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Summary: A growing number of insurers have overseas operations. Actuaries at those companies are faced with a number of unique financial management issues, such as generally accepted accounting principles (GAAP) and statutory accounting for overseas operations; special tax issues, including U.S. taxation of foreign insurers; and specialized reinsurance issues for foreign operations. Panelists discuss these issues and share their experiences in solving these problems.

Mr. Bruce D. Moore: I am a partner with Ernst & Young in New York. I previously served as chief actuary and chief financial officer for the international operations of Prudential. We have tried to put together a panel aimed at people involved in financial reporting for international operations of U.S. companies.

We will discuss several issues which were of interest to me in that function. We are going to address GAAP conversion issues for foreign operations. This has always been of interest to the stock companies and now is of interest to mutual companies as well. We will also discuss U.S. taxation of foreign insurance operations. This is an evolving new area which is potentially a major problem for many U.S.

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companies. We will talk about reinsurance for international operations. In my prior position, international was the first place my company used reinsurance. That is probably true for many large U.S. companies that expand overseas. Finally, we will present an overview of financial reporting process issues based on a survey that we recently did at Ernst & Young. Mark is a partner at Ernst & Young's actuarial consulting practice which is based in Philadelphia. He has over 20 years experience in the life insurance industry, with heavy emphasis on product development, financial reporting, and mergers and acquisitions. Mark has had much experience with GAAP for stock companies and mutual companies, and a great deal of experience in helping companies do GAAP conversions for foreign blocks of business.

Jim Tosti is director of taxes at Aetna International. He has had many years of experience on international tax issues, not just for insurance companies, but also in broader areas. He previously worked at Ernst & Young's office in Hartford, Connecticut. He will talk about a number of important issues for U.S. taxation of international operations, including subpart F taxes, foreign tax credits, and start-up losses.

Graham Mackay is director of international technical services at Lincoln National Reinsurance. He has had previous experience in the reinsurance business with M&G in Toronto, Sydney, and London. He has a lot of experience in foreign operations, both dealing with domestic reinsurance issues and also dealing with reinsurance for foreign operations of U.S. companies. He will talk about conventional uses of reinsurance for international operations.

I will conclude with a brief review of results from a survey Ernst & Young has done on international financial reporting issues. This survey concerned financial management processes. It was not specific to insurance companies, but I selected a number of issues that are similar to the issues insurers face.

Mr. Mark J. Freedman: I am going to talk about my experience with "GAAPing" foreign products.

For the most part, companies do not GAAP their foreign business until it becomes material, and rightly so. You might think it is really easy and all you have to do is read the FASB standards. Logistical barriers themselves are very hard to overcome. Language can be different, time changes (6–12 hours ahead or behind) are difficult to deal with, and cultural differences must be understood. In addition, foreign insurers are largely unaware of GAAP. They know even less than the U.S. mutual companies did a few years ago! Local systems do not lend themselves to GAAP very well, even the ones that are touted to do GAAP conversions.

The biggest issue is with the products themselves. GAAP standards are written for U.S. products. Foreign products are different enough that GAAP standards do not fit, yet GAAP does provide a framework to work in. There is an accounting box, and one has to stay in the boundaries, as painful as that might be. I am going to concentrate on a couple of examples of products I have seen: nonparticipating life products in Japan, some participating products in Europe (excluding the U.K.) and Asia, with profits participating products in the U.K., and unit-linked products in the U.K.

NONPARTICIPATING LIFE PRODUCT IN JAPAN

This basically looks like the U.S.'s indeterminate premium whole-life product, with a couple of exceptions. In the U.S., the company decides when to change the premium rate scale prospectively, depending on what they think experience is going to be in the future relative to what they had originally assumed. In Japan, it is the regulators who tell you when you have to change the premium scale. It is not dependent on your own company, but the entire industry, so everybody has to use similar parameters. In the U.S., the premium rates can go up or down, subject only to maximum guarantees in the contract. In Japan, the change can only be favorable to the insured. The other one is, in the U.S., the changes just apply to the premium scale. In Japan, the changes apply to the guaranteed cash value scale as well.

For GAAP, the product still looks enough like a U.S. indeterminate premium product. Therefore, *Financial Accounting Standard* (*FAS) 60* is probably the best choice. Usually, *FAS 60* requires locking in assumptions when the products are sold. This is one of the rare types of products where one can break that rule. The rationale is that the products are essentially repriced at each premium rate change; therefore, one is not violating the lock-in principle.

It is very easy to get in trouble with this product. For example, assume a company invests long and interest rates go up. Then, the company must reprice at the rates dictated by the government. These rates are higher than the earnings rates.

If a company invests short, and interest rates go down, the company is locked in, because they cannot lower the interest assumption in the premium rate. Therefore, there is a reinvestment risk.

This means one has to be on the constant lookout for loss recognition. There are some systems problems here too. Companies in Japan tend to have every type of premium paying and benefit pattern humanly possible, so one has to create new and changing GAAP factors all the time. It gets very messy.

PARTICIPATING PRODUCT IN EUROPE (EXCLUDING THE U.K.) AND ASIA

Both of these designs have a one-factor dividend formula. The one factor is excess interest. One difference in the European product, which I am giving an example of, is that the excess interest is based on actual experience. The one in Asia has excess interest chosen by the regulator, based on an index and not based on real experience.

The European product also has a very nice relationship between the gross premium and the statutory reserve net premium. In fact, the net premium is a very small percentage of the gross premium in the early years, and a larger percentage of the gross premium thereafter. The Asian product designed here does not have such a relationship.

What does GAAP have to say with respect to participating products? There is a new AICPA *Standard of Practice*, *(SOP) 95-1.* This is mostly for mutual companies. Most stock companies use *FAS 60* for participating business, but the *SOP 95-1* would have to be used if (1) the dividend mechanism uses the contribution principle, and (2) the company is either a mutual or a stock subsidiary of a mutual company. Otherwise, it is optional for other stock companies. I do not see many stock companies running to use this method voluntarily. In the types of products described, the SOP is eliminated, because there is no contribution principle if the dividend only provides for excess interest.

