September 6, 2018

Tax Treaties, Transfer Pricing and Financial Transactions Division
Organization for Economic Cooperation and Development
Centre for Tax Policy and Administration
2, rue André Pascal
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France

Subject: Base Erosion and Profit Shifting (BEPS) Action 8 – 10 Financial Transactions

Dear Sirs and Madams:

We are responding to the invitation to send our comments on the discussion draft Report 8-10 of the BEPS Action Plan ("Aligning Transfer Outcomes with Value Creation"), Working Party No. 6 ("WP6"). Our comment starts with some general remarks, followed by arguments responding to the specific questions included in the boxes.

The Captive Insurance Companies Association (CICA) is a multi-national, domicile-neutral captive insurance association. CICA's approximately 400 members are from a cross-section of domiciles, captive/risk retention groups and service providers from 27 countries around the world. For over forty-five years, CICA has been working to protect the captive industry.

CICA is committed to providing the best source of unbiased information, knowledge, and leadership for captive insurance decision makers. By monitoring emerging issues and regulatory changes in the U.S. and around the world, CICA and its advocacy partners can respond proactively to help mold laws and regulations affecting the captive industry. Our member representatives in partnership with the European Captive Insurers and Reinsurers Owners Association (ECIROA) have reviewed the OECD's report and welcome this opportunity to share our input.

Also attached is CICA's *Guidance for Captive Owners and Managers*, addressing the 2013 OECD Action Plan on Base Erosion and Profit Shifting, which explains in detail how the captive industry is prepared for the requirements formulated in the BEPS Papers. This has been previously submitted to the OECD.

General Remarks:
CICA supports the targets of OECD which have been preformulated by the G-20.

It is imperative that the OECD should ensure that any new guidance relating to captive insurance companies should not contradict certain fundamental accounting and insurance regulations already in place and adhered to by multinational companies. In this regard, we believe that the arm's length principles of any transfer pricing arrangements involving a captive insurance company should firstly be treated as a genuine insurance transaction satisfying the conditions of IFRS 17 and secondly it must fall within the specific categories of insurance classes laid down by the insurance regulations for which the captive is authorized to conduct in the jurisdiction. Currently, the draft discussion paper includes certain comments and examples which could potentially give rise to unnecessary uncertainty and time-consuming administrative burden for both MNEs and tax authorities.

Box E.1. Question to commentators
Commentators' views are invited on the following:
• 1 - when an MNE group member issues insurance policies to other MNE group members, what indicators would be appropriate in seeking to arrive at a threshold for recognizing that the policy issuer is actually assuming the risks that it is contractually assuming;
• 2 - when an MNE group member issues insurance policies to other MNE group members, what specific risks would need to be assumed by the policy issuer for it to earn an insurance return, and what control functions would be required for these risks to be considered to have been assumed; and
• 3 - whether an MNE group member that issues insurance policies to other MNE group members can satisfy the control over risk requirements of Chapter I, in particular in the context of paragraph 1.65, in situations where it outsources its underwriting function. Comments are also invited on whether an example would be helpful to illustrate the effect of outsourcing the underwriting function on the income allocated to the MNE group member that issues insurance policies;
• 4 - when an MNE group member that issues insurance policies does not satisfy the control of risk requirements of Chapter I, what would be the effect of this on the allocation of insurance claims, premiums paid and return on premiums invested by that MNE group member.

Comments:

Ad 1
- Both, direct captive and reinsurance captive are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk transfer

and appropriate capital levels. To align the requirements, IAIS (International Association of Insurance Supervisors) has issued the “APPLICATION PAPER ON THE REGULATION AND SUPERVISION OF CAPTIVE INSURERS, November 2015”. (Link: *https://www.iaisweb.org/page/supervisory-material/application-papers//file/58019/application-paper-on-the-regulation-and-supervision-of-captive-insurers-*)

