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Educational Note

2018 Guidance to the Appointed Actuary for Property and Casualty Insurers

Document 218133

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Committee on Property and Casualty Insurance Financial Reporting

November 2018

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MEMORANDUM

To: Members in the Property and Casualty Insurance Practice Area

From: Faisal Siddiqi, Chair
Standards and Guidance Council

Houston Cheng, Chair
Committee on Property and Casualty Insurance Financial Reporting

Date: November 13, 2018

Subject: **Educational Note – 2018 Guidance to the Appointed Actuary for Property and Casualty Insurers**

In accordance with the Canadian Institute of Actuaries' 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 the Committee on Property and Casualty Insurance Financial Reporting and has received final approval for distribution by the Standards and Guidance Council on November 12, 2018.

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.

The topics covered herein are

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If you have any questions or comments regarding this educational note, please contact Houston Cheng at hhcheng@kpmg.ca.

FS, HC

1. Introduction *(unchanged)*

The Committee on Property and Casualty Insurance Financial Reporting (PCFRC) of the Canadian Institute of Actuaries (CIA) prepared this educational note to provide guidance to the Appointed Actuary (AA) for property and casualty (P&C) insurers. This note reviews relevant Standards of Practice and other educational notes and discusses current issues affecting the work of the AA. Links to all the CIA documents referenced in this educational note are provided in appendix A.

2. Guidance to Members on Specific Situations *(unchanged)*

From time to time, CIA members seek advice or guidance from the PCFRC. The PCFRC strongly encourages such dialogue. CIA members are assured that it is proper and appropriate for them to consult with the chair or vice-chair of the PCFRC.

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

3. Standards of Practice *(modified)*

The Standards of Practice are subject to revision from time to time. At the time of writing this educational note, references to the Standards of Practice correspond to the version effective February 22, 2018. The Rules version referred to became effective September 1, 2016.

While all of the Rules and Standards of Practice are important, your attention is directed to the following that are particularly relevant for AAs:

- Subsection 1220 – Materiality;
- Section 1400 – The Work;
- Section 1500 – Another Person's Work;
- Section 1600 – Assumptions and Methods;
- Section 1700 – Reporting;
- Section 2100 – Insurance Contract Valuation: All Insurance;
- Section 2200 – Insurance Contract Valuation: Property and Casualty Insurance;
- Section 2400 – The Appointed Actuary; and
- Section 2500 – Dynamic Capital Adequacy Testing.

Sections 1100 and 1200 were amalgamated as section 1100, and subsequent sections were renumbered in the February 1, 2018 version of 1000 – General Standards. Section 1600 (former section 1700) was rewritten and renamed "Assumptions and Methods" (formerly

"Assumptions") and now contains references to practice-specific standards. Former subsection 1810, relating to standard reporting language, was deleted, as practices vary by practice area.

In addition, several revisions were made to 1000 – General Standards with respect to the use of models that took effect January 1, 2018. In its memorandum on the final Standards of Practice, the designated group indicated that standard actuarial methods may be so deeply embedded in actuarial work that it may be unreasonable to expect an explicit justification for using that method; for this reason, new paragraph 1450.04 states that "A standard actuarial method used within a model in its proper context would be considered appropriate without further justification; for example, actuarial present value method for a pension valuation and the chain ladder method and Bornhuetter-Ferguson method for unpaid claims liabilities."

4. Materiality *(modified)*

Materiality is addressed in subsection 1240 of the Standards of Practice. The AA would communicate with the external auditor regarding materiality in accordance with the CIA/CICA Joint Policy Statement (subsection 1520).

The AA would consider the users of the report when selecting the level of materiality. For the Appointed Actuary Report (AAR), the end users are not limited to the users of the financial statements. The materiality threshold selected by the AA for the valuation of insurance contract liabilities usually would not be greater than the external auditor's selected materiality threshold. However, it may be substantially less when the actuary considers it appropriate to select a lower threshold. The materiality selected by the AA for the dynamic capital adequacy testing (DCAT) would usually be greater than the materiality selected for the valuation of insurance contract liabilities.

