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Educational Note

Guidance for the 2008 Valuation of Policy Liabilities and DCAT for Property and Casualty Insurers

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Educational Note

Guidance for the 2008 Valuation of Policy Liabilities and DCAI for Property and Casualty Insurers

Committee on Property and Casualty
Insurance Financial Reporting

December 2008

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Members should be familiar with educational notes. Educational notes describe but do not recommend practice in illustrative situations. They do not constitute Standards of Practice and are, therefore, not binding. They are, however, intended to illustrate the application (but not necessarily the only application) of the Standards of Practice, so there should be no conflict between them. They are intended to assist actuaries in applying Standards of Practice in respect of specific matters. Responsibility for the manner of application of Standards of Practice in specific circumstances remains that of the member in the property and casualty insurance practice area.

Memorandum

To: Members in the Property and Casualty Insurance Practice Area

From: Jacques Tremblay, Chairperson
Practice Council

Kevin Lee, Chairperson
Committee on Property and Casualty Insurance Financial Reporting

Date: December 23, 2008

Subject: **Educational Note – Guidance for the 2008 Valuation of Policy Liabilities and DCAT for Property and Casualty Insurers**

In accordance with the Institute's Policy on Due Process for the Approval of Guidance Material other than Standards of Practice, 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 Practice Council on December 23, 2008.

As outlined in subsection 1220 of the Standards of Practice, "*The actuary should be familiar with relevant educational notes and other designated educational material.*" That subsection explains further that a "practice which the 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." As well, "*educational notes are intended to illustrate the application (but not necessarily the only application) of the standards, so there should be no conflict between them.*"

If you have any questions or comments regarding this educational note, please contact Kevin Lee at his C.A. Online Directory address, klee@iao.ca.

JT, KL

The Committee on Property and Casualty Insurance Financial Reporting (PCFRC) of the Canadian Institute of Actuaries (CIA) reminds actuaries involved in valuation of policy liabilities and Dynamic Capital Adequacy Testing (DCAT) reporting for property and casualty insurers that it is important to review the Rules of Professional Conduct (Rules), the Standards of Practice and relevant educational notes. Links to all the documents referenced in this educational note are provided in the appendix.

Standards of Practice

While all of the Rules and Standards of Practice are important, we would like to direct your attention to the following in particular:

- section 1600 – Another Person’s Work
- section 1700 – Assumptions
- section 1800 – Reporting
- section 2100 – Valuation of Policy Liabilities: All Insurance
- section 2200 – Valuation of Policy Liabilities: P&C Insurance
- section 2400 – The Appointed Actuary
- section 2500 – Dynamic Capital Adequacy Testing

Special attention would be given to the fact that during 2007 there were revisions to Standards of Practice, subsections 1620 and 1630 (CIA/CICA Joint Policy Statement, effective October 1, 2007) and section 2500 (Dynamic Capital Adequacy Testing, effective November 1, 2007 for reports based on fiscal years ending October 31, 2007 or later).

Educational Notes and Other CIA Publications

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

- Draft of Educational Note: [Subsequent Events](#) (October 2008)
- Educational Note: [Dynamic Capital Adequacy Testing](#) (November 2007)
- Report of CIA Task Force on Materiality: [Materiality](#) (November 2007)
- Report of the CIA Task Force on the Appropriate Treatment of [Reinsurance](#) (October 2007)
- Educational Note: [Discounting](#) (July 2005)
- Educational Note: [Consideration of Future Income Taxes in the Valuation of Policy Liabilities](#) (July 2005)
- Educational Note: [Valuation of Policy Liabilities P&C Insurance Considerations Regarding Claim Liabilities and Premium Liabilities](#) (June 2003)
- Educational Note: [Evaluation of the Runoff of Claims Liabilities When the Liabilities are Discounted in Accordance with Accepted Actuarial Practice](#) (March 2003)

In addition, the repealed memorandum of November 1993 entitled, [Provision for Adverse Deviations](#) (Property and Casualty) provides useful information for the selection of

margins for adverse deviations until a suitable replacement is published by the CIA. Specifically, it lists many important considerations influencing the selection of margins and provides descriptions of high and low margin situations.

