FERMA
Federation of European
Risk Management Associations

FERMA's Response to OECD BEPS Discussion Draft

BEPS Actions 8-10

Transfer pricing aspects of financial transactions

Introduction

FERMA thanks OECD for the invitation to comment on the discussion draft produced by Working Party No. 6 ("WP6") entitled "BEPS Action 8: Financial Transactions" and more specifically the chapter about captive (re)insurance companies.

We welcome the presence of a whole section dedicated to captive insurance as step that was needed to address efficiently the specificities of captive insurance transactions. We appreciate, in particular, the fact that captive insurance companies are now more generally perceived as one way for multinational entities ("MNEs") to manage risks within the group (§162) and as a component of their risk and insurance management strategies (§172 and (§173).

The OECD discussion draft offers also a better understanding of captives as small insurance enterprises, especially by suggesting that they are regulated entities (§166) and by recognising the various types of captive with an improved understanding of what is a reinsurance captive (§177).

FERMA's main objectives in commenting on the discussion draft are to:

- Clarify understanding regarding the use of captive (re)insurance companies by MNEs;
- Promote consistency in the way BEPS principles are applied to captives going forward;
- Encourage practicality and proportionality in future OECD guidance in the context of the efficiency of multinationals' insurance operations and risk management strategy.

FERMA, therefore, wishes for OECD final guidance that is clear, unambiguous and robust enough to provide MNEs with some legal certainty. Our aim is to reduce legal disputes and avoid any disproportionate increase in the administrative burden which would be detrimental for international businesses without providing the expected outcome for tax authorities.

The following pages gather the comments and recommendations of FERMA to the Public Discussion Draft issued by OECD in respect of BEPS Actions 8-10 and summarise the view of the European risk management community, i.e. the 22 national risk management associations member of FERMA in 21 European countries, representing 4700 risk and insurance managers throughout Europe.

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Executive Summary

Following a detailed review of OECD's public discussion draft document entitled "BEPS Actions 8-10 Financial Transactions", FERMA's views on the boxed questions are detailed in this paper. FERMA's Information Paper sent to the OECD in June 2017 is the foundation for our comments, and it is attached as an appendix to the present document.

1. Any new guidance from OECD relating to captive insurance companies should be consistent with certain fundamental accounting and insurance regulations with which MNEs already comply. More specifically, this means referring to IFRS 17 and the International Association of Insurance Supervisors ("IAIS") definition of "genuine insurance transaction" and "insurable risks", rather than introducing new definitions.
2. In this regard, we believe that the arm's length principles of any transfer pricing arrangement involving a captive insurance company should mean that it is treated as a genuine insurance transaction, satisfying the conditions of IFRS 17, provided it falls within the specific categories of insurance classes which the captive is authorised by the insurance regulations to conduct in the jurisdiction.
3. Currently, the draft discussion paper includes certain comments and examples that we think could create unnecessary uncertainty and administrative burdens for both MNEs and tax authorities.

1. Box E.1

FERMA believes that to evaluate whether a captive is actually assuming a risk, tax authorities can rely on principles which are already well understood and widely applied, such as IFRS 17 and the insurance regulations that generally follow the standards laid down by the European Union directives and/or the IAIS. Another set of indicators is not needed.

Furthermore, the current insurance regulations are extremely stringent about the various functions of a captive such as underwriting, outsourcing, etc. A further layer of regulations by the OECD could create a risk of confusion, ambiguity, uncertainty and ultimately more administration for multinationals and the corresponding tax authorities. The OECD can acknowledge and take advantage of the standards, rules and regulations already set out by the International Accounting Standards, the European Union, the IAIS and the respective insurance supervisory regimes.

In line with these regulatory standards, demonstrating a captive actually assumes the risk can be completed as follows:

a) There should be a real possibility for the captive to have an underwriting loss, and the captive's capitalisation should be commensurate with the risks underwritten.
b) There is a realistic "risk gap" for the specific risks to be assumed, i.e. the annual maximum probable losses could exceed collected premiums.
c) The decision-making aspect of "underwriting function" usually remains with the captive Board (or a committee). Typically, it is the administration and accounting aspect of the underwriting function that is outsourced. However, if the function is outsourced, then the provider should be paid appropriate remuneration and captive would retain only profits related to risk and capital. But the wider governance of the captive should be considered, not just the underwriting function.
d) The decision-making and control of risk are with the captive Board (or a committee). Insurance regulations would not allow a situation where the Board had no say in risk underwriting and declining. However, if some functions are executed outside the captive, again due remuneration should be paid to provider for the function, and captive would retain only profits related to risk and capital. In an

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extreme case where the captive has so little governance that its mind and management are not deemed to be within its domicile, existing Controlled Foreign Companies ("CFC") legislation already address this situation and the captive risks having its entire earnings assessed at a parent company level.

2. Box E.2

Actuarial analysis is a widespread and core pricing methodology in the insurance market, and FERMA welcomes the approach described in paragraph 181. This approach is in line with international supervisory rules such as the Solvency II Directive. As well as a basis for transfer pricing, actuarial modelling can provide a technical price to assess the value of commercial insurance and provide robust support for the risk retention / transfer decision.

