**Association of Bermuda Insurers and Reinsurers**

O'Hara House
One Bermudiana Road
Hamilton HM 08 Bermuda
Tel: 441-294-7221
Fax: 441-296-4207

1445 New York Avenue, N.W.
7th Floor
Washington, DC 20005
Tel: 202-783-2434
Fax: 202-638-0936

**July 23, 2015**

**Exception from Passive Income for Certain Foreign Insurance Companies (PFIC)**
**CC:PA:LPD:PR (REG 108214-15)**
**http://www.regulations.gov (IRS REG-108214-15)**
**Room 5203**
**Internal Revenue Service**
**PO Box 7604**
**Ben Franklin Station**
**Washington, DC 20044**

The Association of Bermuda Insurers and Reinsurers (ABIR)[1] represents 20 commercial property and casualty insurers and reinsurers with underwriting operations in Bermuda. Our members employ 1,500 people in Bermuda. Fifteen of the ABIR members also have subsidiary insurance companies in the United States. ABIR members were mostly created as startup corporations in Bermuda in the last 30 years. ABIR members are global insurers[2] and reinsurers conducting underwriting operations in Bermuda and with subsidiary corporations, branches or other affiliates in major markets such as the United States, the European Union, Asia and Latin America. We write today providing comments on proposed regulations set forth in Internal Revenue Service, Notice of Proposed Rulemaking, 26 CFR Part 1, REG-108214-15, RIN 1545-BM69, entitled "Exception from Passive Income for Certain Foreign Insurance Companies" (the "Proposed Regulations").

The Notice indicates an intention to address "situations in which a hedge fund establishes a purported foreign reinsurance company in order to defer and reduce the tax that otherwise would be due with respect to investment income." The Proposed Regulations, however, would result in current US taxation of income for a wide range of genuine foreign insurance and reinsurance companies.[3]

<u>ABIR believes that the central element qualifying an entity as an active insurer is underwriting and holding insurance risk.</u> Regardless of a chosen business model[4], the primary purpose of an insurance legal entity is to issue contracts that assume risk that otherwise would be held by its customers. That promise to pay future losses uniquely distinguishes insurers from other businesses and is made possible by the capital of the insurance company. The focus of the proposed regulations should be on objective measures of assumed insurance risk.[5]

---

[1] See www.ABIR.bm for membership list; underwriting reports
[2] After the US the most important domiciles globally for ABIR members are: United Kingdom, Ireland and Singapore.
[3] The bulk of the $62 billion in capital that has come into insurance markets in recent years has been provided by pension funds, which by definition are not subject to US tax. The second largest category of investors is sovereign wealth funds, followed by family offices, with hedge funds rounding out the list of so-called alternative capital providers.
[4] Bermuda regulatory law, like US state law, recognizes a wide variety of insurance legal entities.
[5] Ultimately the definition of an insurer is largely shaped by jurisdictional regulatory law. The insurance legal entity and the business of insurance are subject to strict regulatory oversight by state insurance regulators in the US and by the Bermuda Monetary Authority (BMA) as the primary regulator of many ABIR members.

*Executive Summary of Recommendations*

- *The provisions in the active conduct definition restricting recognition of affiliated, shared or contracted employees should be removed from the proposed regulations.*
- *The restrictions on outsourcing investment management should be removed from the proposed regulation.*
- *The proposed regulation should recognize that licensing and regulation as an insurer in a domiciliary jurisdiction is an integral part of a test for an active insurer.*
- *The proposed regulation should be amended to include a bright line safe harbor test of a 15% reserve to assets ratio.*
- *The proposed regulation should include a facts and circumstances test to allow testing of insurers which do not qualify under the bright line test. An analysis of insured exposures should be an essential element of such a test. To afford a fair review in a timely fashion, we recommend this facts and circumstances test be promulgated under a rebuttable presumption combined with a deeming provision.*

**Section One: Active Conduct Definition: Affiliated Employees, Group Structures, Investment Management, Jurisdictional Requirements**

Our first comments relate to the proposed amendments to the regulations 26 CFR part 1, Section 1.1297-4, (b) (1) and (2). This paragraph defines active conduct and the insurance business as follows:

(1) Active conduct. The term active conduct has the same meaning as in Sec.1.367(a)-2T(b)(3), *except that officers and employees are not considered to include the officers and employees of related entities* (emphasis added) as provided in Sec. 1.367(a)-2T(b)(3).

(2) Insurance business. The term insurance business means the business of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, *together with those investment activities and administrative services that are required to support or are substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation* (emphasis added). For purposes of the preceding sentence—

   a) An investment activity is any activity engaged in by the foreign corporation to produce income of a kind that would be foreign personal holding company income as defined in section 954(c); and
   b) Investment activities are required to support or are substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation to the extent that income from the activities is earned from assets held by the foreign corporation to meet obligations under the contracts.

We address three issues in response to this provision: 1) Restrictions on qualifying employees in a related entity; 2) Restrictions on investment management; and 3) Bermuda's regulatory definitions of an insurer.

Restrictions on qualifying employees

The highlighted portions of the above definitions of "active conduct" and "insurance business" can be read together as establishing a broad requirement that a legal entity cannot be an insurance company if that legal entity does not directly employ the staff necessary to (i) conduct the insurance business generally and (ii) engage specifically in the investment and administrative activities of the insurance business. This broad requirement for employing underwriting, investment and administrative staff within the legal entity is not consistent with how insurance business is generally conducted today, and would disqualify a large number of foreign commercial insurers including both long established and recently established companies that assume large amounts of insurance risk and actively employ underwriters and operational staff of an insurance group's entities. In addition to disqualifying insurers that use affiliated entities within the group to employ shared staff, or which use contract or indirect employees for certain functions, these definitions would also disqualify insurers that operate through managing general agents[6] (MGAs), risk retention groups, captives, licensed insurers "fronting" business for entities assuming risk, Special Purpose Vehicles (SPV's), "side cars" or other joint ventures which take on insurance risk. These types of structures are used in the US as well as internationally, and notably by Lloyd's of London. Based on research by Conning and Company, in the US more than 1,000 MGA's are in operation. Following a survey of 400 of them, Conning reported that US MGA's collected premium in 2014 exceeding $33 billion. This is estimated to be 12% of US commercial insurance premium.[7] Treasury's rules should not penalize foreign insurers for using organizational structures that are also widely used within the US by domestic insurers.

