Educational Note

Guidance for the 2019 Reporting on Capital and Financial Condition Testing for Life and P&C Insurers

Committee on Risk Management and Capital Requirements

August 2019

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The actuary should be familiar with relevant educational notes. They do not constitute standards of practice and are, therefore, not binding. They are, however, intended to illustrate the application of the Standards of Practice, so there should be no conflict between them. The actuary should note however that a practice that the educational notes describe for a situation is not necessarily the only accepted practice for that situation and is not necessarily accepted actuarial practice for a different situation. Responsibility for the manner of application of standards of practice in specific circumstances remains that of the members.

MEMORANDUM

To: Members in the Life Insurance or Property and Casualty Insurance Practice Areas

From: Steven W. Easson, Chair
Standards and Guidance Council

Michelle Lindo, Chair
Committee on Risk Management and Capital Requirements

Date: August 26, 2019

Subject: **Educational Note: Guidance for the 2019 Reporting of Capital and Financial Condition Testing for Life and P&C Insurers**

Introduction

This educational note provides an overview of guidance to actuaries in several areas affecting the reporting of the 2019 regulatory capital requirements and financial condition testing of life and P&C insurers operating in Canada. In addition, the note provides an update on recently published educational notes and introductory information about potential changes in future regulatory capital reporting. This educational note is not intended to replace the review of applicable guidelines by the actuary, but provides a high level summary of key changes and updates. The actuary should refer to regulators' publications and to the relevant guideline(s) in order to ascertain whether the changes impact his or her situation. The guidance in this educational note represents a majority view of the members of the Committee on Risk Management and Capital Requirements (CRMCR) of appropriate practice consistent with the Standards of Practice. This educational note, the inaugural one, will be issued on an annual basis. In subsequent years, it will be issued earlier in the calendar year.

In accordance with the Canadian Institute of Actuaries' (CIA) *Policy on Due Process for the Approval of Guidance Material Other than Standards of Practice and Research Documents*, this educational note has been prepared by CRMCR, and has received final approval for distribution by the Standards and Guidance Council on August 23, 2019.

The actuary should be familiar with relevant educational notes. They do not constitute standards of practice and are, therefore, not binding. They are, however, intended to illustrate the application of the Standards of Practice, so there should be no conflict between them. The actuary should note however that a practice that the educational notes describe for a situation is not necessarily the only accepted practice for that situation and is not necessarily accepted actuarial practice for a different situation. Responsibility for the manner of application of standards of practice in specific circumstances remains that of the members.

CRMCR would like to acknowledge the contribution of the working group that assisted in the development of this educational note: Kelvin Lam (Chair), Patrick Douville, David Howard, Christopher Hurlburt, Bruce Langstroth, Michelle Lindo, William Shi, Sylvain St-Georges, and Michael Wang.

Guidance to members on specific situations

From time to time, CIA members may seek advice or guidance from CRMCR. Both the CIA and CRMCR strongly encourage such dialogue. CIA members would be assured that it is proper and appropriate for them to consult with the chair or vice-chairs of CRMCR.

CIA members are reminded that responses provided by CRMCR are intended to assist them in interpreting the CIA Standards of Practice, educational notes, and Rules of Professional Conduct, in assessing the appropriateness of certain techniques or assumptions. A response from CRMCR does not constitute a formal opinion as to whether the work in question is in compliance with the CIA Standards of Practice. Guidance provided by CRMCR is not binding upon the member.

Recent guidance

The following are recent regulatory guidelines issued by the Office of the Superintendent of Financial Institutions (OSFI) and the Autorité des marchés financiers (AMF) and relevant CIA educational notes:

- OSFI regulatory capital requirements: *Life Insurance Capital Adequacy Test* (LICAT) (January 1, 2019)
- AMF regulatory capital requirements: *Capital Adequacy Requirements Guideline (CARLI) – Insurance of persons* (January 1, 2019)
- OSFI regulatory capital requirement: *Minimum Capital Test For Federally Regulated Property and Casualty Insurance Companies* (January 1, 2019)
- AMF regulatory capital requirement: *Guideline on Capital Adequacy Requirements (MCT) – Property and Casualty Insurance* (January 1, 2019)
- Revised educational note: *Regulatory Capital Filing Certification for Life Insurers* (July 12, 2018)
- Educational note: *Life Insurance Capital Adequacy Test (LICAT) and Capital Adequacy Requirements for Life and Health Insurance (CARLI)* (March 8, 2018)
- Second revision of educational note: *Dynamic Capital Adequacy Testing* (November 24, 2017)
- Educational note: *Performance of DCAT in 2017 for Life and Health Insurers*[1]

[1] This educational note was issued to provide guidance on the performance of DCAT when the industry was transitioning from the former regulatory guideline(s) to the Life Insurance Capital Adequacy Test (LICAT) and/or Capital Adequacy Requirements for Life and Health Insurance (CARLI). Although that transition is now complete, the note may still be helpful when considering the implications on DCAT under future transitions that may affect capital calculations.