From a transfer pricing perspective, actuarial pricing is equivalent to a Cost-Plus method. The cost element will be made of expected losses (or so called "pure" premium or "burning cost") and the margin element will comprise:

a) A risk margin for volatility due to low frequency/high severity losses;
b) Compensation for running costs associated with underwriting and claims management;
c) Compensation for costs associated with distribution network / broking;
d) A profit margin.

3. Box E.3

FERMA believes that a captive insurer that insures third party risks introduced by a connected group company, such as an agent, is not really a captive. Such a vehicle is treated as an insurance company by local supervisory authorities – particularly those in the European Union.
These companies are regulated in respect to the remuneration they derive for the nature of risk and cover they provide to third parties. Such arrangements generally follow open market conditions, and the profitability of the captive is usually commensurate with the risks it takes and the capital it has to support its commitments. The agent is paid an arm's length commission, again commensurate with those prevalent in the market.

a) Introducing an example of a captive arrangement in the discussion draft should create more understanding of the practical application of the guidance to actual transactions. FERMA welcomes that.
b) But we believe that the example described in §187 and §188 is not helpful.
c) The key value creation aspect of an insurance contract, and therefore its pricing, is the risk transfer and risk bearing capital element aspects of it. Functions such as the distribution network, underwriting and claims are complementary.
d) In the example, the agent clearly provides the distribution function and should receive an arm's length remuneration for that. Then the captive provides risk and capital, as well as underwriting and claims functions, and it should receive an arm's length remuneration for that as well. If any of those two components are not arm's length, then the situation should be adjusted, but they are separate elements of added value that should not be mixed. We find the example confusing in that respect.
e) To be more specific, A would not have retained any higher profits if it had sold policies underwritten by another insurer, unlike what is described in the example (unless the commission in the example is not arm's length). If A had worked for a commercial insurer, it would have received the same distribution network commission, but the insurer would have kept the entire underwriting profit. Using a captive in the framework enables the MNE to capture this underwriting profit by providing risk and capital in addition to the distribution activities of A. This additional piece of added value in

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the process, and therefore the corresponding remuneration, is created by the captive itself as a risk bearing insurance carrier within the MNE.

In addition to the comments to the specific boxed questions, we urge OECD to review and perhaps revise a number of paragraphs in the draft discussion paper, in particular numbers 165, 167, 171, 172, 173, 176, 178, 183, 184 and 185. We believe that these paragraphs are either mistaken or misleading and could create uncertainty and confusion not only among MNEs, but also insurance supervisors and tax authorities. The reasons for this conclusion are detailed in later sections of this response.

Finally, FERMA would like to reiterate points made in its Information Paper sent to the OECD in June 20171. At the core of FERMA's paper are proposed guidelines which are meant to support national tax authorities when transposing BEPS actions into their national laws. These guidelines cover three areas which raised certain questions of interpretation by OECD members during the implementation stage of the BEPS actions published in 2015: commercial rationale, substance and governance, and transfer pricing - premium setting process.

The objective of our guidelines is primarily to avoid a patchwork of diverging national legislation. The FERMA Information Paper also outlines in detail the commercial reasons why a multinational forms a captive insurance company. It provides evidence that MNEs set up a captive insurance company to manage the Total Cost of Risk (TCOR) and get technical support from the (re)insurance market, not for tax purposes.

We, therefore, hope that OECD will review the guidance in the Information Paper for tax authorities to follow when considering the captive structure, governance and insurance arrangements.

[1] FERMA Information Paper to OECD in order to propose Captive (Re)Insurance Guidelines to National Tax Authorities (June 2017).

Preliminary comment

FERMA believes it is crucial to start by highlighting its comments and recommendations about the core principle of what is a "genuine insurance transaction" before addressing the various questions and commenting on the discussion draft produced by WP6.

The definition of a "genuine insurance transaction" is the cornerstone of how OECD's BEPS guidance should apply to captive transactions. FERMA believes this should be an unquestionable principle and would like to see clarification of the delineation of what is a genuine insurance transaction in order to avoid misinterpretations and uncertainties.

Genuine insurance transaction

The primary underlying principle to assess the transfer pricing aspect of a captive insurance transaction is first and foremost to determine whether it is a genuine insurance transaction.

FERMA believes the WP6 discussion draft could be more precise about this core principle and define it more clearly.

For instance, §166 mixes two different concepts in amalgamating "*what is a genuine insurance transaction*" and "*what would be expected from an independent insurer*". FERMA believes this is confusing, because it implies that an entity should be an "independent insurer" in order to carry on "genuine insurance transactions". This is not necessarily the case. A "genuine insurance transaction" must remain the primary driver, rather than the nature of the (re)insurance risk carrier, and should be defined by its own core features.

§166 mentions that a typical feature of an "independent insurer" is that "*the insured risk would otherwise be insurable outside the group*". If we take this principle literally, it means that no innovation would be possible in the insurance market, as the first insurer to sell a new product would not be carrying on a genuine insurance business. This somewhat absurd argument aims at showing that insurance must be defined by its core characteristics, instead of the nature of the entity carrying the insurance business.

