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In re: OECD Discussion Draft of the Report on the Attribution of Profits to a Permanent Establishment - Part IV (Insurance)

Dear Mr. Owens:

This is in response to your letter of June 24, 2005 requesting feedback on the Discussion Draft of the Report on the Attribution of Profits to a Permanent Establishment - Part IV (Insurance). We provide an overview of our suggested additions and amendments. In addition, we are providing, where appropriate, a specific paragraph-by-paragraph commentary to identify those areas which we feel do require some modification, clarification, or elaboration.

You have asked for factual information in certain contexts. We have endeavored to respond to such requests. Information we rely upon has been obtained from publicly available sources and we have provided references for your convenience so that the country representatives to the working party committee may consider and corroborate the information for themselves. We are willing to address follow up questions, if you so desire.

The comments are from tax professionals who practice in Ernst & Young's global financial services transfer pricing practice. These comments represent the consensus opinion of the undersigned but do not necessarily represent the opinions of Ernst & Young, its affiliates, or any of its clients.

If you have any comments or questions about our response, please feel free to call or email any of the undersigned. We appreciate the opportunity to provide feedback to the OECD and look forward to the opportunity to do so again on this important topic.

Sincerely,

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Robert E. Ackerman (United States)
Katherine Horton O'Brien (United States)
Lisa Blanchard (Boston)
Terry Jacobs (Washington)
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Ernst & Young Comments to Part IV (Insurance)

The OECD has requested comments on the following topics:

- The factual accuracy of the analysis of the most important functions of the modern insurance industry.
- The impact of regulation, and in particular host country regulation, on the conduct of insurance business.
- The commercial rationale for internal reinsurance within a single enterprise.
- The use of alternative risk transfer mechanisms, such as catastrophe bonds.
- The types of risk which require surplus and how to determine the quantum of surplus and its location within a single enterprise.
- Other issues as identified within the body of the Report.

Overview

The Part IV draft is a reasonable effort to summarize the various value chain components of the life, P&C, and reinsurance industry recognizing that such industry and its various subcomponents are constantly evolving. The Part IV draft properly emphasizes that application of the authorised OECD approach will ultimately depend on the facts and circumstances of each taxpayer. To properly account for the facts and circumstances standard, we have included examples where such facts and circumstances may vary. We encourage the OECD to include examples as much as possible in the revised guidance in order to provide taxpayers and tax administration with reference material and support in analyzing and complying with the principles of these draft guidelines in varying situations.

The Part IV Draft should be revised to include:

- Practical and reasonable safe harbors (e.g., the use of host regulatory requirements for local operations as a proxy for surplus/capital required by the operations of the branch)
- More illustrative examples that will facilitate application of the authorised OECD approach
- More explicit recognition that no one activity within a global insurance operation leads to the acceptance of insurance risk for the entity

With respect to the major topics the OECD requested comments, the following represents our summary views and are further elaborated in our paragraph-by-paragraph commentary below.

- *The factual accuracy of the analysis of the most important functions of the modern insurance industry.*

We agree with the OECD's conclusion that underwriting is a critical function of an integrated insurance operation. We suggest a change in the emphasis of this overall function with respect to its component functions, *i.e.*, the underwriting function is not wholly undertaken where the insurance policy/contract is written. We believe that increased emphasis should be placed on the various sub-functions that make up the underwriting function with particular emphasis on:

- Expected loss or actuarial analysis, which may occur in a jurisdiction without the host jurisdiction of the permanent establishment
- Ex-ante risk mitigation strategies and policies, which may occur in a jurisdiction without the host jurisdiction of the permanent establishment
- Post-underwriting risk management activities, which may occur in a jurisdiction without the host jurisdiction of the permanent establishment including efforts to combine risks from other branches and separate legal entities thereby reducing the inherent riskiness of a branch specific pool of risks
- Liquidity management particularly in the P&C industry
- Operational activities including information technology that is developed without the permanent establishment jurisdiction

We feel that the investment function requires increased emphasis to recognize the volatility arising from such activities. The current draft may be misconstrued as automatically attributing investment income returns to where the underwriting functions occur. While we agree, from the perspective of the insured (purchaser) that the pricing of an insurance contract is a combination of the price charged (premium paid) for the insurance contract plus the investment return (opportunity cost of insured in prepaying premium over the coverage period), the perspective of the insurer (seller) may be properly segregated under certain facts and circumstances.

In particular, the permanent establishment where all the underwriting functions occur (assuming all the sub-functions occur within the permanent establishment) may not have the resources to properly invest the reserves it obtains; alternatively, it may be required by its local regulator not to invest in overly risky investment vehicles and be required to earn a conservative return. For example, hedging and use of various of derivative products may be used to maximize investment returns and match the duration of the investment assets with the underwriting liabilities. Such activity may occur within the same legal enterprise if the local regulator is satisfied that sufficient trusteed assets have been committed. Accordingly, just as transfer pricing analysis occurs for investment management activities within any other financial services enterprise, so too should this occur within a global insurance enterprise based on the particular facts and circumstances.

We believe that a permanent establishment may at arm's length agree to accept a pre-determined return in exchange for the avoidance of risk associated with the investment management of the reserves as well as other possible interbranch or intercompany arrangements.

- *The impact of regulation, and in particular host country regulation, on the conduct of insurance business.*

Host country regulations have a material impact on the operations of an integrated insurance operation.[1] The discussion draft certainly recognizes this for purposes of determining what may be an arm's length determination of surplus under the authorised OECD approach. In fact, many (but not all) of these regulations require intercompany activity to occur under a fair and reasonable basis a standard akin to the arm's length standard and even for intercompany reinsurance transactions.[2]

Reduction of an additional administrative burden to comply with the OECD rules should be sought by leveraging off of other regulatory compliance undertaken by insurance companies where feasible. For example, if an insurance branch is required to maintain sufficient capital to support local underwriting, rebuttable deference should be provided to this regulatory requirement.

In addition, we believe more emphasis should be placed on host country regulations for other effects relating to the profitability of the integrated insurance operation. For

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[1] *See, e.g.*, Insurance Bureau of Canada, Key Industry Issues, Financial Sector Regulation which states:

> The P&C insurance industry recognizes that regulation is an integral part of maintaining confidence in the financial system and safeguarding the interests of insurance policyholders. However, many in the industry feel that a "regulatory drag" results from the desire of regulators to control the conduct of companies with insufficient regard for the need for healthy companies. One effect of this is to inhibit capital from coming into Canada. The industry plans to work with organizations representing Canada's banks, life insurers and other financial institutions to seek appropriate balance between government regulation and reliance on market forces.
>
> The industry is seeking to improve efficiency and reduce costs by promoting harmonization among Canadian jurisdictions, streamlining regulatory procedures, eliminating unnecessary practices and ensuring that Canadian regulations are in step with those of Canada's major trading partners. In particular, IBC expects to examine issues related to measuring insurers' solvency, defining business and financial standards of practice, monitoring compliance with regulations, and adapting to the newly emerging field of electronic business. Where possible, Canadian regulations will be compared with those of other industrial nations.

Available at http://www.ibc.ca/ii_financial.asp.

