March 13, 2014

Judith Roberge
Director, P&C Insurance
Capital Division
Office of the Superintendent of Financial Institutions
255 Albert Street, Ottawa (ON) K1A 0H2

Re: Draft MCT Guideline

Dear Ms. Roberge,

This letter is in response to OSFI's request for feedback on the draft Minimum Capital Test (MCT) Guideline released for public consultation in December 2013. It summarizes the feedback provided by a working group of the Committee on Risk Management and Capital Requirements (CRMCR) of the Canadian Institute of Actuaries (CIA), including Andrea Sherry (Chair), Ron Miller, Pierre Laurin, and Kathryn Hyland. In addition, prior to this final response being sent, it was reviewed by the Chair of the CRMCR (Robert Berendsen), the Committee on Property and Casualty Financial Reporting, and the Practice Council, and this document incorporates any subsequent feedback.

Our feedback focuses on the industry's comments on OSFI's discussion paper and the Office's responses to those comments, as documented in your December 2013 Summary of Industry's Comments on OSFI's Discussion Paper: Proposed Changes to the Regulatory Capital Framework for Federally Regulated Property and Casualty Insurers including Earthquake Risk Exposure. As such, lack of comment on any other aspect of the draft MCT guideline should not be construed to be agreement with such. Furthermore, our comments are founded on principled considerations and expert judgment; we did not have sufficient time to perform in-depth analysis to support our comments or measure the effect of OSFI's proposals or ours.

Our comments below are organized by the section numbering of the above-mentioned summary document.

3. Credit Risk

Investment income due and accrued: You invoke simplicity as the reason to have only one factor applied to all investment income due and accrued regardless of the underlying investment. In our opinion, the calculations required in the MCT are quite detailed in many areas. Having a capital requirement on investment income due and accrued from government-grade investments consistent with the corresponding assets would not unduly complicate the calculations. And it would be more equitable. If the added complexity represents a challenge for some insurers, perhaps the differentiation by asset class can be allowed rather than required.

7. Insurance Risk

Credit risk for assumed reinsurance receivables: The credit risk for balances from assumed unregistered reinsurers outstanding for longer than 60 days (proposed to be 10%) should be better aligned with that for unrated obligations with a term of one year or less (for which the charge is 6%). We would argue that the credit quality of collateralized unregistered reinsurance is higher than the other credit risks in the 10% category. The credit quality of this type of balance is higher than it would be for outstanding balances from brokers, so the capital charge should be lower.

General: The various insurance risk margins by line are at times difficult to intuitively justify. It would be very helpful for actuaries to be able to see the analysis undertaken to determine the claim and premium liability factors so that we could understand the decisions that were made.

We recognize that OSFI published the document Disclosure on OSFI's Review of Insurance Risk Factors in order to provide more information on its rationale for the selection of the new insurance risk factors. While this document outlines OSFI's methodology, it is not sufficient to assess the magnitude of the proposed insurance risk factors. Furthermore, in the Background section of this document, OSFI states, "The review of the insurance risk margins was done in collaboration with the CIA (…). The CIA's role was primarily to provide independent advice, and actuarial expertise and data validation during the study." While the CRMCR of the Institute was involved, as mentioned, in the initial stages of the analysis, we would like to stress that the CIA was not consulted on the selection of the final insurance risk margins.

Floor for premium liabilities margin: We see that OSFI has reduced the floor from 40% to 30%. We suggest that the liability risk factor should be applied to the net premium liabilities determined by the Appointed Actuary (i.e., should eliminate the floor equal to 30% of net written premium). The arbitrary floor seems at odds with the general methodology for setting capital requirements, which focuses on in-force business at the reporting date.

Diversification: OSFI has indicated that the line of business risk factors have been calibrated to reflect diversification benefits typically experienced both within a given line of business and across lines of business within a given geography, i.e., there is an implicit credit for these types of diversification embedded in the risk factors. We understand that during the consultation period for the development of this MCT draft guideline there was discussion regarding the various types of diversification benefits and how to reflect them in risk capital, but we understand no material change was made in the draft MCT to the method of recognizing diversification benefits. In particular, no change was made to recognize geographical diversification. In our opinion, the current approach to diversification is unnecessarily crude; it understates the true risk profile for single-line, single-province insurers, who may actually need additional capital, owing to the lack of actual diversification; and conversely for insurers with a diversified book of business. We would suggest a more explicit recognition of diversification benefits across lines of business and across geographies.

Mix of business: In response to the industry's concern that changes to the risk factors may result in companies changing their business mix in order to be more capital efficient, you wrote, "OSFI does not expect insurers to change their business structure solely because of modified insurance risk factors for regulatory capital purposes." In our opinion, the changes to the insurance risk factors may indeed prompt companies to adjust their targeted mix of business, and they will very likely cause companies to update their pricing to recognize the new capital requirements, which in turn may also alter their mix of business.

8. Unregistered Reinsurance

Collateral: In our experience, the security provided by letters of credit (LOCs) is as much as or more than that provided by a trust fund (now called reinsurance security agreement, or RSA). In our opinion, the limit applying to LOCs equal to 30% of ceded recoverables is unnecessary and could be eliminated, and we would like to understand why OSFI believes a limitation on LOCs is necessary.

10. Operational Risk

Risk charge on ceded premium: The formula for operational risk uses direct written, assumed, and ceded premiums. The “3% of ceded premium” component is said to capture the operational risk remaining with the ceding company. However, it seems to us that the factors applied to direct written and assumed premiums already capture the “gross” exposure so we do not understand the need for an additional factor applied to ceded premiums. Further, we observe that the proposed formula would result in greater total operational risk capital requirements for insurers using quota share reinsurance than for insurers using excess-of-loss reinsurance, when the reverse would in our experience be more appropriate. If instead the “3% of ceded premium” were meant to capture the operational risk associated with the reinsurance per se, then we would suggest varying the factor by quota-share vs. excess-of-loss, with the latter attracting a larger factor.

It appears we may not have a full understanding of OSFI’s intentions with regard to capital for operational risk, and we would appreciate the opportunity to further discuss this.

11. Diversification Credit across Risk Categories

The diversification credit seems generally low. While there is admittedly correlation between market and credit risk in the tails, it is certainly less than the 100% correlation implied in the draft MCT. The 50% correlation in insurance risk factors also seems high. It would be useful for OSFI to give some background or justification to support the correlation parameters.

In closing, we thank you for this opportunity to comment on the draft MCT Guideline. We are available and interested to meet with you to discuss the areas identified in this letter as requiring further background, explanation, or discussion, and to address any questions you may have resulting from this letter. We also look forward to the opportunity to provide further feedback in the future.

Yours truly,

Jacques Lafrance
CIA President