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**FERMA’s contribution to the OECD discussion draft on transfer pricing aspects of financial transactions (BEPS ACTIONS 8 – 10*)***

**September 2018**

FERMA welcomes the release of the OECD discussion draft on the transfer pricing aspects of financial transactions (BEPS ACTIONS 8 – 10).

We appreciate in particular the inclusion of a whole section dedicated to captive insurance which is considered as a genuine transaction.

The present contribution builds on FERMA members’ extensive experience with the use of captive insurance companies in Europe.

In particular, FERMA wishes to **clarify how and why captive insurance transactions may differ from independent insurer transactions notably in terms of pricing, commissions and capitalization.**

**Background**

In June 2017, FERMA provided the OECD Centre for Tax Policy and Administration with an [information paper](https://www.ferma.eu/ferma-publishes-guidelines-beps-captive-reinsurance-arrangements?type=advocacy) which proposed guidelines to help national tax authorities understand why risk managers are using captives (commercial rationale) and how risk managers are using captives (substance and governance and premium setting process).

This document presented compiled figures on 462 EU-owned captive insurance companies, and practical examples of captive arrangements used for valid business purposes. It was designed to support a consistent implementation of the OECD recommendations on Base Erosion and Profit Shifting (BEPS).

The paper, enriched and approved by FERMA 22 member associations, represents a strong consensus within the European risk management community on how captives are supporting the operations of their parent organisations.

