

Insurance
Winter 2009

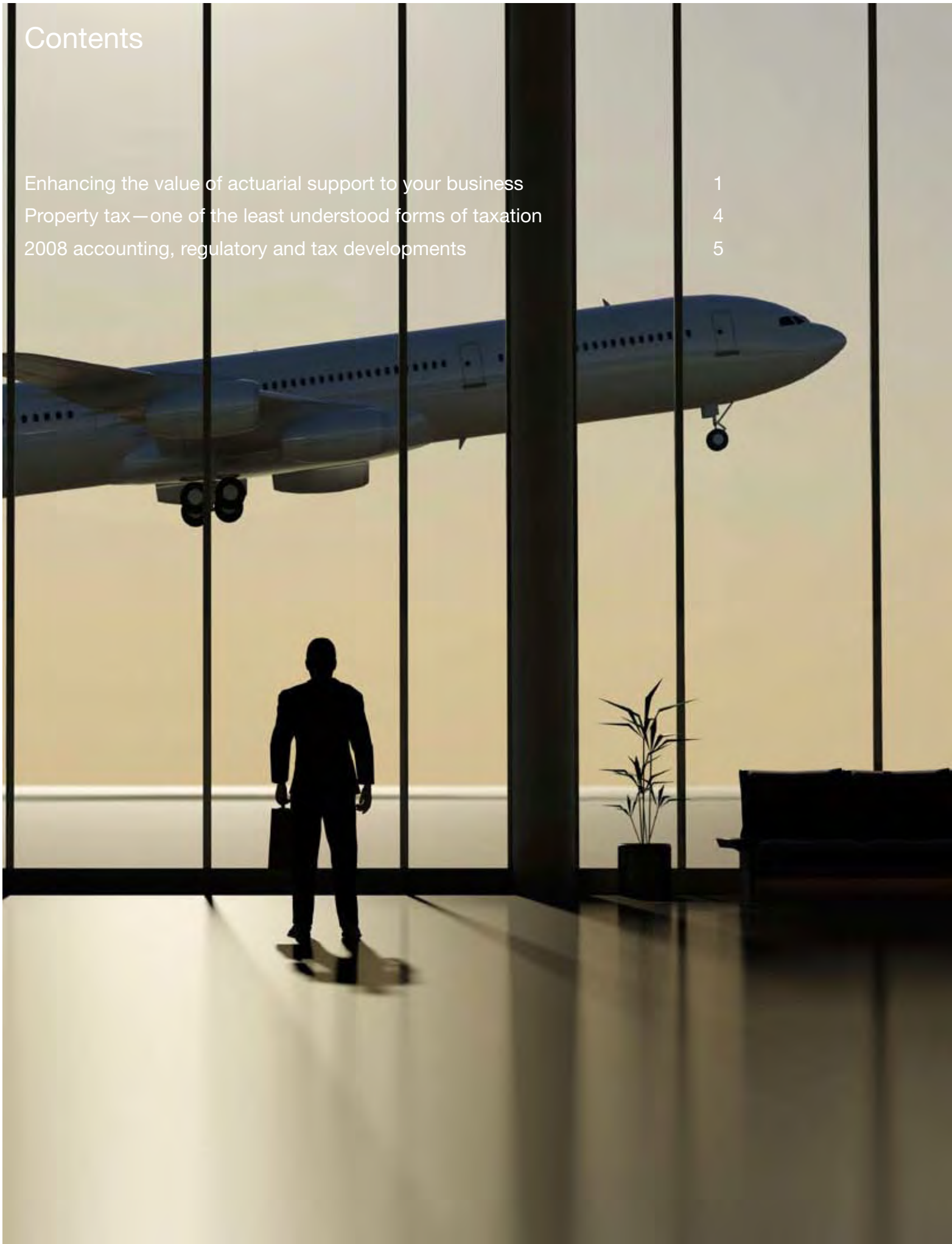
Adapting to a new economic reality

Insurance Review: A Canadian publication



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Enhancing the value of actuarial support to your business

Actuarial departments have been under mounting pressure to increase the quality and sufficiency of their support to the business functions. Business leaders' expectations of actuaries have risen to include value-added analysis and strategic support of business objectives.