For further information on materiality, the AA is referred to the CIA Report on Materiality.

5. Use of Another Person's Work *(modified)*

Section 1500 of the Standards of Practice discusses considerations when using another person's work. Paragraph 1510.07 notes that "the actuary may use and take responsibility for another person's work, given confidence that such actions are justified . . .". However, as stated in paragraph 1510.12, "If the actuary uses but does not take responsibility for another person's work, the actuary would nevertheless examine the other person's work for evident shortcomings and would either report the results of such examination or avoid use of the work."

A particularly relevant example for AAs is the use of industry benchmarks related to Ontario automobile reforms. Similarly, the use of industry benchmark trend factors is another example. When using benchmarks developed by a third party, the AA would consider the professional requirements set out in section 1500.

6. Educational Notes and Other CIA Publications *(modified)*

To assist AAs in their year-end valuation or DCAT work, the following educational notes and documents are valuable sources of information:

- Second Revision of Educational Note: Dynamic Capital Adequacy Testing (November 2017);
- Educational Note: Duration Considerations for P&C Insurers (March 2017);
- Educational Note: Use of Models (January 2017);
- Second Revision – Educational Note: Premium Liabilities (July 2016);
- Educational Note: Discounting and Cash Flow Considerations for P&C Insurers (May 2016);
- Revised Educational Note: Subsequent Events (October 2015);
- Educational Note: Evaluation of the Runoff of P&C Claim Liabilities when the Liabilities are Discounted in Accordance with Accepted Actuarial Practice (June 2011);
- Research Paper: Disclosure Requirements IFRS 4 – Insurance Contracts for P&C Insurers (October 2010);
- Educational Note: Margins for Adverse Deviations for P&C Insurance (December 2009);
- Educational Note: Accounting for Reinsurance Contracts under International Financial Reporting Standards (December 2009);
- Educational Note: Classification of Contracts under International Financial Reporting Standards (June 2009);
- Report of the CIA Task Force on Materiality (October 2007);
- Report of the CIA Task Force on the Appropriate Treatment of Reinsurance (October 2007);
- Educational Note: Consideration of Future Income Taxes in the Valuation of Policy Liabilities (July 2005); and
- Educational Note: Valuation of Policy Liabilities P&C Insurance Considerations Regarding Claim Liabilities and Premium Liabilities (June 2003).

7. International Financial Reporting Standards *(modified)*

The CIA website now has an IFRS 17 blog (login required) that provides up-to-date summaries of the various CIA activities and links to relevant sources of information regarding IFRS 17. Please refer to appendix B for information about the development of standards of practice, guidance, and capital requirements under IFRS 17.

In September 2018, the CIA Committee on International Insurance Accounting (IIAC) released a draft educational note highlighting the key differences in the measurement of insurance contract liabilities between the current Standards of Practice and IFRS 17.

8. Regulatory Guidance *(modified)*

AAs are reminded to refer to updated communications from provincial and/or federal insurance regulators regarding insurance contract liabilities valuation and DCAT reporting.

8.1. Office of the Superintendent of Financial Institutions (OSFI) Requirements

8.1.1. OSFI Annual Memorandum for Actuarial Reports on P&C Business

Annually, OSFI issues a memorandum for the AA. AAs would consult this memorandum for complete instructions from OSFI.

8.1.2. Capital Requirements

References in this section to OSFI's Minimum Capital Test (MCT) for Canadian insurers are intended to encompass comparable requirements for Canadian branches of foreign insurers, i.e., the Branch Adequacy of Assets Test (BAAT).

The MCT Guideline currently in effect was issued by OSFI in October 2017 with an effective date of January 1, 2018.