Even though *FAS 60* is used for most stock companies, *FAS 97* has some scary provisions in it that have to be considered before throwing it out. Basically, *FAS 97* applies to universal-life-type contracts, but in paragraph 12, it suggests that some participating contracts should be considered universal life (UL) for the purpose of *FAS 97.* The clause says a participating contract that includes any of the following features shall be deemed universal life. One of the features described in this paragraph is that the insured expects that changes in any element will be based primarily on changes in interest rates or other market conditions, rather than on experience.

In *FAS 97,* the reserve is merely the account balance. If a product is deemed UL, and there is no account balance, what is the reserve? Paragraph 18 addresses this and says, in the absence of a stated account balance or similar explicit or implicit contract value, the cash value shall be used. Sometimes, this gives a ridiculous answer. For example, if the cash value has an expense allowance and one is also deferring an acquisition cost, there can be double deferring.

Another possibility for the reserve can be found by looking at the SOP 95-1. Even if it does not apply, it gives some guidance for what serves as a good proxy for the reserve. It argues that a participating product's net level reserve using statutory type assumptions is a reasonable proxy. Even if the product falls under *FAS 97*, one can at least get to another answer in terms of a reserve in a way other than using the cash value.

Most companies still like to argue *FAS 60* because it is easier to work with than *FAS 97*, because *FAS 97* causes a great deal of work. Reading a little more into *FAS 97*, paragraph 11 is interesting. This discusses the spirit of *FAS 97*, and it states that *FAS 97* does not apply to conventional forms of participating contracts. Those are addressed by *FAS 60*, and, sometimes one has to investigate a little further. Some foreign products have very high guaranteed interest rates and therefore small dividends, so these products might be argued essentially to be nonparticipating.

With regards to the European product, it is a one factor dividend formula with a nice relationship between the gross premium and net premium, with high front-end loads in early years. How do we GAAP this? *SOP 95-1* is eliminated because the dividends are not based on the contribution principle. *FAS 97* seems to be a nice answer because of paragraph 12. Also, since there is a nice relationship between the gross premium and the statutory net premium, (1) using the statutory reserve as a proxy for account balance and (2) setting up an unearned revenue liability to defer the large front-end loads seem to work reasonably well.

The Asian product, though, does not have that nice relationship. Here, *SOP 95-1* is eliminated again because it is clearly not the contribution principle at work. There is an argument for *FAS 97,* which is based on paragraph 12. Since there is not this nice relationship between gross premium and net premium, the computations can get very complicated, especially with respect to unlocking. Companies are going to tend to try to push for *FAS 60,* citing that paragraph 11 is an argument that talks about the spirit of *FAS 97.* This is not always enough, but I think that the better argument is that the guaranteed rate is fairly high. Therefore, in many situations there are very small dividends, especially in the early years. Therefore, if one wants to push for *FAS 60,* the best argument might be that the product is essentially nonparticipating. There is not a definite answer in this case, but in any case, one has to look at the particular facts and circumstances of a particular product.

WITH PROFITS (PARTICIPATING) PRODUCT IN U.K.

In this product, the dividends do follow the contribution principle. One nuance is that the company has essentially a participating fund and a stockholder fund. The stockholder transfer each year is limited to one-ninth of the policyholder bonuses (dividends). Another nuance is that there are large amounts of terminal bonuses, which are mostly because of capital gains on the common stock and real estate backing the business.

What do we do for GAAP? First, we can revisit *FAS 60* for "normal" participating products, which means reading paragraph 43. With participating contracts, a stock company would set up a net level reserve for all benefits, including dividends, and lock in the assumptions at issue, including the assumption for dividends.

However, this product has limitations on the amount of income that stockholders can receive because of the provision that a stockholder transfer can only be one-ninth of the bonuses. This means that essentially 90% of the pre-bonus income is owned by the policyholders. Paragraph 42 of *FAS 60* applies in that case. The method for setting up a net level reserve, where "restricted participating" accounting is used, is that one does not provide for future dividends. Instead, policyholder dividend liability is set up in a manner appropriate for minority interests. Ninety percent of the pre-dividend income is added to the dividend liability; dividends incurred are subtracted from the dividend liability.

Where are we on this product? The "normal" *FAS 60* technique has been used in some instances, but it would only make sense if a company is not transferring as much to the stockholder fund as the limit allows. Otherwise, *FAS 60* restricted participating accounting makes sense, because of the one-ninth transfers each year. The dividends do follow the contribution principle, so if this were a mutual company or a stock subsidiary of a mutual, one would be stuck with the SOP. On the other hand, the SOP seems to have a flaw in it; it does not talk about restricted participating business as *FAS 60* does. One can either take a hard line approach and ignore the restricted participating issues and just apply the SOP literally, or go back to a minority interest type of accounting method, because it has precedence not only in *FAS 60*, but also in the audit guide and in some other areas in GAAP. The key is how to get it to work in the case of the SOP, which I am not going to discuss. I have also seen some other treatment; for example, there have been proposals about treating this whole product in a similar manner as a separate account product.

UNIT-LINKED PRODUCT IN U.K.

The unit-linked product is similar to a variable universal life product in the U.S. This product has a fixed premium. Front-end loads are deducted. The net premium is invested into units of funds.

It has some nuances, though. There are very large front-end loads in early years, for example, sometimes as much 100% of premium for up to three years. Also, in the U.K., the tax base is sometimes investment income less all expenses. In this product, the pricing is such that the margin, net of tax, is very small. Also, there are little or no surrender gains.

The *FAS 97* part here seems obvious. It is a universal-life-type product for the purpose of GAAP. One could blindly follow *FAS 97.* This would mean amortizing against the gross profits and setting up an unearned revenue liability because of the high front-end loads in early years.

