Facing up to the challenges in the insurance industry*

Insurance Review
A Canadian publication • Year-end 2007

Contents

Insurance Banana Skins 2007

The Centre for the Study of Financial Innovation (CSFI) earlier this year completed its inaugural Insurance Banana Skins survey of leading members of the insurance industry to find out their concerns about the soundness of the financial markets.

The survey, sponsored by PricewaterhouseCoopers (PwC), puts together a league table identifying potential sources of risks to the insurance industry and ranks them by severity. This year's survey is based on 139 responses in 21 countries.

The poll of top insurance practitioners, brokers, regulators and analysts identified regulatory overkill as the greatest risk facing the industry. More than 100 respondents to the survey said that excessive regulation is endangering the industry by loading companies with costs, distracting management and creating barriers to competition and innovation. The finding was linked to concern about growing political interference, particularly in markets where governments regulate insurance products and prices.

Other high-level risks identified by the survey include natural catastrophes and climate change, where insurance losses for the property and casualty sector are rising fast, particularly in heavily populated areas. The main risks facing the life insurance industry include growing human longevity and the soundness of assumptions going into the pricing of life policies.

Following is the summary of the survey. The full report can be obtained from your PwC insurance contact (please see details at the back of this publication) or purchased from CSFI's online store at bookstore.csfi.org.uk.

Summary

The burden of **too much regulation** is the greatest risk currently facing the insurance industry, according to this survey of insurance practitioners and observers. New rules and compliance requirements are eroding the profitability of the industry and distracting management from the task of running an efficient business.

Concern about over-regulation is geographically widespread, affecting markets in North America, Europe and Asia Pacific. Sectorally, it is strongest in the life insurance sector, followed by property and casualty.

The sharp rise in **natural catastrophes** is the No. 2 risk in the industry, led by concerns in the property and casualty and reinsurance sectors. The growing incidence of catastrophe in highly populated areas makes this a difficult risk to price. These concerns are closely linked to risks associated with climate change, which came in at No. 4. These classes of risk were seen to be ones that were rising fastest.

The **quality of management** (No. 3) is a big worry at a time when the industry faces huge pressures on the business and regulatory fronts. There is also apprehension that insurance companies may be failing to attract enough new blood to build future management capability.

The **insurance cycle in the property and casualty sector** is in its downward phase (No. 5), which will test the industry's ability to handle a soft market. A particular concern is the presence of **new competitors** such as investment banks and hedge funds (No. 10) who are adding capacity to the market and driving down prices, but whose ability to withstand the difficult phase of the cycle has yet to be tested. Concern about cycle management was most marked in the property and casualty and reinsurance sectors. The

availability of capital was voted the least of the industry's concerns outside the reinsurance sector.

The survey exposed questions about the industry's management of **longer term risks** and the impact of **greater longevity**. Many respondents felt the industry was being slow to adjust to changes in how long people live, and that its dependence on actuarial assumptions was both excessive and a sign of its conservatism. Longevity issues (No. 9) were of particular concern to the life sector, while the property and casualty/reinsurance sectors focused on long tail liabilities (No. 7).

Questions about the industry's **investment performance** (No. 11) centred mainly on its ability to manage some of the new-fangled investment classes which have appeared on the market, such as derivatives and hedge funds. There was less concern about its exposure to more conventional investment markets such as equities (No. 13) and **interest rates** (No. 22).

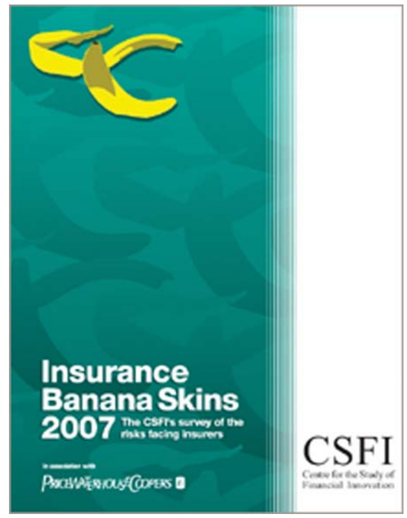
Outside the tops risks, notable findings included **political shocks and pressures** (No. 16) which showed the industry to be facing strong governmental interference in many countries: the US, Canada, New Zealand, Russia and several emerging markets. This pressure usually takes the form of obligations to provide insurance of a type and at a price set by government.