ABIR members include insurance groups, made up of multiple legal entities, which employ and contract for talent necessary to assume and manage insurance risk and operate an insurance group. Shared employees or contracted employees are common in many US industrial group corporate structures. Large insurance groups, domestic or foreign, have for decades shared employees in group insurance structures (for example, by using a wholly owned separate legal entity as employer) that provide services to all or some legal entities of the insurance group. Further, included in many insurance groups are legal entities or joint ventures that are partially but not wholly owned by the insurance group and which have contracted employees. Shared or contracted employee structures exist for these common reasons:

- Employee expenses in legal entities can be kept lower by use of shared employees that can perform the same investing, claims, technology, catastrophe modeling, accounting and underwriting functions for various legal entities in the group;
- Employee sharing or contracting is often necessary due to the need to have technical skill sets that are highly sought after in the employment market; competition is intense for critical underwriting, catastrophe modeling, enterprise risk management and actuarial staff;
- Employees need to be shared or contracted for due to work permit and family reasons; the location of such a shared employee is often dictated by local labor law and social issues within the family;
- Groups create "centers of excellence" in certain locations that provide services to all entities in the group; and provide training for junior staff. Centers of excellence are in some cases tied to

---

[6] Managing General Agent**:** Section 2. Definitions. As used in this Act:

D. "Managing general agent" (MGA) means any person who:

(1) Manages all or part of the insurance business of an insurer (including the management of a separate division, department or underwriting office); and

(2) Acts as an agent for such insurer whether known as a managing general agent, manager or other similar term, who, with or without the authority, either separately or together with affiliates, produces, directly or indirectly, and underwrites an amount of gross direct written premium equal to or more than five percent (5%) of the policy holder surplus as reported in the last annual statement of the insurer in any one quarter or year together with the following activity related to the business produced adjusts or pays claims in excess of $10,000 per claim or negotiates reinsurance on behalf of the insurer.

Volume: II-225-1, Pages: 225-1 – 225-2, Managing General Agents Act, National Association of Insurance Commissioners, Model Regulation Service—October 2002.

[7] Insurance Insider, June 22, 2015, US MGA-sourced premium exceeds $33bn: Conning and Company

academic institutions, and may be located in geographic areas where synergies exist with regard to a large pool of talent operating in related fields.

All these employees and operational functions could not practically or efficiently be located in each and every legal entity in the group corporate structure. Shared employees or contracted employees make insurance companies more efficient and improve their performance for the benefit of insureds and shareholders.

The insurance regulatory rules in the United Kingdom and the rest of the European Union (EU) prevent a regulated insurance entity from performing functions for another regulated insurance entity, thus such shared employees are located in "related entity" service corporations where they can perform the necessary functions for multiple entities within the group. The "service company" model has been widely exported beyond Europe and is common for US and Bermudian insurance groups. The application of these proposed regulations would place foreign insurers in the paradox of being unable to comply with contradictory EU and US requirements.[8]

Therefore: *The provisions in the active conduct definition restricting recognition of affiliated, shared or contracted employees should be removed from the proposed regulation.*

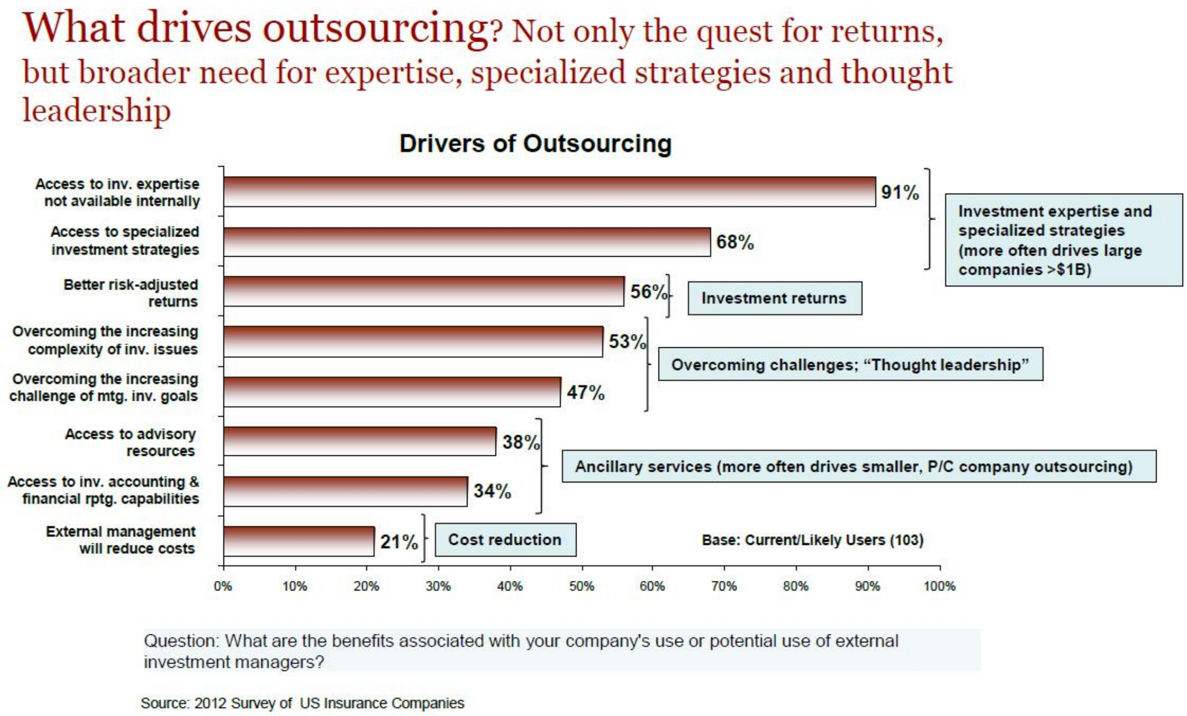
<u>Investment Management</u>

The proposed requirement that the definition of "insurance business" be amended to require that "investment activities" be provided within the insurance legal entity is also problematic. It is long standing practice for US insurance groups and foreign insurance groups to outsource some or all of investment management activities necessary for the business, subject to the oversight of group management. In fact, this arrangement has long been recognized in US tax law. The US tax code has recognized and encouraged for almost 50 years that investment services of foreign corporations could be provided/outsourced across borders into the US without creating a permanent establishment for the foreign corporation. The purpose was to encourage development of investment services in the US[9] to be provided to all foreign companies (including foreign insurers/reinsurers) without adverse US tax consequences to the foreign company. The analysis of an active insurance business should not dictate where or what form the investment advice takes for an insurance company as long as it is clear that the responsibility for investment outcomes rests with those responsible for overseeing the contracted services.

In a survey report published in January, the firm Eager, Davis and Holmes LLC reported that 96 of 103 US insurance companies surveyed outsourced some or all of their asset management/investment activities.[10]

Since the global financial crises, both domestic and foreign property and casualty insurers have increased outsourcing. The table below reviews the drivers of this additional outsourcing.

[8] Article 18(1)(a), Council Directive 2009/138/EC ("Solvency II"), as amended.
[9] 1966 US Tax Act, Code Section 864, (b)(2)(a)(ii).
[10] Insurance Asset Outsourcing Exchange, Jan. 2014, US Insurance Asset Outsourcing Overview, p. 4.




Note from the above chart that the three most important drivers of outsourcing investment management are:

1. Access to expertise not available internally;
2. Access to specialized investment strategies; and
3. Better risk adjusted returns.

Furthermore, FundFire reported in April that 22% of insurers globally expected to outsource more of their investment portfolios.