A traditional way of defining an insurance transaction is to refer to an agreement whereby one party (the (re)insurer), is obliged to indemnify the other party (the (re)insured) upon the occurrence of a fortuitous and uncertain future event in which the (re)insured has a material or pecuniary interest. A fortuitous event is understood as an event beyond the direct control of either party.

FERMA strongly believes OECD should bring clarification to what are the key features of a genuine insurance transaction in order to avoid inconsistencies across jurisdictions and to allow MNEs to operate in a stable regulatory environment with delineated boundaries allowing predictability and legal certainty.

To this end, FERMA strongly recommends following two main sets of core principles for defining a "genuine insurance transaction", IFRS 17 definition and Regulatory Insurance Classes of Business, to avoid introducing new definitions and, therefore, greater uncertainty.

1- IFRS 17

Most, if not all, captive insurance companies owned by MNEs must prepare their regulatory returns and financial statements in accordance with International Financial Reporting Standards ("IFRS") or equivalent. Therefore, so that there is no ambiguity about how the definition of an "insurance contract" can be interpreted, FERMA recommends that IFRS 17 – Insurance Contracts Principles (which replaces IFRS 4 from 1

January 2021 – but companies can adopt it earlier), applies to all insurance and reinsurance contracts and is used to set out principles for the recognition, measurement, presentation and disclosure of insurance contracts.

IFRS 17 requires an entity to identify a contract as an insurance or reinsurance contract under which the insurance entity accepts significant insurance risk from the policyholder by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

According to IFRS 17, at least one of the following must be uncertain at the inception of the insurance contract:

a. The probability of an insured event occurring;
b. When the insured event will occur; or
c. How much the captive insurance company will need to pay to the policyholder if the insured event occurs

IFRS 17 defines insurance risk as "*a risk, other than financial risk, transferred from the holder of a contract to the issuer*". A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract.

IFRS 17 provides further guidance on "significant risk". Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (i.e. no discernible effect on the economics of the transaction).

2- Regulatory Insurance Classes of Business

Insurance regulations generally require all captive insurance companies to be licensed to issue contracts of insurance and reinsurance under classes of insurance businesses.

For instance, the EU Solvency II Directive 2009/138[2] defines the 18 following non-life insurance classes of businesses:

1. Accident
2. Sickness
3. Land vehicles
4. Railway rolling stock
5. Aircraft
6. Ships
7. Goods in transit
8. Fire and natural forces
9. Damage to property
10. Motor vehicle liability
11. Aircraft liability
12. Liability of ships
13. General liability
14. Credit
15. Suretyship
16. Miscellaneous financial
17. Legal expenses
18. Assistance

[2] Annex I - Classification of risks according to classes of insurance - Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

Conclusion

Therefore, FERMA argues that any contract of insurance issued by a captive insurance company and meeting following criteria should be considered as a "genuine insurance transaction" without further or additional challenge:

a) The transaction is about an insurable risk that falls under the specific classes stipulated by the local insurance regulations.
b) The risk being insured must be an uncertain future event at the inception of the contract and must be fortuitous, i.e. beyond the direct control of both the insured/reinsured and the captive.
c) The risk must be in respect of an "insurance risk" and not a "financial risk".
d) There must be a realistic probability the captive could suffer a loss.

It is also worth noting that captives are subject to insurance regulation by the supervisory authorities in their respective jurisdictions. Such supervisors will review the captive's business plan before granting the licence and then will perform regular audits all along the captive's life to ensure that it is properly managed, governed and appropriately capitalised to meet its financial obligations.

As such, any transaction that would not satisfy the definition of genuine insurance, that would be mispriced compared with insurance market practice, or where the captive would clearly have no control over the potential exposure it is underwriting, would not be accepted by the local insurance supervisor.

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FERMA's Response to "Questions to commentators"

Box E.1. Questions to commentators

The first two questions in Box E.1. are:

- When an MNE group member issues insurance policies to other MNE group members, what indicators would be appropriate in seeking to arrive at a threshold for recognising that the policy issuer is actually assuming the risks that it is contractually assuming?
- When an MNE group member issues insurance policies to other MNE group members, what specific risks would need to be assumed by the policy issuer for it to earn an insurance return, and what control functions would be required for these risks to be considered to have been assumed?

FERMA believes these two questions are intrinsically linked and can be answered by asking:

- How can it be demonstrated that a captive company actually assumes the risk that it has contractually accepted?
- What risks should be borne by and considered at the captive level to determine whether it is actually assuming the insurance transaction and as such is entitled to the related insurance earnings?
- What indicators or controlling analysis could be used to verify these risks have been actually assumed?

How can it be demonstrated that a captive company actually assumes the risk it has contractually accepted?
In order to understand how a captive actually assumes the risk that it has contractually accepted, we first refer to § 1.63 and 1.64 of Chapter I of the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations which state the following:

1. "*Risk assumption means taking on the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materialises*".
2. "*Financial capacity to assume risk can be defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materialises*".

