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Educational Note Supplement

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

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

**Committee on Risk Management
and Capital Requirements**

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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: December 11, 2019

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

This educational note supplement provides an update to Section 4, Considerations for Dynamic Capital Adequacy Testing (DCAT)/Financial Condition Testing (FCT) and Appendix C of the [Educational Note: Guidance for the 2019 Reporting on Capital and Financial Condition Testing for Life and P&C Insurers](#) published in August 2019.

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 the Committee on Risk Management and Capital Requirements (CRMCR), and has received final approval for distribution by the Standards and Guidance Council on December 11, 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.

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

SWE, ML

An update to Section 4 and Appendix C of the [Educational Note: Guidance for the 2019 Reporting on Capital and Financial Condition Testing for Life and P&C Insurers](#) is provided below.

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

Revised Standard of Practice: Section 2500

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 Actuarial Standards Board (ASB) on January 18, 2019.

On September 10, 2019, the ASB approved the [revised Standard of Practice](#) (SOP), with an effective date of **January 1, 2020**.

The objectives of the revisions to Section 2500 were 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 key changes in the standard are summarized below:

- Name of the standard: Dynamic Capital Adequacy Testing (DCAT) is renamed as Financial Condition Testing (FCT)
- 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: a) going concern, and b) solvency.
 - The threshold for “going concern” scenarios is the minimum regulatory target
 - The threshold for “solvency” scenarios is that the statement value of assets is sufficient to cover the statement value of the liabilities
- Opinion of the actuary is modified to link to ORSA internal targets and explicitly allow for an opinion of “satisfactory subject to” certain conditions. 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.
- Distinction has been made between ripple effects (which may include management’s routine actions) and corrective management actions.
- General harmonization with ORSA: throughout Section 2500, wording is added to refer

to ORSA or other processes where coordination could be beneficial.

The CRMCR drafted a revised [educational note](#), *Financial Condition Testing*, to provide additional guidance to the actuary on the above topics in the revised SOP. The draft educational note was approved for exposure to the membership by the Standards and Guidance Council on December 3, 2019.

Transition from DCAT to FCT in 2020

The revised SOP, effective on January 1, 2020, applies to all FCT reports that are submitted to the regulator(s) on or after January 1, 2020. It is recognized that for the first year of the implementation of the SOP, methodologies, systems and processes may not be fully developed to perform the FCT as robustly as expected for future mature years. The Appointed Actuary may make reasonable simplifying assumptions and approximations to address these limitations if any. The simplifying assumptions and approximations would be described in the FCT report. If appropriate, the opinion of the appointed actuary may also reflect that the financial condition of the insurer is satisfactory subject to the simplifying assumptions and approximations.

The appointed actuary would assess compliance of the base scenario with current internal targets, and/or known or reasonable estimates of future changes in internal targets. It should be noted that per OSFI guideline E-19, "The assessment of adequacy of capital should also consider the capital needed to support an insurer's longer term business strategies and, in particular, new business and planned growth. Considering this, an insurer should determine an appropriate level or range of capitalization at which it operates, set above its Internal Targets. In determining an operating level, an insurer should consider the impact of future planned, foreseen and likely potential changes to its risk profile due to changes in its operations, its business strategy or its operating environment. For example, it should consider a series of varying adverse scenarios and, at a certain operating level, assess the insurer's ability to continue operating and not fall below its Internal Targets. It should also evaluate whether long-run Internal Targets are consistent with short-run goals, and adjust its operating levels as appropriate; recognizing that accommodating additional capital needs or additional risk mitigants can require significant lead time." Similar expectations regarding the assessment of internal targets consistently with the insurer's strategic and business plan are found in AMF's Capital Management Guideline.

Transition to 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 conducted quantitative impact studies for Life and P&C insurers,

which were 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/FCT 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 therefore 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 in 2019 and FCT in 2020 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 revealed potential issues based on the new draft guideline, and the insurer has not yet filed the DCAT/FCT 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/FCT report or presentation, or through regular IFRS 17 updates.

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Appendix C: CIA guidance

Accession Number	Title	Publication Date
	<u>Draft Educational Note: <i>Financial Condition Testing</i></u>	12/05/2019
	<u>Revised Standard of Practice: Section 2500 Financial Condition Testing</u>	10/15/2019
218097	Revised Educational Note: <u>Regulatory Capital Filing Certification for Life Insurers</u>	12/07/2018
218033	Educational Note: <u>Life Insurance Capital Adequacy Test (LICAT) and Capital Adequacy Requirements for Life and Health Insurance (CARLI)</u>	08/03/2018
217121	Second Revision of Educational Note: <u>Dynamic Capital Adequacy Testing</u>	21/11/2017
217018	Educational Note: <u>Performance of DCAT in 2017 for Life and Health Insurers</u>	09/02/2017

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