Position Paper

Insurance Europe response to the OECD Discussion Draft on the Transfer Pricing Aspects of Financial Transactions

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Insurance Europe welcomes the opportunity to comment on this public Discussion Draft on the transfer pricing aspects of financial transactions. The response is focussed on Section E — Captive Insurance.

General comments:

- Insurance Europe recommends applying existing Chapter 1 guidance to captive insurance, rather than introducing special guidance. This is because Chapter 1 guidance already sets out the principles for the delineation and recognition of transactions. In cases where the Chapter 1 analysis leads to the conclusion that the captive insurer's business is other than that of insurance, Chapter 1 also gives guidance on how to recharacterise the transaction.
- If special guidance for captives is considered necessary, Section E should begin by a more detailed description of captive insurance and captive insurance transactions, to properly differentiate these from other forms of (re)insurance between members of a regulated insurance group.
- Insurance Europe notes that the entire Section E refers to MNE groups and their members. In the absence of further clarification, Section E guidance would therefore also end up applying to intra-group reinsurance between members of a regulated insurance group or intra-group retrocession in a regulated reinsurance group.
- Providing additional clarity would ensure that the guidance is properly focussed on non-insurance MNE groups in which a company provides (re)insurance to other group members (as Insurance Europe understands is the OECD's intention).
- Insurance Europe disagrees with the statement in paragraph 163 that a captive insurance company does not provide insurance but rather insurance-type services.

E.1. Overview of insurance

Regarding the descriptions provided in paragraphs 164 and 165, Insurance Europe would point out that there are many risks that an insured is able to influence by applying loss control techniques. It is insured events and not risks that should be outside of the control of the insured, as paragraph 164 rightly states.

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Insurance Europe believes that Part IV of the 2010 Report on Attribution of Profits to Permanent Establishments should be explicitly referenced in paragraphs 169-171 and that it should be clearly stated that, for regulated (re)insurance groups, the Transfer Pricing Guidelines are to be applied consistent with the Part IV analysis.

E.2. Rationale for a captive

While arm's length pricing might be challenging in situations where it is difficult or impossible to obtain insurance cover, the legitimate use of captives should not be prohibited even if the legitimate purpose may not lie in the present, but rather in the future (e.g. using the captive allows to collect information regarding the respective risks required to generate an insurance appetite with professional insurers, such as for cyber-security).

E.3. Existence of insurance

The terms "insurance" and "reinsurance" are defined in regulatory/legal and accounting standards and the qualification of insurance/reinsurance for tax purposes should follow these existing standards. Insuring or reinsuring risks of multiple legal entities across the MNE represents risk distribution (pooling). Much of captive business is done on a reinsurance basis, with a professional insurer providing the insurance cover towards multiple legal entities across the MNE group and ultimately bearing the credit risk for the sufficient reserving of the captive.

The term "captive insurance" covers a wide range of transactions which can be as small as a single contract of insurance within an MNE group, to a fully-fledged insurance or reinsurance program covering multiple risks in multiple locations. A captive insurer may write only business with associated enterprises, only business with third parties, or a combination thereof. Regulation and capital requirements can accordingly range from light to heavy, depending on the location of the regulator and the mix of business.

Given this wide definition, Insurance Europe recommends applying existing Chapter 1 guidance to captive insurance, rather than introducing special guidance. Indeed, Chapter 1 guidance already sets out the principles for the delineation and recognition of transactions. In cases where the Chapter 1 analysis leads to the conclusion that the captive insurer's business is other than that of insurance, Chapter 1 also gives guidance on how to recharacterize the transaction.

If special guidance for captives is still preferred by the OECD, Insurance Europe believes that the guidance should be focussed on the following factors, which are similar to those in paragraph 166:

- Substance in the captive: are there sufficient qualified and experienced staff within the group and/or in the location of the captive to manage the insurance business of the captive?
- What is the commercial rationale of the captive? What are the realistically available alternatives?
- What risks are being insured and do these meet risk transfer tests under accounting rules? Is there pooling of risk for capital purposes? Can capital benefits from diversification of risk be quantified?
- Does the group reinsure externally? This can be evidence that risks transferred are insurable especially where the captive is lightly regulated.
- Does the captive have the financial capacity to bear loss? Have claims been paid when there is a loss?
- Conversely, is the captive over-capitalised compared to benchmarks? What is the return on capital for the captive?

Paragraph 174 refers to insurance being "defined above". It should be made clearer which paragraphs this is referring to (presumably 164 -166). Paragraph 1.98 of Chapter 1 states that an entity must both exercise control of risk and have the financial capacity to assume that risk. This discussion draft focuses only on control of risk and there does not seem to be any reference to financial capacity, which is essential to insurance business.

E.4. Reinsurance captives – Fronting

Fronting reinsurers often keep a proportion of the risk insured and are subject to regulation. In this context, Insurance Europe does not understand the comment in Paragraph 178 that "fronting arrangements […] involve a third party that is indifferent to the levels of the price of the insurance and re-insurance transactions".

E.5. Determining the arm's length price of captives

Insurance Europe would not recommend specific guidance on what constitutes insurance risk, or how to satisfy control over risk in this context, because facts and circumstances can vary so widely that giving specific guidance in this case could have the unintended consequence of helping MNE groups to navigate around the rules.

Similarly, giving specific guidance on pricing (E.5.1) is not recommended, because this is not a metric appropriate for all insurance business and it does not consider the insurance cycle or functional differences between companies that could drive expense ratios. Further, investment return is heavily influenced by regulatory requirements for what types of assets can be held, so Insurance Europe would not recommend detailed transfer pricing guidance on this either.

Regarding section E.5.2, Insurance Europe does not believe that, by using the combined ratio, a comparable, uncontrolled price for annual premiums and underwriting profit can be achieved. In addition, Insurance Europe does not understand the description given in paragraph 182 for the identification of the captive's combined ratio.

Insurance Europe believes that the guidance on group synergies (E.5.3) is too prescriptive.

- In most cases, the captive insurer is not functionally equivalent to a central procurement entity so the examples in Chapter 1 would not read across easily.
- The captive insurer will be taking on significant insurance/financial risk that a procurement entity would not, so the functions performed, assets used and risks assumed are very different.
- The comparison in paragraphs 184 and 185 is therefore not justified. The suggestions included in these two paragraphs neglect the nature of reinsurance (risk transfer, not service) and are not treating captives in accordance with arm's length principles. Unaffiliated reinsurers would not be expected to share an underwriting profit.
- There are many cases where it would not be appropriate for any savings made in relation to reinsurance to be passed back to the insured participants; this would be very much depend on the functional analysis of the transaction so a full Chapter 1 analysis should be undertaken.
- Suggesting that an insurance return should be allocated to other group members disregards the nature of (re)insurance. For example, when a claim occurs, other entities in the group do not have the financial capacity to settle it. Claims are paid using reserves backed by investment assets, purchased with premium income and these are in the legal ownership of the captive. Therefore, it is the captive that has the financial capacity to settle a claim.
- The discussion draft makes no reference to losses and whether these should also be allocated to other members of the group.

E.6. Agency sales

Finally, the example used for agency sales is of limited use given that the captive insurer in the example has only external business, which is an unusual case. It is also unclear why a group synergy analysis would not apply in this case. Again, using the standard Chapter 1 analysis steps would be of more use in these cases.