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Gearing up for a new capital management regime*

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*connectedthinking

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Contents

Gearing up for a new capital management regime	1
A case of transfer pricing heartburn: Preventive medicine for insurance companies	4
Are you ready for IFRS? Five questions CIOs need to consider now	7

Gearing up for a new capital management regime

Sound capital management has always been an integral part of any business enterprise. Shareholders demand a reasonable return on their capital investment; management has to determine the optimal allocation of capital between product lines and geographic segments. Ratings agencies have yet another point of view regarding the sufficiency of capital. An additional consideration for insurance companies is the regulatory capital requirements, which take into consideration protection for the often long-term commitments to policyholders.

These diverse perspectives can result in differing opinions as to what constitutes an adequate level of capital adequacy and allocation for an individual company. Both the insurance industry and regulators have responded to this challenge with significant advances in the development of economic capital

models, which incorporate a company's various risk factors and are intended to calculate the amount of capital required to meet future obligations.

Economic capital is the amount of capital required to protect a company against potential losses over a defined time horizon given a solvency standard or confidence level.

In an attempt to move away from standardized, formulaic solvency models, regulators in the European Union (EU) have introduced Solvency II (Figure 1), which is expected to be fully implemented by 2012. This new principles-based and risk-sensitive solvency regime has the primary objective of strengthening policyholder

protection by aligning capital requirements more closely with the risk profile of the company, while recognizing the benefits of diversification and negatively correlated risks.

The foundations for Solvency II were laid with the publication of a draft legislative framework (the Directive) by the European Commission (EC) in July 2007. Key principles and related implications are still emerging; the fourth Solvency II Quantitative Impact Study, which ran from April to July 2008, is evaluating the impact of the future regime on companies' capital requirements, systems and strategy.

Regulatory bodies around the globe, including OSFI in Canada, are carefully monitoring what is happening in Europe, with the expectations that similar regimes are on the drawing board for insurance companies worldwide.

Excerpt from Insurance Banana Skins 2007: A survey of the risks facing insurers

Some respondents thought the pain of regulation might be worth it. The head of group risk at a leading European reinsurance company said: "The modernisation of the European solvency system will raise risk awareness, encourage sound risk management and effective governance structures. This will constitute a major challenge for some companies. At the same time, the insights will change the name of the game; an economic risk-based view should bring some surprises."

Solvency II aims to map the regulatory capital requirements of each company against its individual risk profile. This will encourage, if not require, insurers to enhance risk management, upgrade information systems and embed risk awareness more closely into the governance, strategy and operations of their business. While it presents a significant implementation challenge, the move to Solvency II could also provide an opportunity to develop a more informed and forward-looking basis for decision-making.

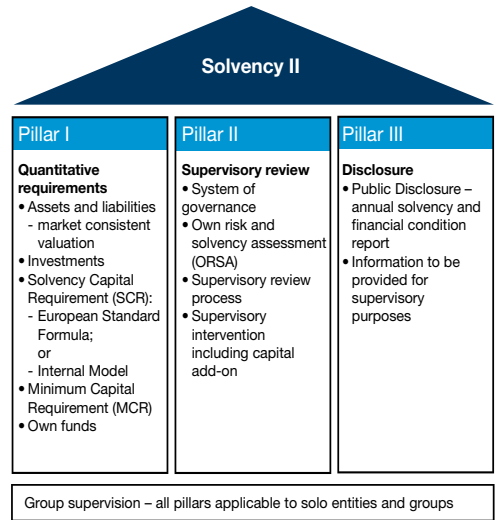
“Companies who already focus on economic capital and work within an enterprise risk management framework will benefit the most from the new capital management regime,” says Jonathan Simmons, a partner with PricewaterhouseCoopers’ insurance practice. “While managing risk and capital have always been important, it is becoming more sophisticated and companies will need to learn to speak the language of risk.”

A principal goal of Solvency II is to ensure that effective risk management and policyholder protection are embedded into the mindset of the business, including its governance, operational and decision-making procedures. This will require a systematic and formalized approach to corporate governance that

includes written policies and clear lines of responsibility, underpinned by an audit trail of oversight and formalized documentation. Maintaining certain core functions, including actuarial, internal audit and risk management teams, will be essential. The draft Directive of the EC moves away from formulaic solvency evaluations. Instead, capital requirements will reflect the risk exposures within the business and the effectiveness of the procedures in place to monitor, manage and mitigate them.

