



Intra-group reinsurance

Outlook: unsettled

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Intra-group reinsurance is a key strategic pillar in the underwriting strategy and capital structuring policies of many insurers. However, there are a number of potential changes taking place around the world that, if implemented, will impact many existing related party reinsurance structures and require companies to re-visit their approach.

The most common drivers

Intra-group reinsurance strategies are driven by both commercial and regulatory factors. One of the key commercial advantages of these structures is to offer capacity and capital strength to geographical subsidiaries by leveraging the credit strength of holding company balance sheets. End customers welcome the credit strength that these structures give their policy.

Group balance sheets will undoubtedly command a stronger credit rating due to their capital strength and exposure diversification. Exposure diversification can also drive cost efficiencies in purchasing outward reinsurance/retrocession, while domestic regulatory authorities may also require the higher credit exposure.

This facility may be used to support market entry, whereby a recently created subsidiary in a new market may leverage

the group's balance sheet to write business that would otherwise be beyond its capacity or credit rating. It is often much quicker and simpler to shift excess risk back to head office by way of reinsurance than it is to provide the necessary additional capital.

Tax is often assumed to be the main driver for the use of intra-group reinsurance, when in fact the benefit is often subsidiary to the commercial drivers listed above. Recent cases of re-domiciliation have allowed companies to reduce their tax bill by 50 percent or more, enabling them to retain capital for investment and to improve group competitiveness by improving shareholder returns and easing pricing pressures. This is a topic that attracts a great deal of attention but the focus is normally on the quantum of the tax saving achieved, rather than the wider commercial and competitive benefits arising from an intra-group reinsurance strategy.

Winds of change

Two key sets of changes are being either implemented or proposed that will have an impact on many existing structures: Solvency II and taxation.

The requirements of Solvency II are now more clearly understood and many of the impacted insurers have now commenced projects to ensure they are Solvency II



compliant by the 2012 deadline.

Solvency II will affect intra-group reinsurance in two ways: firstly, by disregarding any related part reinsurance transactions to domiciles that are considered “non-equivalent” and secondly, by requiring more formalised procedures for effecting reinsurance contracts.

The Solvency II guidelines will categorise domiciles to which related party premiums are ceded on the basis of “equivalence”. Three possible categories of domicile are being proposed: the first is the EU countries that are implementing Solvency II; the second will be countries deemed to have a capital and governance regime which is equivalent to Solvency II; and the third, and arguably most contentious, category will be those domiciles deemed “non-equivalent”.

The regulatory capital regime of domiciles in the last category will be deemed not robust enough to be considered equal to the Solvency II framework and, therefore, it is wished that little or no credit will be given to the ceding entity for related party intra-group reinsurance transactions.

With the exception of EU members who will fall within the first group, membership of the other categories has not been decided. A consultation paper is expected to be published next year to open the debate on the criteria for being designated “equivalent”.

Are there likely to be any surprises? It is assumed that the US will be deemed equivalent, but the same assumption cannot be said about others unless significant changes are made. Countries

such as Switzerland and Bermuda are rapidly implementing capital regulatory measures that mirror the Solvency II requirements in a bid to gain this status. As major reinsurance centres they arguably have most to lose by not receiving the equivalent categorisation. Switzerland has already indicated a form of Solvency II called SST (Swiss Solvency Test) and it is generally considered that it is likely meet the requirements.

Solvency II will also have an impact on the intra-group reinsurance contract process. Companies will be required to go through a formal underwriting review process (which can be evidenced) to check that the impact of the contract on the accepting entities’ balance sheet is fully understood and considered. In practice, this will mean detailed underwriting review meetings that are well documented and minuted.

This second proposal should have much less impact than the first, as the majority of companies already have a process in this area; it should just be a matter of better recording and evidencing of the decision. It will be important to be able to prove that the amount of rigour applied to the internal transaction is comparable to that for a similar transaction entered into with a third party. Given the materiality of limits imposed and the size of risks under intra-group, the transaction would often not be possible in the open market, as one could expect a very high standard to be applied. Tax authorities are equally as interested in this point as the regulatory bodies.