This means that:
1. There should be a real possibility for the captive to have an underwriting loss, and
2. The captive's capitalisation should be commensurate with the risks underwritten.

The principal points to address in this regard therefore are that:

- There should be a reasonable probability of transfer of value between the captive and the MNE entities paying the premiums, i.e. claims payments can potentially be more than the premiums collected by the captive, and
- The captive must have sufficient capital in addition to its premiums to be able to honour its contractual obligations. Such capital would be set with regard to regulatory requirements and a pragmatic economic assessment, i.e. does the captive have sufficient assets (liquid or contingent) to be able to pay a maximum foreseeable loss under a policy in addition to predictable claim payments.

What risks should be borne by and considered at the captive level to determine if it is actually assuming the insurance transaction and as such is entitled to the relating insurance earnings?

Further to these principles, it seems clear that the main risk to be borne by a captive entity is the insurance risk.

According to the OECD 2010 Report on the Attribution of Profits to Permanent Establishments, insurance risk "*is the potential for the amount or timing of actual claims cash flows to differ from expected cash flows*".

In other words, there should be a realistic "risk gap", i.e. the likelihood that collected premiums are insufficient to cover claims and expenses. Actual claims may differ from expected ones because of extreme (severity) or irregular (frequency) events.

That insurance risk must be seen at the company level as the difference between annual earned premium and annual maximum probable loss, thereby creating a true possibility for the captive to have an underwriting loss.

In a Solvency II environment, for instance, this would be demonstrated by an Own Risk and Solvency Assessment ("ORSA") report assessing the impact of potential loss scenarios on the captive's financial strength. Obviously, this should be measured against "reasonably expected" large losses and not total exposure, as an insurer in the market is unlikely to have enough surplus assets/capital to absorb a total loss on its portfolio without re-capitalisation.

To the extent that an insurer, be it a captive or not, assumes insurance risk, it will command a risk premium that will compensate it for the risk it is assuming.

FERMA believes there is no need to consider any specific "indicators" to assess whether the captive is actually assuming any risk. According to the very detailed accounting guidelines (IFRS) usually accepted by tax authorities and the insurance regulatory principles overseeing captive operations, creating another set of "indicators", could lead to confusion, uncertainty, and inconsistency.

However, for the sake of clarity and as an illustration, FERMA would like to highlight again the various ratio and analyses that allow an efficient but simple assessment of the actual insurance risk assumed by a captive (or any insurance or reinsurance carrier):

- UNDERWRITING
  Loss ratio (net claims / net premiums)
- PROFITABILITY
  Net profit before tax (NPBT) / gross written premiums (GWP)
- SOLVENCY
  Net assets / GWP

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Important: Because nature of insurance is also to compensate losses over time, FERMA believes it is of utmost importance that any such indicator is assessed on a mid- to long-term period, and not individually on any given year. In addition, OECD should stipulate that all contracts of insurance satisfy the conditions of IFRS 17.

Box E.1. Questions to commentators

Third item in Box E.1.:

- whether an MNE group member that issues insurance policies to other group members can satisfy the control over risk requirements of Chapter I, in particular in the context of paragraph 1.65, in situations where it outsources its underwriting function. Comments are also invited on whether an example would be helpful to illustrate the effect of outsourcing the underwriting function on the income allocated to the group member that issues insurance policies.

Paragraph 1.65 of Chapter I states the following:

"*Control over risk involves the first two elements of risk management defined in paragraph 1.61; that is (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function*".

When talking about the "underwriting function", one needs to differentiate between the decision-making and administrative elements of it. What is typically outsourced to professional captive managers in the market is the administrative part relating to policy issuance, premium collection, claims payments, reporting, etc.

The decision-making element is not outsourced but always remains with the captive's Board of Directors or Underwriting Committee, delegated by the Board. Decisions at that level include which risks to underwrite or not and under what conditions, as well as which reinsurance mitigation should be purchased in the market or not.

Key criteria should include the ability to demonstrate that there is a sufficient (proportionate) process in place to determine the acceptance of the risk. The captive should be able to show that it has access to the appropriate skills, expertise and depth of resources to undertake its activities. There is no need for own or internal resources as long as the remit under which it operates is clear and defined. Where the resources are provided by a service provider, then appropriate outsourcing/consultancy contracts, incorporating service level agreements should be in place. Where the functions are provided by other employees of the MNE, there should be clear segregation of duties. These resources should be available for use by the captive in its domicile.

FERMA also believes that emphasising only the underwriting function provides an incomplete view of what is required within a captive.

The requirement should be that the captive has the relevant governance structure in place allowing it to make knowledgeable and informed decision through the right and required combination of skills (financial, technical, actuarial, legal and managerial). As such, mentioning the governance structure and the necessary set of skills seems to us more useful than designating a specific function.

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This is, indeed, what many insurance regulations require from captive (re)insurance companies: to put in place a proportionate risk management system and general governance procedures.