At the same time, actuarial departments face increasing challenges from new regulations and accounting requirements, complex new products and financial structures (e.g. securitizations), and additional business needs (e.g. economic capital calculations and enterprise risk management support). Many Canadian insurers are recognizing that even more pending changes will drastically impact their actuarial processes and underlying models. They must consider the impacts of International Accounting Standards, which will require a more modular approach in four to five years; European/Market-consistent Embedded Value; Economic Capital; pending implementation of International Financial Reporting Standards;

Dynamic Capital Adequacy Tests; Minimum Continuing Capital Surplus Requirements; and new Canadian capital requirements under Solvency II. The challenges of dealing with these demands are frequently compounded by legacy systems, valuation models and disjointed processes, which often are the result of past acquisitions and/or mergers.

To overcome current challenges and to attain improved performance, a number of leading insurers have embarked on initiatives, which will improve the efficiency and effectiveness of their actuarial and quantitative operations. To deliver accurate, timely results and management information, while ensuring the most efficient and effective use of key resources, existing processes must be reviewed, redesigned and improved. Insurers increasingly recognize that re-engineering their actuarial environment today will deliver short term benefits, and free up scarce resources to focus on the necessary regulatory and accounting changes as they come.

Insurers who undertake actuarial process re-engineering initiatives focus on reducing complexity (in processes, controls, valuation models, and spreadsheets) and increasing standardization, automation, process efficiency and effectiveness. Typically, a holistic approach requires an examination of:

- People/resources efficiency and effectiveness (workload and performance).
- Organization structures, skills alignment, span of control, job descriptions.
- Core process flows (inputs, outputs, decisions, controls) and supporting tools.
- Effort and elapsed time, process sequencing, costs, integration of non-actuarial processes (tax, investments, finance), procedures and training manuals, signoffs and controls.

- Feeder systems, spreadsheet use, valuation models in terms of structure, efficiency and future requirements.
- Flow of information, inputs/outputs to and from the actuarial team, manual intervention and levels of automation.

Through such initiatives, insurers have been able to design new actuarial environments, as well as identify and prioritize improvement opportunities and the associated costs/benefits.

Typical improvement opportunities that have been identified include:

- Organizational changes to improve staff efficiency and effectiveness.
- Process improvements to reduce costs, time, effort and errors.

- Valuation model consolidation, improvement, redesign; spreadsheet remediation and automation to drive standardization and efficiency.
- Realignment of workload, handoffs and data feeds to improve integration with non-actuarial processes and inputs.
- Controls improvements and rationalization to streamline processes and quality assurance.

The following table highlights general areas of focus and corresponding improvements that insurers have identified through actuarial re-engineering.

Area of focus	Example process improvements
General	<ul style="list-style-type: none"> • Closing calendar that is coordinated with overall company timeframes and dependencies (e.g. data requirements) • Develop company policy that covers cut-off dates, calculation methodologies and process dependencies • Shift non-critical activities outside the critical close cycle • Establish guidelines for materiality and the use of estimates and develop methods for continual monitoring of materiality • Maximizing the efficiency of controls over data accuracy and completeness, for example: <ul style="list-style-type: none"> • Performing key controls as efficiently as possible • Removing non-essential controls
Technical Modeling Approach	<ul style="list-style-type: none"> • Use of more efficient methodologies for performing aggregation and incorporating risk correlations • Reducing the number of variables modeled stochastically for each run (e.g. using stress testing and interpolation to determine the results for less material business lines) • Optimizing the 'complexity versus practicality' equation, balancing the time and resource requirements versus the accuracy of results
Data Inputs and Assumptions	<ul style="list-style-type: none"> • Uniform assumption setting approach • Refine models and processes used to determine certain assumptions (e.g. best estimates, correlation matrices and calibration of stochastic distributions) • Refine data collection processes, data cleansing processes and improve controls around the data sourcing to minimize the risk of a rerun
Model Performance	<ul style="list-style-type: none"> • Moving manually intensive processes and spreadsheets to a more automated and controlled environment • Refinement of the stochastic models to improve run times (e.g. reducing the number of stochastic scenarios modeled for less volatile and/or less material blocks of business) • Refinement of data and technology infrastructure used to support Enterprise Content Management process (e.g. consolidation of risk engines used to model similar risks, multi-processor technology) • Removing immaterial blocks of business currently included in the calculation or reducing the frequency of calculation for these products
Analysis and Results Distribution	<ul style="list-style-type: none"> • Refinement of the processes used to facilitate analysis of the results, for example: <ul style="list-style-type: none"> • Automation of manual processes used to populate results templates • Maximizing the efficiency of the controls used to ensure accurate population of results templates

Increasing pressure for continuous improvement, raising quality and service levels, and to reduce costs is driving actuarial departments to leverage new practices. The challenge of staying abreast of the business leaders' demands plus changing accounting and regulatory requirements has made effective process management an imperative, not a choice. Leading insurers have learned that, in addition to optimizing technology, the most effective improvements result from how they manage the process.

