Position Paper

Position paper on insurance premiums in the context of the reform of VAT rules for the financial sector

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Contact person:	Michele Tadi Policy advisor, life insurance & taxation	E-mail:	Tadi@insuranceeurope.eu
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Insurance Europe welcomes the European Commission's aim to reform value-added taxation (VAT) rules for financial services. These rules are governed by the VAT Directive, which was implemented in 1977 and which is now outdated as it cannot be applied correctly to modern financial services. In particular, the Directive as it stands does not provide clarity and legal certainty about the scope of VAT exemptions that apply to the industry. This leads to an unlevel playing field among economic operators due to hidden VAT, which is decisive, not only in the context of externally purchased services, but also in relation to internally supplied services within an insurance group.

During the impact assessment phase and the consultation, Insurance Europe submitted feedback on several aspects of the Directive that should be updated. As Insurance Europe understands that the European Commission envisages subjecting fees to VAT, the aim of this document is to clarify some key aspects of the discussion, such as why insurance premiums cannot be seen as "fees". As a reminder, the difficulty in determining the taxable base for the purposes of a value-added tax, the unsolved issues about the scope and terms of VAT deduction rights and the existing insurance premium taxes (IPTs) in some member states were among the reasons for establishing a VAT exemption for insurance services.

The paper is structured as follows:

- **The nature of the insurance business**
- **What are insurance premiums?**
- **Difference between premiums and fees**
- **Final remarks**

The nature of the insurance business

Insurance is the pooling of risks within a large group of policyholders. It facilitates the transfer of the risk of financial losses as a result of specified but unpredictable events from an individual or entity to an insurer in return for a premium.

Insurance companies have over time developed methods to assess the probability and cost of future claims; this enables them to calculate premiums, which should cover the claims, but also a margin for variations and unexpected events as well as their operational costs (eg personnel and capital requirements). Therefore, individuals or entities pay insurance premiums which are adequate for the risk that, as individual

Insurance Europe aisbl • rue Champ de Mars,23 B-1050 Brussels
Tel: +32 2 894 30 00 • Fax: +32 2 894 30 01
E-mail: info@insuranceeurope.eu
www.insuranceeurope.eu

policyholders, they represent within the pool of policyholders. This allows them to claim a compensation or a restoration service from the insurer if a specified event occurs.

The generally accepted basic principles of insurance hold that a risk is insurable if:

- It is definable and financially measurable;
- It is random and independent;
- It is possible to build a risk pool in which the risk can be shared and diversified at economically fair terms – otherwise known as mutualisation;
- The insurer can calculate a fair premium for the risk, ensuring that the premium is sufficient to cover future claims on its pool of risks and their handling, and is also affordable to consumers;
- The likelihood of the risk is calculable, implying notably that there is a reasonably large claims history and source of data from which to calculate average severity and frequency of expected future events;
- There is limited risk of catastrophically large losses and the financial impact of such losses are not so significant that an insurer/the insurance sector cannot afford to pay for them.

Insurance helps people and businesses to assess, manage and reduce their risks. Insurance is beneficial to policyholders as it provides them with a means to turn large, unexpected costs into manageable smaller payments. Without insurance, people would be less likely to engage in some activities of modern life because the potential risk of financial costs they would be exposed to would be too great.

Society in general benefits from a competitive insurance market that can use sophisticated risk pricing to encourage better risk management practices. Indeed, the prospect of lower premiums can encourage individuals and businesses to reduce their risks where possible by altering their behaviour or taking preventative measures. Examples include individuals giving up smoking to reduce their life insurance premiums or fitting smoke alarms to reduce their household insurance costs, and businesses implementing more effective risk management systems to reduce their liability premiums. Another common example is the promotion of safer driving through no-claims discounts on motor premiums. Moreover, in most EU countries, insurance can be mandatory, especially in the case of general insurance.

Insurers usually invest the premium income they receive, making the insurance sector the largest group of institutional investors in Europe. For life insurance companies in particular, the products they offer tend to be long-term in nature, and these insurers consequently make and hold until maturity long-term investments. This steady flow of long-term capital invested by the insurance industry on behalf of policyholders is crucial for the financial system as a whole, as it reduces market volatility and therefore contributes significantly to the stability and functioning of markets.

What are insurance premiums?

Policyholders pay a premium in exchange for insurance cover. A fair premium is calculated on the basis of sufficient experience or knowledge of past events (based on mathematical and statistical methods), and an estimate of the expenses incurred for the insurer. The process to determine the premium involves calculating the probability of the risk for each insured or category of insureds. Based on the principle of large numbers, the larger the pool of policyholders, the more accurately the probability of the risk can be calculated. The premiums charged are based on these calculations.

Insurance companies assess the risk of policyholders through their underwriting. The premium and terms of the insurance contract are based on the insurer's assessment of the level of the risk. Each individual or entity wishing to be insured brings a specific level of risk to the insurer; a timber house is at greater risk of fire than one made of brick, for example.