[2] "Regulating the Reinsurance Marketplace," Kashyap Saraiya and Wayne Cotter, Chapter 7 of Reinsurance: Fundamentals and New Challenges, page 107 states:

> In New York, all reinsurance agreements between members of a holding company that includes a domestic New York insurer must be submitted to the New York State Insurance Department for approval. Department examiners review these contracts to ensure that they are "arm's length" transactions that the contracts comply with the aforementioned standards for credit.

example, the insurance industry recognizes that the regulatory environment in Bermuda, Canada, and Switzerland is less onerous and less costly than the multi-layered regulatory environment in the United States. Such regulatory operating differences should be accounted for when applying the authorised OECD approach in order to avoid attributing profits from less regulatory complex jurisdictions to highly regulated jurisdictions. For example, a KERT based transfer pricing approach where sales and marketing occurs in the United States would need to account for the high regulatory costs of operating in the U.S. in order to avoid over attribution of profit to the U.S.-based KERT functions.

In similar vein, the OECD should also state clearly that differences in tax rates among the countries that host multinational insurance operations is not to be construed as some form of harmful tax competition for which the authorised OECD approach is a means to "cure." Tax administrations and their respective policy makers that wish to discourage the efficient movement of capital may do so through direct means such as excise taxes or controlled-foreign-corporation regimes. In doing so, tax officials should be consistent with non-tax insurance officials. For example, the use of captives in low-tax jurisdictions is recognized by non-tax governmental agencies including Canada which recognizes the use of Bermuda and Bahamas based reinsurance companies.[3] OECD tax officials should recognize that many innovative insurance structures arose from the then traditional insurance markets inability to otherwise insurance certain risks (e.g., captive insurance companies and CAT bonds).

- *The commercial rationale for internal reinsurance within a single enterprise.*

If by reinsurance, the OECD means strictly a risk transfer, we would agree that in all but rare circumstances, insurance regulators would not recognize an interbranch reinsurance arrangement. Reinsurance generally recognizes a transfer of risks from one separate legal entity to another.[4] In this regard, this is why such transfers should be recognized by the OECD when such a transaction occurs among related separate legal entities.

Reinsurance, as the OECD has recognized in the draft, is a rapidly evolving industry. Reinsurance no longer simply refers to just "risk transfer" but encompasses "risk financing."[5] We understand that the OECD accepts that risk financing arrangements are a type of reinsurance on which the authorised OECD approach applies. Within a whole enterprise where each branch may be subject to separate surplus and reserve requirements, the whole enterprise may reduce the riskiness of the aggregated permanent establishment risks pools through the use of experts located in another part of the whole enterprise who in turn may reinsurance all or part of the combined pool to another legal entity, whether related or unrelated. The pooling of such risks and pricing them for further reinsurance

[3] Property and Casualty Insurance in Canada, Updated Version (November 2001), Reinsurance and Self-Insurance, Canada Department of Finance, available at http://www.fin.gc.ca/toce/2001/property_e.html. which notes that "captive insurers established by Canadian companies are domiciled in offshore centres, such as Bermuda or the Bahamas, on the condition that captives limit themselves to providing a reinsurance function to the Canadian market."

[4] "Regulating the Reinsurance Marketplace," Kashyap Saraiya and Wayne Cotter, Chapter 7 of Reinsurance: Fundamentals and New Challenges, page 104.

[5] Par. 39 of Part IV.

does not just arise, *i.e.*, it is not an inherent condition, and such risk management should be properly remunerated.

Risk financing techniques allow for one part of a whole enterprise to fix its position in a financial asset at a point time. Risk financing techniques require risk management by professionals. These techniques are fundamentally no different than those used in global banking or global trading operation whole enterprise (such as credit transfer arrangements that allow one functional activity to manage overall counterparty risk for the benefit of numerous branches). For example, the market risk of a financial asset will change over time; one part of a legal entity may transfer that risk to another part of the same legal entity in another jurisdiction for non-tax purposes because it has the skill set to undertake that activity. Such a transfer is not an ex-ante tax motivated transaction assuming an arm's length transfer pricing for the value of the asset, which would include a return for the functions to create the asset. Similarly, for insurance companies, certain risks, particularly long-tailed risks, may likely have the underlying risk profiles change over time and thus require on-going risk management (*e.g.*, mold claims for the P&C industry in the U.S.). Accordingly, these types of reinsurance transfers, assuming they are supported by people activity, are a legitimate risk transfer for both non-tax and tax purposes.

To the extent that the OECD believes that "risk financing" is not a type of reinsurance for intercompany or interbranch arrangements, it should revise Part IV to explicitly state so; in this regard the OECD further should discuss the applicability of the standard tenets of insurance – risk transfer and risk pooling. Nevertheless, the OECD will need to address when risk financing arrangements are acceptable and reconcile the standards set forth for Part IV purposes with the standards forthcoming in Parts II and III.

Finally, the OECD should reward risk management activities within a whole enterprise that "packages" risks and transfers such risks out of the enterprise through a reinsurance arrangement. This reinsurance activity is of vital importance in the life and P&C industries and allows the local underwriting operations to temporarily take on sales and underwriting activities that they would not otherwise be able to accommodate.

- *The use of alternative risk transfer mechanisms, such as catastrophe bonds.*

We encourage the OECD to adopt a facts and circumstances approach to the use alternative risk transfer (ART) arrangements. ART techniques are an evolving aspect of the reinsurance industry and need to be addressed on a facts and circumstances basis in order to fully implement the tenets of the authorised OECD approach. As discussed above, risk financing arrangements which are type of ART mechanism, can be handled under the authorised OECD approach so long as the initial transfer pricing analysis properly accounts for the functions performed, assets employed and risks borne up to the point of the intra-branch dealing. For ART transactions occurring within a whole enterprise, risk management activities that facilitate a change in the risk profile of the ceding branch should be analyzed and properly rewarded.

ART comprises two aspects:[6]

- Risk transfer through alternative risk carriers
- Risk transfer through alternative financial products or solutions

The market for alternative carriers currently consists primarily of self-insurance, captives, risk retention groups, pools and capital markets.[7] ART products include:

- Finite risk reinsurance
- Run-off solutions
- Multi-line/multi-year products
- Multi-trigger programs
- Committed capital (e.g., credit guarantees)
- Capital market solutions such as securitization

ART products are particularly useful in creating tranches of risk that may be allocated through the capital markets instead of through traditional insurance and reinsurance avenues.

- *The types of risk which require surplus and how to determine the quantum of surplus and its location within a single enterprise.*

There are numerous risks that arise in the operation of a global insurance enterprise. All risks should be allocated adequate surplus to support these various operations and thus insurance risk should not be the sole category of risk that attracts capital for purposes of applying the authorised OECD approach. Specifically, operational risk should be considered as appropriate under the facts and circumstances of the particular insurance operation.

To avoid double taxation arising from the allocation of surplus under the authorised OECD approach, no more than the whole amount of the surplus of the whole enterprise that actually exists should be allocated. This point should be borne in mind by the host country tax administrations as well as the home country tax administration.

