

## The Brattle Statement on the LECG's Report

Michael Cragg, J. David Cummins, and Bin Zhou<sup>1</sup>

On January 19, 2011, the Coalition for A Domestic Insurance Industry issued a press release announcing that a new economic analysis prepared by LECG (the LECG Report) refutes the Brattle Group's economic study (the Brattle Study) of the impact of HR 3424, a bill introduced in the 111<sup>th</sup> Congress by US Representative Richard Neal (D-MA). The original Brattle study was released on May 1, 2009 (<http://www.brattle.com/Publications/ReportsPresentations.asp?PublicationID=1038>) and updated on July 12, 2010 (<http://www.brattle.com/Publications/ReportsPresentations.asp?PublicationID=1179>). After a preliminary review of LECG's 99-page critique of our report, we conclude that the LECG Report is based on:

- (1) Subjective assumptions that affiliate reinsurance plays no economic role and the U.S. transfer pricing rules fail to curb abusive tax dodge using affiliate reinsurance;
- (2) Fundamental mismeasurement of nationwide supply of reinsurance in the U.S.: and
- (3) Misunderstanding of our dynamic simulation model that measures the Neal Bill impact.

Nothing in the LECG Report alters our assumptions, analyses, and conclusions used in the Brattle Study.

### **Assumptions on Role of Affiliate Reinsurance and Failure of Transfer Pricing Rules**

The premise of the LECG Report is its *subjective assumption* that offshore affiliate reinsurance “merely moves risk from one pocket to another; it does not remove risk from the group and does not create additional underwriting capacity.” This belief and assertion completely ignore the fact that insurance operations in the U.S. are regulated on a state level and hence are also managed not only at the group level but also at the insurer level.

As argued in our report, affiliate reinsurance is a fundamental tool used by all insurance groups, both domestic and foreign, to manage their group-level and insurer-level risk. Affiliate reinsurance is particularly potent in mitigating the informational problems between the insured and the insurer. The Brattle Study lists a number of reasons why this is the case, and cites a large body of economics literature on internal capital markets in mitigating the informational problems (including a few papers in the insurance/reinsurance setting). The LECG Report simply ignores the economic bases and the empirical evidence, and dismisses the informational problem as an “exaggeration.” In contrast, we reasoned that affiliate reinsurance, non-affiliate reinsurance, and capital, while all employed by the insurance groups to manage their insurance exposures, have different cost and benefit characteristics, and are not perfect substitutes. Their substitutability is, however, an empirical matter and can be estimated and analyzed in the

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<sup>1</sup> Dr. J. David Cummins is the Joseph E. Boettner Professor of Risk Management, Insurance and Financial Institutions at the Fox School of Business at Temple University and the Harry J. Loman Professor Emeritus of Insurance and Risk Management at the Wharton School at the University of Pennsylvania; Dr. Michael Cragg is a Principal, and Dr. Bin Zhou is a Senior Consultant of The Brattle Group.

regression analyses. This is indeed what we did in our study. **To date, our study remains the only independently performed empirical analysis of the Neal Bill impact.**

Furthermore, the LECG Report completely ignores the enforcement of U.S. transfer pricing rules to assume that offshore affiliate reinsurance is a tax dodge strategy. It also ignores the fact that foreign reinsurers pay U.S. taxes on the profits earned in the United States (via ceding commissions paid to the U.S. affiliates) which cannot be obviated through affiliate reinsurance.

### Measurement of Supply of Reinsurance

The LECG Report also criticizes that the Brattle Study failed to include \$300+ billion onshore affiliate reinsurance in measuring the nationwide supply of reinsurance. This criticism is fundamentally mistaken. As pointed out by the LECG Report, the National Association of Insurance Commissioners (NAIC) mandates that that each NAIC-reporting entity report affiliate reinsurance ceded and affiliate reinsurance assumed separately. At the insurance group level and the national level, insurance analysts could report the total group-level or nationwide affiliate reinsurance as the simple sum of each subsidiary as is done by SNL, or could offset the affiliate cession with the affiliate assumption as is done by Highline. Consider the typical pooling arrangement by a U.S. insurance group consisting of two NAIC-reporting entities (A and B). If entity A cedes \$100 premium to its onshore affiliate B, SNL will count the \$100 premium **twice** for the U.S. insurance group — first as “reinsurance assumed from affiliates” and then as “reinsurance ceded to affiliates.” To the contrary, Highline will report zero affiliate reinsurance at the group level, since both affiliate reinsurances are **eliminated** in group consolidation.

**U.S. P&C Insurance and Reinsurance in 2009**  
(\$ Billions)

	Highline	SNL
Direct Business	475.2	477.4
Reinsurance Assumed From		
Affiliates	11.5	310.0
Non-Affiliates	44.3	43.6
Reinsurance Ceded To		
Affiliates	41.9	341.0
Non-Affiliates	65.2	65.4
Total Reinsurance Ceded	107.1	406.4

The two consolidation conventions are followed by SNL and Highline at the national level as well. As shown in the table above, a large portion of the onshore affiliate reinsurance reported by SNL (\$310.0 billion assumed and \$341.0 billion ceded) simply reflects the pooling arrangements by the insurance groups. What remain after the offset by Highline (\$11.5 billion assumed and \$41.9 billion ceded) are much smaller affiliate reinsurance transactions between NAIC-reporting entities and their non-NAIC reporting affiliates. These non-reporting entities

include primarily foreign reinsurers but also include some foreign subsidiaries of the domestic insurance groups. The disparity between Highline and SNL on the total reinsurance ceded is more than a mere reporting anomaly. **Since the objective of our simulation of the Neal Bill is on U.S. insurance and reinsurance on a whole, the total reinsurance ceded on a net U.S. basis should be \$107.1 billion instead of \$406.4 billion.**

### **Misunderstanding of Dynamic-Effects Simulation**

The next major attack of the LECG Report is that, even if we measure the substitution correctly, the effect we projected on the nationwide insurance capacity “wrongly assumes that written premium drives surplus, but rather it is surplus that creates overall capacity to write business.” To the contrary, our underwriting capacity impact is neither demand-driven, nor supply-driven. Rather, as shown in Figure 9 of our 2010 report, the impact of the Neal Bill on the national insurance capacity is based on a dynamic interaction of substitutions of non-affiliate reinsurance and capital for affiliate reinsurance (using our first set of regression results), and a secondary feedback impact of underwriting premium adjustment (using results from our second regression). As a result, our simulation projects the new equilibrium after an initial, external shock to the affiliate reinsurance. **In the new equilibrium, the increases in non-affiliate reinsurance and in surplus, and a reduction in underwriting premiums are solved simultaneously.**

### **Conclusion**

The litany of so-called flaws identified by the LECG Report is misplaced. We have responded to the main economic criticisms above. Nothing identified by the LECG Report leads us to change our assumptions, analyses or conclusions. While the Brattle Study has taken an approach grounded in the academic and practitioner literature to analyze the impact of the Neal Bill, the LECG Report offers no economic analysis of its own. It simply accepts the Coalition for A Domestic Insurance Industry’s position, and asserts that affiliate reinsurance does not create underwriting capacity in the U.S.