

# Understanding the Financial Interest Clause

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*A Financial Interest Clause (FIC) is one of many options available to companies with multinational exposures. Like other multinational insurance options, it has both benefits and limitations. AIG will accommodate its clients' preferences when designing multinational programs; in doing so, we believe our clients should be aware of the benefits and limitations of using an FIC. While an FIC can potentially mitigate regulatory and tax risks in countries where unlicensed insurance is not permitted (addressing a significant compliance concern), it does not replace a local policy — and does not afford local insurance services, such as premium collection, claims handling or tax settlement. This Briefing Paper provides additional details on the FIC and the implications it carries for a parent company and its subsidiaries.*

## Background

Global insurance policies, issued to a parent company, often include a worldwide coverage territory and/or broad named insured wording to cover not only the parent company, but also its worldwide operations. When issued within a Controlled Master Program (CMP), the global policy will cover local subsidiaries.<sup>1</sup> In contrast, a locally issued policy typically covers only the local subsidiary.

Laws in some countries require in-country exposures to be covered by a carrier that is licensed to conduct business in that country. Other countries require the carrier to be licensed in order to carry out specific activities in that country, such as claims adjusting and/or payment. Still, other countries are silent and/or unclear on these issues. There may also be important nuances or exceptions by lines of business or applicable party<sup>2</sup>, or inconsistency in the local implementation and enforcement of the requirements themselves.

The global policy insurer is typically not licensed in the locally subsidiary's country; accordingly, the global policy may cover some of the worldwide subsidiaries on an unlicensed basis. Since unlicensed insurance may not be permitted in the countries where some subsidiaries are located, the multinational's worldwide subsidiaries may be exposed to local regulatory risks. Even where local policies are issued within a CMP, the same regulatory risks may be triggered when a claim arises under the DIC/DIL provisions of the global policy. This predicament has spurred some multinational companies to request an FIC in their global policy.

The FIC enables a parent company to be insured for its financial interest in its subsidiary's loss where no local policy is issued. Effectively, the loss suffered by the subsidiary causes a reduction in the value of the parent company's financial interest in the subsidiary, for which it is indemnified under the global policy.



## The Nuts and Bolts of Multinational Insurance

A multinational company has several options to insure exposures around the globe. One is to utilize a series of separate local policies in each country. Another is to rely on a single policy with global territory coverage — often referred to as a global policy, which is issued in the multinational company's home country to cover itself and its worldwide operations. A third option is a Controlled Master Program (CMP), which combines local policies issued in various countries, with a global policy in the multinational's home country. Within a CMP, the global policy often functions as a backstop to the local policies, providing coverage for claims not covered under a local policy (i.e., Difference-in-Conditions or DIC) or where a local policy limit has been exhausted (i.e., Difference-in-Limits or DIL), subject to the global policy's terms, conditions and remaining limits. Because it usually has a worldwide territory, the global policy may also cover exposures in countries where no local policies have been purchased.

<sup>1</sup> In the interest of brevity, this Briefing Paper refers to subsidiaries. Both a global policy and Financial Interest Clause may, however, apply to other types of operations.

<sup>2</sup> The law of a particular country may expressly indicate which party it applies to and/or apply different requirements on different parties (i.e. broker, insurer or insured).

## Benefits and Limitations

The main benefit of an FIC is its potential to mitigate regulatory and tax issues that may arise for subsidiaries covered under a global policy issued by an insurer that is not licensed in the subsidiary's country. The local subsidiary is removed as an insured entity under the global policy; it is no longer involved in the transaction.

The FIC is also potentially cost-efficient for multinational companies that are concerned with centrally assessing and managing exposures, experience a low frequency of local losses, and/or have well-capitalized, independent local operations. Each of these factors mitigates the need for local insurance protection. The costs of multiple premiums, potential fees and taxes typically associated with purchasing separate local policies may outweigh the likelihood of a local loss or the costs to a well-capitalized operation able to manage potential losses on its own. In such cases, the multinational company may prefer to cover the parent and worldwide operations centrally, for the price of one global policy with the FIC.