The manner in which to allocate surplus should be as administratively simple as possible, even if this means a level of precision less than that contemplated currently by the OECD. Surplus may have to be allocated in a different proportion than the proportion of the profitability of one line of business compared to all the lines of business within a whole enterprise. We believe that the host regulatory requirements to allocate surplus should be deferred to if the surplus requirements are reasonably related to the protection of the insureds located there.

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[6] "Alternative Risk Transfer (ART) Products," by Thomas Holzheu, Chapter 8 of Reinsurance: Fundamentals and New Challenges, page 113.

[7] *Id.* and "The Picture of ART," Thomas Holzheu, Sigma, available at http://www.swissre.com/INTERNET/pwswpspr.nsf/fmBookMarkFrameSet?ReadForm&BM=../vwAllbyIDKeyLu/bmer-5jfcnm?OpenDocument.

Factual Observation Responses

Par. 6, Sec. B-1. We agree that the pricing of insurance generally starts with this model. However, operating expenses must be included in determining how to structure and price a premium. We note that use of the common insurance term "combined ratio" is not explicitly used in the draft. The term means, for non-life insurance lines, the combination of the non-life claims ratio (losses per dollar of premium) and the expense ratio (administrative costs per dollar of premium). If the ratio is greater than 100%, a "system-wide" loss may have occurred unless investment income can more than offset the loss.[8] The use of these industry standards may be appropriate in understanding whether transfer pricing issues may exist.

It should also be noted that the actual pricing approach may vary from this model when the industry encounters its all too frequent underwriting price cycle.[9] The return required by the insurer will depend on the stage of the underwriting price cycle. Understanding the relationship between the average combined ratio and average return on investment over a business cycle will be a critical component in allocating income under the authorised OECD approach. For example, there may be instances where system wide losses may be required to be recognized by all members within whole enterprise.

Par. 8, Part B-1. The OECD needs to more clearly define the term of "underwriting risk" for purposes of applying the authorised OECD approach. It is important to emphasize that the underwriting risk does not result solely from the execution of a written contract between the insured and the insurer (or its agent). The various activities undertaken by the insurer make up subcomponents of the underwriting risk. Under the authorised OECD approach, all the KERT activities that lead to the assumption of underwriting risk will be critical in allocating the profit (loss) within the single legal enterprise.

The statement in Par. 8, "To the extent that an insurer assumes underwriting risks, it will command a risk premium that will compensate it for the risks it is assuming," may be misconstrued as being the sole factor requiring a return. The return from investment income is a critical component to whether an overall profit is earned from the underwriting of such risks especially in a competitive market.

Par. 12, page 9. The statement "The amount of expected profits will vary according to the perceived degree of risk for the different lines of business" should be clarified. We agree that the return on equity from P&C, life, and other lines of insurance business varies; however, we do not agree that the profitability is necessarily due to the difference in risk levels. Differences in competition within each of these lines may also affect profitability. In addition, the amount of competition among various local markets throughout the world may affect the amount of expected profits from region-to-region.

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[8] A system-wide loss can occur when the combined ratio is less than 100% and the investment income is negative.

[9] See, e.g., Property and Casualty Insurance in Canada, Updated Version (November 2001), Reinsurance and Self-Insurance, Canada Department of Finance, available at http://www.fin.gc.ca/toce/2001/property_e.html.

Par. 23, page 11. Clarification on the following statement is requested "When the functions are generally more important in one category of insurance, that importance will be highlighted in the following sections but it should be stressed that the relevant importance of these functions will vary according to the particular facts and circumstances of each taxpayer." In particular, guidance on whether weighting the difference in such functions should be limited to the fully burdened salaries of such employees. For example, if a sales professional's fully burdened salary is 200,000 Euros and the actuary's fully burdened salary is 300,000 Euros, then the actuary's contribution is 50% greater than that of the sales professional. If not, please consider listing some potentially acceptable weighting factors in addition to or in lieu of fully burdened salaries.

We also suggest that a graphical presentation of functions be provided. By way of example, a functional analysis as described in the industry value chain below may be appropriate. We present a graphical analysis as an illustrative means to demonstrate that a function may affect more than one aspect of the insurance value chain.

Customers	Market Research and Product Creation	Market Development and Distribution	Underwriting	Back office (Account maintenance, claims administration	Investment	Risk management	Capital Market	Whole Enterprise Management
Product Management								
	Marketing research							
	Product Development/Refinement							
	Product Lifecyle Management							
		Sales						
		Sales Planning						
		Sales Force Management						
		Customer Analysis						
			Underwriting					
				Administration				
				Policy Issuing				
				Policy Changes				
				Claims Handeling				
				Claims Recovery				
				Claims Analysis				
			Reinsurance					
			Reinsurance and risk management					
			Reinsurance administration					
					Asset Management			
					Asset Allocation			
					Portfolio Management			
					Portfolio Administration			
								Strategic Management
								Corporate Treasury
								Operations Management

Par. 28, page 12. It should be noted that for many insurance products, a suitable proposal will be based on pre-designed pricing parameters incorporated into a software program and that the sales professional herself may have very little to do with the actual pricing of a proposal.

Par. 30. page 12. We think it is instructive that independent agents and brokers may exist for the sale and marketing of insurance products. Just as these agents and brokers do not place the capital of a principal into the tax jurisdiction, so too may this be a possible outcome under the authorised OECD approach where the sales and marketing activities receive a commission and don't participate in the loss or profits of the overall underwriting activity.

Par. 32, page 13. We agree that selection of risk is an important sub-function of the underwriting function. Selection may occur through ex-ante processes and procedures developed without the host jurisdiction of the PE and should be considered a KERT function for application of the authorised OECD approach.

With regard to the paragraph regarding the acceptance of risk, the paragraph implicitly over-emphasizes the risk associated with the execution of an underwriting contract. The pooling effect along with other risk management efforts must be considered and should minimize the isolated effect of the assumption of any particular risk arising from a single contract and the consequent attribution of capital from such isolated activity. For example, other PEs outside of the PE may underwrite risks which viewed collectively reduce the risk associated with any particular PE's underwriting activities. The efforts to manage the risks on a collective basis which are provided by members within the single enterprise should be attributed profit for reducing the risks otherwise faced by the PE.

With regard to the paragraph labeled "Acceptance of risk", we believe that this discussion could be narrowly misconstrued to be the only KERT subfunction related to the underwriting function. For many underwriting agents or brokers, the ability to "accept" a risk cannot occur without the guidelines set forth by other underwriting functions within the whole enterprise.

Par. 39, page 15. The following information regarding alternative risk transfer (ART) arrangements is provided.

ART is provided in two general forms: alternative insurance carriers and alternative insurance products.[10] Alternative insurance carriers consist of self-insurance arrangements, captive insurers, risk retention groups and pools.

