Insurance business and the OECD programme of work

This paper outlines a number of principles that the insurance industry views as crucial to establish as the OECD/G20 Inclusive Framework on BEPS (“IF”) continues to focus on its “Programme of Work to Develop a Consensus Solution to the Tax challenges Arising from the Digitalisation of the Economy” (“Programme of Work”).

Insurance for the global economy

Insurance is crucial to the successful operation of the economy and to global investment and growth. Insurers and reinsurers 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 business is about the transfer of risk between the insured party and the insurance company. In exchange for the payment of a premium, an insured party can transfer to an insurer the risk of loss from a particular source. By pooling the risks of multiple insured parties, the insurer can spread the risk of loss. The same is equally true for life insurance protection and long-term savings business with the pooling of mortality and longevity risks. To ensure that it will be able to pay any claims that arise beyond those expected, the insurer holds an appropriate amount of capital.

For insurers, risk and capital cannot be separated; there can be no assumption of risk without the provision of appropriate capital in an insurance context. The regulatory capital rules which insurers are subject to are designed to ensure that the company bearing the risk of the loss has the capital available to meet such losses.

Reinsurance – Insurance for Insurers

Reinsurance is an agreement that takes a single large risk, or a collection of risks written by the original insurer and transfers them to a reinsurer, in return for a premium. Reinsurers aggregate business, diversifying risks from different geographies and with different exposures which helps them to manage their own capital position.

Reinsurance is a common market transaction, used by insurers all over the globe and is strictly business to business (B2B). As noted below, reinsurance plays a key role in the insurance industry value chain and all references in this document to insurance refer to all types of insurance including reinsurance unless otherwise specified.

Pillar 1

GFIA understands that while discussions are continuing on a unified approach to addressing the issues of profit allocation and nexus, the expected outcome of Pillar 1 is the allocation of more taxing rights to market jurisdictions (the jurisdiction of the customer/user). The objective is to recognise value creation by a business activity in a jurisdiction which is not recognised in the current framework for allocating profits.

GFIA notes from Paragraph 24 of the Programme of Work, that Pillar 1 is focused on:
determining the amount of profits subject to the new taxing right and the allocation of those profits among jurisdictions;
- the design of a new nexus rule that contemplates the existence of a taxable presence without physical presence and
- instruments to ensure full implementation and efficient administration of the new taxing right.

It is suggested in Paragraph 37 that not all businesses will be in the scope of the Programme of Work. In particular, Paragraph 37 notes that “The programme of work would explore issues and options in connection with design scoping limitations” and goes on to say that “It would also include an evaluation of rules that could focus the scope of the rules on businesses that are of a type to which the rules should apply.”

It is the industry’s position that for the reasons outlined below, insurance should not be included in the scope of Pillar 1 in the Programme of Work. The very essence of how the insurance industry operates means that the objectives of Pillar 1 have less relevance to insurance than other industries.

- Although insurance and reinsurance groups are often multi-national, their business model is generally based on companies (or branches thereof) with a local physical presence as insurance companies need to be close to their customers.
- Insurance is highly regulated in a way which requires local capital to be held to match local risks plus a margin for additional security. A licence for insurance business will not be granted if local regulatory requirements are not met and a local licence is key to sell products in that jurisdiction.
- Data is important to (re)insurers and they use data from numerous sources, but traditionally insurance is not a highly digitalised business model.
- Insurance income streams are volatile and can result in substantial losses in any specific period which would also have to be subject to any reallocation.
- There are significant measurement and identification issues for insurance companies in the context of Pillar 1 that are different from other industries; insurers do not have misaligned non-routine profits as envisaged by the Programme of Work.
- Insurance is a service the purchase of which, is already subject to indirect taxes based on location of risk (largely the location of the user) in a number of jurisdictions.

**Insurance Business Model and Value Chain**

Insurance company’s business models focus on the assumption and management of risk. The insurance business model is generally based on companies with local presence supported by diversification of risk which is often global. Insurance companies manage the level of risk they retain through diversification either through writing additional often uncorrelated business or via reinsurance.

