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REPORT ON THE ATTRIBUTION OF PROFITS TO A PERMANENT ESTABLISHMENT PART IV (INSURANCE)

Dear Jeffrey,

The Association of British Insurers (the ABI) welcomes the opportunity to take part in the discussions on the special considerations for applying the authorised OECD approach on the attribution of profits to permanent establishments of insurance companies, detailed in Part IV of the draft report.

The ABI appreciates the fact that OECD has made significant changes to the earlier draft to reflect the concerns that the industry had raised. We now believe that the draft is much clearer and will be easier to apply in the insurance sector, but we do have some comments specific to Part IV which we hope can be taken into account in drafting the final version.

Key Entrepreneurial Risk Taking Function (KERT)

a) Insurance Risk Assumption

While we are able to agree that the main KERT in insurance transactions in the insurance sector is insurance risk assumption we recommend that the definitions of this function throughout Part IV should be sufficiently broad in order to cover the various facts and circumstances that can arise in the insurance business as set out in paragraphs b) and c) below.

For example, in paragraph 69 it is stated that underwriting is the most important activity generating a single key entrepreneurial activity (KERT) in insurance risk assumption. Even though paragraphs 34-37 attempt to widen the definition of underwriting, this could link the function to underwriters and thus present difficulties. We prefer the approach taken in paragraph 94 which focuses on the KERT function of 'assuming insurance risk'. The focus should be on the key decision to assume insurance risk, and this will depend on the facts and circumstances of each business.

We therefore support the position that in all circumstances the range of activities that make up the insurance risk assumption must be fully analysed and that the following activities should be considered as relevant, depending on the individual facts and circumstances of each transaction:

- Setting the underwriting policy
- Risk selection
- Pricing
- Acceptance of insured risk
- Risk management
- Capital management
- Risk retention analysis (reinsurance policy, or retrocession policy for a reinsurer).

b) Ongoing insurance risk management and internal reinsurance

The ABI believes that the ongoing management of risk can be justified as a key function, even though this may not be on a day-to-day basis, and that the facts and circumstances should again determine its inclusion in the KERT. In certain lines of business, for example, life bonds, profitability is dependent more on active risk management after risk is assumed than to initial risk assumption itself.

We are also concerned that internal dealings such as reinsurance, which is a major activity within the industry, is recognised within other Parts of the reports but not in Part IV. The rationale for recognising internal reinsurance is that in many cases, once the risk has been assumed by the PE, the insurance contract may have no further empirical connection with the PE, but, rather the insurance risks are wholly managed by another part of the insurance enterprise. An internal reinsurance is a simple method of recognising that the KERT has shifted from the originating branch to another part of the enterprise.

In terms of reinsurance the key decisions for risk assumption can be the personnel who manage capital. These personnel are not underwriters but they can be key decision makers for assuming the risks of a reinsurer. We believe therefore that activities in relation to internal reinsurance should also be recognised as being key entrepreneurial tasks.

c) Quantification

In the ABI's view the location of where the KERT function is actually performed should be considered despite the relative numbers of personnel who might be involved. For example a large number of employees working in one state in a call centre inputting information to a computer system should not be considered to be performing a KERT. However a small number of employees in another state making real entrepreneurial, risk and policy decisions should be considered a KERT.

Investment Assets

The draft specifically raises the issue of whether there is any key data that could be used to identify how to split asset allocations between business lines and locations (paragraph 151). A number of data sources are already used in a number of countries, such as liabilities and reserves, premiums, and even expenses (in cases of run-off business). The issue for the industry is the diversity of the business being carried out under the banner of insurance means that there is no simple single data source that would satisfy all requirements or lead to the best result in all cases.

We believe that the allocation key would have to rely on the facts and circumstances in each case, as a number of allocation keys may be appropriate even within a single group entity.

We would also suggest that any allocation method is not only based on the facts but also the companies own systems and policy for allocation where possible. As the methods of recording assets allocation may differ from company to company depending on their mix of business where this is life investment business, property and causality business or a mixture, and also whether they are focussing on short term risk only or long term.

In addition we have identified three potential areas of confusion, beyond the need for guidance on how to determine the amount of investments assets that need to be attributed to a PE as discussed by yourselves in paragraphs 75 and 151.

