FERMA's input to OECD on the Progress Report on Amount A of Pillar One

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Key messages:

- FERMA is pleased to provide comments on the OECD's 'Progress Report on Amount A of Pillar One'.[1]
- While FERMA is, on the whole, supportive of the OECD's push to modernize tax systems we are concerned that captive (re)insurance undertakings ['captives' hereafter] are not considered as '*Regulated Financial Services*' → reference Schedule C.
- FERMA therefore calls upon the OECD to revise its guidance on Pillar One so that captives would be considered as '*Regulated Financial Services*', which would ultimately be more consistent with other guidance and regulations, as well as the business rationale for using captives. With this document we elaborate on the reasons why.

The Federation of European Risk Management Associations (FERMA) is a European professional association that represents through its 22 Member Associations in 21 countries nearly 5,000 risk professionals. Many of these work for organisations that make use of captives.

FERMA provides its comments to the OECD focusing on specific elements of the Progress Report on Amount A of Pillar One, namely the scope and Schedule C 'regulated financial services'. With these comments, FERMA aims to illustrate to the OECD the case for classifying captives 'Regulated Financial Services' in Schedule C.

1. What is a captive?

Captives are group entities set up and owned by corporate groups to partially or totally insure some of their risks. They are efficient risk management and financing vehicles that supplement the imperfect offer from the private insurance market to large commercial insurance buyers.

Furthermore, captives perform genuine and highly regulated (re)insurance activities by mobilising capital to cover (re)insurable risks against a fair remuneration (i.e. the premium). They also add operational efficiency to their owner by helping to build better awareness of cost of risk and loss-control over a longer-term. In this respect, captives play an important role in protecting commercial companies' assets and as such significantly contribute to economic resilience.

[1] OECD (2022), Progress Report on Amount A of Pillar One, Two-Pillar Solution to the Tax Challenges of the Digitalisation of the Economy, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris, https://www.oecd.org/tax/beps/progress-report-on-amount-aof-pillar-one-july-2022.pdf

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2. *Captives as Regulated Financial Services (RFS)*

In reference to the OECD's progress report document, FERMA understands that in order for captives – or any other financial undertaking, for that matter – to be considered as RFS, three requirements must be met:

a) A licensing requirement;
b) A regulatory capital requirement; and,
c) An activities requirement.

Captives meet these three requirements, hence why FERMA strongly believes they should be considered as RFS.

2.a) Licensing requirements

In the European Union, captives are formally recognised as insurance undertakings by the prudential regulatory framework that governs all insurance and reinsurance undertakings in the Single Market. Article 13 (1) of the Solvency II Directive (Directive 2009/138/EC) defines an insurance undertaking as '*a direct life or non-life insurance undertaking which has received authorization [by a national supervisory authority]*'. Article 13 (2) of the same directive goes on to define a captive insurance undertaking as:

> '*an insurance undertaking, owned either by a financial undertaking other than an insurance or reinsurance undertaking…or by a non-financial undertaking, the purpose of which is to provide insurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking of undertakings of the group of which it is a member.*'

Captives are generally incorporated as Limited Companies or Cell Companies and are subject to formal licensing by their local insurance supervisor before they can start doing business. The supervisor will check the business plan, the (re)insurance transactions, the adequacy of capitalisation, the intended capital structure, the shareholders and ultimate beneficiaries, the Board members, and key persons or services providers. This process is fully transparent in each jurisdiction. The supervisor can also withdraw the licence of existing captives at any time if supervisory requirements are not met.

2.b) Risk-based regulatory capital requirement

Captives, as genuine insurance undertakings, are therefore subject to the full extent of solvency and capital regulatory requirements in the EU. Outside of the EU, capitalisation requirements for captives are set by the Insurance Core Principles (ICPs) of the international Authority of Insurance Supervisors (IAIS) in other key jurisdictions.

Solvency II capitalization requirements are by principle risk-based and apply to captives in the same way as they apply to commercial insurance and reinsurance companies, only subject to the proportionality principle based on the nature, scale and complexity of the captives' operations, which rightly considers that captives pose reduced risk to external stakeholders and to the overall financial stability of the insurance market. Proportionality enables captives to use 'simplifications' in the Solvency II Standard Model for Solvency Capital Requirement

(SCR) calculation, i.e. making the computation of SCR somewhat less complex, but it clearly does not provide any exemption and any EU captive needs to comply in full with SCR.

2.c) Activities requirement

Captives are all subject to licensing by their local insurance supervisor, which checks the ability of the captive to perform its activities and meet all regulatory requirements locally, assesses the 'fit and proper' quality of the Board members and the people in charge of operations, and checks the shareholding and ultimate beneficiaries. Captive subsidiaries are also included within the perimeter of consolidated companies (listed in the owner's annual report) and are subject to external audit, as well as quarterly or annual reporting to their supervisory authority and 'on-site' inspections by the supervisor.

By 'localising' decision-making activities, captives provide control over risk to implement the risk transfer transaction that generates the value creation. This is done via the Captive Board of Directors or Executive Committee, which can decide locally to:

- take on or decline risks
- track the performance
- make decisions on how to respond to risk occurrences
- decide to outsource day-to-day operations to a professional service provider for cost efficiency, in which case they:
    - define the duties of that provider
    - select and appoint the provider (ensuring that provider meets supervisory requirements)
    - track the provider's performance over time
    - ultimately, they can also decide to terminate the contract with that provider and move to another provider.