But, here are some of the problems. The products are priced to have small post-tax interest earnings, yet the pretax margins are a material part of gross profits. This means that the GAAP earnings pattern is going to be much different than the so-called true pricing margins pattern. Also, the front-end loads include a lot of front-ended profits, and that could cause small or negative gross profits in the future. What do we do? I have heard many solutions, but none of them work very well.

This just gets back to the point that GAAP was not designed for foreign products, and as foreign business becomes more material, the hope is that FASB is going to do some rethinking on these types of products. But, it is not very likely to be on FASB's agenda any time soon, so we are forced to work within the framework that we already have.

Mr. R. James Tosti: I would like to talk about the U.S. income tax issues associated with expanding your insurance operations overseas. The focus of my presentation is on U.S.-owned foreign insurance companies that operate and insure risks in a foreign country. I am not going to be focusing on captives- or inbound-type investments. The focus of my presentation is life insurance companies. I am going to talk about some U.S. income tax problems encountered and some alternative solutions. I will focus mainly on subpart F, the foreign tax credit, and start-up losses. I also plan to talk about some of the U.S. tax issues involved with joint venturing.

As background, the income tax expense of a worldwide company is made up of not only the local income taxes on your foreign affiliates, but also the U.S. income taxes that can arise on the foreign affiliates income. The U.S. taxes that arise include both current and deferred taxes, with current taxes mainly comprising income taxes on dividends or on subpart F income, less the related foreign tax credits. Deferred tax accounting under *FAS 109* is required. Therefore, U.S. income tax expense is made up of two components.

You are going to hear a great deal about subpart F. The question is: "What is that and why am I using those strange words?" Basically, the income of a foreign affiliate is not taxed in the U.S. until that foreign subsidiary pays a dividend back to the U.S. parent. Subpart F says if the foreign affiliate earns certain types of income, then that income is going to be taxed currently in the U.S., even if there is no cash (no dividend) paid by the foreign affiliate back to the U.S. shareholder.

Subpart F income is calculated on a separate company-by-company basis. There is no consolidation at a country level; each company that you have is a separate tax paying entity for subpart F purposes. It is very important to structure your entities properly. The calculation of subpart F income is based on the current year's income only. It does not look back or look forward. Expenses are allocated between subpart F income and nonsubpart F income based on a couple of different methodologies. Right now we are in the midst of finalizing the 953 regulations. This is probably one of the biggest issues facing U.S.-owned foreign insurance companies. There are basically two different ways of allocating expenses to foreign source income. Under the gross-to-gross method, which is the preferred method, you are going to end up having lower subpart F income. Under the proposed regulations put out by the IRS about four years ago, but never finalized because of the controversy, the amount of the subpart F income would be substantially higher. I am going to have an example of the two different methodologies of computing the allocation of expenses.

Subpart F income is also based upon earnings and profits computed under U.S. tax accounting principles. It is not statutory (STAT) accounting; it is not GAAP accounting; it is its own separate U.S. tax accounting. In fact, you are going to have four sets of books as a result of this. You are going to have STAT, local tax, U.S. GAAP, and U.S. tax books and they are not going to be the same.

Subpart F income is the portion of the net income or the earnings and profits, as we call it in U.S. tax principles, of a controlled foreign corporation (CFC) that is taxable in the U.S. which includes investment income and insurance income from risks located outside of the country of incorporation. Basically if you are just doing business within one particular country, then only the net investment income will be taxable currently. If you are doing insurance income in multiple countries through one entity, then you could have both types of subpart F income, insurance income, as well as investment income.

Earnings and profits are important because it is from earnings and profits that subpart-F income is computed. You start with statutory income and you add in U.S. GAAP adjustments, and also U.S. tax adjustments. The primary GAAP adjustments are to record realized capital gains and reverse unrealized capital gains and losses. On a statutory basis, mostly the unrealized gains are included in income in the foreign countries and you will need to reverse that out. Actuarial reserves are not STAT reserves nor GAAP reserves. They are computed on a U.S. tax basis, but with special computations for U.S. tax reserves. Also provisions for estimated losses, for example, real estate writedowns, bad debt provisions, and vacation pay accruals are all eliminated from your STAT income to arrive at earnings and profits. Proxy deferred acquisition costs (DAC) have to be capitalized and amortized over a 5–10 year period and for property casualty (P&C) companies, 20% of the unearned premium reserve is nondeductible for earnings and profits purposes. All those things are going to tend to increase your earnings and profits substantially above your statutory income.

Table 1 is an example of rolling forward statutory income to U.S. earnings and profits and show the major adjustments. The first step is to adjust investment income by reversing out unrealized gains and recording realized capital gains. Also, the reserves are computed separately under U.S. tax accounting principles and DAC is computed separately under the U.S. tax DAC rules. The deferred income taxes are completely reversed. Those are not included in the computation at all. Even though they hit your GAAP books, they are not included in the computation of earnings and profits and your foreign tax credit.

TABLE 1
SUBPART F INCOME ISSUES
EARNINGS & PROFITS/EXPENSE ALLOCATION METHOD
STAT. TO U.S. TAX

	Statutory Earnings	**Adjustments**	**U.S. Tax E & P**	**Percentage**
Premiums	350,000	(4,000)	350,000	64.5
Investment Income	197,000	(4,000)	193,000	35.5
	547,000		543,000	100.0
Reserve Change	57,000	14,500	71,500	
Claims	(476,000)		(476,000)	
Commissions	(46,000)		(46,000)	
DAC		7,900	7,900	
General expenses	(72,000)	500	(71,500)	
Other	2,900	800	3,700	
Current Income tax	(2,359)	1,360	(999)	
Deferred Income tax	(2,241)	2,241	0	
Net Income	8,300	23,301	31,601	

You can see from this example that statutory earnings are substantially lower than U.S. earnings and profits for this particular year and that this can give rise to substantial amount of U.S. income taxes. Also note on the far right, the percentages of premium income to total gross income and investment income to total gross income. Those percentages will be key in Table 2.

