

OECD launches public consultation document on Pillar One - Amount A: Regulated Financial Services Exclusion

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In brief

The OECD released the public consultation document on the [Pillar One - Amount A: Regulated Financial Services Exclusion](#) on 6 May 2022. Comments on the consultation document are due by 20 May 2022. This alert provides a short overview of the proposed approach to the Regulated Financial Services Exclusion and some initial observations. This is the fifth in a series of public consultations on the Pillar One Amount A Model Rules that the OECD is expected to release over the coming months, with very short comment periods, as part of a 'rolling consultation.'

Similar to the [consultation document on the Extractive Exclusion](#), the rules are presented mainly in narrative format as opposed to Model Rules format (noting that other parts of the Amount A Model Rules linked to the Regulated Financial Services Exclusion are yet to be finalised).

It is particularly important to note – yet again – that these draft rules for the moment represent the work of the OECD Secretariat. The Inclusive Framework has not approved the draft rules yet. They may, therefore, be subject to change, unrelated to the consultation process. The consultation document specifically identifies several open issues that the Task Force on the Digital Economy (TFDE) is currently exploring and invites input from stakeholders. Extensive footnotes throughout the document state that the practical application of the rules and definitions will be covered in commentaries (which are not included in this document).

In detail

Overview

The Regulated Financial Services Exclusion is intended to exclude from the scope of Amount A the revenues and profits from 'Regulated Financial Institutions' (RFIs). There are seven types of RFIs defined in the consultation document:

- Depository Institution
- Mortgage Granting Institution
- Investment Institution
- Insurance Institution
- Asset Manager
- Mixed Financial Institution
- RFI Service Entity (a service entity that exclusively performs functions for a RFI)

The definition for each type of RFI generally contains three elements, all of which must be satisfied: a licensing requirement; a regulatory capital requirement; and an activities requirement. The exclusion will apply on an entity-by-entity basis. An Entity that meets the definition of RFI will be wholly excluded from Amount A. An Entity that does not meet that definition will be wholly included in Amount A.

As noted in the consultation document, the defining character of the Regulated Financial Service sector is that it is subject to prudential requirements based on capital adequacy, which is the regulatory driver that helps align the location of profits with the market. The scope of the exclusion derives from that requirement, meaning that Entities that are subject to risk-based capital measures (and only those) are excluded from Amount A.

Observation: It is particularly important to note that the consultation document highlights that some Inclusive Framework members hold the view that reinsurance and asset management should not be excluded from Amount A. As this is not a matter for the OECD Secretariat, the consultation does not go into any further detail on this point.

Steps to apply the Regulated Financial Services Exclusion

The consultation document lays out the seven steps that a Group that qualifies for the Regulated Financial Services Exclusion would follow to apply Amount A as a whole. Steps Two and Three are specific to the Regulated Financial Services Exclusion:

Step Two: After applying the [general scope rules](#) as Step One (i.e., EUR 20 billion global revenue test and 10% profitability test) and subtracting third party revenue derived from Regulated Financial Services (i.e., considering each RFI on an entity-by-entity basis) from the Group or segment's consolidated revenue figure, a Group or segment must re-determine whether the EUR 20 billion revenue threshold is met by testing only the in-scope revenue (i.e., third party revenue). If this is not above EUR 20 billion, the Group is not in scope. If it is above EUR 20 billion, then the profitability should be tested (Step Three).

The consultation document outlines two simplified approaches to apply Step Two as a means to reduce compliance burdens (these are elective and don't require an exact computation):

- A Group can identify its largest RFIs and subtract the total third party revenues of such entities from the consolidated revenue figure - i.e., a Group is not required to apply the exclusion to the fullest extent, but only insofar as it is necessary to establish that the remaining in-scope revenue does not exceed EUR 20 billion and therefore the Group is not in scope.

- As an alternative, a Group can test whether revenues from in-scope entities (i.e., entities that are not RFIs) exceed EUR 20 billion by adding the total revenues of all such entities. This approach means that a Group or segment may over-include revenue because intra-group revenue is not subtracted.

Step Three: Similar to Step Two, the calculation to exclude out-of-scope profits is performed on an entity-by-entity basis. To re-determine whether the 10% profitability threshold is met, a Group must identify every in-scope Entity, combine them into a consolidated bespoke segment for Amount A purposes, and determine the profit margin of this consolidated bespoke segment. If the profit margin is above 10%, the Group is in scope of Amount A.

The consultation document notes that work is ongoing in considering how the application of the Regulated Financial Services Exclusion can be simplified, particularly for Groups that exceed the revenue threshold, but whose in-scope profit margin is consistently below the 10% profitability threshold. The OECD also is still considering how to apply the average test, profitability test, and loss carry forward rules (outlined in the Model Rules on Scope) in the first years of the application of Amount A.