Insurers are expected to perform a risk and solvency self-assessment that reflects the company’s own risk profile and complies with a prescribed solvency capital requirement (SCR). Falling below the prescribed SCR level would require companies to restore their capital to the SCR level or to adjust their risk profile. Under the modular approach to risk assessment, the SCR evaluation should include all material risks facing the company, including operational risk, along with underwriting, credit, market and other financial risks. The Directive allows companies to use an internal model to calculate the SCR, subject to supervisory approval. For well-diversified companies, this is expected to result in a lower regulatory capital requirement; however some companies, likely smaller or uni-line entities, will have to increase their capital.

Figure 1: The three pillar approach



Under Solvency II, companies will be required to publicly disclose details from their solvency and financial condition reports annually. Gathering and validating the necessary data and analysis needed to prepare these highly detailed reports will be a challenge, underlining the desirability of close coordination with financial reporting systems. Clearly, more extensive disclosure will intensify the spotlight of scrutiny on the effectiveness of each company’s risk management systems and processes, along with the viability and validity of the underlying

tolerances and assumptions. This is a critical development at a time when analysts, rating agencies and other key stakeholders are taking an ever keener interest in such information as part of their evaluation of the strength of the business and the sustainability of its returns. Solvency II takes a number of important steps toward bringing prudential regulation more closely in line with the way businesses manage their capital (Figure 2). It will promote the development of innovative risk mitigation techniques, including more frequent use of derivatives and securitization strategies.

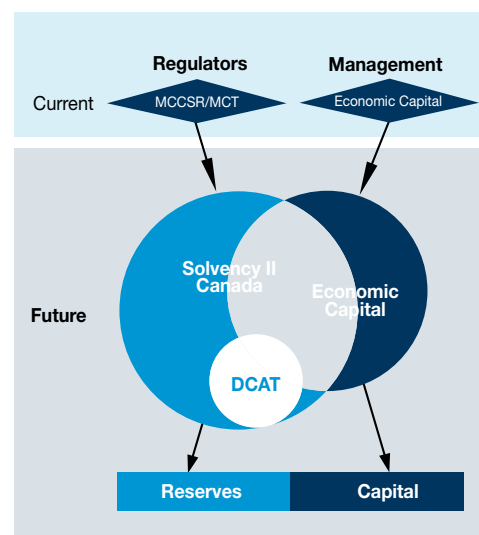
The final details of Solvency II in the EU are subject to a complex, uncertain and potentially lengthy political process. However, while much may change between now and 2012, the key foundations of Solvency II are in place. Although the model and timing of implementation for Canadian insurers is still undetermined, Canadian companies should ensure they keep abreast of global developments. It would be beneficial to start thinking now about the objectives and direction of their implementation strategies. Even though it is likely to be a costly and demanding exercise, it does offer opportunities to embed best practices in governance and risk management and develop a more informed and assured basis for decision-making.

While the insurance industry in Europe has a widespread desire to have the Directive adopted in 2008, at the time of printing, it is uncertain if political developments will force implementation to slip to next year.

A key consideration in defining a company's ambitions for the new capital regime is deciding whether to treat this as a compliance project or as an opportunity to embed enterprise wide risk management techniques more closely into the operations of the business. The objectives need to consider how Solvency II will affect the company operationally and strategically, including any particular threats or opportunities, and how it should respond in the most effective and proactive way.

According to Dan Doyle, a partner in PricewaterhouseCoopers's actuarial practice, "Solvency II, or its equivalent, will be coming to Canada and insurance companies will have to implement it – regardless of the cost to manpower or systems. But, looking at the positive side, insurers can realize benefits if they use the models in Solvency II to better manage their business. They can either follow or they can lead and use Solvency II as a tool to gain competitive advantage."

Figure 2: Development of the capital management regime



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A case of transfer pricing heartburn: Preventive medicine for insurance companies

Canada's first major transfer pricing court case, which was decided by the Tax Court of Canada (TCC) on May 30, 2008, could have a significant impact on insurance companies dealing in multiple jurisdictions. Canadian insurers should ask themselves what impact this decision may have on the company's transfer pricing policies and practices.

