Response to OECD consultation on Pillar One – Amount A: Regulated Financial Services Exclusion

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Introduction
Insurance Europe welcomes the OECD/G20 consultation on the development of a Regulated Financial Services Exclusion as part of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS).

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 involves the transfer of risk between an insured party and a (re)insurance company. The exclusion of regulated financial services from Amount A of Pillar One, as stated in the Inclusive Framework Agreement of October 2021, correctly reflects the risks borne by such multinational enterprises and generally makes it possible to align the location of the profits with the market. Insurers therefore acknowledge and endorse the fact that the Model Rules should be designed on this basis.

Please find below comments on several aspects of the proposal that are of fundamental importance for the insurance industry.

General comments
Insurance Europe expressly welcomes the fact that the consultation document continues to classify reinsurance and asset management as excluded regulated financial institutions. Reinsurance as well as asset management are highly regulated businesses, already taxed at local jurisdiction level. There is no need for a reallocation of profits under Pillar One. Nevertheless, the consultation documents twice state that the exclusion of reinsurance and asset management does not yet have consensus in the OECD's Inclusive Framework. As the rules drafted for Pillar One should be as clear and practicable as possible, insurers wish to highlight once again the nature of reinsurance business and asset management and the reasons why these exceptions are logical and reasonable.

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, ie. the licensing requirement, the regulatory capital requirement and the 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

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to the location of the (re)insurance company. Regulation in the reinsurer's location ensures that it is appropriately capitalised to be able to honour its liabilities to its policyholder (ie, the insurer).
- Reinsurance is insurance for insurers. Reinsurers contract with the primary insurer to reimburse future claims that the primary insurer may face against the payment of a premium today. The relationship is linked to the primary insurer's commitments and the occurrence of an insured event.

Reinsurance business model

Reinsurance is a commercial transaction that is both functionally and economically integrated with the writing of primary insurance. It is a necessity from a business perspective since it provides risk diversification and thus reduces the required capital of the primary insurer. It is, by design, an international business with a significant local presence due to regulatory requirements or simply strategic interest. Beyond regulatory requirements, large reinsurers are global companies, and it is part of their business strategy to have an effective local presence in the important markets. Pooling risks across markets at an international level is the best way to mitigate losses due to major claims or natural catastrophes that arise in a specific geographic area. An insurer's risks must be aggregated and pooled to benefit from the law of large numbers, but concentrating the risks in a single jurisdiction will overwhelm the risk-absorbing capacity of any single company or even economy.

Reinsurers versus captives

The reinsurance business model of globally operating insurance companies is not comparable to that of captive insurers. A captive typically provides insurance policies exclusively or almost exclusively to cover the risks of non-financial entities of the multinational group to which it belongs. The reinsurer of a multinational insurance group, on the other hand, predominantly does business with third-party customers, as well as providing intra-group reinsurance to cover the risks of unrelated parties that are insured by other entities in the multinational group. It is therefore appropriate to differentiate between the business models of reinsurers and captives in the consultation document.

Regulatory requirement for a local presence

The following key points and extracts from the OECD publication "The Contribution of Reinsurance Markets to Managing Catastrophe Risk" (https://www.oecd.org/finance/the-contribution-of-reinsurance-markets-to-managing-catastrophe-risk.pdf) highlight the regulatory requirements placed on reinsurers:

- While a reinsurer may often be required by local jurisdictions to have some form of local presence or pledge local assets, this will not always be the case. The regulator of the reinsurer's client — the primary insurer — in the local market will regulate and supervise reinsurance transactions "with the aim of mitigating the counterparty and executions risks that could materialise as a result of risk transfer to reinsurers without a local presence or locally-based assets" (p7).
- On p44, the report says: Regulators or supervisors in many (if not most) jurisdictions have applied additional measures or differing requirements (such as different levels of capital credit for risk transfer) to the transfer of risk to foreign reinsurance companies, usually in recognition of the reduced level of access to — and oversight of — reinsurers (and the assets backing reinsurance liabilities) without a local presence. These include:
    - Measures that require or encourage the transfer of risk to reinsurers with some form of local presence or local recognition. For example, several jurisdictions require some form of registration to assume business from a domestic cedant (including specific criteria that must be met, usually related to financial strength), while others limit (or altogether prohibit) risk transfer to a reinsurer without a local presence. In some countries, reinsurers without a local presence may not be able to market their policies directly to local cedants.
    - Measures that require or encourage the pledging of assets in the cedant jurisdiction (local assets). Several countries require collateral to be provided for transactions involving reinsurers without a local presence (or require that the transactions be collateralised in order to benefit from capital relief). In a few countries, branches of foreign reinsurers are

not permitted, meaning that foreign reinsurers wishing to assume risks in that jurisdiction would need to establish a (capitalised) subsidiary.

- Measures that require or encourage local retention or otherwise limit the amount of premiums ceded to foreign reinsurers (or foreign reinsurers without a local presence). Some jurisdictions provide different levels of capital credit for transactions involving reinsurers without a local presence. A number of jurisdictions, particularly in non-OECD, emerging markets, have imposed local retention requirements and/or requirements that reinsurance business be initially offered to reinsurers with a local presence (or a publicly-owned domestic reinsurer).

Group operation set-up

Most reinsurers operate globally through a large number of subsidiaries and permanent establishments which are located in the more important insurance markets. Generally speaking, most of the operational reinsurance functions are managed by the group entity that assumes the underwritten risk. Such an entity is usually responsible for a certain region, ie, it writes contracts in other jurisdictions in the region. Often, the insurance contracts are tailormade, which requires a presence not necessarily within the same jurisdiction but at least in the region in order to have close contact with clients (primary insurers) and to understand their needs and their risks.