Companies will often use reinsurance to reduce the risk that they assume in a specific line of business or specific geographic territory. Reinsurance is insurance that insurance (and reinsurance) companies buy to protect themselves from excess losses due to high exposure to major events such as earthquakes, hurricanes and epidemics.
Reinsurance is an integral component of an insurance company’s business model providing it with the ability to manage the risk that it assumes often before a decision is made to write the business. Reinsurance can be used to increase capacity so that the insurance company does not have to decline business, to facilitate the growth of an insurer’s new products or aid entry into new lines of business. This in turn helps the insurer to manage its capital position.

Insurance companies need a local market presence for market access, to enable them to be close to customers and brokers and meet the regulatory requirements to sell insurance. Those regulatory requirements regulate the way in which a company can market and sell insurance. When insurers operate cross border (for example specialty commercial lines or reinsurance), the insurance would often be intermediated through local brokers who are themselves subject to regulation and provide a local presence.

The footprint of an insurance company is important to serving customers, who look to a local presence for immediate assistance with claims. Insurance companies generally do not have scale without the requisite mass and do not participate in the economic life of a jurisdiction without an associated or meaningful economic presence. Different business models need different numbers of people, but insurance always requires highly qualified employees to assume and manage risk; this is one of the tests of the substantial activities standard as determined by the OECD Forum on Harmful Tax Practices.

Each risk bearing entity within an insurance group operates as a separate legal entity and is regulated in that way by local regulators (in Europe via the home state regulator). The regulatory environment has been put in place to offer protection to policyholders and places constraints on the group structures that are acceptable. Generally, regulators want to be able to regulate operations that are local to them both in terms of the product sold and to ensure that the insurer has enough capital to pay all claims, even after a significant event.

Insurance products themselves, are generally designed, marketed and costed to the market where the regulated insurer is resident. In a life insurance context, as well as the insurer being regulated, the individual products often have to be approved by the regulator and licensed to sell in that particular jurisdiction and cannot be sold outside that jurisdiction.

**Regulation and Capital Adequacy**

The ability for an insurance entity to assume risk is governed by local regulation. Insurance groups are required to operate within very specific regulatory constraints. The key area of focus for regulators in an insurance context is the amount of capital held. Each regulated entity is required to have sufficient capability and capital in their local regulated territory (or host state for passported entities within the EU) to manage risk assumed. The location of the assumption of insurance risk is therefore also the location where the capital relating to that business is held.

Similarly, there are constraints on the movement of capital within groups and therefore the location of risk and capital will generally have to reflect the economic activities carried on in that location.

The balance between risk and capital is critical for a regulated insurer. Capital has a high cost for insurers, as regulators force insurers to hold high quality capital in excess of expected liabilities and limit the amount and type
of debt that may be included in regulatory capital. In addition to regulators, rating agencies, analysts and other external bodies that measure capital adequacy also impose discipline in this area.

There is a strong incentive not to hold excess capital beyond what regulation requires. If an insurer cannot earn an acceptable return on capital (e.g. by expanding into new markets or writing new lines of business) it will often return the capital to shareholders. Being over-capitalised means that the insurer will not earn an acceptable return on capital, which will damage its ability to attract and retain investors.

Regulation and local capital requirements and the need for specific types of capital in each regulated entity are further reasons why taxing rights are already largely located in the jurisdiction of the customer.

**Volatile Income Streams and Losses**

An insurer assumes a variety of risks in relation to the business it writes. One of the main risks for an insurer is underwriting risk which is the risk that premiums paid by policyholders are not sufficient to cover claims and expenses. Payment for protection from risks that may never materialise is core to insurance industry pricing. Protection from risk has economic value even if the risk never materialises.