For instance, within the EU, under Solvency II, Chapter IV, Section 2, Article 44, the captive's risk management systems must address, in written policy documentation, the following risks: underwriting and reserving, asset liability management, investments, liquidity and concentration, operational, and reinsurance. The policy document must be reviewed annually by the Board of Directors. The captive Board of Directors is responsible for implementing the above. Whilst the captive is meant to be a lean organisation to ensure that the group's Total Cost of Risk ("TCoR") is economical and optimal, the responsibilities of the board cannot be "outsourced" to third parties.

The governance rules of the local regulatory body impose strict requirements on the board to ensure that the risk management policy covers the type of risk that the captive should underwrite, its underwriting procedures and parameters such as limits, retentions, reinsurance, and terms and conditions.

Given the level of activity in a captive in the terms of the number of contracts of insurance and reinsurance, the number of policyholders, the limited amount of risks, etc., it is frequently uneconomical to hire full time underwriters or other dedicated employees as it would disproportionately increase the TCoR of the multinational parent company. Therefore, the captive may use outsourced suppliers to execute the policies and procedures set by the board.

In addition, we refer to Chapter 3.2. Substance and Governance of the FERMA Information Paper to OECD from in which FERMA suggested a full set of guidelines to assess the appropriateness of a captive's substance. It seems to FERMA that it gives a broader and more comprehensive view than a single technical area of the captive's business can do.

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Box E.1. Questions to commentators

Fourth item in Box E.1.:

- when an MNE group member that issues insurance policies does not satisfy the control of risk requirements of Chapter I, what would be the effect of this on the allocation of insurance claims, premiums paid and return on premiums invested by that MNE group member ?

As per paragraph 1.51 of Chapter I: "*Functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions*".

Therefore, in a captive transaction there are 3 elements to consider:

(i) Who performs the critical decision making and control activities?
(ii) Is there actual risk transfer?
(iii) Is the captive actually providing capital to bear the risk?

In this respect, FERMA believes there should be no reason to challenge the transaction as long as:

(i) The captive's Board of Directors (or Underwriting Committee) is making the underwriting decisions and control of risk activities,
(ii) There is a "real" risk gap with possibility for the captive to make a loss, and
(iii) The captive's capitalisation is commensurate with the risk it underwrites.

The question could lead to a situation where the Board of Directors of the captive did not have any say in the underwriting strategy of the captive and would not have the possibility to decline underwriting. Such a situation would not be possible under insurance regulations, as the supervisor ensures constantly that there is adequate governance locally, and the captive's Board, or its legal representative, is accountable to the local supervisor in this respect.

Moreover, even in such case, if there is still actual risk transfer to the captive and the captive does provide risk bearing capital, it would not justify tax authorities challenging the allocation of premiums and claims under transfer pricing rules as they are directly attached to the risk transfer and risk bearing capital aspects of the transactions.

If some functions are executed outside the captive, the question from a transfer pricing perspective is more relevant to the appropriate remuneration of those functions through service level agreements.

And, in an extreme case where the captive has so little governance that its mind and management are not deemed to be within its domicile, then this situation is already addressed within existing CFC legislation and the captive risks its entire earnings being assessed at a parent company level.

The FERMA Information Paper outlines how the captive insurance company should be structured, governed and set its insurance premiums to satisfy the various transfer pricing rules of the OECD member states. As we have stressed, multinational enterprises do not form or use captive insurance companies for tax avoidance purposes. They are primarily a risk management tool. Chapter I states in paragraph 1.2 that "*Tax administrations should not automatically assume that associated enterprises have sought to manipulate their profits*". The FERMA Perspectives paper *Captives in a Post-BEPS World* clearly shows in the form of verifiable data that captive insurance companies' premium income, reserving, taxable profits and corporate income tax are comparable with those of third party insurers.

If the contract of insurance issued by the captive insurance company and the manner in which the captive is governed and structured do not satisfy the requirements of the local regulations, IFRS and transfer pricing rules, then it would lead to one or more of the following:

- The captive loses its licence as insurance or reinsurance company in its jurisdiction;
- Insurance supervisor is criticised for not regulating the licensed insurance companies in accordance with the Insurance Core Principles (ICP – as amended in November 2017) issued by the IAIS. The ICP provide a globally accepted framework for the supervision of the insurance sector (including captive insurance companies). The ICP statements are the highest level in the hierarchy of supervisory material and prescribe the essential elements that must be present in the supervisory regime in order to promote a financially sound insurance sector and provide an adequate level of policyholder protection;
- Insurance premiums paid to the captive are not treated as a tax deductible expense;
- The captive will not pay losses suffered by the group entities;
- If the captive is reinsured with third parties, it is quite possible that those reinsurance monies will not be received as the captive has not paid any claims to the insured;
- The losses suffered by the MNE group entities will be treated as tax deductible expense in their respective local tax computations;
- This could create fluctuations in the return on investments and dividend flows between group companies, and could require an injection of additional capital from the parent to a loss-making subsidiary within the group;
- The Board of Directors may be criticised by the shareholders for mismanagement of funds and avoidable adverse share price movements.

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Box E.2 Question to commentators

Commentators' views are invited on the relevance and the practical application of the approach described in paragraph 181 of this discussion draft.

