Position Paper

Insurance Europe comments on the Commission's proposal for tackling hybrid mismatches with third countries

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Summary

Insurance Europe took note of the Commission's proposal for tackling hybrid mismatches with third countries and would like to comment how these proposed rules could impact the hybrid regulatory capital of insurers.

First, Insurance Europe agrees with the ECOFIN Council that hybrid mismatch rules should be "consistent with and no less effective than the rules recommended by the OECD BEPS report on Action 2".

Insurance Europe welcomes the fact that the Commission's proposal foresees that hybrid financial instrument rules should only apply to financial instrument transactions entered into with a related party or where the payment is made under a structured arrangement and the taxpayer is party to that structured arrangement.

This is indeed in line with the recommendations of the OECD under Action 2 of the BEPS Action Plan and ensures that transactions between unrelated parties are not included under the newly-proposed rules. The Commission's approach also means that transactions involving the hybrid regulatory capital of insurers, which almost always occur between unrelated parties, would not be targeted by hybrid mismatch rules.

Insurance Europe fully agrees with this, given that hybrid regulatory instruments are issued (whether to the market or intra-group) for non-tax purposes and cannot be regarded as tax abusive. This type of capital is very useful to insurers, for regulatory and commercial reasons. Insurance Europe would therefore encourage Member States to maintain the carve-out for unrelated parties in the final text of the Directive.

If for any reason Member States would wish to deviate from the Commission's proposal and decide to include transactions between unrelated parties under the scope of the hybrid mismatch rules, Insurance Europe would urge Member States to also include a carve-out for hybrid regulatory capital for the same reason as above.

In what follows, we argue our position in more detail.

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The role of (hybrid) capital in insurance

In all jurisdictions, regulators require insurers to hold an appropriate amount of capital in order to ensure that policyholder claims are paid out in all circumstances. This requirement constitutes in effect a protection for policyholders. Without capital, risk can't be assumed and, therefore, insurance business cannot be written (i.e. the insurer cannot operate). The precise amount of capital depends on the regulatory regime in question and on the nature of the underlying risk. But in all situations, this will be the minimum amount of capital that is held by the insurer.

In addition to regulatory capital, rating agencies impose capital conditions to satisfy credit rating requirements. For insurers, the rating applied is critical as certain types of investors may only be able to invest in entities with a prescribed minimum credit rating. Insurers and their brokers placing reinsurance will also examine the reinsurer's credit rating very critically.

Therefore, the maintenance of an appropriate level of capital within a jurisdiction is not a business choice for insurers, open to flexibility depending on tax treatment but instead it is critical to insurers' ability to carry on business.

While regulation does not require insurers to issue hybrid regulatory capital specifically, it foresees that a certain percentage of capital requirements can be satisfied through hybrid instruments. In other words, regulation places an upper cap on the amount of hybrid capital that can be counted towards an insurer's regulatory capital. In Europe, the Solvency II Directive allows up to 20% of Tier 1 capital under the MCR and the SCR to be made up of hybrid instruments. This upper cap is an additional guarantee that these instruments are not used for harmful tax practices. Of course, insurers are free to issue hybrid instruments in excess of the upper cap imposed by Solvency II, but these will not count towards their capital requirements and will therefore not constitute hybrid regulatory capital.

Virtually all major European insurers issue hybrid regulatory capital in the market and there are a number of reasons for which they choose to do so:

- Hybrid instruments allow insurers to raise capital in a cost-effective way, as debt carries less risk for the investor and, as a result, provides a cheaper form of capital than equity.
- Hybrid instruments enable an insurer to raise "risk" capital without having to issue equity and thereby diluting existing shareholders.
- Despite their features — which combine debt with equity characteristics — hybrid instruments are typically bought by fixed income rather than equity investors. As a result, hybrid capital instruments broaden the investor base for regulatory capital instruments for insurers.

Hybrid regulatory capital can be issued to the market and listed on exchange but can also be issued intra-group. Regardless of the mechanism, the purpose of the issue is the same, namely to obtain hybrid regulatory capital that meets regulatory requirements of having loss absorbent characteristics. Intra-group issues of this type of capital can be necessary when a subsidiary cannot issue to the market itself given regulators' preference for capital to be issued at parent company level. Regulators prefer this type of issue because capital can then be more easily redeployed among members of the same group.

