

Affiliate Reinsurance Does Not Present Base Erosion Concerns Which May be Present in Other Cross-border Transactions

Introduction

The Global Federation of Insurance Associations (GFIA) supports the objective of the OECD and governments to combat tax evasion. However, we are concerned that legitimate business activities could be inadvertently negatively impacted under the OECD's Action Plan on Base Erosion and Profit Shifting (BEPS). Our comments are focused on ACTION 4 - Limit base erosion via interest deductions and other financial payments, and, in particular, on the brief reference to "captive and other insurance arrangements" in that section. Any action to address tax-driven captive insurance arrangements must be carefully targeted to avoid penalizing commercially driven affiliate reinsurance.

Unless insurance business models are fully understood and taken into account in the BEPS process, there is a risk that the insurance industry may be inadvertently impacted. In addition to the comments below, we would welcome the opportunity to help the OECD understand the operations of the insurance industry, particularly around the use of capital, risk management and reinsurance.

Reinsurance Business

This section explains the insurance industry business model and establishes that reinsurance, including affiliate reinsurance, is fundamental to risk management and as such should not be impacted by the outcomes of Action Point 4 as it applies to "captive and other insurance arrangements". Reinsurance is a genuine commercial activity, as supported by the presence of a significant number of large third party reinsurers. Reinsurance consists of the genuine transfer of risk, along with the transfer of the profits and losses that eventually emerge in relation to the insurance of those risks. Commercially driven affiliate reinsurance is fundamental to risk management and, as such, is therefore necessary for re/insurance groups to undertake. Affiliate reinsurance is the same or similar to reinsurance that would take place between independent parties. Under current tax laws around the world, affiliate reinsurance is already required to be on arm's length terms and priced in accordance with the current OECD arm's length pricing guidelines.

Fundamentally, affiliate reinsurance is essential to match risk with capital. This affords the added benefits of diversification which provides enormous advantages to insurance consumers. Affiliate reinsurance promotes competition in markets, which provides additional insurance capacity and puts downward pressure on prices paid by the ultimate consumers.

Property and Casualty (P&C) insurers protect businesses, homeowners and others against a wide range of risks, including catastrophes such as earthquakes, hurricanes, crop failures, workers' compensation claims, and class action lawsuits. Life insurers play a special and invaluable role in allowing individuals and families to effectively plan for unexpected financial catastrophes as well as secure guaranteed income for retirement, by providing products such as life and health insurance, annuities, long-term care insurance, and disability income insurance. Providing reinsurance protection to, and purchasing reinsurance protection from, other insurers is an integral part of the insurance business.

Insurers and reinsurers establish reinsurance pricing with the expectation of making a profit, but risk is inherent in the process, as a contract's experience and profitability are unknown at the contract's inception and therefore losses may arise. Unlike other

businesses, insurers do not know “their cost of goods sold” at the time a product is priced. Insurers use reinsurance to distribute this risk in order to:

- 1) diversify the insurer’s portfolio of risks;
- 2) protect or improve its capital position; and
- 3) increase its capacity to take on other risks.

Insurance companies routinely enter into reinsurance contracts with affiliates and with non-affiliates, both domestically and across borders. Reinsurance with a foreign affiliate is completely different from other cross-border transfers (i.e. the issuance of debt, guaranteed payments of interest or certain license payments on transferred intellectual property). Affiliate reinsurance involves the real economic transfer of risk, and may result in a transfer of losses, rather than profits, between two separately incorporated entities, pursuant to legally binding contracts. Today, tax codes specifically recognize reinsurance transactions between affiliated companies, requiring that such transactions are priced at arm’s length, have economic substance, and do not involve tax avoidance.

- **Reinsurance¹ – insurance for insurance companies – is a key tool for managing risk.**
 - Absent reinsurance, regulators would require each company within an insurance group to have enough capital on a stand-alone basis to support the business it writes. Higher capital requirements would result in higher costs for consumers.
 - Reinsurers can bear risks more efficiently because they assume them from a variety of sources and because many of the risks are uncorrelated.
 - For example, an insurance company that writes a substantial amount of California, Chilean, Japanese or New Zealand homeowners insurance could reduce the potential volatility of its losses by reinsuring some of its exposure to losses from earthquakes. Similarly, where there are three life insurance companies within a group, one writing mortality business, another morbidity business and the third writing longevity insurance, their potential volatility of losses due to these risks could be reduced by reinsuring them. The reinsurer assuming the business would benefit from a diversified block of business. In cases of composite reinsurers that write both life and non-life business, they can further benefit from the diversification between life and non-life business.
 - Affiliate reinsurance is central to the business model of international insurers.
 - No major reinsurer exists on a purely regional or national basis; all major reinsurers are global businesses with a broad diversification of risk.
 - Diversification of risk is essential to the effective operation and risk management of both insurance and reinsurance groups
- **Affiliate reinsurance is extensively used within both domestic and foreign insurance groups within country markets for bona fide non-tax business purposes.**
 - Affiliate reinsurance reduces the total amount of capital needed to support the company's combined businesses. Lower capital requirements are a result of the benefits of diversification through pooling of risks of potential losses at a global level.
 - Insurers in particular must be able to diversify across the globe because certain countries are “over exposed” to catastrophe risk in the case of P&C risk (for example Japan, New Zealand, China, Chile, Mexico and the United States) and because of pandemics in the case of mortality risk.
- **Affiliate reinsurance is an "ordinary course" business transaction.**
 - Affiliate reinsurance involves the *bona fide* shifting of insurance risks in the same manner and for the same purpose as in the case of a transaction with an unrelated reinsurer.
 - It must meet regulatory, actuarial and accounting standards to be classified as reinsurance.
 - It must be priced at arm’s length in accordance with applicable transfer pricing regimes.

