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Offshore Reinsurance

Track: Financial Reporting/Reinsurance

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Summary: This session focuses on the advantages and practical applications of offshore reinsurance. Topics include:

- *Types of reinsurance*
- *Brief history of the development of the offshore market*
- *Tax and regulatory advantages*
- *Number of reinsurers and size of market*
- *Risks that offshore reinsurance can best address*
- *Financial reinsurance arrangements*
- *Impact of Regulation XXX on demand and price*
- *Regulatory considerations*
- *Details of the use of letters of credit*

Mr. Michael E. Gabon: To start things off, I'll give an overview of the market including some statistics on market size. Bob DeMarco will then give the perspective of the ceding company. Following Bob will be Hugh McCormick, covering legal and tax issues. Finally, Gordon Rowell will provide us with an offshore regulator's perspective.

In terms of the statistics, offshore market considers annuity, life, and A&H business within a life reinsurance entity. A&H business written by property and casualty reinsurers was excluded. Just as a point of information, of the life and A&H business, combined life reinsurance was 77% in 1998 and grew to 87% in 1999. These percentages are based on reserve credit.

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In terms of annuity reinsurance market, from 1995 to 1998, the market has grown from about $30 billion to $42 billion. In 1999 there is little growth from 1998 that may be due to a few transactions that didn't close. That should give you an idea of the size of the market and an indication of the trend.

Turning to the life side, the first notable item is that almost all the transactions were coinsurance. The second item to note is that the reserve credit taken grew from $700 million in 1998 to $2.7 billion in 1999. Part of this increase is due to the entry into the offshore market of reinsurers domiciled offshore, and there are some onshore reinsurers making more extensive use of offshore reinsurance.

You might be wondering, just where are these offshore companies domiciled? Barbados is at the top for 1998 and 1999, followed by Bermuda for both 1998 and 1999. The third to fifth positions changed in 1999. Ireland became more popular. There were a couple of large transactions done in Ireland, so the rankings could fluctuate from year to year, depending upon one or two transactions, if they are significantly large. The Cayman Islands moved to the fourth position in 1999 primarily due to one of the new entrants domiciled offshore, Scottish Annuity and Life.

Last, one of the concerns we hear from ceding companies is the security of dealing with an offshore reinsurer. Here are a few of the security mechanisms and the extent to which they are used: letters of credit (LOCs), trust agreements, and funds withheld. This leads us into Bob's talk on the ceding company's perspective.

Mr. Robert DeMarco: You may wonder why someone who works for a reinsurance company is telling you about the ceding company's perspective for offshore reinsurance. Quite simply, reinsurers have been availing themselves of offshore reinsurance facilities for decades. I work for a domestic U.S. reinsurer, yet we see offshore as part of our normal course of business.

I'm going to handle this at a very high level and then Hugh and Gordon will take you into some detail.

Recently, direct companies have started to cede there too and now have a lot of questions. There are three basic areas that to be concerned with when you cede offshore: regulatory, tax, and due diligence.

What I mean by regulatory, is U.S. regulatory. What are the issues? What are your concerns? What are your risks? The biggest one that should come to mind is the reserve credit. How are you going to get credit for the reinsurance you ceded offshore? They are alien reinsurers, and under the rules, you're not entitled to take a reserve credit unless it's secured.

Offshore reinsurers and domestics ceding offshore have a number of options to secure reserve credit. The two most common that Mike mentioned are LOCs and reserve credit trusts (RCTs).

The NAIC Model Act provides explicit guidelines on how these need to be established and what their terms need to be. The NAIC has taken a lot of the guesswork out of this. Ten years ago there was a lot of debate over what was a qualified security.

I'll briefly run through what an LOC is, how it works, and what the concerns are. The Medici banks in Italy did the first letters of credit in the 15th and 16th centuries. They are virtually unchanged from that time. It was a mechanism for merchants going from one city to another to be able to bring assets/cash with them without having to actually carry the gold and silver, which was risky. The actual letters of credit that were written then look exactly like the letters of credit that we use today. It is a one-page letter. In fact, in the NAIC Model Act, there is a sample that you can utilize. It basically says that the issuing bank (the issuer) will make funds in cash available to the beneficiary, (the domestic U.S. ceder) upon demand in so many dollars, whatever the notional amount is.

The grantor of the LOC is the offshore reinsurer you've done business with. Why would a bank do this? I mean, this is dead silly, unless somebody is securing the LOC. Many years ago there were unsecured letters of credit, but they are really not in vogue, and haven't been used for a long time. Today, all letters of credit are almost always secured.

The guarantor is the company that guarantees to the bank that should the LOC be drawn on, they will make the bank whole. And by the way, that can be anybody. It does not have to be the grantor, which in our case would be the offshore reinsurer. It could be anybody else. They could pay somebody to do it: a parent, an affiliate, or non-affiliate. The bank doesn't care, as long as the person who is securing the LOC is credit-worthy and can make good if they need it.

The LOC is evergreen. Evergreen simply means that the beneficiary, in this case, our U.S. ceder, can pull the LOC at any time for any reason. There need not be a default on the reinsurance agreement for the beneficiary to pull the LOC. That's what everybody needs.

For a lot of reasons letters of credit are generally only done in one-year durations. That means the bank can withdraw at any time after a year. Then you may be in a position of then having to find a new LOC and/or the price may go up.

RCT trusts are a better solution in many instances. The reinsurance agreement that you will enter into, for all intents and purposes, will usually be a very long-term agreement.

RTC trusts are simply assets that meet NAIC requirements; usually they have to be securities valuation office (SVO) valued. You, as the ceder, would want some say in the quality of the assets that go into that trust. You, as the ceder, would probably be more restrictive than the NAIC Model Act is. It's simply a trust with the bank where the assets go in as nominee-named, for the benefit of the U.S. ceder. The assets belong to the offshore reinsurer. They may be bought and sold by the offshore reinsurer and stay on the offshore reinsurer's balance sheet.