Under the first expense allocation method, on the left in Table 2, the gross-to-gross method, you are basically going to allocate all of your expenses between investment income, subpart F investment income that will be taxable currently in the U.S., and insurance income that is deferrable off shore. Roughly 35.5% of the net earnings and profits are taxable currently. You want to make sure you drive down earnings and profits to the extent that you are able to.

TABLE 2
SUBPART F INCOME—ISSUES
EARNINGS & PROFITS/EXPENSE ALLOCATION METHOD

	Gross to Gross		Section 953	
	Subpart F Investment Income	Same Country Insurance Income	Subpart F Investment Income	Same Country Insurance Income
Premiums		350,000		350,000
Investment Income	193,000		193,000	
Reserve change	25,413	46,087	(86,500)	158,000
Claims	(169,186)	(306,814)	(7,500)	(468,500)
Commissions	(16,350)	(29,650)	(11,000)	(35,000)
DAC	2,808	5,092	2,000	5,900
General expenses	(25,413)	(46,087)	(17,000)	(54,500)
Other	943	2,757	(6,000)	9,700
Current income tax				
Deferred income tax				
Net income	11,215	21,385	67,000	(34,400)
Subpart F US dollars @ .70	$7,850		$22,120	
Subpart F Tax @ 35%	$2,748		$7,742	
Less FTC	($200)		($729)	
Net Subpart F Tax	$2,548		$7,013	

Under the Section 953 proposed regulations on the right, there would have been substantially more subpart F income because most of the expenses would have been allocated to insurance income. Those regulations were never finalized and as I have said, they are being finalized right now. That is probably one of the biggest issues, if not the biggest issue, for foreign insurance companies that are owned by U.S. corporations. There is a dramatic difference at the bottom of Table 2; the subpart F tax before the foreign tax credit under the gross-to-gross methodology is about $2.7 million in this example. Under the Section 953 proposed regulations, all of the earnings and profits from Table 1, $31 million, would have been currently taxable in the U.S. Even though you accrued a substantial amount of local taxes, an amount of taxes that is higher in fact than the U.S. tax rate, you are going to be paying U.S. taxes. Why?

Another big issue for foreign companies is that subpart F tax is reduced by the foreign tax credit. The foreign tax credit is computed using only income taxes, not premium taxes. Foreign tax credit is only allowed for income taxes and withholding taxes, and they have to be paid or accrued. In the situation where you are accruing deferred taxes, but you are not paying those taxes with respect to the current year, no credit is allowed. Therefore, there is no reduction in the net U.S. tax in the current year unless you actually pay foreign income taxes.

The foreign tax credit is allowed when a subpart F inclusion is recognized by the U.S. parent of a foreign subsidiary, or when a dividend is paid by the foreign subsidiary. Then the foreign taxes that the foreign subsidiary pays are allowable as a foreign tax credit against the subpart F inclusion of the dividend income. The amount of foreign tax which may be used to offset this income is calculated by dividing the dividend or subpart F income for the current year by the previously untaxed cumulative post 1987 earnings and profits of the subsidiary multiplied by cumulative foreign taxes paid. There is a big mismatch caused by including only the current year’s income for purposes of calculating subpart F inclusions and the related U.S. tax, and the actual cumulative earnings of a subsidiary. If there are negative earnings in your subsidiary, then no foreign tax credit is allowed for the current year. That ratio is multiplied by your income taxes paid, but not your income taxes paid for the current year. Even though you may be paying a high rate of taxes in the current year because you had a high income (and if you had high income, you might have high subpart F income), what ends up happening is that you have to go pool your income taxes from 1987 onward. Even though you are paying high taxes in the current year in the foreign country, you may have additional U.S. taxes to pay, because the pool of earnings is lower on an effective rate basis than the U.S. effective rate. There are many traps in these computations and it requires monitoring to see where you are to make sure you are not paying U.S. taxes.

Foreign tax credit reduction of the U.S. tax is basically limited to the tax on the foreign source income. Take the U.S. tax, multiplied by a ratio of foreign source income to worldwide taxable income. This calculation must be performed for nine baskets of income in order to limit the blending of high tax rate countries with low tax rate countries.

For insurance companies, there are really only two baskets. If you have wholly owned foreign subsidiaries owned by the U.S. parent, you are likely only going to have the financial services basket. In this case, you are able to blend your high tax rate subsidiaries with your low tax rate subsidiaries. The other basket I will get into later is the high withholding tax interest basket. That is another trap, and I will show you how that trap works.

Planning in the foreign tax credit area revolves around whether you have excess foreign tax credits or excess foreign tax credit limitation, and all of your planning is going to be driven by that. If you have excess foreign tax credits, you want to try to generate some foreign source income that has low taxes, so you will not have to pay any additional U.S. taxes. Vice versa if you have excess limitation, you want to try to generate some income in the U.S. on which you do not have to pay additional taxes, or you want to accrue additional income in the U.S. that has high taxes associated with it, so you can eliminate the taxes on the low tax rate income.

Some of the things you can do in terms of planning for the U.S. income taxes on subpart F income is to try to minimize earnings and profits. One of the best ways which I have seen to do that is to focus on your U.S. tax reserve computation. Even though the actuaries have done the STAT reserve computation and the GAAP reserve computation, there is a tendency at that point to just throw your hands up and say that is the end of it. One of the areas where you can save some money is by focusing on the U.S. tax reserve computation as much as possible.

We also try to identify expenses that are directly allocable against investment income to try to reduce the amount of the net investment income that is considered subpart F income. We also do some realized capital gains tax planning at year end to make sure that we do not have any realized capital losses that are nondeductible for U.S. tax purposes; this can be another trap. We maximize local income taxes paid instead of capital taxes and that often can be the case. For example, in Canada, because of your maximum tax actuarial reserves (MTAR) calculation, you can put yourself in capital tax position, whereas if you just backed off in the maximum reserves allowed for local tax purposes, you end up paying the same amount of tax, but it will be income tax instead of capital tax.