¹ References to reinsurance also include retrocession, which can be thought of as insurance for reinsurers.

- It is impossible for P&C insurers to know how claims will develop at policy inception. In fact, publicly available data demonstrates that in a number of years, reinsurance has resulted in the ceding of what ultimately turns out to be significantly unprofitable business.
 - Life insurance and reinsurance involves a substantial timespan. Reinsurance treaties last many years and often decades, providing sizable long-term risk cover for changes in longevity, morbidity and investment risk.
 - Insurers are in the business of insuring risk. Entering into reinsurance contracts is a vital part of managing those risks – it is part of their day to day business. Affiliate reinsurance is a part of the ordinary business of insurance (and not some extraordinary affiliate transaction).
 - *Bona fide* “ordinary course” business transactions should not give rise to base erosion or profit shifting concerns.
- **Optimized retrocession² protection.**
Affiliate reinsurance allows the pooling of risks in one central location to ensure diversification benefits as well as to exercise better control over the accumulation of risks that has occurred within the group. In addition, once this is done, the insurance group can retrocede risk more efficiently by purchasing protection that covers the group as a whole rather than having independent business units each purchase retrocessional protection. As a result, a group receives better terms on the retrocessional purchase; and may need to retrocede less of its portfolio. This efficiency results in savings for the ultimate consumer.
- **Affiliate reinsurer as a center of excellence for global risk diversification.**
As a result of the pooling of risk in an affiliated reinsurer, the affiliated reinsurer is able to develop specialized knowledge and expertise about the different types of products with correlated and uncorrelated risks in the global marketplace. Accordingly, affiliate reinsurers may serve as a center of excellence for global risk diversification and have the unique ability to provide reinsurance coverage at optimal prices benefitting the ultimate local policyholders.
- **Enterprise risk management.**
Affiliate reinsurance affords better opportunities for strengthened enterprise risk management, which is central to both minimizing operational risk and meeting corporate and regulatory risk objectives.
- **Affiliate reinsurance is distinguishable from industrial captive insurance.**

	Industrial Captive with General Business Entity	Affiliate Reinsurance within Insurance Group
<i>Sells insurance on the open market</i>	No	Yes
<i>Manages third party risk</i>	No	Yes
<i>Insurance risk is core to business</i>	No	Yes
<i>Insurance company tax and accounting rules apply</i>	No, if self-insurance was used, insurer accounting and tax rules would not apply; captive replicates use of third party insurance tax and accounting	Yes
<i>Underlying risk directly reinsured rather than using fronting arrangements</i>	No	Yes

² Retrocession is insurance for reinsurers.

<i>Takes insurance risk from more than a small number of different territories</i>	No	Yes
<i>Keeps much of the day-to-day operational functions in house rather than outsourcing it to local captive managers</i>	No	Yes

- **Insurance regulators provide added protection against artificial profit shifting.**
 - In contrast to related-party transactions in unregulated industries, insurance regulators pay special attention to the economics of affiliate reinsurance, to ensure that the interests of policyholders in their jurisdiction are protected. Insurers and reinsurers are subject to extensive supervision by insurance regulators and this provides an independent analysis of the transaction to ensure economic substance, which helps prevent against artificial profit shifting. Affiliate transactions are a particular focus of group supervision of insurers under the standards created by the International Association of Insurance Supervisors (IAIS).

- **Artificial profit shifting is already precluded by existing transfer pricing standards embedded in jurisdictional law.**
 - The appropriate focus for tax policymakers is whether a reinsurer's affiliate is properly compensated for entering into a reinsurance arrangement.
 - When a company cedes an insured risk to a reinsurer (affiliated or not), it receives a ceding commission that reflects compensation for the ceding company's expenses.
 - This ceding commission is fully taxable whether or not there turns out to be any profit on the ceded business.