There is no liability attached. The fees the bank charges for trust funds are way below those for the LOC. They can be de minimus in some instances, depending on your banking relationships, but even when you're paying basis points, the fees are way below LOC costs. The nice thing about it is even under the NAIC Model Act, RTC trusts can be somewhat restricted to pay only upon default of the reinsurer.

It also has little glitches in it. One of the things in the NAIC Model Act, and the reason I keep referring to that is because as each state adopts this, there can be little tweaks in here, so I'm staying with just the Model Act. You should refer to your own laws in your own states before you do anything. But the NAIC Model Act does allow for book value assets to go into these trusts, but require you to hold 102% of the book value.

I'm on your side. I'm a ceder. I want market-value assets. I want that trust marked-to-market, at least quarterly. Because when I pull, I want cash, and so should you.

The next issue that you're going to run into with U.S. regulators is mirror reserving. New York has mirror-reserving rules, and I think Texas has adopted some form of it. The reality is that you are reserving, and here we go, I'm going to get a big uproar, because their reserving for proportional reinsurance has always been there. Nobody likes to hear this; nobody likes to believe it. But in an informal poll of 38 states, when asked, if they believe, under coinsurance or modified coinsurance (modco) proportional, if the reinsured reserves are equal to the reserve credit taken by the ceder, they will tell you yes. This is not in regulation. Quite frankly, the regulators don't think they have to. They think it's a foregone conclusion that is the right result.

So, mirror reserving is already around. It may be just stored right now, but sooner or later, as regulators worry about whether we are handling this correctly, they will formalize it. Anybody who thinks they are going to get away with mirror reserving is fooling themselves in the long term. I'm not talking about what you can do today or tomorrow, but about long-term transactions. Be prepared to do mirror reserving.

What does that mean to the offshore company? It means they have to secure the entire statutory reserve. They have to, anyway, for you to take a reserve credit.

There is no real issue to the offshore reinsurer. Because, quite frankly, when they get done with their accounting, they run on a different reserve methodology. The fact that they put the reserve up on their books does not negate their ability to offset that reserve. It is not an issue.

The next thing you need to be concerned about is, as more and more business goes offshore, what might be the potential U.S. regulatory backlashes, and how might you get caught in that? If you have used prudence, thought your deals through, and have done them correctly with proper security, there should be no U.S. regulatory backlash. Because the security you obtain is better than the security you obtain from a domestic reinsurer.

If you stop and think about it, when you take a reserve credit with a domestic reinsurer, you simply have the full faith and credit of that domestic reinsurer supporting the reserve credit you've taken. Fine. They are AAA rated; they have billions of dollars of surplus. We have seen what can happen to surplus in any company. We have seen how events can change a company's rating from A to BB overnight.

When you have security offshore, you actually have an LOC from a non-correlated risk, a bank. When assets are put in trusts, as long as you use good prudence in establishing those trusts, you have assets available at market to fund your reserve. You actually have better security offshore than you have onshore if you do it right, you're thorough, and you've checked out the issues.

The next major area you need to be concerned about is tax. Excise tax is, of course, the first one that comes to mind. Again, I'm only going to touch on these things briefly, because we have an expert on our panel. Excise tax is based on premium. It's 1% of the reinsurance premium ceded offshore. Over the years there have been a number of issues bubbling up around excise tax, so it's not a slam-dunk. It's not like a blinding clear light in the tax law. One of the issues that bubbled up years ago was whether modco premiums were excise-taxable on the initial reserve transfer. Are co-funds withheld premiums, on the initial funds transfer, excise-taxable?

We currently had another issue bubble up, on coinsurance. You have a gross premium and then an allowance. That results in a net premium to the reinsurer. Which is the excise tax? Is it on the gross reinsurance premium as stated in the treaty or the net reinsurance premium that is net of the commission?

The Internal Revenue Service (IRS) has always been vague. It would like us to believe it is on the gross premium. There are a number of offshore companies that don't follow that currently and are prepared to take that case. I will tell you it is wrong. There is no doubt about what the right answer should be, but the IRS isn't about correctness, it's about raising revenue.

Given the current state of affairs with some domestic companies worried about the transition to the offshore reinsurance world, and it's probably about some tax issues, you can bet that excise tax will be in the forefront for quite a while.

The ceding company is liable for the excise tax to the U.S. Government. You can have your reinsurer pay that for you. It can agree to do it, file the return, and pay it. But, when push comes to shove, the IRS is not going to go after the offshore reinsurer for its excise tax. It will be coming after you. You have to make sure that this is covered in your treaty, and that you get property security to make sure that, if the offshore company fails to pay the excise tax or is delinquent, that if you get in trouble with the IRS, you have recourse.

The next issue is about people trying to use their own offshore facilities for a lot of reasons. One of the things you should be aware of, and I am just mentioning this in passing, is under the consolidated rules, even if your offshore subsidiary consolidates with you on a life-to-life consolidation, losses of the 953(d) company are not consolidatable. You can only offset income of the 953(d) company.

Income of the 953(d) company could be consolidated and then offset by losses of the U.S. taxpayer. For those who don't know, 953(d) is the section of the Internal Revenue Code that allows a company to elect to become a U.S. taxpayer. Any company can be a U.S. taxpayer. And that, of course, waives the excise tax.

Right off the bat, and that's why I mentioned this, if you are doing business with an offshore that has elected 953(d), excise tax is not a concern because there is none. Also, there are certain countries that have what we call tax treaties with the U.S., which under their terms may waive the excise tax. Probably the most notable is the Romanian one because there is so much business going out to Romania. However, there are a number of countries that you will probably come across.

The last issue that I want to touch on is due diligence. Due diligence is a real concern now. You are dealing with an offshore entity, which is not subject to U.S. regulatory issues. Gordon will tell you about what the regulatory environment is like offshore. I think Gordon will do a great job of convincing you that it is not the highway to making money disappear that we probably all thought it was.