Regulatory Guidance

We remind the appointed actuary to refer to updated communication from provincial and/or federal insurance regulators regarding policy liabilities valuation and DCAT reporting.

In the November 3, 2008 covering letter to OSFI's 2008 Memorandum for Actuarial Reports of Property and Casualty Business, Stuart Wason, Senior Director, Actuarial Division, Regulation Sector, states that the Actuary's Report should clearly show the provisions (both case and IBNR) that the company is currently holding in connection with the legal challenges to the caps introduced as tort reform measures in Alberta, Nova Scotia, and New Brunswick. His covering memorandum states: "The Report should also disclose the potential liability should the challenges ultimately succeed. Supporting exhibits for the Actuary's estimates should be included in the report. Where no liability exists or where the amounts are not material a comment to that effect should be included in the report."

It is our understanding that legal challenges are arising in Prince Edward Island as well.

To evaluate the insurer's potential liability to the legal challenges, the appointed actuary may use a variety of approaches, including but not limited to:

- a market share approach based on estimates of the industry-wide impact of the cap in each province (e.g., Ron Miller's analysis, RPMG analysis or individual company's analysis),
- a detailed review of the individual company's open and/or closed claim files,
- traditional actuarial methods based on a review of loss development experience pre- and post-reform.

The appointed actuary may also want to consider the potential for reopened claims and a backlog of late reported claims. The selection of approach will vary depending on the size of the company's portfolio in each province as well as the availability of data pre- and post-reform.

Subsequent Events

The draft educational note on subsequent events was presented and discussed at the 2008 Seminar for the Appointed Actuary. The impetus for the development of this note was the uncertainty that arose following the Alberta Court Bench decision of February 8, 2008 and its possible impact on the December 31, 2007 policy liabilities. The purpose of the educational note is to clarify the course of action to be followed by appointed actuaries following a subsequent event. The educational note includes the following:

- review of the relevant Standards of Practice,
- definition of a subsequent event from the appointed actuary's and the auditor's perspective,

presentation of a decision tree for the actuary to consider following a possible subsequent event,

illustration of the issues with various examples of potential subsequent events, and

reminder of the importance of communication between the auditor and the appointed actuary with respect to subsequent events.

Financial Crisis

The recent financial crisis may pose additional challenges for the appointed actuary at year-end 2008. For example:

if the appointed actuary has not yet completed the DCAT report, he or she would take into consideration the current financial environment in the base scenario, at least with regard to investment income, investment market values and investment amortized values,

in his or her DCAT, the appointed actuary would consider any potential for parent companies limiting the capital available, and

the actuary would consider the effect of the current financial environment in the determination of the interest rate and margins for adverse deviations for discounting policy liabilities.

Use of Benchmark Industry Information

At the 2008 Seminar for the Appointed Actuary, session PD-8 dealt with the issue of using benchmark information for the valuation of policy liabilities. The session addressed four topics, specifically

What benchmarks do Canadian actuaries use?

What are the general issues with all types of benchmark data?

What are the specific issues with the benchmarks most frequently used by Canadian actuaries?

What are your responsibilities as appointed actuary?

This session emphasized the need for the actuary to evaluate the appropriateness of the benchmarks used in his or her analyses. We refer you to the CIA website for copies of the presentation slides from this session.

International Financial Reporting Standards

Since International Financial Reporting Standards (IFRS) are expected to be adopted in Canada on January 1, 2011, appointed actuaries should become aware of the effect thereof for their respective companies.

As part of the reporting for fiscal year 2008, companies will be required to disclose plans for their IFRS transition and the expected effect on the financial statements of the conversion. IFRS 4, which applies to insurance contracts, is an interim standard that allows insurers to mostly retain their current accounting policies for contracts that meet the standard's definition of insurance.

Phase II of IFRS 4 is intended to result in a single international standard for all insurance contracts; the date for the adoption of Phase II is not yet finalized but the earliest possible

date is January 1, 2013. While the current IFRS 4 is concerned mostly with the definition and classification of insurance contracts, the revised standard will introduce some changes in the measurement of policy liabilities and the presentation of the balance sheet.