Conclusion:

The Action Plan states that the BEPS problem is due to “practices that artificially segregate taxable income from the activities that generate it”. Affiliate reinsurance does not meet this test. Affiliate reinsurance does not artificially segregate the earning of profits from economic substance. Affiliate reinsurance is driven by core risk management and the needs of insurance groups to manage capital, through diversification and other synergies. The BEPS Action Plan also states that actions to address BEPS are not “aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.” Existing international standards clearly respect arm’s length reinsurance premiums paid to foreign affiliates as fully deductible expenses of the payer.

Therefore, we strongly believe affiliate reinsurance does not present the base erosion or profit shifting concerns associated with other cross border affiliate transactions. Accordingly, any action to address tax-driven captive insurance must be carefully targeted to avoid inadvertently negatively impacting commercially driven affiliate reinsurance.

Supporting Examples and Commentary

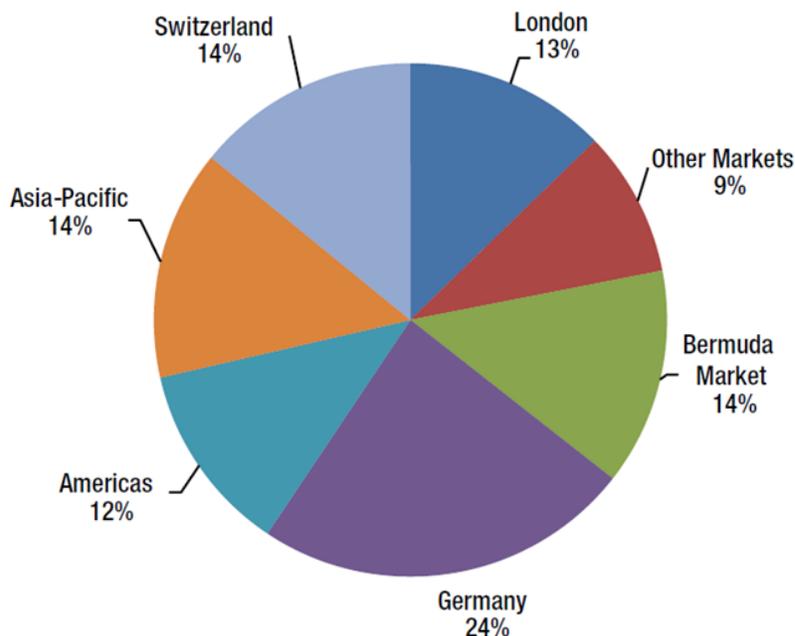
There is considerable evidence that affiliate reinsurance serves important *bona fide* non-tax business purposes. Insurance companies are part of global insurance groups – both insurers and reinsurers engage in affiliate reinsurance transactions. In fact, global operations are essential in managing risk and capital which is otherwise concentrated in local insurance markets. Insurance groups often establish subsidiaries or branches in local markets to comply with local insurance regulatory law and to enable better client relationships.

Proposals that would negatively impact the use of reinsurance by targeting affiliate transactions are clearly inappropriate because *affiliate reinsurance is extensively used within both domestic and foreign insurance groups* for legitimate non-tax business purposes. Affiliate reinsurance involves the real economic transfer of risk between two separately incorporated entities, pursuant to legally binding contracts. It is impossible for insurers to know what their losses will be at the time policies are written.

According to AM Best, the top reinsurance markets are fairly evenly distributed around the globe. The six largest markets are: Germany, Switzerland, Bermuda, Asia, United States and the United Kingdom.

The charts below clearly indicate the important *bona fide* non-tax business purposes and benefits of affiliate reinsurance.

Global Reinsurance – Non-Life Gross Premium Written by Region (2012)



Note: Region determined by the domicile of ultimate parent. *Americas includes the US, Canada and Latin America. Americas also includes GPW of National Indemnity & General Re Corp. (subsidiaries of Berkshire Hathaway).