The heartburn case

GlaxoSmithKline Inc. (GSK Canada), the Canadian distributor of a patented anti-ulcer drug, purchased an active ingredient from a Swiss related party, which was originally manufactured by a related party in Singapore. Under the GSK group's transfer pricing policy, the Singaporean party earned gross profits of approximately 90% on the sale of the active ingredient, the Swiss related party was required to earn a minimum 4% profit (by agreement with the Swiss tax authorities) and GSK Canada earned gross profits of approximately 60% on the sale of the final product.

GSK Canada had a separate licence agreement, which included this drug, with its parent company in the United

Kingdom and paid royalties for the rights to certain intangibles and services. The supply agreement between GSK Canada and the Swiss related party granted GSK Canada only the right to purchase the active ingredient.

Market comparables bolstered CRA position

Available market information showed that third party generic pharmaceutical distributors sold generic versions of the drug in Canada during the 1990 to 1993 taxation years. During these years, the third party generic pharmaceutical distributors purchased the generic active ingredient from arm's-length manufacturers for approximately 12% to 20% of the cost paid by GSK Canada.

Given the existence of the generic price of the active ingredient, the Canada Revenue Agency (CRA) argued that the comparable uncontrolled price (CUP) method applied to the GSK Canada transaction. The TCC concluded that the CUP method is the preferred method and that the purchase price paid by the generic pharmaceutical distributors is an appropriate CUP.

The decision was made under the transfer pricing rules of Section 69 of Canada's Income Tax Act (the Act), the predecessor section to the current Canadian transfer pricing rules found in Section 247 of the Act. The former transfer pricing rules required the transfer prices between related parties to be reasonable in the circumstances rather than – as required by the current transfer pricing rules – to be equivalent to the amounts that would have been paid between arm's-length parties. The judgment also included withholding tax implications for GSK Canada.

Taxpayer evidence rejected

In defence of its position, GSK Canada provided a resale price analysis using a set of comparable European licensees. The TCC rejected these third party European licensees for various reasons: GSK Canada and the European licensees did not operate in the same market, the judge challenged the quality of the financial data used to establish the gross margins of the licensees and the judge questioned the source of data (obtained from an industry report). The judge also stated that GSK Canada did not disclose

various promotional allowances paid to the third party licensees and, therefore, the net transfer price could not be accurately estimated.

GSK Canada also presented a transactional net margin method (TNMM) as a secondary method to the resale price method. The TNMM was also dismissed by the TCC.

The TCC did not consider the link between the supply contract with the Swiss related party and the licence agreement with the UK parent company. No consideration was given by the TCC to the fact that GSK Canada needed access to all intangibles and services to sell the final product under a brand name at a premium price in the Canadian market. The judge focused solely on the price of the active ingredient purchased from the Swiss related party.

Preventive measures for insurance companies

Apply hierarchy of methods

The TCC's decision supports the use of transactional-based analysis in accordance with the hierarchy of

methods discussed by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). The CUP method was considered superior to the taxpayer's resale price method. Virtually no consideration was given to the TNMM analysis supporting the taxpayer's position.

The case facts are very unusual: due to Canada's compulsory licensing laws, an identical chemical was available in the market at the same time as the patented product. But in most cases, the CUP method's usability remains in question, because only very rarely will a taxpayer find a usable CUP for its particular case.

Insurance companies should evaluate carefully whether traditional transactional methods (CUP, resale price and cost plus methods) can be applied. This should be done by reviewing available internal and external comparable transactions and putting together a comprehensive analysis of the transactional comparables before reverting to profit-

based methods (profit split method and TNMM).

Although the TCC's decision was made under the previous transfer pricing regime, the judge referred to the OECD Guidelines currently in use. The OECD Guidelines state that traditional transactional methods are the most direct means of establishing whether conditions in the commercial and financial relations between related parties are at arm's-length. As a result, traditional transactional methods are preferable to transactional profit methods.

Because insurance industry transactions are becoming more creative and often unique, internal and external comparables may seldom be available. For example, in the case of an intercompany reinsurance transaction, the CUP method may be applicable, but in most cases the use of an unspecified method (not the traditional transactional method or a profit-based method) may be found to be the most appropriate to demonstrate that the transactions adhere to the arm's-length principle.