Regulatory environments offshore have stiffened significantly. Bermuda, Cayman, and Barbados, are three of the larger jurisdictions, with established companies. In fact, I saw a statistic recently that Bermuda has more insurance companies than life insurance companies in the U.S. Bermuda, Cayman, and Barbados have stiffened up their regulations quite a bit. They always regulated, but they promulgated some stuff to reassure you, the ceder, that this isn't some loosey-goosey jurisdiction where you can do anything you want.

The thing about offshore, and why it has become very important in recent years, is that the regulatory environment is rational offshore. In deference to my friends in the U.S. regulatory area, we have never had rational regulation in the U.S.; it's solvency regulation. Cayman and Bermuda use rational regulation, which is very similar to what you would see in England, Canada, and U.S. GAAP.

You're going to go offshore, how do you do due diligence? Reinsurance is a long-term contract. You must be worried that your reinsurer will be there 5–20 years down the road. That's a due diligence burden. Due diligence is good for about two to three years because things change. How are you going to manage it? One of the things that you should take some comfort in is the regulatory environment that is offshore. Second, pay a trip out to your offshore reinsurer in Cayman to see their facilities. Do they have an office? Are there people in it? I cannot tell you how many times that would have saved somebody a ton of money because there were no people in the office. Most offshore reinsurers will provide audited U.S. GAAP financials today. In reality, they don't have to. But they know, as well as you do, if they don't provide you with U.S. GAAP audited financials, you're not going to feel very comfortable ceding to them. After all, they are in business if the are legitimate.

I think it is important to ask about an offshore company's pricing. If the response is, "Whatever it is you want to do," they are pricing at the normal rates, less 20%. "Well, excuse me, how are you doing this?" The pricing philosophy of your offshore should be of interest to you because if it is going to be around long-term, you might want to know how it is giving that kind of discount. When you can't get that same price onshore, and it is giving it to you offshore, how it is doing it matters to you, and you have a right to know that. If it is doing it with smoke and mirrors, it is not going to be there long-term. But if it uses sound actuarial approaches to what it is doing, it is using capital advantages that it is getting offshore; it should be able to explain that to you rationally and succinctly. And if it can't, your antennas should be going up.

Hugh will now talk more about the tax issues.

Mr. Hugh T. McCormick: I'm a partner at the New York International law firm of LeBoeuf, Lamb, Greene, & MacRae. We are, as many of you are aware, very active in the insurance business and have been for many years. We have 100 of our 750 lawyers spend a significant amount of their time on insurance matters. We're talking about current regulatory tax issues affecting offshore reinsurance. We're going to do this from a Romanian perspective. We're going to touch a little bit on current U.S. legislative proposals that might affect insurance and reinsurance companies in the offshore market. We'll talk about what I call miscellaneous tax issues. We will touch on the excise tax, trends in taxation, and things that I think will affect the domestic life insurance industry, and of necessity then affect the offshore reinsurance industry. Then we'll move on and we'll talk about some of the regulatory concerns that Bob mentioned.

The U.S. domestic life insurance industry, at least according to the industry, is more heavily taxed than other U.S. domestic industries. In the Clinton's administration's 2001 budget proposal, there was a provision that would have imposed an even higher tax on life insurance companies operating in the U.S. market. In essence there was going to be a taxation of the Phase 3 accounts, the old stock companies, and then more importantly, increases in the deferred acquisition cost (DAC) tax on life insurance companies.

It is generally accepted that the President's budget proposals were dead on arrival on the day they were floated. But I think it's something that people need to keep their eye on. The fact that the administration keeps proposing tax increases on the life insurance industry is something you just have to be watching out for because sooner or later, the administration does get its way.

The high taxation of the life insurance industry or the insurance industry, generally, has led to people to look to the offshore market—what a number of people refer to as the offshore advantage. Reinsurers operating outside of the U.S. or out of other high-tax jurisdictions such as the U.K. can offer reinsurance on an advantageous basis.

As Bob mentioned earlier, outbound reinsurance draws a 1% federal excise tax (FET) and provides no DAC tax benefit; although there is no FET and there is a DAC tax benefit if the offshore company is a 953(d) electing company. But if it is not, there is an excise tax and no DAC tax benefit. Nonetheless, there are pricing benefits operating in a corporate tax-free environment. That would be true of most of the standard offshore jurisdictions, Bermuda, Cayman, Isle of Man, and the Channel Islands.

It is not completely true in Ireland, but there is the International Financial Services Center (IFSC) in Dublin where there is, I believe, a 10% or 11% corporate tax rate imposed. You can even operate in the Dublin IFSC on a tax-advantage basis, and have access to the European Economic Community because Ireland is part of the European community.

The offshore tax advantage has led to what is called in Washington, at least by some, myself included, the Bermuda Triangle problem; the disappearance of taxes into the Bermuda Triangle. The domestic property casualty industry has seen the migration of members of the domestic industry to Bermuda to take advantage of what the newspapers call the newest loophole in the tax law: the fact that the Bermuda insurers and other offshore insurers do not pay corporate taxes. Why they call this a new loophole is a little bit of a mystery to me. It's been there since as long as the island of Bermuda has been there or at least as long as there has been an income tax. But the newspapers do need a hook, and they like that one.

What the property casualty companies have been doing is setting up situations where they write business onshore, and then turn around and reinsure under

various kinds of automatic arrangements to an offshore parent. The net advantage, supposedly, and I believe that it is true, is that the onshore insurance, pricing is advantageous by reinsuring offshore into a tax-free environment. You can compete by selling in a direct property casualty market on a better pricing basis than you can in a completely domestic operation.

