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INTERNATIONAL REINSURANCE

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What opportunities are you missing by not looking beyond your country's borders for reinsurance? What can we learn from the casualty industry, where international reinsurance is commonplace? A discussion of the issues including:

- Profit potential
- Regulatory concerns
- Taxation
- Security
- Costs

MR. JAY A. NOVIK: I am Vice President of North American Reinsurance Company, a wholly owned subsidiary of the Swiss Reinsurance Group, one of the world's largest reinsurance companies. I have been involved in reinsurance for about six years, the last three years primarily concerned with property and casualty business.

We have a very distinguished panel today. In alphabetical order, Mr. Gordon Dowsley is well known to many of you who read Best's Life & Health Report. He is a prolific writer on tax and reinsurance topics, and is an Assistant Vice President at Crown Life Insurance with varied responsibilities including taxation, reinsurance, acquisitions, corporate development and government relations. Our second panelist, Mr. Steven Fickes, is a Consultant with Tillinghast, Nelson and Warren in the Jacksonville, Florida, office. He has responsibility for coordination of all of the firm's international reinsurance consulting business, and specializes in international taxation, international strategic planning, international insurance and United States (U.S.) taxation. Last, I would like to introduce Mr. Kirk Roeser, an FSA.

*Mr. Dowsley, not a member of the Society, is the Assistant Vice-President of Reinsurance in the International Operations Division of Crown Life Insurance Company.

He is currently President of Gill and Roeser, a reinsurance intermediary specializing in financial reinsurance programs. He started his career at Mutual of New York, where he had varied responsibilities, including the formation of MONY's property/casualty (PC) reinsurance subsidiary, MONY Re. He left MONY Re in 1979 to become Senior Vice President of North American Reinsurance Company, then in 1983, with Mr. Ardian Gill, formed Gill & Roeser.

MR. STEVEN W. FICKES: I will start with a summary of the various considerations, and some obstacles, involved in international reinsurance. The emphasis of the first part of my talk will be on reinsurance in Europe, primarily the United Kingdom (U.K.), since a lot of the problems over there would be the same wherever one went. The first thing to look out for in the European market, and at the same time this is an opportunity for reinsurance between the U.S. and Europe is the European Economic Community (E.E.C.) solvency margins.

I don't know if you are familiar with the E.E.C., but it was formed in order to facilitate trade between European countries. Of course, one of the arguments that insurance companies in Germany advanced about the prospect of letting a French company come in was that those companies were not solvent, or that they didn't have adequate capital and surplus. So one of the first things accomplished by the E.E.C. was the adoption of solvency margins. These are formula definitions of what the minimum surplus levels have to be for any E.E.C. company. Very quickly and simplistically, for contracts greater than five years, a company needs to put up $3.00 per 1,000 on the sum assured portion plus 4 percent of the reserves. On contracts between three and five years, a company has to put up only $1.50 per 1,000 plus 4 percent of reserves and if a contract is less than three years, then the company has to put up only $1.00 per 1,000 plus 4 percent of reserves. I think that most U.S. companies would be able to meet these requirements. The problems come in with the new, faster growing companies primarily because of the past profit offsets. Such an offset is granted in the anticipation that one will continue to make profits in the future.

Another consideration in several countries, but I will highlight the U.K., is stamp duties. Every reinsurance policy issued in the U.K. has to be stamped. The stamp duty in the U.K. is 50 pence per 100 pounds sum assured. If the reinsurance involves anything like term insurance, it can be quite costly to reinsure. It's payable only at the inception of the contract, but there is a special provision in the U.K. Tax Act that allows one, for a contract of less than two years, regardless of what the sum assured is under the contract, to pay only 5 pence. So one can reinsure billions of dollars by paying only 5 pence.

Another item to look out for is currency exchange risk. People have solved this by always putting the funds in the currency of the ceding office's domicile, so one always deals with what the original insurance is denominated in. But, a lot of times, companies aren't aware that there are hidden risks behind this. I will cite one example that I have run across in the U.K., to illustrate this.

Let's assume that on January 1 we have this particular policy in the U.S., and the currency exchange rate is a $1.50 per pound (that's what it was about a year and a half ago). We reinsure this in the U.K. The U.S. company would show the amount owed the U.K. company as $150, for example, and take a reserve credit for that amount. Then the U.K. company would take this exact same policy and put it on its books in pounds. So it has 100 pounds as an asset (the amount due for the U.S. company) and a 100 pound reserve. As of December, of course, the U.S. books remain identical to what they were on January 1. But now we see exactly what happened last year-end when we went to an exchange rate of $1.00 per pound. Now the U.K. company goes through a revaluation. It is allowed to restate its assets, valuing them at the current rate. A $150 asset comes to be worth 150 pounds. The reserves also get restated, but one of the things about U.K. companies is that they do not get to take the increase in life reserves into account in computing taxation. They are taxed on an income minus expense (I-E) basis and what will happen is, for tax purposes, they will end up with a statutory gain, or a tax gain of 50 pounds, because the increase in assets of 50 pounds is due to changes in exchange rates. However, for tax purposes, they will not be allowed an offsetting reserve increase, so they end up with a tax on 50 pounds, without a statutory gain. This happens quite often, again one has solved the currency problem directly, but indirectly one has gotten some back-end problems to look out for.

The next item on my list is federal excise tax. Anytime you do any business with a foreign insurance company, you have to deal with federal excise tax. For direct casualty insurance on U.S. property written by a foreign casualty company, the federal excise tax rate is 4 percent of premiums. On casualty and life reinsurance, it's .1 percent of premiums. A couple of countries are exempt from this by tax treaty--the U.K. and France. Federal excise tax becomes quite important in the Caribbean and Bermuda.

Another item is withholding tax, the U.S. Government imposes a withholding tax which is really not a withholding tax, it's just a tax on the investment income a foreign company earns in the U.S. This is 30 percent of investment income. So it becomes quite important if one reinsures with a foreign company holding U.S. assets. It may be required to pay the 30 percent withholding tax.

Another thing, as of late being recognized as not working out too well, is the use of letters of credit (LCs or LOCs). If a U.S. company reinsures business with a foreign company, and if it uses the money to establish reserves in its own country, it is going to have to give the U.S. concern a letter of credit to allow it to take the reserve credit. One recent problem is that although the reinsurance agreement will say that the letter of credit is attached to and made a part of the contract, and cannot be separated under any terms, a few U.S. companies have discovered that the staple remover works fine to separate the letter of credit from the reinsurance treaty and have taken them down to the bank and cashed them in. So letters of credit can be quite dangerous, primarily from a foreign company's standpoint.

At one time surety bonds were thought to be the save-all to letters of credit. The problem with surety bonds, though, is that regulatory officials just don't seem to understand them. I have one client, for example, who was going to enter a reinsurance treaty with an unauthorized company and they were going to use the surety bond. They went to the state insurance department, and asked: "Can we use this?" They were told: "It's fine as long as you back it with a letter of credit." So the use of surety bonds doesn't always work, that is probably more a question of understanding than anything else.

The newest trend that we are seeing is in the use of trust and escrow arrangements for reinsurance agreements, both internationally and domestically. This has the better attribute that one can actually transfer assets, which many times, especially for tax purposes, is advantageous.

