Will that be a Branch or Sub, Ma'am?

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With the heightened emphasis on the roles and responsibilities of Boards of Directors and management described elsewhere in this issue, some 100% foreign owned Canadian Companies may be looking wistfully at the Canadian Branch operations of other foreign companies and wondering just how much easier their lives might be under that structure. Governance is just one of many areas of difference between the operations of a Canadian incorporated insurer and those of the Canadian Branch of a foreign insurance company. This article will look at the process for getting established under each structure and highlight some of the differences and similarities relating to ongoing operations.

Company and Branch Insurers:

First a little background on the two types of organization. A foreign company that is authorized and has received an Order under the Insurance Companies Act ("ICA") to Insure in Canada Risks operates in Canada on a Branch basis. That Canadian operation is not a separate legal entity, though it is taxed separately in Canada, has specific record keeping and capital requirements and must prepare regular standalone financial statements, similar those required for a Canadian company. To operate as a Canadian company, Letters Patent of Incorporation must be issued by the Minister of Finance (upon the recommendation of the Superintendent of Financial Institutions ("Superintendent")) followed by an Order under the ICA to Commence and Carry on Business issued by the Superintendent. P&C Canadian Branches are sometimes referred to as P&C-2 companies based on the regulatory return they file by that name, while Canadian incorporated insurers are sometimes referred to as P&C-1 companies based on their regulatory return. It should be noted that companies can also be incorporated under provincial insurance legislation, though this is becoming less common. The process of obtaining licenses to write specific classes of insurance from the Provinces is relatively similar for Branches and Companies.

It may seem obvious, but the option of operating as a Branch is only available to an organization with a foreign based, established and reasonably large insurance company. The Branch option is therefore ruled out for most start-ups, smaller foreign insurers, and foreign investor groups without an operating insurance company who would need to consider setting up a standalone Canadian company instead.

This examination of the factors to be evaluated when considering a company versus branch structure has been organized under the following main headings.

Approval process and timing
Governance
Administration
Capital, trust assets and ratings
Reinsurance and security agreements
Taxation

Policy marketing, issuance and regulation

The chart below displays several key metrics for the groups of insurers operating in Canada as Branches and Companies.

Total Equity, NPW & MCT in Canada							
Insurers Reporting June 30, 2012 data to MSA Research							
	June 30, 2012						March 31, 2012
	# of insurers	% of Insurers	Total Equity ($'000)	% of Equity	NPW ($'000)	% of NPW	Industry wide MCT/BAAT
Branches of foreign companies	83	40.3%	12,360,082	28.8%	4,263,747	19.9%	329.75
Canadian incorporated companies	123	59.7%	30,619,512	71.2%	17,122,506	80.1%	244.03
	206	100.0%	42,979,594	100.0%	21,386,253	100.0%	

Approval process and timing

In addition to the many provisions in the ICA relating to the establishment of Companies and Branches, OSFI has published Guides designed to assist organizations to incorporate a company or establish a Branch. See Reference Notes 1 & 2 for details of how to find these guides. Many of the core requirements such as a Business plan, financial projections and scenarios, management and ownership background and engagement of actuaries and auditors are similar under either structure.

The foreign company sponsoring a Branch must have a minimum of $200 million of assets and at least $40 million of capital and unappropriated surplus. Assets to be vested in trust in Canada will vary based upon the business plan and products to be offered. A theoretical minimum of $5 million of capital exists for a new company, but in practice a higher figure is often requested. Practice has shown that it is generally a little cheaper and takes a shorter period of time (six to nine months) to establish a Branch as opposed to a company (nine to twelve months), partly due to elimination of the incorporation step and reduced governance requirements. It is perhaps indicative that the Branch Guide referred to above is three pages long and the Incorporation Guide runs to nineteen pages.

Governance

Perhaps the most significant difference between how a Branch and a Company operates relates to the governance process. An incorporated insurer must appoint a Board of Directors which consists of at least one third independent directors. The Board will then need to establish a variety of committees. The remuneration of such boards and committees has increased in recent years in step with expanded regulatory responsibilities.

A Branch must appoint a Chief Agent (Note 4) who, in large branches, is typically a member of senior management of the Canadian Branch. Smaller Branches often appoint a lawyer or other knowledgeable third party service provider to fill the role. The Chief Agent fulfils many of the governance responsibilities of a company Board of Directors, but does not have to be independent of the insurer. The absence of a requirement for a Canadian Board of Directors may in some cases be perceived as a significant advantage to a foreign ownership group.

OSFI's recent draft Corporate Governance Guideline and its concept of a Risk Appetite Framework ("RAF") place a significant new responsibility on Boards of companies. It is possible that it will be easier for a foreign company to develop its RAF in consultation with a single Chief Agent than to negotiate such with an entire Board of Directors.

Administration

It is sometimes less expensive to maintain a Canadian Branch than a Canadian Company due to greater utilization of Head Office resources including personnel, systems and physical premises, though some larger Branches do have fully fledged and independent Canadian operations. OSFI Guideline E-4A (Note 4), in addition to outlining the responsibilities of a Chief Agent, also specifies Branch record keeping responsibities. Careful attention must also be paid to OSFI Guideline B-10 - Outsourcing of Business Activities, Functions and Processes and also to the requirement to self assess for GST/HST on outsourced functions. For smaller Branches there are several organizations which specialize in performing administrative roles such as regulatory reporting on behalf of Canadian Branches of foreign companies. In these cases, most decision making is based in the Head Office.