> "The outsource trend continues," Mike Siegel, global head of insurance at Goldman Sachs Asset Management, says. "There is increasing desire to outsource into asset classes where they don't have expertise in or where they want to reduce their costs of managing assets."[11]

Therefore: *The restrictions on outsourcing investment management should be removed from the proposed regulation. If they were applied to US insurers they would disqualify large numbers of companies as active insurers.*

Bermuda Requirements

Although it is common for Bermuda-regulated insurers to use affiliated service companies, shared employees and even some outsourced employees, it is a cornerstone of Bermuda regulation that the insurers have sufficient key employees in Bermuda to enable the regulator to have proper oversight. Under Bermuda insurance regulations, key officers are subject to "fit and proper" testing of character; and contracting of key employee functions is subject to regulatory review and approval. Regulations also require the insurer to properly oversee and direct any outsourced activities. Bermuda law was recently amended to create a "head office" requirement for legal entities which specifies criteria for the

[11] FundFire, April 22, 2015, Marianna Lemann

regulator—the Bermuda Monetary Authority (BMA)—to determine if the insurance legal entity meets a test for having established its head office in Bermuda. This is also a critical component of the EU's Solvency II insurance prudential regulatory system which takes effect January 1, 2016. Bermuda's regulatory authority is a candidate for an "equivalency" finding from the EU. Such a finding would make cross border trade more efficient by eliminating collateral requirements and would eliminate redundancy in group supervision frameworks. Thus, Bermuda regulatory requirements for insurers must meet a set of principles and standards set in European law for its own insurance groups.

Legislation signed into law this month establishes the head office requirement. The BMA describes its "head office" requirements as follows with *emphasis added on the key employment and decision making criteria*:

> **"B. Establishment of the Head Office in Bermuda**
> 9. Commercial insurers shall be required to establish a head office in accordance with the proposed requirements of Section 8C of the Act. The Authority proposes this amendment to make its current insurance supervisory and regulatory framework more robust. … The Authority further measures compliance with the insurance framework by taking into consideration various factors to ensure that it can exercise sufficient regulatory oversight over the business to be carried on in Bermuda. … *The Authority will consider, inter alia, the following matters in ascertaining whether the direction and management is in Bermuda for determining if the head office has been established: a. Where the underwriting, risk management and operational decision making of the commercial insurer takes place; b. Presence of senior executives who are responsible for and involved in the decision making related to the insurance business of the commercial insurer; c. Where board meetings of the commercial insurer are taking place; d. The location where management meets to effect policy decisions of the commercial insurer; e. The residence of the senior officers, insurance managers or operational employees of the commercial insurer; and f. The residence of one or more directors of the commercial insurer."*

Although this new provision does not take effect for legal entities until January 1, 2016, it is already in effect with regard to Bermuda regulatory requirements for identification of a "group supervisor", pursuant to Insurance Act 1978, Section 27B. Under EU, US and other countries' regulatory guidelines, insurance groups which conduct cross border business or which conduct business through legal entities in multiple jurisdictions, must have a group supervisor identified in order to coordinate regulatory oversight. The BMA has identified more than 20 such insurance groups and within the ABIR membership 14 are identified by the BMA for the purposes of group supervision and thus are already subject to this kind of employee and decision making structural analysis.

As noted, the BMA regulations and Bermuda law state certain characteristics of an insurance company. This rule strikes a proper balance between employees, decision making and residence. Jurisdictional regulatory requirements[12] should be a factor in determining whether an insurer meets an active insurer test.

Therefore: *The proposed regulation should recognize licensing and regulation as an insurer in a domiciliary jurisdiction as being an integral part of a test for an active insurer.*

[12] For a description of the BMA's approach to supervision, see: http://www.bma.bm/AboutUs/SitePages/BMA%20Standards%20and%20Regulations.aspx

**Section Two: Income From Assets Held to Meet Insurance Obligations; Passive vs. Active Income**

The Notice also requests comment on "appropriate methodologies for determining the extent to which assets are held to meet obligations under insurance and annuity contracts."

Bermuda regulatory requirements

On this point we note that it is a requirement of Bermuda law that non-insurance operations be conducted outside of an insurance legal entity. Since 2013 the Bermuda Insurance Act has prohibited commercial property and casualty insurers and life and annuity insurers from conducting a "non-insurance" business in the insurance legal entity.[13] Thus by definition all insurance assets in the insurance legal entity are "held to meet obligations under insurance and annuity contracts."

We know of no defined methodology to distinguish the portion of an insurer's assets held to meet obligations under insurance and annuity contracts from other assets. By definition assets held in an insurance legal entity are there to support all obligations of the insurer and can be called upon in receivership to settle the obligations of the policyholders.

Market Conditions and Regulatory Requirements Determine How Much Capital (Assets) an Insurer Holds

Customer contracts, market conditions, regulations and rating agencies all compel insurers to hold capital that is in excess of the amount necessary to cover known liabilities under insurance and annuity contracts. Bermuda regulatory capital requirements are robust and include elements not included in the risk based capital requirements imposed by US state regulations. The BMA attests to this noting that its Bermuda Solvency Capital Requirement, which applies on both a legal entity and group basis, must be robust due to the volatile types of business written by Bermuda insurers. Among these types of business are: property catastrophe, energy, directors and officers liability, excess liability, professional liability, financial guaranty, annuity and long term life insurance.

But even with more robust solvency capital requirements, domestic and foreign insurers hold capital in excess of regulatory requirements for several reasons. Insurers compete for business by stressing strong balance sheets. Insurers qualify reinsurers on "approved reinsurer lists" based on their unencumbered capital, financial strength, business reputation and other factors. In the US market, it is critical that a reinsurer or commercial insurer maintain a suitable credit rating by the leading rating agencies AM Best and Standard and Poor's. An essential part of a rating agency assessment is a review of the risk exposure data as mentioned later in this statement.[14]

For foreign reinsurers doing business with US ceding insurers on a cross border basis, ratings are embedded in US state insurance regulatory collateral requirements. Reinsurers wishing to conduct cross border trade with US ceding insurers, per the laws of most states, based on model legislation adopted

[13] "Prohibition of non-insurance business to be carried on by insurers, Section 19 (1) Subject to subsection (2), no Class 3A, Class 3B, Class 4, Class C, Class D or Class E insurer shall engage in non-insurance business. (2) An insurer may engage in non-insurance business only where such business is ancillary to the insurance business carried on by the insurer. [Section 19 repealed and replaced by 2012: 36 s. 13 effective 1 January 2013]

[14] In a different business model, insurers that don't have financial strength ratings contract with cedents to provide substantial collateral beyond reported liabilities, under the cedent's control, to support expected future loss obligations. In recent years, this sector has seen significant growth.

by the National Association of Insurance Commissioners (NAIC), must have credit ratings equivalent to A- or higher in order to achieve meaningful regulatory relief from collateral requirements.[15]

The relevant portion of the NAIC model law and regulation on credit for reinsurance is reprinted here. This chart specifies necessary financial strength ratings from third party credit rating agencies and then links these ratings (with other qualitative factors) to identify what level of collateral must be posted to support the US ceding insurer's potential future claims liabilities.

| Ratings | Best | S&P | Moody's | Fitch | Security Required |
|---|---|---|---|---|---|
| Secure – 1 | A++ | AAA | Aaa | AAA | 0 |
| Secure – 2 | A+ | AA+, AA, AA- | Aa1, Aa2, Aa3 | AA+, AA, AA- | 10% |
| Secure – 3 | A | A+, A | A1, A2 | A+, A | 20% |
| Secure – 4 | A- | A- | A3 | A- | 50% |
| Secure – 5 | B++, B+ | BBB+, BBB, BBB- | Baa1, Baa2, Baa3 | BBB+, BBB, BBB- | 75% |
| Vulnerable – 6 | B, B-, C++, C+, C, C-, D, E, F | BB+, BB, BB-, B+, B, B-, CCC, CC, C, D, R | Ba1, Ba2, Ba3, B1, B2, B3, Caa, Ca, C | BB+, BB, BB-, B+, B, B-, CCC+, CC, CCC-, DD | 100% |

State regulators grant "credit for reinsurance" to US licensed insurers based on their reinsurer's financial strength and other qualitative measures. The higher the financial standing, the lower the amounts of collateral the reinsurer must post for the benefit of the client. As the sliding scale (security required, column 6, above table) documents, an A++ or AAA (Best and S&P) rated reinsurer can conduct business with a US cedent without posting collateral. A reinsurer with an A- rating (Best and S&P) can conduct business with a US cedent but has to post 50% collateral.