ART insurance products typically possess characteristics of risk transfer that is passed through to the capital markets. The OECD should understand that some ART products do not share all the characteristics of traditional insurance, e.g., risk shifting (per se) and risk pooling, and that the draft guidelines herein may not map out exactly to an ART product. In fact, the difference between insurance and the capital markets has blurred as

[10] New Swiss Re sigma study: The picture of ART, 5 Feb 2003, available at http://www.swissre.com/.

derivatives have been structured to approximate the effects of a traditional insurance policy.[11] Multi-trigger business interruption policies have become more prevalent.[12]

Alternative risk transfer products include:

- Finite risk products
- Committed (contingent) capital which allows an insured to issue (sell) a debt or hybrid debt/equity instrument in the event of a defined loss event which allows the insured to have capital to support it through the loss event.
    - Standby credit facilities
    - Contingent surplus notes
    - Catastrophe equity put options
- Multiline products
- Credit securitization

ART is used when traditional forms of insurance or reinsurance cannot handle a particular risk of a potential insured or group of insureds. ART is also used by corporate insureds that seek to reduce the volatility of their insurance expense thereby reducing their cost of capital. [13]

Par. 42, page 15. We believe that asset management deals with the liquidity risk associated with running the whole enterprise. The management of liquidity risk is one of the most important risks that a financial services institution or insurance company must manage and such activity should be deemed a KERT function under the appropriate facts and circumstances.

Par. 46, page 16. The statement:

> "It will be important to identify not just what functions are performed (taking into account assets used and risks assumed) but also their relative importance. The functional and factual analysis will therefore have to identify the most important risks for the particular taxpayer and which functions give rise to those risks."

requires much more elaboration from the OECD in order for taxpayers to implement such a charge. For example, should some type of weighting of functional activity occur? If so, how? No such guidance has been previously provided in Parts I-III.

One could surmise a situation where the functional activity either places capital of the firm at the risk or not. Once such a threshold determination is made, the weight or relative importance of such activity could be measured by the fully burdened cost to the

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[11] The ART of Transferring Risk, from the University of Chicago: "alternative risk transfers" blur distinctions between insurance companies and banks., David M. Katz, CFO.com August 21, 2003, available at http://www.cfo.com/article.cfm/3010007?f=insidecfo.

[12] *Id.*

[13] Enterprise Risk Management, By Michael J. Moody, MBA, ARM , ART UPDATE, March 2004, available at http://www.roughnotes.com/rnmagazine/2004/march04/03p78.htm.

firm, *i.e.*, allowing the marketplace determination of the value of these functions to serve as the proxy for the relative weight of each risk-bearing function. If not, the OECD should propose acceptable alternatives to taxpayers.

Par. 48, pages 16-17. We agree that the determination of whether the acceptance of risk is complex is determined on the facts and circumstances of such risk. Moreover, in an integrated insurance operation, the sales effort and the analytics needed to support the underwriting function will likely be in different legal jurisdictions.

We suggest that the OECD consider whether other types of transfer pricing models may be appropriate under the proper facts and circumstances. For example, we believe that the use of intermediaries and brokers is common in the reinsurance and insurance industries and comparables obtained from such activity may be appropriate. We do not believe such models are inherently inconsistent with the authorised OECD approach's concern for inherent conditions of a whole enterprise as the fact of the matter is independent agents can bind an insurance principal without having the agent liable to the insured to pay on an actual loss. We believe with respect to reinsurance, that the use of remuneration for reinsurance intermediaries may be more appropriate in some circumstances than the authorised OECD approach that would require the allocation of reserves/surplus/investment income to some part of this function under the guise that such activity placed surplus of the whole enterprise at risk. For example, with regard to the reinsurance of catastrophic risks, the risk management of process, parameter, and model risk may be associated with a part of the whole enterprise without the sales and marketing activity within the permanent establishment.

Par. 49, page 17. This paragraph may create confusion with the basic tenets of transfer pricing analysis that the OECD has previously defined. Bonds, stock, and cash, are a form of liquid capital. Such liquid capital should be allocated to support the operations of the PE in the same manner as equity capital, just as Tier 2 capital is allocated to a global bank under the authorised OECD approach as described in Part II. Thus liquid capital should not be considered an asset within the typical meaning of an "asset" for transfer pricing purposes. Moreover, such liquid capital may be invested overnight on a global basis where returns are the highest; if so, the entity managing the efficient use of the liquid capital of the whole enterprise should receive an arm's length return.

Par. 50, page 17. Clarification on sales of insurance through the internet is requested. If the internet sale does not require functional support from people in the host jurisdiction, then no attribution of profit under the authorised OECD approach to the PE should be needed.

We respectfully disagree with the suggestion that selling insurance through the internet may by less expensive than selling insurance through an agent or broker. First, the use of the internet may be more of a marketing channel than a sales channel. Second, the fully burdened costs of an internet insurance distribution channel may be significant and can only be provided by insurance companies that can achieve certain economies of scale as

evidenced by the fact that many smaller insurance companies do not have such electronic distribution capabilities.

Par. 51, page 17. The OECD should reconsider its description of marketing intangibles as including a sales force in place. Unlike a brand, a sales force in place cannot be readily sold or licensed.

Further guidance is requested under what contexts a brand may have sufficient value to require the recognition of a dealing or transaction. In this regard, a description of the circumstances when a branch may have contributed to the value of the brand and thus preclude the recognition of a dealing.

Par. 53, pages 17 and 18. We believe the category of liquidity risk should be added as this is a key risk that relates to how insurance risk is managed particularly for P&C insurance lines of business that cover natural disasters such as earthquakes and hurricanes.

Underwriting risk should include a sub-risk related to an unexpected concentration of risks, often referred to as "process" risk. This is the risk that a disproportionate number of loss events occur. The risk for the insurance company relates to its ability to fund such losses (a liquidity risk). Over the long-term the insurance company can fund such risks but needs alternative forms of financing or capital to manage the adverse timing of such losses.

Par. 58, page 20. Regulators also typically regulate which particular reinsurance companies may be used in order for the ceding company to receive credit for premiums transferred.

Par. 59, page 20. Trusteed assets should be considered a proxy for capital required to support the risk bearing activities of the PE under the authorised OECD approach. The last sentence regarding the inability of the whole enterprise to marshal resources from various parts of the whole enterprise suggests that the credit rating of the whole enterprise may not always be an inherent condition of each permanent establishment. The OECD should note that the inherent condition of similar credit rating may not be as applicable to branches of an insurance company as it may be for a global banking enterprise.

Par. 65. page 22. Unnecessary confusion arises when the OECD tries to address the transfer pricing implications within a single legal entity and among separate legal entities. It behooves the OECD to provide separate guidance to reduce the unnecessary confusion that arises regarding the important distinctions regarding capital and internal credit ratings of a single legal entity. Such concern is not misplaced as some OECD member tax administrations are already extending the principles of Parts II and III to transactions between or among separate legal entities in situations where no deemed permanent establishment has been implicated.

Par. 66, page 22. We agree that reinsurance is an important part of a P&C insurer's business. We disagree that it is the single most important transaction. We suggest that

the insurance must analyze such underwritten risks properly in order to maintain its reinsurance relationships over the long term as reinsurance companies will not accept ceded premiums if they are mispriced or have unusual loss exposures.

There are other business reasons for the use of reinsurance as well. Business reasons include:

- Increased diversification by pooling the risks of the separate legal entities into one legal entity
- Increase in surplus arising from the primary insurer's earning of a commission on premiums ceded to the reinsurance company
- Increased profitability by having the related reinsurance party negotiate with other reinsurance companies about the terms of the ceded risk pool that arises from concentrating expertise in one part of the MNE

Par. 67, page 22. Insurance and reinsurance transactions are subject to regulation in many jurisdictions which precludes non-arm's length related party transactions for non-tax purposes. Insurance and reinsurance companies are cognizant of these regulations and avoid intercompany transactions which may be viewed as non-arm's length for non-tax regulatory reasons.

