Depicting reinsurance transfer pricing

CAS Reinsurance Seminar 2017

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Building a better working world

Agenda

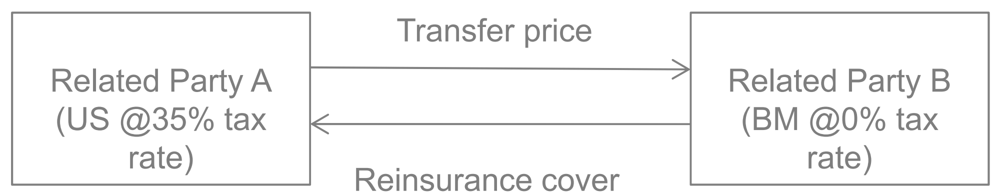
- Transfer pricing in a nutshell
- Why should companies care about transfer pricing?
- Transfer pricing ground rules relevant to internal reinsurance
- When do transfer pricing and actuarial analysis overlap and do they?
- What else do you need for transfer pricing if you already have an actuarial analysis in place?
- Common pitfalls and best practices in reinsurance transfer pricing

Speaker – Anna Lam

- Anna Lam is a senior manager in Ernst & Young's (EY) financial services transfer pricing practice. Anna joined EY in 2011. Anna has seventeen years of experience working in and servicing the financial services industry during which she spent most of the time on the insurance sector. In her current role, Anna provides transfer pricing advice to clients in the financial services industry on various types of related party transactions, including services, insurance and reinsurance, funding, guarantees, hedging, factoring, cash pooling and intangibles. Anna has experience in preparing US and OECD compliant transfer pricing documentation and planning studies. She also has experience working on APA and transfer pricing controversies.
- Prior to joining EY, Anna was an Associate Principal of the transfer pricing practice at Charles River Associates, an economic and financial consulting firm with headquarter in Boston. While at Charles River Associates, Anna focused on transfer pricing issues on treasury, reinsurance as well as captive insurance transactions. Before working in the transfer pricing area, Anna was an underwriting portfolio manager in the Hong Kong office of RSA Insurance Group, a UK based insurance company. Other than insurance, her financial services industry experience also includes asset management and wealth management.
- Anna received her Master of Business Administration from the honors program in the Zicklin School of Business, Baruch College. She got her Bachelor of Arts in General Business Management from the Hong Kong University of Science & Technology. She was a chartered insurer and she is an associate of the Chartered Insurance Institute in the UK.

Transfer pricing in a nutshell

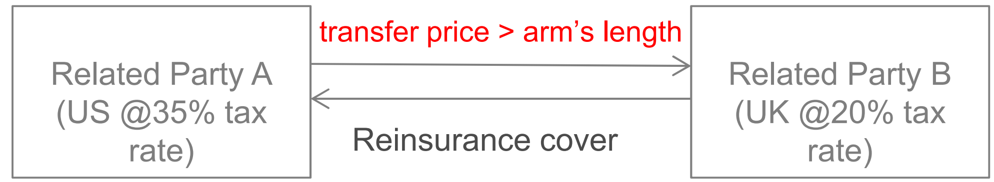
- Transfer price
  - Price for a "controlled" transaction
  - Or the price of a transaction between related parties
  - Facts and circumstances driven
- Broad definition of "Control"
  - No bright line test
  - "direct or indirect, whether legally enforceable or not", "acting in concert or with a common goal or purpose"
- Defining a "Transaction":
  - Services
  - Financing
  - Reinsurance
  - Whether there is an agreement or not



- Arm's-length standard/principle
  - If the result is the same as the result realized by uncontrolled/unaffiliated parties engaged in the same transaction under the same circumstances.
  - Same is ideal; comparable is acceptable
  - Price approved by regulators does not imply that it complies with the arm's length standard

Why should companies care about transfer pricing?

- Tax implications
  - Potentially large adjustment by tax authorities
    - Adjust to the mid point!
  - Potential penalties
    - 20% / 40% in the US



- Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) Project
    - Focus on tax avoidance strategies that exploits gaps in tax rules to artificially shift profits to low/no tax jurisdictions
    - Under the spot light with political motivation
    - C-suite topic and reputational risk
    - Action 13: transfer pricing documentation
    - Actions 8-10: Aligning transfer pricing outcomes with value creation (Intangibles, risk capital and high risk transactions)
- Reinsurance is a type of transaction with
    - Sizable transaction amount and is heavily capital driven but with LOW headcount per transaction
    - Characteristics not intuitively in line with the "norm" seen by tax authorities from other industries

Transfer pricing ground rules relevant to internal reinsurance

- Characterization of an internal reinsurance transaction
  - Quota share / non-proportional / fronting
- Factors that affect the transfer price
  - Not only numerical facts
  - Also depends on functions performed and assets employed by related parties
  - Comparability standard
  - OECD BEPS Actions 8-10:
    - Contractual relationship should be in line with actual conduct
    - Should have risk control and financial capacity
    - Mere provision capital will attain no more than a risk-free return
- (Lack of) rules/guidelines on how to assess whether an internal reinsurance transaction is consistent with the arm's length standard
  - US transfer pricing rules were not written for insurance/ reinsurance industry
  - Specified transfer pricing methods vs Unspecified method
  - US vs OECD
  - One sided vs two sided test

When do transfer pricing and actuarial analysis overlap and do they?