The best way that I think that we can help ourselves to avoid U.S. taxes on subpart F income is to do some planning with acquisitions and with start-up ventures; do some pro-active tax planning whenever we enter into new ventures, whenever we are acquiring new companies, and whenever we are doing intercompany dividends or intercompany asset transactions. Intercompany asset transactions are eliminated for GAAP purposes and consolidation, but for tax purposes they are recognized separately. You can end up actually creating subpart F taxes from an intercompany transaction, but it is going to hit your bottom line.

If you are in a situation where you are paying subpart F taxes, there is actually an additional cost of doing business. The question becomes whether you should be including this in your product pricing. If you include it in your product pricing, the issue is, can you be competitive in the foreign country? If you are doing business in a low tax rate country, say a 15% country, and your subpart F taxes are being calculated at 35%, you have an additional cost of doing business. How can you compete with local insurance companies? But if you do not include it in the product pricing, then your return on equity is going to suffer. You need to think about how you want to address this.

Instead of being in an income-generating position, assume that you are in a loss-generating position. In many situations you may be starting up your operations with a significant amount of capital, and in order to do business in a foreign country, you have to obtain a license in a separate foreign company. The trick is going to be to try to get one government or another to help you pay for those losses that you are going to incur. What I mean by that is, instead of just investing the money and generating losses with no tax benefits, what can you do to try to get a cash tax benefit for those losses as you are incurring them? Your GAAP books may not be reflecting that you are in a loss position. Your STAT books generally will. They are more on a cash method type of accounting. When you set up a separate entity and the losses are incurred in the separate foreign entity, those losses are not deductible currently in the U.S. As you earn statutory income, if the foreign country allows those losses to be carried forward, and as you earn income, you will generate some tax savings. Subpart F has limited loss carryforward rules. Just at the time when you are turning the corner and you are saving some money on a local tax basis from using those net operating losses (NOL), you are going to start paying Uncle Sam subpart F taxes. You must watch out for that rule as well.

The question becomes, how do you obtain a current tax refund for losses incurred on the STAT basis? One of the things we have looked at is making a Section 953D election or treating the foreign insurance company as a domestic insurance company. The problem with the rule is that Uncle Sam is not going to allow you to deduct losses. They do not mind having you pick up the income and taxing that, but they do not want you to record the losses. They do allow the losses to be carried forward to the point where you have income, but there is no way to get the loss currently. We have considered using branches of the U.S. corporations. If you can get the license in the foreign country to do business through a U.S. corporation, that is one way of getting the loss deductions back into the U.S.

The other idea is to use a dual-incorporated company. If you have obtained a license to do business in a foreign country in a foreign corporation, after you have incorporated in the foreign country, you may want to consider also incorporating it in

Delaware, and in that way, you have a dual-incorporated entity. It gets rather complicated, but it is a way of getting the loss deduction into the U.S. You also may want to consider using reinsurance as a means of achieving this, which involves putting the loss in the best jurisdiction.

If you have multiple businesses located in a foreign country, you may be in a position to offset the loss company against the profit company in a consolidated return in a local country or through group relief. The trick again is going to be to watch out for your subpart F taxes. In the first structure where foreign company one owns foreign company two and foreign company one is owned by a U.S. company, and if foreign company one is a loss company and foreign company two is a profitable company, and both of those are insurance companies, then you can offset the losses of one company against the profits of another for subpart F purposes. In the second structure, the two insurance companies are owned by a holding company. That is a typical structure going into a country if you are going to have multiple operations. In that structure, the losses of one company are not allowed to offset the losses of another company for subpart F purposes. If you use that sort of structure, you may be, again, creating subpart F taxes in the U.S., but not paying local taxes and, again, those subpart F taxes are going to hit your books.

Joint ventures are a typical way of doing business in a particular country. The insurance industry is unique. There is very limited ability to use partnerships because the U.S. tax code requires that an insurance operation be in a corporation. Much of the loss planning, and planning that is done by manufacturing companies, is done through partnerships, but in the insurance industry, there is limited flexibility in that area.

If you are entering into a joint venture, the trade-off is going to be if you can get more than 50% ownership, then you have the possibility of creating subpart F income. That subpart F income is going to carry with it foreign tax credits that are in the overall financial services basket, and they are cross creditable with your other operations. You can blend high tax operations with low tax operations, if you own more than 50% of the subsidiary, of your joint venture. If you own less than 50% of the joint venture, you are not going to have to worry about subpart F, but you are going to have to worry about the foreign tax creditability if the tax is paid by that operation. The issue then will become how to blend your income taxes paid in high-tax and low-tax countries for foreign tax credit purposes to avoid increasing the U.S. effective rate for GAAP tax purposes.

Often times, if you are doing joint ventures, you will want to consider using a holding company. There are disadvantages to using a holding company, but in your joint venture, if you own less than 50%, you may want to start to consider using the holding company as a way to blend your high-tax and low-tax joint venture operations.

There is one other trap I want to talk about in the insurance industry. I have seen most of the foreign operations funded with equity capital, and there is very limited use of DAC capital. In manufacturing, there is a lot of planning going on with using DAC capital to strip out earnings.

If you have a subsidiary in need of capital and the withholding tax on interest in that country is going to be more than 5%, you are going to create a tax problem for yourself. That interest is going to be included in a separate foreign tax credit basket called the "high withholding tax interest basket." The withholding taxes are generally less than 30%, so you would normally think that the withholding taxes would be fully creditable against the U.S. tax rate, which is 35%, but there is a special provision for life insurance companies that require expenses to be allocated using prorating between investment income and insurance income. If your profit margins are say 10%, and if you are not at a 100% profit margin, those withholding taxes are not fully creditable. The big picture issue is if you are lending money to your foreign subsidiary, and the withholding tax is higher than 5%, you have to watch out for that. This is a trap.