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Property tax — one of the least understood forms of taxation

The recent market value reassessment of all properties by the Province of Ontario has called attention to an issue that often is a matter of contention for owners and landlords.

Property tax is managed and levied by municipalities on all properties within their boundaries. It is a major component of municipal taxes, the main source of funding for the municipal budget, which pays for services such as fire and police protection, garbage collection, road maintenance among others. Property tax usually is comprised of two components—education tax, which is set by school boards, and municipal tax, set by the municipality.

Provincial assessment authorities estimate the value of properties to which tax rates are applied. Periodically, the property assessment authority revalues all properties to a more current base year. This revaluation varies by province; for example, British Columbia and Alberta revalue properties annually, while Ontario has a quadrennial reassessment program. The estimate of the property value is a conservative market value as of a specific date.

Tax rates vary considerably between jurisdictions, depending upon the budget requirements of the municipality. The use of the property also is a factor in the determination of property tax rates.

Property taxes tend to be a big concern for owners and landlords, because they are inherently inequitable. It is more like a capital tax rather than an income tax—there is no notion of ability to pay in the assessment. Businesses tend to pay property tax at a higher rate than residential taxpayers, without the proven need for more public services. The rationale for this is the argument that businesses have a greater ability to pay.

Owners and landlords have the option to review the calculation of property taxes for their portfolio of properties. A property tax review can be described as an audit of the process the government applies when determining the property tax. Reviews typically include evaluating the quality of the assessment records, the steps taken and subjective considerations by the assessment authorities to estimate the value of the property, examining the applied tax rates and whether the rates properly reflect the use of the property, and equity among similar taxpayers.

Ontario completed a reassessment of all its 4.3 million properties with a base year of January 1, 2008 for taxation commencing January 1, 2009. With the roiling of the real estate markets through the latter part of 2008, and which is expected to continue in 2009, property owners and landlords may be well advised to review the property tax levy on their properties; however, time is of the essence. To initiate a review, an appeal for each property must be filed with the Assessment Review Board by March 31, 2009; otherwise, the opportunity to reduce the property tax payable for 2009 is lost.

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2008 accounting, regulatory and tax developments

Since the February 18, 2008, announcement of the Canadian Accounting Standards Board (AcSB) that publicly accountable enterprises will be required to use International Financial Reporting Standards (IFRS) for fiscal years beginning on or after January 1, 2011, revisions and amendments of Canadian Generally Accepted Accounting Principles (GAAP) have been minimal. In general, pronouncements have focused on convergence with IFRS standards.

The progress towards global implementation of IFRS was strengthened in August 2008, when the US Securities and Exchange Commission (SEC) proposed a roadmap for potential mandatory adoption of IFRS by issues in the US beginning in 2014. Subsequently, in October, the US standard setters (FASB) announced its decision to join the International Accounting Standards Board's (IASB) accounting for insurance contracts project. The objective of this joint IASB/FASB insurance contracts project is to develop a common, high-quality standard that will address recognition, measurement, presentation, and disclosure requirements for insurance contracts.

PricewaterhouseCoopers (PwC) recently issued the publication, *Called to account: A survey of insurers' 2007 IFRS annual reports*, in which it analyzed a cross section of 2007

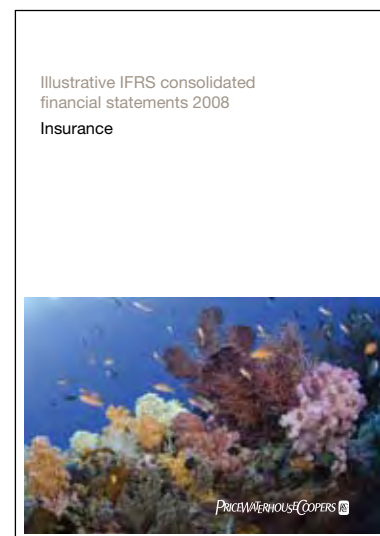
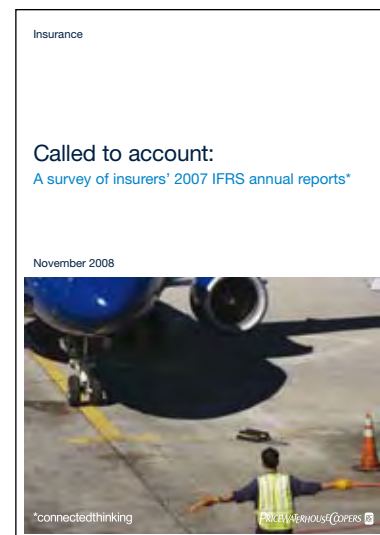
annual reports and explored how insurers are applying the latest developments in IFRS. This publication provides a survey of the disclosures from the major companies around the world and several good examples of the best practices.

