsurance. For reinsurance between two affiliated U.S. companies, the reinsurance premium remains in the U.S. and is subject to the U.S. income taxes.

If the reinsurance is, however, ceded from a foreign-owned U.S. firm to its foreign affiliate, the premium (net of a ceding commission to cover the U.S. firm's underwriting activities) is deducted from the U.S. firm's income, although the gross premium is levied a 1 percent federal excise tax. (The excise tax may be waived by treaty for countries such as Switzerland and Germany, but not for Bermuda.)

The U.S.-owned P&C insurance groups claim that the different tax treatments produce an unfair tax advantage to foreign reinsurers. Without quantifying why the combined taxes brought through transfer pricing and federal excise do not eliminate the claimed tax advantage, H.R. 3424 seeks to effectively deny deductions for reinsurance premiums that exceed an industry average. The proposed disallowance of deduction amounts to a 24.5 percent tax on the premium ceded to offshore affiliates.

To put this into perspective, the pre-tax income of the U.S. P&C industry has been 9.9 percent of premiums on average over the last decade. Thus, this revenue tax is more than 2.5 times larger than the profit tax, which creates an effective barrier to trade rather than simply "leveling the playing field." According to our estimate, such a tax would effectively eliminate all affiliate offshore reinsurance.

Analysis of Economic Impact

To quantify the economic impact of such a confiscatory tax, we use a three-step approach that combines regression analysis with a mathematical simulation of the U.S. insurance market to estimate the effect of the tax on the supply of reinsurance (step one), and on the supply and price of primary insurance (steps two and three). Our regression analysis is based on a sample of 700 large U.S. P&C firms over a 10-year period (1996–2006) and uses analytical methodologies drawn from the peer-reviewed academic literature.

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Given a reduction in affiliate reinsurance, we first estimate the rate at which U.S. subsidiaries would replace their affiliate reinsurance with capital and non-affiliate reinsurance. We estimate that, for each dollar drop in affiliate reinsurance, insurers would substitute 29 cents worth of non-affiliate reinsurance and 56 cents worth of capital.

We analyze how the market supply of primary insurance as a whole would adjust to this new market environment (more capital, less reinsurance). Our second regression analysis indicates that the supply of primary insurance would drop by 0.68 percent for each 1 percent decrease in the amount of reinsurance and would go up by 0.36 percent for each 1 percent increase in the amount of capital.

These two separate regression analyses, however, do not capture the dynamic effects linking insurance, reinsurance, and capital. Specifically, while the supply of primary insurance would drop in response to less reinsurance and more capital (step two), the drop in the insurance supply would in turn reduce the need for capital and reinsurance (step one).

To reflect this dynamic process, we develop a mathematical simulation of the P&C market that captures the simultaneous changes in reinsurance, capital and insurance premiums. Based on the simulation, we calculate that the overall supply of insurance would decline by between $11 billion and $13 billion or about 2.1 to 2.4 percent overall.

Finally, we estimate the change in the price of insurance as a function of supply in our historical data. We estimate that the proposed tax would increase the price of insurance by 2.1 — 2.4 percent, on average, and as much as 9 percent in some lines of business. U.S. businesses and consumers would have to pay $11 — $13 billion more per year to obtain the same coverage. Correspondingly, the insurance coverage would drop by 4.1 — 4.8 percent, on average, and as much as 16 percent in some lines of business.

Conclusion

The current combination of tools (capital, affiliate and non-affiliate reinsurance) represents the P&C industry's optimal approach to risk management under the current configuration of laws and regulation.

If Congress were to limit or close off any one option, it would reduce industry's ability to manage its own risk. Limiting the use of offshore affiliate reinsurance in particular would drive U.S. subsidiaries away from the high-risk lines in which they specialize, thus restricting the supply of insurance to these lines.

We conclude that H.R. 3424 would lead to a degradation of the ability of firms to manage risk, both inside and outside of the P&C industry. The financial burden of excess catastrophe risk, in particular, would fall more heavily on government.

Adoption of such legislation would be imprudent under the best of conditions. Under current conditions, with the risks due to natural catastrophes growing and the ability of the government and private industry to absorb shocks still tentative due to an uncertain economic recovery, it seems especially unwise.

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