According to these criteria, FERMA doesn't see any additional reason justifying why captives could not be recognized as RFS as they meet exactly the same requirements as all other insurance and reinsurance undertakings which will benefit from the exemption.

3. Technical features

Compared to other types of commercial activities, captive (re)insurance has some specific features justifying the removal of their revenue from the Amount A to be re-allocated to market countries. In addition to the aforementioned 'regulatory' considerations, FERMA wishes to highlight these more technical features, as follows.

3.a) Inverted economic cycle and the need for long-term assessment

Unlike traditional commercial products or services, (re)insurance is an activity for which the final selling price (i.e. the premium) has to be defined before knowing the final service costs (i.e. the claim settlement). In addition, because of the time needed for claims to materialize, be adjusted and finally settled, the said costs may only be known several years after the premium has been collected. That uncertainty is addressed through actuarial and financial assumptions and computations (on claims reserving in a first stage, and on capital requirements as the ultimate safeguard against volatility) but it will always remain. The underwriting profit of a captive, as for any other insurance transaction, is therefore highly dependent on how much and when claims occur (or not).

As such, the profitability of a (re)insurance business, be it captive or commercial, should never be assessed on a single year basis, but moreover be seen as multi-year means of smoothing volatility and absorbing shocks. The underwriting ethos of majority of captives is simply to break even over the long run, not willing to make an underwriting loss in the long run (which would not be authorized by the insurance supervisor anyhow), but also not wishing to make an excess profit at the expense of the multinational enterprises' trading subsidiaries given the fact that the business rationale of captives is to reduce the cost of insurable risks for their owner. Reallocating the captive's annual profit to subsidiary countries on a single year basis would simply disregard the (re)insurance transaction and the long-term nature of insurance underwriting. The profit of one insurance year is in the main simply brought forward as a reserve (technical provisions) or retained earnings (capitalization) to be able to absorb losses and possible insufficiency of reserving (i.e. ensure solvency strength) in the future.

In addition, a building block in the definition of a genuine insurance transaction is for the risk carrier to have a realistic probability of loss. This aspect is closely looked at by the insurance supervisor in ensuring there is a real risk transfer contract, ensuring the pricing is sufficient against the exposure, ensuring the captive has necessary knowledge and expertise at hand to make sound underwriting decisions, ensuring reserving policy is adequate, and ultimately ensuring the captive holds enough capital to be able to survive to an adverse economic scenario. Within a sound and technical underwriting strategy, that probability of loss is controlled by the captive through different techniques (e.g. setting annual aggregate limits to the contracts, buying reinsurance protection, diversifying between lines of business, etc.), including the ability to compensate such a loss scenario over the years through adequate technical provisions, profits brought forward, etc.

3.b) Less diversification

Captives' portfolios have the potential to be significantly more unpredictable than those of commercial insurers due to their limited size, lower level of diversification, and higher exposure, compared to commercial insurers. This leads to much less predictable profits, which are also much more dependent on large claims occurrence due to the constraints on expanding portfolio and benefiting from the 'law of large numbers' as a commercial insurance carrier would do when underwriting personal lines such as household or motor; captives are rather exposed to large industrial/commercial exposures of the group it belongs to. Profits of a captive can therefore really only be evaluated against long-term risk materialization and/or catastrophic risk exposures.

3.c) Capital and Risk bearing capacity

Captives accept to cover risks and to pay claims in return for payment of a premium. This is exactly in line with the definition of an insurance contract mentioned in paragraph 10, Section 20, of Schedule C in the Pillar A document.

The value creation aspect of an insurance contract, be it intragroup or not, is the risk transfer and risk bearing capital aspects of it. A captive bears risks and needs to provide capital (subject to minimum regulatory requirements) in order to do so, as well as underwriting and claims functions, and it should receive an arm's length remuneration for that value creation.

That value creation is only feasible if the captive undertaking centralise its Group's insurance operations (thus the cross-border nature of their activities) and is properly license in a country allowing it to perform its activities.

4. Conclusions

Like any insurance contract, captive insurance transactions are subject to insurance premium taxes in the source countries. These tax revenues would not exist if the captive owners opted for self-insurance. Moreover, captive insurance companies are fully exposed to the corporate tax rules applicable in its EU domicile and thereby contribute a fair share of its profits to society.

As highlighted in FERMA's *Captives in a post BEPS world* report, the effective tax rate of captives reached 15% in 2015 against 12.1% for European commercial insurers[2]. In other words, captives' corporate income tax liabilities are in line with those paid by the European commercial insurance markets.

FERMA is of the view that the tax treatment of captives should remain consistent and aligned with the prudential treatment where captive insurance companies are subject to the same regulatory environment in terms of governance, risk and capital as other insurance and reinsurance companies.

Captives provide a host of technical risk management benefits to multinational enterprises, as well as a long-term means of managing volatility, which is crucial in these tumultuous times.

FERMA stands ready to continue to contribute its expertise to this topic and looks forward to engaging further with the OECD at the workshop in September.

About FERMA
The Federation of European Risk Management Associations brings together 22 national risk management associations in 21 European countries. FERMA represents the interests of nearly 5000 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

[2] FERMA report 'Captives in a post-BEPS world', available here: https://www.ferma.eu/publication/ferma-publishes-guidelines-for-beps-on-captive-reinsurance-arrangements/