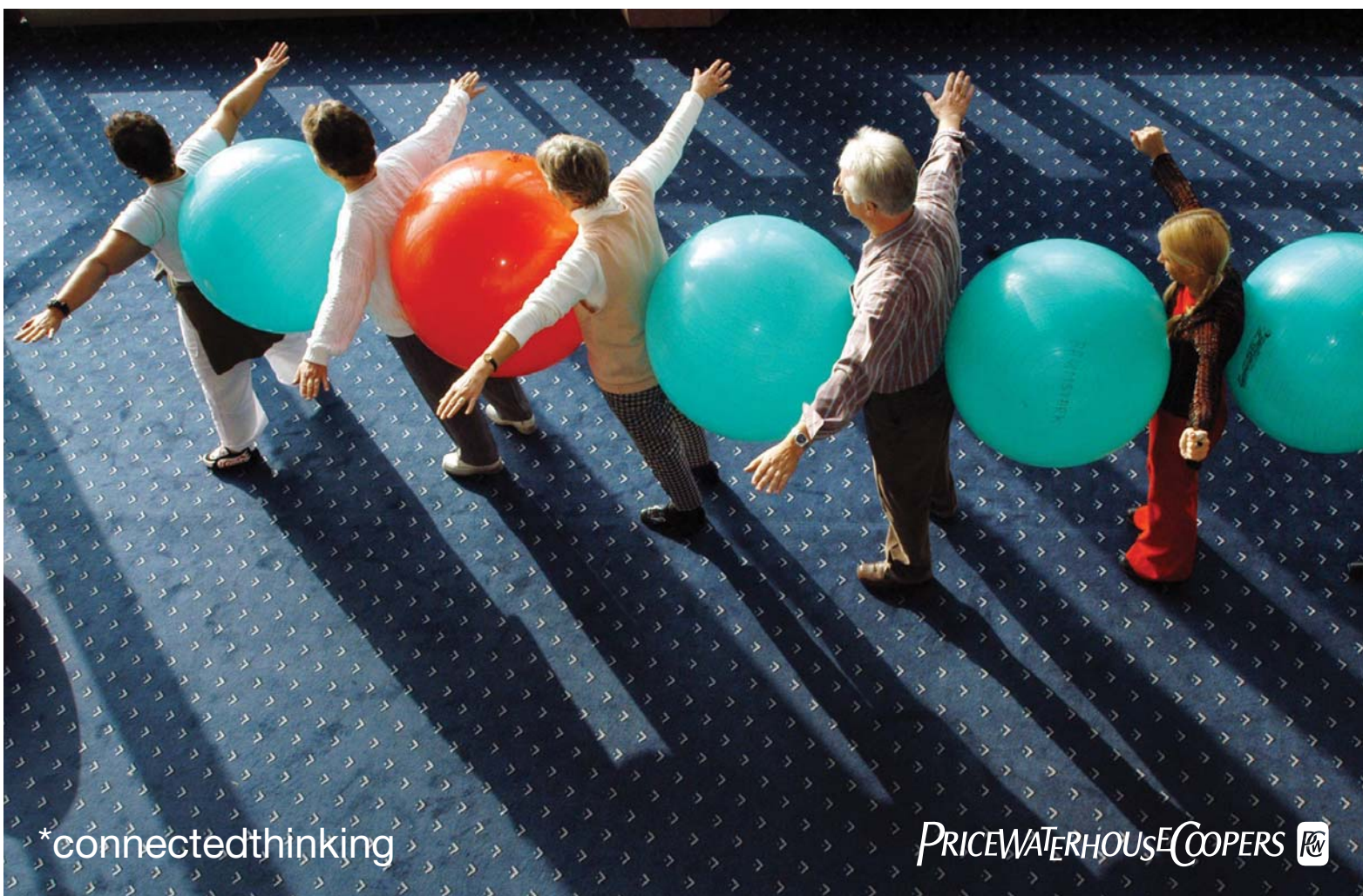


# Focusing on the outcomes that matter\*

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\*connectedthinking

PRICEWATERHOUSECOOPERS 



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# Integrating governance, risk management and compliance

Given today's global business environment, organizations are starting to see governance, risk management and compliance (GRC) as integrated concepts that offer significant benefits regardless of cost or effort. Undeniably, these benefits do not come easily.