A starting point is that actuarial analysis is a core pricing methodology for the entire commercial insurance market. Every insurer, when underwriting a risk will have actuarial pricing performed, either on a portfolio basis (e.g. motor risk, household risk), or an individual basis (e.g. industrial property risk).

The actuarial analysis is particularly relevant for classes of business where there are material volumes of claims and it is the basis that insurers will use to price such policies. Where losses for an individual insured are too few for this approach in isolation, an actuarial approach can still be used for extrapolation by supplementing the experience from relevant industry losses and/or by using extreme events market models (various sources exist within the industry for this).

For instance, natural catastrophe modelling can be used to provide a modelled price for certain perils and industry rating curves can be used to inform loss frequency used in actuarial modelling. As well as providing a basis for transfer pricing, actuarial modelling can provide a technical price to assess the value of commercial insurance and inform the risk retention / transfer decision.

From a transfer pricing perspective, actuarial pricing is equivalent to a cost-plus method. The cost element will be made of expected losses (or so-called "pure" premium or "burning cost") and the margin element will comprise:

1) A risk margin for volatility due to low frequency/high severity losses
2) Compensation for running costs associated with underwriting and claims management
3) Compensation for costs associated with distribution network / broking
4) A profit margin

Actuarial analysis is a widespread pricing methodology in the insurance market and FERMA welcomes the approach described in paragraph 181.

Additionally, this approach is in line with international supervisory standards. For instance, ICP 8 from the IAIS requires any insurer to have an effective actuarial function capable of evaluating and providing advice regarding, at a minimum, technical provisions, premium and pricing activities, capital adequacy, reinsurance and compliance with related statutory and regulatory requirements.

Similarly, under the *Solvency II* regime, all captives are required to utilise, where appropriate, the services of an actuary to set insurance and reinsurance premiums and technical reserves.

Box E.3 Question to commentators

Commentators' views are invited on the example described in paragraphs 187 and 188 of this discussion draft.

Introducing a captive arrangement example in the discussion draft should allow for more understanding of how to practically apply the guidance to actual transactions. FERMA welcomes the principle but finds the example in paragraphs 187 and 188 is misleading for the following reasons:

As per the IFRS 17 definition, an insurance contract is "a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."

Therefore, the key value creation aspect of an insurance contract is the risk transfer and risk bearing capital aspects of it. As explained under Box E.2 in respect of actuarial pricing, expected losses and risk margin are the primary building blocks of insurance premium setting. Running costs to compensate for the key functions of distribution network, underwriting and claims are then added, as well as a profit margin.

In the example, the agent clearly provides the distribution function and should receive an arm's length remuneration for that. Then the captive provides risk and capital, as well as underwriting and claims functions, and it should receive an arm's length remuneration for that. If either of those two components are not arm's length, then the situation should be adjusted, but they are separate elements of added value that should not be mixed. We find the example confusing in that respect.

Indeed, in the example, introducing a captive arrangement into the framework allows overall greater profitability to the MNE rather than just taking a commission from an insurer. But this would not be possible without the captive providing risk and capital. More precisely, whilst the commission would capture a share of the profit to compensate for running costs of the distribution network, the insurance carrier will look to generate underwriting profit and a return on capital for itself. Only the captive involvement provides access to this underwriting profit.

To be more specific, A would not have gained higher profits for itself if it had sold policies underwritten by another insurer, contrary to what is described in the example (unless the commission in the example is not arm's length). If A had worked for a commercial insurer, it would have received the same distribution network commission and the insurer would have kept the entire underwriting profit. Using a captive enables the MNE to capture this underwriting profit by providing risk and capital in addition to the distribution activities of A. This additional piece of added value in the process, and therefore the corresponding remuneration, are clearly created by the captive itself as a risk bearing insurance carrier within the MNE.

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FERMA's Comments on Specific Paragraphs

The insurance and reinsurance industry operates in a highly regulated environment. Supervisory and regulatory authorities around the world are governmental bodies or agencies applying rules incorporated in national laws and overseen and coordinated at the international level, for instance by the European Insurance and Occupational Pensions Authority (EIOPA) or the IAIS.

Although the regulatory requirements may obviously vary from one country to another, FERMA's overall comment is that WP6 does not seem to have taken these requirements into account.

Further to its answers to "questions to commentators", FERMA wants to highlight concerns about several statements within the WP6's draft discussion.

- Paragraph 165
  It is inappropriate to state that *the insured can influence its product liability risk*. In any case, as per insurable risk definition in the appendix, only fortuitous events would be insured and any loss that is the consequence of the insured's voluntary action will not be eligible for claim under a valid contract of insurance.

- Paragraph 167 (*…local regulators may impose a lighter regulatory regime*)
  We disagree with that statement which is not in line with market practices and does not acknowledge the way insurance supervisory and regulatory regimes are implemented around the world.

  Captives are not subject to "lighter" regulatory regime, as they are fully regulated like all other (re)insurance entities. What is applicable in almost all supervisory regulations is the "Principle of Proportionality" ("PoP"). The PoP means that supervisory authorities should apply regulatory requirements to all entities in a proportionate way, i.e. in line with their nature, scale and complexity. That does not mean a "lighter" regulatory regime but the application of the full regulatory regime to all companies, whether captive or not, in a proportionate way, for example the extent of detail required in documentation or reporting to allow the supervisory authority to verify all regulatory requirements are met.