(February 9, 2017).

The publications listed above can either be found on the OSFI website under Table of Guidelines, the AMF website under Guidelines – Insurers, or the CIA website under Publications. A list of some of the current guidelines, educational notes, and research papers related to capital management is available in the appendices.

Notable potential future changes

OSFI issued proposed revisions to Guideline B-3: Sound Reinsurance Practices and Procedures and expected to release the final guideline in 2020. OSFI also issued draft guideline E-25: Internal Model Oversight Framework for comments.

- OSFI *Draft Revised Guideline B-3: Sound Reinsurance Practices and Procedures* (June 12, 2019);
- OSFI *Draft Guideline E-25: Internal Model Oversight Framework*, for P&C insurers (June 21, 2019)

This educational note is organized in the following sections:

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If you have any questions or comments regarding this educational note, please contact Michelle Lindo at mlindo@munichre.ca.

SWE, ML

1. Changes in life regulatory capital requirements for 2019

The Office of the Superintendent of Financial Institutions (OSFI) and the Autorité des marchés financiers (AMF) introduced new regulatory capital frameworks called respectively Life Insurance Capital Adequacy Test (LICAT) and Capital Adequacy Requirements for Life and Health Insurers (CARLI), effective January 1, 2018. OSFI and the AMF developed in collaboration LICAT and CARLI over a period of more than 10 years, in consultation with life insurers and other industry stakeholders. LICAT and CARLI were designed to "better align measures of risks with the economic reality faced by life insurers, thereby promoting appropriate risk management and business decisions."[2]

OSFI and the AMF kept changes in the 2019 LICAT/CARLI guideline to a minimum given the recent release of the 2018 LICAT/CARLI guideline and significant future changes expected with the introduction of IFRS 17.

Notable changes in the 2019 LICAT guideline include the following:

- Section 2.1.2.9 – The marginal insurance risk requirement negative reserve deduction can now include the operational risk general requirement (i.e., the 5.75% factor in section 8.2.3).
- Section 3.1.1, Appendix 3-A, Appendix 5-A – OSFI has expanded the list of recognized rating agencies for determining ratings for use in determining credit risk factors; specifically, the following agencies have been added: Kroll Bond Rating Agency (KBRA), Japan Credit Rating Agency (JCR), and Rating and Investment Information (R&I).
- Section 3.1.9.1, Section 5.3 – Where the insurer is the lessee of investment property, plant, or equipment, under an operating lease, the capital requirements are now to be determined in the same manner as the requirements for assets that are owned (consistent with previous treatment of finance leases). This change reflects implementation of IFRS 16 – *Leases*, effective January 1, 2019.
- Section 3.4 – This section includes wording updates with respect to pass-through type mortgage-backed securities (section 3.4.2) and other asset-backed securities (section 3.4.3) to create consistency with the revised Guideline B-5: Asset Securitization, effective January 1, 2019.
- Section 5.1.1 – There are several changes in benchmarks/indices for determining the initial discount rate scenario for interest rate risk.
- Section 5.1.3.4 (previously section 5.1.3.6) – Aside from moving the section, some modifications were made to the treatment of preferred shares and innovative instruments.
- Section 5.1.3.7 – This is a new section that covers treatment for projecting interest rate risk cash flows for bonds and preferred shares with embedded options.

[2] OSFI's "Life Insurance Capital Framework Standard Approach", published January 5, 2015.

- Section 5.1.3.13 – Refinements have been made to the wording for reflecting interest rate and currency swaps in projecting interest rate risk cash flows.
- Section 5.1.3.20 – This is a new section that covers projecting interest rate risk cash flows for assets replicated synthetically.
- Section 5.6.1 – The second item listed under structural positions and related hedges to be excluded from the calculation of net open currency positions has been removed.
- Section 6.1 – The wording on projecting insurance risk cash flows for group business has been updated to be based on the guaranteed coverage period (defined in new footnote 88) rather than the premium rate guarantee period.
- Section 6.2 – Mortality level and trend shocks have been extended to group business that is not individually underwritten. In addition, the approximation to apply shocks to net written premiums, adjusted by the expected claims loss ratio, has been extended to mortality risk (previously just noted for morbidity risk).
- Section 6.4.1 – The morbidity level incidence shock has been extended to group business that is not individually underwritten where the guaranteed coverage period remaining exceeds 12 months (see footnote 88 for further clarification).
- Section 10.1.2 – The criteria for an entity to be deemed registered reinsurance has been clarified.
- Section 10.4.1 – New conditions have been included for a ceding insurer to be able to obtain credits for funds held under a funds withheld reinsurance arrangement.