- Using actuarial analysis for internal reinsurance is natural
- While actuarial based method is well received, it's not always the best method according to Treas. Regs. 1.482
  - No specific section on reinsurance (excluded in Treas. Regs. 1.482-(9))
  - Apply other sections of the regs by analogy (e.g. Treas. Regs. 1.482-(9) or Treas. Regs. 1.482-(4))
- Although there is no hierarchy of methods, IRS tends to have a typical way of looking at reinsurance transactions, e.g.:
  - Cases when comparables can be used directly or reliably adjusted
    - Underwriters know the market rates –evidence?
    - Independent reinsurer's participations in the same treaty
  - Cases where the transfer pricing question is on the intermediary function rather than the risk taking function
    - Quota share
  - Traditional profit level indicators are more intuitive for tax authorities
  - Pricing model may serve as indirect evidence to support the transfer price
  - Some countries tends to accept profitability analysis only

What else do you need for transfer pricing if you already have an actuarial analysis in place?

- Check comparable transactions with third-parties ("internal comparables")
  - Usually weigh heavily by many taxing authorities
  - Stringent comparability standard
    - at a minimum – LOB, limit, attachment point, geographical coverage
  - If differences exist, consider whether the differences can be "reliably" adjusted
- Check assumptions against transfer pricing rules
  - Use of industry ratios is not always accepted by taxing authorities
  - Common assumptions to check
    - Use of company loss experience data vs industry loss data
    - Return to capital ratio: which peers are "comparable"? how does market cycle affect the analysis?
    - Expense ratio: same level of market?
    - Discount rate: geographical difference
  - If differences exist, consider whether the differences can be "reliably" adjusted

What else do you need for transfer pricing if you already have an actuarial analysis in place? Cont'd

- Perform collaborating analysis if needed or use actuarial analysis as collaborating method
  - Profitability analysis – proportional vs non-proportional
  - Selection of comparable
    - Ideal vs practical approach
- Understand the functions each related party performs with respect to the internal transaction
  - Underwriting
  - Actuarial pricing
  - How are they compared to unrelated parties?
- Transfer Pricing Documentation
  - Penalty protection
  - Guidelines and requirements vary across the globe – some are mandatory
  - Changes due to OECD BEPS Project
  - Generally a transfer pricing documentation report includes description of transaction, industry analysis, company analysis, functional analysis and economic analysis

Example 1 – Quota Share

	Internal reinsurance transaction	Transaction with third-party
Line of business	Property	Property
Reinsurance provider	Bermuda	Bermuda
Cedent	US	US
Limit	$100m	$100m
Attachment point	$150m	$180m
Quota share cession %	50%	60%
Ceding commission %	30%	30%
Override commission %	2%	0%
Actuarial analysis	Yes – premium to surplus	No – follow lead
Expense ratio %	30%	30%
Markup on total cost	6.67%	0%

- Typical question asked by taxing authority
- Benchmarking analysis

Example 2- XOL

	Internal reinsurance transaction	Transaction with third-party
Line of business	Aviation	Aviation
Reinsurance provider	Bermuda	Bermuda
Cedent	US	US
Limit	$25m x/s $50m	$25m x/s 75m
Reinstatement	2	1
ROL	5.26%	2.58%
Order	100%	30%
Actuarial analysis	Yes – internal, exposure based	No – follow lead
Expected ROE from actuarial analysis	15%	

- Typical question asked by taxing authority
- Benchmarking analysis

Common pitfalls and best transfer pricing practices

- Common pitfalls
  - Failure to recognize internal comparables
  - Failure to meet comparability standard due to direct use of industry ratios
  - Lack of support on assumptions used in actuarial analysis
- Best practices
  - Agreement
    - Have an agreement in place
    - Agreement should be in line with the actual
  - Functional discussions involving transfer pricing team
    - Best before conclusion of transfer price
  - Transfer pricing documentation
    - Penalty protection
    - Audit trail
  - Timing of transfer pricing analysis
    - Best before conclusion of transfer price

Questions?

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