The next items I thought to touch upon, just to give you an idea of the different possibilities for international reinsurance, are regulatory and tax systems in a handful of foreign countries. This treatment is very simplistic and not meant to be so detailed that you could pass an exam on it.

The U.K. allows the setting of statutory reserves using an interest rate of 7.2 percent, if the company isn't in a current tax paying position and doesn't perceive to be in the near future. That's higher than in the U.S., which permits some margins for surplus relief to the U.K. on life insurance. On annuities, a company is allowed to use 92 1/2 percent of the underlying asset's rate of return, which provides quite a bit of margin for surplus relief between the U.S. and the U.K. on annuities. The advantage, of course, as I stated earlier, in going to the U.K. is that companies there are exempt, by tax treaty, from the withholding and the federal excise taxes. The U.K. and U.S. tax systems are quite different. Again, U.K. companies are taxed on an I-E basis, so they are not taxed on a profit basis.

Australia follows the U.K., or, I should say the U.K. and Australia were parallel at one time, until the U.K. changed. In Australia the tax system for life companies is similar to the old Phase I and Phase II system in the U.S. where the Phase I investment income is taxed at the full 46 percent tax rate, but Phase II, or underwriting profits, totally escape taxation in Australia. New Zealand patterns its tax system almost identically after Australia. Both New Zealand and Australia generally have more conservative reserving systems than either the U.K. or the U.S.

South Africa has a unique tax system although it is parallel to Australia's in that a company is taxed only on investment income, but it is a very low rate. There the government raises revenues by requiring insurance companies to invest a portion--a large one--of funds backing reserves in government bonds which are generally low yielding.

France has a profit's tax, but, in France one can diminish taxes by moving profits to a branch where they will not be taxable until they are brought back.

The Netherlands has a rather unique system. It is based on profit, but recognizes what are called regulated and unregulated companies for reserving purposes. A regulated company has to exactly follow the law in setting up reserves (and in everything else). But then a company may not be regulated, in which case it doesn't have to follow the prescribed reserving procedures.

Japan's tax system is unique in that a company pays one tax rate if it doesn't distribute profits and another one if it does. So tax planning there involves leveling out earnings to pay level dividends.

Just to make this complete, one of the things I always try to do is treat off-shore insurance and reinsurance separately--I consider off-shore to be Bermuda, the Caymans, the Bahamas--from the rest of the international reinsurance world. Several developments in this area are occurring. First, of course, is old surplus relief where one can actually play with reserving differences, because in all three of the countries just mentioned one can set up reserves on what the actuary feels is a proper basis.

Something new in the Caribbean and Bermuda is deferred compensation arrangements, and these are primarily for agents of insurance companies. An insurance company will establish an off-shore company for agents and reinsurance a portion of all of the agents' business to that company. They (the salesmen) accept lower commissions up-front in order to generate higher profits.

The secret to these deferred compensation arrangements rests in what are referred to as Subpart F income rules. Any U.S. shareholder will have imputed income for tax purposes, derived from the income of a controlled foreign corporation. A controlled foreign corporation is defined as a foreign company if:

1. over 5 percent of its premiums come from U.S. insurance risk, and

2. over 25 percent of its voting stock is held by U.S. shareholders.

Now, the key to all this is in the definition of a U.S. shareholder. To be a "U.S. shareholder," one must own at least 10 percent of the voting stock of the company. So, if there are eleven shareholders, all owning the same amount of voting stock, the company is not a controlled foreign corporation, and no income will be imputed back in the U.S. An example of how one of these arrangements might work is as follows: An agent writing $100,000 in premiums gets $70,000 in commission. In lieu of taking the $70,000, he writes a product with reduced commission, and may take only $25,000 up front. The rest, through the magic of reinsurance, appears off-shore.

Then, of course there is the old grandfather of off-shore reinsurance, the credit insurance captives. These are still alive and healthy.

The newest trend in off-shore reinsurance is salary savings business. Companies are now subdividing off-shore captives in order to reinsure salary savings business back to the employers that control the business in the U.S.

This was just intended to give you a flavor of what's going on in the international reinsurance field now.

MR. GORDON DOWSLEY: Canada has experienced a tremendous expansion in reinsurance within the last decade or so. At one time, the Canadian reinsurance market was pretty well dominated by branches of European companies, with a few players from the U.S. But in the last few years, big Canadian companies have come into the field with a real vengeance. We now have retrocessionaires and a lot of direct written business reinsured, we have special risk products coming here from all over the world and we conduct a lot of financial reinsurance. I think that, typical of this expansion of activity in Canada, is the formation of the new Toronto Exchange, or the Canadian Insurance Exchange, which we hope to have in operation in a year. It will take any and all risks from any place in the world, whether they're direct or reinsurance. It will be free of the restrictions that various other exchanges have, and we hope that it's going to further enhance the reinsurance environment in Canada. Of course, it's a great time for a new exchange to get started, given the troubles that Lloyds is having, and given the long range trend where Lloyds is declining and the U.S. exchanges have not been as successful as they might have hoped to be in picking up that slack. So I think, in Canada, we really are in the old reinsurers' mood of: "Let's make a deal." There is an awful lot going on, and you can get almost anything reinsured here.

MR. NOVIK: What is the perceived need for the Toronto Exchange?

MR. DOWSLEY: I guess that depends on who is perceiving the need. In Canada, about a billion dollars a year in PC reinsurance premium is leaving the country. That is also one of the reasons for the formation of the New York, Miami and Chicago Exchanges. There is also a perceived need, at least in the long run, for capacity. Exchanges don't necessarily compete with one another, they enhance one another. Because the risks will be shared back and forth, exchanges and syndicates will be better able to spread their risks. I would say that the long-range capacity problem and the economic exchange problem, with the billion dollars a year leaving the country, would probably be the two big reasons for the formation of the Toronto Exchange. Then, of course, the various companies will be getting into it because of the perceived profits.

MR. NOVIK: Mr. Roeser, would you comment on international reinsurance in the casualty area?

MR. KIRK G. ROESER: In the mid 1970s, I switched from the life business to the casualty business. I have thus been able to observe differences between the two. One which stands out in my mind is the type and variety of losses in the property and casualty business and its here-and-now nature. In 1975 I left MONY to report to my new assignment at MONY Re. MONY Re's offices in downtown New York overlooked the East River and beyond that, Brooklyn. On my first day

I encountered the chief of property facultative underwriting (that's individual risk underwriting) at his desk with area maps of lower Brooklyn. These area maps were of the Gowanus Canal and fuel storage depots. There were about a dozen of them, and he was the reinsurer on approximately a third of them, apparently randomly located. He had an open telephone line to an underwriter from another company, and they were watching the depots blow up, comparing notes as to who was on which risk. A depot would blow up and an assistant underwriter would run in saying: "$300,000 on that one." Then on the next one, they would scrape by with no loss. What impressed me was that there was something very immediate about the business.

At the Swiss Re, one of our Austrialian underwriters told me the following story: He had agreed to reinsure helicopters in New Zealand and was experiencing bad losses. Helicopters had been pretty good to him in Australia, so he traveled to New Zealand to investigate. There, they were being used for ranching, which he knew, but what he didn't know is that in New Zealand the macho approach to ranching was to use these helicopters to close the corral gates at the end of the day--this by spinning the tail of the hovering helicopter against the gate. The damage incurred to the helicopter was in the main rotors. The helicopters were turning on their sides, the rotors were pommeling into the ground and the insides of the helicopters were being turned up, generally rendering them a total loss.