Structure group agreements carefully

The TCC was also unwilling to look at the overall relationship within the multinational group and whether the generic CUP method achieved an arm's-length commercial result for GSK Canada. Having structured its intercompany arrangements with two agreements, as opposed to one, seems to have penalized the taxpayer.

Given the very narrow focus applied in this case, insurance companies should expect their transactions to be evaluated independently and should, therefore, take particular care in drafting intercompany agreements and structuring their transactions. If appropriate, interdependence of prices in related transactions should be included in intercompany agreements and contemporaneous documentation.

Present reliable data

The TCC dismissed the taxpayer's evidence because the comparable European licensees did not operate in the same market as the taxpayer and because the resale price method did not use reliable data to accurately measure the profitability of the European licensees.

Insurance companies should consider the quality of the information used in setting and testing intercompany prices. Such information should be appropriate for the local market and must present a reliable analysis and tenable conclusion.

Consider other preventive measures

The judgment was rendered in 2008, 17 years after the filing of GSK Canada's 1990 tax return. Is 17 years an acceptable length of time to face uncertainty on a transfer pricing issue? The interest costs alone on any unpaid balances could be more than 300% of the taxes owing, not to mention the people costs, external fees and effort needed to collect information that is more than a decade old.

In view of this decision, alternatives for dealing with possibly contentious issues, such as the Advance Pricing Arrangement program, may seem much more attractive for taxpayers.

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Are you ready for IFRS?

Five questions CIOs need to consider now

While the conversion to International Financial Reporting Standards (IFRS) may be a finance led initiative, it has a significant impact on several aspects of a company, including the information technology function. The conversion to IFRS presents an opportunity for the Chief Information Officer (CIO) to look ahead to the requirements of the business and design a conversion plan that takes advantage of project synergies, embeds change throughout the organization and creates a more efficient business structure going forward.

To determine the level of effort required for the conversion, CIOs should consider the following five questions now:

1. Do we need to add new data sources and/or change existing financial data to ensure the organization has the underlying financial data required to support IFRS?

The experience of most European insurers showed that the changes to existing financial data were the most underestimated IFRS conversion project activity.

2. Where will we make changes within the application architecture to support IFRS reporting?

IFRS can affect various financial systems, such as transactions systems and reporting tools and applications. You should involve your CFO when evaluating the options, since a key factor in the decision will be the statutory/regulatory requirements of each transaction system. Irrespective of where the changes are made, there is bound to be a ripple effect to interfaces, data and metadata.

3. What impact will the change to IFRS have on our IT projects that are already planned?

The effect of the IFRS project on the current and planned IT projects needs to be evaluated. Your project plan has to ensure that opportunities for efficiencies are taken advantage of, potential conflicts and overlaps that create dependencies between projects are identified and minimized.

4. What impact will IFRS have on our ongoing operational processes such as current financial certification requirements?

It is important to align your IFRS conversion project with your ongoing certification processes to ensure any impact of the change to IFRS is assessed, documented and tested, and is consistent with the existing IT control environment.

5. What are the organization's objectives for the project and appetite for change?

Some organizations may approach IFRS simply as a project that they need to complete by the deadline, while others will look for opportunities to benefit from the conversion by embedding change throughout the organization. Understanding the approach your organization is planning to take will help you assess the scope of the project and the level of effort needed to complete the conversion.

On November 27, 2008, PwC presents the Insurance Club EyeOpener Series, where the five questions the insurance CIO should ask are discussed in more detail.

You can register for the event online at www.pwc.com/cainsuranceeyeopener or by phoning Simone Knott at 416 941 8383, ext. 14498.

For further information, contact Cory Gurevitz at 416 814 5887.

SEC proposes roadmap for potential use of IFRS by US issuers

On August 28, 2008, the US Securities and Exchange Commission (SEC) voted unanimously to seek public comments on a release that will include a proposed roadmap for the potential mandatory adoption of IFRS by issuers in the US.

The proposed roadmap targets potential mandatory adoption of IFRS in the US beginning in 2014, but lays out several milestones that would need to be achieved prior to the SEC mandating the use of IFRS for all US issuers. The proposed rule would allow certain qualifying domestic issuers to use IFRS as early as fiscal years ending on or after December 15, 2009.

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