

Insurance  
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# The economic turmoil: Managing risks and opportunities

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Insurance companies are facing unprecedented challenges in this period of economic turmoil. Stock markets around the world are wreaking havoc on investment portfolios. The weakness in the banking system is eroding public confidence and has led to a tightening of the credit system. The Canadian dollar is being driven lower. Jobs are being lost and real estate prices are declining. All of these economic indicators point to challenging times ahead.

In this special edition of the Insurance Review, we explore some of the issues your companies may be facing and offer some thoughts on what you might do to lessen the blow.

We trust you will find this publication of interest and encourage you to contact us if we may be of assistance.

# Determining fair values of financial instruments — A challenge

As mentioned in our recent newsletter *Accounting for Turbulent Times*, the FASB has recently issued FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active*. This guidance may be of assistance to companies with difficult to value investments. The paper provides guidance, for example, on considerations for assessing the priority of inputs under the fair value hierarchy in markets that are not active; clarification on the use of broker quotes; and explains that when observable market data does not exist, the use of management's internal assumptions about future cash flows and discount rates must include appropriate risk adjustments for non-performance and liquidity risks. The IASB also recently published educational guidance on the application of fair value measurement which takes into consideration and is consistent with the FASB guidance. The educational guidance can be accessed at [www.iasb.org/expert-advisory-panel](http://www.iasb.org/expert-advisory-panel).

On October 16, 2008, The Accounting Standards Board approved amendments to section 3855, *Financial Instruments Recognition and Disclosures*, which would allow entities to transfer certain types of financial assets out of categories that require fair value changes to be recognized in net income or other comprehensive income. However, there are strict conditions that must be met before an entity can do this. Our newsletter, released October 21, 2008, includes our preliminary views of these changes,

and can be accessed on our website [www.pwc.com/ca](http://www.pwc.com/ca). The final text of the S.3855 amendments has not been released yet.

Management will also have to ensure that the financial statements contain transparent disclosures with respect to credit and liquidity risk as well as appropriate market risk sensitivity analysis as required by CICA Handbook 3862, *Financial Instruments – Disclosure*. Fair value assumptions and policies must be disclosed. Those companies that issue a Management Discussion and Analysis should consider disclosing the impact of credit rating downgrades, counterparties experiencing financial difficulty, material adjustments to estimates and goodwill impairment or valuation allowances for future taxes.

Some companies may be experiencing a negative impact on their Minimum Capital Test (MCT) or Minimum Continuing Capital and Surplus Requirements (MCCSR) ratio as a result of sharp movements in fair value. We believe the turbulence in the financial markets will push the risk and capital management principles of Solvency II further up the regulators' agenda so keeping informed on what is happening in this area is a must.

Solvency II aims to map the regulatory capital requirements of each company against its individual risk profile. This will require insurers to enhance risk management, upgrade information systems and embed risk awareness

## Accounting for Turbulent Times

PwC recently issued a newsletter that addresses many of the issues that require special consideration given the current credit crunch and deterioration in market conditions. Matters discussed include:

- Fair value of financial instruments
- Impairments
- Future income tax assets
- Pension plans
- New requirements to disclose the significance, nature and extent of risks in financial instruments
- Liquidity disclosures and balance sheet classification
- Going concern disclosure
- Measurement uncertainty and economic dependence
- Subsequent events
- Internal control considerations

The newsletter can be obtained from your PwC contact or by accessing our website [www.pwc.com/ca](http://www.pwc.com/ca)

more closely into the governance, strategy and operations of their business. A more detailed discussion of this topic is included in the Fall 2008 issue of *Insurance Review*, *Gearing up for a new capital management regime*. This publication can also be obtained from our website [www.pwc.com/ca/insurance](http://www.pwc.com/ca/insurance).