I have tried to go over some things in general. There is really no substitute for specific tax planning advice, and if you need some help, please give your tax adviser a call.

Mr. Graham W. G. Mackay: Imagine that you are the actuary of a multinational insurance company, and you are setting up new operations in an emerging market. You have just learned about tax laws, both in the U.S. and in the foreign country and you know as much as you can possibly know about GAAP accounting. Do you need reinsurance? So far, it is hard to say. In the U.S., you work for a fairly large company, you have a retention of, say $1 million, and you are retaining most of the risks that you write, and you manage your assets and liabilities with a few financial reinsurance transactions; you are fairly sophisticated in managing your risks. Unfortunately, for all the size and the strength and the sophistication that you have here in the U.S., you just put your company in a situation where it has become a small inexperienced operation, and you have to begin to act accordingly.

We are going to go through three things: a brief overview of reinsurance, general reasons to purchase reinsurance, and a few specific issues that a new overseas operation is likely to face.

OVERVIEW OF REINSURANCE

We will look at types of reinsurance methods and some refunding mechanisms that you might want to consider. First, let's look at three methods of reinsurance.

Excess Share

An insurance company will use this method of reinsurance to maximize its retention on a per-life basis by retaining all risks below this retention. It is a very effective way of limiting the impact on the bottom line of any one claim. The only real disadvantage is that it requires policy-by-policy administration, which can be more costly to administer. Ordinarily, an insurer will want to shift the volatile risk to the reinsurer who can pool these risks. Excess reinsurance does accomplish this goal very well. Care must be taken, however, with reinsurance in emerging markets, as a conflict can be created between this goal of risk transfer and the need for a long-term partnership. The insurer must set its priorities and act accordingly.

Quota Share

This is much simpler. The insurer's retention on a per-life basis is defined as a constant percentage of the total policy amount, regardless of policy size. It is much easier to administer and it does reduce exposure on all lines, but it does cause the insurer to underretain on most lives; this means the insurer will not maximize the value that is retained. Volatility is not really reduced as the fluctuations are just on a smaller scale.

Aggregate Stop Loss

This is an attractive reinsurance mechanism, though not widely available. Here, the insurer is looking at aggregating its claims, measuring its total claims under a certain block of business against an attachment point, usually defined in terms of expected claims. Claims above this attachment point are reimbursed by the reinsurer. If available, this is considered for large group coverages with stable results. Remember, this is not always available, but it does serve a purpose, and it is something you may wish to consider.

METHODS OF REINSURANCE

A number of years ago, co-insurance was probably the most popular form of reinsurance. Here the risks and obligations of the insurer are transferred to the reinsurance company. It allows the insurer to take reserve credits and can offset the solvency margins that they hold on the risks reinsured. The reinsurer fully reserves for the obligations that they have assumed, putting the reinsurer in the same position as the insurance company. This often affords the insurer some relief of its new business strain. Unfortunately, the assets backing those reserves are also transferred to the reinsurer and many companies wish to retain the assets under their own management. Reinsurance commissions can be heaped in the first year to provide some relief for new business strain, and this obviously is negotiable between the insurer and the reinsurer. If there is an acute problem, very large first-year commissions can be available to provide some form of surplus relief. The trade-off, of course, is that you are giving up profits in future years. It is a balancing act that you must be careful with.

Modified co-insurance is effectively the same mechanism as co-insurance, but the insurer holds the reserves on behalf of the reinsurer, maintaining the assets under its management.

Risk premium, or yearly renewable term insurance, allows the insurance company to reinsure the net amount of risk on attained-age rates. The retention is defined as a constant amount by duration, or as a constant percentage of the net amount of risk, defined at duration zero. This method allows the insurance company to keep the assets backing these risks in their own offices. Administratively, it is easier than co-insurance and allows bulk reporting to the reinsurer. The only real disadvantage is the inability for the reinsurer to support any business strain.

REFUNDING MECHANISMS

If the insurer's goal is to get the lowest possible reinsurance rates, and to minimize reinsurance costs, then it probably does not want a refunding arrangement. A nonrefunding agreement will be the cheapest form of reinsurance where there is a full transfer of risk to the reinsurer. The only real disadvantage in emerging markets is that the risks are not always understood by the market; margins, either implicit or explicit, will be built into the rates, and if you have a belief or a feeling that the reinsurer has been conservative in pricing, you might want to consider experience refunding.

Experience refunding premiums will be higher than nonrefunding rates, reflecting its obligations to share its excess profits. These excess profits will be returned to the insurance company after the close of the year. Thus, the cash flow in the first year will be more strained on the reinsurance costs. Over time, however, it should balance out, and if you expect that the reinsurer is going to have favorable experience, you should be better off.

The refunding formula is typically split into two parts: a reinsurance charge, which the reinsurer would describe as a reasonable charge to cover expenses and profit that it should earn on its business, and a percentage of the profits in excess of this reinsurance charge that would be refunded. Both pieces are negotiable. As a more generous experience refund formula is negotiated, the cost will, of course, increase.

Working cover is very similar to experience refunding, often called "experience refunding in advance." Here, the premium is defined as a function of actual claims and the reinsurer's retention charge. The reinsurer is effectively returning 100% of the excess profits. Minimum and maximum limits are set on the premium rates. Usually the insurer receives all of the benefits of experience refunding. It gets a lower rate upfront, and the reinsurer is willing to do this because there is the ability for the reinsurance rates to move upwards as well as downwards to fluctuate with experience. Some of the variability is being taken out of the reinsurance transaction. Unfortunately, it is not always available; it is available only for larger group business.

Administrative services only: here the only real premium paid to the reinsurer is for the risk that claims exceed a preset level. This is essentially stop-loss coverage and has already been covered.