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| **BEPS discussion draft on the transfer pricing aspects of financial transactions** | | |
| **SECTION E. Captive Insurance** | **FERMA comments** | **FERMA recommendations** |
| **ELEMENTS THAT FERMA WELCOMES/SUPPORTS** | | |
| 166. (…) it reinsures a significant proportion of the risks it insures outside of the MNE group (…) | ***Page 8 of FERMA information paper on captives and BEPS: “****A captive allows the multinational a direct relationship with the reinsurance market which may offer greater capacity, lower prices, a larger geographical scope and more flexibility than the primary insurance market.****”*** | ***xxxxxxxxxxxxxxxxx*** |
| 166. (…) both the insurer and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk transfer and appropriate capital levels; (…) | ***Page 11 of FERMA information paper on captives and BEPS:*** *“Captive companies have to meet the same set of supervisory requirements (i.e. corporate governance, minimum solvency level, fit-and-proper constraints for their management bodies, etc.) and so cannot be drastically different from traditional commercial insurers, except for their lower level of diversification.”*  ***Page 16 of FERMA information paper on captives and BEPS: “****The captive is subject to a “risk-based” insurance regulatory regime in its jurisdiction, in line with the Insurance Core Principles of the International Association of Insurance Supervisors, or to full Solvency II regulations or equivalent regime.”* | ***xxxxxxxxxxxxxxxxx*** |
| 166. (…) the captive has a real possibility of suffering losses. (…) | ***Page 7 of FERMA information paper on captives and BEPS:***  *“Before deciding to use a captive, the parent company of the multinational group will need sufficient financial strength to support its control and governance, operating costs, regulatory capital requirements, and as well as potential underwriting losses.”*  ***Page 9 of FERMA information paper on captives and BEPS:***  *“Improved data collection, loss control and prevention measures*    *According to its central role within a multinational group, a captive can be used as a central unit for insurance data collection coming from all the group’s entities, such as loss statistics, nature of the cover, control measures, intermediation costs, recourses, etc.*  *A captive can promote greater awareness of factors that commonly give rise to losses and be a strong support to improve loss prevention and control policies as well as to initiate relevant control actions.”* | ***xxxxxxxxxxxxxxxxx*** |
| 177. A reinsurance captive is a particular type of captive insurer which does not issue policies directly but operates as a reinsurer under an arrangement known as “fronting”.  Captive insurers may not be able to deal with all risks in the same way as traditional insurance companies. For instance, certain insurance risks must be placed with regulated insurers as a legal requirement.  This may lead to the use of a fronting arrangement in which the first contract of insurance is between the insured member of an MNE group and an unrelated insurer (the fronter); the fronter then reinsures with the captive most or all of the risk of the first contract.  The fronter may remain responsible for claims handling and other administrative functions or these functions may be handled by a member of the same MNE group as the captive.  The fronter retains a commission to cover its costs and to compensate for any portion of the insured risk which it retains. The majority of the fronter’s premium passes to the captive as part of the reinsurance contract. | ***A captive allows the multinational a direct relationship with the reinsurance market which may offer greater capacity, lower prices, a larger geographical scope and more flexibility than the***  ***primary insurance market.***  ***By the same process, it may also allow multinational corporations to access government pools, such as GAREAT in France, Pool Re in the UK, etc.***  ***Captives might operate also on a reinsurance basis if “rated” insurance paper was required.***  ***See page 7, 8, 20 of FERMA information paper on captives and BEPS*** | ***xxxxxxxxxxxxxxxxx*** |
| 181. Alternatively, actuarial analysis may be an appropriate method to independently determine the premium likely to be required at arm’s length for insurance of a particular risk.  In setting prices for an insurance premium, an insurer will seek to cover its expected losses on claims, its costs associated with writing and administering policies and dealing with claims, plus a profit to provide a return on capital, taking into account any investment income it expects to receive on the excess of premiums received less claims and expenses paid. | ***An efficient premium setting process will show that the premiums paid by the group subsidiaries to the captive are set on an arms-length basis with model-based technical premium using standard actuarial methodologies and based on loss history and/or exposure measures and/or cost of capital.***  ***To achieve it, captives acting as a direct insurer or reinsurer should demonstrate that premiums are correctly priced by a combination of comparable market pricing benchmarking and modelling performed by qualified actuaries, using transparent methodologies based on risk exposure and historical loss experience.***  ***Page 17 of FERMA information paper on captives and BEPS*** | ***xxxxxxxxxxxxxxxxx*** |
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| **ELEMENTS WHICH IN OUR VIEW ARE MISSING** | | |
| *162. There are many ways that MNE groups may* ***manage*** *risks within the group.*  *For example, they may choose to set aside funds in reserves, pre-fund potential future losses, self-insure, acquire insurance from third parties or simply elect to retain the specific risk.* | ***As part of a full Entreprise Risk Management approach, MNE groups would also consider the identification, analysis, evaluation and handling of the risks.***  ***The paragraph is missing the following ERM components: risk avoidance and risk control/ reduction. Only risk transfer/ financing solutions are mentioned here to manage risks.*** | 162. There are many ways that MNE groups may **~~manage~~** **treat** risks within the group **as part of a full Entreprise Risk Management (ERM) approach.**  For example, they may choose **to implement prevention and protection measures,** set aside funds in reserves, pre-fund potential future losses, self-insure, acquire insurance from third parties or simply elect to retain **or avoid** the specific risk. |