ABIR members generally are categorized as Secure 4 or higher with most having a Secure 3 or higher rating so that regulatory collateral requirements can be reduced to 20% of reported liabilities.

Thus although rating agency capital requirements are not considered when calculating jurisdictional solvency capital requirements, the US illustration above explains how they find their way into a de facto capital requirement. Meeting this insurance regulator "secure" reinsurer test affords the foreign reinsurer the opportunity to operate more efficiently, but the quid pro quo is that the reinsurer has to hold the higher capital needed to meet the rating agency security test. Requirements such as these further demonstrate that assets held by a foreign insurer are maintained to support the insurance obligations.

[15] See www.NAIC.org; Bermuda as a Qualified Jurisdiction, http://www.naic.org/documents/committees_e_reinsurance_findings_recommendation_report_bermuda.pdf; List of states having adopted NAIC model language: Alabama, California, Colorado, Connecticut, Delaware, Florida, Georgia, Indiana, Iowa, Louisiana, Maryland, Massachusetts, Missouri, Nebraska, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, Virginia; excerpts Appendix 2

**<u>Section Three: Safe harbor bright line test</u>**
We appreciate and welcome the fact that Treasury is soliciting comments on a bright line test to be used to accurately identify the difference between an insurance company and an investment vehicle. It's not an easy task to accomplish. If such a test could be accurately constructed it would remove long standing uncertainty with regard to application of PFIC rules and it would allow Treasury to accomplish its objective of challenging companies that are attempting to "defer and reduce the tax that otherwise would be due with respect to investment income." To accomplish Treasury's goals we think inclusion of a bright line test would be constructive. As noted on page 6 of the Notice:

> "Comments specifically are requested with regard to how to determine the portion of a foreign insurance company's assets that are held to meet *obligations* under insurance contracts issued or reinsured by the company. For example, assets could be considered as held to meet obligations under insurance or annuity contracts issued or reinsured by the corporation to the extent the corporation's assets in the calendar year do not exceed a specified percentage of the corporation's total insurance liabilities for the year…." (emphasis added)

We think the use of the word "obligations" in the Notice is significant and appropriate. The obligations of an insurer under its insurance contracts would include both:

- The obligation to pay covered losses that have already occurred or can otherwise appropriately be reserved against under accounting rules; and
- The obligation to pay covered losses that have not yet occurred and are not permitted to be reserved against under the accounting rules.

Insurers are required by regulations, rating agencies and prudent risk management practice to hold capital against both current and potential future losses, as discussed more fully below, and therefore we think it is necessary to have tests to address both types of "obligations."

In this section we propose defining a safe harbor for an insurance company via a bright line test; and then offer a facts and circumstances test which would allow some insurers that are disqualified under the bright line test to be qualified after documenting their insurance industry risk bearing activities.

<u>Proposed 15% Reserves to Assets Test</u>
We concur with the Reinsurance Association of America (RAA) that a "reserves to assets" test is an acceptable test for measuring the appropriate amount of capital for a property and casualty insurer to hold with respect to losses that have already occurred or can appropriately be reserved against under accounting rules. The test, however, has to be calibrated carefully so as not to exclude many legitimate insurance entities. No one test would accurately define diversified commercial insurers or reinsurers, property catastrophe specialists, mortgage insurers or financial guaranty insurers, let alone companies in start-up or runoff modes.

After reviewing an analysis of data of US insurers done by the RAA based on US insurer public filings and by ABIR, based on Bermuda insurance company public filings[16], we suggest a bright line test based on a reserves to asset ratio that can be equitably applied to many insurers writing property and casualty insurance. Since the same test when applied to US legal entities documents a level at which a significant number of insurers including well-known insurers would begin to fail a bright line test, it is a credible measure to apply as an active insurer test for foreign insurers. The working assumption with using this

[16] http://www.bma.bm/Insurance/Filings/SitePages/Home.aspx

measure is that it is inequitable to apply a bright line test to foreign insurers when if that same test were applied to US insurers – they would fail.

ABIR believes that a new Treas. Reg. §1.1297-4 should retain the requirements that Code §816(a) and Treas. Reg. §1.801-3(a) must be taken into account as if the foreign corporation were a domestic corporation subject to taxation under Subchapter L. In addition, the regulation would provide a new "safe harbor" using a "bright line test" reserve to asset ratio:

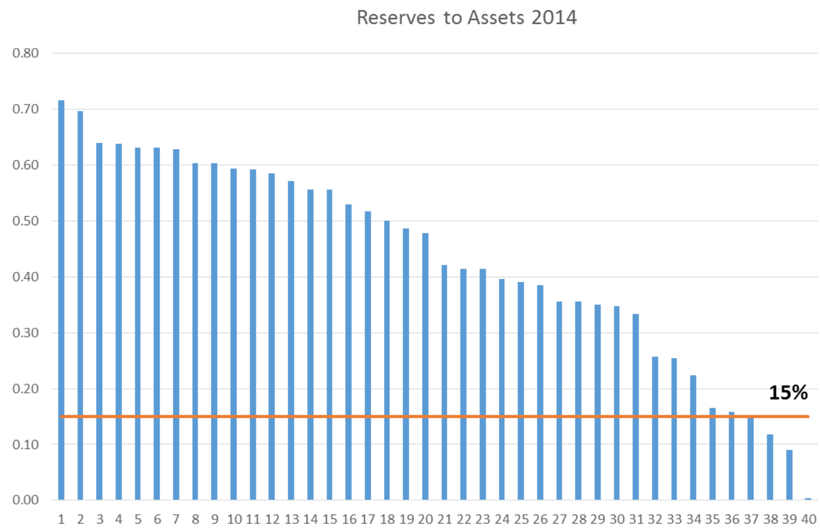
1. The foreign corporation's insurance reserves net of reinsurance ceded must be equal to or greater than 15 % of its assets as of the last day of each taxable year.
2. Insurance reserves: the term insurance reserves shall be equal to the sum of the following items (determined net of reinsurance):
    a. Undiscounted unpaid loss reserves,
    b. Undiscounted unpaid loss adjustment expense reserves, and
    c. Undiscounted unearned premium reserves.[17]

The definition of assets would be defined by GAAP and IFRS accounting rules and the data would be found in the publicly available, audited financial statements of the insurers. The computation of insurance reserves shall be made on the basis of the financial statements as of the end of the taxable year that are filed with the regulatory authority of the jurisdiction in which the foreign company is organized and regulated.