However, underwriting risk is inherently unpredictable and can be impacted by factors that are beyond the control of the insurer and result in claims that exceed premiums and other income and the insurer makes a net loss. Examples of these factors include severe or frequent natural disasters such as earthquakes, hurricanes and other storms and floods as experienced in 2017 and 2018 when substantial underwriting losses occurred.

The selection and pricing of underwriting risk is the core business of insurance and over time is forecasted to give positive returns, but this cannot be guaranteed in any specific time period. It is very difficult to predict income streams for insurance particularly over the short term. Despite sophisticated risk management techniques such as reinsurance that can help to manage volatility through diversification, particularly international spread of risk, insurers cannot eliminate risk and volatility completely. There are years when insurance companies make significant losses. A single large natural catastrophe or other unexpected event can wipe out several years’ earnings.

In addition, insurers invest premiums into investment assets to meet future claim payments. Investment risk arises from the exposure of the asset side of insurers’ balance sheets to market forces. Many life insurers for example, have significant exposure to equity and bond markets and a stock market sell-off or interest rate change can lead to significant losses in a very short time scale.

If insurance were to be included in Pillar 1, this volatility would have to be allocated, which in any given year could mean an allocation of significant losses. It is not clear how tax authorities or regulators could get comfortable with the allocation of such losses to a jurisdiction where there is no physical presence.

The volatility is currently borne by the capital provider which for insurance, GFIA takes the view that is the only feasible and viable entity, as only it has sufficient financial capacity to bear losses (as well as earning profits in the good years).
Measurement and Identification Issues

The income statement of an insurance group is very different to a standard trading company. In addition, IFRS 17 will shortly impose accounting changes that will further distance insurance company accounts from those of non-insurance companies.

While GFIA understands the IF’s objectives in looking at taxing rights and nexus in a different way, in an insurance context, existing profit allocation guidance provides detailed and comprehensive advice that still holds true. Insurers do not have the types of intangibles that might be market differentiators and produce non-routine profits.

It is therefore not clear how routine and non-routine profits for insurance could be identified and calculated. Neither is it entirely clear how non-routine profits are linked to residual profits, but in an insurance context, residual profits (and losses) should be returned to the capital provider. These residual profits (and losses) must be returned to the capital provider after remunerating other functions (such as brokers, financial advisers or sales agents), as there is simply no other party that has the capacity to bear insurance losses. As discussed earlier, this is in the jurisdiction of the customer and therefore residual profits are not misaligned.

Other Taxes

In addition to paying corporate taxes, insurers pay indirect taxes like insurance premium taxes, in jurisdictions around the world. There are 20 countries across the European Economic Area alone that apply a tax on almost all non-life insurance premiums and some of those countries also apply tax to life insurance premiums. Premium taxes are based on location of risk. For property risks, the risk location is usually where the property is situated. For vehicles it is usually the physical location of the vehicle or the jurisdiction in which the vehicle is registered. For other risks, the risk location is the territory in which the insured (the customer) is resident or where its business establishment is located.

While premium taxes are levied on insureds, the economic costs of premium taxes are important for the whole industry. Tax is already levied in the jurisdiction of the customer or “user” of insurance products.

Except in limited cases, insurers also bear rather than collect VAT/GST as they cannot recover VAT incurred on expenses. This contrasts with most industries who are collectors rather than bearers of VAT/GST. Insurers are also one of the main payers of stamp duties and financial transaction taxes that arise on asset portfolios.

Conclusion

Insurers are subject to extensive supervisory regulations including how products are marketed and sold to customers and the need for specific types of capital in each regulated entity. Residual profits and losses are returned to the capital provider which is usually located in the jurisdiction of the customer. Therefore, by design the current taxing rights are already largely with the customer jurisdiction and there is no need to apply the supplementary provisions of Pillar 1 to insurance.
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About GFIA
Through its 40 member associations and 1 observer association, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 64 countries. These companies account for around 89% of total insurance premiums worldwide. GFIA is incorporated in Switzerland and its secretariat is based in Brussels.