Although Phase I is expected to have little impact for most P&C companies, two areas are of immediate concern to the appointed actuary:

- The January 1, 2011 implementation date means that comparable financial statements will be required for 2010. Therefore, issues must be identified rapidly to be addressed in time for this deadline.
- Under IFRS 4, an insurance contract is defined as a “Contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.” All insurance contracts would be reviewed to make sure they meet this definition. For most P&C insurance contracts the determination will be straightforward. However, the classification of some contracts may be more complex, for example: mortgage insurance, warranty, fronting, self-insured retentions, etc. For reference, the actuary could consult Appendix B of IFRS 4 describing the classification of insurance contracts.

Numerous papers have been published on the topic of IFRS. The PCFRC refers you to the following publicly available documents:

Handout from presentation PD-10 at the CFA’s 2008 Seminar for the Appointed Actuary,
OSFI’s October 7, 2008 communication regarding, “International Financial Reporting Standards”,
OSFI’s April 25, 2008 communication regarding, “Adoption of International Financial Reporting Standards”,
International Actuarial Association’s (IAA) International Actuarial Standard of Practice (IASP) – IASB Classification of Contracts,
“At the Crossroads – The Future Direction of Insurance Accounting”, Ernst & Young (recently added to the syllabus of CAS exam 7C.),
“Impact of IFRS on Canadian Property & Casualty Insurers”, KPMG LLP (recently added to the syllabus of CAS exam 7C.), and
International Accounting Standards Board (IASB) May 2007 paper, “Preliminary Views on Insurance Contracts,” Part 1, Chapters 1 through 3.

APPENDIX

Following is a list of all documents referenced in this educational note, along with the corresponding hyperlinks.

Rules of Professional Conduct:

<http://www.actuaries.ca/members/publications/2006/206091e.pdf>

Standards of Practice:

http://www.actuaries.ca/SOP/sop_e.cfm

Draft of Educational Note: Subsequent Events (October 2008)

<http://www.actuaries.ca/members/publications/2008/208069e.pdf>

Educational Note: Dynamic Capital Adequacy Testing (November 2007):

<http://www.actuaries.ca/members/publications/2007/207108e.pdf>

Task Force Report: Materiality (November 2007):

<http://www.actuaries.ca/members/publications/2007/207092e.pdf>

Task Force Report: Appropriate Treatment of Reinsurance (October 2007)

<http://www.actuaries.ca/members/publications/2007/207081e.pdf>

Educational Note: Discounting (July 2005)

<http://www.actuaries.ca/members/publications/2005/205052e.pdf>

Educational Note: Consideration of Future Income Taxes in the Valuation of Policy Liabilities (July 2005):

<http://www.actuaries.ca/members/publications/2005/205048e.pdf>

Educational Note: Valuation of Policy Liabilities P&C Insurance Considerations Regarding Claim Liabilities and Premium Liabilities (June 2003):

<http://www.actuaries.ca/members/publications/2003/203051e.pdf>

Educational Note: Evaluation of the Runoff of Claims Liabilities When the Liabilities are Discounted in Accordance with Accepted Actuarial Practice (March 2003):

<http://www.actuaries.ca/members/publications/2003/203023e.pdf>

Memorandum of November 1993 entitled, Provision for Adverse Deviations (Property and Casualty):

<http://www.actuaries.ca/members/publications/1993/9371e.pdf>

Handout from presentation PD-10 at the CIA's 2008 Seminar for the Appointed Actuary:

<http://meetings.actuaries.ca/meetings/aa/2008/Presentations/PD-10%20IFRS%20-%20Gauthier.pdf>

Handout from presentation PD-8 at the CIA's 2008 Seminar for the Appointed Actuary:

<http://meetings.actuaries.ca/meetings/aa/2008/Presentations/PD-8%20Benchmarks%20-%20User%20Beward%20-%20Friedland.ppt>

International Actuarial Association: IASP 3 – Classification of Contracts

http://www.actuaries.org/STANDARDS/Current/IASP3_EN.pdf