ABIR determined 15% (reserves equal to or exceeding 15% of assets) as the appropriate ratio for the bright line based on an analysis of publicly available data for US and Bermuda insurers and modeling of reserves-to-assets. Forty Bermuda insurers were analyzed based on published, legal entity, audited financial statements required to be filed by the BMA. That measure of insurance company reserves-to-assets in 2014 shows that four Bermuda companies would fail the bright line test, of which two are sometimes identified in the press as potential foreign investment companies. They would need to prove that they qualify for the exception by using other measures. Notably this failure rate is consistent with that of US insurers in the RAA data analysis. Other Bermuda insurers whose operation as insurance companies is not in question would clear the threshold as shown in Reserve to Asset Table 1. When the reserves-to-assets ratios of comparable U.S. property casualty legal entities are compared to those in Bermuda, the 15% threshold seems entirely fair. For example, a leading US personal lines insurer had a ratio of 17.3% in 2014, and a leading commercial lines carrier had a ratio of 18%. A large US insurer, part of a diversified holding company group, had a ratio of 18.5%. And the country's oldest insurer—established by Benjamin Franklin in 1725— had a ratio of 14.6%. These U.S. companies' classification as insurance companies has never been questioned.

[17] For composite companies writing both life insurance and P&C contracts, UPR includes life insurance reserves.

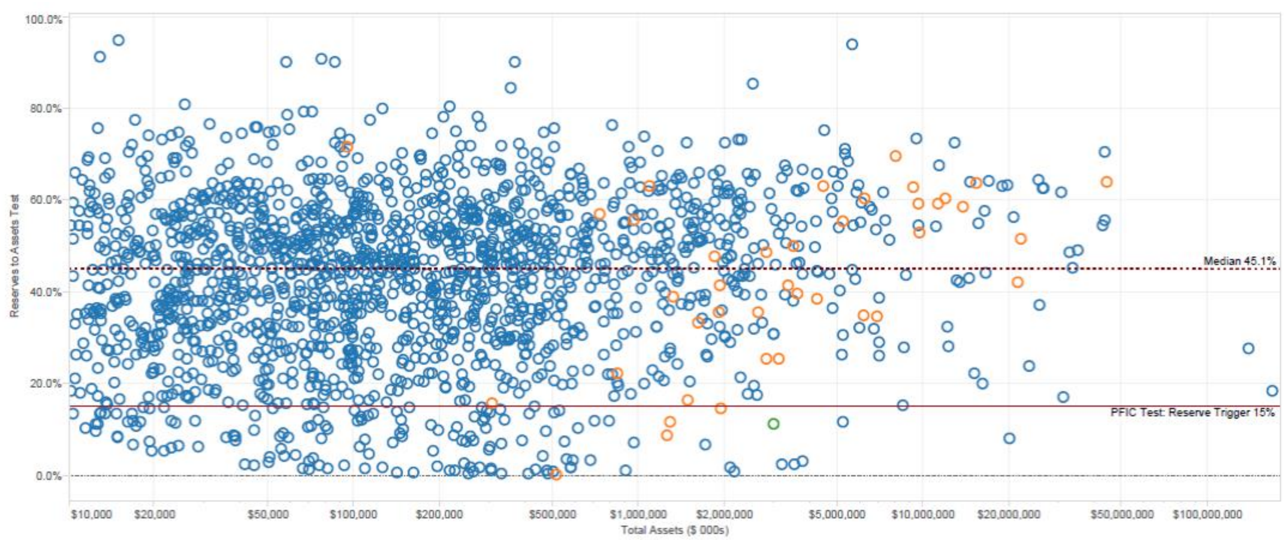
Reserve to Asset Table 1: Bermuda insurer ratios for yearend 2014




Reserve to Asset Table 2 displays the reserves to assets ratio results of US and Bermuda insurers. The US/Bermuda comparison shows that different bright line test levels would result in similar percentages of US and Bermuda insurers failing at those levels. This shows that how the US and Bermuda insurance markets overall measure against a reserves to assets test is not dissimilar. It also undercuts the argument that a low measure of reserves to assets is grounds for classification as a PFIC.

- At a 15% bright line level, overall 8% of US insurers would fail and 10% of Bermuda insurers would fail.
- At a 20% bright line level, overall 12% of US insurers would fail and 15% of Bermuda insurers would fail.

Reserve to Asset Table 2: Bermuda insurer ratios highlighted (orange) against US insurer ratios (blue) for yearend 2014[18]




[18] Source: U.S. Annual Statement Data Provided By SNL Financial. Bermuda GAAP data aggregated by ABIR from BMA filings; note there are thousands of insurers in the US data set and 40 in the Bermuda data set.

Although this test is not an accurate reflection of the level of assets reasonably required by all insurers, it would help begin sorting qualifying insurance companies from potential offshore investment vehicles allegedly operating as insurance companies.

Therefore: *The proposed regulation should be amended to include a bright line safe harbor test of a 15% reserves to assets ratio.*

**Section Four: Facts and Circumstances Test**

Importance of an Insured Exposure Measure

Bermuda's reinsurers have paid $35 billion in catastrophe claims to US cedents in the period from 2000 to 2014.[19] But since Florida has not experienced a hurricane landfall since 2005, reinsurers that specialize in natural disaster catastrophe reinsurance have largely run off their reserves from the record number of seven US land falling hurricanes of 2004 and 2005. Statistically speaking, the odds of this decade long hurricane landfall drought are extremely low; nothing like it has occurred in the 150 years of US National Oceanic and Atmospheric Administration recordkeeping.

> "Another way to look at this statistic is that none of the last 25 major hurricanes in the Atlantic have made landfall in the U.S.," Brian McNoldy wrote[20] after the quiet 2014 hurricane season came to an end. "According to [Phil Klotzbach, a hurricane researcher at Colorado State University], an average of 29 percent of all major hurricanes hit the U.S., so the odds of avoiding 25 consecutive storms are about 1-in-5,200."[21]

These property catastrophe insurers are obviously in the reinsurance business and have reinsured substantial risk during this light hurricane experience period but would likely fail a bright line reserves to assets test. Since Treasury has indicated they do not intend to penalize insurers taking on substantial risk, a facts and circumstances test would need to be timely and workable to exempt these insurers.