Although concern about the quality of **corporate governance** (No. 23) in insurance companies is relatively low, the survey showed that the industry is worried about its **reputation**, both as a business partner and as a career prospect.

Striking too are the lowest risks: **too little regulation** came one from the bottom at No. 32 (though some respondents felt more could be done to increase international co-operation) and **asbestos** (No. 33), once the scourge of the industry but now distinctly passé.

Preparedness

The survey sought views on how well-prepared the insurance industry was to handle the risks that had been identified. The majority of the respondents felt preparedness was "mixed." Just over a fifth answered "well," and only three per cent thought the industry was poorly prepared.



Top 10 Insurance Banana Skins 2007

1. Too much regulation
2. Natural catastrophes
3. Management quality
4. Climate change
5. Managing the cycle
6. Distribution channels
7. Long tail liabilities
8. Actuarial assumptions
9. Longevity assumptions
10. New types of competitors

Ontario tax harmonization – strengthening business through a simpler tax system act

Ontario's corporate income tax and minimum tax will be administered by the Canada Revenue Agency (CRA) starting with taxation years ending after December 31, 2008. As a result, the compliance burden of corporations that are taxable in Ontario will decrease. They will file a single combined federal and Ontario tax return, make combined tax payments to the CRA and will also benefit from a streamlined tax system that includes a harmonized corporate income tax base.

Bill 174, Strengthening Business through a Simpler Tax System Act, received Royal Assent on June 4, 2007 and implements changes to Ontario corporate income tax in order to align the Ontario and federal corporate income tax base. Most of the changes are to eliminate Ontario-only measures that cause differences with the federal tax base.

Ontario will become the eleventh of the thirteen provinces and territories for which the CRA administers the collection of corporate income taxes.

Transitional rules

Harmonization will affect items included in, or deductible from, income for Ontario tax purposes that differ from those used in computing income for federal tax purposes. For taxation years ending after December 31, 2008, federal tax attributes, such as balances in loss pools and undepreciated capital cost pools, will also apply for Ontario corporate tax purposes. Under transitional provisions, the adoption of federal tax attributes may create an additional tax liability (transitional debit) or a non-refundable tax credit (transitional credit).

Corporations have a five-year amortization period, starting in their transitional year (i.e. first taxation year ending after 2008) and up to four calendar years later to pay any transitional debit or utilize any non-refundable transitional credit.

Tax accounting

The harmonization rules were substantively enacted under Canadian generally accepted accounting principles (GAAP) on December 13, 2006, and enacted for US GAAP purposes on June 4, 2007.

Before the transition date arrives, corporations must determine the possible financial statement effect of moving to the harmonized tax system. For most, the recognition of any transitional debit or credit arising on the transition date will likely be offset by an equivalent increase or decrease in the financial statement current and future tax adjustment required on transition. However, in some situations, a corporation may have to recognize an unexpected recovery or expense in the financial statements.

Early planning

Bill 174 implements substantial changes to the Ontario tax legislation. A key challenge for insurers is assessing the impact of these changes on their business.

Early planning should be done to assess the likely differences between the federal and Ontario tax attributes and what measures can be implemented to minimize any tax transitional debit and fully utilize any tax transitional credit.

For additional commentary refer to our publication, "Ontario Corporate Tax Harmonization: What it means" on our website, at www.pwc.com/ca.

2007 accounting, tax and regulatory developments

Following is a discussion of selected accounting, tax and regulatory developments that are of interest to Canadian insurance companies.

Accounting developments

New financial instruments standards

2007 saw the implementation of several new financial instruments standards: CICA Handbook Section 1530, *Comprehensive Income*; Section 3855, *Financial Instruments – Recognition and Measurement*; Section 3861, *Financial Instruments – Disclosure and Presentation*; and Section 3865, *Hedges*.