  This is not the same as a "*lighter regulatory regime*". Proportional supervisory actions do not apply to captives only but also to various commercial insurance companies, for instance to small, traditional companies that specialise in one line of business only. Another way to illustrate the point is that very large captive companies will not have access to proportional regulation because of their nature, scale and complexity of their business, regardless of their "captive" nature.

- Paragraph 171
  It is the captive's Board of Directors or a delegated Underwriting Committee that makes the decisions about assuming the risk of insuring. Other entities within the group would typically propose the risk to the captive, but they cannot make decisions on behalf of the captive's Board of Directors.

- Paragraph 172 *(…potential commercial reasons for an MNE to use a captive include… to benefit from tax and regulatory arbitrage…*)
  FERMA strongly disagrees with that statement which seems to imply that "tax and regulatory arbitrage" is one of the key commercial reasons for an MNE to set up a captive.

  We again highlight the main underlying reasons for an MNE to set up a captive, which are:

1- **(Re)insurance pricing technicalities:** via the captive, the MNE gets access to technical elements relating to (re)insurance covers and pricing structures which allow it to optimise the risk financing process. This includes reduction or stabilisation of the TCoR, buffering market conditions and developing an accurate (re)insurance strategy for financing low- to medium-impact risks over the years. A captive gives the MNE direct access to worldwide reinsurers, mutualisation of non-correlated risks, central negotiation tool, etc.

2- **Risk control:** a captive may add improvements to the overall risk management and control process of an MNE thanks to its central position in the MNE, and its data collection capabilities for losses, prevention and control measures, etc. As such, a captive can be used as a central unit for insurance data collection. It can, therefore, promote greater awareness of factors that commonly give rise to losses and be a strong support to improve loss prevention and control policies, as well as to initiate relevant control actions.

The feasibility and viability of a captive as an effective risk management tool will always be assessed on genuine commercial basis, even if tax is part of the calculation of its overall cost efficiency.

As such, FERMA believes that "*benefiting from tax and regulatory arbitrage*" should be removed from the list as it is not a genuine commercial reason.

- Paragraph 173 (stating that if a captive covers a risk which is difficult or impossible to cover in the insurance market, the commercial rationality of such an agreement could be questioned, and subsequently the possibility to assess the arm's length principle)

FERMA does not agree that using a captive to insure risks which have not been accepted by the traditional insurance market could raise questions about the commercial rationale of such transactions. Instead, we want to emphasise that a captive may provide solutions that an MNE needs in case of insurance market inadequacies, such as coverage for non-traditional or overpriced risks.

From time to time, the traditional (re)insurance market dictates restrictions to some policies, particularly in hard market conditions, and is unwilling to provide cover for certain risks. A short term shortage of capacity can create spikes in cost. The use of a captive to buffer market conditions or to provide additional capacity can be an answer. The captive actively helps its parent company to avoid carrying uninsured risks or paying for overpriced insurance solutions.

A traditional example of the value a captive (re)insurance company can add to its group to provide coverage for risks that are emerging and for which little capacity is yet available from the insurance market, as was the case with cyber risks, or because of their very specific nature and potential impact of the risk, such as nuclear, aircraft, natural disasters, etc.
FERMA believes the key driver should not be "market benchmarking", as traditional insurers' risk appetite may be restricted for multiple reasons, but the characteristics of a "genuine insurance transaction" and "insurable risks" as described above.

The distinction between "insurable risks" and other considerations that commercial insurers may have in building their portfolios is essential and primary in the captive context. All "insurable risks" can potentially be insured, but commercial insurers will not wish to underwrite them all. It varies among insurers, and over time depending on insurance market cycles and competition. Filling this gap between what is insurable and what commercial insurers are willing to underwrite with acceptable conditions at a certain point in time is a key element of the captive strategy. Therefore, the reference point to assess a captive transaction is not

necessarily what other insurers are doing in the market, just as the innovative insurance product launched by one commercial insurer cannot be judged according to what its competitors are underwriting or not.

- Paragraph 176

  We believe this paragraph is too vague and does not acknowledge insurance supervisory regulation by governmental authorities. Lack of diversification will be taken into consideration by the insurance supervisory bodies to determine the minimum capital requirement of any (re)insurance entity, be it a captive or not. Lack of diversification is not an exclusive characteristic of a captive but can also affect independent (re)insurers. It is just one important technical component of any (re)insurance entity management and can have multiple causes. For example, the insurance entity is focusing on one territory or one line of insurance products or it is a new company starting a portfolio from scratch.

  In all situations, the insurance supervisory authority will assess and authorise (or not) such an underwriting strategy and can require additional capital to ensure any less diversified insurer can meet its contractual obligations. If the (re)insurance entity is not sufficiently capitalised to meet its underwriting exposure, the insurance supervisory authority would cancel its licence.

