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## Educational Note

# Guidance for the 2010 Valuation of Policy Liabilities and DCAT for Property and Casualty Insurers

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## *Educational Note*

# Guidance for the 2010 Valuation of Policy Liabilities and DCAT for Property and Casualty Insurers

Committee on Property and Casualty Insurance Financial Reporting

October 2010

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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:** Tyrone G. Faulds, Chair  
Practice Council  
Pierre Dionne, Chair  
Committee on Property and Casualty Insurance Financial Reporting

**Date:** October 28, 2010

**Subject:** **Educational Note – Guidance for the 2010 Valuation of Policy Liabilities and DCAT 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, 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 October 27, 2010.

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 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." 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 Pierre Dionne at his CIA Online Directory address, [pdionne@ccr.fr](mailto:pdionne@ccr.fr).

TGF, PD

The Committee on Property and Casualty Insurance Financial Reporting (PCFRC) of the Canadian Institute of Actuaries (CIA) has prepared this educational note to provide guidance to actuaries in several areas affecting the valuation of policy liabilities and dynamic capital adequacy testing (DCAT) reporting for property and casualty (P&C) insurers. This educational note reviews relevant Standards of Practice and educational notes and discusses some current issues affecting the work of the appointed actuary (AA). Links to all the documents referenced in this educational note are provided in the appendix.

### Standards of Practice

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

- Subsection 1340 – Materiality,
- Section 1500 – The Work,
- 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, and
- Section 2500 – Dynamic Capital Adequacy Testing.

Of particular note is the December 2009 change in Section 2200 – Discounting. In addition, the Actuarial Standards Board recently published a notice of intent to revise subsections 2260 and 2270, which address margin for adverse deviations for property and casualty insurance. The intent of the revision is to address the issue of selecting a margin below the low end of the range. The current Standards of Practice related to margins for adverse deviations (MfAD) derived from both deterministic and stochastic analyses are very specific in not allowing for a MfAD less than the low end of the range. The desired outcome is to make it clearer to members that selection below the low margin may be acceptable in unique circumstances. Reference to the complete notice of intent is:

Notice of Intent: [Notice of Intent to Revise the Standards of Practice – Practice-Specific Standards for Insurers \(P&C Insurance\) – Subsection 2260 Margin for Adverse Deviations – Deterministic Analysis and Subsection 2270 Margin for Adverse Deviations – Stochastic Analysis](#) (August 2010).

### Educational Notes and Other CIA Publications

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

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: [Classification of Contracts under International Financial Reporting Standards](#) (June 2009),

Draft of Educational Note: [Subsequent Events](#) (October 2008),

Educational Note: [Dynamic Capital Adequacy Testing](#) (November 2007),

Report: [Report of the CIA Task Force on Materiality](#) (October 2007),

Report: [Report of the CIA Task Force on the Appropriate Treatment of Reinsurance](#) (October 2007),

Educational Note: [Discounting](#) (July 2005)<sup>1</sup>,

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), and

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

### **Regulatory Guidance**

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

#### ***OSFI requirements***

The Office of the Superintendent of Financial Institutions (OSFI) issues a memorandum for the Appointed Actuary on an annual basis. AAs would consult this memorandum for the latest instructions from OSFI.

OSFI published guideline E-18 Stress Testing in December 2009. This guideline states that, from time to time, OSFI may ask institutions to carry out standardized scenario tests to assess system-wide vulnerabilities. Approximately 50 P&C insurers were asked to complete a specific standardized stress test with an April or May 2010 deadline. The remainder of the insurers were asked to consider the scenario and, if appropriate for the institution, to include it in the DCAT and if not, provide details to support this decision in the DCAT report.

OSFI published draft guideline A-4 Capital Targets in May 2010, setting out OSFI's expectation with respect to the setting of insurer-specific capital targets and how those targets relate to the assessment of capital adequacy within the context of OSFI's supervisory framework. This guideline outlines possible approaches an insurer could use to determine an internal capital target ratio. The guideline also notes that analysis supporting the setting and maintaining of an insurer's internal capital target ratio should be clearly and formally documented, updated at least annually, and should be discussed with the insurer's board of directors or chief agent. Upon issuance of the final guideline, OSFI expects that insurance companies will become compliant with the guideline within one year.

