

**EXAM 6 – CANADA, FALL 2018**

23. (3 points)

The AA of a federally regulated property and casualty insurance company is involved in the preparation of the internal and operating capital targets. Based on an analysis of past variability of the MCT ratio, the AA initially proposes to establish the internal target 40 points above the supervisory target capital ratio, resulting in an internal MCT target of 190%. The AA then reduces this estimate by 10 points to consider that the parent company could inject capital in case of financial distress, bringing the internal target to 180%. The AA finally proposes to use an operating target at the same level as the internal target (180%) as he believes that this level of capital is sufficient to cover the risks of the insurance company.

Describe four ways in which the AA likely did not follow the appropriate regulatory guidance and briefly describe what the appropriate action would have been in each instance.

**CONTINUED ON NEXT PAGE**

## SAMPLE ANSWERS AND EXAMINER'S REPORT

QUESTION 23	
TOTAL POINT VALUE: 3	LEARNING OBJECTIVE(S): C2, D1
<b>SAMPLE ANSWERS</b>	
<u>Sample 1</u>	
<ul style="list-style-type: none"><li>• Internal target should be set using ORSA. OSFI states the internal target should not be some percentage higher than MCT. The actuary chose 40 points higher than MCT.</li><li>• Actuary considered the past variability of the MCT, but this is not valid. The process should be forward-looking as a company's circumstances can change.</li><li>• Operating level should be higher than the internal target. If a company believes it may fall below its internal target, it should notify OSFI and explain plans to be back up within 2 years. If operating target equals internal target, there is no buffer for the company.</li><li>• AA considered an injection of capital as a reason to lower target but he should not unless the parent company explicitly considers it as part of their plan.</li></ul>	
<u>Sample 2</u>	
<ul style="list-style-type: none"><li>• In establishing the internal target the AA should not be looking at past variability in the MCT, but should calculate it using the ORSA in conjunction with the DCAT. It is not sufficient to look at the past MCT variability to set the internal target.</li><li>• When the AA reduces the estimate by 10 points down to 180%, it is not appropriate to assume the parent company can inject capital in case of financial distress. The target should have stayed at 190% and not consider the capital injection.</li><li>• A company should operate above the internal target. In fact, if a company is at or below the internal target, they need to contact OFSI to tell them.</li><li>• The AA should be establishing the internal target separately from the supervisory minimum. In this case, the AA just adds 40 basis points to the minimum. However, the AA should have come up with his own internal target.</li></ul>	
<u>Sample 3</u>	
<ul style="list-style-type: none"><li>• AA needs to consider more than just historical MCT when establishing internal targets. He should have done ORSA to assess capital needs, possibly using stress testing.</li><li>• The AA selected an operating target the same as the internal target but OSFI expects insurers to operate above the internal target. The AA should select a higher buffer above the internal target.</li><li>• The AA reduced the internal target due to the parent company, which is not appropriate. The parent company could become insolvent or refuse to inject capital. The internal target should not be reduced for this.</li><li>• The AA established the internal target in relation to the supervisory target, rather than doing an independent analysis to come up with the target. The internal target should reflect the own view of risk and should not depend on the MCT.</li></ul>	
<b>EXAMINER'S REPORT</b>	
Candidates were expected to describe how the Appointed Actuary (AA) did not follow regulatory guidance with respect to the selection of the internal target. They were also expected to briefly describe appropriate action that the AA should have taken.	

## SAMPLE ANSWERS AND EXAMINER'S REPORT

Partial marks were given for mentioning that the internal target setting also fall under the responsibility of management and the Board.

Common mistakes included:

- Not including proper action from the AA.
- Being too vague on the appropriate action, for example, "The AA should base the internal target on more analysis."
- Confusing capital required for operational risk in the MCT with operating target.
- Not mentioning which one of the operating target and internal target should be higher.
- Not mentioning that the AA should not set the internal target only by adding an arbitrary margin to the supervisory target.
- Providing an incorrect answer such as stating that the AA should not be involved in the internal target setting process.