The OECD should also distinguish between permissible tax planning and impermissible tax evasion. Balanced guidance requires this distinction in order to avoid unnecessary tax controversy. The use of tax effective jurisdictions in the insurance business is quite common. If the OECD is concerned about harmful tax competition, it should explicitly state so and deal with such a perceived problem through mechanisms other than the transfer pricing guidelines.

Par. 68, page 22. With regard to economic substance, we have concerns about the phrase "there were no economic reality to the form of the transaction that putatively insures or reinsures risk solely within a controlled group." This phrase creates a number of problems for transactions among related separate legal entities and more clarification is required on basic tenets including:

- Respect of captive insurance arrangements where risk is transferred from one separate legal entity to another (a situation where economic loss has not left the "economic family" but has been recognized by judicial authorities as legitimate.[14])
    - We suggest the more appropriate inquiry is whether the transfer of risks occurred at arm's length.[15]
- Analysis of the arm's length transfer pricing method used for the transactions put into place. Judicial authority has been loathe to accept a tax administration's disregard of separate legal entity status and has instead

[14] See, e.g., *Sears, Roebuck and Co. and Affiliated Corporations v. Commissioner*, 96 T.C. 61 (1991), *aff'd in part and rev'd in part*, 972 F.2d 858 (7th Cir. 1992).
[15] See, e.g., *UPS v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001), *reversing and remanding* T.C. Memo. 1999-268.

properly focused on whether such transactions are properly priced at arm's length under local transfer pricing rules.[16]

- Risk transfers are per se acceptable if the entity receiving the transferred risks is adequately capitalized.

Par. 68 (continued), page 23. We disagree with the second circumstance where a tax administration can presumably disregard properly documented transaction among separate legal entities which states "where the elements of the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner, and the actual structure practically impedes the tax administration from determining an appropriate valuation of the transaction." This statement creates new standards for transfer pricing enforcement which have not been properly approved as part of the OECD Model Transfer pricing Guidelines. Creation of a new set of enforcement standards as an extension of Article 7 principles should be considered an impermissible form of substantive rule creation that should not be adopted without first having Article 9 properly amended. In particular, a transaction does not lack economic substance merely because the tax administration is unable to determine an arm's length transfer pricing charge vis-à-vis third party transactions.

- MNEs exist in part because of the inability of the marketplace to provide market mechanisms for globally integrated activities. To suggest that the lack of third party behavior creates a transaction that lacks economic substance is an improper deduction and a wholly new enforcement standard that has not been properly put into the OECD enforcement guidelines. Transfer pricing analysis is often based on hypothesizing what would happen if in fact the related parties were acting at arm's length; there is no requirement that such behavior in fact exist in order to devise an acceptable transfer pricing method.
- Tax administrations have broad-based market behavior parameters to guide their examination of intercompany reinsurance transactions including:
    - Parties dealing at arm's length where one party sustained short-term losses (whether start up or as part of a business cycle) expect on average to earn higher than normal profits in profitable years to offset such losses
    - Parties dealing at arm's length are willing to earn a lower return on a consistent basis over time, everything else equal, if the volatility regarding the annual loss is substantially reduced
    - Actuarial analysis is a key component in valuing the return that should be earned for the transfer of a risk or pool of risks
    - Numerous businesses that employ professionals with the highest functional skill sets cannot earn a return for their employees' services without having capital
    - Capital earns a return based on the principles of opportunity cost and the amount of risk borne

Par. 70, page 23. We think the OECD should limit comments regarding what it considers to be harmful tax competition in the drafts regarding the attribution of profit to PEs. The

[16] See, e.g., *UPS v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001), *reversing and remanding* T.C. Memo. 1999-268.

comments only fuel the concern that the clarifications to Article 5 are part of an overall to attack harmful tax competition.

Alternatively, a balanced set of guidelines require a statement of when tax minimization behavior should be accepted by tax administrations. We would be happy to provide such suggested language; however, we think the better approach is that statements such as those in Par. 70 which do not focus on how to conduct transfer pricing analysis under the authorised OECD approach should be stricken.

Par. 71, page 23. We agree that volume differences may require a potential adjustment to an otherwise comparable transaction with a third party. However, it certainly is not clear if an adjustment is required whether it would be positive or negative. Factors affecting such adjustment may include:

- Size of tail; a large or "fat" tail suggests that the greater proportion of the quota share the larger the premium that should be received by the reinsurer
- Costs of administration of ceded insurance; depending on whether there exists economies of scale in administering a particular ceded risk pool, the adjustment could be positive or negative

Par. 71, page 23. We disagree that "offsetting compensation for services" would implicate the use of a transactional profit split method. The mere use of process intangibles, a customer list, and other intangibles that would be used by similar unrelated third parties (independent agents) does not necessitate the use of a transaction profit split. Instead, the use of properly selected comparables will implicitly include a return to these routine intangibles as part of the return to the entity performing these services.

We agree that transactional profit split methods may be an appropriate transfer pricing method under the appropriate facts and circumstances. Such a profit split method may require a primary insurer to accept a loss from previously ceded premiums that were not realized until a subsequent tax period. The tax administrations must be willing to accept both profits and losses (including deferred losses) in order to fully implement the authorised OECD approach under a profit split method.

Par. 74, page 24. While we agree with the statement "[a] PE is not the same as a subsidiary since it is not in fact legally or economically separate from the rest of the enterprise of which it is a part,", we believe that in fact a PE may be in fact operating under the same conditions as a separate legal entity if the local regulatory authority imposes surplus and other conditions on the PE similar to that of a separate legal entity. To the extent this is true, we believe that the authorised OECD approach should be similarly inapplicable regarding the certain inherent conditions articulated within the draft and that the Article 9 guidelines, without exceptions, are more applicable. Such a determination would be based on the facts and circumstances. We believe the OECD draft recognizes this point in some circumstances.

Par. 86, pages 26 and 27. We generally agree that under authorised OECD approach that the credit rating of a PE would be the same as the whole enterprise. However, for

insurance companies this may not be always the case as is noted when local regulatory rules treat the permanent establishment as a stand alone entity for purposes of protecting the insureds of the host jurisdiction.

While we agree with the general principle that a permanent establishment should not pay a guarantee fee to the whole enterprise, there are situations where one permanent establishment's adverse loss experience could reduce the profitability of other branches and which arguably requires some reimbursement. For example, if one permanent establishment experiences a catastrophic loss (e.g., hurricane losses), other permanent establishments throughout the world may have to take actions to increase its liquidity from which the head office would marshal such resources to pay losses for the permanent establishment that incurred the hurricane losses. The provision of increased liquidity comes at the expense of tax bases of the other permanent establishments and arguably the permanent establishment experiencing the catastrophic loss should remunerate the other jurisdictions within the whole enterprise.