Notable changes in the 2019 CARLI guideline were harmonized to a significant extent with the changes to OSFI's LICAT guideline with the following additions/differences:

- Section 1.2 – For consistency with the AMF's Capital Management Guideline, added "risk related to access to market capital" as a risk to be considered when establishing an insurer's internal capital target ratio, and removed the "cushion" notion from the AMF's expectations as insurers are expected to maintain a level of capital in excess of the internal capital target ratio or level.
- Section 2.3 – A 25% limit has been added to the amount of Tier 1 Capital Instruments Other than Common Shares recognized in Net Tier 1 capital (this limit was already included in the 2018 LICAT).
- Section 3.1.1, Appendix 3-A, Appendix 5-A – added only Kroll Bond Rating Agency (KBRA) in AMF's recognized rating agencies.

2. Changes in P&C regulatory capital requirements for 2019

OSFI's Guideline A, Minimum Capital Test (MCT) for property & casualty insurance companies was originally implemented in 2003. The following year, the AMF implemented its own MCT, the *Guideline on Capital Adequacy Requirements – Property and Casualty Insurance*, largely harmonized with OSFI's MCT guideline. Each year, OSFI and the AMF consider whether changes are required to improve the risk measures, address emerging issues, and encourage improved risk management.

The guidelines provide the framework within which OSFI and the AMF assess whether a P&C company maintains adequate capital and whether a company operating in Canada on a branch basis maintains an adequate margin. The guidelines describe the capital required using measures based on risks, and define the capital that is available to meet the minimum standard.

In June 2018, OSFI and the AMF published draft versions of their respective 2019 MCT guidelines for consultation. As a result of comments received and other inquiries throughout the year, OSFI and the AMF incorporated the amendments below in the final version of the 2019 MCT guidelines. The 2019 MCT guidelines were effective January 1, 2019.

Notable changes in OSFI's 2019 MCT guideline include the following:

- Section 2.3.1, Section 6.1.2.3 – Removed securitization exposures from deductions on capital available and added capital requirement section on asset-backed securities that references Guideline B-5: Asset Securitization.
- Section 2.4.3, Section 4.3.3.2, Section 6.1.2.5 – Added a capital requirement for insurance receivables, unpaid claims recoverable and unearned premiums recoverable from associated registered reinsurers, except for intra-group pooling arrangements approved by OSFI. There are also eligible deductions on the balance sheet value used to calculate the capital requirement of the registered reinsurance.
- Section 2.4.7 – Updated summary table on type of exposures for non-qualifying subsidiaries, associates, and joint ventures and the capital treatment.
- Section 3.1.2 – Added "balance sheet values of right-of-use assets associated with owner-occupied leased properties, as recognised on the branch's balance sheet" to additions of Branch Adequacy of Assets Test's (BAAT's) net assets available.
- Section 4.3.3.2 – Amounts payable to or funds held from assuming P&C insurers that are associates and non-qualifying subsidiaries of Canadian P&C insurers are no longer excluded from the capital available deduction calculation for unregistered reinsurers.
- Section 4.3.3.3 – Introduced a transition period for the increase in the margin required for reinsurance ceded to unregistered reinsurers from 15% to 20%.
- Section 4.3.3.4 – Amended "funds held to secure payment from unregistered reinsurer" to allow the return of excess funds withheld or collateral associated with reinsurance ceded to unregistered reinsurers.
- Section 5.1.1.2 – Added "liabilities due to reinsurers under funds withheld reinsurance arrangements" under interest rate sensitive liabilities.
- Section 5.5 – Added "right-of-use" assets into the market risk capital requirement.

- Section 6.1.1 – Added “Japan Credit Rating Agency (JCR)”, “Kroll Bond Rating Agency (KBRA)”, and “Rating and Investment Information (R&I)” into the recognized rating agencies.