Despite its potential advantages, however, the FIC is not a clear cut solution. To begin with, FICs do not replace local policies, nor do they afford any comparable local insurance services, such as premium collection, claims handling or tax settlement. This may carry important implications for both the parent and its subsidiaries, as discussed later in this paper.

Additionally, any recovery under the FIC may be defined by the amount of ownership interest the parent has in the local operation — whether it is a wholly-owned, majority-owned, or minority-owned subsidiary. Arguably, the actual loss suffered by the subsidiary may not necessarily equal the actual post-loss reduction in its value to the parent. In contrast, the parent is often looking to be covered for an amount equal to that which the subsidiary would have been covered for, had it been insured under the global policy.

## Weighing the Need

Some fundamental considerations can help you begin to assess whether an FIC makes sense for your world-wide exposures.

### Subsidiary Issues

- Do the subsidiaries experience a high frequency or severity of claims?
- Are the subsidiaries equipped to handle claims without insurance and/or capital from the parent?

Because the FIC does not afford any local claims handling or insurance servicing, it may not be effective for subsidiaries that have a history of high frequency or severity claims and/or are poorly capitalized to handle claims.

In contrast, the FIC may benefit a multinational company with a network of well-capitalized subsidiaries, assuming these subsidiaries are equipped to handle and absorb losses without relying on insurance or a capital infusion from their parent, and without jeopardizing their solvency. In such case, the FIC would allow the multinational company to centrally manage and be reimbursed for any shortfall created by foreign losses, without the additional costs associated with multiple local policies.

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## Compliance Issues

- How is unlicensed insurance addressed in the subsidiary's country?
- Will the parent company charge its subsidiaries premium for coverage under the FIC?
- Will the subsidiary seek a tax deduction for payments to the parent for FIC coverage?
- If the parent company is paid under the FIC, will it incur tax liability in its home country?
- If the parent company repatriates the FIC payment to its subsidiary, will the subsidiary incur local tax liability?

The regulatory climate in the subsidiary's country would need to be assessed, particularly with respect to any requirements for licensed insurance. Any inter-company payments for FIC coverage and/or tax deductions for these payments by the subsidiary may need to be evaluated from a local regulatory or tax perspective.

An FIC payment to the parent may also trigger unforeseen taxes in its home country. The tax authority may take the view that the parent company did not actually sustain the loss, and tax the FIC proceeds, often at significantly higher rates than insurance premium tax.

Additionally, the parent may seek to repatriate the FIC payment to its foreign subsidiary to make it whole for its loss. The effects of this capital infusion may need to be evaluated from a local tax perspective to assess possible consequences for the local subsidiary. The capital infusion could also be taxed as corporate income by the subsidiary's tax authority, requiring the parent to provide additional funds (in addition to the FIC payment) to fully cover the loss after tax. The local tax authority may alternatively impute local insurance taxes and penalties for insurance that was not procured locally.

## Conclusion

There is no one right way to structure a multinational program. The most appropriate program for each multinational company is the one that reflects its worldwide exposures, strategies, and preferences. As these aspects will differ from company to company, and evolve from year to year, so will the structure of the corresponding multinational insurance program. A well-structured CMP, including local policies with adequate limits, remains the most efficient option to ensure central coordination and consistent global coverage tailored to local requirements and needs.



### Biography

Rajika Bhasin is Associate General Counsel, AIG Multinational. In this capacity, she advises on a wide range of cross-border legal, financial and operational issues, including the design and implementation of sound risk management strategies across a multitude of industries.

Before joining AIG in 2006, Rajika was an Associate with Nixon Peabody LLP, where she represented multinational businesses in complex commercial, insurance and securities transactions and litigations.

Rajika has 15 years of experience in multinational business. She earned a B.A., summa cum laude, from the State University of New York at Buffalo and a J.D., cum laude, from Fordham University School of Law.

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