Analysis of Insured Exposure Data in a Facts and Circumstances Test

As noted above, the "reserves to assets" test is essentially a backwards-looking test that works for insurance companies that have been in business for an extended period of time and have years of loss history. We believe that it is necessary to also have a forward-looking test that takes into account that an insurance company must also hold capital to meet its "obligations" under contracts to pay claims on losses that have not yet occurred. This is particularly important for specific types of insurance companies, such as start-up companies, property catastrophe insurance companies and other specialty companies that form a large proportion of the insurance companies domiciled in Bermuda.[22]

---

[19] http://abir.bm/wp-content/uploads/resources/raa_cat_modeling.pdf

[20] http://www.washingtonpost.com/blogs/capital-weather-gang/wp/2014/12/01/unprecedented-lull-in-major-hurricane-landfalls-continues-as-atlantic-season-comes-to-a-close/

[21] http://www.washingtonpost.com/blogs/capital-weather-gang/wp/2015/04/28/major-hurricane-drought-nears-decade-milestone-will-it-continue/

[22] Property Catastrophe Reinsurers: Evidence from the 1906 San Francisco earthquake demonstrates that property catastrophe reinsurance products have often been provided to US insurers by foreign carriers. US cedents selected non-US reinsurers for historical and financial security reasons. Reinsurance was created in Europe in the 15th century with the oldest reinsurers today having their roots in Germany, Italy, Switzerland and the United Kingdom. Property catastrophe perils were long understood to be solvency threatening so US insurers exposed to their own earthquake and hurricane risk looked to reinsurers which were not exposed to the very same domestic catastrophic risk. Thus as the San Francisco earthquake later demonstrated non-US reinsurers were viewed as being more likely not to be rendered bankrupt by the same event occurrence that could render them insolvent. Regulations outside of the US have often recognized property catastrophe reserves which further encouraged the

In dealings with rating agencies, the US Securities and Exchange Commission (SEC), investors and regulators, insurers are required to analyze, explain, report and manage insured exposures. This is an essential part of both an insurance company's enterprise risk management and an insurance regulator's prudential supervision of an insurer. Their ability to manage these exposures is critical to their success as an insurer and their ability to protect their shareholders from insolvency. For example, under the Bermuda regulatory capital regime insurers are required to report aggregate coverage limits provided by the legal entity in any one year and are required to report the largest Probable Maximum Loss (PML) expected by the insurer in a one year timeline with a certain statistical confidence criterion. Among the appropriate measures to ascertain whether real insurance risk is being assumed would be either the insured exposures as measured by the aggregate coverage limits contracted for by the insurer; or by the expected PML in a one year time horizon for a 1/100 or 1/250 year statistical return period. The PML measure, though not familiar to taxing authorities, is commonly analyzed today by insurance regulators, customers, investors, rating agencies, catastrophe modeling firms and others. A great deal of literature is available to document the relevance of such measures in enterprise risk management models.[23]

Half of the ABIR membership participated in a confidential data call to collect information on legal entity insured risk. Confidential data was reported by 16 legal entities. In this statement we provide a summary of data results on reported measures of 1/250 PML's and 1/100 PML's for US hurricane and US earthquake per legal entity[24]. The measures are reported on a "net" basis, thus if the insurer itself has reinsurance or retrocessional protection its gross numbers are reduced to its net held exposure. This measure is then related to shareholder equity on a GAAP basis.

Such PML measures are commonly filed (but not required) by publicly traded insurance groups in SEC filings and are commonly used by investor analysts as a measure of the insurers risk appetite and adequacy of capitalization. The legal entity measure, though, is not part of SEC disclosures but is a

---

development of the business. Bermuda then became a new domicile for property catastrophe specialist reinsurers in 1992, following Hurricane Andrew which led US insurers to suddenly seek substantially larger amounts of protection against hurricane risk. The 1994 Northridge earthquake further increased demand for additional catastrophe protection.

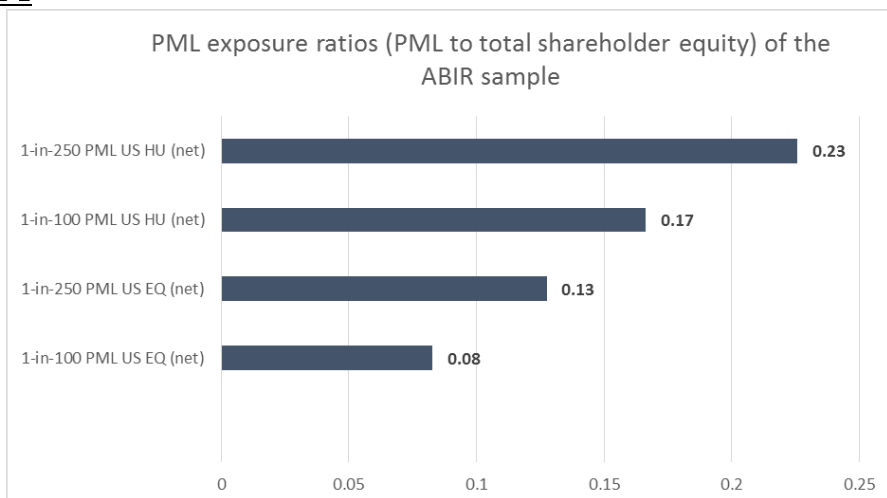
For insurers such as property catastrophe reinsurers that operate with large insured exposures, but a remote risk of substantial loss in any one year, the bright line reserve to asset test likely mistakenly would disqualify such reinsurers as failing the active insurance test established in this proposed regulation. We say mistakenly because insurers or reinsurers that fail this test have still insured substantial exposures but have not established reserves because public accounting rules and regulatory requirements do not allow reserves to be established until a loss event has occurred. Yet the reinsurer needs to hold capital to meet regulatory, rating agency, broker and client demands as if the losses were to be paid tomorrow. This holding of capital is consistent with the level necessary for companies to be in a position to meet future obligations under existing contracts. Reinsurers—be they domestic or foreign—that serve this highly volatile, severe-but-infrequent loss market (including retrocessional protection)—could fail nearly any reserve to asset test.

[23] AMBest, www.AMBest.com/ratings; Property/Casualty Supplemental Rating Questionnaire; Karen Clark and Co., www.KarenClarkandco.com/news, Increasing Concentrations of Property Values and Catastrophe Risk in US, April 2015; Standard and Poor's Ratings Services, Global Reinsurance Highlights 2014, Cat Exposure—Global Reinsurers' Appetite for Catastrophe Risk Remains Largely in Check, page 58; and Tough Competition Could Put Ratings on Global Reinsurers Under Pressure, page 62; http://casualtyactuarialsociety.net/pubs/proceed/proceed82/82195.pdf.

[24] The BMA also collects PML data on Japanese earthquake and typhoons; and European windstorm. PML's are calibrated to a 99% VAR; 16 Bermuda based legal entities reported data.

requirement for filing by legal entities to the BMA as part of the Bermuda Solvency Capital Requirement (BSCR)[25]. Under Bermuda regulatory law these measures are required to be audited and are part of an ongoing enterprise risk management assessment by the supervisor. Bermuda law also requires the filing of insured coverage limits or reinsurance treaty limits by legal entity. This would be another way to measure insured exposures. Additional exposure measures for different global geographic territories are also required to be filed in the BSCR. And the BMA requires completion annually of various stress tests tied to catastrophic loss scenarios including hurricane, earthquake, terrorism and financial markets. These and other measures would be appropriate to consider in a facts and circumstances test to document that the entity is functioning as an insurer.

<u>Exposure Table 1</u>




Key findings for the average of the 16 reporting legal entities in the above US PML exposure summary Table 1:

- For a 1/100 year net US earthquake event, insurers risk losing 8% of their capital due to a single loss event;
- For the 1/250 year net US earthquake event, insurers risk losing 13% of their capital due to a single event;
- For a 1/100 year net US hurricane event, insurers risk losing 17% of their capital due to a single event;
- For a 1/250 year net US hurricane event, insurers risk losing 23% of their capital due to a single event.