Notable changes in the AMF’s 2019 MCT guideline were harmonized to a significant extent with the changes to OSFI’s MCT guideline with the following additions/differences:

- Section 1.3.1 – For consistency with the AMF’s capital management guideline, added “risk related to access to market capital” as a risk to be considered when establishing an insurer’s internal capital target ratio, and removed the “cushion” notion from the AMF’s expectations as insurers are expected to maintain a level of capital in excess of the internal capital target ratio or level.
- Section 1.3.3 – Specified the audit requirement, which was already a requirement under a notice published by the AMF in 2013.
- Section 5.1.1 – Added only Kroll Bond Rating Agency (KBRA) in AMF’s recognized rating agencies.

3. Considerations for the 2019 own risk and solvency assessment (ORSA) report

As per Subsection 2430 of the *Standards of Practice*, the ORSA report is part of the information needed to provide an understanding of the insurer’s operations, its obligations, and the resources available to meet those obligations.

On January 18, 2019, the Actuarial Standards Board (ASB) approved the Exposure Draft for the Revision to the Standards of Practice to Incorporate Changes to Section 2500 Dynamic Capital Adequacy Testing. One of the objectives of the proposed revisions is to allow for a better alignment with ORSA regulatory requirements as they relate to work needed to report on the expected future financial condition of an insurance entity. Further information on the exposure draft can be found in the next section.

The following guidelines have been published by Canadian insurance regulators with regard to ORSA:

- OSFI, *Guideline E-19, Own Risk and Solvency Assessment*, effective January 1, 2018.
- AMF, *Capital Management Guideline*, Section 5, Own Risk and Solvency Assessment, effective May 2015.

In addition, here are other actuarial publications on ORSA:

- *Report on the CIA ORSA Survey conducted in April 2015*.
- *IAA Risk Book*, Chapter 10—Own Risk and Solvency Assessment (ORSA), March 8, 2016.

4. Considerations for Dynamic Capital Adequacy Testing (DCAT)/Financial Condition Testing (FCT)

Exposure draft

An exposure draft of the *Revision to the Standards of Practice to Incorporate Changes to Section 2500 Dynamic Capital Adequacy Testing* was approved by the ASB on January 18, 2019.

The objectives of the proposed revisions to Section 2500 Dynamic Capital Adequacy Testing are to:

- Provide a more robust approach to satisfy the federal and provincial insurance acts requirement to report on the expected future financial condition of an insurance entity; and
- Allow for a better alignment with own risk and solvency assessment (ORSA) regulatory requirements as they relate to work needed to report on the expected future financial condition of an insurance entity.

The CRMCR is working on an educational note to provide the actuary with the necessary guidance to apply the revised standard. We plan to issue the educational note concurrently with the new standard of practice.

The key expected changes indicated in the exposure draft are summarized below:

- Name of the standard: Dynamic Capital Adequacy Testing (DCAT) is renamed as Financial Condition Testing (FCT) to be more reflective of the Insurance Companies Act (ICA) requirements and of the exposure draft's proposed expanded definition of "satisfactory financial condition" and ORSA's core principle of assessing current and future solvency positions.
- Definition of "satisfactory financial condition": the threshold for the base scenario is changed to internal target rather than the regulatory supervisory level. It is also expanded to test two additional thresholds.
- Opinion of the actuary is modified to link to ORSA internal targets and explicitly allow for a qualified opinion, it also removes wording related to scenarios tested and their description in the report, significant assumptions described in the report, and the identification of key risk exposures in the report.
- Recent financial position and forecast period: the most appropriate number of years is left for the actuary to decide, based on the facts and circumstances of the insurer and the analysis.
- Risk categories: the detailed listings of risk categories are removed.
- General harmonization with ORSA: throughout Section 2500, wording is added to refer to ORSA or other processes where coordination could be beneficial.

The designated group is reviewing the comments received on the exposure draft and the proposed standard will be modified based on the feedback. However it is expected that the general concepts outlined above will remain the same.

Performance of DCAT and IFRS 17

In May 2017, the International Accounting Standards Board (IASB) issued *IFRS 17 Insurance Contracts*, replacing *IFRS 4 Insurance Contracts*. The implementation date is expected to be fiscal years beginning on or after January 1, 2022, with comparative financials produced for the immediately prior fiscal year. Insurers are proceeding with their implementation plans but many may not yet be able to reliably estimate earnings and/or balance sheets based on the new standard.

The regulatory capital guidelines will be adapted to reflect changes related to IFRS 17. As part of a directed confidential consultation, OSFI and the AMF have issued draft regulatory capital requirements guidelines and are also conducting quantitative impact studies for Life and P&C insurers, due on October 31, 2019. The ability of insurers to estimate required and available capital will be impacted by their ability to estimate IFRS 17 financial statements.