| *164. As stated in Part IV of the 2010 Report on the Attribution of Profits to Permanent Establishments, “As a general matter, the insurance business is the business of accepting obligations or liabilities in respect of uncertain losses arising from the realisation of events outside the control of the insured. Insurance businesses are able to do this by pooling the potential losses of many risk-averse persons via the payment of an amount by the insured to the insurer, called a premium. In consideration of the payment of the premium, when the insured incurs a loss or a specified event occurs, he, she or a beneficiary is indemnified for the amount of the value of his or her loss or receives an agreed payment or service.”* | ***The definition of a captive insurance is missing. In our information paper released in June 2017, FERMA referred to the definition of captive insurance in the chapter 2 of the*** [***IAIS Application Paper on the Regulation and Supervision of Captive Insurers***](https://www.iaisweb.org/page/supervisory-material/application-papers/file/58019/application-paper-on-the-regulation-and-supervision-of-captive-insurers) ***(Nov 2015):  “****an insurance or reinsurance entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities, the purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which it belongs, or for entities connected to those entities and only a small part if any of its risk exposure is related to providing insurance or reinsurance to other parties.”*  ***Without being overly prescriptive, this definition offers the clarity and flexibility to fit the various situations where an organisation might use a captive insurance.*** |  |
| 166. (…) the captive has the requisite skills, including investment skills, and experience at its disposal, including employees with senior underwriting expertise; (…) | ***Page 16 of FERMA information paper on captives and BEPS:***  *“The captive engages local resources, either as third party professional captive managers, or as employees, with relevant experience, skills and capacity for underwriting support, accounting, company secretarial, local compliance and regulatory reporting.*  *The captive has four key functions (risk management, actuarial, compliance and internal audit). These roles are pre-approved by the local regulator and generally performed by outsourced service providers and individuals with the appropriate skills and experience.”* | 166. (…) the captive has the requisite skills, including investment skills, and experience at its disposal, including employees with senior underwriting expertise **and outsourced service providers and individuals with the appropriate skills and experience**; (…) |
| 178. Fronting arrangements represent particularly complex controlled transactions to price as they involve the participation of a third party that is indifferent to the levels of the price of the insurance and re-insurance transactions.  The key issues which are likely to arise in fronting cases are whether the transactions involved amount to genuine insurance or reinsurance and, if there is genuine insurance, whether the premiums payable (ultimately to the MNE reinsurance captive) are on arm’s length terms. | ***In such a reinsurance framework, there is no transaction between the operating entities and the captive, which “follows the fortunes” of the fronting insurer.*** ***The premiums payable to the reinsurance captive are therefore on arm’s length terms.***  ***Page 17 of FERMA information paper on captives and BEPS***  *3.3. Transfer Pricing (premium setting process)*  *Documentation that can show the appropriateness of the pricing for a captive acting as a reinsurer includes some of the following:*   * *Evidence that reinsurance pricing follows the fronting insurer’s pricing and/or the pricing from other participants in the (re)insurance programme in which the captive participates.* * *Market quotes from third party (re)insurance companies, or benchmarking analysis, in respect of the insurable risks.* * *Model-based technical premium using standard actuarial methodologies based on loss history and/or exposure measures and/or cost of capital.* |  |
| 182. A comparable uncontrolled price can be arrived at by considering the arm’s length profitability of the captive by reference to a two staged approach which takes into account both profitability of claims and return on capital. (i) The first step would be to identify the captive’s combined ratio. This can be determined by expressing claims and expenses payable as a tested party's claims and expenses paid to arrive at an arm’s length measure of annual premiums and thus underwriting profit (premiums receivable less claims and expenses). | ***In our FERMA information paper on captives and BEPS, we have shown that in fiscal 2015, the 462 captives owned by European resident multinational companies, underwrote US$10bn net premiums and paid back US$7bn net claims to the multinational groups’ operating entities (loss ratio of 72%).*** |  |
| (ii) The second step is to assess the investment return achieved by the captive against an arm’s length return. This step requires two further considerations (a) the **amount of capital** held by the captive and (b) to the extent to which the captive invests in connected party investments (e.g. intra-group bonds, loans, etc.), the rate of investment return achieved by the captive on those investments.  The sum of underwriting profit from step one and investment income from step two gives total **operating profit**. | ***In our FERMA information paper on captives and BEPS, we compare the captives’ sample net assets on gross written premium ratio (1.40) with the book value to sales ratio of European commercial insurers (1.25), and it showed that those captives were not excessively capitalised compared to the European commercial insurance markets.***  ***When comparing the captives’ net profit before tax on gross written premium ratio (14.8%) with the pretax unadjusted operating margin of European commercial insurers (15.4%), it was apparent that captives are not making excessive profit compared to the European commercial insurance markets.***  ***See page 13 of FERMA information paper on captives and BEPS*** |  |
| E.6. Agency sales 186. | ***See also example 3 of FERMA information paper on captives and BEPS*** |  |
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| **ELEMENTS THAT FERMA OPPOSES OR ON WHICH WE ASK FOR FURTHER CLARIFICATION/REFLECTION** | | | |
| **166. (…) Prescriptive definitions of insurance are beyond the scope of this guidance (…)** | | ***This seems contradictory with the statement provided above for point 164. Definitions are important here and insertion of IAIS definition of a captive would be relevant to clarify its risk management purpose for an organisation.*** | 166. A frequent concern when considering the transfer pricing of captive insurance transactions is whether the transaction concerned is genuinely one of insurance, i.e., whether a risk exists and, if so, whether it is allocated to the captive in light of the facts and circumstances. **~~Prescriptive definitions of insurance are beyond the scope of this guidance and t~~**The accurate delineation of the actual transaction for transfer pricing purposes must follow the principles set out in Chapter I. The following are indicators, all or substantially all of which would typically be expected in an independent insurer: |