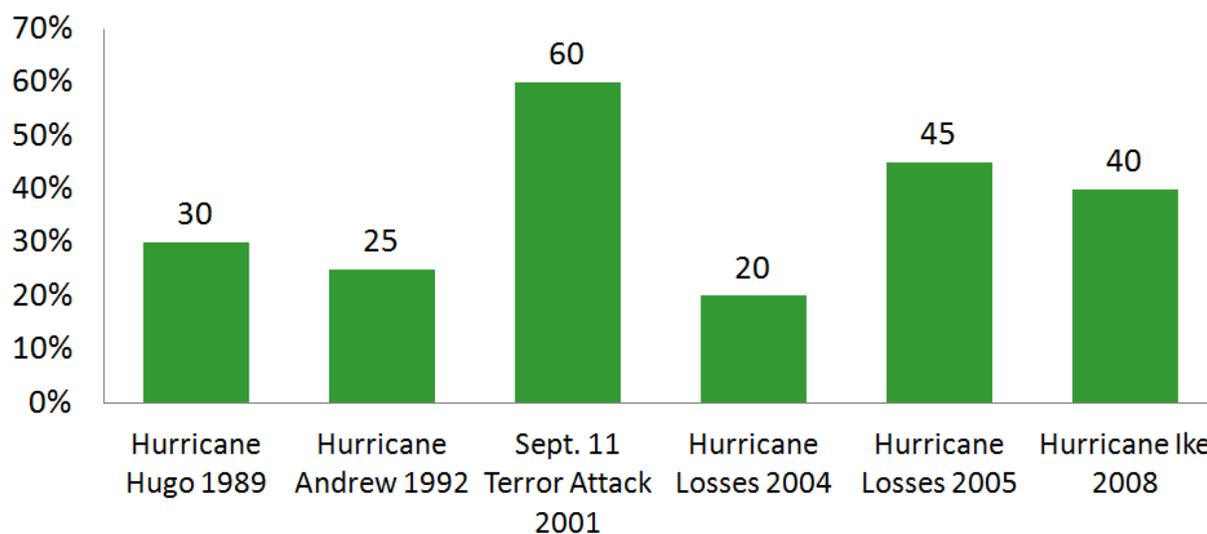
Source: Best's Special Report. August 26, 2013

The Role of Global Reinsurance in Managing Large Catastrophic Losses

The Insurance Information Institute (III) has published data from a series of large US catastrophes that documents the contribution to US insurers of claims paid by reinsurers. The table below documents that, for six major catastrophe (cat) events in the last 25 years, reinsurers' share of cat loss has ranged from 20% for the Florida quartet of hurricanes in 2004 to a high of 60% for the September 11, 2001, terrorism attacks. Generally, the larger the loss, the greater the share of insurance claims that will be passed onto reinsurers. In this discussion of averages, it should be noted that some insurers use more reinsurance, while others use less.

Share of Losses Paid by Reinsurers, by Disaster*

Reinsurance is playing an increasingly important role in the financing of mega-CATs



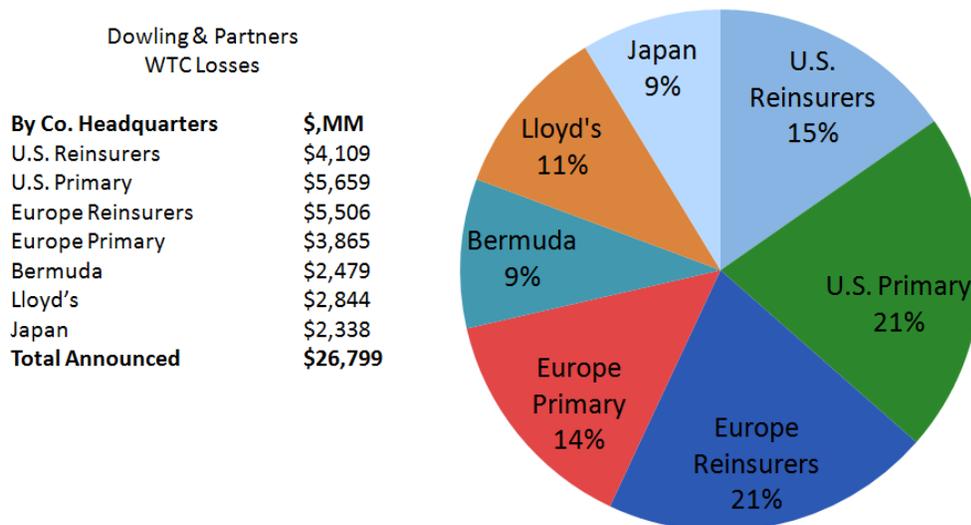
* Excludes losses paid by the Florida Hurricane Catastrophe Fund, a FL-only windstorm reinsurer, which was established in 1994 *after* Hurricane Andrew. FHCF payments to insurers are estimated at \$3.85 billion for 2004 and \$4.5 billion for 2005. Ike share is an estimate as of 2/9/09. Sources: Wharton Risk Center, Disaster Insurance Project; Insurance Information Institute.

Illustrations of Global Risk Sharing, Large Loss Events

The following loss illustrations document how jurisdictional catastrophic losses are managed through global risk sharing programs. Again, often jurisdictional law requires a licensed local insurer to underwrite specific types of business. For the largest losses, these local insurers also rely upon reinsurance to help them manage the losses that might otherwise erode their capital base. Reinsurers pool insured exposures from around the world so that they gain the benefits of diversification in pricing; and support volatile catastrophic risk from a “flagship” company balance sheet.

