GLOBAL FEDERATION OF INSURANCE ASSOCIATIONS

20 May 2022

GFIA response to the OECD public consultation on the Regulated Financial Services Exclusion from Pillar One — Amount A of the Inclusive Framework on BEPS

Introduction

GFIA welcomes the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) consultation to inform the development of a Regulated Financial Services Exclusion.

Given the short nature of the consultation period, GFIA has primarily focused on the importance of reinsurance being excluded from Amount A alongside insurance. GFIA supports the submissions made by its members on the specific technical rules outlined in the consultation document.

Summary

Insurance and reinsurance are crucial to the successful operation of the economy and to global investments and growth. (Re)insurers play a unique role in the global economy, protecting individuals, businesses and governments against financial loss from risks ranging from natural catastrophes to poor health and unemployment. Insurance and reinsurance business is all about the transfer of risk between the insured party and the (re)insurance company.

GFIA expressly welcomes the fact that the consultation document continues to classify reinsurance as part of an excluded insurance institution. It believes it is crucial that reinsurance is excluded from Amount A. From the GFIA perspective, there can be no doubt that reinsurance, like insurance, is a highly regulated business that is subject to robust capital requirements and should be treated in the same manner in Pillar One.

Nevertheless, the consultation document notes on two separate occasions that the exclusion of reinsurance and asset management does not yet have consensus in the Inclusive Framework. Therefore, GFIA wants to highlight again the nature of reinsurance business and the reasons why the exclusion of reinsurance from Amount A is systematic and the right way forward.

Exclusion of reinsurance from Amount A

Meeting the definition of the Regulated Financial Services Exclusion

Reinsurance satisfies the three key elements of the definition of regulated financial services as set out in the consultation document, namely that there is a licensing requirement, a regulatory capital requirement and an activities requirement.

- A licence to conduct insurance and reinsurance business will not be granted if local regulatory requirements are not met.
- Reinsurance, like insurance, is subject to prudential and capital regulation. This regulation for reinsurance is similar to that of a primary (direct) writer of insurance and aligns the location of capital to the location of the (re)insurance company. Regulation in the reinsurer's location of business ensures that it is appropriately capitalised to be able to honour its liabilities to its policyholder (the insurer).

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- Reinsurance is insurance for insurers. Reinsurers contract with the primary insurer to reimburse future claims that the primary insurer may have against the payment of a premium today. The relationship is linked to the primary insurer's commitments and the occurrence of an insured event.

Insurance business model and value chain

Reinsurance and retrocession are inextricably linked to the underlying insurance contract between the insurer and the customer. Without the underlying contract with the customer, there would be no need for reinsurance or retrocession. Reinsurance — whether of the primary contract or the reinsurance contract — plays a key role in the insurance industry value chain.

Reinsurance is simply insurance for insurers; in the same way consumers buy insurance to lay off their exposures to risk, insurers buy reinsurance. Reinsurance is a business-driven, commercial transaction that is both functionally and economically integrated with the writing of primary insurance. Reinsurance is a necessity from a business perspective, since it provides risk diversification and thus reduces the required capital of the primary insurer. The law of large numbers means that an insurer's risks must be aggregated and pooled, but the concentration of risk in a single jurisdiction will overwhelm the economic capacity of any single company, or even economy, to manage that risk.

Risk and capital management

For (re)insurers, risk and capital cannot be separated; there can be no assumption of risk without the provision of appropriate capital in a (re)insurance context. As noted above, the regulatory capital rules to which (re)insurers are subject are designed to ensure that the company bearing the risk of the loss has the capital available to meet such losses. Insurance and reinsurance company business models therefore focus on the assumption and management of risk. At all levels — primary, reinsurance and retrocession — companies manage the level of risk they retain through diversification either through writing uncorrelated business or via reinsurance. They will often use reinsurance or retrocession to reduce the risk that they assume in a specific business line or geographic territory. Reinsurance and retrocession are integral components of an insurance company's business model, providing it with the ability to manage risk (and capital) before a decision is made to write the primary business. It is artificial to try to separate insurance and reinsurance in the context of Pillar One, when the management of risk and capital at all levels is interdependent.

Volatile income streams and losses

Reinsurance is about pooling risks on large scales across geographies to mitigate possible losses. Despite sophisticated risk-management techniques, reinsurance income streams are volatile in the same way as insurance income streams and can result in substantial losses in any specific period given the exposure to infrequent and catastrophic events.

Including reinsurance in the scope of Amount A could lead to adverse results by allocating taxing rights to jurisdictions where the reinsurer incurs losses, based on profits generated elsewhere through the built-in diversification process of pooling risks.

How would Pillar One deal with these losses for reinsurers, which may not be recouped for many years? Would losses be allocated to market locations in the same way as residual profits? Would losses be carried forward to future periods and for how long? A short loss carry-forward window would not work for reinsurance and could lead to double taxation. It is also not clear how regulators could get comfortable with a company being allocated such losses.

In addition, due to the volatile nature of the insurance industry, profitability varies over time, which means companies will move in and out of the 10% margin threshold and simple rules to deal with this are unlikely to be effective.