I will refer to casualty business, in general, as covering anything that's nonlife insurance. It is an international business, and always has been. It always will be that because of the need the casualty business has for worldwide capacity. I'll give you, for a frame of reference, some statistics. The casualty business in the U.S. is a $100+ billion business (measured by premium volume). An excess of 10 percent of that is reinsured, so that the U.S. has a $10-12 billion reinsurance market. About two-thirds of that stays in the U.S. and one-third is reinsured with what is called alien reinsurers. Thus $3 to $3 1/2 billion is being exported. As Mr. Dowsley mentioned, Canada, with an $8 billion direct market, is exporting $1 billion. So in the North American continent, a fair amount of reinsurance is, in fact, shipped overseas. By comparison, and maybe Mr. Fickes could put a finer point on this, 2-3 percent of life reinsurance direct premiums are exported.

MR. FICKES: In that regard, I think if you rounded all the traditional, nontax motivated, nonsurplus relief motivated life insurance going overseas, probably the closest percentage would be zero. Very, very little international reinsurance is traditional life business. The reinsurance business going from the U.S. to Europe generally involves casualty-oriented risk such as Credit Life, Credit Accident and Health (A&H) and A&H in general, so I would say 2-3 percent would probably be a generous estimate of exported life reinsurance.

MR. ROESER: Of the worldwide reinsurance premium volume, approximately 90 percent is casualty and 10 percent is life. The U.S. reinsurance casualty business is $10 billion, or a fourth of the reinsurance business generated worldwide--a $40 billion market, at the moment, of which two-thirds is generated in Western Europe. If these figures seem soft, it's because reinsurance data is soft.

It's estimated that between one-fourth and one-half of all worldwide reinsurance business crosses a national boundary at some point. Thus international reinsurance is, quite obviously, important to casualty reinsurers. The question is "Why?" Let me define what international or exported reinsurance means. In the U.S., a domestic reinsurer is a reinsurer conducting business in its domiciliary state; a foreign reinsurer is a reinsurer conducting business in a state other than its domiciliary state; it is neither of those two reinsurers that we are speaking of. We are speaking of a third category which is the alien reinsurer, which is a company domiciled outside of the U.S. conducting business there.

Casualty reinsurance serves essentially four purposes:

1. Capacity

2. Financial relief

3. Stabilization of underwriting results

4. Protection against natural perils, for example accumulated losses from wind storms, earthquakes, and floods

In the area of capacity, insurers purchase reinsurance to spread large risks, for two basic reasons,

1. to obtain enough coverage to cover the risk, and

2. to attempt to move the risk around to other geographic or national markets for conservatism.

The numbers can be large. Due to the Soviet (U.S.S.R.) boycott of the 1980 Olympics, the National Broadcasting Corporation (NBC) was paid $78.3 million by Lloyds, and recovered from other reinsurers as well. At the moment, there are oil rigs in the North Sea with billion dollar values. A number of them sit on the worst fault line on the planet. The need for capacity actually goes beyond what can be provided on a worldwide basis. Satellite launchings, pharmaceutical products, hazardous substances (such as Agent Orange and asbestos), risks unique to the U.S. (such as medical malpractice) and industrial accident exposures (such as Bophal in India) all demand the worldwide resources of reinsurance capacity.

The second need for reinsurance is financial relief. This is similar to life reinsurance, the relief of surplus strain created by new business writings. This reinsurance need does not push anyone into worldwide markets, it can be satisfied domestically.

The third need for reinsurance is stabilization of underwriting results, basically, chronological stabilization. This need can also be met domestically.

The fourth need is for protection against natural catastrophes. This does require the worldwide market. The 1906 earthquake in San Francisco demolished 500 city blocks. The insured losses were $300 million. Lloyds paid for $100 million of that, and paid it promptly. Actually, many other reinsurers and insurers did not pay.

The insurance industry tabulates natural catastrophes and serializes them. These are known as designated catastrophies--hurricanes, tornadoes and the like. There are approximately fifty per year. In 1979 there were fifty-four. There were roughly forty per year during the 1970s. In 1979 hurricane David caused $122 million of insured losses. Hurricane Frederick, that same year, caused $.75 billion of insured losses. Tornadoes in Wichita Falls that year were $.25 billion. These were considered relatively mild storms. The industry is hard pressed to estimate what the total insured loss would be from another hurricane of Betsy's force and path, which, in 1965, worked its way up the East Coast of the U.S. The industry is also hard pressed to estimate the insured and noninsured damage potential from another major earthquake in California, but the estimates are in the billions. (An earthquake loss would be aggravated if it occurred during working hours, because of the workers compensation claims that would accumulate.) That's a thumb-nail sketch of why the casualty business has historically looked, and will continue to look, beyond its own borders to meet its reinsurance needs.

MR. NOVIK: I guess you and Mr. Fickes are in agreement that there doesn't appear to be a great deal of activity, or need, to reinsure traditional life coverages internationally. Mr. Fickes, do you agree with that?

MR. FICKES: European reinsurance of traditional business comes from companies interested in ultimately entering a particular country as a direct writer. For example, if you're interested in going into the U.K., you may want to start by reinsuring some U.K. business. The same thing works in the other direction. However, just for the sake of capacity, and the fact that U.S. reinsurers are so generous with their allowances on traditional business, my company isn't forced to go to France or other countries to get better deals. It can get them right here in the U.S. So, no, I don't see a great need unless there is some other reason to go abroad.

MR. DOWSLEY: Can I raise a question on this as to why we don't seek reinsurance around the world, either to cede or to receive? It's similar, I think, to the question of the direct products of insurance. I wonder if we, as an industry, do not have a lack of faith in our products. I think that our industry is perhaps the most unself-assured of any industry in North America. If you look at the farm equipment industry, those companies went and sold machinery around the world. When someone invented a cutter, they didn't say: "Well, gosh, you know the Japanese or the Brazilians, or the Argentineans, the Australians, they all have cutters too." They went out and they sold them. When they came up with a new idea, they said, "Hey, we've got a machine here that not only thrashes the wheat, but it cuts the straw and bails it all at the same time." They went out and they sold those things around the world. You find that the farm machinery industry in North America is worldwide. What is it about our industry that when we invent a new product, whether that be family life plans going back into the 1950s or universal life or whatever, we do not sell it all around the world? I suspect that deep down we are all saying, "Well, life insurance is an example of numbers, you have a mortality table which gives you some probabilities; you have some interest rate assumptions and you put together a basic product, now you may change, add a few bells and whistles and in fact we might even separate the savings and risk portions. But other countries are doing the same thing so there is not much opportunity there." I think we are in the only industry in North America that takes that attitude.

MR. NOVIK: Do you really think we have that much innovation in the U.S.? The product you are talking about, universal life, was developed in South Africa about thirty years ago and later carried into the U.S. When we do have some innovative products, they get transported. Right now, a lot of the world is interested in utilizing our mass marketing expertise, which was particularly well developed in the U.S. Companies like American Family, with their cancer product, are doing very well in Japan and elsewhere.