Capital, Trust Assets and Ratings

A significant difference between a Company and a Canadian Branch is the manner in which Regulatory Capital is measured and managed. OSFI has taken steps recently to harmonize the capital provisions of Guideline A – Minimum Capital Test as much as possible, but significant differences remain. The Branch test used to monitor ICA subsection 608(1) requirements is called the Branch Adequacy of Assets Test ("BAAT") while the Company test used to monitor ICA subsection 515(2) requirements is the Minimum Capital Test. The principal difference is the assets starting point for the tests. A Branch must establish a Vested Trust Account which has limitations on the types of assets which can be vested per the Assets (Foreign Companies) Regulations whereas the starting point for a Company is all assets. This vesting requirement can potentially put Branches at a disadvantage when certain contra assets such as those relating to new pension liabilities accounting rules are involved.

It has been my observation (confirmed by Exhibit 1) that Branches typically carry a higher level of capital than an incorporated company, though this is often related to the types of business underwritten. Maintaining a vested asset account can create extra administrative steps and Canadian Companies also have a slightly broader range of investment alternatives as they are not restricted by the vested in trust rules.

Another potential advantage of operating as a Canadian Branch is access to parent company claims paying and financial stability ratings. In addition to the ability of a Branch to reference a larger and better capitalized parent, there are very significant internal and external costs which can be avoided if an independent Canadian rating is not required. Rating agency presentations can represent a very significant and costly management distraction for Companies, particularly if more than one rating is sought.

A further advantage of operating as a standalone company in Canada can be the independence that provides from the parent.

Reinsurance and security agreements

A separate Canadian company will often need to negotiate most of its own reinsurance arrangements while a Branch may be able to better leverage existing Head Office programs where economies of scale may provide better leverage and also better risk diversification. The recent Canadian tax legislation changes which attempt to apply GST/HST to non-arm's length cross border reinsurance premiums has caused great concern and put a significant chill on such arrangements for both Branches and Companies. New OSFI unregistered reinsurance rules abandoning Reinsurance Trust Agreements in favour of Reinsurance Security Agreements has also created a significant new legal and administrative burden for Branches hoping to access unregistered Head Office programs.

Taxation

Canadian Branches are taxed individually in Canada and are subject to most of the same tax rules and rates as standalone Canadian companies. A major difference is that taxable investment revenue is calculated under a tax formula subject to minimum investment income requirements which can provide certain tax planning opportunities. Withholding tax is payable on dividends paid by corporations to foreign parent companies and a Branch tax upon cessation of Canadian branch operations is also payable at the withholding tax rates which vary based upon tax treaty arrangements between the countries.

Policy marketing, issuance and regulation

An insurer established to insure uniquely Canadian personal lines risks may benefit from the branding advantages and expanded local presence of a Canadian subsidiary. It is interesting to note that the only major personal lines insurer in Canada operating on a Branch basis is State Farm. Conversely, virtually all large reinsurers operating in Canada (except Munich Re and SCOR) are structured as Canadian Branches, as are most of the large commercial risks specialty underwriters. Part of the explanation for this may be that global policies may be more easily underwritten when the Canadian arm of the foreign company operates as a Branch but …… recent ICA Part XIII changes require greater record keeping discipline and paperwork for such policies. Large commercial insurance brokers, buyers and cedants may also demonstrate a better initial acceptance of a Branch due to access to parent company branding and assets.

Should brokers and policyholders be concerned that Canadian Branches may have significantly less robust governance requirements than a Canadian Company with a Board of Directors? It is quite intriguing that virtually identical insurance operations (think State Farm vs. Allstate; Munich Re vs. Swiss Re) can have such different oversight obligations. All four are 100% owned from abroad, all four no doubt have fully engaged local and head office management guiding their operations, but only the incorporated companies have Audit and Conduct Review Committees and have to have their Risk Appetite Frameworks and Reinsurance Risk

Management Policies approved by a Board of Directors. Part of the justification for Canadian Branches not having such rigorous (and partially independent) oversight requirements is that their generally higher regulatory capital is vested in trust in Canada. In addition and as noted above, most of the direct premiums and reinsurance written by Canadian Branches is sold to more sophisticated commercial buyers, usually through larger brokers with extensive security review departments.

Exit strategies

Use of a corporate structure may provide owners of an insurance company with additional flexibility should they decide to exit the Canadian market by allowing for the option of a share sale as well as the reinsurance portfolio transfers and asset sale options available to a Branch. It can be very time consuming to get Branch vested assets released from Canada. The steps involved in domesticating a Canadian Branch are also relatively straightforward, providing organizations with the option of starting as a Canadian Branch and later deciding if they wish to domesticate.

Caveat lector

We have seen above a variety of both advantages and disadvantages to each type of insurance company structure and the regulatory playing field keeps evolving. Governance is clearly a growing burden for Companies, but recent reinsurance and tax rule changes have reduced some of the previous advantages of Canadian Branch status. It is essential that anyone considering the appropriate structure for operating an insurance business in Canada consult with knowledgeable legal and finance professionals experienced with OSFI registrations and also with both parent company and Canadian insurance tax experts. There will be many unique issues relating to each organization's situation which will arise and need to be evaluated.

References

1) OSFI Guide for Incorporating Federally Regulated Insurance Companies (Document is on the OSFI website under Application and Approval Guides)

2) Establishment of Branch by Foreign Insurer and Order to Insure in Canada Risks (Document is on the OSFI website under Application and Approval Guides; Transaction Instructions; Transaction Instructions for applications not subject to the deemed approval process (Index A); No. 4)

3) Termination of Insurance Business in Canada of Foreign Insurance Companies (OSFI Application and Approval Guides; Transaction Instructions; Transaction Instructions for applications not subject to the deemed approval process (Index A); No. 9)

4) OSFI Guideline E-4A - Role of the Chief Agent and Record Keeping Requirements