A draft 2019 MCT guideline was issued for public consultation in June 2018. Effective January 1, 2019, the draft guideline

- Introduces credit risk capital charges to right-of-use assets resulting from the implementation of IFRS 16;
- Adjusts net assets available for Canadian branches to admit the right-of-use asset for owner-occupied property leases resulting from the implementation of IFRS 16;
- Introduces counterparty credit risk capital charges on amounts receivable and recoverable from registered associated reinsurers;
- Recognizes accounts payable created under a funds-held reinsurance arrangement between Canadian insurance companies and unregistered associated insurers as acceptable collateral to reduce the margin required for cessions to unregistered reinsurers, subject to a condition;
- Updates the credit risk factors for securitized assets and transfers the updated risk factors from Guideline B-5 – Asset Securitization to the MCT guideline; and
- Implements other minor edits or clarifications.

Effective, January 1, 2020, the draft guideline

- Increases the margin required for reinsurance ceded to unregistered reinsurers from 15 percent to 20 percent.

8.1.3. Stress Testing

From time to time, OSFI may ask institutions to carry out standardized scenario tests to assess system-wide vulnerabilities. No stress testing was required by OSFI in 2017 or 2018.

8.1.4. Guideline A-4 Regulatory Capital and Internal Capital Targets

The current Guideline A-4 was updated in December 2017, effective January 1, 2018. There were no significant changes applicable to P&C insurers in the updated guideline. The guideline sets out OSFI's expectations with respect to the setting of insurer-specific target capital ratios and how such targets relate to the assessment of capital adequacy within the context of OSFI's supervisory framework. The AA is usually involved with and understands the insurer's process and assumptions used to select the target capital ratio.

8.1.5. Guideline E-19 Own Risk and Solvency Assessment

The current guideline was updated in December 2017, effective January 1, 2018. There were no significant changes applicable to P&C insurers in the updated guideline. The guideline sets out OSFI's expectations with respect to an insurer's own assessment of its risks, capital needs, and solvency position and for setting internal targets.

The AA is usually involved in the preparation of the own risk and solvency assessment (ORSA) given the significant role the AA has in preparing key elements that are part of ORSA (e.g., the DCAT, stress testing in accordance with Guideline E-18, internal capital target setting per Guideline A-4, and the policy liabilities valuation report). The AA may also be involved in the qualitative aspects of ORSA (e.g., assisting in the determination of the risk appetite and risk tolerance of the insurer). On an annual basis (prior to December 31 each year), OSFI requires the board or chief agent to review and discuss the ORSA report. OSFI also requires the key metrics report form to be submitted at least annually and within 30 days of review by the board or sign-off by the chief agent.

8.1.6. Guideline E-15 Appointed Actuary: Legal Requirements, Qualifications, and Peer Review

A full peer review of the AAR and DCAT report is required every three years. In addition, OSFI expects the reviewer to undertake a limited scope annual review and to prepare and file a report annually.

8.1.7. Guideline B-9 Earthquake Exposure Sound Practices

OSFI requires insurers to file the Earthquake Exposure Data Form and instructions by May 31 of each year using the Regulatory Reporting System.

8.2. Requirements of the Autorité des marchés financiers (AMF)

8.2.1. AMF Annual Guides for Actuarial Reports on P&C Business

The AMF issues specific guides to AAs of Québec-chartered insurers for both the valuation of insurance contract liabilities (copy and paste the link into your browser) and DCAT. The AA would consult these guides for the complete requirements from the AMF.

The AMF guide regarding the mandatory insurance contract liabilities report is updated annually and addresses regulatory requirements and the report's expected content and prescribed layout. The AMF guide also mandates prescribed exhibits for reporting results of the AA's valuation of insurance contract liabilities. Prescribed exhibits include the unpaid claims and loss ratio exhibits for which specific instructions are also available along with the guide.