MR. DOWSLEY: Well, if we are not as innovative as the insurance industries in other countries, that's a more telling damnation than what I said about simply lacking faith in ourselves. We have invented a great deal in life insurance in North America that we can be proud of. It's true that there is nothing new under the sun, but I will cite an example of innovation. Recently, I saw a reproduction of ads in Canada at the turn of the century. Those were for blue jeans, workers' overalls, which I think cost $1.25. However, if you bought those overalls, you got a life-insurance policy that paid $100 if you were killed while wearing those overalls. We have invented a lot of things in the North American industry, but we haven't exported those and we haven't said: "Here is the idea we are going to go out and sell around the world."

MR. NOVIK: Getting back to reinsurance, could you go into a little more detail about U.S. regulatory requirements regarding alien reinsurers?

MR. DOWSLEY: Regulatory requirements, any place in the world and whether they be for reinsurers or direct writers, are centered on solvency. I think the standard procedure is, if you are not a national company, I mean by that incorporated within the country in which you are selling your business, you have to put up trust funds. This, of course, brings about the interesting fact that if you live in Canada, you are much safer dealing with an American company because the trust funds are there. The reverse is true in the U.S., you should be dealing with a Canadian company because Canadian companies have trust funds set up. It is a strange quirk in the regulations. These requirements come to bear through the issue of reserve credits. If your company cedes to another company that is not licensed, then you are not allowed to take the reserve credits. I think that is a pretty standard rule around the world.

That brings us into the whole area of letters of credit, which brings us to surety bonds, MODCO Insurance, coinsurance with funds withheld and so on. I know that letters of credit are currently under a shadow for a variety of reasons. In the Cherokee case (I believe that is being heard in New York), there is some question as to whether or not the bank would actually come up with the money when the letter of credit was called. The Ideal Mutual case is another one where the letters of credit have come under attack. That's an interesting case, and many of you may have been involved in the debate. I was at a conference recently where about half the people felt that Ideal Mutual really had done nothing wrong, there was just an over zealous reaction by the authorities--who were really upset with Ideal Mutual because it was too heavily involved in the captive market. The other half felt that the regulators if anything, were too lax. One of the problems, the regulators said, was that the letters of credit were not sufficient to cover the risks, and the reinsurers were really not standing behind the risk. It's interesting, because, if I just might mention it, one reinsurer (there have been articles written on it) operated out of a bordello in Amsterdam. It was set up in order to guarantee the bonds for a gold mining company down in Bolivia, that, of course, was owned by the same people. So you do get into a lot of interesting regulatory questions, and, if you have to do on-site investigations in other countries, you never can tell where you may end up.

MR. NOVIK: How many people are familiar with the Ideal Mutual situation? Ideal Mutual is a medium-sized property/casualty mutual insurance company domiciled in New York, and has recently been put into rehabilitation or liquidation. It has a stock subsidiary called Optimum Insurance. There is a major controversy over the fronting activities of Ideal Mutual. Ideal accepted business from many major U.S. corporations and reinsured it out to the captive subsidiaries of those corporations. While we probably won't know for years exactly what went wrong at Ideal Mutual, I would guess that it was the other risk business that they were taking in, and not the business flowing to these captives, that caused the problems. I think the LC issue and reinsurers operating out of bordellos are probably a minor part of the whole problem. Mr. Fickes, you mentioned something about having troubles with LCs and moving into trust and escrow accounts. Could you comment on that?

MR. FICKES: As I said, the problem we have been seeing with LCs is that people do remove them from the basic reinsurance agreements. About five years ago there didn't seem to be a problem, maybe that's because nobody realized that they were clean, and if you didn't bring the reinsurance agreement into the bank along with LC, they would cash it. But the problem right now is that LCs are so liquid. In order to be approved by a state insurance department, the letter of credit must be clean and irrevocable, and there can't be any conditions in the LC itself. As a result of that, and just to make transactions have the appearance of more legitimacy, we're seeing people actually put the money in trust or in escrow, and money actually does move. The other party can't place their hands on it, but at least it moves out of your own company.

MR. NOVIK: Mr. Roeser, you are familiar with the New York requirements. Under New York law, would there be the same accessibility to trust funds as with letters of credit?

MR. ROESER: New York Circular Letter 19 cites the situation Mr. Fickes mentioned earlier, putting "near cash" in the hands of the beneficiary (the ceding company). It also requires an Evergreen Clause, as probably will the NAIC model LOC bill. An Evergreen Clause requires the issuing bank to notify the beneficiary thirty days in advance if it is not going to renew the letter of credit. Letters of credit work pretty well when all parties are solvent. The problem now is what happens in an insolvency. Individuals from more than one company have confided to me that the first thing they would do to raise quick cash would be to go in and draw down all the letters of credit they were holding. There is also concern about what liquidators will do when presented with a stack of letters of credit. So, it's the insolvency scenario which defeats the original purpose of letters of credit. Trust agreements, at least as drawn up in New York, have been used by some carriers to replace LCs. New York Regulation 114 permits the ceding company, rather than turn the funds over to an alien reinsurer, to withhold them in such a trust and to obtain reserve credit.

MR. NOVIK: Mr. Roeser, are there any other New York regulations that you wanted to discuss?

MR. ROESER: We've covered them all pretty well. Property and casualty ceding companies seek to obtain credit for ceded unearned premium reserves, ceded loss reserves and, as of the middle of last year, ceded incurred but not reported (IBNR). There is a new administrative nightmare for companies operating in New York, since the letter of credit for IBNR cannot be backdated. It has to be in place as of December 31 and cover IBNR as of December 31, which, of course can be done only on an estimated basis. It's creating havoc, and is a major problem with respect to U.S. business reinsured in Europe and the U.K.

The subject of surety bonds is interesting. In November of last year, the New York Department released Circular Letter 17 reversing its previous position that a surety bond guaranteeing the performance of a reinsurer was an acceptable form of security. New York reasoned that it is invalid for a surety writer to provide a performance bond against an insurance operation.

MR. NOVIK: There is one other regulation, Regulation 102, that might be mentioned. This regulation sets forth a number of restrictions on reinsurance contracts in order to obtain credit in New York State. I am not going to discuss it in any depth. There is also a letter out from Commissioner Bunner, of California, which essentially replicates 102. These enhanced requirements for obtaining reserve credit from reinsurance treaties will be something that we'll have to deal with on a broad basis in the future. This will obviously also affect any international reinsurance. In talking about regulatory requirements, one of the objectives of a lot of these transactions is to utilize differences in regulatory requirements throughout the world. Mr. Dowsley, would you care to comment on this?

MR. DOWSLEY: I am not sure if there is an implied criticism in that question, as to reinsurance trying to circumvent regulatory requirements. I don't think that circumventing regulatory requirements itself is an evil. It really depends what the requirements are. If, for instance, the actuary feels that the reserving table he is required to use is outdated, and this requires him to set up deficiency reserves that are not needed, then I don't think that it's evil to reinsure those deficiency reserves. Of course, the gimmick used to be to reinsure this business in the U.K., where the receiving company is not required to set up deficiency reserves, so the deficiency reserves would disappear some place between here and London. This lead to the description that the deficiency reserves sunk in the North Atlantic. I don't think this is a problem, I think the problem comes when valuation actuaries do not stand up to their professional requirements. Because of pressures of business or because or pressures from colleagues or whatever, they are a little too quick to take reserve credits. There are a lot of companies, I think, in North America that are under reserved now because actuaries were able to, perhaps, bend their standards or whatever. The difficulty comes because no reserve is being held, it's not because reinsurance is involved. I am not quite sure what we can do about that. You can have all the standards and professional codes of ethics that you want, but it doesn't mean that the valuation actuary, for whatever reasons, is going to follow them. Those are some general comments.