- There is pooling of risk in the captive insurer, carrying a diversity of risk spread within the group`s scope of activity,
- Captives have the requisite skills and experience at their disposal in accordance with the supervisory requirements (such as Solvency II or IAIS paper) to third party service providers acknowledged and/or registered by the local supervisor. All required functions - identical with those for all other insurance companies - have to be exercised and approved. No lighter regulatory regime for insurance of group risks is existing.
- *Note:* in some regulatory regimes captives are granted some simplification due to the application of the Proportionality Principle
- Outsourced functions such as premium collection and claims handling are appropriately remunerated according to the service they provide based on contracts or service level agreements which are transparent and following the arm´s length principles (and which are under pressure of a strong competitive market).
- The commercial rationale to establish the captive is determined by the risk management concept of the owner to carry part of the insurable risk within the group to save cost and administrative burden. The use of the term `mitigation` may mislead the reader due to the fact that the captive is assuming the insured risk within the limits of their policy (contract) and protects itself via reinsurance in the market (e.g. stop-loss cover).
- Risk in excess of the capacity which the captive can pay for, based on equity, premium and reserves, usually is insured in the insurance market outside the group.
- The captive has a real possibility of suffering losses, i.e. to pay in accordance with the policy underwritten up to the limits of these policies and in the annual aggregate.
- A properly managed and regulated captive will have sufficient reserves to meet its liabilities. The extent of risk diversification is relevant only to the likely level of reserves that may be required.
- A properly managed captive will have risks presented to it. The captive board will decide whether to accept the risk, and if so, on what terms. This decision is not taken elsewhere in the group.
- OECD should not try to introduce new definitions of insurance and insurance contract but rather refer to IFRS 17 and IAIS definitions of “genuine insurance transaction”
- In a Solvency II environment for instance this would be demonstrated by the ORSA report

- It is unnecessary to create another set of indicators to evaluate whether the captive is actually assuming risk. There are currently well understood and applied principles in this regard that tax authorities could rely upon such as IFRS 17 and the insurance regulations. They generally follow the standards laid down by the European Union directives and/or the International Association of Insurance Supervisors. Creating another set of "indicators" is likely to create confusion, uncertainty, and inconsistency between accounting, insurance, and tax regulation.
- Captives are required to apply for insurance / reinsurance licenses from regulators and test the ability for the entity to act as an insurance risk bearing vehicle. The application process will evaluate the risk that the captive is proposing to take, which will be clearly outlined in the proposed insurance contract that is required to contain certain minimum standards, such as appropriate risk triggers, consistent with the principles of insurance set by the IAIS and IFRS 17.
- Regulators will stipulate the financial conditions required by insurance / reinsurance entities to accommodate the levels of risk proposed.
- Regulators will also test the governance and oversight arrangements of the proposed operation, requiring certain standards.
- Only when these areas have been scrutinized and evaluated against the requirements as set for the jurisdiction in question, will insurance / reinsurance license be granted.
- With these comprehensive measures in place, we suggest that the OECD acknowledge the measures already in place by insurance regulators to determine the legitimacy of insurance for individual captives as further tests will undermine the insurance regulatory processes, create duplication and will be unlikely to strengthen the tests of insurance already in place.

Ad 2

- The commercial reasons for an MNE group to use a captive insurer normally include some or all of the following: a. stabilizing premiums paid by MNEs within the MNE group; b. gaining access to reinsurance markets; c. reducing the cost of risk because the group considers that retaining the risk within the group is more cost effective; d. providing coverage when the commercial insurance market makes it difficult or too expensive to get insurance coverage for certain risks; e. centralizing the MNE´s insurance data and costs - but f. definitely **not** to benefit from tax and regulatory arbitrage.
- Where such difficult to insure risks are insured by a captive insurer this will be on an arm's length price calculated on the risk assessment of insurance experts experienced in bundling a variety of risks which allow to place these risks in the reinsurance market with a high attachment point (always due to approval of the local supervisor).
- For any risks for which market comparability is difficult, the OECD should bear in mind that this does not mean the risk in 'uninsurable', but that either the market is insufficiently informed on the risk or has only a developing appetite for the risk.