NEEDS FOR REINSURANCE

Capital Strain

For each piece of new business written, the insurer incurs acquisition costs and must meet its capital and reserve requirements. Often this will lead to a statutory loss. Co-insurance or modified co-insurance arrangements with the heaped first-year commissions can provide some relief as the reinsurer is actually fronting you a portion of this strain. The insurer must consider its retention levels; if the strain is an acute problem, the insurer may underretain slightly to get financing from the reinsurer. If the insurer views the strain as only a short-term problem, then recapture may be an issue that should be addressed when negotiating the reinsurance terms. In the case of acquisition, the insurer does not really have any acquisition expenses per se, but may face resource and capital requirements resulting in strain. Here, the insurer may want to consider a quota-share-type arrangement or financial reinsurance if it is available.

Reduced Exposure

If the insurer subscribes to a balanced portfolio style of management, a new operation may have sales for one or two products that outperform its other lines, resulting in an imbalance in the portfolio of products. Rather than backing off on sales, the insurer may seek to reduce that exposure through reinsurance on a quota-share basis. You want to make sure that the reinsurance allowances you receive from this agreement do support this. You do not want to be losing money on the reinsurance, and hopefully you will be able to use arbitrage to leverage your results. Arbitrage can happen when the reinsurer holds different views regarding the mortality, morbidity costs, or lapse rates. They could have different profit objectives or expenses. They could have different reserving practices, or different accounting rules. Any of these, or a combination of these, could lead the reinsurer to have a lower cost of insurance than the insurer. If this is the case, you may have the opportunity to convert some of your risk business into fee income, and the fee income can leverage the results on the retained portion. The only real issue you have to decide is how much you are going to retain and what business are you really in. You could reinsure all of this and effectively become a front for your reinsurer.

Access to Information

Most reinsurers offer some form of value-added services without a direct cost to their clients. This can be in the form of training, product development, research and development, or even turnkey products. If you want this, then you need to make sure that enough business is reinsured to allow the reinsurer to be able to cover the cost of these services. You may want to talk specifically to the reinsurer about services that they are going to provide at the time of reinsurance. It becomes part of their service contract.

Regulatory Constraints

Remember you are going into a new country which is going to have new rules and you are going to have to play by them. The best example I have come across is in Argentina where an insurer is required to produce evidence of reinsurance before a new product will be approved for sale. In that case, the insurer will probably want to bring the reinsurer in a little earlier to ensure that there is no slow-up in the process towards getting the new product to market.

Image

Often, the image of the reinsurer can impact the image of the direct writing company. The stakeholders would be the clients, the policyholders, or the regulators. If this is an important issue to management, then they should develop a short list of reinsurers which they wish to deal with and stick to that list.

ISSUES FOR AN OVERSEAS OPERATION

Limited Capital

We have hit on this a little already. The new business strain is a very real problem. If you think about it, when a new operation is set up, they are given an operating budget and told to go off and work on their own. Professional pride of that management may cause them to try and work out their own solutions, keeping head office out of their business as much as possible. We have covered the solutions as well. Co-insurance or modified co-insurance with heaped first-year commissions can cause reinsurance to be a source of capital for the office.

Limited Knowledge of the Market

Say you just moved into a new country. How much do you really know about it? You have obviously done enough research to know that this country offers enough potential, you will trade all the value for your shareholders. How much do you know of the details? Do you know about the morbidity and mortality costs? Do you know what is happening in the market. Do you know what works and what does not work. You can probably hire local people. Do they have the training to manage the risks that you are about to write. Reinsurers can again help here. The value-added services that the reinsurance companies offer are going to come into play in terms of the training. They can concentrate on the actuaries, the underwriters, and claims adjudicators. They can provide training for sales people if you wish. Take advantage of this; there is a lot of value to be gained here. Regarding claim costs, they will tell you what they can about the local market conditions. They also have to operate in the market and have their own views on the cost of insurance. If you are uncertain of it, it is a good time to purchase some reinsurance.

Low Tolerance to Fluctuation of Results

Low tolerance to fluctuations can result from a number of circumstances including limited capital, cultural differences, or management style. This would cause management to, again, look at the retention very carefully. Reinsuring on an excess-share basis makes sense if you want to limit the impact of any large claims. If they are extremely adverse to this sort of fluctuation, then they might begin to look for aggregate stop-loss coverages; however, for a small operation stop-loss would probably be prohibitively expensive.

Regulatory Constraints

We have covered one already. All I can do is offer a few other examples that we have seen. Oftentimes you will see that countries have set up their own government monopoly and require all companies to reinsure a portion of their business with this company. The reinsurers that have operated in the market know how to deal with this government monopoly, and they may be able to help you or coach you in dealing with them. You may find that the reinsurer can even manage the administration and effectively retrocede the required risks to this company thus gaining some efficiencies in your operation. Oftentimes, countries will establish tight foreign exchange control; these governments do not want assets leaving the country. If you are dealing with a reinsurer that is not domiciled in the country in which you are now operating, you should consider modified co-insurance or risk premium revenues as the method of reinsurance.

Internal Retrocession

We will go back to our example. You have a home office with a retention of $1 million. Let's say the retention for this overseas operation is $50,000; that is as much of a claim as they can take at any one time. From the home office perspective, they are losing a great deal of value in reinsuring risks above $50,000. The most direct way to capture this value is to have the home office act as a reinsurer; however, their operations may not be able to support this activity. One solution would be to go to your reinsurer of choice, take advantage of the services (the value-added services that they are already offering), and customize to that market. When you talk to them about reinsurance, talk to them about retrocession as well, and have at least a portion of that excess risk brought back into the home office. At least this way the home office can capture some of the value created by the overseas operation.

To close, I would like to return to my example. You have set up a new operation and you have probably lowered your retention. If you have bought reinsurance you should have purchased reinsurance in a way that your volatility and exposures would have been reduced to more manageable levels. You may even have been able to leverage your results through arbitrage, so the risks retained are giving you better returns. Your reinsurer should help you understand the risks that you are writing and they should help you manage your risks better through training. All this leads to a closer relationship with your reinsurer than you currently have in the home office.