  The OECD statement suggests that considerations other than the existing regulatory and supervisory ones may be applied to assess the right level of diversification within a given (re)insurance entity, which raises the question about what methodology would be needed in addition to supervisory and regulatory rules.

- Paragraph 178 (stating that fronting arrangements involve third parties that are indifferent to the price of the transaction)

  This statement is not accurate. A fronting insurer is not indifferent to the level of premium paid by its insured, mainly because of its own compliance, regulatory and supervisory requirements. A fronting insurer will always require that the right level of premium is paid by its insured, regardless of whether or not it is reinsured by a captive. The premium must adhere to its internal underwriting guidelines set by the Underwriting Committee and Board of Directors and the insurance regulations of the jurisdiction in which it is resident.

  In addition, fronting arrangements are not "particularly complex" transactions: they usually involve a risk sharing between the fronter and the captive in the form of a quota share reinsurance agreement (with corresponding profit split on the underwriting result), alongside a fronting commission paid by the captive to the fronter as compensation for the administrative work involved (e.g. policy issuance, claims management, underwriting and claims reporting, etc.). The fronting insurer will be using underwriting technical analysis in setting or agreeing to the premium ceded to the captive, as it retains share of the same risk.

- Paragraph 183 (stating that capital adequacy requirements for captives are likely to be lower than for traditional insurers)

  Capital adequacy requirements of captives are not lower than those applied to traditional insurers. It is important to look not just at minimum capital requirements, but also consider what risk-based capital requirements are applicable.

  In absolute terms, the amount of capital required for a captive will be lower than most commercial insurance entities, because the portfolio of risks is smaller, but proportionally to risk exposure, captives' capital requirements actually tend to be higher, mainly because of lower diversification effects and minimum requirements applicable.

Captive insurance portfolios have the potential to be significantly more volatile than those of commercial insurers due to their limited size. Where commercial insurers can have a loss or loss and expenses that exceed the premiums collected, it tends to be a few percentage points over 100%, whereas captives can have loss ratios of several hundred percent in one year and then be very profitable for multiple years. As such, straight comparison with commercial insurers' profitability is not necessarily relevant any one year in isolation. The underwriting ethos of many captives is to break even over the long run, not wishing to make a regular profit at the expense of the MNE's trading subsidiaries, so this considerable year to year volatility will be accepted with comfort provided by the related nature of the business.

We refer back to the Principle of Proportionality, which is the only principle allowing a supervisory body to apply a proportionate control process to (re) insurance entities depending on their nature, scale and complexity. Captive companies must meet exactly the same level of capital adequacy requirements like all other (re)insurance entities.

- Paragraph 184 and §185 (about group synergies)

Whilst synergy does come from combined purchasing, this is only practically possible by the utilisation of the captive as a regulated (re)insurance entity which provides risk and capital. Only the captive can (i) unify the attachment point of the policy to cater for different risk appetites within the MNE before going to the market and (ii) access the reinsurance market. Without the existence of the captive within the MNE, the benefit of the synergy could not be achieved by the insured participants themselves.

Once again, the underwriting ethos of many captives is to break even over the long run, so the assessment of profitability will not be necessarily relevant any one year in isolation.

We believe, therefore, that the value added by a captive vehicle to an overall risk financing strategy goes far beyond the single "collective purchasing agreement".

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APPENDIX

References to international rules applicable to insurance entities including captive insurance companies

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1. **IFRS 17 Insurance contracts - APPENDICE A - Defined terms**
   - Insurance contract
   - Insurance risk
   - Significant insurance risk
   - Uncertain future event

2. **Solvency II - Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance**
   - Recital 10 – Inclusion of captive insurance companies in the Solvency II Directive
   - Recital 21 – Principle of Proportionality (nature, scale and complexity of insurance business)
   - Article 13 – Insurance definitions
   - Article 42 - Fit and proper requirements
   - Article 44 - Risk management
   - Article 45 – ORSA (Own Risk and Solvency Assessment)
   - Annex I - Classification of risks according to classes of insurance

3. **Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)**
   - Article 306 – ORSA (Own-Risk and Solvency Assessment) supervisory report

4. **Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution (IDD)**
   - Article 25 Product oversight and governance requirements

5. **OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 – Chapter 1 The Arm's Length Principle**
   - 1.51 - Functional analysis
   - 1.61 - Risk assumption
   - 1.63 - Financial capacity
   - 1.65 - Control over risk

6. **International Association of Insurance Supervisors (IAIS) - Insurance Core Principles (ICP – as amended in November 2017)**
   - Actuarial function 8.6 (p.85)

7. **IAIS Application Paper on the Regulation and Supervision of Captive Insurers (Nov 2015)**
   - Chapter 2 – definition of a captive insurance

8. **IAIS - ICP 19A: Statistical Basis for Insurance Basic-level Module - Insurance Supervision Core Curriculum**
   - Characteristics of insurable risks (p.6-7)

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FERMA - The Federation of European Risk Management Associations brings together 22 national risk management associations in 21 European countries. FERMA represents the interests of more than 4700 risk and insurance managers in Europe active in a wide range of business sectors from major industrial and commercial companies to financial institutions and local government bodies. More information can be found at www.ferma.eu

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