- Captives, supported by appropriate data and robust transfer pricing techniques, can also legitimately accept risks, subject to the overriding insurance regulatory framework requirements.
- Captives issue an insurance policy based on a lot of criteria/parameters, similar to the traditional market: a. loss ratio (of insured) compared to market, b. experience based, c. premium adjustment due to loss/claim development, d. risk mitigation tools of insured, loss prevention i.e. technical standards or legal provisions
- Captives are used to insure previously uninsured risks as an incubator for new products. The captive gathers loss information to enable the product and pricing to be refined.
- The OECD still questions whether putting difficult to insure risk (i.e. insurance too expensive in the commercial market) is a valid transaction. It absolutely is: while it may be a crucial risk, it is still a risk to the company who has a captive, thus they need to account for it in some way to protect themselves, and a captive is a great way of doing that. – *Examples:* Where companies have incubated risk in their captive to build up a risk profile, or where the commercial market is undeveloped, and actually transferred this into the commercial market after a few years (cyber or supply chain risk are examples of this).
- In relation to the OECD's suggestion that tax arbitrage is a driver for captive utilization, it should be highlighted that, through the use of a captive, the MNE is attracting additional indirect taxes such as Insurance Premium Tax and equivalent tax charges, which, on a consolidated view, can result in higher tax liability position for the MNE.

Ad 3

- As in all relationships between insurer and insured there is a learning aspect for the risk management function of the insured group. Captives assume risk. The responsibility for risk in the group is assigned to the Board level of the group. The control and daily management of risks within the group is delegated to a separate function. Either a risk management or an insurance department takes care for the risk transfer – this is done usually in the insurance market. Part of this risk can also be presented to a captive, but the captive Board has in its own responsibility to decide whether to accept these risks and, if so, on what terms. The captive has to secure that the financing of the notified claims and losses is guaranteed.
- The performance of outsourced functions is based on a contract/service level agreement which determines precisely what the service provider has to do. The work is remunerated in accordance with his performance and can be compared with the prices of competitors.
- Outsourced underwriting for the direct captive is based on the criteria/parameters mentioned above. The service has the same effect on the captive as if the underwriter would be an employee of the captive.
- A properly managed captive will have risks presented to it. The captive Board will decide whether to accept the risk, and if so, on what terms. This decision is not taken elsewhere in the group.

- Decision-making always remains with the captive's Board of Directors or Underwriting Committee. This includes decisions about which risks to underwrite or not, under what terms and conditions, as well as which reinsurance protection should be purchased or not.
- The captive should be able to demonstrate access to the appropriate skills, expertise and depth of resources to undertake its activities. These need not be employees as long as the remit under which they operate is clear and defined. Where the resources are provided by a service provider then appropriate outsourcing/consultancy contracts should be in place, and where the functions are provided by other employees of the MNE there should be clear segregation of duties.
- Generally, the current insurance regulations are extremely stringent about the various functions of the captive such as underwriting and outsourcing etc. That would not require further layer of regulations by the OECD. There is a risk that any additional requirements issued by the OECD could potentially create unwarranted confusion, ambiguity, uncertainty and in the end lot of administration for MNEs as well the corresponding tax authorities. OECD need to respect and acknowledge the standards, rules and regulations set out by the International Accounting Standards, the European Union, International Association of Insurance Supervisors and the respective insurance supervisory regimes.
- The captive Board is responsible for all decisions relating to the operation of the captive. All risk decisions must be considered in relation to the Board approved underwriting policy, which will comprehensively outline the nature, type and quantum of risk that the captive can assume. The underwriting policy of the captive, as with all the Board approved policies, are subject to Regulatory approval and ongoing audit scrutiny.
- This process is buttressed by numerous control functions, internal procedures and oversight measures, including the presence of an underwriting function, whose primary function is to oversee the correct application of the underwriting policy and apply expert judgement on the performance of risk assumed by the captive.
- It is important for the OECD to appreciate the highly regulated environment in which captives operate and the high standard of expertise required and expected to satisfy regulatory requirements.