MR. FICKES: I would like to comment on this briefly. I think that when you go abroad and sink large reserves between here and Bermuda, the issue of whether or not you really should be doing it arises when you're just playing with reserving differences. We would all be in agreement that the conclusion we came to, or would come to, is that it is acceptable as long as you step back and look at what you are doing and apply some sound actuarial judgment.

A lot of time the U.S. has so many statutory restrictions that when a minimum reserving basis is adopted, it also becomes a maximum reserving basis for everybody. We tend to think that, if it is in the law, we are going to meet the letter of the law and no more, and don't apply a lot of actuarial judgment. It's very easy to get caught up in that. In countries like the U.K., where the actuary has more flexibility, I have seen a lot more judgment exercised. Actuaries set up a reserve according to what the statutes say, and a lot of times they will sit back and say: "That's not sufficient, we need to put more money away." Whereas in the U.S., we get so involved in form over substance, that we get locked in on what the laws are, and we're merely going to meet them. We get into playing games, or just trying to meet the letter of the law, and forget the general principle of what we were trying to accomplish. Does that make any sense?

MR. NOVIK: Your comments make a lot of sense. Do you have any ideas or any suggestions as to what kinds of things can be done, where the substance of the transaction can create advantages?

Mr. Fickes, do you have any comments in the life area? For example, we were talking about deficiency reserves and other differences in regulatory environment in various countries. Are there any areas where there is obvious potential for advantageous exchanges of business?

MR. FICKES: I think, internationally there is potential anytime the laws of two countries are different. Just now, key areas are the Netherlands and the U.K. The latter is a very good choice because the people there speak the same language that we do and they have more liberal practices. I will also recommend any place in the Caribbean, within reason. I wouldn't advise the Turks and Caicos, but there are other legitimate places to go. There are a lot of opportunities for moving business to a home that is a better and more comfortable environment to work with.

MR. NOVIK: Mr. Roeser, I know you have seen a lot of this on the casualty side. In the loss portfolios, we have an enormous amount of reinsurance going to Bermuda. Could you comment on that?

MR. ROESER: The casualty industry is, at the moment, starving for capital, having been through a six- or seven-year period of depressed earnings. A lot of insolvencies have already been reported and there will be quite a few more in the next eighteen months. At the same time, recently, rates have firmed up dramatically. The timing is excellent to gain a notch or two in market share, but capital is needed to do that. The general rule of thumb is that net writings should not exceed three times surplus. Thus, lack of surplus can dampen the ability to move ahead. Many companies are looking at the reserves on their casualty business, which cannot be discounted, and reinsuring them at a negotiated fair-market price. Many times that reinsurance ends up in Bermuda. As Mr. Fickes said, the reserves get dropped into the ocean because, in Bermuda, reserves can be discounted. The transactions do, therefore, generate surplus. They also generate other benefits. A company can stabilize its investment policy by not having to keep as many liquid funds for sudden, early and unanticipated shock losses. The risk of the timing of these payments has been reinsured. Thus, there is the opportunity for the company, beyond having created surplus, to do more in the way of effective financial planning.

MR. DOWSLEY: Can I raise a question there, Mr. Roeser? It's an interesting question that I have heard actuaries raise. You mentioned that the PC companies are forced to hold reserves that are, in effect, calculated without the consideration of the present value of money. That seems very strange to us in the life insurance industry. I heard some people from the PC industry saying that it would be a disaster if they ever allowed PC companies to hold reserves which did, in fact, take into account the present value of money. The reason for that was that their taxes would put them out of business. Do you have any comments on that?

MR. NOVIK: The current tax proposal, for casualty companies, would require that they discount their loss reserves for tax purposes. But, there is nothing in the works right now that would allow them to discount for statutory purposes. This means, in times of major losses, they could easily be generating taxable income while they are suffering statutory losses. That could be a major disaster. I think it is really a myth that, in practice, companies don't discount long-tail coverages. To a certain extent the reserving reflects interest, even though the claim is that they're setting full, ultimate value. But I do think that changing the tax basis radically, without a change in the statutory reserving basis, would create the same kind of problems that it might in the life industry if we were to have a much lower reserving basis. The current life insurance tax proposal is to allow the increase in cash value, rather than the increase in statutory reserve, as a reduction to taxable income. If there were massive differences between cash values and reserves, we would have the same kind of problem in the life insurance industry as discounting reserves on a tax basis would create in the casualty insurance industry.

MR. DOWSLEY: I am a little unclear about your comment. If it is true that the PC companies are discounting, why is it that these loss reserve transfers that Mr. Roeser was talking about work?

MR. NOVIK: Because they are not allowed to discount. We'll get into this later, but basically many companies are implicitly discounting on the reserves they set up. Translated, they are under-reserving. And they need loss portfolios basically to make them even.

MR. DOWSLEY: Well, as a life reinsurer, what does that mean for me? If some of these people come and say: "I have a reserve of 100 which is really not adequate, and I would like to transfer that to you as 80." Should I run or should I take the case?

MR. ROESER: You mean as a reinsurer of one of those transactions?

MR. DOWSLEY: Yes.

MR. ROESER: Most reinsurers of those transactions will put a cap on their obligations. If they are assuming a 100 for 80, they'll actually specify a dollar limit of 100 or 120, or, in some way, cap it. Thus the adequacy of the reserve is germane to them, only to the extent to which it has an effect on the timing of the payment of that limit of 100 or 120. Clearly, if 100 or 120 is in fact 200, the implication would be that the first 100 would pay a lot quicker. So it translates to a financial timing risk.

MR. NOVIK: Mr. Dowsley, could you go into a little more detail on some of the international tax aspects that Mr. Fickes alluded to: the withholding tax and excise tax problems? One of the reasons that a lot of the surplus relief treaties don't work internationally is the excise tax problem. As far as withholding tax, I thought that the 30 percent had been eliminated in the last tax law.

MR. FICKES: I think the 30 percent withholding tax went away, but you have to meet certain qualification rules.

MR. NOVIK: It's got to be a debt instrument issued after a certain date last year.

MR. FICKES: The Internal Revenue Service (IRS) has really been picky about it and so, in essence, a lot of things do not get around the 30 percent any more.

MR. NOVIK: Like what? How about treasuries issued after the date? Does anybody else know anything about this?

MR. CLAUDE PAQUIN: I'm with General Re. The current law provides for portfolio interest to be exempted. For portfolio interest, essentially, the Internal Revenue Code provides for interest issued as part of a bond issue. It's not a casual form of interest payment as might be implicit in a normal surplus relief treaty or what I would call a casual, one-time transaction. If you have a formal bond issue abroad, then the 30 percent withholding tax requirement has been abolished in that respect, but only in that respect. And Mr. Fickes is right in saying that the IRS has taken a rather restrictive view of the whole thing. My recollection is that about two weeks ago, in the Internal Revenue Bulletin, there were some rulings issued in that respect which stated essentially what I have just started here.