# The impact on the life insurance industry

Despite a highly regulated and strongly capitalized Canadian life insurance industry, the equity market free-fall may leave companies bruised by deteriorating credit markets. But even as the S&P/TSX dropped by roughly 35% from the beginning of the year, life insurers risk based capital ratios remain healthy for the most part.

As at July 1, 2008, the industry average MCCR/TAAM (Test of Adequacy of Assets in Canada and Margin Requirements for Foreign Life Insurance Companies) was 212%. Life insurers typically do not hold equity assets to support actuarial liabilities, since the resulting capital requirements and reserve provisions are onerous. These requirements, however, do not apply to assets where the interest risk is passed through to policyholders. More commonly, life insurers hold

equities to support a portion of free surplus. However, even for an insurer holding 20% of surplus assets in equities — a 30% decline in their value would translate roughly to a drop in MCCR from 212% to 200% — well in excess of the regulatory minimum of 150%.

Insurers' assets are generally made up of primarily provincial or federal bonds or other highly rated securities, thus buffering credit losses on fixed income securities. However, exposure to other global financial institutions, in particular troubled US insurers, has severely slashed financial results of Canadian life insurers. Changes in interest spreads should not have a significant impact, as life insurers are generally well matched for assets and liabilities cashflows and tend to hold fixed income assets until maturity.

For insurers with lower capital ratios or holding a higher portion of equities, the decline in market value may drive their capital ratios closer to the OSFI threshold. These insurers may be looking for relief from regulatory capital requirements by entering into reinsurance risk transfer transactions. This provides an opportunity for well capitalized Canadian life reinsurers to step up with innovative capital relief solutions. For direct-writing companies, the solutions may not only reduce regulatory capital, but also cause reserve provisions to be released into income.

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# The impact on the P&C industry

P&C insurers in Canada have generally managed their investments in a conservative manner, thanks in part to the penalties imbedded in the Minimum Asset Test for common stocks. The fact, however, that the Canadian P&C insurance industry to a large extent is owned by foreign entities, some of whom have suffered large losses in their home countries, makes the industry more sensitive to global developments. Add to this the revision to Part XIII in the Insurance Companies Act (see Insurance Review Fall issue 2007: *What is an insurance risk in Canada?*) and foreign parent companies may be prompted to revisit the need to have a Canadian operation.

## A silver lining?

These developments may create opportunities for financially solid Canadian insurers to acquire assets or blocks of business. We are not insinuating that fire sales will occur, but foreign head offices may be more amicable to the notion of repatriating capital deployed in Canada, especially since paid-up capital may be repatriated without Canadian tax consequences for Canadian subsidiaries of foreign insurers. From a buyer's standpoint, the insurance market is in the soft part of the cycle and acquiring assets may be less expensive than competing in the retail market to gain market share.

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# Tax planning opportunities

The very recent changes proposed by the Accounting Standards Board may affect the tax treatment of insurers' investments, particularly debt obligations. While it is not entirely clear that these will lose their market-to-market status for tax purposes, it is quite likely that declines in their values, and in equities, will result in insurers experiencing a significant reduction in, or elimination of, taxable incomes. The question then becomes how best to recoup cash from this unhappy circumstance in fiscal 2008. Here are some steps to consider.

Refiling returns of the prior three years to apply losses back against taxable income (earliest usually first) is a first step. Importantly, the Canada Revenue Agency (CRA) must accept a carry back claim filed by the due date of the 2008 return. Subsequent to that date, the Minister "may" accept the claim (and in fairness most often does). When refiling, avoid unpleasant surprises by considering the effect of reduced

income taxes in these earlier years on other federal taxes such as Part I.3 and Part VI, and on Ontario Corporate Minimum Tax and Nova Scotia Large Corporation Tax.

Remember, too, that insurers need not deduct the maximum amount available for claims reserves and other discretionary deductions. This avoids creating losses that may expire, although one hopes this strategy is unnecessary, given the twenty year carry forward now available on tax losses.