In a recent PwC survey, many CEOs acknowledged that integrating GRC is a significant challenge. But in order to avoid surprises, make better business decisions, improve efficiency, proactively protect brand value and corporate reputation, and maintain shareholder value, it is a challenge that must be met.

## Understanding the current environment

Insurance executives are well aware of the markedly increased regulatory and compliance requirements in the past few years—the Sarbanes-Oxley Act of 2002, the introduction of Auditing Guideline 43 in 2006, plus the proposals to apply Solvency II to insurance companies—the launch of new regulations is beginning to seem like a never-ending event.

The proliferation of rules and regulations has resulted in inefficiencies and, in many cases, duplicate efforts. Businesses are being stretched and the effort to comply is taking its toll.

Financial institutions are also facing an amplified focus on risk management, and more and more insurers are using economic capital to support capital allocation and risk-based performance measures. In addition, rating agencies have expanded their analysis of Enterprise Risk Management (ERM) practices when determining credit ratings. This is not new, but the rating agencies have expanded their focus on ERM considerably in recent years, and today their analysis encompasses operational risk and the governance related to risk management processes, e.g. the setting of tolerance levels.

GRC are important elements when it comes to the reputation and brand of financial institutions. Organizations need to address GRC integration at its foundation; “band-aid” or “stopgap” solutions are no longer enough.

Financial institutions have typically approached compliance with the new rules and regulations with a “silo” mentality. Compliance activities in the underwriting department may use different data sets than the ones applied in the policyholder service department. As a result, there is a lack of integration across business lines and corporate functions. In an effort to meet deadlines and other organizational constraints, management often has not exploited the opportunity to adopt a measured and strategic approach, which could determine how existing processes and platforms might address new needs. While this is an understandable line of attack, it is not sustainable and cannot continue in an increasingly competitive market.

Through thoughtful analysis and study, institutions can identify points of integration within a function or across functions and potentially leverage common methods, processes, technology, people and data across their existing governance, risk management and compliance silos.

## Challenges of integrating GRC

Insurance companies are now looking at GRC—and the processes they rely on to manage and protect their brand reputation, the organization and ensure a controlled approach to financial growth—in a new light. Connecting and integrating GRC has quickly become a “top of mind” issue for virtually every financial institution looking to reduce the burden on its organization and establish an integrated and consistent approach to controlling exposures, managing risks and creating value.

Through this targeted integration, companies can optimize risk and governance performance enterprise-wide and enhance operational effectiveness and efficiency.

Adopting an integrated approach to GRC presents two key challenges:

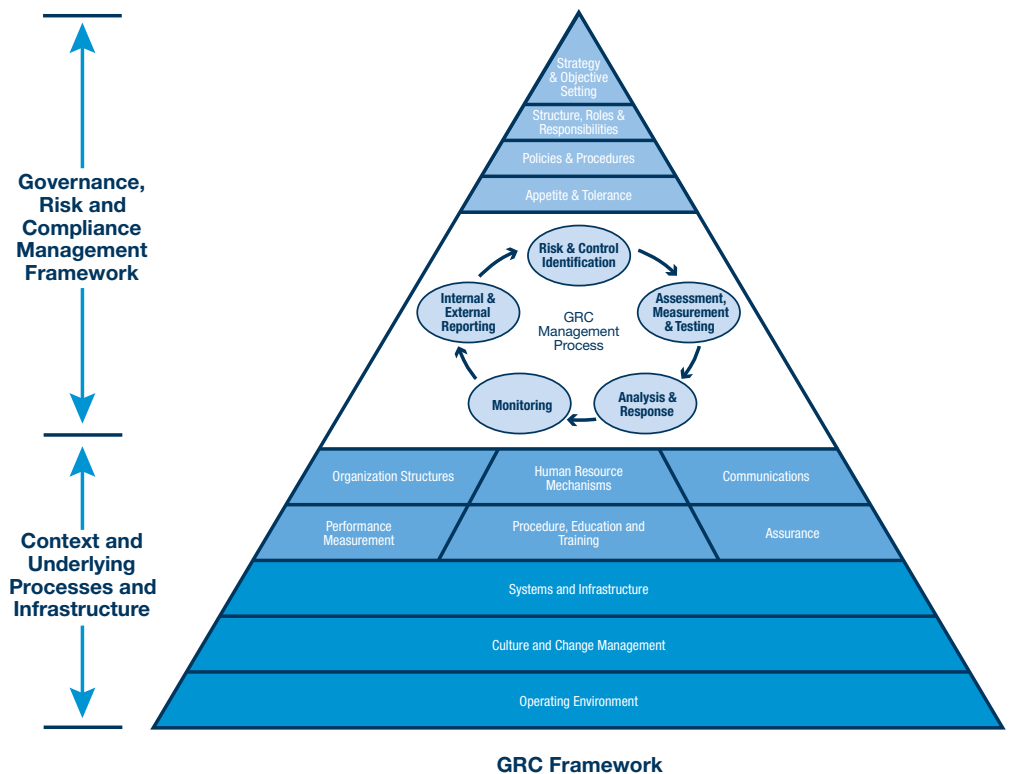
- Aligning the GRC frameworks and processes already in place; and