Ad 4

- As an insurance company the captive has to follow the requirements of the regulation. It cannot be influenced by other parties in the MNE group how to act or react. The only ultimate control over the captive is given on the Board level of the captive based on a delegation of responsibility (from MNE Group Board level) which is a requirement of Corporate Law and Corporate Governance Guidelines.
- Fronting: Captives can apply for the license to underwrite all lines of risk. The supervisor has to approve it. Fronting insurers are necessary to issue local policies in numerous countries to structure a compliant IIP. The direct captive cannot issue local policies in other (third) countries without a license. Only in Europe, based on the Freedom of Services Rule the direct captive can issue

policies. Fronting insurers provide the service for the entire group of insurers which carry part of the risk – in a quasi-syndication. The fronting carrier is reinsuring the lower part of the programme (with an expected higher frequency) to the captive. The premium includes the cost of doing (ceding commission), i.e. the entire policy issuing, money transfers and claims handling, beside the price for carrying the risk.

- There are two different approaches, gross and net structures of the IIP. In a gross structure the entire premium is running through the captive and the captive has to pay for reinsurance in excess of the risk which it assumes on its account; the premium share is appropriate and sufficient to cover to the two parts of the risk (i.e. for captive and reinsurer). The reinsurers invoice the appropriate part of the premium to the captive. In a net structure the captive receives based on the fronting policy only the premium which is necessary to cover the assumed risk. This leads to the question of the calculation of this premium which has to be arm`s length.
- A situation where the Board of Directors of the captive would not have any say in the underwriting strategy of the captive and would not have the possibility to decline underwriting would not be possible under insurance regulations
- But even in such case, if there is still actual risk transfer to the captive and the captive does provide risk bearing capital, the captive would still be entitled to the risk premium. The question from a transfer pricing perspective is more around the appropriate remuneration of those functions through service level agreements.
- And if the captive has so little substance that its mind and management is not deemed to be within its domicile at all, then this situation is already addressed within existing Controlled Foreign Companies ("CFC") legislation and the entire profit would be reallocated to the parent country, and/or premiums would not be deductible and claims could not be paid. The local regulator could also cancel the captive's license for lack of local governance.
- The insured third party (which is the owner of the captive) is not indifferent to the levels of the price of insurance - Why would the transaction not be genuine insurance? The captive needs to ensure that it collects sufficient premium to cover its risk. The insured wishes to keep the premium to a minimum to reduce premium taxes and ceding commission

Box E.2. Question to commentators
Commentators' views are invited on the relevance and the practical application of the approach described in paragraph 181 of this discussion draft.

Comment on the entire Chapter E.5. - Determining the arm´s length price of captives:

- The calculation of an arm`s length premium is in the best interest of all involved parties. The criteria and parameters to determine and calculate the "correct" rate is not an exercise of one method (in comparison to other methods). It is the combination of all mentioned so-called methods under para. E.5 (Determining the arm`s length price of captives).

