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Impact of US Tax Reform on Group Rating Affiliations

A.M. Best comments on how tax reform affects group rating affiliations

The purpose of this briefing is to address anticipated structural changes to certain reinsurance arrangements between affiliated (re)insurance companies, prompted by the December 22, 2017 enactment of the Tax Cuts and Jobs Act (TCJA), and the impact of such changes as they relate to A.M. Best's assessment of group rating affiliations.

It is expected that rated US domiciled (re)insurers that have material financial arrangements — in particular, quota share, excess of loss, or stop loss agreements with foreign affiliates —will, in response to the base erosion and anti-abuse tax (BEAT) measure of TCJA, make significant changes to these reinsurance contracts. These contracts, considered explicit support under *Best's Credit Rating Methodology*, are considered in our assessment of group rating affiliations. A.M. Best's group rating affiliation contemplates a combination of ten factors when determining eligibility for a group rating.

An affiliate of a lead rating unit that carries a group rating affiliation is important to the group's primary mission based on its financial, operational, and/or strategic importance. The assessment of whether the affiliate is important to the group contemplates how it meets the following criteria:

- Is the affiliate critical to the group's strategy and ongoing success?
- Is the affiliate fully integrated in the group's operations and management?
- Is the affiliate material to the group's business profile?
- Will the affiliate's divestiture lead to a major shift in business strategy?
- Does the affiliate carry the group name or is it easily identified with the group?
- Is the affiliate a significant contributor to the group's earnings?
- Is the parent willing and able to provide explicit support?
- Does the affiliate have a track record of supporting the group's strategy?
- Is the affiliate necessary for rate flexibility?
- Is the affiliate necessary to meet licensing requirements?

Material changes to a reinsurance agreement, or outright non-renewal, for any reason would affect the assessment of whether the parent is willing and able to provide explicit support to the affiliate. The other items used to establish explicit support are: (1) demonstration of a recent material capital injection (excluding initial capitalization), (2) an intercompany loan, and (3) a guaranty or net worth maintenance agreement, or other contractually explicit support.

As explicit support is only one of ten qualitative or quantitative factors used to assess group rating affiliation eligibility, and reinsurance is only one component (although an important component) of explicit support, clearly the presence of a quota share agreement is not the sole determinant of group rating eligibility. The cessation of a reinsurance agreement between a lead rating unit and an affiliate does not automatically negate the group rating affiliation status. A.M. Best will consider all ten factors, including all forms of explicit support, on a situational

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basis. A.M. Best will contemplate the permanency and materiality of explicit support as well as regulatory and legal considerations (including tax changes), while performing this part of the analysis.

A.M. Best realizes that an exogenous event has caused a change in the economic value of a reinsurance agreement. We will consider reasonable alternative strategies that demonstrate explicit support, as well as the other qualitative and quantitative factors, to assess group rating affiliation eligibility.

Entities started or acquired within the last 18 to 24 months are generally not eligible for the **(g)** affiliation code, as they might not: have made a contribution to the group's earnings, be fully integrated with the rest of the rating unit, or have a track record of supporting the group's strategy. Therefore, a start-up or recently acquired entity would likely need, as a minimum, explicit parental support (e.g., affiliated reinsurance, financial guarantee) to be assigned a group **(g)** affiliation code.

Establishing Explicit Support

Recent Capital Injections: generally, a hard common equity capital injection, separate and apart from initial capitalization, made within the last five years will receive the most "credit". Other forms of capital injection, including preferred or preference shares, can receive significant credit based on the common equity-like features of the shares.

Guaranty, Net Worth Maintenance Agreement, or other Contractual Agreements: Fully executed agreements of support will be analyzed for policyholder protection and are viewed as strong if the agreements contain at least 12-month termination clauses; cover all obligations of the subsidiary; and include clear jurisdictional conflict resolution clauses, policyholder assurance of enforcement language, and claim and reserve run-off protection.

Intercompany Loans: Fully executed intercompany loan agreements will be analyzed to ensure arms-length terms and conditions and the same policyholder protection language as delineated in the Contractual Agreements section directly above.

Execution of contractual agreements and intercompany loans will cause the BCAR of the company that provides the support to be stress tested by synthetically deducting from capital a conservative support scenario. This will have the effect of reducing the company's policyholders' surplus and resultant BCAR scores.

The impact of tax reform will be a net positive for the financial position of US property/casualty insurance companies and US-parented global (re)insurers. The largest benefit will be the reduction in the corporate tax rate; however, other tax reform provisions may serve to limit the benefit of the reduction. Foreign-parented global (re)insurers have publicly stated that the impact of tax reform will not be material, presumably as a result of the multiple platforms in which they can transact business.

Summary of Material Tax Law Changes as They Affect Property/Casualty (Re)insurance Groups

1. Reduces Corporate Tax rate from 35% to 21%;

2. Base erosion and anti-abuse tax (BEAT) taxes payments to foreign affiliates by adding payments back to taxable income — the definition of payments is evolving;

3. Repatriation tax implements a tax system that taxes foreign subsidiaries' earnings not distributed; and

4. Modifies the discount calculation and loss payment patterns used to determine tax-basis loss and LAE reserve balances.

Please see our December 21 briefing, *First Look — Tax Reform 2017*, for additional coverage of the new law.

Companies have begun to report their expected financial adjustments to their 2017 financial position. This will include an adjustment to their deferred tax assets or liabilities, incorporating an estimate of the effects of the items listed above and additional less prevalent changes. A.M. Best will continue to monitor the impact of tax reform on insurers' financial statements as they close their books and report their results.

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