U.S. 9/11 Losses as Reported by Reinsurer Headquarters

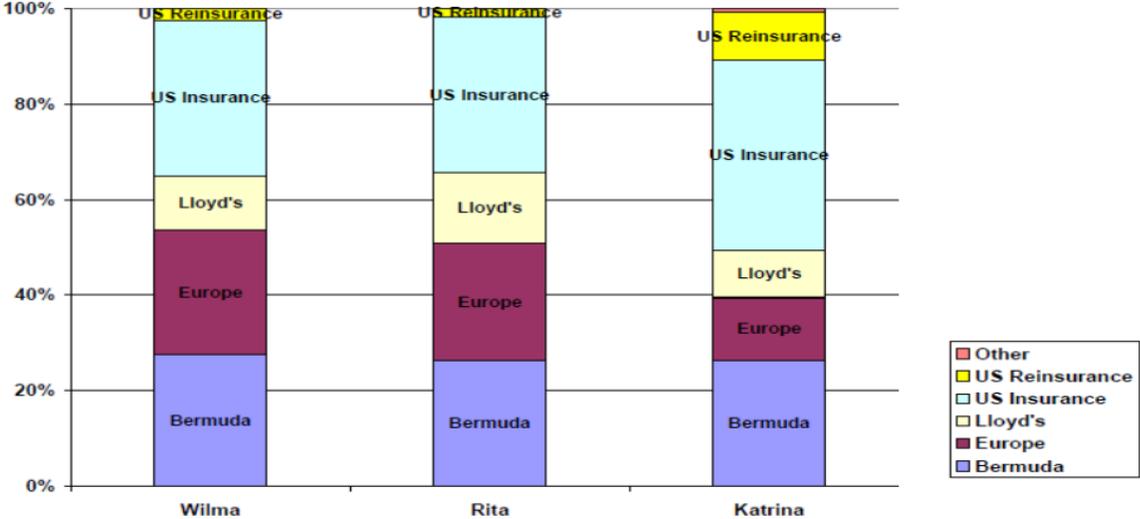
International insurers and reinsurers paid 64% of U.S. 9/11 claims.



The US 9/11 terrorism losses show the same distribution of loss payments outside the US. Although this chart includes both insurance and reinsurance, it illustrates the point that a majority of the losses were spread evenly around the world.

The chart below makes the same point for the loss payments from Hurricanes Katrina, Rita and Wilma.

Regional Distribution of '05 Hurricane Payments: Wilma, Rita, and Katrina



Source: J. David Cummins, The Bermuda Insurance Market: An Economic Analysis, May 6, 2008

Global Catastrophe Losses, 2011

Finally, we cover the lessons learned in 2011. In 2011, we witnessed the largest catastrophe losses in history – they were largely unnoticed in the EU and the US because the mega-loss events occurred in Australia, Japan, New Zealand and Thailand. The world’s leading associations of reinsurers submitted a letter entitled *"Global Reinsurers, 2011 Record Catastrophe Losses: Strong, Reliable, Dependable Reinsurance Market Support for Global Catastrophe Risk"*, to the IAIS Reinsurance Subcommittee on the lessons learned and raising issues pertinent to the IAIS and insurance regulators generally.

The 2011 global insured catastrophe losses were the highest ever recorded. Of the \$105 Billion (US) in total insured losses, the bulk of these fell in Asia and Oceania. What was extraordinary about the 2011 losses were that they were dominated by “mega cat” events that occurred in several cases in relatively small jurisdictions as measured by market size or GDP. The lesson to insurance underwriters continues to be that extraordinary losses can occur in places where catastrophe losses are unexpected (Thailand) and can occur on a scale that is much larger than expected (New Zealand).

Reinsured Share of 2011 Catastrophe Losses

1. Of the \$105 billion in global cat losses, it is estimated that 45% (\$47.5B) of this loss was ceded to reinsurers.
2. With regard to the largest events, the “mega events”, the share that was reinsured rose to 54%.
3. The reinsured share of the very largest incurred losses of 2011 (Australian flooding and windstorms, New Zealand earthquakes, Japanese earthquakes, Thai flooding) were very heavily reinsured. The larger the loss, generally the greater the share of the loss that flows into reinsurance markets. The share of the 2011 mega event cat losses that were reinsured ranged from 40% to 73%. The Chilean earthquake, which occurred in 2010, had a reinsured share of 95%.
4. The ultimate parent reinsurers of these incurred losses were generally not located in the jurisdiction where the loss event occurred. Thus the losses were exported to “foreign” reinsurers who then made claims payments to the local insurers in the economy where the event occurred. The impact of this is to improve speed of recovery in the disaster-affected economy since the loss is not largely borne by the local business and insurance community. Of the reinsured share of the losses, the amount sent to non-domestic reinsurers from these events ranged from 90 to 100%.
5. Although the US and Europe were spared large loss events in 2011, previous evidence (Hurricane Katrina, Windstorm Xynthia) demonstrates that for mega events, a large share of incurred losses are distributed to non-domestic reinsurers.

