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In this issue … we look at two topics which may come to affect the U.S. insurance marketplace.

Speculation over when the soft market will end, with a return to higher corporate insurance prices, is a mostly harmless exercise indulged by many. Those looking for firmer pricing might find comfort in knowing that there is a limit to how low prices can go. Rather than conjecture about when the market might change, this first newsletter of 2011 will discuss two factors that could, in time, be contributory.

THE NEAL BILL

First introduced into Congress in 2009 as HR 3424 (PDF) by Representative Richard Neal of Massachusetts, the "Neal Bill" has been a divisive element within the insurance industry. The stated intent of the 10-page measure seeks the "*Disallowance of [tax] deduction for excess non-taxed reinsurance premiums paid to affiliates*." In plain terms, the goal is to eliminate current tax advantages enjoyed by offshore-domiciled reinsurers.

The original bill never progressed out of committee before time expired, but Representative Neal is unlikely to let the matter drop. His membership of the House subcommittee on Select Revenue Measures provides a platform from which he can promote his agenda. In today's political climate, initiatives which produce new sources of revenue generally find widespread approval; this could lead to the substance of the bill being tacked on to other legislation.

Despite its dormancy, the Bill's implications have produced passionate adherents and opponents. Opinion has crystallized behind two organizations: the Coalition for a Domestic Insurance Industry, which supports the Neal Bill, and the Coalition for Competitive Insurance Rates, which opposes it.

The Coalition for a Domestic Insurance Industry

The basic tenet of the bill's supporters is that tax advantages afforded to offshore entities create an uneven playing field, to the disadvantage of tax-paying domestic insurers, with a considerable loss of revenue resulting from what amounts to a tax loophole. "In light of the current economic climate, we should not continue to allow unintended tax breaks for foreign companies doing business in the U.S. at the expense of their U.S.-based competitors and other American taxpayers." The coalition currently represents thirteen U.S.-based insurance groups.

The Coalition for Competitive Insurance Rates

The main thrust of this group's argument is that the current system helps maintain a business and consumer-friendly competitive market, with the specter of alarming premium increases if such a measure were to be enacted: "a bill which threatens to drastically raise insurance rates across the country." Support is strongest in regions most exposed to those catastrophes which reinsurance is essential in ameliorating; backers include the insurance commissioners from Florida, Louisiana and Mississippi.

Individuals will have to decide for themselves which group has the most persuasive arguments. To its opponents, the Bill could single-handedly transform the U.S. insurance market —a prospect that might be appealing to insurance executives weary of shrinking premiums and rising expenses. Supporters of the Bill dismiss such fears as a red herring, and that rates will be largely unaffected and capacity undiminished.

SOLVENCY 2

Capital adequacy for companies which assume financial risk is paramount. This newsletter recently looked at Basel III (PDF), the global banking community's proposed solution to mitigating the risk of banks' insolvency. Simultaneously, the European Union (EU) has been formulating a framework to bolster capital requirements for insurance companies in its member-states. Known as Solvency 2 (or II), the new regime is planned to take effect on November 1, 2012, at which time it will replace the current Solvency 1 requirements.

The details of Solvency 2, as might be expected, are complex; Solvency 2 is split into three "pillars:" (PDF) Pillar one is concerned with financial requirements; pillar two with insurer governance and risk management, with pillar three addressing transparency for both regulatory supervisors and the public. Because of their interconnection, pillars two and three together are sometimes referred to somewhat cryptically as "pillar five."

For most insurance professionals, the nutshell description is that EU insurers will generally be required to increase the size of their capital cushions. At the same time, insurers will be reevaluating their exposure to risk through their product lines; some may decide certain risks are no longer worth the capital cost, while reinsurance purchasing may increase as primary insurers seek to relieve their exposure. There will probably be unintended consequences, but one immediate result is that Lloyd's fears it will need to hold twice as much in reserves, and is lobbying the EU for what amounts to a special exemption.

SUMMARY

Supply of and demand for capacity is probably the key force which drives pricing patterns in the insurance industry—just like almost every other free market. The expanded roster of insurers willing to contribute to an abundant supply has helped produce the current market conditions. That roster will probably not shrink without a change of philosophy, financial pain or a combination of both. Opponents of the Neal Bill are convinced that its provisions will force commercial premiums up; that remains to be seen—even its passage into law is by no means certain.

The changes being wrought by Solvency 2, however, are both real and imminent. A generation ago, the effect in America of new European insurance regulation would have been minimal. But today's global economy is much more connected. Few of the world's major reinsurers are based in the USA: The dominant companies are in Europe and Bermuda, where the Bermuda Monetary Authority has already pledged to achieve regulatory standards equivalent to Solvency 2.

The strengthening of European insurers' capital adequacy and risk management practices will likely cost insurers money. Just how much money, and where that money is found, could eventually influence commercial premium levels on both sides of the Atlantic. ❖

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