In response to this, domestic companies, in particular Chubb and Hartford, led the way, and they were joined a number of domestic property casualty companies, and approached the Treasury and Capitol Hill to request remedial legislation. There is draft legislation that has been circulated that would add a layer of tax on the U.S. affiliates of the offshore companies that cede at risk to a related offshore reinsurer.

The legislative proposal is phrased as a further amendment to Section 845 of the IRC, which, as many of you are aware, allows the IRS to reallocate income between related and unrelated ceding insurers and reinsurers. The proposal would create taxable income in the hands of the ceding domestic company. The taxable income would be a tax on notional income on the reserves that were ceded to the offshore affiliates.

The draft that has been circulated thus far is phrased in terms of property casualty tax rules. It does not, by its own terms, apply to life insurance companies. There is some question whether this legislation is going any place. There is a lot of interest in pushing the property casualty industry. There does not appear to be so much interest in the legislature. The reception on Capitol Hill thus far has been mixed, at best, and it is not at all clear that this legislation is going any place. But, if it does, I would expect to see that, life insurance would get picked up as well, because I can't think of any policy reason why, if legislation of this nature is passed, it would not cover both life and property and casualty companies, even though the life side history has not been particularly active in this area.

Actually, Gordon mentioned to me earlier that there might be some developments in terms of some of the offshore jurisdictions, their status as tax havens, and whether there might be some elimination of advantageous tax rules for companies that operate in the offshore jurisdictions. Frankly, I don't know enough about it. Gordon might be able to fill us in on the details.

Bob mentioned the reinsurance trust. In New York it is referred to as Regulation (Reg) 114 Trust: trusts that are established for credit for reinsurance purposes. There is a NAIC Model Act analog that is very similar to New York Reg 114. There are some differences, but they are not significant.

If, as Bob said, a reinsurance treaty is not structured as coinsurance funds withheld or modified coinsurance, the assuming reinsurer will post an LOC or fund the trust. It has been generally accepted that the trusts are grantor trusts under U.S. tax law. Grantor trusts pass through the income and gains of the trust to the

offshore reinsurer responsible for establishing the trust. The way that you eliminate any U.S. tax liability for the offshore insurance company is to fund the trust with assets that are not subject to the U.S. 30% withholding tax.

Typically, what you fund the trust with will be portfolio debt instruments. There is a special exception under the U.S. tax law. For those of you who are not familiar with it, for non-resident individuals and foreign corporations not doing business in the U.S., there is a 30% withholding tax on certain forms of what you might call passive income, such as dividends, rents, interest royalties, things of that nature. There is a subset of special rules for the 30% withholding tax that exempts portfolio debt from the withholding tax.

When you use one of these Reg 114 trusts that are funded for offshore insurance companies to maintain the tax advantage, you fund them with the portfolio debt instruments. The IRS issued regulations a year or so ago that seemed to recognize that these Reg 114 trusts were grantor trusts for the benefit of the foreign insurance company. However, we ran into a situation recently with one of the Big Five accounting firms—they were not willing to sign off on an opinion stating that was the correct result. That's something you might watch out for. It is the correct result. I will tell you that the Big-Five accounting firms are simply wrong, but it did become an issue in a transaction that I was involved in.

At a meeting a couple of weeks ago in Washington, someone was talking about modco and funds withheld treaties. One of the IRS people started speculating, "Well, if you have a modco that pays a modco interest rate to the credit, to the benefit of the offshore reinsurer, or funds a withheld treaty that pays a notional interest rate on the withheld funds to the offshore reinsurer, isn't that subject to the 30% withholding tax?"

My reaction to that is, on the funds withheld treaty; it's probably a good argument. You do have a 30% withholding tax issue, because the ceding company holds funds for the benefit, at least the notional benefit of the reinsurer and promises to pay what is usually denominated as interest. I would think that does raise a 30% withholding tax issue. When you look at the form of the funds withheld treaties that you do, think about trying to design the arrangement so that the treaty can take advantage of the portfolio debt rules. We have looked at that, and we believe it can be done, but it is something to think about.

On the other hand, with a modco treaty, where just the modco interest rate goes into the netting of the various reserve credits back and forth, and all the things that go into a net number, I would argue much more strongly that there is non-interest subject to 30% withholding. But I can't tell you with total certainty that the IRS couldn't actually succeed on that issue. It's something that merits thought, and it probably can be addressed in the treaty drafting by including wording that you would put into a traditional debt instrument to make it eligible for the portfolio interest exception. It is something to keep an eye on.

Bob mentioned the federal excise tax. He is correct; it is 1% on reinsurance. It's 4% on direct non-life business and 1% on direct annuity, life, and health business. The federal excise tax looks to the origin of the risk. For reinsurance that relates to risks on life or health on a U.S. citizen or resident, the tax is due. Now this gets a little interesting when you're dealing with people, for example, U.S. citizens who have been residing in Europe for the last 40 years. If someone sells a policy to a U.S. citizen in permanent residence in Europe, is the FET due? The answer is technically, yes.

There are regulations that impose the tax on the U.S. person who pays the premiums and regulations focus on the U.S. person. The regulations do not, however, track more recent legislative changes. The legislative changes make it clear that the taxes are imposed on the transaction, and any U.S. person who is involved, for whose benefit the reinsurance or insurance is placed or is involved in the transaction, is theoretically liable for the tax.

It really means various people in a chain of insurance and reinsurance could be liable for the FET. Bob is absolutely correct when he says that the IRS will go for the U.S. person that last had the premium in his or her hands obviously because that's the easiest port of collection. But the IRS reserves the right to go after offshore companies, and to the extent that the offshore companies have assets or affiliates in the U.S., there could be a point of collection.

This leads to an interesting view of the IRS—that there is a cascading tax. The cascading tax is if a U.S. company cedes a U.S. risk to a foreign insurer, a 1% tax is due. If the foreign insurer retrocedes to another foreign insurer, the IRS will tell you, that a second tax is due. And, if it is re-retroceded to a third reinsurer, there is yet another tax due. This is an official IRS position; the IRS has stated it in writing.