The table below summarizes the jurisdiction, the type of loss and the insured and reinsured amounts. The data is taken from publicly available sources and is based on liabilities assumed and not necessarily claims that have been paid to date.

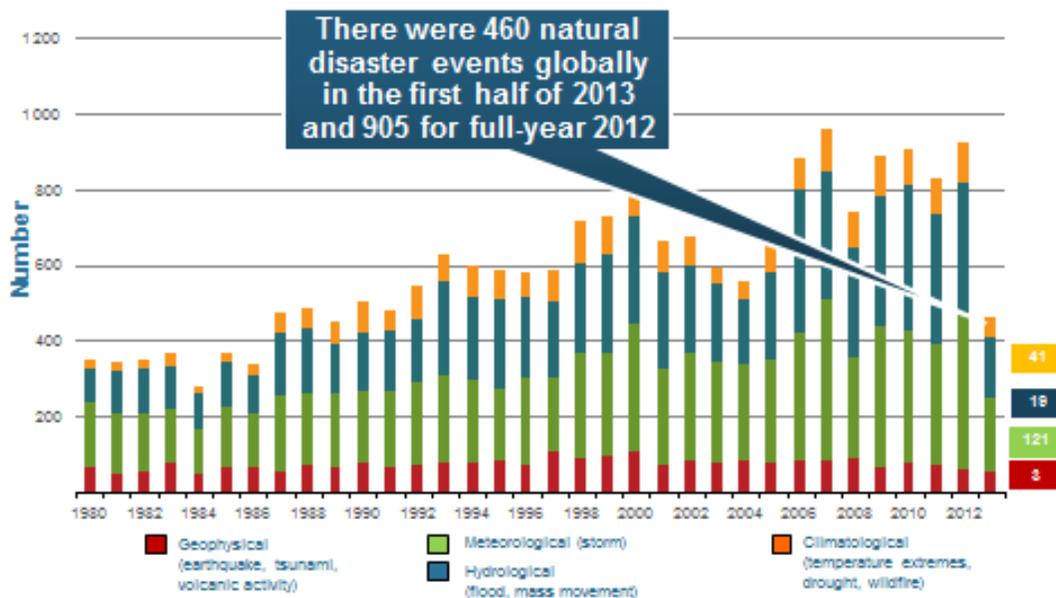
Jurisdiction	Insured Losses (Mega Cats)	Reinsured Losses (Mega Cats)	Estimated Reinsured Share	Non-Domestic Reinsured Share
Australia^I	\$ 8 B	\$ 3.5 B	44%	90%
New Zealand^{II}	\$17 B	\$12.5 B	73%	100%
Japan^{III}	\$35 to \$40 B	\$12 to \$14 B	40%	98%
Thailand^{IV}	\$15 to \$20 B	\$12 B	60%	95%
Chile^V	\$ 8.5 B	\$ 8 B	95%	100%
2011 Summary	\$75 to 85 B	\$40 to 42 B	54% average	96% average
Summary (with Chile 2010)	\$83.5 to 93.5B	\$48 to 50 B	62% average	97% average

Future Loss Trends, More Capacity Needed

Moreover, loss trends and climate scientists indicate that, in the future, more and more insurance will be needed to help economies recover from a growing frequency of weather related losses: tornados, hailstorms, hurricanes/typhoons. Tax policy makers need to make sure that policy recommendations do not run counter to broader economic policy goals of assuring greater insurance coverage for catastrophic losses.

A growing frequency of loss globally:

Natural Disasters Worldwide, 1980 – 2013* (Number of Events)



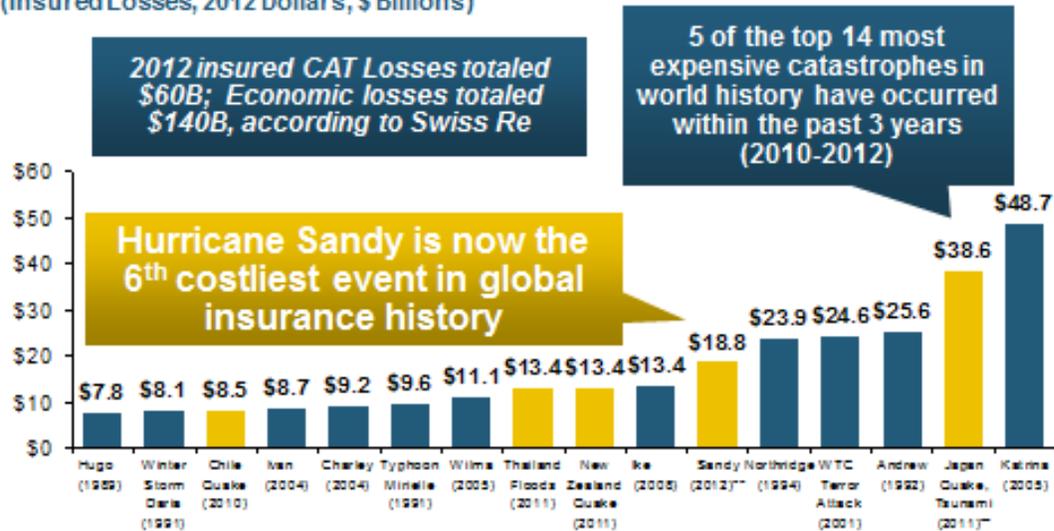
*Through June 30, 2013.
Source: IIR NatCatSERVICE