IFRS Insurance Illustrative Financial Statements 2008

This publication has been prepared by PwC's global Accounting Consulting Service team in the UK and illustrates the disclosure and presentation requirements of IFRS and interpretations applicable to financial years beginning on or after January 1, 2008. We believe this publication will provide insights that can help enhance your understanding of IFRS and assist you as you prepare your own shell IFRS financial statements as part of your conversion process.

The illustrative financial statements are for a fictional multinational insurance group with both Life and Property & Casualty lines of business. Each component of the financial statements is referenced to the relevant IFRS requirements and certain additional example disclosures are provided in an Appendix to the financial statements.

Copies of both publications can be obtained from your PwC contact or the insurance leaders listed on the back cover of this publication.



Following are some Canadian developments of interest

Revised Handbook Section 3862, *Financial Instruments – Disclosures*

In November, the AcSB issued an exposure draft to revise Section 3862 to correspond to proposed amendments in IFRS 7. The changes are intended to enhance disclosures, especially considering current market conditions. Also, enterprises had expressed concerns that the nature and extent of liquidity risk disclosure requirements were unclear and difficult to apply.

For publicly accountable enterprises, the proposed amendments would be effective for interim and annual financial statements relating to fiscal years beginning on or after July 1, 2009.

Part XIII amendments – Insuring a risk in Canada

As discussed in the fall 2007 issue of the *Insurance Review – Focusing on the outcomes that matter*, modifications to the Insurance Companies Act will affect both foreign life and property and casualty entities in Canada. The main criterion now is on the location of insurance, rather than the location of risk.

In December 2008, OSFI issued implementation instructions, which assist insurance companies in the implementation of the amendments to Part XIII. Any business that will be removed from the books of a Canadian branch must be approved in advance by OSFI. All foreign insurance companies are required to file quarterly progress reports for 2009 – 2010, outlining the progress made on the implementation. The first report is to be filed no later than May 31, 2009.

CICA Section 3855 and Related Tax Legislation

Section 3855, *Financial Instruments – Recognition and Measurement*, which was effective for fiscal years beginning on or after October 1, 2006, continues to provide challenges for insurers with respect to tax provisions.

For purposes of calculating tax provisions, EIC-111 requires that legislation be “substantively enacted.” The proposed tax legislation, which outlines various transitions rules relating to fair value accounting of financial instruments, was tabled in November 2007 and also in July 2008. However, it never made it to a bill in parliament and was never substantively enacted.

Insurance companies should review both their 2007 tax provisions to ensure that potential adjustments are booked and that the 2008 tax provisions reflect the appropriate legislation. Disclosure of differences between filing according to the proposed rules and providing on the existing rules may be required depending on materiality.

Ontario corporate tax harmonization for insurance companies

Ontario’s corporate income tax and minimum tax will be administered by the Canada Revenue Agency, starting with taxation years ending after December 31, 2008. As a result of harmonization, the compliance burden of corporations that are taxable in Ontario will decrease significantly. Further details are provided in a recent tax memo issued by PwC. It is available from your PwC contact or from the website www.pwc.com/ca.

Flexibility in capital requirement calculations

In response to the volatile global market developments in 2008, OSFI gave special consideration to some stresses encountered by insurance companies.

In November, it issued an advisory, which gave additional flexibility to Canadian financial institutions when calculating its capital requirements. Certain borrowings, which are insured by the Government of Canada's Canadian Lenders Assurance Facility, or assets which benefit from equivalent guarantee or insurance programs operated by other governments, receive the same capital treatment as exposures to the government providing the support. Also, the aggregate limit on Tier 1 qualifying preferred shares and innovative instruments included in Tier 1 capital was being increased from 30% to 40%. These changes are intended to assist Canada's financial institutions in maintaining their position of strength compared to their international competition.

In December, two advisories related to innovative Tier 1 capital were revised. One provides clarification regarding preferred shares; the second has been updated for the Tier 1 capital treatment of trust preferred securities. The latter were previously qualified as Tier 2B capital.