There are just enormous collectibility issues, there are basic legal issues, such as, what authority does the IRS have over an offshore insurer that otherwise has no contact with the U.S.? From a practical point of view, it is an almost silly view. But it's not the first time that the IRS has taken a view that people describe as silly, it firmly believes it.

Many tax treaties do contain excise tax waivers. The U.K. and Romanian treaties are what you call an unqualified waiver. If the risk goes into the U.K., the treaty doesn't attempt to trace the risk out of the U.K. The excise tax is waived once the risk goes into the U.K. If it leaves the U.K., the IRS might try to argue that there is some kind of cascading tax issue. But the U.S. person who ceded the risk has sent the risk to a U.K. reinsurer. There is no excise tax.

There are other treaties; the French treaty comes to mind immediately. The more modern treaties actually have a rule that the excise tax is waived as long as the risk resides in a country with an excise tax waiver in the treaty. Therefore, unlike

England, if the risk goes to France and then goes to the Ukraine, the excise tax would in fact become due.

When the risk is retroceded out of France, and most of the modern treaties—the Swiss, German, and Dutch—have this tracing of the risk rule. You do have to be thoughtful of the change of retrocessions in and out of treaty countries. The IRS has implemented procedures whereby they have the offshore, the treaty, the companies that are looking for the treaty benefits on the excise tax entered closing agreements, where they agreed to pay the tax if in fact there is a retrocession to a non-treaty company.

As I mentioned in the offshore market, Barbados and Bermuda do have treaties that contain excise tax waivers, but both treaties were overwritten by legislation, therefore, they don't have treaties.

I have been very involved in an issue in the offshore market for annuities issued by foreign insurance companies to U.S. taxpayers. An issue first cropped up concerning the Black Feet Bank in Browning, Montana. A bank decided to manufacture and distribute annuities four or five years ago. It led to the issuance of regulations that brought non-insurance company annuities under what is known as the original-issue discount (OID) rules, which are basically the rules that apply to zero-coupon bonds that forces individuals to accrue interest, even though they are not normally accrual-basis taxpayers.

There is a rule in the code that appears to state that annuities issued by offshore life insurance companies are also subject to the OID rules simply by virtue of the fact that they are offshore life insurance companies. This issue is on the Treasury's 2000 Business Plan to be addressed and resolved by regulation. I visited the Treasury last week with some other people, talked to them about these regulations, and pointed out that there are probably violations of some of the trade agreements that the U.S. has entered into over the last four or five years.

That is an issue that we are going to be watching very carefully, but it is of great interest to people who are operating in the offshore market, because there are a lot of people who would like to issue very high big-ticket variable annuities. And they prefer not to issue variable life products, because they don't want to get into the mortality issues and all of the reinsurance issues that are necessitated by huge life insurance contracts. They really like these $40-50 million variable annuity policies. But right now, there's some question about whether it is safe to do that in the offshore market when you're dealing with U.S. taxpayers.

A couple of issues that relate more to direct business, but could conceivably have a bearing on reinsurance; again going back to the Administration's 2001 Budget Proposal, which would require reporting of payments of $10,000 or more to identities in identified tax havens. I understand that the list of identified tax havens does not exist yet, but I would think that it would start with the usual

suspects. I understand that the usual suspects within the last few days are beginning to shrink as the various international lobbying forces are going to work. Bermuda, Cayman, or the Isle of Man are not really tax havens. This is going to be an interesting thing to watch. The European Economic Community has their list of tax havens. The Treasury Department will start developing its list of tax havens, and then we have to figure out what it will do with these tax havens, and whether it will eventually take away the offshore tax advantage with which I opened this whole talk.

On individual business, the proposal would require reporting by domestic companies, what they call private separate accounts. Private separate accounts, for those of you in the life business, are separate accounts that are specifically set up for a small number of life insurance contracts. This is very commonly done in the offshore market.

I think what we see in the President's proposed Budget Bill about private separate accounts is kind of the nose under the tent. The IRS is going after variable products more aggressively, looking at private separate accounts and investor-control issues, for those of you who deal in the variable contract world. The Treasury is beginning to become aware of some of this high net worth life insurance business that is going out in the offshore market.

There are a couple of trends I see which are important. The inside build-up appears safe. The domestic life insurance industry is built around death and taxes. Death is not going away, although I know there are people working on that. Life insurance companies continue to be tax-favored. That, I think, is a very positive development. The inside build-up has been attacked on Capitol Hill the last couple of years, but for the moment, it appears safe.

There is a proposal floating around Washington right now that is building steam to repeal the federal estate tax. For a handful of conservative senators and congressmen, it began as their pet issue, but it has caught on, much to everybody's surprise. Over the last couple of weeks, it has turned into something that may actually be given to the President for signature. It's not clear yet, but it may actually go that far. And I have read that there may be enough votes on Capitol Hill to override a veto. President Clinton has said he would veto an estate tax repeal.

Why is that important in this group? Stop and think about how much life insurance is sold to fund estate plans. I would guess most of it. You all have a better sense of that than I do. But the repeal of the federal estate tax, I would think, could be potentially devastating to the American life insurance industry.

Employee benefits going global is just a trend that we have begun to see. As Bob said, the regulators in the U.S. have become concerned about offshore reinsurance because there have been a number of failures of offshore property casualty

reinsurers. But as Bob also said, the credit for reinsurance rules really has kept the regulators somewhat at bay. The fact that money is in trust or in other forms of secure vehicles for the benefit of the ceding insurer, the entrepreneur-ceding insurer, at least on the life side of the industry, has kept the regulators reasonably comfortable.

The NAIC has revived the NAIC Reinsurance Task Force with the usual major states behind it: New York, California, Illinois, and so forth. Thus far, their focus on offshore reinsurance has been, again, on the property casualty side. They have been looking at the Lloyd's trust fund and the major trust funds that some of the offshore property casualty companies maintain in the U.S. I'm not aware of any issues in this new task force or on the life side of the industry at this point.