Transactions involving hybrid regulatory capital are made between unrelated parties

Hybrid regulatory capital instruments used by insurers are typically placed in the market in the form of bonds. With respect to the issuance process, the bonds are usually sold to international investors in a book building process via banks, which buy the bonds from the issuer and immediately sell them to investors.

There is little or no direct contact between the issuing insurance company and the investors. Even on the day of the pricing of a new transaction, the issuing insurance company has only limited information on the identity of the bond investors. Also, during the payment process for both the coupons and the principal, there is no direct contact between issuer and holder because the former typically employs paying agents (banks) to make the actual payments. It is therefore clear that the transactions involving the hybrid regulatory capital of insurers are made between unrelated parties.

Currently, there are few intra-group issues of hybrid regulatory capital between third countries and insurers in EU Member States. This is to be contrasted with the banking sector where such issues are – to our understanding - more common, as a result of the different regulatory requirements applicable to banks which include a requirement that any hybrid regulatory capital issued externally be passed down on arms-length basis to insurance subsidiaries in the same form as the external issue. Banking regulation is a number of years ahead of insurance regulation and therefore it is quite possible that there may be more intra-group of hybrid regulatory capital in the insurance sector in the future.

The treatment of hybrid regulatory capital under anti-BEPS rules

Action 2 of the OECD BEPS Action Plan made proposals to neutralise the effects of hybrid mismatch arrangements based on the concern that some hybrid instruments can lead to base erosion. The European Commission and the Council included intra-EU hybrid mismatch provisions in the ATAD and the Commission is now proposing rules for hybrid mismatches with third countries.

This OECD report states that "countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise under intra-group hybrid regulatory capital". In this context, Insurance Europe strongly recommends that the scope of EU anti-hybrid mismatch rules should not include hybrid regulatory capital. In addition, we fully agree with the ECOFIN Council that any new EU hybrid rules should be consistent with the OECD BEPS recommendations.

In its Action 2 recommendations, the OECD recognised that hybrid financial instrument rules should only apply to financial instrument transactions entered into with a related party or where the payment is made under a structured arrangement and the taxpayer is party to that structured arrangement.

Insurance Europe welcomes this recognition and supports the inclusion of a carve-out for unrelated parties in the EU rules as well. Article 2 (b) point 9 in the Commission's proposal states that a hybrid mismatch can only exist "between a taxpayer and an associated enterprise or a structured arrangement between parties in different tax jurisdictions". In addition, the definition which is given for "structured arrangement" in Article 2 (c) point 11 suggests that the Commission does not intend to extend the scope of the hybrid mismatch rules to include transactions between unrelated parties.

Insurance Europe therefore welcomes the Commission's proposed approach and would encourage Member States to maintain the carve-out for unrelated parties in their final text of the Directive. If for any reason Member States would wish to deviate from the Commission's proposal and decide to include transactions between unrelated parties under the scope of the hybrid mismatch rules, Insurance Europe would urge Member States to also include a carve-out for hybrid regulatory capital for the reasons explained in this paper.

Any rules placing an additional tax and compliance burden on these instruments would increase the cost of raising capital and adversely impact the competitiveness of the European insurance sector as a consequence.

Conclusion

Insurance Europe strongly believes that hybrid capital issued (whether to the market or intra-group) for regulatory and rating purposes by the insurance sector should not be impacted by any hybrid financial instrument anti-BEPS rule at EU level, as these types of capital are issued for non-tax purposes and cannot be regarded as tax abusive.

Not applying the proposed rules to unrelated parties goes a long way to achieving this outcome. However, we believe that if there is a regulatory requirement for a holding company that issues hybrid regulatory capital in the market to pass this down in the same form within the insurance group then consideration should be given to carving out intra-group hybrid regulatory capital from the EU hybrid mismatch rules. In general, any European hybrid rules should be fully consistent with the OECD BEPS rules.

Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 200bn, directly employ over 975 000 people and invest nearly €9 800bn in the economy.