MR. NOVIK: Are you talking about situations where cash is transferred and invested in securities, or are you talking about a funds-withheld type of arrangement?

MR. PAQUIN: What I am talking about is any payment of interest by a U.S. entity to a non-U.S. entity. It could be with respect to any sort of arrangement, unless the interest qualifies as portfolio interest. That is part of a regular issue of something like an issue of bonds, which is issued pursuant to a formal program of raising funds abroad and paying interest thereon. Unless you have that formal type of program, and meet the qualifications outlined in the Internal Revenue Code, you are paying casual interest and the withholding tax is a price you pay.

MR. NOVIK: Then what you're saying is that the area that would be exempted is virtually all the new bond offerings of major U.S. corporations and of the U.S. Treasury. It's not a trivial exemption, there are many investments that are exempted from the 30 percent withholding tax. If a major U.S. corporation puts out a new bond issue, that would be exempted from the 30 percent.

MR. PAQUIN: That is correct.

MR. NOVIK: We still have a 30 percent withholding tax, but what it's covering now is much smaller than what it's not covering.

MR. PAQUIN: Yes, I would agree with that.

MR. NOVIK: There is no need now for foreign investors to purchase Eurobonds in order to avoid the excise tax, they can now invest in U.S. securities without any withholding tax.

MR. PAQUIN: That was the purpose, I think, of abolishing the withholding tax on those types of transactions for people who do raise money in a regular or organized, systematic way abroad.

MR. NOVIK: OK, I guess that all I am saying is that the 30 percent withholding tax is essentially eliminated for newly-issued investments with exceptions.

MR. FICKES: Reinsurance is one of those exceptions.

MR. DOWSLEY: I think there are a host of points that could be brought up on withholding. One, it does not apply to any kind of interest credited under a reinsurance contract if the other side of the contract is doing business in the U.S. and paying taxes there. So the branch of the foreign company, if doing business in the U.S., would not cause someone to incur withholding tax. The 30 percent rate is a general rate that is reduced by various treaty requirements, and it may actually be 15 percent or something else.

MR. NOVIK: Any more comments on that? Mr. Dowsley, do you have any comments on the U.S. excise tax?

MR. DOWSLEY: The federal excise tax is a pretty major tax in reinsurance transactions, and most of what I know about that I've learned from you, Mr. Novik. As I understand the situation, the IRS people say: "We think that you should pay tax if you are doing business in the U.S." Therefore, if a U.S. company cedes business to a non-licensed reinsurer, that reinsurer is, in a sense, doing business in the U.S. even though it is not paying any income tax. To make up for that, the federal excise tax is imposed. But that tax, because it involves international players, gets distorted by various treaties. I understand it is a half rate for Guam, it's a zero rate for Hungary, Romania, Bangladesh and the U.S.S.R. In the PC business, there are reinsurance treaties that do cross these borders. In fact there was a case, not long ago, I believe against the Romanian National Insurance Company for not paying up as the New York State Commissioner felt it should.

MR. NOVIK: Any questions?

MR. PHILIP GOLD: I'm with National Reinsurance Company of Canada. I'll take this opportunity to ask Mr. Dowsley, and maybe one or two others of you, what you feel about transactions between Canada and the U.S.? When is it advantageous to move business between those two countries, and what are the problems of being licensed and unlicensed in those situations?

MR. DOWSLEY: Well there certainly must be a lot of opportunity because business is going back and forth across the border with billions of dollars of premiums and tens of billions in face amount. There were several parts to your question. Certainly if a U.S. company feels that it would like to reinsure with a non-U.S. company, then the Canadian companies are their best friends, because the Canadian companies tend to be admitted reinsurers in all fifty U.S. states. So any problems of reserve credits are immediately removed. The Canadian income tax is on the basis of territory, so if you have a multinational insurance company, it pays Canadian income tax only on its Canadian operations. It does not pay worldwide with foreign tax credits as is the case in the U.S. So frequently a transaction can be made on the fact that a Canadian company could take on a block of U.S. business without substantially affecting its Canadian income tax. I say "without substantially affecting it" because you may not bring the profits directly into income, but you may destroy a certain ratio by which they determine, on the basis of reserves, just what is the Canadian section of the operation. Those are my general comments.

MR. NOVIK: Mr. Dowsley, when you said that the Canadian companies are admitted, you meant through a branch, correct?

MR. DOWSLEY: That's correct, some of the Canadian companies have subsidiaries in the U.S., but I don't believe any of the subsidiaries are doing a lot of reinsurance at the present time.

MR. NOVIK: But in order for the foreign company to be admitted in all the U.S., they would have to have a branch operation.

MR. DOWSLEY: Yes, that's correct. Most of the Canadian companies make Michigan their state of domicile, or their state of entry. Michigan is up near the top in the strengths of its regulation. It might not be as stringent as New York, but it is not at the bottom of the list by any means.

MR. FICKES: On the financial reinsurance side, the new U.S. tax act created a lot of opportunities for U.S. companies to help out branches of Canadian mutuals. I don't know if anybody is familiar with it, but we used to have something called the Secretary's Ratio, under the 1959 Act, that imposed or imputed surplus on companies. Just to make this very brief, that was carried over into the new act and now Canadian companies that do business on a branch basis in the U.S., if they're mutuals, will get surplus imputed on them. They will have to pay the surplus tax just like any other U.S. mutual company would. They tend not to like this very much. Since they really don't have U.S. surplus, this is having to pay tax on something that's not even there.

Mr. Novik, if I could ask you a question, how do you think the requirements of section 845(b), (the section of the tax code that now says, even if a company is unrelated to a reinsurer, the IRS can walk in and do nasty things to both parties if there is significant tax avoidance), will affect the growth of international reinsurance? My question is in the sense that if you do business with a Romanian company, the IRS cannot get at them.

MR. NOVIK: In the first place, I think 845(b) will affect reinsurance internationally the same way it does domestically. A substantially greater amount of risk transfer will be required to have a reasonable chance of getting the tax treatment that you believe is appropriate. The suggestion of dealing with a Romanian company is an interesting example. We deal with Bermuda through withholding tax and excise tax whereas Romania has a special tax treaty, there is no excise tax. Did you pick it because there is none?

MR. FICKES: Partially.

MR. NOVIK: If the Romanian company has a subsidiary in the U.S., it will be taxed in the U.S. If there is no subsidiary in the U.S., and there is no applicable excise or withholding tax, I don't think there would be any U.S. tax impact. Mr. Fickes, do you have a different answer for this question?

MR. FICKES: No, it's just an argument for going international that we didn't have before. I know that, before 845(b) came out, when financial reinsurance was considered, company managers many times would just say: "Well, the worst that can happen is that we go back to where we would have been without this reinsurance agreement." But 845(b) introduces the ability of the IRS to hurt one party without making it right with the other party, and international reinsurance may now be an answer to this.

MR. NOVIK: It's true; if both parties are U.S. taxpayers, there is that potential. However, if one party to a reinsurance transaction is not taxable in the U.S., the potential for adverse impacts, due to 845(b), is eliminated. I think that's a good point.