We also note based on published SEC reports summarized by Dowling and Partners[26] that 10 insurers (in their data set) had reported group PML's for 1/100 year events ranging from 5.9% loss of shareholder equity to 18.2% loss of shareholder equity. Thirteen insurance groups had reported group PML's for 1/250 year events ranging from 8.1% loss of shareholder equity to 27.6% loss of shareholder equity.

---

[25] The BMA requires multiple PML's to be reported for the US, Europe and Asian exposures. The BMA also requires insurance and reinsurance coverage limits to be reported by legal entities. The BMA's measure is calibrated to a Tail Value at Risk (TVaR) measure; the ABIR data call was calibrated to a Value at Risk (VaR) measure since this is more commonly used with rating agencies and reported by some entities in SEC filings on a group basis.
[26] Dowling and Partners, IBNR #XX, Vol. XXII, published May 7, 2015.

After reviewing the SEC group data and the ABIR legal entity survey data we note the broadly similar reported PML's for the averages of the legal entities vs. groups as reported in exposure Table 2 below.

Exposure Table 2, Legal Entity vs. Group

| | **Legal Entity Survey[27] 1/100** | **Legal Entity Survey 1/250** | **SEC Group Data 1/100** | **SEC Group Data 1/250** |
|---|---|---|---|---|
| **Highest reported % Lost capital** | 35.5% | 44.2% | 18.2% | 27.6% |
| Average | **12.5%** | **17.7%** | **13.95%** | **17.24%** |

Based on the confidential survey of ABIR members, we believe it will be beneficial for the IRS to review insured exposure data as one of the key elements in a facts and circumstances test. Review of such data helps solve some of the problems created by an exclusive reliance on a bright line backwards looking reserve to assets test. Consideration should also be given to information submitted by insurers to regulators, particularly in jurisdictions where capital requirements are robust and insured exposure data is built into regulatory capital requirements. The insured exposure analysis can also be used to ascertain the degree of insurance risk held in new types of legal risk bearing entities.

Therefore: *A measure of insured exposures is a way to understand insured risk held by the legal entity and assess the adequacy of capital to support that risk. Both aggregated insured limits and PML measures are common ways to measure and weigh the impact of insured exposures held by a legal entity and are appropriate elements of any facts and circumstances review*.

Financial Guaranty Insurance

One of the clearest examples of the inequity of a bright line reserve to asset test for foreign insurance companies is the financial guaranty insurance industry. In looking at publicly available information for 11 financial guaranty insurers and reinsurers, 10 based in the US and one based in Bermuda, more than half would fall below a 25% reserve to asset test and three of the 11 would fall below 15% as of yearend 2014. Throughout the financial crisis, financial guarantors have paid billions of dollars in claims on insurance policies and now hold low ending reserve balances. All of the companies below these thresholds are US insurance companies, and the failure to meet these thresholds highlights the unfairness in holding a foreign insurance company in the same line of insurance business to a higher standard.

Financial guaranty insurance, also known as bond insurance, is a single line of business whereby an insurance company guarantees scheduled payments of interest and principal on a bond or other debt security in the event of a payment default by the issuer of the bond or debt security over its life. Financial guaranty companies are limited from entering other lines of insurance business and, accordingly, are often called monolines. Bond insurance is a form of "credit enhancement" that generally results in the rating of the insured security being the higher of (i) the claims-paying rating of the insurer and (ii) the rating the bond would have without insurance. The financial guaranty industry's assurance that insured bonds will make timely principal and interest payments to investors must be backed by a very strong claims-paying ability that is rigorously reviewed by major rating agencies, regulators as well as investors.

[27] Legal entity survey is the average of the 16 reporting entities; the SEC group data is reported with a high and a low for the individual groups and as an average for the groups.

The business model of bond insurance requires financial guarantors to be highly leveraged. There is typically low probability of loss on any single bond issuance but, in aggregation, significant exposure and risk. The premiums charged for bond insurance are driven largely by what financial markets will allow and the economic benefit of credit enhancement for a security being issued. A viable return on equity for a bond insurer is only achieved through the aggregation of premiums of many policies. This results in the amount of insured debt service (i.e. the principal and interest outstanding on the bonds) far exceeding the amount of premiums charged for the insurance. Thus, the nature of the product is that bond insurers are always highly leveraged when comparing the amount of debt service outstanding to statutory capital or assets. In reviewing capital adequacy, a number of stress environments are applied to evaluate the ability to pay claims not just at one point in time but until a bond matures, which may be in excess of thirty years. This requires a build-up and maintenance of high capital levels over many years to absorb high potential losses but often have low reserve balances.

Bond insurance has always focused on insuring securities with a low risk of default and, until the 2008 financial crisis, the bond insurers suffered few material losses. However, the financial crisis impacted financial guaranty companies particularly hard. It left numerous financial guarantors with billions of dollars of obligations for insurance policies written years earlier. Each of the legacy financial guarantors paid claims exceeding one billion dollars. In addition, all sustained multi-notch downgrades from rating agencies and two were placed in rehabilitation by their state insurance commissioners. These events have only elevated the need for financial guaranty companies to maintain sufficient claims paying resources. Similarly today, bond insurers face credit exposure to public finance debt such as Puerto Rico, which was written years earlier but shows higher risk currently.

A bright line test that measures an insurance company on one ratio such as loss reserves to total assets at a point in time would disqualify a financial guaranty company in a given year without regard to the amount it has already paid in claims or the true insurance risk and exposure remaining in its portfolio. This result would be illogical for companies that have paid out massive claims and no longer hold a high reserve balance, similar to catastrophe underwriting mentioned above with an insurance product that features the likelihood of low frequency of an event yet high severity. However, bond insurers do not use PML levels and this would not be a workable benchmark for its exposure. Financial guaranty companies measure their exposure in the form of net debt service outstanding which is defined as the total principal and interest insured, net of reinsurance. This benchmark would be indicative of true insurance risk and would prevent well accepted insurance companies such as financial guarantors from being unfairly isolated by this proposed regulation.

<u>Insurance Companies in Non-Traditional Structures</u>

Over the past 25 years, new reinsurance structures and new types of licensed legal entities have been developed to meet the needs of insurance companies, particularly those ceding US property risk. This evolution has taken place due to the paradigm shifting loss events in the United States such as Hurricane Andrew in 1992, Hurricane Katrina in 2005 and the 9/11 terrorism tragedy in 2001. These new entities may be affiliated with existing insurance groups; or they may be standalone structures operated by managing general agents. These new types of legal entities would also be affected by the proposed Treasury regulations. See Appendix One for a description of these new entities.

Rebuttable Presumption Facts and Circumstances Test

Because a bright line test is an imperfect measurement of true insurance activity, we believe it is essential that a company which fails the test be allowed to demonstrate that it is engaged in the insurance business by a facts and circumstances test of its operation.

Facts and Circumstances Test

A facts and circumstances test needs to operate in a manner that affords a fair review for the shareholder while also providing a timely determination. Insurers can document their active insurer status.