Unlike primary insurers, it is widespread in reinsurance business to write contracts not only with customers in the reinsurer's jurisdiction of residence but across several jurisdictions. Reinsurance business is based on the capacity to diversify risks across geographies, perils and lines of business and thus reduce the amount of capital needed to cover potential losses.

Asset management

Firstly, the asset management industry in general represents a highly regulated industry operating under significant and specific legal, regulatory, transfer pricing and tax frameworks. This is particularly true for retail asset management, which is largely carried out by intermediaries in the form of banks, insurance companies and brokers, all of which are subject to appropriate regulatory regimes, so there is no real distinction between any component of the financial services sector. The overall regulation on asset management is comparable to that imposed on banking and insurance, as also confirmed by the OECD blueprint of 2020.

Secondly, distribution activities are already subject to taxation in the market jurisdictions as those profits are mainly driven by the business of the intermediary. They are normally conducted inside the market jurisdiction; either by local third parties who are already subject to local taxation, or by affiliates of the asset manager to whom revenues are allocated under transfer pricing methodologies. Therefore, insufficient tax base allocations to the consumer jurisdiction should not arise.

Lastly, especially in retail asset management, the interactions are largely conducted between consumers and financial intermediaries and any contact between the investment manager and the consumer is only indirect. Therefore, the investment manager does not have access to end user data, as they are only held by the intermediary. Therefore, a proper allocation of revenues of the management industry to the various consumer jurisdictions involved would be a challenging exercise.

Considering the variety of the distribution models, it seems difficult if not impossible to define one solution that would allow to determine an adequate allocation of profit for all types of asset management business models. Given that asset management regularly operates through several layers of professional intermediaries between a fund and the ultimate investor, only identifying the residency of the ultimate investor would be extremely difficult. Building a comprehensive allocation key would be even more complex and would trigger significant tax compliance costs, most likely resulting in little or no adjustment in profit allocations.

Other technical comments on the consultation document

- According to Step 1 of the application of the Regulated Financial Services Exclusion on p6 of the consultation, the revenue and profit margin must be determined both on a consolidated basis at the level of the entire group and also at the level of the "disclosed segments". However, a definition of this term is not included in the consultation. Insurance Europe understands that there will be a separate consultation on covered segments. Nevertheless, it is useful to already point out that "disclosed segments" refers to the segmentation provided for in IFRS reporting. Insurers therefore request clarification that "disclosed segments" means the segmentation to be performed in accordance with IFRS. Otherwise, an explicit definition should be included and in line with IFRS reporting principles.

- The revenue threshold test for Amount A — Step 2 (paragraphs 12 to 14) is designed to be applied by taking the consolidated group revenue and subtracting third-party revenue derived from regulated financial services.

  Insurers would like to highlight that the granularity of data required to conduct revenue threshold tests such as those proposed in paragraphs 12 to 14 are not currently available in the consolidated group financial statement. Developing a new set of data solely for the purposes of computing the revenue threshold for Amount A each year would be cumbersome, especially so as there is little probability that a financial group would have enough in-scope activity to meet the threshold.

  In that case, to avoid time consuming yearly computations or analysis of the group's financial statements, the Model Rules for Pillar One should provide multinational enterprises with a simplification option to exclude regulated financial institutions as defined by the public consultation document from the scope of Amount A, more so when it comes to multinational corporations conducting predominantly regulated financial activities. That is because it is likely that the remaining non-financial or unregulated activities would not have a sufficient materiality to exceed the proposed thresholds.
  This simplification option implies that such deemed excluded Financial Groups would be exempted of classic reporting obligations under Amount A and would not have to perform revenue thresholds tests, except upon formal request from the tax authorities in the event of a tax audit. In that case the financial group deemed excluded would run the revenue threshold test including an adjusted entity-by-entity analysis as provided for in the comment below to justify its exclusion from the scope of Amount A.

- Groups with mixed activities should be offered other simplification options, as an alternative to the aforementioned deemed exclusion, when carrying out tests as set out through paragraphs 12 to 14. The simplifications presented in paragraph 14 are intended to make it easier for financial services groups to carry out the necessary calculations in accordance with Step 2. For this purpose, the regulated financial institutions covered or, alternatively, the entities not covered by the exceptions must be identified. In IFRS reporting, however, no categorisation is used that corresponds to the definitions in Schedule G of p9 of the consultation. According to paragraph 15, it is intended to provide a filtering function that is easy to apply and document. To achieve this goal, Insurance Europe suggests using the pre-existing categories for country-by-country reporting in order to identify the excluded entities.

- To enable proper application of the definition of "RFI Service Entity", Insurance Europe supports the inclusion of explanatory examples.

- The differentiation between captives and reinsurance business in paragraph 23 of the consultation document is appropriate to differentiate between the two business models. For reasons of clarification, insurers suggest confirming that intra-group-reinsurance within an insurance group is treated in the same way as reinsurance business with third parties, as it is not comparable to captives (see also the argumentation above).

- The definition of "insurance contracts" in paragraph 29 is too narrow and might not fully reflect the diverse insurance market. Firstly, the payment of the issuer is not necessarily a money payment. There are instances in which insurance contracts may contain payment in kind instead of in cash. Secondly, the list of insurance risks is incomplete. For example, longevity and cyber risks are missing. The list of risks should be phrased in a non-exhaustive manner since insurance contracts may cover various types of risks. Such issue could be clarified by replacing the term "involving" with "for example" or by stating that the list of examples is not exhaustive, and the definition should be aligned with the scope of IFRS 17, so that contracts that are accounted for under IFRS 17 are in any case included.