In principle, DCAT forecasts beyond January 1, 2022 should be produced under IFRS 17 and the updated regulatory capital requirements guidelines. However, neither the regulatory capital requirement guidelines nor IFRS 17 are final (the IASB issued a revised exposure draft on June 26, 2019), and many insurers are not yet able to produce reliable financial projections under IFRS 17 and may not be able to do so for the foreseeable future. In these circumstances, an appropriate practice would be to continue to perform DCAT using the current accounting standards, actuarial standards, and current regulatory capital guidelines, with additional qualitative analysis on IFRS 17. Quantitative analysis could also be added if available. If the quantitative impact study reveals potential issues based on the new draft guideline, and the insurer has not yet filed the DCAT report, it would also be appropriate for the appointed actuary to describe these potential issues to the board or chief agent along with any potential mitigating actions, either in the DCAT report or presentation, or through regular IFRS 17 updates.

5. Draft *Guideline B-3: Sound Reinsurance Practices and Procedures*

On June 8, 2018, OSFI issued a *Discussion Paper on OSFI's Reinsurance Framework* that included proposals to enhance and clarify OSFI's expectations for prudent reinsurance practices.

On June 12, 2019, OSFI issued proposed revisions to *Guideline B-3: Sound Reinsurance Practices and Procedures*. The revisions to the guideline reflect some of the proposals in the discussion paper, as well as comments received in response to the discussion paper.

Key changes to the guideline encourage insurers to better identify and manage risks arising from the use of reinsurance, particularly counterparty risk. Revisions to the guideline include that reinsurance payments flow directly to a cedant insurer in Canada, and reaffirm OSFI's principles-based expectation that an insurer not cede substantially all of its risks. A federally regulated insurer's (FRI's) ceding limits should be set for its overall book of business, and may also be established by line of business, as appropriate. The draft guideline also includes a statement that OSFI will generally not recognize or grant credit for a foreign FRI's reinsurance arrangement(s) when risks insured in Canada are ceded back to the foreign FRI's home office through affiliated reinsurers.

Based on the draft guideline, some insurers may need to adjust aspects of their reinsurance programs. OSFI intends to offer information sessions when it releases the final guideline in 2020.

6. OSFI *Draft Guideline E-25: Internal Model Oversight Framework*, for P&C insurers

On June 21, 2019, OSFI issued for comment draft guideline E-25 *Internal Model Oversight Framework* for federally regulated property and casualty insurance companies (P&C insurers).

This guideline applies to insurers that have received approval to use an internal model to calculate MCT regulatory capital requirements for insurance risk. The guideline establishes OSFI's expectations for insurers when they establish and maintain an oversight framework for the internal models.

The key elements of the draft guideline include:

- Establishing a model oversight framework;
- Periodic assessment of the framework via an internal model risk control (IMRC) process;
- Documentation of the framework and IMRC process; and
- Periodic review and assessment of the framework and the IMRC process by internal audit.

Appendix A: OSFI guidelines

Filename	Title	Effective Date
LICAT19	*Life Insurance Capital Adequacy Test*	01/01/2019
MCT2019	*Minimum Capital Test For Federally Regulated Property and Casualty Insurance Companies*	01/01/2019
E19	*Own Risk and Solvency Assessment*	01/01/2018
Draft B3	*Sound Reinsurance Practices and Procedures*	2020
Draft E25	*Internal Model Oversight Framework*	2020

Appendix B: AMF guidelines

Filename	Title	Effective Date
20190101-ligne-directrice-suffisance-capital-ass-personnes_an	*Capital Adequacy Requirements Guideline (CARLI) – Insurance of persons* (English version available soon)	01/01/2019
20190101-ligne-directrice-exigences-suffisance-capital-dommages_an	*Guideline on Capital Adequacy Requirements (MCT) – Property and Casualty Insurance*	01/01/2019
G_capital_management_final	*Capital Management Guideline*	01/05/2015

Appendix C: CIA guidance

Accession Number	Title	Publication Date
218097	Revised Educational Note: *Regulatory Capital Filing Certification for Life Insurers*	12/07/2018
218033	Educational Note: *Life Insurance Capital Adequacy Test (LICAT) and Capital Adequacy Requirements for Life and Health Insurance (CARLI)*	08/03/2018
217121	Second Revision of Educational Note: *Dynamic Capital Adequacy Testing*	24/11/2017
217018	Educational Note: *Performance of DCAT in 2017 for Life and Health Insurers*	09/02/2017