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Economic Advantages of Offshore Life Reinsurance

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The press and the United States government have paid attention to the negative connotations of “offshore,” particularly regarding tax avoidance and money-laundering schemes. There are, however, legitimate means of conducting reinsurance business offshore, and there are often cost savings in doing so. In fact, most of the large reinsurers have their own offshore companies, and much of the reinsurance obtained from U.S. reinsurers is retroceded offshore.

Legal, financial and tax advisors should be consulted regarding the issues discussed here. This article is meant to be general in nature and is not meant to replace such consultation.

This article discusses some of the economic advantages of reinsuring life insurance offshore whether it is with your own captive company, a “rent-a-captive” or an existing offshore reinsurer. It is based on information gathered regarding life reinsurance in the Bahamas, Barbados, Bermuda, the British Virgin Islands and the Cayman Islands. These are the primary locations of interest to U.S. insurers because they are well



established with respect to “exempt” insurance companies. Other locations, such as Panama, Belize and other Caribbean islands, are developing the laws and expertise needed to attract insurance companies. European insurers have shown interest in Guernsey, Isle of Man,

Luxembourg, Ireland and other locations for offshore reinsurance, which are not addressed here.

Exempt insurance companies are insurance companies incorporated in one of these offshore jurisdictions for the purpose of insuring non-domestic risks. These companies are exempt from some of the local requirements for domestic insurers and are exempt from local taxation for at least 15 years from the date of incorporation.

Some of the differences in United States and offshore life reinsurance are listed, then discussed, below:

1. Reserve standards and compliance
2. Actuarial testing and certifications
3. Taxation
4. Investment restrictions
5. Solvency requirements

Reserve Standards and Compliance

United States

The US has a proliferation of laws, regulations and guidelines that the actuary must follow when setting statutory reserves for U.S. domiciled companies. These regulations and guidelines often change and are inconsistent among states. Triple X, “The Valuation of Life Insurance Policies Model Regulation,” is an example of a regulation that quickly changed the rules for reserving for many life insurance products. Actuarial guidelines have further complicated the reserving arena with their various requirements. Use of conservative mortality and interest assumptions is also mandated.

Offshore

Offshore life insurers are required to calculate statutory reserves and other financial items according to “generally accepted accounting principles.” These principles may be those defined in the International Accounting Standards, in Canadian standards or elsewhere. U.S. GAAP-like reserves are often acceptable, as are reserves calculated according to other methods approved by the company’s independent auditor and the Supervisor of Insurance. The international and Canadian standards generally demand the use of best-estimate assumptions, possibly with some

margins for adverse deviation. The international standards for life insurance are in the development stage.

For the most part, offshore jurisdictions allow much more flexibility and reliance on actuarial judgment than found in the U.S. jurisdictions. Rather than establishing many laws, regulations and guidelines, their goal for exempt insurance company legislation is to promote business and minimize red tape while ensuring the solvency of the companies.

Actuarial Testing and Certifications

United States

Once the revised Actuarial Opinion and Memorandum Regulation (AOMR) is approved, all U.S.-domiciled life insurers must perform cash flow testing annually and must have an actuary sign a certification annually with respect to asset adequacy.

Offshore

Offshore actuarial certifications, when required, are often simply worded documents that certify that the policy liabilities make appropriate provision for obligations or that the actual company liabilities are correctly reflected on the financial statements. In many jurisdictions these certifications may be only a few sentences in length.

Taxation

United States

U.S. insurers incur federal income tax, including equity tax for mutual companies, DAC tax, state premium tax and Guarantee Association fees. With respect to offshore reinsurance, there is an excise tax of 1 percent of gross life insurance premiums paid to foreign entities (i.e. those not electing to be taxed as a U.S. tax entity). Repatriation of profits to the United States from offshore reinsurers is taxable.

Offshore

Offshore exempt companies incur no domestic income, capital gains or premium taxes, but there are government registration fees, stamp duties and other indirect taxes. The other fees and taxes generally do not exceed \$10,000 per year, but may increase with company size. If the

exemption from taxes is not guaranteed to be permanent, the government may guarantee such exemption for 15 to 20 years from the date of incorporation. The duration of the tax exemption varies by jurisdiction, and the guarantees may sometimes be renewed. Offshore tax savings may flow to the U.S. insurer through reduced reinsurance premiums.

Offshore insurance companies, particularly those owned by U.S. companies, may elect to be taxed as U.S. tax entities under Internal Revenue Code 953(d). Under this section, a foreign company may enter into an agreement with the

U.S. Internal Revenue Service to be taxed as if it is a domestic U.S. corporation, and it may be required to post a letter of credit securing the prompt payment of applicable U.S. taxes. The company would then be taxed by the United States on its worldwide income. The premium excise tax would not apply, and there is no "repatriation" of profits to be taxed.

Investment Restrictions

United States

State laws restrict U.S. insurers as to how much they may own of particular investments. For example, the amount of common stock owned is limited. Furthermore, companies are restricted indirectly through the risk-based capital formulas. These formulas assign large amounts of required capital to certain asset classes, making it difficult for U.S. insurers to invest heavily in those asset classes.