- Ensuring that the approach can adapt to new regulations and requirements and won't cause problems down the road as the environment and business requirements change.

Adopting a principles-based view to understanding and framing GRC requirements and a structured

approach, which aligns and integrates the GRC environment, can decrease costs and streamline GRC processes. Consistent policies, procedures and enhanced information allow business units to achieve greater efficiencies which, as a result, effectively reduces the organization's GRC overhead.

**Exhibit 1 – Sample GRC framework**



## Establishing a GRC framework

Regardless of its final form, a GRC framework should leverage the strengths of the organization and be grounded in five critical elements:

- strategy and objectives;
- governance;
- policies;
- risk appetite and tolerance; and
- GRC processes.

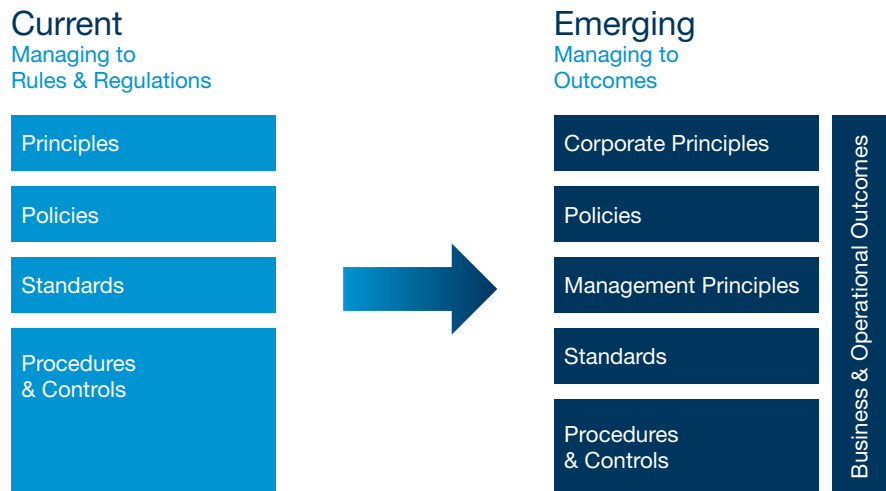
While there is not one definitive GRC framework, they all have similar elements. Exhibit 1 depicts one possible representation. A successful GRC framework will build on and be supported by the institution's culture, competencies, processes and infrastructure.

A good first step is to align the rules and regulations the institution operates within. Institutions that want to move to a principles-based approach need to frame how the institution thinks about its GRC strategy and objectives; this will provide a structure that aligns internal and external requirements.

A principles-based approach also ensures the completeness of the framework and activities, and offers a defensible base for evaluating and discussing changes to the GRC environment. This approach enables insurers to more effectively communicate with regulators and stakeholders, and these organizations will be better positioned to respond to changing objectives, strategies or regulatory requirements.

Moving to a principles-based approach will also present the opportunity to reduce the complexity of the control environment, as well as the ability to rationalize the number of controls in place. Exhibit 2 presents a visual representation of the change in the governance and controls structure that is possible with such a move. A critical element when applying this methodology is the definition of expected business and operational outcomes. Expected