Par. 94, pages 28-29. We respectfully disagree with the characterization regarding travel insurance that "The lion's share of the premium must therefore be attributed to the marketing function, together with any income generated by investment of that part of the premium." The statement is potentially faulty for the following reasons:

- If the travel insurance industry is competitive, it is not clear that the marketing function is the residual profit taker or that it is necessarily a KERT activity. Some travel insurance is provided by entities that may have recognized brands owned by an entity other than that marketing the insurance within the host jurisdiction.
- If the underwriting function is located in a jurisdiction other than the PE, parties at arm's length would negotiate the returns from the sale of such insurance. It is not apriori clear whether marketing would receive the "lion's share" of the profit. The share of the profit would be determined based on all facts and circumstances.

Par. 95, page 29. We think the OECD should refrain from making generalizations about the relative value of functional activity because such determination is ultimately based on the facts and circumstances. Rather, guidance should be provided on how to apply the authorised OECD approach once a functional analysis has determined the KERT functions. With regard to the value of marketing of a complex insurance product, there is a high likelihood that such activity is a KERT function for the following reasons:

- The marketer must understand the needs of her customer to assist in structuring a complex insurance products
- The marketer must understand the risk "appetite" of her customer to present possible complex insurance products
- The marketer must communicate the risk attributes of the prospective insured to the underwriting function structuring the product to ensure proper pricing of the insured risk.

Par. 99, page 29. We disagree with the conclusions to be drawn from the following statement: "It may also be necessary to determine whether some of ancillary or support functions, although performed outside the PE, should nevertheless be taken into account

when attributing profit to the PE as being related to, at least in part, the functions and characteristics of the PE." We had thought all along that if a functional activity occurs outside of the PE, such activity should be reimbursed at arm's length; if such activity is and of itself a KERT function, then profits from such activity should be attributed to the location where such activity occurs. The OECD should further explain what it means by this statement and how it is consistent with applying the authorised OECD approach.

Par. 102, page 30. The earning of income from investments and reserves is not "automatic" or given. Returns to investment could be negative or below the market average. We suspect that if functional investment activities outside of the PE led to substantial investment losses, the tax administration of the PE where the economic ownership of the underlying asset would be "disinclined" to accept such losses.

The OECD should allow for situations where the PE could agree that the investment function would provide the underwriting PE with an expected return based on some benchmark for the reserves that are properly attributed to that PE. Variations from this expected return would inure to the location undertaking the investment activity.

Par. 105, page 30. With regard to the statement "Mere "rubber stamping" of a decision to accept the insured risk already taken in practice would not amount to performance of a key entrepreneurial risk taking function.", while we agree with the "spirit" of such statement, more guidance about this statement is required. In potential contravention of such statement, the head office of a single legal enterprise should not be considered to be "rubber stamping" a functional activity of the PE if the head office had analyzed under what conditions such a risk such be accepted or rejected on an ex-ante basis. Such "pre-conditions" reflect the functional activity of the head office in advance and an on-going basis and should not be attributed to the PE merely because the head office does not review itself on its own policy on a daily basis or because the PE in fact abides by the pre-determined policy.

Par. 106, page 31. The OECD has requested views regarding:

- what types of risk require surplus
- how to determine the quantum of surplus required and
- the location of that surplus

We believe under a facts and circumstances approach, all risks and there subcomponents related to running an insurance business should be allocated surplus. The OECD has properly noted that there are asset risks and liability risks from operating an insurance business that require the allocation of surplus.

In addition, we believe other risks (which have been noted throughout the draft) associated with running the insurance business, i.e., "enterprise" risk, should be allocated surplus including:[17]

[17] See, e.g., Managing and Financing Catastrophe Risk: The Need for an Enterprisewide, Value-Oriented Approach, Published in Alternative Insurance Capital, Issue 95, July 1999, by HEMANT SHAH, Senior Vice President, Risk Management Solutions, Menlo Park, California, and PETER NAKADA, Director,

- Operational
    - Business risks resulting from changes in demand or supply in the industry for insurance based products
    - Event risks from internal fraud, errors, or system failures
- Reputational, in particular how it effects either the credit worthiness of the (re)insurance company or its ability to obtain business
- Market risk with respect to other insurance products offered by competitors
- Regulatory risk (i.e., changes in reserve and minimal capital requirements)
- Pricing risk (i.e., the actual policy premium is too high or low vs. the market or with respect to the risk assumed)

With regard to the quantum of surplus to allocate, the first step is agreeing on the aggregate amount to allocate. Administrative efficiency strongly suggests that no more than the whole amount of the surplus of the insurance enterprise should be allocated among its permanent establishments. While we appreciate the difficulty in reaching consensus on this issue, it will be no easier for taxpayers to foster an agreement among the effected tax administrations on a case-by-case basis. We think an OECD position that may lead to a notional allocation of capital greater than what exists within the whole enterprise (i.e., double taxation by design) is inherently poor tax administration and should be avoided.

With regard to allocating the surplus, a reasonable allocation key chosen by the taxpayer should be accepted in the same manner taxpayers choose allocation keys to divide shared service center or beneficial head office costs. Many insurance companies have suggested that a KERT based approach to allocating capital will be cumbersome and unlikely to achieve a more precise allocation of surplus than other keys. We encourage the OECD to allow for a facts and circumstances approach that a taxpayer can demonstrate as being a reasonable approach. In this regard, the OECD should encourage its members not to substitute their judgment on methods that may or may not be slightly more precise in theory or application.

Par. 110, pages 31 and 32. We agree with the general conclusion of the paragraph. We reiterate our request for exemplatory guidance on how to relatively value such contributions. We suggest from an administrative point of view that the fully burdened salaries of the KERT functions may be one possible method for weighting such activities. We would be happy to suggest alternative methods of weighting if the OECD so requests.

Pars. 116 and 117. We note that, few, if any, taxpayers set up a separate legal enterprise under the impression that there is also a taxable dependent agent PE. The separate legal entity is not a "dependent" enterprise; it is independent if it has business purpose and economic substance. If it in fact habitually binds the related party, we would agree that it is an agent; we would not necessarily agree it is a "dependent" agent within the meaning of Article 5 and would in fact state such a situation is rare. It may well in fact be

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Oliver Wyman & Company, New York, available at http://www.rms.com/Publications/Managing_Financing_CAT_Risk_Alternative_Ins_Capital_July99.pdf, page 5.

independent because it has economic viability as a separate legal entity and is not per se economically dependent on the principal that it binds. It would also be likely that the principal is not guiding the subsidiary agent on a day-to-day basis thus precluding a determination that the agent is legally dependent. On this matter, finalization of the guidance of Parts I-IV may be best served through postponing such deemed PE guidance until the commentary to Article 5 is finalized. As it stands now, there are essentially two moving targets which undermine the usefulness of the guidance regarding Article 7.

Par. 119, page 33. We disagree that deemed PEs, i.e., "accidental" PEs, are as common as seems to be suggested by this paragraph.

Par. 120, page 33. We disagree with the emphasis on deemed permanent establishments when criteria for such determination have not been forthcoming. We believe that it is possible in most circumstances for a separate legal entity that is an agent of a related principal to be an independent agent and thereby preclude the determination of deemed permanent establishment. Statements regarding the transfer pricing consequences of a deemed permanent establishment cannot adequately be responded to without the proper Article 5 commentary context.