| **166. (…) the insured risk would otherwise be insurable outside the group; (…)** | | ***Page 9 of FERMA information paper on captives and BEPS:***  *“Solution to market inadequacies (coverage for non-traditional or overpriced risks)*  *From time to time, the traditional insurance market dictates restrictions to some policies, particularly in hard market conditions, or is unwilling to provide cover for certain risks.*  *The use of a captive to buffer market conditions or to provide additional capacity can be an answer.*  *By filling market gaps, a captive is a useful tool to actively help its owner avoid lack of cover or overpriced insurance solutions. This will lead to an improved loss control efficiency.*  *A traditional example of the added value a captive (re)insurance company can add to its group is the ability to cover risks that are emerging and not yet well known by the insurance market (e.g. cyber risk exposure) or which have a very specific nature and severe potential impact (e.g. nuclear, aircraft, natural disasters).* | **~~166. (…) the insured risk would otherwise be insurable outside the group; (…)~~** |
| E.2. Rationale for a captive  172. Potential commercial reasons for an MNE group to use a captive insurer include the following: to stabilize premiums paid by MNEs within the MNE group; **to benefit from tax and regulatory arbitrage;** gaining access to reinsurance markets; or because the group considers that retaining the risk within the group is more cost effective. | | ***Captive fulfils a genuine risk management purpose and so should not be regarded as a tax avoidance vehicle by the respective tax authorities.***  ***Captives are comparable to traditional insurance companies when it comes to their underwriting results, taxation and level of equity and solvency parameters.***  ***Page 13 of FERMA information paper on captives and BEPS:***  *“captives’ corporate income tax liabilities are in line with those paid by the European commercial insurance markets.”*  ***Page 9 of FERMA information paper on captives and BEPS:***  *“In summary, the main business reasons to have a captive are the following:*   * *Increase overall efficiency of risk management* * *Increase long term stability by mitigating market pricing and capacity volatility* * *Obtain coverage for risks not readily available or economically feasible in the commercial markets* * *Provide flexibility in responding to changes in risk retention and risk transfer strategies* * *Build better awareness of the cost of risk andloss control with central accountability for risk management* * *Reduce and/or smooth the TCOR including administration costs* * *Access reinsurance markets* * *Maintain control over claims* * *Obtain access to government pools, e.g. terrorism insurance via GAREAT or Pool Re”* | E.2. Rationale for a captive  172. Potential commercial reasons for an MNE group to use a captive insurer include the following: to stabilize premiums paid by MNEs within the MNE group; **~~to benefit from tax and regulatory arbitrage~~**; gaining access to reinsurance markets; or because the group considers that retaining the risk within the group is more cost effective. |
| 176.  (…) A captive insurer within an MNE may lack the scale to achieve significant risk diversification **and may lack sufficient reserves to meet additional risks represented by the relatively less diversified portfolio of the MNE group.** **In that case, the accurate delineation of the actual transaction may indicate that the captive is operating a business other than an insurance one.** (…) | | ***Page 13 of FERMA information paper on captives and BEPS:***  *Comparing the captives’ net assets on gross written premium ratio (1.40) with the book value to sales ratio of European commercial insurers (1.25), it is apparent that captives are not excessively*  *capitalised compared to the European commercial insurance markets.*  *A slightly higher ratio for captives compared to commercial insurers is justified by a lower diversification of risks, which implies higher regulatory capital requirements.* | 176.  (…) A captive insurer within an MNE may lack the scale to achieve significant risk diversification **~~and may lack sufficient reserves to meet additional risks represented by the relatively less diversified portfolio of the MNE group. In that case, the accurate delineation of the actual transaction may indicate that the captive is operating a business other than an insurance one.~~** **Combining non-correlated risk retentions, such as property and transport, and varied geographical exposures will improve the diversification and mutualisation effect within a multinational corporation** **A lower diversification of risks might imply higher regulatory capital requirements compared to commercial insurers.** (…) |
| 185. By bringing together a portfolio of insurance risks across different geographical zones, the group already represents a diversified risk to the market.  The synergy benefit arises from the collective purchasing arrangement, **not from value added by the captive.**  It should be allocated amongst the insured according to the level of premium they contributed. | | ***There is a contradiction with point 176. Which was stating that MNEs may lack the scale to achieve significant risk diversification.***  ***It is the use of a captive as part of the group risk management framework that adds significant business value.***  ***A captive enables a group to provide insurance at acceptable economic conditions, as opposed to purchasing cover from the insurance market, in terms of managing the Total Cost of Risk, administrative and operational issues, and overall control.***  ***See example 2 of FERMA information paper on captives and BEPS*** | 185. By bringing together a portfolio of insurance risks across different geographical zones, the group already represents a diversified risk to the market.  The synergy benefit arises from the collective purchasing arrangement. ~~,~~**~~not from value added by the captive.~~**  It should be allocated amongst the insured according to the level of premium they contributed. |
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The Federation of European Risk Management Associations brings together 22 risk management associations in 21 European countries, representing 4800 risk managers active in a wide range of organisations. FERMA provides the means of co-ordinating risk management and optimising the impact of these associations outside their national boundaries on a European level.

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