The AMF also publishes a guide for the preparation of the report on the insurer's financial condition (DCAT report). This guide is updated annually, usually in November, and addresses the same general aspects as the guide on the valuation of insurance contract liabilities. When completing the DCAT report, AAs are advised to be aware of the latest developments in the calculation of the MCT ratio. The AMF requires the AA to annually disclose the insurer's internal capital target ratio, and the DCAT guide states that the AA would take care to detail the methodology and assumptions used in the determination of the internal capital target ratio.

8.2.2. Capital Requirements

In November 2017, the AMF published its revised MCT guideline, which came into effect on January 1, 2018. The changes were harmonized to a significant extent with the changes to OSFI's 2018 MCT guideline.

The AMF issued its draft 2019 MCT guideline in June 2018 for public consultation. The final guideline is expected to be published in fall 2018 with an effective date of January 1, 2019. The proposed changes are harmonized to a significant extent with the changes to OSFI's MCT guideline.

AAs of Québec-chartered insurers would also be aware that AMF requires insurers to file the earthquake exposure data by April 15 of each year, using the AMF Earthquake Exposure Data Form and Instructions and based on latest year-end exposure.

AAs would be expected to be familiar with any subsequent revisions to the capital requirements and incorporate them where applicable.

8.2.3. Stress Testing

From time to time, the AMF asks institutions to carry out standardized scenario tests to assess system-wide vulnerabilities. No such specific standardized test was requested by the AMF in 2017 or 2018.

The AA is reminded that the insurer's performance in previous stress tests can be a useful consideration when designing/selecting current-year insurer-specific scenarios.

8.2.4. Integrated Risk Management Guideline and Capital Management Guideline

In May 2015, the AMF published a revised version of its Integrated Risk Management Guideline to accompany the publication of its new Capital Management Guideline. The revision and the addition of the new guideline were meant to update certain concepts and to give specific expectations regarding capital and risk management, particularly for elements such as the

- Notions of risk appetite and risk tolerance levels;
- Relations between the risk management framework, the solvency position, and the strategic objectives of the insurer and their disclosure to the board of directors and senior management; and
- ORSA related to capital management (governance, choice of capital instruments, planning of capital needs) and its impact on the insurer's risk profile.

The AMF expects AAs to be involved in the own risk and solvency mechanism, especially with regards to setting of the internal capital target and stress testing as a complementary tool to DCAT.

The AMF also expects the application of the ORSA mechanism to be the subject of an official report to the board of directors at least once a year, or more often if the financial institution's risk profile changes significantly, and assesses the degree of compliance to these guidelines as part of its supervisory framework.

9. Current or Emerging Issues and Other Considerations *(modified)*

9.1. Auto Reforms

The AA would consider the potential effect that automobile product reforms could have on both the valuation of insurance contract liabilities and the DCAT. For example, for all motor vehicle accidents in Alberta occurring after June 1, 2018, changes to the Minor Injury Regulation apply. The AA is also expected to consider the effect of recent auto reforms in Ontario when undertaking both valuation and DCAT work.

9.2. Recent Judicial, Legislative, and Political Events

Regular communication with claims professionals is essential to the work of the AA. These discussions would encompass the potential effect of recent court decisions, judicial events, and political events that may be relevant to the valuation of insurance contract liabilities and DCAT.

Recent examples of such events include the following:

- *El-Khodr v. Lackie (2017), Cobb v. Long Estates (2017)*

  On September 19, 2017, the Ontario Court of Appeal ruled on the application of the rate of pre-judgment interest (PJI) for general damages claims arising from a motor vehicle accident. The court concluded that the 1.3 percent rate of PJI is to be applied immediately to both pending and future claims. Moving forward, parties may use the Courts of Justice Act rate when calculating PJI, bearing in mind that the rate is subject to the discretion of a trial judge.

  The Appeal Court also ruled on the application of the indexed deductible for general damages. For all current and future claims, the new inflation-adjusted deductible applies to all pending cases. Similarly, the court ruled that costs are to be determined on the net amount for general damages. Now, costs are to be calculated after the statutory deductible is applied.