MR. JOSEPH KOLODNEY*: I want to raise the question that, if the IRS can walk in and attack whichever party it so chooses, and if it couldn't get at the Romanian entity, wouldn't it just manufacture some kind of a cause against the U.S. company that was party to the reinsurance?

MR. NOVIK: Yes, but it can change only one side of a transaction. I think what Mr. Fickes is talking about is creating a situation where losses from one U.S. company are moved to another U.S. company. There is the possibility that

- the ceding company would lose the tax loss.

- the assuming company would not obtain a tax loss.

In other words, there could be two adverse effects creating additional taxable income between the two parties to the agreement. On the other hand, the income is moved out of the country, the worst that could happen is that the U.S. taxpayer doesn't gain a benefit. I think that's what Mr. Fickes is mentioning, it takes part of the risk out of reinsuring.

MR. DOWSLEY: I would like to ask Mr. Roeser a question. There is a concern among several people that various cessions to the off-shore islands have resulted in instability in the industry. The reasoning behind this is that, in order to avoid the federal excise tax, the

*Mr. Kolodney, not a member of the Society, is President of Fairfield Life Insurance Company.

cession was made with as low a premium as possible, which meant that a catastrophe coverage was purchased. It seems that the company ceding business on a catastrophe coverage is taking credit for reserves in this off-shore company. This off-shore company supposedly is (I don't know if the expression is setting up reserves, since the requirements might not be that it actually set those up), at least in theory, assuming the risk attached to the reserves. Are there any grounds for a concern in this area?

MR. ROESER: That sounds like a description of a life insurance transaction. May I direct your question to someone active in life reinsurance?

MR. NOVIK: Getting away from what is obviously a sensitive subject, why don't we discuss a neutral issue, reinsurance security. This is one of the major issues in international reinsurance. There is not the kind of control in the international market that you have in dealing with a company in another state. There have been many problems involving reinsurance security, some domestic and many international. Mr. Roeser, could you discuss this problem?

MR. ROESER: There is no question that reinsurance, particularly international reinsurance, is a flash point in the chain and has the potential for creating major problems. Several frauds of very large proportions have just, in the last several years, emerged. There is one in particular that first became known in 1983. If you had about six hours, I would narrate all the details of the Kennelworth Scandal, which, according to the trade press, stemmed from the activities of an alleged perpetrator of fraud and scams going back twenty years, all of which hinged on placing imaginary, foreign reinsurance. This is why you see so much vigilance, both at the state regulatory and at the National Association of Insurance Commissioners (NAIC) levels over reinsurance with alien carriers. Here are just a couple of details about it.

Kennelworth was an insurance fraud being run in Illinois. It was first uncovered in February, 1983, and subsequently took Illinois investigators three-quarters of a year to figure out what really had been taking place. In effect, the perpetrator had a book of business (what we call excess of surplus lines business) consisting of heavy commercial risks that are not regulated. The Kennelworth situation involved about a $30 million block of this business, including race horses, bars, taverns and long-haul truck exposures--all pretty significant liability risks both in Canada and the U.S. Allegedly, this $30 million book of business was continuously moved from one carrier to another--small carriers, on the edge financially, who were hungry for premium volume in the distant hope that if they could write premium now and invest it before losses were paid, they could in some way climb back into a better financial position. These companies were allegedly the victims. The one that eventually went belly up and triggered the investigations was The Heritage Insurance Company. The Heritage had $3 million of surplus when it began to run this book of business through it. What it essentially did is, through intermediaries in London, fabricated the appearance of reinsurance. When the investigators went to London to track down the gentleman who was creating this appearance of reinsurance, they had to go to a pub in London to find him, because that's where he could normally be found doing his business. His mission, according to allegations, was to receive telexes and create the impression of binding U.K. companies to the risk. But, in fact, when his story was told, he said he was just receiving the telex and confirming that he had received it.

And so you can see how fragile the system is, when it's a simple matter to create confusion over whether a business has been bound, or, in fact, there are just acknowledgements that a telex has been received. On the basis of that confusion, certain individuals are alleged to have successfully created an insurance scam which was moved from one victim company to the next for better than ten years. One of the frustrations acknowledged by Commissioner Al Lewis, when he was Superintendent of Insurance in New York, was that once regulators were on to this and knew it was taking place, they could get very little support from prosecuting authorities in the U.S. The situation was, in the view of the U.S. judicial system, an international problem, a Lloyds of London problem. For several years he was frustrated in his attempts to move against these people. The Kennelworth scandal is the one that, I think, got the most publicity and raised the most concern amongst insurance regulators, perhaps because it occurred in the heartland of the U.S. (in the Midwest) and it really wasn't very international except for the tail end--the Lloyd's portion.

Another major scandal, one that has yet to be sorted out, is something called the Posa Scheme. Posa is the Panama-based Promitara de Occidanta, an affiliation of managing agents who were binding reinsurance contracts on behalf of companies for whom they were writing insurance. They had, in the end, accumulated $150 million of reinsurance which, at best, was questionable. It's still being unwound. There is a great deal of uncertainty as to who, in the end, will pay what, if anything.

Another problem situation is that of the Alexander Howden Company in the U.K. The company was merged with Alexander and Alexander of the U.S., after which certain reinsurance transactions came to light. Business had been transacted with companies secretly owned by officers of the Howden organization.

The common thread running through these stories is that reinsurance--at the tail end of an insurance transaction--is where a larcenous person can abuse the system.

It is not a fraud, but nevertheless, an indication of a problem, that Mr. Dowsley referred to earlier when he mentioned the Cherokee case. Letters of credit created a problem in that transaction. Cherokee is an insurance company that was purchased by a manufacturer in the U.S., the Dana Corporation. It's a good company (it makes truck and auto parts), but it made a mistake when it bought Cherokee. It bought something that it didn't understand. The Cherokee became involved in some reinsurance transactions with insurance subsidiaries of the St. Regis Paper Company and the Beacon Insurance Company. Credit was secured by letters. The allegations against Dana and Cherokee, at this point in time, are that they coerced, and effectively did stall transactions until certain letters of credit expired. All the time, they gave assurance to St. Regis that the letters of credit were valid and current. But, when St. Regis went to draw them down they had expired. The estimated exposure to Dana, if it can be brought into the action, if coercion can be proved, is $25 million. This is only now being recognized by Dana's securities analysts.

MR. DOWSLEY: I think that that example raises a question that Mr. Novik had spoken about briefly, and that's on the type of security that one should seek in international reinsurance. Just because a reinsurer is owned by a large company doesn't mean that the reinsurer should be given the same security rating that the parent would be. Here we have a case where, obviously, that company was not as strong as Dana. I think another example (that's not in the insurance area, but I think shows the reasoning that is going to prevail in the corporate world) is the Bophal disaster. It was reported in the press that one of the executives of the parent company, Union Carbide, when asked about it, answered that it really was a terrible tragedy, but that it concerned a small company in India that Union Carbide owned part of, but it was not Union Carbide and therefore Union Carbide could not be held responsible. Union Carbide's corporate structure and the law were such that the subsidiary company was responsible, and Union Carbide was not involved. The same thing is true in reinsurance. Do not expect that the parent will be there in a crisis, unless you have a written guarantee from the parent itself.