Offshore

Offshore jurisdictions have few, if any, investment restrictions for exempt insurance companies, and those that have restrictions may waive them on a case-by-case basis.

Solvency Requirements

United States

The initial capital required for U.S. companies varies by state. Risk of insolvency is minimized through the conservative nature of statutory reserves and is monitored through asset adequacy and cash flow testing.

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Differences in United States and offshore reinsurance

	United States	Offshore
Reserves	Tabular; complicated variety of rules by state; conservative assumptions	Flexible Best Estimate Assumptions
Actuarial Certification	Asset Adequacy Testing	Certify Reserves
Taxation	Federal Income Tax Mutual Company Equity Tax DAC Tax State Premium Taxes Guarantee Association Fees	No income, capital gains or premium taxes for at least 15 years Government fees generally less than \$10,000 annually U.S. Federal Excise Tax of 1%
Investments	Restricted	Few Restrictions
Solvency	Varies by State	\$200,000 - \$300,000

Offshore

Offshore jurisdictions require initial capital of \$200,000 to \$300,000 to incorporate an exempt life insurance company. Risk of insolvency is monitored and minimized through annual certificates of solvency, early warning operating ratios, minimum solvency margins and/or minimum ratios of net worth to premium income.

The chart above summarizes the differences in U.S. and offshore reinsurance.

Demonstration

To demonstrate the potential financial benefits of some of these differences, we will look at the reinsurance premiums required on a sample nonrenewable term product to meet the reinsurer's profit goal and show the step-by-step impact of changing assumptions from U.S. reinsurance to offshore reinsurance. With each assumption change, the reinsurance premium is adjusted to calibrate the profit for each profit cell to the five percent of premium profit goal. The sample product uses generic assumptions and is not representative of any insurer's particular product. The profit goal of five percent of premium may not meet a reinsurer's profit goal for a similar product. This demonstration is for illustrative purposes only. Actual premiums and premium savings will differ from those shown. Actual profit results after reinsurance should be tested using actual product assumptions and actual quoted reinsurance rates to ensure that the profit goals of the company are being met.

The values discussed are shown in the tables and graphs following the discussion. The base profit study consists of a U.S. company reinsuring model cells representing males and females, preferred, nonsmoker and smoker, issue ages 25, 35, 45 and 55, for 10-, 20- and 30-year term periods. The profit goal after tax and target surplus is five percent of premium with a discount rate equal to the net investment rate of six percent. Reasonable assumptions were used for lapses and mortality. The premiums and premium changes demonstrated for each assumption change below might not be indicative of actual reinsurance premiums quoted by U.S. and offshore reinsurance companies but are used for illustration.

1. Change to Offshore Reserve Standards

The first assumption change in moving from U.S. reinsurance to offshore reinsurance is the use of offshore reserve standards. Offshore reserve standards often permit lower reserve levels than those required by U.S. statutory reserve laws and regulations. If the offshore valuation actuary and auditor believe that deficiency reserves are redundant, the offshore reinsurer may hold reserves equal or near the basic reserve level. Reducing the reserves to the basic reserve levels allows a 13.4 percent decrease in the composite reinsurance premium rate to maintain the five percent of premium profit margin. Higher ages and longer guarantee periods incur the greatest reductions in reinsurance premium. To the degree the

actuary deems that reserves higher or lower than the basic statutory reserves are appropriate, the available premium decrease may be less or more.

2. Reduce Target Surplus

The second assumption change is the reduction of target surplus from 250 percent to 100 percent of risk-based capital (RBC). Again, the implication is that targeting surplus at 100 percent of RBC is adequate. The reduction in target surplus allows a decrease in the composite premium of 4.7 percent of the original premium to maintain the five percent of premium profit margin. In this case, the greater effects are seen at the lowest ages and guarantee periods. Again, to the degree the actuary deems that higher or lower surplus is appropriate, the available premium decrease may be less or more. The ceding company's RBC requirement will also be reduced by going offshore in that the reinsurance reserve credit addition to RBC is canceled out by the letter of credit, trust account or funds withheld account. The effect of this reduction in RBC for the ceding company is not reflected in these premiums.

3. Use of a non-U.S. Tax Entity

Assuming the offshore reinsurer is not a U.S. tax entity, FIT does not apply, allowing the reinsurer to now reduce the original composite premium by another 7.4 percent to maintain the five percent of premium profit margin. The DAC impact on the ceding company and the reinsurer is ignored, assuming the net reinsurance considerations are \$0 in every year.

4. Add Federal Excise Tax

The direct U.S. insurer will incur a federal excise tax of one percent of net premiums paid to non-U.S. tax entities, directly increasing the ceding insurer's cost. Assuming that the offshore reinsurer reimburses the U.S. insurer for the federal excise tax, the composite premium increases by .9 percent of the original composite premium to maintain the five percent of premium profit margin.