One of the regulatory issues that has been interesting, and I think for offshore reinsurance, will assume a more important part of the scene, is the use of the Internet, the use of electronic means of transacting business. For direct insurance companies and direct writers, this is going to be more of a problem, because more states appear to be taking the view that the use of the Internet is similar to the use of the mail. And using the mail to do business in the U.S. is regulated in all 50 states because it is a form of doing business in the state. The place of delivery of something that is dropped in the mailbox in Cayman and delivered in New York, according to New York and all of the states, is New York. If you try to do business through the mail in New York, you need to be licensed. The states seem to be leaning towards the idea that some of the same issues will arise with respect to the Internet.

Offshore reinsurers, by and large, are not required to be licensed under the insurance laws of most states. There are a handful. New York does require a license, although all of their reinsurers do business through the mail. But most states just simply waive the licensing requirements for reinsurers. As a ceding insurer, you're not going to get arrested for aiding and abetting offshore reinsurance and doing illegal insurance business.

Triple X Reserves is more your bailiwick than mine, but we've had a number of transactions brought to us to look at involving different ways to disappear Triple X reserves into Bermuda or some of the other markets. The mirror reserving rules do apply; you cannot dump reserves in a Triple X kind of reinsurance setting.

I understand the offshore companies can set up assets against the liabilities that U.S. companies cannot, and thereby have advantages, and can do things that you cannot do, by reinsuring with U.S. domestics. It's not on the liability side that you can do interesting things, because of the mirror reserving rules. It's on the asset side.

A number of years ago, we looked at various securitization proposals. I was involved in working with the Chicago Board of Trade on the original insurance

futures contracts, which you remember, was catastrophe futures, hurricane coverage and that kind of thing. But it originally tried to develop a health insurance contract, or a health insurance futures contract. It never got to market because the catastrophe futures contract went to market and didn't work. Work was dropped on the health insurance futures market. But there is an interest in securities, various forms of securitization, or alternative risk transfer mechanisms for life insurance-type products.

Some of the issues from a legal perspective that we've run into is the question of whether the capital markets are doing an insurance business. Is the risk transfer that they are engaging in through securitization vehicles a form of doing an insurance business? Generally, the answer has turned out to be "no," but it is an issue that one has to think about from time to time, when looking at securitization deals.

How does an insurer account for capital markets transactions? To make reinsurance accounting work, in a lot of these securitization transactions, people are looking for offsets to reserves or losses, and the question really is whether you get the treatment that you want. For the insurance futures contract, we actually got statutory accounting treatment that was not exactly the same as reinsurance accounting, but profits under the futures contracts were used to reduce underwriting losses. Therefore, at the end of the day, you got the treatment you were looking for.

I did recently attend a presentation by an academic actuary and an investment banker, both of whom were looking at securitization issues. The actuarial professor at the University of Waterloo in Canada, thought that life insurance securitizations were possible; the investment banker stood up and said, "That's all very interesting, but I can't sell it." That's kind of the bottom line when you're dealing with bankers.

Gordon will talk about offshore regulatory issues.

Mr. Gordon Rowell: I'm going to divide this talk up into a couple of topics. First, a little bit of history about offshore insurance. Let's talk about how we regulate offshore insurance, and then some international issues that have come to the forefront the last couple of years, including money laundering and those kinds of issues.

I want to give you a broad understanding about how the offshore market works. Let's start with a definition of what a captive is. Briefly, a captive is an alternative risk vehicle that organizations self-insure. These can be any organizations, generally speaking. They are not really insurance companies, they tend to be just organizations with significant risk exposures.

The development of Cayman has been of long-tail-type liability lines. A typical captive retains the predictable working layer of losses, and cedes out or retros, the excess to a traditional reinsurer. Generally, a captive program will only be successful if an organization has a better-than-average loss history, compared to the regular market. This whole development over the last 20 years has led to quite a substantial number of companies in Cayman.

The reason I am telling you this is not because I want you to find out about captives, because the offshore market has been developed along the lines of captives. Not all companies in Cayman, Bermuda, and the offshore territories are captives. A lot of companies insure third-party risks, they maintain their own operations, and they do specialist reinsurance, such as annuities.

The Cayman Islands are the second-largest jurisdiction in the world for offshore insurance. There are 1,400 companies worldwide that are captives of one sort or another; we have about 500 of them, about 16%. This places a great deal of responsibility on regulators. It requires a great deal of flexibility in understanding the various products that come forth, which tend to be from the obscured to the typical.

Let's briefly discuss the types of companies we have there. We have 32 domestic insurers that offer products to local citizens in Cayman. Offshore companies can't do business in Cayman, so we need to service all needs. There are 500 offshore insurance companies, including captives, operational reinsurers, and special purpose vehicles. The remainder is about managers, and their own agents to set up the domestic and offshore insurers.

The offshore history developed in the 1970s. In '74-75 there was a liability crisis in the professional medical side. It was really coming into its own. And a couple of teaching hospitals, Harvard, in particular, came forward to try and cover their teachers and their hospital physicians. They couldn't get professional medical malpractice coverage in the commercial market, so they looked offshore, and they came to Cayman. Out of that, Harvard is the oldest standing captive insurance company that we have in Cayman. Other liability markets developed from that. Workers' Compensation was the next one that came along, which was an actual natural by-product of general liability, other professional liability.

Cayman developed into a market for innovation over a 20-year period, where products could be suggestions with a practical business plan and practical financial projections, which would be acceptable to the regulators in Cayman. And it has developed very well.

In 1978-79, the law developed by David Furlow, who was a Sedgwick director at the time, was one of the most effective legislations in the offshore world. I'm going to talk a little bit about that legislation shortly. I just want to give you an

idea of the size of the assets and the premiums that developed in Cayman—about $12 billion in assets and close to $3 billion in premiums.