Par. 138, page 36. This paragraph supports a proportional allocation of capital/surplus to the deemed permanent establishment. We support such a method from an administrative convenience perspective. However, we understand that the latest draft of Part 2 was unable to support such a position and that each host country was allowed to determine the amount of capital/surplus needed within its jurisdiction so long such a method otherwise met the arm's length standard. Please advise whether Part IV surplus attribution and Part II capital attribution will be applied in consistent format (proportional or subject to host country arm's length rules.)

Par. 141, page 37. We support the authorised OECD approach on allocation of surplus as stated in this paragraph. We believe Part II should be revised in a comparable manner. We would add this paragraph supports allocation of surplus to all risks including the operational risks associated with the entire enterprise as previously discussed.

Par. 142, page 37. The head office, as such, may have the ability through internal and external means to marshal resources to cover contingencies arising from poor performance of a particular permanent establishment that the permanent establishment itself may not otherwise have the ability to perform on a stand alone separate legal entity basis. If so, a portion of surplus to manage the liquidity of the whole enterprise may properly allocated to the head office.

Par. 144, page 38. We generally agree with the advantage of "pooling" within a whole enterprise. However, people activity is usually required to make this benefit a reality. Moreover, the pooling may not be recognized by local regulators unless the whole enterprise packages a portion of the pooled assets and cedes them to a reinsurance company.

Par. 147, page 38. We have deep concern about the administrative burden for taxpayers to apply the following statement "Other trusteed assets, in excess of the amount necessary to support the PE's business activity, may be attributable to the PE if properly allocable to the PE under a capital allocation approach." Arguably the local regulator determined that the amount of trusted assets was in fact necessary to support the underwriting activity within the jurisdiction of the PE. The OECD should provide a safe harbor for taxpayers in such situations. We do not think tax administration examiners should be in the business of reviewing the regulatory determinations of insurance officials within the same legal jurisdiction. If a rebuttable presumption must exist, the burden of proof should be on the tax administration that seeks to modify the allocation of trusted assets.

In the U.S., for example, the trusteed assets and surplus required for a foreign insurance company operating through a branch would be the same as if that branch was operating as a U.S. company with the same kind of business activity.[18] Arguably this limited perspective will result in more surplus being allocated to the branch than would be required if the financial aspects of the remaining portion of the whole enterprise was considered. Thus it would be unlikely that additional surplus would be required under the authorised OECD approach.

In addition, many jurisdictions use a form of risk based capital (RBC) that accounts for the particular aspects of the line of insurance business, e.g., life insurance. In such, cases an RBC-based surplus calculation should be considered a prima facia correct determination of the surplus/capital of the PE and that the tax administration would have the burden of proof to demonstrate a more appropriate calculation.

Par. 148, page 39. We question to what extent the following statement is applicable: "in many cases this will not be a problem in practice, as the amount of minimum surplus held as trusteed assets and investment income earned on that surplus may be less than the amount of surplus and investment income that would have been allocated to that jurisdiction if the entire surplus of the insurance company were taken into account." In the U.S., states require minimum amount of capital as if the branch were separately incorporated within that state.

Par. 153, page 40. The OECD has requested comments on the desirability and feasibility of the hybrid approaches for allocating surplus. We believe a hybrid approach chosen by the taxpayer based on the facts and circumstances of its business is the most practical

[18] Texas Insurance Code, CHAPTER 982. FOREIGN AND ALIEN INSURANCE COMPANIES, available at http://www.capitol.state.tx.us/statutes/docs/IN/content/htm/in.006.00.000982.00.htm which provides:
§ 982.253. IMPAIRMENT OF TRUSTEED SURPLUS. (a) If the commissioner determines from a statement filed under Section 982.252 or any report that an alien insurance company's trusteed surplus is less than the greater of the minimum capital required of, or the minimum surplus required to be maintained by, a domestic insurance company authorized to engage in the same kinds of insurance, the commissioner shall:
(1) determine the amount of the impairment; and
(2) order the company, through its United States manager or attorney, to eliminate the impairment within the period designated by the commissioner.

approach given that the OECD will not be able to posit one surplus allocation method. We suggest that the OECD note that the tax administrations should provide deference to the taxpayer's choice of method if reasonably applied and documented.

Par. 156. pages 40-41. We think the thin capitalization approach should be rejected from the outset as it necessarily leads to an over-allocation of surplus/capital thereby resulting in double taxation, unless of course all the local regulators already require a thin capitalization approach, in which case the two approaches will align. Moreover, the administrative burden in calculating what the hypothetical stand alone surplus amount will be as difficult, if not more, as any other method. Thus no argument can be made that there are administrative advantages to such an approach.

Par. 157, page 41. A quasi-thin capitalization process has the advantage of reducing tax controversy if:

- double taxation does not result; and
- standards for determining the amount of surplus are readily available.

While a quasi-thin capitalization approach may lead to a different amount of surplus allocated to otherwise identical PEs, such a result is not inconsistent with the arm's length standard as the profit earned from any type of activity is inherently dependent on where such activity occurs. The administrative convenience of referring to local surplus minimum requirements should be considered a positive attribute in favor of allowing for this method as least a safe-harbor.

Par. 162, page 42. We believe that safe harbor should be allowed irrespective of whether the PE would report more or less profit if the authorised OECD approach was used. The safe harbor should be allowed for the administrative convenience of both tax administrations and effected taxpayers. We note that a safe harbor necessarily means less than exact precision. The OECD should weigh the cost from less than exact surplus allocations with the benefit from the reduction in the cost of compliance for both taxpayers and OECD-member tax administrations in precisely calculating an arm's length among of capital for the PE.

In addition, the OECD, should under the facts and circumstances, consider the use of other safe harbors. A safe harbor should be allowed for PEs that apply a risk based capital approach which has been acceptable in the U.S. by the National Association of Insurance Commissioners (NAIC) for over ten years.[19] The NAIC's risk based capital (RBC) formula "generates a customized minimum capital and surplus requirement based on the particular business risks faced by an insurance company."[20] Such an approach assumes that the respective state department of insurance accepts such risk based capital approach.

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[19] U.S. Regulatory and Rating Agency Update available at http://66.102.7.104/search?q=cache:P5oistQxMNEJ:www.guycarp.com/portal/extranet/pdf/US_Regulatory_Update_03_30_05.pdf+rbc+minimum+capital+requirements+insurance+&hl=en

[20] *Id.*

Par. 168, page 43. We recognize that Article 23 will be the basis to resolve double taxation that arises from an inconsistent application of the arm's length standard for surplus attribution among the OECD member nations. We are concerned that administrative protocols will not be properly communicated to examination personnel within the OECD tax administrations to facilitate such resolution in order to preclude the need for taxpayers to invoke the Competent Authority process to resolve this matter.

Par. 172, page 43. The OECD should allow for the transfer of foreign exchange risk within the same enterprise if personnel outside of the host jurisdiction of the PE have the capabilities to manage such risks on behalf of the whole enterprise.