You have to remember one thing when dealing with these reinsurers; they are placing some fairly big bets on the growth of these small operations and they are going to put forth time and effort to make these companies successful. So work with them to help manage this aspect of your operation.

Mr. Moore: I have some results from a survey recently conducted at Ernst & Young on multinational financial reporting and management processes. A number of these results were interesting to me and I thought they would be of interest here.

This first issue addresses the management level that determines exchange rates. For consolidated reporting in the U.S., they are almost always determined at corporate headquarters (80% of the time). The next issue is judgmental reserves for local statutory reporting. Survey respondents (74%) overwhelmingly require corporate approval even though they are local books.

Can a local basis financial report be issued without corporate approval? Generally, yes. That is consistent with my experience.

Moving on to consolidation reporting issues, how is the reporting package submitted to the corporate office? For over half of the companies, 58%, a computer diskette file or tape is the method. For most others some combination of manual, computer file, or a hard copy of the system printout is used.

How are the financial statements that are sent to corporate prepared? In these companies, 95% of them had the statements prepared under U.S. GAAP. My guess would be that for a life insurance company, you would find a smaller percentage because it is difficult to train the local people to understand all the nuances of GAAP.

Is there reconciliation from local statutory to U.S. GAAP? Seventy percent of the companies said yes. That reconciliation is done by the reporting staff in the local operation.

Are reconciling items that have significant differences between local statutory and GAAP approved by corporate prior to filing the statutory report? Most of the people say no, but 37% do require that reconciliation before filing the local reports.

The period of time to close the books was the next issue. For the monthly and quarterly reports, the most frequent response is five to seven days.

What level of management determines how local books are maintained? Local management makes that determination in about a third of all cases, and about a third have standard, worldwide company-wide systems.

Monitoring compliance is next. Almost half the companies have an internal audit at least every three years. In my experience that would be typical, but it would be more frequent in the early years of operation.

Approval processes for hiring local accounting management and financial management people is the next area. Seventy-eight percent of the people require background investigations. Sixty-three percent of the respondents required corporate approval.

Is there a written policy defining financial accounting and tax responsibilities for the company for foreign joint ventures? Fifty-nine percent of the companies responded yes. Does local management enter into foreign currency forward or through option contracts? While over half the companies said yes, for significant transactions, 96% of the companies require corporate approval. So that activity is largely guided by the corporate office.

Similarly, tax planning is largely guided by corporate or a combination of corporate and local. That reflects the comments that Jim made, in the bottom line you have to consider both foreign and U.S. implications. In many cases, the U.S. tax rules may dominate.

What level of management looks at tax compliance and reporting? For most types of taxes, it is largely local management that looks at payroll taxes. For income taxes, there is a greater role for the corporate headquarters.

Does the corporate office review local tax returns before they are filed? Mostly no, but 22% do require that review.

Finally, what level of management determines the income tax provision to be reported on the foreign books? The two most frequently used approaches are corporate and a combination of corporate and local.

Those were some of the issues dealt with. You can see in all these issues that there is a wide range of practice, but it is interesting that for many issues like tax reporting and foreign exchange management, a fairly consistent practice exists across a number of different industries and organizations.

Let me make an observation provided by Virgil Wagner, who works for Aegon in the Netherlands. He points out that Mark has shown a number of problems and interpretation issues that arise for U.S. GAAP in foreign operations. In his company, they have all the types of products that Mark covered. Because they are a New-York-Stock-Exchange-listed company, they must convert to GAAP to make SEC filings. He observes that this could create a growing need for U.S. actuaries, as more and more companies look to U.S. basis GAAP advice when trying to raise capital in our markets.

Mr. R. Thomas Herget: Mark, you did a fine job of going through every FAS and SOP that I can recollect about how to report earnings, but it did inspire one question. Some foreign countries do have a restriction on the amount of earnings that can go back to stockholders—or to a parent, say, in the U.S. Is there any type of liability established for earnings that could not come back to the U.S.?

Mr. Freedman: Tom, the only thing I have seen that is similar to what you are talking about is the U.K. example I gave. There is effectively a minority interest liability, given that there is a stockholder fund and a policyholder fund because of the restriction in movements from the policyholder fund to the stockholder fund.

Mr. Daniel J. Kunesh: Mark, I also very much appreciated your comments on the difficulties in overseas compliance with U.S. GAAP. Just a comment and then a question.

I find that *FAS 60* is oftentimes a very difficult accounting methodology to apply for two reasons. Ordinarily, you cannot build a history to come up with assumptions. Overseas companies have very poor databases and oftentimes you just cannot build a history. You are in the dark, and to the extent it is with-profit business, it is almost better to find reasons to stretch the rules ever so slightly to apply the *SOP 95-1.* This is because the statutory reserves may be able to be used as a proxy for GAAP reserves, so half of the job is done. The DAC is computed by simply looking at the margins, which are much easier to predict, although the historical true-ups are difficult. The second thing in *FAS 60* is that most foreign entities do not have a dividend scale at issue. They have reversionary bonuses that are determined on a year-by-year basis, based on investment returns. That also makes it difficult. You have to make some judgments as to what those returns are.

My question is that many countries have an investment income minus expense taxing structure. What have you seen or what do you do in these cases in terms of before-tax or after-tax assumptions?

Mr. Freedman: Theoretically, if you do consider it an income tax, you should use the pretax interest rate, although that can be a big issue in terms of some products, for instance, the unit-linked product in the U.K. I think GAAP does read that way.

I have seen some arguments that say you should look at it after the tax, because you do withhold the amount from the policyholder. I think the only way you would get to that answer would be to argue that the tax is not an income tax, but it is more of a premium-type tax. Then, it could somehow be classified as a maintenance-type expense.