To make sure that each insured pays a fair premium, insurers use a series of rating factors to assign the level of risk. In general, the higher the risk, the higher the premium. The underwriting process will differ from insurer to insurer, depending — for example — on the level of risk they are prepared to accept. Terms and conditions may be applied to policies to further homogenise the risks by removing particular events or circumstances under which claims would be paid. Terms and conditions are also important to help reduce the impacts of moral hazard and adverse selection.

Difference between premiums and fees

Insurance Europe understands that the European Commission views insurance as though it is a fee-based service, which would mean insurance premiums would be subjected to VAT requirements. However, it is important to underscore that the nature of premiums is inherently different from the nature of fees and that insurance cannot be typified as a fee-based service.

In the case of a service, its contents are usually established in advance, so that it is possible to calculate the exact costs. This way, the customer receives something in exchange for a compensation or **fee**, which is a fixed amount, and that is normally in direct proportion to the particular service that specific customer receives.

A **premium** instead is an individual contribution to the collective, to be able to cover risks and damages for some insureds (and build up sufficient reserves). For instance, a payment from a non-life insurance is a compensation for a loss, a restoration to the policyholder. Insurance premiums are also calculated in a sophisticated manner, and in such a way that they allow insurers to cover the likely claims arising from an insurance contract, with a safety margin to ensure the long-term viability of the insurer. Put differently, unlike the amount of a fee, the calculation of a premium is generally based on the probability of the insured event occurring, combined with the likely financial loss resulting from the claim. This "risk premium" is then adjusted to cover the expenses of the insurance company and to provide some profit:

(Expected claim amount x probability) + expenses + profit + safety margin = premium

The insurer must be able to calculate a fair premium for the risk: the premium charged to the policyholder must make economic sense. On the one hand, the insurer must be able to charge a premium that is high enough to cover future claims on its pool of risks and its expenses (including hidden VAT incurred from processing the compensation) while still taking into account a margin that would also allow the insurer to make a profit. On the other hand, the amount charged to insure an individual or entity must be a sum that the insured is willing to pay and must be substantially below that of the covered amount or it would not make sense to purchase the cover. This balance is best struck in an open, competitive private insurance market.

The inevitable variations in claims costs at different times lead to the inclusion of a margin in the premium, which enables the insurer to build up a reserve to draw on in years that involve significant claims. Moreover, the expense adjustments of premiums must cover:

- The initial cost of writing the product (including processing the application and performing underwriting).
- Regular costs associated with maintaining the product.
- Any additional costs incurred at the point of claim (including processing the claim and any expenses due to verifying the claim).

How these expenses are charged to the premium depends on the type and structure of the product and how the expenses are incurred. These may be fixed amounts, percentage increases based on the size of the potential claim amount (the sum assured), or a combination of both. In some cases, the premium calculated may end up not being high enough to cover all the expenses incurred.

Conclusion

Insurance Europe welcomes the Commission's efforts to boost harmonisation and to secure a level-playing field among financial services providers. Insurance Europe also agrees that the Directive must be updated, as it is currently not correctly applicable to modern financial services and results in a disadvantage for financial services providers when compared to other economic operators.

As part of the update, the interaction of VAT with the different national tax regimes for insurance must be carefully examined to ensure a level playing field in the interest of policyholders and avoid any increase in the costs of insurance contracts. Currently, in many European countries, insurance premiums are already subject to taxation such as insurance premium taxes (IPTs) and other similar levies (eg payroll taxes, parafiscal levies), whose rates have often increased over the past few years. In some cases, with regard to specific classes of insurance, the rate of the taxes levied on insurance premiums is as high as VAT (eg Germany at 19%) or results in an important source of revenues in others (eg ~5 Bn €/year in Italy, or ~15 Bn € in France).

Whatever options are considered by the European Commission, the goal should be to avoid passing down the tax to customers and prevent cumulation between IPTs and VAT.

A general increase of costs for insurance coverage due to the occurrence of double taxation or the general application of the standard rate of VAT on insurance services must be avoided. Considering the initiatives in various member states or at EU level to reduce protection gap by increasing insurance penetration, raising premiums would have a detrimental effect.
Insurance is also a common means to save money for retirement. Insurers believe as a general principle that savings within the framework of insurance (health and life insurance as well as contributions to pension schemes) should not be subject to VAT.

Importantly, insurance premiums should not be considered fees, as their amount is not fixed, but rather result of a calculation based, among other things, on the probability of the insured event occurring and on the level of risk that undertakings are willing to accept. It is crucial that any legislative initiative to review the VAT takes account of the unique features of insurance, its products and its business model, in order for insurers to continue playing their key role in the protection of policyholders, and in the assessment, management and reduction of risks.