To give you an idea of the type of companies involved, you have some typical ones Harvard, McDonald's, Ford Motor Company, Federal Express, Automation Imperial Chemicals in the U.K., S.E. Johnson, Pittsburgh University, and a bunch of university and teaching hospitals in the U.S. in one form or another.

The market developed, generally speaking, in health care, general liability, Workers' Compensation, and all the other long-tail business. It takes up about 17% of the business that is done in Cayman. Separate portfolio companies and other special purpose vehicles, such as finite risk funding and catastrophe bonds are the newest innovations. All of them are offshore. And purely speaking, are being done in Cayman rather than Bermuda in the last few years.

Why do companies settle offshore? Flexibility. We talked about rational regulation. I'll try to put something tangible to that. My view is the ability to recognize the individual needs of the insurer and discuss viable opportunities, but still maintain strict regulation and competence in regulation: GAAP-based filing, consistency among policyholders and regulators, similar to Canada, while ensuring solvency and protection. There's nothing wrong with it, and it works very well.

The modernistic approach to regulation. I'm going to talk about access on risk-based regulation. Corporate covenants, on-site business strategy, as well as traditional methods. These are the laws: the insurance law, the Proceeds in Criminal Conduct Law (PCCL), and the Companies Law. These are the foundations of regulations on the Island of Cayman. The PCCL has been used as the standard model in other offshore territories; it is a successful piece of legislation that fights money laundering and other crimes of various natures.

Our purpose is to supervise financial soundness, protect consumers and investors, and detect international crime. Pretty typical, but the difference between the U.S., and Cayman and Canada is that we are not only concerned about solvency and policyholder protection, but also money laundering. And that makes for a wider, broader range of paths.

Let's focus on the regulatory side for the time being. Very broadly speaking, this is what we do. We accept applications and processing is done. We look at the business plan, the business strategy, and we perform on-site inspections. A great deal of emphasis in Cayman is spent on face-to-face meetings. This doesn't come forward as much, but when we meet once every two years— whether that's an average or a maximum—with every company that we have, we can get a good idea of where the company is going by sitting across the desk, face-to-face with them, talking about their strategy and what they do. This a much better idea than receiving annual returns on a triannual basis or a biannual basis and record whether they are in compliance.

This is not just about financial solvency. This is about whether the strategy will make the company and organization a success in the future. We don't want just the companies that come and remain in the status quo. We want companies that are bright. The business plan changes are the key here. Business plans are integral. We review the feasibility study with the organization before it is even licensed. And it is the fundamental key to success for the company.

We also focus on corporate covenants. We place a great deal of emphasis on the auditor and actuary. We want to use them. It's critical we have both views on the situation. Similar to Canada and the U.S., the board of directors is fundamental. It has the responsibility to us, the policyholders, as well as to the shareholders, and we don't let it forget that.

Importance of corporate governance. There are three parts: realization that the supervisor can't prevent all problems, directors and senior management are the ones that really know what's happening in an organization, and that governments simply don't have the resources to check every single detail of a company's functioning. This sounds a bit like we're handing the cat the keys to the birdcage, but it's not. We oversee and we focus on real problems, rather than looking at all the companies as a whole.

Standards of sound practice. We, generally speaking, look at 11 major areas when we are doing regulation. No law will affect an organization at any one time, but where they do, the board must affect a policy and sound business practice. And we review that. For each risk area, the board must put out this policy to senior management, and the policy must be in writing, and be part of the day-to-day operations.

If you look at the approach, I think you'll find it similar to other jurisdictions offshore. The old approach is, find contraventions of the law, regardless of materiality. I'm sure you've all seen that before and the reconciliation of data. The new style is to look at the business strategy, management style, and attitude, and you can do that through a variety of means, on-site inspections and meetings. The whole picture gives you an idea of the risk profile of the company.

In a risk profile, as part of the on-site inspection process, we put together a list of the risk activities, and focus on meetings or discussions in our investigations on those particular areas. We were the first and only jurisdiction in the offshore world to implement formal on-site inspection process about four years ago. It was established based on the Office of Superintendent of Financial Institutions model in Canada.

We do inspections of everything that is insurance-related in Cayman: offshore, domestic, brokers, the works. The purpose of that is to understand the insurer and his business environment, detect solvency problems that otherwise were undetectable from the financial statements, detect non-compliance with

legislation, obtain information on other issues, outsourcing, in particular, and resolve detected problems early. In other words, try to be a little more proactive, rather than looking back.

The four main phases are: planning, on-site, the reporting, and the action. Generally speaking, the phases take about two months for the first three; putting the report together, actually doing the inspection, all the planning work that goes into it, takes about eight weeks. The actual implementation and on-site work for a company takes about two or three years, with action feedback, consultations, and constantly going back to make sure that everything is in line with what we decided. It's a very interesting phase. As I said earlier, all of our regulation is done behind a desk. All the regulators that I work with come from insurance companies, not from a regulatory environment. They were trained in regulatory environment necessarily, so they understand the needs of an insurance company. That helps a lot. To sit face-to-face with the board and talk helps you to understand where they are coming from.

The risk areas. In summary, in an on-site inspection process, we look at the risk areas in the feasibility study. Business plan, lost control, loss of control being critical, taking the long-term business. Fronting, reinsurance, and claims are applicable. Premiums and capitalization, financial projections, you name it. Even rating agency assessments. We do a lot of rating agencies, and a number of our companies are rated.

I want to switch topics and talk about money laundering and international issues of the corporation, etc. Here's a brief history of this whole issue. In 1988, the Ewing Convention had a discussion about crime; drug crime, in particular. And they put forward a proposal to form a task force to look at this. And in 1989, a financial task force was formed, established by G7, the present EEC, to look at an international approach to fighting money laundering.