A discussion of some of the fundamental changes resulting from these standards was included in the 2006 year-end issue of "Insurance Review." For detailed guidance on the enhanced disclosure requirements, please refer to PwC's recent brochure, "Dealing with the impact of the new financial instruments standards – A guide to the expanded disclosure requirements," which is available from our website or from the contacts listed at the back of this publication.

The accounting standards referred to above represent the first wave in the overhaul of financial reporting for financial instruments. 2008 will see expanded reporting requirements, as other accounting standards, in particular, CICA Handbook Section 1535, *Capital Disclosures*; Section 3862, *Financial Instruments – Disclosures*; and Section 3863, *Financial Instruments – Presentation*, come into force.

International Financial Reporting Standards (IFRS)

The Accounting Standards Board intends to implement IFRS for publicly accountable Canadian companies effective for fiscal years beginning on or after January 1, 2011; the final decision on the date of the implementation is expected in March 2008. Adopting IFRS will be a complex undertaking for all entities. For insurers, the task will be even more challenging as a result of the implementation of IFRS 4, which will fundamentally change the way insurance contracts are measured.

A successful transition to IFRS will require planning, developing and executing a well-thought-out conversion strategy. Companies are encouraged to start early on the path to implementation—especially, considering the requirement to provide comparative numbers for prior years—by performing a top-down diagnostic review, identifying differences between Canadian GAAP and IFRS, determining the impact on required disclosures and addressing any necessary system changes.

IFRS 4

In May 2007, the International Accounting Standards Board (IASB) released a paper proposing that insurers measure their insurance liabilities using the following building blocks:

- explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows;
- current market discount rates that adjust the estimated future cash flows for the time value of money; and
- an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).

The IASB sought comments on the paper, which it plans to analyze in the first quarter of 2008. While the exposure draft is expected to be published in 2009, we understand that the standard may not be finalized until after 2011.

Tax developments

New GST measures

Early in 2007, the Department of Finance (Finance) released measures that impact the administration and recovery of the federal goods and services tax (GST).

In the Summer issue of "Insurance Review," we outlined these changes and encouraged insurers to conduct a review and determine the implications for their organization.

Draft legislation relating to the new financial instruments standards

It appears that the draft legislation by Finance is consistent with the principles stated in its December 2006 press release. One significant change is the treatment of bonds held as at December 31, 2006, which now are marked-to-market, consistent with the accounting treatment, i.e. carried at fair market value; the impact of the tax changes is being spread over five years. Changes in actuarial liabilities resulting from the new financial instruments accounting standards also will be brought into taxable income over a five-year period.

As well, the definition of "mark-to-market property" has been expanded to include a new item defined as "tracking properties." This will include certain properties that are carried at fair value in the financial statements. Therefore, the mark-to-market property definition may have been significantly broadened. The specific types of items that will be considered to be tracking properties are uncertain.

Ontario corporate tax harmonization

Ontario is moving towards harmonization of its tax regime with the federal government effective in 2009. For more details, please see the article, "Ontario tax harmonization," in this issue of "Insurance Review."

Regulatory developments

Insurance risk in Canada

An amendment to the Insurance Companies Act (Act) that was enacted in April 2007 clarified that Part XIII of the Act only applies to foreign life and property and casualty entities that insure a risk in Canada. In particular, the focus will now be on the location where the insurance is underwritten rather than on the location of risk.

The impact that this change could have on foreign insurers was discussed in the Fall issue of "Insurance Review."

Equity investment limit

The adoption of the new financial instruments accounting standards may have caused some companies to exceed the equity investment limits outlined in the Act.

If the violation of the limits can reasonably be attributed to the adoption of the new financial instruments accounting standards, the Office of the Superintendent of Financial Institutions (OSFI) has stated that it will not issue a notice of violation or impose a monetary penalty.

OSFI's Memorandum to the Actuary

This year's memorandum includes additional disclosure requirements to address the effects of Section 3855, enhanced disclosure of financial reinsurance arrangements and related party reinsurance, and enhanced disclosure for segregated funds.