Tax storms

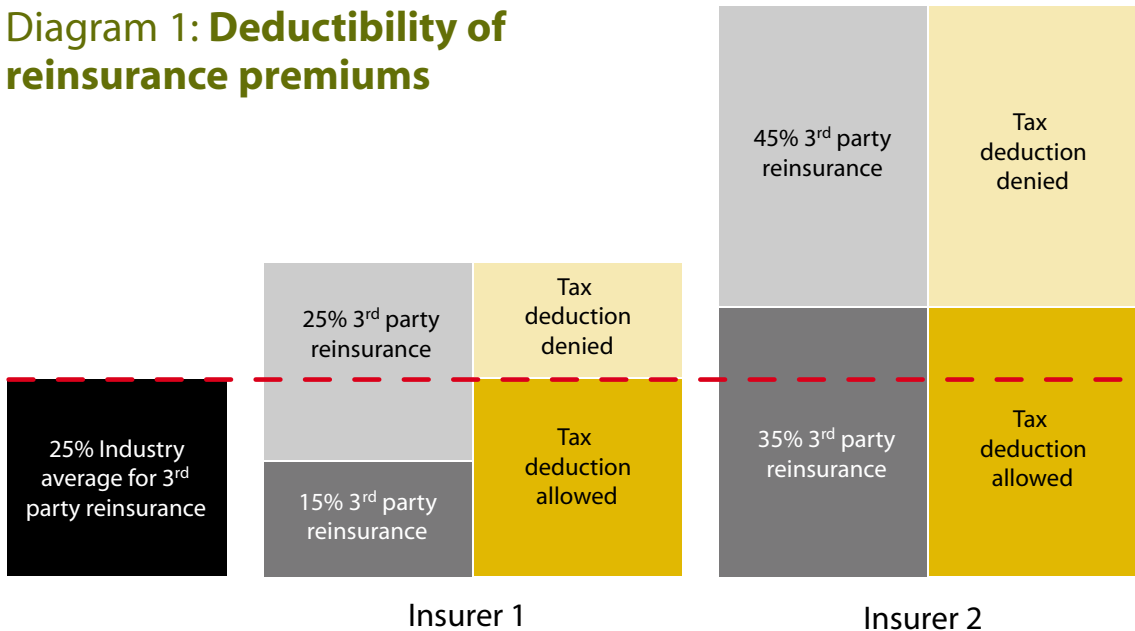
Solvency II is not the only change in legislation that will affect intra-group reinsurance arrangements. Changes to tax practice and/or legislation are also being considered by key domiciles that may adversely impact the use of intra-group reinsurance and may dis-incentivise insurers from using this medium to manage a group's risk and business model.

For example, there is the revised Neal Bill currently being debated by the US. This bill is targeted at related party reinsurance contracts where the percentage of premium ceded to a connected party is greater than the "industry average

percentage" (an amount determined by the IRS on the basis of available market data). The proposed bill will restrict the deduction available for US tax purposes on those connected party premiums to a level which the IRS say would be the average cession on a line-by-line basis, to third parties (see diagram 1). The current draft makes no distinction on the location of the reinsurance entity – i.e. whether it is a so-called "tax haven" or not.

The Coalition for a Domestic Insurance Industry – representing 14 major US-based insurance groups – is a strong supporter of the Neal Bill proposals. It argued in a recent open letter to members of Congress