5. Add Cost of Letter of Credit

In order for the U.S. insurer to receive a full reinsurance reserve credit, and assuming that the offshore reinsurer is not "admitted" in the insurer's domiciliary state, a letter of

Reinsurance Premium Development - U.S. to Offshore
Composite Premium Rates per \$1,000

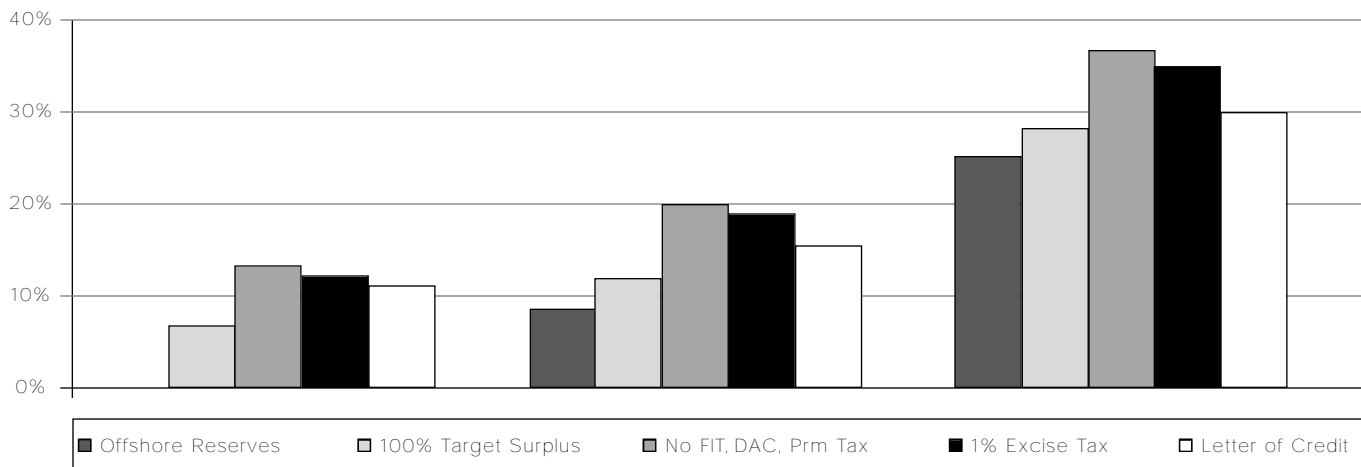
Assumption Change	Base	(1)	(2)	(3)	(4)	(5)
Term: 10	1.75	1.75	1.64	1.52	1.54	1.55
20	2.59	2.36	2.24	2.07	2.10	2.18
30	3.76	2.84	2.70	2.39	2.42	2.63
Composite All Term Periods	2.65	2.29	2.17	1.97	2.00	2.10

Decrease as Percent of Base Premium

Assumption Change	(1)	(2)	(3)	(4)	(5)	Total
Term: 10	0.0%	6.4%	7.1%	-1.1%	-0.8%	11.6%
20	8.7%	4.7%	6.5%	-1.0%	-3.2%	15.6%
30	24.4%	3.8%	8.2%	-0.7%	-5.6%	30.0%
Composite All Term Periods	13.4%	4.7%	7.4%	-0.9%	-3.6%	20.8%

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Cumulative Percent of Premium Changes by Term Period



credit, trust account or funds withheld arrangement must be made. A letter of credit issued at a cost of 60 basis points is assumed, resulting in an increase in the composite premium by 3.6 percent of the original composite premium to maintain the five percent of premium profit margin.

The final result is a 21 percent potential reduction in the reinsurance premium between a U.S. reinsurer and an offshore reinsurer. Note that only term insurance is addressed here. The results for other types of insurance products, such as whole life, annuities and long-term care are expected to differ from these results.

The following tables and charts summarize the composite premiums and their step-by-step changes. The assumption changes are as follows:

Base: U.S. Reinsurer

- (1) Use offshore reserve standards
- (2) Set target surplus at 100 percent RBC
- (3) Use of a non-U.S. Tax entity
- (4) Add one percent excise tax
- (5) Add 60bp cost for letter of credit

Offshore Options

There are three main options for reinsuring offshore:

1. Reinsure with an existing offshore reinsurer.

Appropriate due diligence on the offshore reinsurer is required. To the degree the risk

is transferred to the reinsurer, so are the profits. Potential difficulties with cross-border legal disputes and currency risks must be reviewed.

2. Start a captive reinsurance company.

This will keep the risk and the profits within the ceding company's family. The cost to set up and operate a captive includes government and license fees, audit fees, captive management fees, legal fees, local director's fees and, in those jurisdictions requiring local meetings, annual meeting costs. The jurisdictions vary somewhat in government and management costs, but the deciding factor for location will often be based on local expertise and working relationships with government officials, insurance managers, banks and lawyers.

3. Reinsure through a "rent-a-captive," allowing the company to retain the risk and more of the profits without incorporating its own subsidiary.

The management fees must be analyzed with respect to the savings otherwise incurred. The rent-a-captive should have segregated portfolios to protect the ceding company's coverage from losses of other client companies.

Conclusion

There are economic reasons to reinsure offshore. The reinsurance actuary should explore offshore opportunities to determine the potential benefits for his/her company. ✍



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