- *A.F. v. North Blenheim Mutual Insurance Company*

  Although section 56 of the statutory accident benefit schedule (SABS) states that proceedings must be commenced within two years after an insurer refuses to pay a claim, in a decision released December 13, 2017, the Ontario Licence Appeal Tribunal found that section 7 of the License Appeal Tribunal Act could be relied upon irrespective of the provisions of the Insurance Act and SABS.

- *Abdirahman Abyan and Sovereign General Insurance Company, Constitutional Challenge of the Minor Injury Guideline (MIG)*

  On September 14, 2017, a Financial Services Commission of Ontario (FSCO) arbitration declared that the MIG insofar as it applies to "chronic pain" victims of motor vehicle accidents is unconstitutional and in violation of section 15 of the Charter of Rights and

Freedoms. This decision may make it difficult for insurers to treat chronic pain conditions differently than other disabilities.

Prior annual guidance to the AA contain additional historical court cases that are still relevant for the AA's work.

9.3. Catastrophic Events

From time to time, catastrophic events occur that have the potential to affect an AA's estimate of claim liabilities and, in some cases, the premium liabilities. Events that are considered catastrophic on an industry-wide basis may not have a catastrophic effect for a given insurer, while smaller industry events may. The extent to which any event is significant in the context of the valuation of a specific insurer's insurance contract liabilities depends on the nature of the insurer's business, its exposure in the affected region, policy wordings, and the date on which the event occurred.

The AA would consider the effect of extreme events on the following:

- Additional costs on other losses due to post-event inflation in the region as well as the rest of the country;
- The payment pattern and any change that the event may have on paid claims;
- Unallocated loss adjustment expenses (ULAE) estimates that may need to be tempered to the extent that the factor used to calculate the provision is a ratio to unpaid losses; and
- Margins for adverse deviations, particularly for recovery from reinsurance ceded.

Appendix A

The following is a list of selected documents referenced in this educational note:

Standards of Practice

- Standards of Practice
- Rules of Professional Conduct

Task Force Reports

- Materiality (October 2007)
- Appropriate Treatment of Reinsurance (October 2007)

Educational Notes

- Dynamic Capital Adequacy Testing (November 2017)
- Duration Considerations for P&C Insurers (March 2017)
- Use of Models (January 2017)
- Premium Liabilities (July 2016)
- Discounting and Cash Flow Considerations for P&C Insurers (May 2016)
- Subsequent Events (October 2015)
- Evaluation of the Runoff of P&C Claim Liabilities when the Liabilities are Discounted in Accordance with Accepted Actuarial Practice (June 2011)
- Accounting for Reinsurance Contracts under International Financial Reporting Standards (December 2009)
- Margins for Adverse Deviations for Property and Casualty Insurance (December 2009)
- Classification of Contracts under International Financial Reporting Standards (June 2009)
- Consideration of Future Income Taxes in the Valuation of Policy Liabilities (July 2005)
- Valuation of Policy Liabilities P&C Insurance Considerations Regarding Claim Liabilities and Premium Liabilities (June 2003)

Research Paper

- Disclosure Requirements IFRS 4 – Insurance Contracts for P&C Insurers (October 2010)

CIA IFRS 17 Blog

- CIA – IFRS 17 Blog (login required)

Appendix B

The following information discusses the development of standards of practice, guidance, and capital requirements under IFRS 17.

Standards of Practice

In May 2017, the International Accounting Standards Board (IASB) published the final standards for insurance contracts, IFRS 17. The implementation date is fiscal years beginning on or after January 1, 2021. The IASB website contains the most current information (including the final standard and related documents) but requires an eIFRS professional account to access.