Overpaid instalments of 2008 federal income tax can be recovered more quickly by applying them against the employer's obligation to remit payroll withholding taxes, Employment Insurance and Canada Pension Plan contributions. This CRA administrative policy produces cash for a company without waiting for the preparation, filing and assessment of the 2008 income tax return.

CRA and the relevant provinces also routinely (and helpfully) permit the transfer of tax instalments between companies within corporate groups. This permits at least some marrying of "winners" taxes due with "losers" overpayments, again without waiting to actually file corporate income tax returns.

Finally, remember that any year with little or no tax payable sets an equally low instalment base for the following year.

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# What about the GST? — Always a smart question

When loans secured on real property go into default, a range of remedies is available to the lender. Each remedy has very specific GST implications and often, these are overlooked. A brief reminder to always consider the GST result of any remedial action may be timely, as we enter a period when borrowers may struggle to meet their commitments. An ounce of prevention is always preferable to a pound of care.

A lender may attorn the rents payable on the borrower's property as an initial step, until a more permanent measure is selected. Depending on how precise the instructions are to the tenants, the lender may end up holding the GST on the borrower's supplies to the tenant. Simply handing the GST to the –delinquent- borrower for remittance, may expose the lender in the event that the GST does not get remitted; therefore, the lender needs to channel the GST safely to the CRA, providing the borrower's GST number.

The most unexpected GST outcome arises from a power of sale transaction. When triggering this mechanism, the lender is first deemed to have been supplied the property, and then to have supplied it to the third party buyer. If the property is commercial in nature and the buyer is not registered for GST on the date of the transaction, the lender is obliged to collect and remit the GST. Surprised? So have been many lenders, when presented with an assessment for the GST.

At least with ultimate foreclosure, the lender is aware that at a clear point in time, it owns the property, along with all the GST obligations of the hotel, ski hill, part-built condo tower, etc. Easy to overlook though, is the transaction where, following foreclosure, the property is placed into a stand-alone corporation for liability purposes. Failure to register the new company by the actual transaction date will trigger a liability for the lender (who is now, for GST purposes, the vendor) to collect and remit the GST on the value of the property.

As the lender takes various actions in the period before actual foreclosure, the CRA may take the view that certain actions of the lender in relation to the property constitute seizure, thereby making it the “builder” of a development for GST purposes. This can confer the joy of having to remit GST on the *fair market value* of any units that are let as the first use.

Suffice it to say, every remedy has a GST facet that should be addressed. In the early 1990's, when many lenders were working out loans secured on real property, the GST was often overlooked. However, at that time the CRA had a fairly lenient face, because the tax was relatively new. The GST is now 18 years old. “What about the GST” is always a smart question to ask.

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# Considerations for defined benefit pension plans

Defined benefit pension plans are affected by a number of developments resulting from the credit crunch and the turbulence in the current economic environment. Companies that sponsor these plans must carefully evaluate the impact on the following aspects:

- **Assets** – falling stock markets and credit losses around the globe are pushing many company pension funds into deeper financial deficits.
- **Pension Obligations** – the credit crunch has widened the credit spreads and increased the yield on high quality corporate bonds (the measure used in financial statements to place a value on the pension plan obligations), resulting in a decrease in the pension obligations. If credit spreads revert back to lower levels, the funded status of the pension plans for accounting purposes will deteriorate.
- **Pension Deficits** – when combining the impact of assets and pension obligations, pension deficits are expected to develop or grow.
- **Pension Expense** – companies can expect their pension expense to increase in 2009, largely due to lower returns from the plan's assets.
- **Cash Contributions** – an increase in pension contributions for the next few years is likely, as companies file updated

valuation reports for funding purposes with the pension regulator. However, companies and industry may be successful in persuading the government to provide temporary relief in funding.

- **Various Policies** – a thorough review of a number of policies will be required, e.g. funding policy, liability-driven investment policy, and benefit policy.