Characteristics of insurance/reinsurance that make Pillar One hard to apply

The income statement of an insurance group looks very different to a standard trading company and there are accounting changes under International Financial Reporting Standard (IFRS) 17 from the beginning of 2023 that will make the difference even greater in the future. (Re)insurance contracts are often long-term in nature and ascertaining a (re)insurer's profit or loss on an annual basis depends crucially on the evaluation of reserves for future claims payments. Although a (re)insurer knows with some certainty the premium income that it has received for a year, it will usually not know the costs of earning that premium income for many years to come. The Pillar One Blueprint of October 2020 notes these factors as follows (see paragraph 133):

"Insurers measure income and costs differently than other industries so traditional profit measurements might inaccurately result in excess profits that do not in reality exist. Most industries incur costs such as labour, raw materials, etc. at an early stage in the business cycle, with the corresponding revenues generated later in the process. The opposite is true of insurance: insurers collect premiums upfront but incur unpredictable costs later — sometimes much later — when they pay claims. The effect of these types of losses on the insurance industry is unique. The insurance industry's role is to assume risk over many years, with an uncertain realisation and timing of the insured event. This exposes the industry to volatile profits and losses. Premium rates change over the cycle depending on the availability of capital. During a soft market (when capital is plentiful), competition reduces premium rates. But as the market hardens (when capital becomes scarce, typically after a major catastrophe), premiums rise. This creates a multi-year business cycle unique to the insurance industry. Current-year profits are often based on insurance reserve estimates that reflect losses that may (or may not) occur and are based on complex actuarial modelling techniques. The ebb and flow of the insurance cycle makes the determination of normal returns for the industry difficult."

This unique multi-year business cycle is equally applicable to reinsurance and retrocession, so how would normal returns be determined under Pillar One for reinsurance?

Decoupling reinsurance from insurance

There are many reasons why decoupling insurance from reinsurance is very difficult and totally artificial. Most large insurance groups will provide multiple classes of insurance via business to consumers and/or business to business. Most large multinational insurance groups will write both insurance and reinsurance and it would take a detailed accounting exercise to separate them. This will be further complicated by the accounting changes under IFRS 17 referenced above.

Finding a suitable allocation key for any reallocation that is fair would be very difficult in practice, as it would mean unpicking the effects of risk diversification, which is one of the drivers of profits. Using an arbitrary allocation such as reinsurance premiums by country would be unfair.

Further interaction between insurance and reinsurance

Another complicating issue related to reinsurance is that the ceding company will pay premiums to the reinsurance company, while the reinsurer pays a ceding commission to the ceding company. How would this be dealt with in Amount A?

This ceding commission paid by the reinsurer to the cedant is already subject to tax in the cedant country's territory. This ceding commission includes:

- In almost all cases, an over-rider that is a percentage of premiums and is paid irrespective of the profits on the contract. (It is even due where the contract is loss-making).
- In some cases, it also includes a profit commission that returns to the cedant a share of the reinsurer's profits on the contract, which is again taxed in the cedant company's jurisdiction.

There is therefore already an industry standard to allocate a taxable share of the reinsurer's return to the country in which the policyholder bought the direct insurance policy.

Finally, insurance groups may reinsure a material amount of business to wholly owned domestic reinsurance companies for capital and regulatory reasons. Reinsurance can also take place between unrelated reinsurers in the same country. Such transactions would have to be tracked, even though the risk and profit remain in the same country.

Technical comments on the consultation document

As noted above, GFIA has focused on reinsurance being excluded from Amount A. However, below are some of the concerns raised by GFIA members.

- According to the regulation on Step 1 of the application of the Regulated Financial Services Exclusion provided for on p6 of the consultation, the revenue and profit margin must be determined both at the level of the entire group on a consolidated basis and at the level of the "disclosed segments". However, a definition of this term is not included in the consultation. GFIA understands that there will be a separate consultation on covered segments. Nevertheless, it wants to point out its assumption that "disclosed segments" refers to the segmentation provided for in IFRS reporting. GFIA therefore ask for clarification that "disclosed segments" means the segmentation to be performed in accordance with IFRS.

- Insurance companies often hold and manage investments supporting insurance liabilities through subsidiaries. Those investments in the insurance subsidiaries support the reserves and capital of the insurance institution. If an investment subsidiary has a majority owner that is an insurance institution, the investment subsidiary should also be considered a regulated financial institution, and accordingly the investment income earned through those investment subsidiaries should be included in the Regulated Financial Services Exclusion. (Majority ownership, rather than wholly owned, is the necessary standard, as insurance companies often invest alongside third-party money).

- In addition, payments from these investment subsidiaries to consolidated affiliates should be treated as related party revenues excluded from the third-party revenues which are in scope for the purposes of Pillar One's €20bn threshold.

- For the purposes of the 75% gross income test for an insurance institution, relevant premium income should be measured on a gross premium basis (rather than a net premium basis) to reflect that Pillar One's €20bn threshold is based on gross revenues (and not net revenues).

- Paragraph 29 provides a list of risks that, in GFIA's opinion, is not and cannot be exhaustive. For example, longevity or cyber risks are not listed. To avoid any confusion, it should be stated that this list is not exhaustive: "insurance contract" means a contract of insurance or reinsurance (other than an annuity contract) under which the issuer agrees to pay an amount upon the occurrence of a specified contingency involving risks, including but not limited to mortality, morbidity, longevity, accident, liability or property loss risk. It also includes a contract under which a participant agrees to contribute to a common fund providing for mutual financial benefits payable to the participants or their beneficiaries upon the occurrence of a specified contingency involving risks, including but not limited to mortality, morbidity, longevity, accident, liability or property loss risk.

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About GFIA

The Global Federation of Insurance Associations (GFIA), established in October 2012, represents through its 40 member associations and 1 observer association the interests of insurers and reinsurers in 67 countries. These companies account for 89% of total insurance premiums worldwide, amounting to more than $4 trillion. GFIA is incorporated in Switzerland and its secretariat is based in Brussels.