The FATF examined measures to combat money laundering. In typical fashion, it took a couple of years to put together; it made 40 recommendations, and established the Caribbean Financial Action Task Force (CFATF) that became known as a member. However, out of the 40 recommendations that were made, the policies of criminal conduct law was formed. Reflexive actions came from the CFATF. The PCCL was one we talked about earlier, and was modeled on U.K. legislation with some modifications. Once this was implemented, Cayman volunteered for a self-assessment by the CFATF, and received an excellent report in 1996. Its initial task was fighting money laundering—not an easy task to do—and it is not limited to offshore, but to onshore as well. And it doesn't include just drug crimes. It includes fraud, the Internet, etc. and is also an area that is going to be high exposure to crime.

Countries with criminal legislation are the U.S., U.K., Canada, France, Germany, and Japan. While the PCCL was the law, the code of practice is the regulation; it's

how it is actually done. And this was issued on 7-20 of PCCL, and tries to update it to keep us highly competitive as possible in standards of combating money laundering. It was processed with consultation of the FTAF in the private sector and reinforces this loyal customer basis, which is a common catch phrase among money launderers, knowing when you're doing due diligence, and knowing who you're doing business with. It sounds easy; it's not always as easy as it is made out to be.

What is money laundering? The process by which the benefit of a crime is channeled transactions to conceal its true origin and ownership. There are a couple of stages to money laundering. An idiot's guide to money laundering is placement. That's the conversion of cash proceeds for the crime typically done through deposits into a banking system. That's the most common one, everyone knows about it. It's almost virtually impossible to do any offshore work now, you are limited by what you can bring in and out of any country in terms of cash. If you try walking through a bank with a suitcase full of money, they would probably laugh you out, if not arrest you on the spot.

There are so many regulations in place now, restricting who can open an account. My mother-in-law has lived in the Cayman Islands for 50 years, and she tried to open an account with banking people she knows, and they refused her, because she didn't have the proper identification. This poor lady was saying, "Where am I going to open an account if I can't open it here?" and they still refused her. She had to go back and get three references. That's how strict it is.

I wasn't allowed to open a bank account myself when I first came to Cayman, because my wife was working but I wasn't. They needed three forms of I.D. to prove that I was actually working. They are fairly strict.

Layering and integration are the more common forms of laundering money. Layering involves separating the proceeds of the crime from its source by creating complex financial transactions, trust companies, show companies, etc. Integration, which relates to insurance, is placement of funds into the economy as apparent legitimate business funds. This gets away, to some degree, from the typical financial transactions. Real estate agents, for example, accepting money to purchase properties is a form of integration. Of course, now you have to look outside the financial industry and start examining if there are non-financial-related transactions.

The offences include providing assistance, other people who share benefits of criminal conduct, the acquisition, possession, or use of property, knowing it represents the proceeds of criminal conduct, or tipping someone off if an investigation is about to go ahead. The penalties involve an unlimited fine, and 14 years in prison in Cayman. I'm sure you're thinking there are probably a lot worse places to be in prison, but believe me; it doesn't have a beachfront view.

Financial services providers (FSPs) do have certain responsibilities. They must develop internal policies and procedures. Again, it goes back to the corporate governance principle. We're looking at the policies and procedures of the organization, whether they know the risks that they are involved in. We're not looking at the organization; we're looking to be sure there's enough there to make a premium-surplus ratio function properly.

FSPs must be diligent to money-laundering activities and cannot accept assets if there is a reasonable cause to believe assets were obtained illegally. A procedure must be established to evidence a client's identity. Depending on the size of the FSP, they must employ a compliance officer. And the authorities will review the above rules and regulations and take appropriate action against companies that don't comply.

There's a lot of talk about international corporations in the offshore world. Do they or don't they incorporate? There are a lot of misnomers. I'll tell you about some of the areas I've been involved in, in the organization of monetary authority as a whole. First, there is the International Association of Insurance Supervisors. They are published sets of codes, by which everyone, onshore or offshore, must abide by. Everyone has done a self-evaluation; nobody has passed that self-evaluation. Even in the U.S. or Canada there are some areas that can be improved on. But generally speaking, everyone is cooperating, to try and bring those standards up to the standard codes.

Offshore Group Insurance Supervisors (OGIS) meet three times a year to discuss issues that affect offshore groups such as the OECD, etc. It also sets standards; every Cayman Island and offshore group is involved in OGIS.

I'm in regular contact with state regulators, even in California, discussing issues, matters, and compliance. We are very open with the information we give. I make regular trips to Canada. I also deal with the U.K. and the Financial Services Act and again we discuss issues. We try to make it a learning process, as well about things that affect us. We talk to them about what the actual world is really like, what we're doing, and we try to give them a degree of understanding.

We meet with the ones I've mentioned earlier, A.M. Best and Standard and Poor's, throughout the year to discuss the companies that are rated, not rated, and companies potentially to be rated.

The OACB recently came into Bermuda. A perspective of the OACB is to basically remove either of them from being blacklisted by the OACB. Somebody might be aware that the OACB was looking to publish a black list of companies that are on islands and jurisdictions that seem to be unfair tax competitors. That view is brand new. It's only been agreed to in the last week. I'm not too sure of the details in the negotiations yet, but certainly it is something worth reviewing.

The KPMG Review is something else that should be briefly mentioned. The British Government has done a review of all of its territories that might be independent consultants from KPMG in the U.K., to look at the way that jurisdictions regulate. KPMG did the Bermuda, Cayman, and a couple of others. That review is to be published on the Web in about three weeks. By all accounts and purposes, it looks like it will be a pretty competent.

There is a realization in Cayman that transparency, proper and strict regulation without losing the fundamentals of business growth; that the bottom line is fundamental. Transparency in its national corporation is critical to the global economy, and really, Cayman has to be up there, fighting our way to make ourselves appear as positive as possible.