The factors that would be included in the facts and circumstances examination for insurers that failed the bright line test would include but not be limited to:

1. The company's insured exposure is reasonable when measured against assets, or capital. Insured exposure can be measured in a variety of ways including but not limited to the following: aggregated policy or treaty coverage limits, PML measures or stress tests; and in the case of financial guaranty companies net debt service outstanding;
2. The company is writing a type of business such as retrocessional business ("reinsurance of reinsurance"), natural catastrophe coverage, financial guaranty, mortgage, surety, or municipal bond insurance which is often associated with low reserves but a high degree of risk tied to infrequent events; low frequency events can lead to "lumpy" reserving patterns;
3. The company is regulated and supervised as an insurer; the company manages and holds insured risk;
4. The company is a start-up insurer; we'd estimate that a start-up insurer needs three years to gather business volume that would allow it to meet metrics associated with typical insurers;
5. The company is intentionally shrinking its underwriting business (affecting both premiums and liabilities) due to economic conditions in the insurance business;
6. The company has an uneven distribution of underwriting premium, liabilities and assets due to merger and acquisition activity, licenses held by affiliated entities, regulatory requirements including difficulties in merging capital held in various legal entities of an insurance group, or other historic business reasons;
7. The company's premium income represents a significant portion of its total gross receipts;
8. The company is in runoff, not generating premium income while managing investments to match the declining liabilities so that it can pay off policyholder claims and avoid insolvency. This is consistent with public policy adopted by insurance regulators to assure an orderly stewardship of assets for the benefit of insurance policyholders whose claims will become due over time;
9. The type of assets held by the company including an assessment of liquidity needs tied to payment of claims and investment quality tied to regulatory requirements;
10. The company's capital levels are reasonable with regard to rating agency requirements to achieve a minimum rating necessary to participate in a particular market or specific line of business; the company's capital levels are reasonable for a particular market, based upon insurers in the same competitive marketplace.

Therefore: *The proposed regulation should include a facts and circumstances test to allow a review of insurers which do not qualify under the bright line test. To afford a fair review in a timely fashion, we recommend this facts and circumstances test be promulgated under a rebuttal presumption approach with a deeming provision. Insurers would make documentation available that would define their status* *as an active insurer. In the course of an audit, US taxpaying shareholders could make the material available to the IRS. Unless informed by the IRS within 90 days that the taxpayer submission is insufficient to establish that the insurer is actively engaged in the business of taking on insurance risk, the taxpayer can operate as it does currently without the insurer being identified as a PFIC. If the IRS determines that more information is needed then it informs the taxpayer that additional information must be provided and reviewed by the IRS so that within the preceding 90 days the IRS can reach an affirmative decision after a review of the additional facts and circumstances.*

**Section Five: Conclusion**

The US is the world's largest economy with the world's largest loss exposures due to the trillions of dollars of property exposed to natural disaster perils; and due to the unique liability exposures of US businesses and professionals. Insurance plays a vital role in managing risk for consumers and businesses. The US successfully accomplishes this by spreading risk into the global marketplace. Large potential loss exposures require risk to be held on large balance sheets which benefit from the diversification of risk across perils and across national boundaries. As a result, foreign insurance companies play an important role in the US insurance marketplace—they help the US recover and rebuild when catastrophe strikes. For example, 47% of Hurricanes Katrina, Rita and Wilma claims were paid by international insurers. In addition, 48% of Hurricane Sandy losses were paid by non-US insurance companies. For the 9/11 terrorism tragedy, 64% of the US insurance claims were ultimately paid by non-US insurers. Foreign insurers' participation through US subsidiaries and through cross border trade has long made the US market once of the most competitive in the world – something which has provided important benefits to the US economy. The influx of alternative capital has also made US insurance markets more competitive – offering US consumers lower prices for coverage and affording US consumers more choices for an insurance carrier.

In this statement we've provided answers to specific questions posed by Treasury and documented our concerns about the proposals in the proposed regulation. We've also made five specific recommendations for change to the proposed regulation. The ABIR comments apply to property and casualty insurers.

If the Treasury were to adopt these recommendations then we believe it could fairly establish an active insurer PFIC test that would:

- Afford legitimate insurers the opportunity to remove uncertainty about their tax status for their shareholders;
- Help identify certain insurers which Treasury could test for classification as investment vehicles; and
- Be reasonable to administer in a timely fashion.

In summary our recommendations, if adopted, would:

- Apply the bright line reserve to assets test to provide a simple, verifiable, reliable means to identify active insurers;
- Apply a facts and circumstances test that allows the IRS to consider other factors as enumerated elsewhere in these comments; and
- Identify some insurers which Treasury would classify as PFIC's.

Once Treasury adopts the proposed regulation there should be a three year transition rule to allow existing companies to document their activities to shareholders in order to best comply with the new regulations.

We would request a public hearing on this proposed rulemaking and would look forward to an opportunity to speak at the hearing. We also believe it would be useful to have a further consultation on the next iteration of the Treasury proposed regulation.

We thank you for the opportunity to comment on the proposed rulemaking.

Sincerely yours,

Bradley Kading
President and Executive Director
Association of Bermuda Insurers and Reinsurers
Bradley.Kading@abir.bm; 202 783 2434

**Appendix One: New Insurance Risk Bearing Entities**

In Bermuda insurers can be licensed to assume insurance risk in various ways. In addition to long established commercial insurance vehicles, risk bearing can occur in Insurance Linked Securities issued via a Special Purpose Insurer or in "collateralized reinsurers." An example is the purchase of reinsurance either through an insurance-linked security (ILS) (commonly known as a catastrophe bond) or through a "collateralized reinsurer". A cat bond is issued for the benefit of a US insurer but is sold by a Special Purpose Insurer (SPI), a separate class of reinsurer licensed by the BMA. The typical structure of the SPI is to hold, for a single risk transfer transaction, the funds received by the sale of the bond, in trust for the benefit of the ceding insurer. If the ceding insurer purchases $100 million of reinsurance coverage, $100 million worth of bonds are sold and the $100 million of proceeds is placed in trust to secure the entire coverage limit under the control of the ceding insurer. Only a small amount of regulatory capital is required since the entire assets of the SPI are held in trust and controlled by the ceding insurer that is the beneficiary of the catastrophe bond. SPI's do not have financial strength ratings from the rating agencies.

Another type of vehicle is a collateralized reinsurer. It could be licensed as an SPI or as a Class 3a insurer in the BMA licensing regime. This business and licensing model allows for multiple contracts to be issued for the benefit of cedents. In this structure, as in the case of ILS, the investors in the collateralized reinsurer provide assets that are held in trust under the control of the ceding insurer to fund an agreed to amount of expected losses or of the coverage limits sold. Again, regulatory capital is required at a smaller level since the policyholder protection is provided by the dedicated security held for the benefit of the ceding insurer. Assets held are basically allocated for the benefit of ceding insurer clients in segregated cell or trust arrangements. Collateralized reinsurer vehicles similarly do not maintain a financial strength rating.

Whether the reinsurance is issued by a SPI or by a collateralized reinsurer substantial insurance risk is held by the insurer. The business models require risk to be insured, without that no income or profit would accrue to the company. Investment risk is kept to a minimum since the assets are held for the benefit of the ceding insurer. Expenses are kept to a minimum since the entities contract for services with an affiliate or joint venture partner.