In February 2018, the International Actuarial Association (IAA) released its Exposure Draft of Proposed International Standard of Actuarial Practice 4 (ISAP 4) on IFRS 17 Insurance Contracts. ISAP 4 addresses actuarial practice in support of the valuation of insurance contract liabilities in accordance with IFRS 17. The changes proposed in the CIA exposure draft align the Canadian Standards of Practice with the requirements of IFRS 17 and incorporate the guidance of ISAP 4. Changes are required to the Canadian Standards of Practice as there are significant differences in some aspects of the valuation of insurance contract liabilities under IFRS 17 (such as discounting and risk adjustment) from the current accounting standards.

In May 2018, the ASB Designated Group on Insurance Contract Standards of Practice published Exposure Draft – Incorporate changes required by the adoption in Canada of IFRS 17 Insurance Contracts, including Principles of International Standard of Actuarial Practice 4 – Actuarial Practice in Relation to IFRS 17 Insurance Contracts, into the Canadian Standards of Practice. The Canadian Accounting Standards Board indicated its intention that, once adopted by the IASB and subject to its due process, IFRS 17 will be adopted without modification for the valuation of insurance contracts in Canadian generally accepted accounting principles (GAAP) financial statements.

Guidance and Education

With respect to international accounting and actuarial standards for the valuation of insurance and related products, the CIA Committee on International Insurance Accounting (IIAC) under the International Relations Council has the following mandate:

- Monitor developments and ensure that news of relevant and material developments is dispersed appropriately within the CIA;
- Recommend where specific additional Canadian guidance may be helpful, and if so, assist in its development; and
- Where relevant and appropriate, provide input from a CIA perspective to the international governing bodies.

On September 21, 2018, the IIAC released a draft educational note highlighting the key differences in the measurement of insurance contract liabilities between the current Standards of Practice and IFRS 17. Revisions to this educational note may be made in coming months if changes are made to any of the relevant international standards or guidance.

The IAA has been working on an International Actuarial Note (IAN 100) to support actuaries involved in implementing IFRS 17. An IAN is similar to a CIA educational note, except produced at the international level. Although IAN 100 is still under development and review, the IAA has released a draft working version to actuaries of member organizations to give actuaries a starting point in this process. The IFRS 17 blog (login required) now includes a link to this document, accessible to members only given the IAA's specific request for limited distribution at this time.

The CIA is very active in the area of IFRS 17, with several committees reviewing the IFRS 17 standard and related guidance. The PCFRC will review the IAN and will consider adopting it as educational guidance in the form of an educational note or other types of papers. The primary focus will be on areas that require Canadian-specific guidance. The PCFRC will also consider providing additional material beyond IAN 100 that may be helpful in implementing the new standards. Thus far, the PCFRC has formed working groups to look at the following topics:

- Discounting;
- Risk adjustment;
- Premium allocation approach (PAA) eligibility; and
- Reinsurance.

The CIA is also engaged in educating members about IFRS 17 through webcasts, sessions at CIA meetings, and other forums.

Capital Requirements and IFRS 17 Considerations for DCAT

On September 21, 2018, OSFI released 2021 Life Insurance Capital Adequacy Test (LICAT) and Minimum Capital Test (MCT) draft guidelines directly to insurers and other selected stakeholders, including the Committee on Life Insurance Financial Reporting (CLIFR) and the PCFRC. Given the importance of the MCT to the AA role, AAs would typically be involved in the review of the draft guidelines and providing comments. OSFI indicated that the revisions outlined in the drafts are intended to minimize the extent of capital policy changes associated with the implementation of IFRS 17. OSFI's deadline for comments is November 30, 2018.

Given that OSFI's MCT Guideline is in draft and potentially subject to further change, AAs are not yet able to perform DCAT forecasts under an IFRS 17 basis. Accordingly, it is appropriate to continue to perform DCAT using the current accounting standards, Standards of Practice, and regulatory capital guidelines. For DCAT performed in 2019, it is appropriate to qualitatively describe through routine updates or in the DCAT report, the potential effect of IFRS 17 on the insurance entity's financial results and regulatory capital, and explain the limitations on the assessment of financial condition.