Growing costs of those losses:

Top 16 Most Costly World Insurance Losses, 1970-2012*



(Insured Losses, 2012 Dollars, \$ Billions)



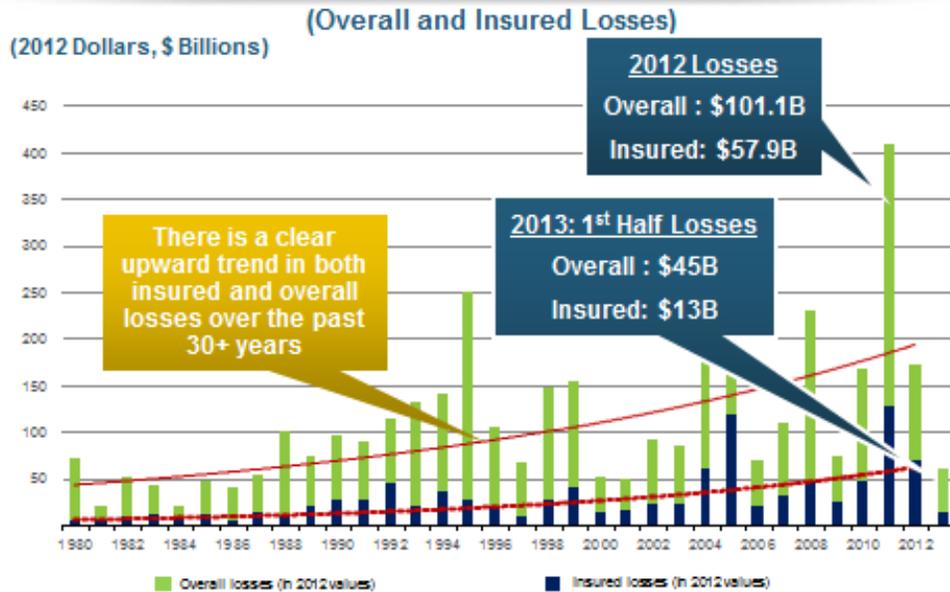
*Figures do not include federally insured flood losses.

**Estimate based on PCS value of \$18.75B as of 4/12/13.

Sources: Munich Re; Swiss Re; Insurance Information Institute research.

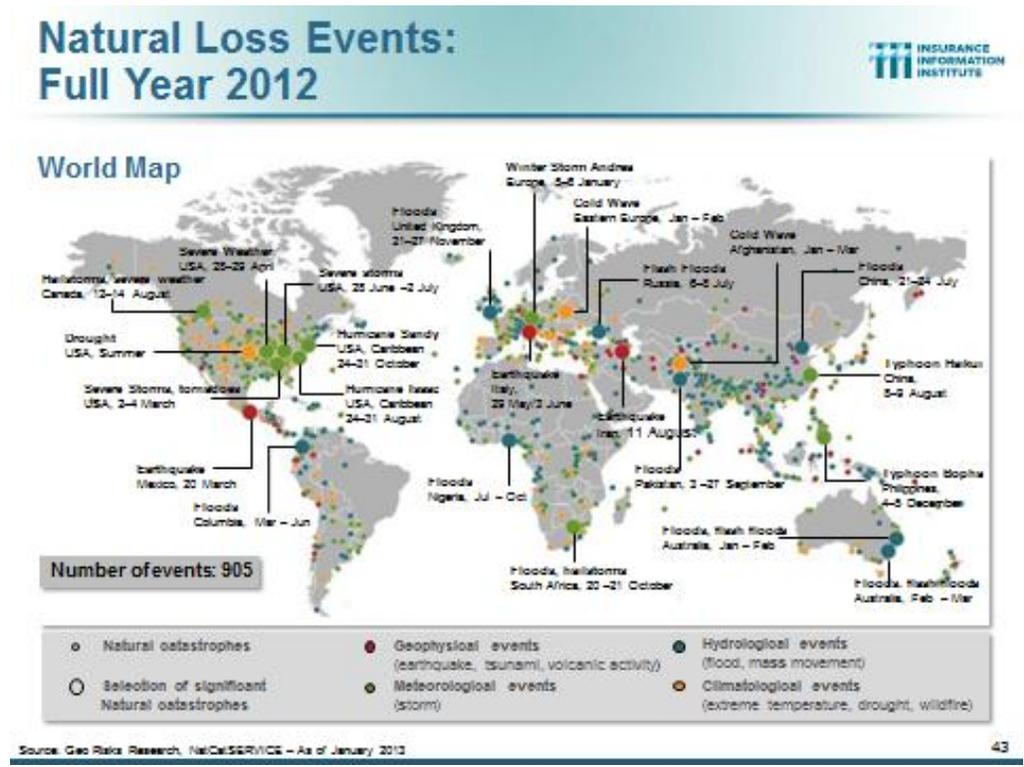
Growth in both economic and insured losses will lead policy makers to seek broader insurance market support:

Losses Due to Natural Disasters Worldwide, 1980–2013* (Overall & Insured Losses)



*Through June 30, 2013.
Source: MR NatCatSERVICE

It is truly a global issue, the developing world will need more and more insurance capacity in the coming decades:



Summary

The stated purpose of the Action Plan is to “provide countries with domestic and international instruments that will better align rights to tax with economic activity.” While there may be some misalignment of taxation with economic activity for some tax-driven captive insurance arrangements, this is not the case for the reinsurance industry, where arm’s length pricing prevails. In the case of affiliate reinsurance, the economic activity of underwriting the risk takes place in the jurisdiction where the underwriting occurs. That is the place where the economic activity of matching risk with capital and ensuring appropriate diversification of assumed risk occurs through a global pooling function. Finally, the Action Plan states a concern about “contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties.” In the case of affiliate reinsurance, it is clear that affiliate and non-affiliate transactions, which are priced using the same methodology, are both being underwritten in jurisdictions with quite variable tax rates. Thus, the Action Plan’s concern over captive insurance arrangements, which may be tax-driven, is not applicable to affiliate reinsurance since these companies enter into both affiliated and non-affiliated transactions on similar terms.

Currently, domestic insurance markets benefit enormously from a robust, vibrant, global reinsurance market that can operate free of regulatory restrictions such as rate and form regulation^{vi}, localized capital and purchase requirements, and discriminatory taxation.

Global reinsurance markets function well because they effectively pool risks of large loss events. Reinsurers of large events rely on the principles of diversification in underwriting the risks they assume. Reinsurance pools risk from the full spectrum of catastrophe losses, from varying jurisdictions, and from perils which are not interconnected. This allows reinsurance to be provided on a lower capital base which in turn allows it to be priced lower than would be the case if capital had to be held to support only a

specific risk, or a specific jurisdiction's risk exposures. This is why "ring fencing" of capital through locally mandated jurisdictional reinsurers (or through government funds) leads to higher reinsurance costs and less capacity when viewed over the long time horizon. Ill-conceived/inadvertent constraints – in the form of regulations or discriminatory taxes – will restrict capacity which inevitably will increase consumer prices.

Since affiliate reinsurance is central to the business model of international insurers, we want to ensure that insurance business models are fully understood and taken into account by policymakers working on the BEPS project. Failure to do so could well have inadvertent adverse consequences on the insurance sector and, ultimately, on business, consumers and governments who look to insurance for risk protection. We would like to help the OECD fully understand insurance business models in any way we can, and would be pleased to provide any assistance in this matter.

ⁱ Holborn, 2012 Reinsurance Market Outlook, January 2012; Australian flooding in Queensland and Victoria; Cyclone Yasi; other loss events included in aggregate global cat loss total but not in this table

ⁱⁱ Aon Benfield Reinsurance Market Outlook, Sept. 2011; Insurance Insider Analysis. Jan. 2012/1, Issue 468; AM Best Special Report, Nov. 7. 2011

ⁱⁱⁱ Aon Benfield Reinsurance Market Outlook, Sept. 2011; Various investor reports Barclays, Stifel Nicolaus, Moody's, Insurance Insider Report Jan. 2012/1, Issue 468; Research notes memo Aon, Jan. 2012

^{iv} Insurance Insider Report, Jan. 2012/1, Issue 468, Insurance Insider Reports Nov. 8, 2011 and Nov. 24, 2011

^v Aon Benfield Reinsurance Market Outlook, Sept. 2011; Insurance Insider Chilean Loos Tracker Report.; ABIR Summary and Analysis, Jan. 25, 2012

^{vi} The United States imposes standardized policy form requirement for insurance, but not reinsurance; similarly most US states impose rate regulation on insurance products, but not reinsurance products.

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About the GFIA

Through its 35 member associations, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 56 countries. These companies account for around 87% of total insurance premiums worldwide. The GFIA is incorporated in Switzerland and its secretariat is based in Brussels.