The first issue is the assumption (paragraphs 90 and 151) that the allocation is only of 'investment assets'. The concern here is that many companies may not cover risk within a PE solely by holding interest-bearing assets, they may also do so though holding receivables or other non income bearing assets. This focus on investments assets does increase the risks of double taxation or at a minimum distort the tax position of the companies involved, if the capital requirements in any PE are treated a solely arising from the investment assets of the whole enterprise rather than applying any allocation to the total assets, investment or other.

The second is that the allocation of assets specifically held to back unit-linked polices sold by that PE. Where, although the assets are legally the company's, they are specifically held to back the policyholder's investment requirements,

under the unit-linked policy. They can therefore be clearly be ascribed to that particular contract. In these cases we would suggest that such assets – as they can be clearly identified to a specific class of policy sold within the PE – should be excluded from step one (page 29) and any further allocation requirement, as they can be easily linked to the PE’s reserve requirements.

Thirdly it is still unclear how you intend companies to allocate assets between the KERT function of underwriting and the ‘significant people functions relative to the attribution of economic ownership’. We assume the latter would imply that office buildings used in the day-to-day operations of the PE, which may also be owned within the company’s investment fund, would be excluded from the need for the KERT as it would automatically fall within the remit of the PE for the purposes of any functional analysis. But this is unclear given the steps indicated at Page 29 indicate that the KERT ‘underwriting function’ may take precedence. It would be useful if this could be clarified in further versions.

Regulatory requirements

The regulatory requirements of some nation states may be a strong factor in deciding where the profits of an enterprise should be allocated. This has been discussed in paragraphs 95-106 of the report.

The draft states that the although the regulatory requirements may mean that capital must be maintained in a host state for risk liabilities that may occur for an insurance business, this necessity does not in itself mean that the KERT activity must also be within that same host state.

We welcome the guidance stating that the nation state in which the assumption and management of insurance risk is undertaken is decided by the facts of the individual case. We agree that the regulations imposed by certain nation states is a participating factor in determining where the KERT is undertaken, but that should not in itself a determining factor.

We also generally agree with the guidance given in paragraph 105 that states that book value of profits should be respected as far as they are consistent with the fact and function analysis to determine the location of the KERT. We feel that more guidance may be needed however, to decide what is meant by ‘a material amount’. This is obviously not audit materiality, and the ambiguity in definition could lead to confusion or confrontation between taxpayers and tax authorities.

Language suggestions

Finally we have a number of concerns around the need for greater clarity in the definitions and use of language within the paper. We recognise that the draft has in part tried to ensure parity of treatment or language as between Parts I to III and this Part IV, however, we are not entirely sure this recognises the difference between insurance and the other business strands, such as banking and global

trading. For example the concept of 'free' capital may be well known in banking but needs further clarification in respect of insurance where its use muddies the concepts already applied of reserves and surplus. Equally, use of the description 'surplus' in paragraph 74 creates a concept that is currently only used for life insurance business, not elsewhere. Yet the description used here does not match the usage for life business.

We note that there is a tendency for the same phrase to be used inconsistently throughout the paper. The key example is the use of 'reserves', where the exact meaning is unclear within the text. Whilst we agree with the conclusion that the different regulatory arrangements make it impossible to identify appropriate levels of regulatory capital and solvency margins required to be held within insurance reserves. It is unclear what is then meant by reserves compared to the definition of surplus funds in paragraph 74 where it describes :

- Reserves as “amounts set aside from premiums and investment returns to pay future claims and expenses” compared
- Surplus as “amounts held in excess of reserves and other liabilities”

Especially as the draft then go on to discuss “free” capital, which suggests assets outside the category of 'surplus', and the separate attribution of the solvency margin (paragraph 122).

We had assumed that the focus of the allocation was on the attribution of 'capital' not this 'surplus' so it is unclear what is achieved by these various definitions. In reality reserves are usually all amounts considered necessary by the company's underwriter or actuary, taking all circumstances into account including solvency and prudent management requirements, to cover the risks assumed. Other liabilities will then be more clearly delineated as being subject to attribution under Part I as opposed to Part IV and associated with assets other than investment assets.

Finally on language we believe that the reference (paragraph 18, line 1) to mechanisms for managing risk by 'shifting' risk is inappropriate, when 'ceding' is the recognised and correct terminology.

The ABI looks forward to attending the meeting in Paris on 26 November for further discussion of these issues.

Yours sincerely,

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