Recent PwC publications

European InsuranceDigest

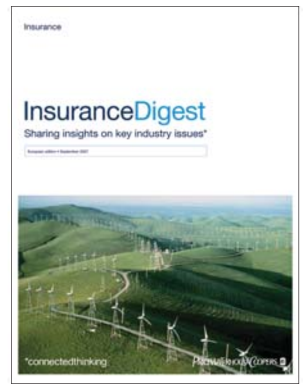
This publication is dedicated to providing thought-provoking insights into some of the key strategic issues facing the insurance industry in Europe.

May 2007
Articles in this edition are:

- Sourcing at the crossroads
- Taking claims to the next level
- Releasing the value in discontinued business
- The insurance sector in India: Poised for further liberalization and growth
- Turning risk into reward: Making the most of economic capital

September 2007
Articles in this edition are:

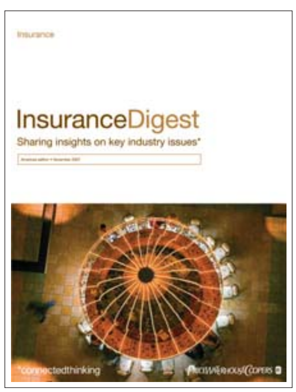
- Feeling the heat: Dealing with the impact of climate change
- Growth through acquisition: Drivers and developments in insurance M&A
- Accession accelerates growth: The insurance markets in Central and Eastern Europe
- Realizing the potential of life securitization
- Capitalizing on opportunity: The insurance market in Bermuda
- Measuring up: Fair value and IFRS for insurers



Americas InsuranceDigest

November 2007
The Americas InsuranceDigest addresses the key issues driving the insurance industry. This edition includes articles on the following hot topics:

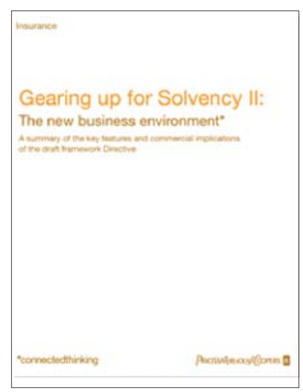
- Economic capital: Recognizing the value of risk
- ERM: No longer a nice-to-have
- A road map for surviving the credit crunch
- Catastrophic loss estimation: Overview of current practice
- Insurance risk transfer: Tax red flags to watch for



Gearing up for Solvency II
The new business environment

The European Commission's draft framework Directive for the rationalization, harmonization and modernization of insurance regulation in the European Union was launched in July 2007. The Directive includes ambitious and far-reaching proposals for a new, principles-based and risk-sensitive solvency regime.

Gearing up for Solvency II is designed to give readers an overview of the key features and their broad commercial implications.



The new deal: Financial services M&A in an IFRS environment

This paper discusses International Financial Reporting Standards (IFRS) and their impact on financial services institutions and the users of their accounts.

In the long run, the more revealing IFRS information will make it easier to judge whether a takeover has been a success or failure, and lead to more probing questions from the market. Companies will therefore need to increase evaluation and due diligence and look more closely at how to justify any deals.

Fresh perspectives 2007

Globalization offers opportunities for new market penetration, broader customer service offerings and innovation. Yet to realize the full potential, financial services organizations need to understand the risks and realities of growth, including working with diverse cultures and managing dispersed resources.

The fifth edition of this annual publication provides a snapshot of our activities in the UK financial services sector, along with insight on some of the key issues linked to globalization facing the industry, including M&A, risk and regulation.

Get set for IFRS Insurance Phase II

The planned changes, the business implications and what you should consider doing now

IFRS Phase II proposes to replace any old-fashioned, often excessively prudent approaches and move towards a more current and market consistent basis that applies to all types of insurance contracts. Solvency II proposes a very similar approach. Mindful preparation will ensure adequate resource is in place to deliver plans to meet the 2012 expected implementation date.

Companies should consider:

- Systems upgrades would be necessary for all businesses. Insurers who have already implemented group-wide systems that use current market data (e.g. economic capital or embedded value) could have a head start over competitors.
- Finance and actuarial departments must evolve to transform themselves in hybrid units where both actuarial and accounting excellence is concentrated to deliver optimal input in all business decisions.

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100 Years

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