Temporary Adjustments to Regulatory Capital Returns

In December, OSFI issued an advisory on *Temporary Adjustments to Regulatory Capital Returns to Take into Account Proposed Tax Changes*

on Fair Value Accounting for Financial Instruments. This advisory allows insurers to reflect the tax impact of the proposed mark-to-market tax law changes as though such changes had been substantively enacted. In January, OSFI clarified that regulatory financial statements will continue to be filed in accordance with GAAP.

Reinsurance regulations and supervision

In order to maintain a relevant regulatory framework that reflects the evolving global environment of reinsurance, a recent discussion paper outlines OSFI's regulatory and supervisory approach to reinsurance and identifies a number of initiatives. OSFI invites comments by the industry on the overall policy direction of reinsurance regulation and supervision in Canada.

Regulatory developments related to the pending adoption of IFRS

As discussed in detail in the 2008 summer issue of *Insurance Review*, OSFI expects all insurance companies to submit a semi-annual progress review of the IFRS implementation project. The reports, which commence in the 2008 fiscal year-end, should be modelled after the disclosure requirements issued by the Canadian Securities Administrators.

Optional Accounting Policy Changes Arising From the Adoption of IFRS 4 Insurance Contracts

At the time of IFRS implementation in 2011, the IASB does not expect to have finalized Phase II of its project related to accounting for insurance contracts. Thus, on an interim basis, insurers would be required to adopt IFRS 4, Insurance Contracts.

However, where permitted by IFRS, insurers may intend to continue to account for insurance contracts using their existing accounting policies, including the applicable Canadian actuarial standards and guidance until Phase II is implemented.

OSFI issued guidance on certain financial reporting implications and expects that insurers will continue to use pre-IFRS 4 Canadian GAAP accounting policies for insurance contracts until Phase II is adopted. The exception are required IFRS changes and certain permitted accounting options, which are outlined in the letter; as well, OSFI must agree to a change in accounting policy for insurance contracts in advance.

Framework for a New Standard Approach to Setting Capital Requirements

Since the early 1990s, there have been advances in actuarial and economic capital theory that are difficult to incorporate into the existing solvency framework. The increased complexity of products and globalization of insurance products requires a modernization of the current approach for measuring capital requirements. Also, impending accounting changes will make it necessary to update the standard Minimum Continuing Capital and Surplus Requirements (MCCSR) approach.

A working group to update the current framework that would form the Standard Approach for the new solvency framework was formed in 2007. It includes representatives from the Autorité des marchés Financiers, OSFI and Assuris.

Figure 1 shows the four categories of risk that will be the foundation for the new methodology. In future, the possible recognition of concentration or diversification of risk may be incorporated.

Figure 1: Four Categories of Risk

Risk Category	Solvency Buffer
Credit risk is the risk of default by counterparties on loans, debt instruments, derivatives, and reinsurance.	The solvency buffer for credit risk will use factors developed from the best available information, and be similar to the method currently used in the MCCSR.
Market risk is the risk that changes in the financial markets will affect the value of assets and liabilities. This includes interest rate, spread, equity, and currency risks.	The solvency buffer for market risk will use deterministic shock calculations for interest rate, equity, real estate, and currency risks.
Insurance risk is the risk of adverse future experience in mortality, morbidity, and policyholder behaviour, including lapse rates.	The solvency buffer for insurance risk will be calculated using either a formula or an integrated combination of shocks to the mortality, morbidity and lapse assumptions used in calculating best-estimate insurance obligations.
Operational risk is the risk that the company's business processes will fail, or that the company will fail to comply with laws and regulations. The financial impact of loss of reputation is also included in operational risk.	The solvency buffer for operational risk will be calculated by applying a factor. In addition, the solvency buffer will also contain a margin for future expenses that exceed those assumed in the calculation of the best-estimate insurance obligations.

PwC Insurance Club
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March 5, 2009

Total tax contribution and corporate social responsibility of insurance companies

Organizational accountability and the burden of taxes are two significant issues faced by insurance companies. An increasing number of influential stakeholder groups expect organization to report on their environmental, social and economic performance in a comprehensive, understandable and timely manner. As a result, many organizations release corporate social responsibility report, which include information on all of the business taxes they pay over and above corporate incomes taxes. For the insurance industry, there are also additional regulatory costs which may not be recognized as part of the industry's overall economic contribution.

To join us for the presentation, please register by calling 416 941 8383 ext. 14498 or online at www.pwc.com/ca/insuranceeyeopener

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