The market in the United Kingdom for transferring pension plan risk to insurance companies has accelerated sharply over the past year. Pension buyout activities may increase as well in Canada as companies seek to transfer pension risks to insurers. As a result of current credit markets, many companies may also find it more difficult and costly to obtain financing with some experts predicting that the number of companies going bankrupt over the next few years will increase. This could provide an opportunity for insurance companies that sell annuity products, as company pension plans are wound up.

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# Sustainable cost reduction – Pursuing savings while protecting value

The current economic environment is forcing companies to take a hard look at their operating expenses and identify opportunities to reduce costs. Unfortunately, there is great potential to cut value when attempting to cut costs. From a strategic perspective, companies need to be wary of poorly targeted reductions. Ill-planned strategies like across-the-board budget cuts, percentage headcount reductions, and recruitment and salary freezes potentially cut the good with the bad and can hinder growth strategies. In addition, these efforts often reflect internal politics and further embed organizational ‘silos’. Insurers, operating in a highly competitive environment where growth is a key strategic objective, should bolster their long term objectives by protecting growth potential when pursuing savings goals. Sustainable cost reduction is a discipline rather than a group of “one-off” programs and interventions.

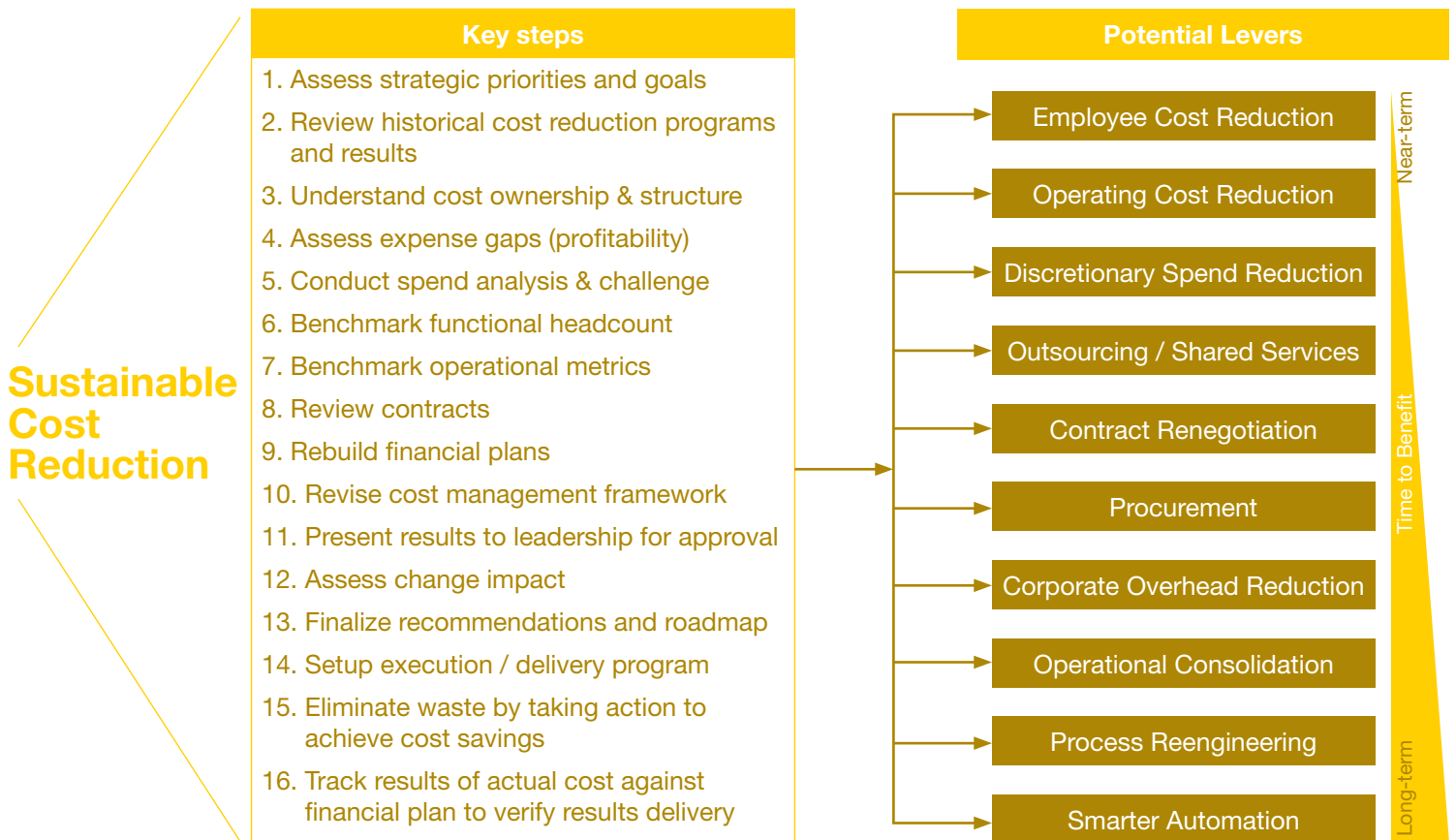
Other than game-changing strategic decisions, we see companies generally taking three approaches to cost reduction (Exhibit 1).

