13. (2.75 points)

a. (0.75 point)

Briefly describe how the following investments will be recorded in an insurance company's financial statements:

i. Held-to-maturity bonds
ii. Available-for-sale bonds
iii. Held-for-trading bonds

b. (2 points)

Describe the likely impact of a reduction in the yield to maturity of held-for-trading bonds on each of the following components of the Minimum Capital Test (MCT) formula:

i. Margin for unpaid claims
ii. Margin for premium liabilities
iii. Margin for interest rate risk
iv. Margin for operational risk

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QUESTION 13

TOTAL POINT VALUE: 2.75	**LEARNING OBJECTIVE(S): C1**

SAMPLE ANSWERS

Part a: 0.75 point

Sample 1

i. Held-to-maturity: Amortized value
ii. Available for sale: Fair/Market value
iii. Held-for-trading: Fair/Market value

Sample 2

i. Held-to-maturity: Amortized value
ii. Available for sale: Unrealized gains are recorded in OCI
iii. Held-for-trading: Unrealized gains are recorded in NI

Sample 3

i. Held-to-maturity:
BS: Amortized Value
IS: Changes in amortized value flow through net income
ii. Available for sale:
BS: Fair Value
IS: Changes in amortized value flow through net income. Difference between fair value and amortized value flow through OCI.
iii. Held-for-trading:
BS: Fair Value
IS: Changes in fair value flow through net income.

Part b: 2 points

Sample

i. Margin for unpaid claims: Since APV of liabilities will be greater, margin for unpaid claims will necessarily be greater (risk factor applies directly).
ii. Margin for premium liabilities: It depends on whether the cap is reached (30% of net WP in last 12 m). If the cap is already reached, then no change. Otherwise, there would be an increase in this margin as well.
iii. Margin for interest rate risk: Might increase or decrease. The formula looks on one side at interest rate sensitive assets and subtract the other component of interest rate sensitive liabilities. The effect thus depends on relative increase of assets vs liabilities.
iv. Margin for operational risk: Assuming the increase in margin for insurance risk (from i. and ii.) is greater than for market risk (iii. Increase or decrease), the operational margin will increase.

EXAMINER'S REPORT

Candidates were expected to understand when to recognize and how to measure financial instruments under current accounting standards. Candidates were also expected to understand how a change in yield would impact the balance sheet value of a financial instruments and in turn, affect the components of the MCT calculation.

Part a

Candidates were expected to know the measure (amortized or fair/market) by which each category of financial instrument is recorded on the balance sheet.

Common errors included:

- Stating that held-to-maturity bonds are recorded at book value. The CIA educational note indicates that "The book value of an asset may be the market value, the amortized value, or such other value consistent with Canadian generally accepted accounting principles."
- Inverting the measures between the categories of financial instruments (for example, stating that HTM bonds are recorded at market value, or stating that HFT bonds are recorded at amortized value).

Part b

Candidates were expected to describe the likely impact of a reduction in the yield to maturity of held-for-trading bonds on the components of the MCT calculation.

Common mistakes included:

- Failing to describe that the margin for unpaid claims increased due to an increase in APV of liabilities or decrease in discount rate
- Failing to mention the cap in the formula for the margin for premium liabilities
- Not demonstrating an understanding of how the interest rate risk is calculated
- Not demonstrating an understanding that the impact on the operational risk margin was dependent on the impacts on the margins examined in i., ii. and iii.