Diagram 1: Deductibility of reinsurance premiums



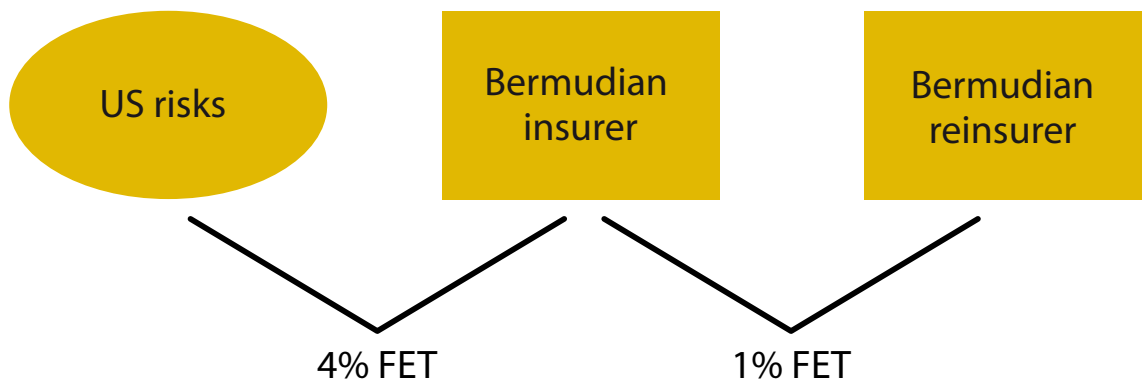
and the Senate that the bill is necessary to close a tax loop-hole for foreign-based insurers that costs the Treasury significant tax revenues and provides such companies with a significant unfair advantage over the US-based property and casualty insurance industry.

Opposition to the bill is led by the Coalition for Competitive Insurance Rates, which is made up of several insurance industry bodies, insurance focus groups and international insurance and reinsurance companies. It argues that the bill proposes an isolationist tariff on international reinsurers conducting business in the US. It has also questioned the suggested billion dollar figures for lost tax revenues and argued that the recent results of US property and casualty companies suggest they are in good financial health. Moreover, the group claims that the international

insurers targeted by the bill have traditionally absorbed large percentages of the claims incurred from major US insurance losses.

The IRS has recognised the scale of intra-group reinsurance and, in some circumstances, is seeking to levy a tax on these transactions. In 2008, the IRS published its interpretation of the way federal excise tax (FET) should be applied to reinsurance and retrocession. The IRS would contend that a 1 percent FET should be charged when a group reinsures US risks from one company to another, if the receiving entity is located in a country which does not have the benefit of a US tax treaty (see diagram 2). It is not yet clear how successful the IRS have been in enforcing this tax, but it is nonetheless evidence of tax authorities' increased focus on these transactions.

Diagram 2: Potential FET charges where no tax treaty protection exists (IRS view)





The US is not the only territory where large related party reinsurance transactions are under the spotlight. A European tax authority recently advised that it may ignore an intra-group reinsurance contract where the percentage ceded was greater than what would be expected with unrelated third parties.

In the past, the focus of most fiscal authorities has been on whether the pricing of the contract was “arm’s length” for the amount of risk that was being transferred. Provided the premium and commissions had been set at a level where both parties would have entered into the transaction had the other party been unrelated, the contract would be recognised and the tax deduction allowed.

Extending the focus to include the proportion of the cessation may well restrict the tax benefit of large intra-group reinsurances and would, in effect, be using transfer pricing principles to give effect to the Neal Bill proposals via “the back door”.

Transfer pricing rules require the terms of a connected party transaction to be “arm’s length” and as they would have been between unrelated entities. They have traditionally been seen as the simplest, and potentially most successful, way for fiscal authorities to challenge intra-group reinsurance. Most tax authorities would admit that their ability to challenge arrangements in this way was hampered in the past by their lack of experience and detailed understanding of the insurance and reinsurance industry. The last two years has seen a significant investment by many revenue authorities to strengthen their

teams in this market and today they are able to allocate dedicated and highly skilled resources to focus on this issue.

The recent judgment in the DSG captive tax case by the members of the Tax Tribunal in the UK shows a detailed understanding of the way an insurance premium is priced. It would not be unreasonable to expect more challenges of this type in the future.

Be prepared

While many of the above items are “proposed” changes only, it would be prudent for senior management to run some business scenarios to understand the impact they may have on an individual or collective basis. The results will highlight the need to create contingency plans should the various changes take effect.

In the past, insurers have tended to organise their tax affairs in line with their commercial structure and needs. It may not be so easy to manage the impact of Solvency II. Regulatory and tax arbitrage will be key to the competitiveness and success of jurisdictions as insurance marketplaces, and the treatment of intra group reinsurance will be one of the key factors.



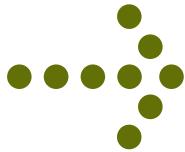
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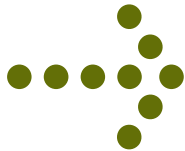
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