## Exhibit 1 – Approaches to cost reduction

Slash and Burn	Strategic	Boil the Ocean
‘Business as usual’ but at less cost – by reducing plans by set target (e.g. 10% cost reduction)	‘Top-down’ review of the business – typically organization and process changes required	A bottom-up analysis across all departments to identify potential opportunities
<ul style="list-style-type: none"> <li>• Overall target set by CEO or CFO</li> <li>• Target differentiated at Dept or Process level</li> <li>• Function heads responsible for execution</li> </ul>	<ul style="list-style-type: none"> <li>• Cost management team frames “available” population of costs and strategic options</li> <li>• Cost management team and department leads responsible identifying potential opportunities (e.g. organization alignment, re-allocation of work, etc)</li> </ul>	<ul style="list-style-type: none"> <li>• Cost management team frames “available” population of costs</li> <li>• Cost team or department performs extensive interviewing, process analysis &amp; benchmarking</li> <li>• Teams also identify process reengineering and technology enablement opportunities</li> <li>• Integrated and coordinated execution</li> </ul>
<b>Reasons for failure:</b> <ul style="list-style-type: none"> <li>• Reactive, short-term cost cutting and focus on one-off savings (e.g. travel)</li> <li>• Based on arbitrary targets; lacks sufficient analysis</li> <li>• Savings difficult to sustain</li> <li>• Negative impact on morale and culture</li> </ul>	<b>Reasons for failure:</b> <ul style="list-style-type: none"> <li>• Organization focus and betting on a “silver-bullet” (e.g. shared services, off-shoring)</li> <li>• Little consideration to the management decision driving costs</li> <li>• Complexities of reducing costs and existing behaviours are not changed</li> </ul>	<b>Reasons for failure:</b> <ul style="list-style-type: none"> <li>• Timeframe constraint and lack of urgency</li> <li>• Greater investment required</li> <li>• Typically loses momentum and focus</li> <li>• Negative impact on morale and culture</li> </ul>

The most successful sustainable cost reduction programs generally combine short-term, quick wins with longer term strategic initiatives. Knee-jerk cost-cutting initiatives can often prove short-lived and may impede a company’s ability to achieve its strategic objectives. What is required is an informed, sustainable and strategically focused approach to cost management to appropriately target limited resources, where they can deliver the most value. Timeliness, accuracy and transparency are critical, but unfortunately, there is no “silver bullet” — it is through incremental wins that companies are able to create sustainable solutions (Exhibit 2).