Observation: The application of Step Two and Step Three can be done using either a top-down or bottom-up approach. The entity-by-entity approach means that the profit of the bespoke notional segment comprising the non-excluded entities will recognize revenues earned, and costs incurred, by such non-excluded entities on intra-group transactions with other group entities that meet the definition of Regulated Financial Institutions. The revenues earned, and costs incurred, on such intra-group transactions will be based on the arm's length principle.

'Regulated Financial Institution' defined

The definition for each type of RFI generally contains three elements: a licensing requirement; a regulatory capital requirement; and an activities requirement.

Licensing requirement

Depositary, Mortgage, Investment and Insurance Institutions and Asset Managers must be licensed to carry on specified activities as a business under the law or regulations of the jurisdiction in which the Group Entity does that business, or in the case of a Group Entity that does such business in an EEA Member State, is licensed by a competent authority to carry on such business in an EEA Member State. The rules indicate that the Commentary would explain that this licensing requirement is tested looking at the operations in the local jurisdiction, and may need to be tested at the branch rather than the Entity level. It may also provide for recognition of the licensing decision of another jurisdiction, for example, under equivalence regimes.

Regulatory capital requirement

Depositary, Mortgage, and Investment Institutions must be subject to capital adequacy requirements that reflect the Core Principles for Effective Banking Supervision as provided by the Basel Committee on Banking Supervision¹. Investment Institutions can alternatively be subject to the Objectives and Principles of Securities Regulation as adopted by the International Organisation of Securities Commissions (IOSCO)² and the related implementing methodology³. Insurance Institutions must be subject to solvency standards incorporating a risk-based capital measure.

Asset Managers must be subject to capital adequacy requirements incorporating a risk-based measure. The consultation document notes that future Commentary would explain that this requires that the determination of the amount of capital to be held takes into account an entity's risks. The risks that could be considered in this assessment include assets under management, size, liabilities, execution volumes, credit risk, market risk, or operational risk. This requirement would therefore not be met in jurisdictions that impose a fixed minimum amount of capital for all firms, without any variation according to the facts and circumstances of individual entities.

Activities requirement

The types of permissible activities for each category of RFI are listed below. Generally, the total gross income attributable to the permissible activities of an RFI must equal or exceed [75%] (i.e., this percentage, and other percentages in square brackets, has not yet been agreed) of the Group Entity's total gross income during the Period. For Insurance Institutions, this requirement can alternatively be satisfied if the aggregate value of the assets held to manage risk associated with Insurance Contracts and Annuity Contracts exceeds [75%] of total assets as at the balance sheet data for the Period. For Depository Institutions, this requirement is replaced with the requirement that at least [20%] of the liabilities of the Entity consist of Deposits, as at the balance sheet date for the Period.

'Substantial portion'

The RFIs other than the service provider category broadly require that a 'substantial portion' of the business is not intra-group. A 'substantial portion' currently is defined in square brackets as [50%] as measured against the Group Entity's total gross income during the Period from the activity. Footnotes in the consultation document note that future Commentary would explain that the effect of this rule is to ensure that Entities such as group treasury centres (or captive insurers and finance centres that provide loans for the purchase of the group's own goods) do not qualify for the Regulated Financial Service exclusion.

Depository Institution

The permissible activities of Depository Institutions are limited to accepting Deposits in the ordinary course of banking or similar business as a bank. The consultation document notes that future Commentary would explain that an Entity is considered to be engaged in a 'banking or similar business' if, in the ordinary course of its business with customers, the Entity accepts deposits and regularly engages in one or more of the activities specified in Footnote 9 of the consultation document.

An Entity is not considered to be engaged in a banking or similar business if the Entity solely accepts deposits from persons as a collateral or security pursuant to a sale or lease of property or pursuant to a similar financing arrangement between such Entity and the person holding the deposit with the Entity.

Observation: The requirement that a 'substantial portion' of the business is not intra-group (discussed above) precludes group treasury centres, who may hold funds of associated entities and also manage liquidity, foreign exchange risk, intra-group payment processes, financial governance and risk management, and related analytics, from availing of the exclusion in respect of services provided to non-RFI group members.

Mortgage Institution

The permissible activities for Mortgage Institutions are limited to accepting repayable funds from the public in the ordinary course of a banking or similar business, provided the credits are granted directly to individuals for the purchase of real estate (or refinancing of such prior credits) and it receives security for the repayment of those credits in the form of mortgages. The consultation document notes that future Commentary will explain that the term 'repayable funds' means funds that are the subject of a contractual agreement to repay the funds, and includes bonds and other comparable securities such as negotiable certificates of deposit, provided that these are continually issued by the credit institution (and not as a one-off or occasional form of capital-raising).