### Exhibit 2 – Moving to a principles-based GRC approach



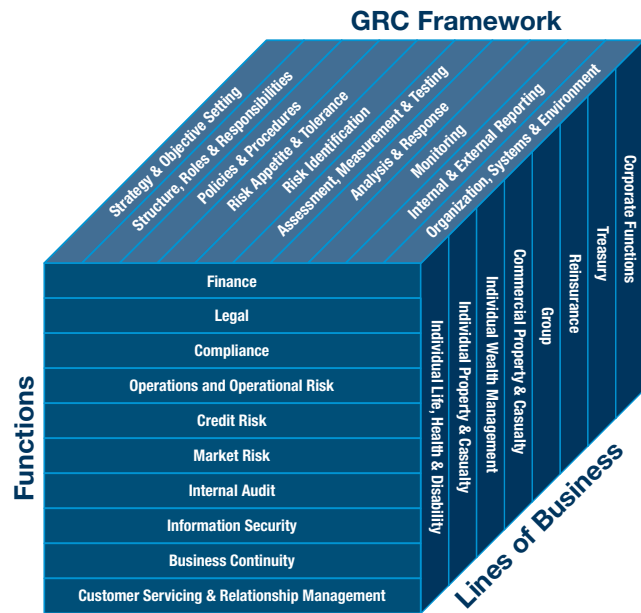
outcomes need to be established at all levels of the organization and should be integrated with corporate level objectives. In this way, principles are used to focus the organization on the outcomes that matter and to align organizational governance in support of achieving those outcomes.

The second step is aligning the organization’s GRC processes; this ensures consistency and reduces duplication of effort in responding to GRC issues. Insurance companies need to map their risk and compliance processes to identify common steps and process elements, then areas of potential consolidation. Essentially, organizations need to deconstruct their risk management and compliance processes and rebuild them, using a set of common elements that are shared across the organization.

To achieve this goal, organizations should leverage a “Building Blocks” approach. The Building Blocks should be underpinned by the established GRC principles—this allows the principles to be put into operation in a way that’s easily understandable. A Building Blocks approach helps companies design a GRC process that is both comprehensive and robust.

Exhibit 3 illustrates how a GRC framework connects to the institution’s GRC functions and lines of business. This perspective helps evaluate opportunities for integration and alignment of GRC processes, roles (people), systems and information.

**Exhibit 3 – The GRC matrix**



The GRC matrix leverages the overarching GRC principles and maps them against the GRC functional areas and lines of business inside the institution. The GRC matrix can be used at a principles level or taken to a process level.

### Keys to successfully integrating the GRC environment

- Determine scope. After an initial scan of the organization, determine the scope of the GRC silos to be optimized. Limit the scope initially, then demonstrate value and quickly expand.
- Build on a proven GRC principles' taxonomy and a common process framework. Begin by ensuring the completeness of the standards and practices for each area. Provide a basis to identify common objectives, requirements and components.
- Use an operating levers model for evaluation. Operating model levers can establish a shared framework for identifying common components across GRC silos and can provide a structure for evaluating the

GRC environment across the organization.

- Leverage internal and “real world” expertise. Capitalize on the depth of understanding of discrete business units and GRC functions from internal and external sources. Capture the breadth of knowledge and understanding across disparate GRC silos.
- Clearly communicate expectations. Include stakeholders in the integration of the GRC environment early and keep them engaged. Communicate critical project elements like scope, approach and timing on a regular and consistent basis.

### The tipping point

New rules and regulations are rapidly being introduced and global competition is increasing. Financial institutions have reached a tipping point and they can no longer afford to take a disconnected, “siloed” approach to GRC. It's time for governance, risk management and compliance units to work with business units to reduce the organizational burden and better enable profitable growth.

# Mergers and acquisitions in the P&C brokerage industry

The fast pace of recent merger and acquisition (M&A) activity amongst large insurance companies was the topic of discussion in the Spring 2007 issue of Insurance Review. Transactions such as the acquisition of John Hancock by Manulife, the management buy out of GCAN Insurance Company (backed by Teachers' Private Capital) and Great-West Life's purchase of Putnam Investments, pose significant challenges for integration and optimizing the return on the deals.

In addition to these large, headline-making deals, there is another sector of the insurance industry that is also experiencing significant M&A activity: property and casualty (P&C) insurance brokers. These transactions, while much smaller in absolute dollar value, create their own, though different, challenges.

The M&A activity in the P&C insurance broker field is being driven by a number of factors:

- the aging demographics of insurance brokers cause some of them to seek exit strategies;
- independent insurance brokers looking to grow their business, develop their expertise and achieve economies of scale;
- insurance companies seeking to grow their own channels to market their products; and
- private equity investors with available capital looking for investment opportunities in highly specialized sectors.