- Before establishing a captive, the MNE group has insurance experience and price expectations having placed their insurance policy in the market without captive. Once, the captive starts underwriting part of the MNE´s risks, the comparison with the former premium is one of the factors to find the risk adjusted premium for the two parts of the insurance cover, a. for the captive and b. for the insurance market which is still carrying most of the risk, especially the higher sums insured (e.g. in a layered insurance programme). Before a MNE will agree on and accept an offer from the insurance market, the MNE has received different submissions from various insurers at a market price. The captive now has to calculate how much of the total risk of an insurance policy (or programme) it can underwrite (based on the signed capital and expected premium income) and parallel, the premium can only be part of the total market premium, appropriate to run this type of risk over a midterm period.
- There is always the opportunity for a back-testing in the market whether a premium rate would be too high or low. Submissions are done regularly or frequently to receive from the market comparable quotations.
- The premium always includes cost of administration of the captive, the fronting fee (or ceding commission) for the fronting insurer, for claims handling, investment management and the service providers which take over some functions described as necessity in the IAIS paper or in Solvency II and/or for broker services as part of the value creating chain.
- Abuse can easily be identified when some of the parameters and charges are beyond the market standard and also offending common sense evaluation based on a diligent observation.
- The insured third party (which is the owner of the captive) is not indifferent to the levels of the price of insurance - Why would the transaction not be genuine insurance? The captive needs to ensure that it collects sufficient premium to cover its risk. The insured wishes to keep the premium to a minimum to reduce premium taxes and ceding commission
- The actuarial analysis presented under para 181 is an alternative which is comparable to the combined approach mentioned in the para above. Why? Because all data and experience which is used, applied and integrated in the process to determine the rate of line (premium as above) is used also as the basis for the actuarial quantification.
- The application of actuarial science is a requirement in all (or most of) the regulatory regimes for the respective portfolio; this has to be applied for all captive lines of business as well.
- Actuarial pricing is indeed a widespread pricing methodology for the entire commercial insurance market
- Actuarial pricing is similar to Cost Plus transfer pricing method. The cost element is made of expected losses and the margin element comprises a risk margin for volatility, a compensation for running costs (distribution, underwriting, claims), and a profit margin.
- Actuarial analysis is indeed a widespread pricing methodology in the insurance market and we welcome the approach described in paragraph 181. This approach is in line with international supervisory standards such as the Solvency

II Directive. As well as providing a basis for transfer pricing, actuarial modelling can provide a technical price to assess the value of commercial insurance and provide robust support to the risk retention / transfer decision
- It is our view that actuarial techniques represent an exceedingly reliable pricing approach, where the exposure data, loss history and other relevant factors are developed into a bespoke model to forecast losses which enables the determination of an appropriate technical premium for the risk in question.
- However, a matrix 'approach should be appropriate, with option for market comparability or actuarial approaches, dependent on the individual circumstances involved. The nature, scale and complexity of the risk in question should be considered in the determination of the appropriate transfer pricing approach, i.e. a stable property portfolio with 10 years loss data and accurate exposure data may require triennial actuarial review with underwriting oversight in intervening periods. Less stable or more complex risk types requiring more frequent assessment.
- Synergy benefit comes from three elements: synergy between group entities, risk transfer, and risk bearing capital. Only the captive can provide risk and capital as a licensed insurance or reinsurance entity. Entities would not be able to achieve same level of benefit without the captive. So, the captive does provide added value in the transaction and should be duly remunerated for that. The captive should be recognized as a substitute for another commercial insurer, being subject to approval of supervisors.
- We follow the description of the group synergy effect with one additional comment: the synergy benefit arises from the collective purchasing arrangement which include a multiple of legal entities in a multiple of countries and has to be monitored in such a way that for the big insurance entity (i.e. the captive). The captive has the opportunity to buffer the payout for claims and losses based on the regulatory requirement to set aside reserves for the future events. These reserves are assessed under the regulatory regime as capital beside the equity. This explains why the captive is adding real value to the MNE group`s activity.

Box E.3. Question to commentators
Commentators' views are invited on the example described in paragraphs 187 and 188 of this discussion drafts.

Comment:

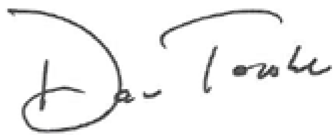
- Depending on the line of business a captive is underwriting and who is the insured customer (and/or beneficiary), the business may be direct underwriting with third parties and consequently not a captive business, its pure traditional insurance.
- The Dixon`s case is in our view definitely no captive arrangement and we agree that this type of business should be run as traditional insurance. The main issue of this case has been alleged circumvention of tax payment. We never advice MNEs to structure such a SPV for tax reasons.

- The paragraphs 187 and 188 are not an example to discuss captive business. In this world there are lots of SPVs using the financial markets which try to avoid or circumvent tax or to mislead customers, supervisors, taxmen and the public. They may generally present non-transparent and non-conclusive numbers, are not regulated and not approved by supervisory authorities.

Captive insurance is a risk financing tool that is essential for stable business operations, not tax avoidance. Captives are highly regulated entities by the authorities where they are registered.

Thank you again for this opportunity to submit comments.

Respectfully submitted,



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