Investment Institution

The permissible activities for Investment Institutions include one or more of the following activities:

- a. dealing, broking or trading in Financial Assets for own account or for account of customers; and / or

- b. holding securities in inventory; and / or
- c. hedging customer transactions; and / or
- d. participating in underwriting, mergers and acquisitions, syndication, securitisation and securities issues and providing financial services related to such activities; and / or
- e. holding, transferring, controlling, administering or distributing Financial Assets for the account of other persons.

Footnote 15 of the consultation document notes that the term 'Investment Institution' is a generic term, intended to capture what may be called a custodial institution, investment bank, investment firm, or broker / dealer.

Insurance Institution

'Insurance Institution' is defined as a Group Entity that is licensed to enter into Insurance Contracts and Annuity Contracts. 'Insurance Contract' is defined as a contract of insurance or reinsurance (other than an Annuity Contract) under which the issuer agrees to pay an amount upon the occurrence of a specified contingency involving mortality, morbidity, accident, liability, or property loss risk. It also includes a contract under which a participant agrees to contribute to a common fund providing for mutual financial benefits payable to the participants or their beneficiaries upon the occurrence of a specified contingency involving mortality, morbidity, accident, liability, or property loss risk. 'Annuity Contract' is defined as a contract under which the issuer or operator agrees to make payments for a period of time determined in whole or in part by reference to the life expectancy of one or more individuals. The term also includes a contract that is considered to be an Annuity Contract in accordance with the law, regulation, or practice of the jurisdiction in which the contract was issued, and under which the issuer agrees to make payments for a term of years.

Asset Manager

The permissible activities for Asset Managers include investing in, administering, managing or distributing interests in, an Investment Fund or Real Estate Investment Vehicle, Financial Assets, or money for or on behalf of other persons. Footnote 20 of the consultation document notes the future Commentary would explain that these definitions are intended to be expansive, and include traditional portfolio investments such as those held by collective investment vehicles, as well as alternative asset classes such as infrastructure or controlling interests in other companies. The reference to "for or on behalf of other persons" means that it includes both the management of investments for an investor, as well as the management of investments for a third party, such as the management of segregated accounts or pension plans on behalf of clients.

Mixed Financial Institution

A Mixed Financial Institution is defined as a Group Entity that is licensed to carry on more than one business as a Depository, Investment, or Insurance Institution, or Asset Manager (as defined above). It must hold a minimum level of capital as required for each respective RFI category and the total gross income attributable to any of the permitted activities for Investment or Insurance Institutions, or Asset Managers must equal or exceed [75%] of the Group Entity's total gross income during the Period.

RFI Service Entity

A RFI Service Entity is defined as a Group Entity that is wholly owned (directly or indirectly) by a ultimate parent entity of a Group that also wholly owns (directly or indirectly) another RFI (other than an RFI Service Entity) that is a Group Entity of the same Group and performs services exclusively for the benefit of one or more other RFIs (other

than an RFI Service Entity) that is a Group Entity of the same Group. The services provided must be necessary to the carrying out of the activities of such RFI.

The consultation document notes that future Commentary would give examples of services that are “necessary to the carrying out of the activities of the other RFI.” Footnote 23 provides that this is intended to be a narrow category, focusing on administrative services that would typically be remunerated on a cost-plus basis, such as providing payroll functions for employees that perform services solely for the RFI, holding real estate that is invested in or used by the RFI as part of its business, and performing other back office and procurement functions for the sole benefit of the RFI.

Observation: Footnote 23 of the consultation document describes the activities that RFI Service Entities are not permitted to conduct, which include the conduct of customer-facing activities, or activities that are not otherwise permitted for RFIs. In a parenthetical example, the document notes that it would not cover the provision of fintech or payment processing services. Careful review of the Commentary will be required to determine whether group service companies will in fact fall within the definition of an RFI Service Entity, given the comment that it will be narrow in scope and the examples used.

‘Rolling’ public consultations

This is the fifth in a series of public consultations on the Pillar One Amount A Model Rules that the OECD is expected to release over the coming months. The first release covered the [revenue sourcing and nexus rules](#), the second release covered the rules for [tax base determinations](#), the third release covered the [general scope rules](#), and the fourth release covered the [exclusion for extractive industries](#).

The takeaway

Considering the late stage in the project’s official timeline for completion, it is concerning that significant aspects of these rules remain completely unagreed (e.g., the treatment of reinsurance and asset management), or have been left open (e.g., percentages used in the RFI definitions), or are stated to be addressed in forthcoming commentary (too many to list).

Let's talk

For a deeper discussion of how the draft Model Rules might affect your business, please contact:

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¹ “Core Principles for Effective Banking Supervision”, Basel Committee on Banking Supervision, September 2012, available [here](#).

² “Objectives and Principles of Securities Regulation”, International Organisation of Securities Commissions (IOSCO), May 2017, available [here](#).

³³ “Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation”, IOSCO, May 2017, available [here](#).