PwC Corporate Finance insurance specialists have been tracking both broker and managing general agent M&A activity in Canada over the past 12 months. While details of the transactions are not always disclosed, the market is experiencing unprecedented multiples ranging from 2 to 3 1/2 times commission income or earnings before interest, taxes, depreciation and amortization (EBITDA) multiples between 6 and 13.

These high multiples, which are primarily driven by larger institutional transactions, are attractive to some insurance brokers seeking an exit from their business. However, not all brokers are swayed by the high multiples and many individuals in the

broker community continue to place a high value on their ability to remain independent. Consequently, there are a growing number of brokers across Canada who themselves are pursuing aggressive growth strategies through acquisitions. Yet another alternative is provided by private equity investors, which allows brokers to exit their business and also maintain the independence of their brokerage.

## No end in sight to broker M&A activity

In the article "Timing is Everything" (Canadian Insurance, April 2007), it is estimated that over the next five years, buyers will outnumber sellers by a ratio of nearly 2 to 1, which will continue to place upward pressure on multiples.

Given the current level of activity in the marketplace and the multitude of diverse buyers, it is imperative that brokers carefully analyze the various alternatives available to them, be they exit strategies, remaining independent and/or expanding their business. In order to understand the implications of these choices, they should draw on the expertise of professional advisers to assist them in making decisions that are of optimal benefit to them.

# What is an insurance risk in Canada? The change in the definition may affect your business.

As part of the regular five year review of the federal financial institutions legislation, several modifications to the Insurance Companies Act (Act) were enacted in April 2007. One of the amendments clarifies that Part XIII of the Act only applies to both foreign life and property and casualty entities that insure in Canada a risk. In particular, the regulatory focus with respect to foreign companies will be on the *location of insurance*, rather than the *location of risk*. Until now, Canadian branches of foreign insurers have generally accounted for risk located in Canada only.

In a letter to Canadian branches of foreign insurers, OSFI indicated it has recommended to the Department of Finance that this amendment come into force on January 1, 2009. At that time,

- (1) risks located in Canada but insured outside of Canada by foreign companies will no longer be subject to Part XIII requirements (including reporting and vesting requirements); and,
- (2) risks located outside Canada, but insured in Canada will become subject to Part XIII requirements.

As a transitional measure, OSFI will presume all risks reported on the books of a Canadian branch as at January 1, 2009 to have been insured in Canada. These risks will therefore be subject to Part XIII requirements, unless the foreign company satisfies OSFI that some or all of those risks were insured outside Canada.

In respect of scenario (2), OSFI expects that insurers will use their best efforts to identify all risks located outside Canada within a reasonable time frame. To assist foreign companies in determining where a risk was insured, OSFI issued an Advisory entitled “Insurance in Canada of Risks.”

The impact of the above changes is summarized in Table 1.

## Financial reporting considerations

Prior to 2009, risks located in Canada, but insured outside of Canada, are required to be recorded in the financial statements of a Canadian branch. The new legislation will require such business to be identified and removed from the branch records effective January 1, 2009. One of the main benefits of removing this “insured outside of Canada” business from the branch will be the reduction of the required capital. However, there may potentially be adverse impacts on reinsurance arrangements, in particular if, due to the location of the risk, licensed reinsurance becomes “unlicensed.” OSFI is developing a standard form of notification that will assist branch reinsurers to keep ceding insurers informed of decisions made with respect to Part XIII.

Currently, risks located outside of Canada, but insured in Canada, are excluded from the Canadian branch. Effective January 1, 2009, these risks must be identified and recognized in the branch; it appears that there is no option to “grandfather” this business and thus exclude

it from the records. This may be a difficult task for foreign companies that have had a branch in Canada for a long period of time. Identifying such business from recent years may be straightforward, but identifying long tail business which, for example, was written 20 years ago, may be challenging. Also, additional capital, i.e. assets vested in Canada, may be required for this pre-2009

business. These capital requirements should be evaluated well before 2009 to ensure that sufficient assets are vested in Canada prior to the transition date. As this pre-2009 business will relate to risks located outside of Canada, insurers may find that they might be required to hold capital for the same risk both in Canada and in another foreign jurisdiction.