Par. 175, page 44. The OECD has requested views on how to compensate the investment management function and on how to determine the yield from the investment of the surplus and reserves attributed to the PE. If investment activity occurs outside of the PE, the issue of calculating an expected return to the PE arises. The PE could expect to receive a fixed return while the investment manager bears risk of a return less than the expected return or earns profit if the return is higher. Various models exist to calculate such returns. Alternatively, a type of service fee or hedge fund model could be used to reward the investment management function within the whole enterprise.

With regard to the return that should be attributed to the PE, we believe, as a starting point, the management of all returns from investment management should be combined in the same manner that other inherent conditions of operating as a whole enterprise are combined. The overall return from such collective investment should be attributed in the same fashion as surplus. An exception should be made for instances where the local regulator requires that investments be limited to certain categories. In such instances, the returns should be ring-fenced and attributed accordingly.

Par. 185, page 46. To the extent a regulator recognizes reinsurance with a separate legal entity which may be in the context of changes in trusted assets required within the host jurisdiction, so too should the OECD recognize such a transaction.

Par. 188, page 46. The first statement about reinsurance is partially true but may be over simplification. Reinsurance that involves risk transfer and risk pooling is more than the provision of capital but includes sophisticated risk management. Moreover, many reinsurance companies provide value-added risk mitigation services as part of its reinsurance business.

Business reasons for reinsurance include:

- Satisfying an unique insurance need not readily handled by unrelated insurance entities
- Reducing issues of moral hazard and adverse selection
- Providing a self-funding mechanism
- Reducing the impact of the insurance industry’s underwriting price cycle
- Providing opportunities and incentives for the related party insurance entity to improve risk management

- Increasing control over funds and improving liquidity throughout the organization
- Reducing regulatory control
- Lowering overall capital requirements

Par. 192, page 47. The OECD has requested views regarding whether there are key entrepreneurial risk-taking functions in connection with the on-going management of a risk. We believe that there are instances where the whole enterprise must manage the risks of the various insurance pools created by the PEs over time. Reasons include:

- Correlative risk exposures arising from the activities of one PE with respect to another PE, neither of which would be aware of such correlative risk on a stand alone basis.
- Changes in the legal environment that may change how much remuneration may be required if a loss event occurs (a type of basis risk) and which requires the whole enterprise either to change how it undertakes underwriting and/or to reinsurance a portion of the existing pool
- Changes in medical information that may effect the length and severity of long tail risks related to liability insurance pools which may require whole enterprise either to change how it undertakes underwriting and/or to reinsurance a portion of the existing pool
- Changes in the actual loss experience of the whole enterprise which requires it to undertake financing or reinsurance strategies to maintain its credit rating and standing
- Changes in modeling used to perform underwriting that may require the whole enterprise to change how it currently assesses the attributes of the current risk pool it has insured that may lead in turn to reinsurance or some other risk management activity

We believe the OECD should allow for a facts and circumstances approach to whether a KERT type of ongoing risk management activity exists within a global insurance enterprise. If so, such risk management activity should be appropriately managed.

Par. 195, page 47. We are aware of situations where some regulators may allow trusteed assets to be credited through some form of internal dealing. Under an appropriate facts and circumstances analysis, such a dealing may be properly recognized for purposes of applying the authorised OECD approach.

Par. 199, page 48. We note that in fact many important insurance services can be contracted including actuarial services. We note that contract underwriting services are offered in life insurance and mortgage insurance.

Pars. 208 and 209, page 50. We note that the decision to underwrite a policy or set of policies will likely be undertaken by more than one person and such decision making may be in more than one jurisdiction. We agree that dealings in such contexts should be recognized and remunerated.

Par. 210, page 50. We suggest that the volume issue associated with reinsurance may be minimized by reference to quota-share or other long term reinsurance contracts.

Par. 213, page 51. With regard to the purchase of insurance for operational risk, we do not believe such benchmarking is as straightforward as suggested. For example, with regard to standard errors and omissions policies, such policies generally require a judicial or formalized proceeding before a claim can be made and the policies primarily cover third-party liability, not first-party losses.[21] Even with insurance, banks are only allowed to reduce by 20% the amount of capital set aside for operational risk.

Par. 223, page 52. The OECD has requested views on whether for some of the more complex insurance products, there is a role equivalent to the "structuring" role in global trading. We believe that such a similar structuring role in the insurance industry exists. Many companies offer structured insurance programs to clients. As such, a functional analysis should attribute profit to the locations within the whole enterprise that perform KERT type activities.

Par. 226, page 53. The OECD has requested views on how to analyze support functions related to regulatory compliance provided by a part of the whole enterprise without the PE. We believe a facts and circumstances analysis is required. We posit the following possibilities:

- The local regulator effectively ignores the home jurisdiction regulations and requires the PE to comply with local rules. There may be instances where the PE may use home office regulatory analysis for its local compliance. To the extent that the local office avoids costs for complying with local rules, it should reimburse the head office for the benefit it received. The benefit may require an adjustment to reflect local rates (next best alternative opportunity cost) and not necessarily on the costs of the head office.
- The local regulator allows the PE to use home regulatory submissions as much as possible and only requires supplementation as needed for business occurring within the local jurisdiction. The benefit should be remunerated by the PE. The amount of the benefit should be the lesser of the actual properly allocated amount to the PE or the amount the PE would have paid to have had the services performed had it in fact done the regulatory compliance itself.
- In both examples above, an allocation of regulatory costs may be appropriate in addition to those described above (assuming there is a portion of these costs that remain unallocated) if the surplus required by the PE is less than it would have been on a stand alone basis. The regulatory compliance costs of the home office should be seen as part of the inherent condition (both benefits and burdens) that is attributed to the PE in this situation.

[21] See, e.g., "Insuring Operational Risk: How Good Is the Coverage?", by Sandra E. Giuffre, available at http://www.mmc.com/views2/Giuffre200412.php.

Par. 228, page 53. We would note that a highly developed information technology platform may be a significant asset that draws substantial profit related to accepting and managing of insurance risk.

Typos and Suggested Edits

Par. 2., page 7, currently provides "However, the insurance industry rapidly I s becoming more global." Should read "However, the insurance industry rapidly is becoming more global."

Par. 12, page 9, currently provides "Insurance premiums are set at a level that covers the insurer's expected costs of claims, its costs of administration (including sales commissions) its expected investment return and a profit return." An additional comma is required resulting in "Insurance premiums are set at a level that covers the insurer's expected costs of claims, its costs of administration (including sales commissions), its expected investment return and a profit return."

Par. 33, page 13, the "and" in the series of 5 factors should be moved from the third factor to the fourth factor.

Par. 34, page 13. The sentence "In particular, the following sub-processes are involved in executing the contract: processing the proposal, underwriting insured risk, preparing the contract, commissioning." requires an "and" before the fourth factor.

Par. 36, page 14. Third sentence has a stand alone right parenthetical ")".

Par. 103, page 30. Extra period at the beginning of the sentence.

Par. 111. page 32. This paragraph seems to be an orphan.

Heading between paragraphs 115 and 116. An extra ")" should be eliminated.

Par. 128. Second to last sentence has two periods.

Par. 208. Eliminate one of the two "the" articles in the third sentence.