**Exhibit 2: Sustainable Cost Reduction**



### Often over-looked short-term cost saving areas

In our experience, immediate savings can be gained in a number of areas that are less commonly considered:

- **Rationalize contract (contingent) labour** – Review the use of part-time and contractual labour for necessity and consider converting long serving contractors to full-time employees. Benefits include improved risk management (e.g. Canada Revenue Agency), Intellectual Property protection and better controls. Savings can easily amount to over \$1 million/year in a typical insurance company.
- **Reduce property tax spend** – Changing provincial legislation has exposed a number of Canadian insurers to increased property taxes. A critical review of a company's individual situation and exposure can identify mitigation strategies that, when implemented, could save hundreds of thousands in taxes.
- **Reduce over spend in existing contracts** – A critical review of third party contracts with an eye to modernizing terms, current pricing and value for money (e.g. paying a prime contractor who subcontracts part of the work, versus contracting directly). We have seen savings in the range of \$500K to \$2+ million/year depending on the number and complexity of contracts.
- **Cut waste in IT spend** – The lack of detailed inventories (e.g. desktops, telephones) can result in overspending on software licenses, maintenance and service provider costs, as well as the retention of unnecessary assets. Savings often exceed \$1 million/year.
- **Rationalize claims procurement** – Most insurers have preferred third party claims suppliers. Consider further aggregation of existing suppliers to drive better pricing. Focus on increasing the use of those preferred suppliers to further reduce costs. Short term savings can be in the millions, while longer term benefits are easily in the tens of millions, depending on the size of the claims operation.

- **Proactive vendor management** – Focus on more rigorous vendor management programs to improve third party contract compliance, limit spend overruns, and increase value for money. Typical savings in third party spend can be in the 5% to 20% range depending on the maturity of the sourcing and vendor management function.
- **Rationalize internal and external training costs** – Review training programs to promote less costly delivery methods (e.g. web-based training). Evaluate programs from a 'value for money' perspective, eliminating outdated or low-demand courses. Additional benefits may be gained through reduced travel and associated expenses as well as increased productivity.

The rapid changes in the economic environment require insurance companies to nimbly respond to the challenges. Best-in-class insurers will make every effort to realize sustainable cost reductions without impairing their potential for future growth.

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# Lessons of the credit and liquidity crises

Excerpt from the PricewaterhouseCoopers LLP global enterprise risk management (ERM) study, *Does Enterprise Risk Management Matter?*

In March 2008, the Senior Supervisors Group (SSG) published the results of a study into why some companies managed to anticipate and respond effectively to the emerging threats and over-concentrations of risk and why others proved more susceptible to them.<sup>1</sup>

The study concluded that while some institutions believed that their ERM programs were up to speed, there were marked variations in the level of senior management oversight, focus on emerging risks and decisiveness with which risk considerations were anticipated, communicated and acted upon. Largely as a result, some firms proved more susceptible to the subsequent losses than others. In particular, the study cited the failure of leadership teams to adequately 'challenge business lines' assumptions', 'test the accuracy of valuations' or respond 'on a timely basis... despite an array of data indicating rising stress in the sub-prime mortgage market'.

The key attributes of companies that largely avoided the problems as identified in the SSG study are as follows:

- Effective alignment of strategy and risk appetite;
- Ability to identify and accurately represent risk in a timely manner within risk measurement, monitoring and reporting systems;
- Better understanding of risk concentrations, correlations and their potential implications, based on effective risk analytics and underpinned by regular validation, calibration and adjustment;
- Ability and readiness of senior management to understand and, where necessary, challenge underlying risk assumptions;
- Effective communication of risk to decision-makers and appropriate escalation of issues for action;
- Consistent implementation of risk management practices and standards across businesses and geographies; and
- A culture that builds risk considerations into performance objectives and management in key areas such as unit targets and individual incentives.

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1. 'Observations on risk management practices during the recent market turbulence', published by the Senior Supervisors Group on March 6, 2008.

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