**Table 1 – Impact of Changes**

| <i>Location of insurance</i> | <i>Location of risk</i> | <i>Old basis (pre-2009)</i> | <i>New basis applicable in 2009 for pre-2009 business (transitional)</i>                      | <i>Basis for 2009 and subsequent business</i> |
|------------------------------|-------------------------|-----------------------------|---|---|
| Insured in Canada            | Canada                  | Included                    | Included  | Included                                      |
| Insured in Canada            | Foreign                 | Excluded                    | Included (on best efforts basis <sup>1</sup> within reasonable time frame <sup>2</sup> )      | Included                                      |
| Insured outside of Canada    | Canada                  | Included                    | To be removed from Canadian branch, if insurer can demonstrate risk is insured outside Canada | Excluded                                      |
| Insured outside of Canada    | Foreign                 | Excluded                    | N/A (assuming no such business recorded in Canadian branch)                                   | Excluded                                      |

1 OSFI expects branches to document their approach and employ “best efforts” to identify pre-2009 business insured in Canada that must be recorded in the branch. The determination of business insured in Canada can generally be based on a “business model” basis, and not on a “policy-by-policy” basis. This methodology should ease an otherwise fairly challenging task. A more granular approach may be required if no particular business model is followed for a line of business.

2 Substantially all of the insured in Canada business must be identified and recorded in the branch by the finalization of the 2009 branch audits.

## Tax considerations

Another important consideration is the potential impact on income taxes. In general, both taxpayers and tax authorities, rightly or wrongly, use the financial statements included in the regulatory annual returns for foreign insurers as the basis for tax filing and assessment. Business actually conducted outside Canada regardless of the location of the risk could be excluded, but doing so required demonstrating that such business was not actually carried on in Canada.

The amendments to the Act will move regulatory reporting much closer to the technical requirements of the Income Tax Act. It remains to be seen whether reporting under the revised Part XIII will cause the tax authorities to reconsider earlier years' filings, and how readily they will accept that profit earned on risk located in Canada does not automatically become subject to tax here.

## Planning considerations

While 2009 may seem to be quite some time away, branches should be preparing a plan now to address the new requirements under Part XIII of the Act, including OSFI financial reporting requirements. The Appointed Actuary should be involved in the process to determine the value of adjustments to the policy liabilities in the branch records. In addition to the considerations discussed in this article, management should consider any system and reporting changes that may be needed and if any restructuring of current operations will be required to continue to meet business objectives in light of the Part XIII changes. Finally, companies should keep in mind that provincial insurance legislation will continue to apply to their business.

Further implications of this legislative change and any significant future developments will be discussed in subsequent issues of this publication.

A reminder...

## IFRS Discussion Paper: Preliminary Views on Insurance Contracts

The discussion paper outlines the preliminary views of the International Accounting Standards Board (IASB) on the measurements and recognition of insurance contracts. The proposed method of measurement will fundamentally change the accounting for insurance contracts. The IASB has invited interested parties to submit comments on the proposals by November 16, 2007. A high-level summary of some of the significant changes to the valuation of insurance contracts was included in the summer issue of Insurance Review. The full discussion paper is available on the IASB website ([www.iasb.org](http://www.iasb.org)).

# For more information

## Audit and Assurance Group

### Greater Toronto Area

|                  |              |
|------------------|--------------|
| Bill Bawden      | 416 947 8970 |
| Bob Bosshard     | 416 947 8996 |
| Alodie Brew      | 416 947 8957 |
| Leigh Chalmers   | 416 869 2359 |
| Peter Eccleton   | 416 869 2363 |
| Bill McFarland   | 416 869 2859 |
| Jonathan Simmons | 416 869 2460 |
| Diane Woodruff   | 416 365 8201 |

### Edmonton

|                |              |
|----------------|--------------|
| Barry James    | 780 441 6838 |
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### Kitchener

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### Montreal

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| Alain Dugal      | 514 205 5091 |
| Kenneth Hotton   | 514 205 5292 |
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| Raynald Lafrance | 418 691 2440 |
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|-----------------|--------------|

### Vancouver

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| Len Boggio       | 604 806 7016 |
| Jane Butterfield | 604 806 7519 |
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## Actuarial Services

|                   |              |
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|                |              |
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## Advisory

### Corporate Advisory and Restructuring

|             |              |
|-------------|--------------|
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| Alan Martin   | 780 441 6718 |
| Kas Rehman    | 613 755 4328 |
| Bruce Webster | 416 815 5250 |

## Insurance Services Director and Insurance Review Editor

|             |              |
|-------------|--------------|
| Irma Freese | 416 365 8829 |
|-------------|--------------|

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