MR. KOLODNEY: I'll just make a general comment about doing business overseas. That is that you have to always be aware of what the local culture is. In Mr. Dowsley's comment about why we don't export our product, I think you run into market situations where:

a. the regulators don't want your product, because they have a pretty cozy situation themselves (ask Occidental about how it tried to do some reinsurance business in Germany), and

b. there are certain idiosyncratic cultural attitudes about what we promote here in North America.

For example, "Family Security," is not a hot button in many countries. Historically, life insurance business on the continent has always been sold more as an investment than as a death benefit. That's why ten year endowments are such a big deal, purchasers are trying to get their money back in another ten years.

MR. JOSEPH A. A. (TONY) GILLETT: I'd like to ask a question of Mr. Fickes. It's a two-fold question about reinsurance arrangements between U.S. companies and those in my native England. As a consultant in such a transaction, who exactly is your client? Is it the U.S. company or the U.K. company? From a U.K. company's point of view, the tax environment in the U.K. is very unstable at the present time. There is a lot of belief that the Inland Revenue will step in and disallow transactions. How do you advise clients in the U.K.? How do you advise setting up extra liabilities in case the Inland Revenue disallows a transaction which could actually cause insolvency (in theory, in some cases).

MR. FICKES: First of all consultants, a lot of times, actually represent both parties. At my firm, our involvement in international reinsurance is never where we are going around trying to hawk some tax deal. What we like to do is bring a client in the U.S. in contact with a client in the U.K. We do not package an idea and go from company to company until we find two buyers for it.

The second question dealt with liability and our general position is--I assume you are referring to I-E deals--that we do not go out and try to conclude a deal solely because it saves taxes on one side. I think we can remain legitimate, as consultants, only as long as we consistently put together commercial reinsurance treaties. If you can make money on a pretax basis, then anything you get after tax is great. That's the type of deal we try to promote.

MR. GILLETT: Is there a possibility of conflict of interest if you represent both sides?

MR. FICKES: I don't think there is. When we talk here about security, one of the things at my firm is that we insist that our clients meet each other. They actually sit down and have a face to face meeting, and our job is to make both clients aware of all the problems and pitfalls in a particular reinsurance treaty. We have nothing at stake if they sign, we don't do anything on a contingent fee or percentage basis. We are paid to tell both clients what's wrong with the treaty. If we go through and put twenty pairs of clients together and walk away with zero treaties we make the same amount of money as if all twenty sign. Our main business at Tillinghast is being actuarial consultants.

MR. NOVIK: You don't really have a problem as long as both parties know that you're consulting for both sides.

MR. GILLETT: If there are any lawyers in the audience, I'd like their comments on that.

MR. PAQUIN: I think there's been a gross abuse of the word "represent." There is a difference between representing and advising, and I believe that the role that you have described here is that of an adviser. The parties essentially speak for themselves and you do not speak for them. If, at any stage of the communication process, you speak on behalf of one part or the other, then you are representing that party, but otherwise you are simply an adviser. So, if you're not representing, I don't see what kind of conflict of interest there might be.

MR. FICKES: Are there other questions before we move on?

MR. ARDIAN GILL: I'm with Gill and Roeser. Could I ask Mr. Fickes a couple of questions? Isn't there another problem with letters of credit, in that they are now a balance sheet item, and the availability and price of the letters of credit has changed significantly in the last six months? Also, I didn't hear you close the loop on this Canadian mutual company with the Secretary's Ratio of surplus in the U.S. I thought I heard you say there were a lot of things you could do, but I didn't hear you mention any.

MR. FICKES: Well, that was intentional. I'll leave it that way as well.

MR. GILL: You've got the Secretary's Ratio, whether or not a company has surplus in the U.S. Is that correct?

MR. FICKES: Yes.

MR. GILL: You can't make the imputed earnings or the imputed surplus go away.

MR. FICKES: May we talk about this later? And yes, letters of credit are getting more expensive. But at the same time, as I said, almost all my clients have moved away from using them. The trust works so much better, and escrow agreements do well. You can also normally get those a lot cheaper than old LOCs. The only difference now is that you have to deal with companies that have the money out there. Again, most of the clients do have that kind of money.

MR. JOHN H. GREENHALGH: I'm with World Wide Assurance. Regarding Section 845(b), when you're ceding business from a U.S. company to a foreign company, it may be stretching it a bit, but it is possible for the Inland Revenue or IRS to disallow deductions and allow income which comes in at different time periods to the same company, and thereby still attack a financial reinsurance transaction.

MR. NOVIK: Do you mean tax the U.S. company?

MR. GREENHALGH: Most of these transactions produce a deferral, not a destruction, of income. So when the deferral is taken, the revenue service can disallow that, and when the income comes back in, it can treat that as income. A close reading of the law does seem to indicate that it can do this. I don't know if it would.

MR. NOVIK: I think there's good reason to believe that that kind of impact would not occur, based on general tax principles, but no one can guarantee anything. Right now, I don't think there is enough information. There are no currently available regulations, just a lot of surmises. The American Council of Life Insurance (ACLI) is putting together some ideas on what regulations would be, and very clearly the ideas don't include that kind of treatment. It remains to be seen what the IRS will actually attempt to implement.

MR. KOLODNEY: You probably won't get a definitive answer on that until after litigation. I don't think that they are going to clarify their position any more.

MR. NOVIK: I would also be very surprised if the IRS clarifies its position. As long as they keep it muddy, they'll minimize the amount of what they perceive as abuse. They forget the fact that people also have to do business. That's a secondary issue with them. Section 845(b) has also opened up a lot of cloudy issues in traditional reinsurance. Are there any more questions or comments?

MR. GREGORY T. GLASHAN: I'm with Multinational Benefit Associates. Recently the German tax authorities declared that dividends generated in multinational pooling arrangements in Germany are taxable income to German subsidiaries. Some of the insurance companies involved have used, as a defense, the fact that the dividends were not generated in Germany but rather were a result of reinsurance treaties to Switzerland, Italy or the U.S. Does anyone on the panel think that that defense will hold up? In my view, I don't think it will, but it will open up the potential for attacking a lot of other arrangements where reinsurance has been used for avoiding taxes.

MR. NOVIK: This is German taxation?

MR. GLASHAN: German taxation, that's correct.

MR. FICKES: Mr. Dowsley, you're our expert on German taxation.

MR. DOWSLEY: I really don't know anything at all about the issue. Sorry.

MR. JAMES W. PILGRIM: I'm with Frankona America Life. This may not speak directly to that, but we have a related situation at my company. We are a subsidiary of Frankona Reinsurance Company of Munich, Germany. When the operation originally opened in the U.S. in 1980, it went after impaired risk business and was not very successful. When we came to Frankona, one of the things we got them to agree to do was to put a stop-loss on the in-force business, so we wouldn't get run over by a truck as we were changing the direction of the company. However, the German government has said that Frankona can't put a stop-loss with an attachment point where we, in fact, have no loss, because income is transferred out from Germany to us. Germany will tax that benefit at a 65 percent rate. So that's related somewhat to the question that you raised, and that's our problem. We have a need, but we have to get the stop-loss at such a point that we still incur a loss, so that Frankona can convenience the German government that it, in fact, has not transferred money out of Germany that would otherwise be taxed.