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<sup>1</sup> This educational note is currently being updated to reflect the December 2009 changes in the Standards of Practice related to margins for adverse deviations.

### **Judicial Decision on Canadian Automobile Cap on Damages**

Over the last few years, judicial challenges on damage caps for automobile accident benefits have been an issue in Alberta and the Maritimes.

In February 2008, Alberta's Court of Queen's Bench struck down the \$4,000 cap on non-pecuniary damages for people who suffer minor injuries in car accidents. The Alberta government appealed that decision. On June 15, 2009, the Alberta Court of Appeal released its decision in which the court overturned the first decision and upheld the validity of the minor injury pain and suffering damages cap.

On December 17, 2009, the Supreme Court of Canada denied leave to appeal to overturn the Alberta Court of Appeal decision. The damages cap on non-pecuniary damages for minor injuries has been maintained.

On May 27, 2010, the Supreme Court of Canada denied leave to appeal to overturn the Supreme Court of Nova Scotia decision to uphold the \$2,500 cap on non-pecuniary damages for people who suffer minor injuries in car accidents.

If appropriate, the AA would consider any implications that exist in New Brunswick or Prince Edward Island.

### **Ontario Auto Reforms**

On September 1, 2010, a new Statutory Accident Benefits Schedule (SABS) became effective in Ontario. As a result, new standard auto insurance policies apply on or after September 1, 2010. However, some of the reform changes also apply to

auto insurance claims that occurred after November 1, 1996 and are open on or after September 1, 2010, and

auto insurance policies in-force as of September 1, 2010 before their renewal on or after September 1, 2010.

At year-end 2010, the AA would be expected to consider the effect of the Ontario auto reforms on the valuation of policy liabilities. Although the effect on claim liabilities at year-end 2010 is likely to be minimal, the AA would consider

limitation of accident benefit claims which is expected to result in an increase in tort claims and the effect on the pure IBNR for third-party liability coverages,

need to identify claims pre- and post-reform and the availability of supporting data,

effect of changes in claim reserving and processes, and

effect on the assumptions used to calculate the premium liabilities.

AAs would also consider the expected effect in future claim costs resulting from the Ontario auto reforms in their DCAT analyses.

Information on the new SABS and transition rules is available on the Financial Services Commission of Ontario's (FSCO) [website](#).

### **Part XIII of the Insurance Companies Act**

Changes to the Insurance Company Act regarding the definition of insurance of risks in Canada became effective January 1, 2010 and, therefore, affect fiscal year 2010 valuations. AAs of branches would be familiar with the new definition of “insurance in Canada of risks” and the implications for their companies. If the portfolio of business defined as insured “in Canada” has changed substantially, the branch’s experience, including loss development triangles, may be significantly different before and after January 2010. Therefore, the AA may need to restate historical experience according to the new definition. Data consistency issues could arise for future valuation if the AA is not able to adjust historical data according to the new definition. While the restated triangles will be needed for the 2010 valuation, the branch would have estimated these provisions before filing their first quarter results (due May 15, 2010). Therefore, the AA would have prepared a second valuation showing the provision on the business according to the new definition, as of year-end 2009.

Part XIII also resulted in changes to the regulation of marine insurance which is now included with other lines of business. The presentation of the statutory financial statements and the branch adequacy of assets test (BAAT) were amended accordingly.

### **Harmonized Sales Tax (HST) and Provincial Sales Tax (PST)**

Effective July 1, 2010, the Ontario and British Columbia provincial sales taxes (PST) were harmonized with the federal goods and services tax (GST) to become the harmonized sales tax (HST). The implementation of the HST increases costs for insurers in Ontario and British Columbia as financial institutions (including insurers) will not be allowed to claim input tax credits.

Many services, such as legal, independent adjusters, expert witnesses, medical assessment, and labour costs on automobile and property repairs which were not previously subject to PST are now subject to HST. (Note that this list is not intended to be exhaustive of all categories of expenses subject to increase.)

At year-end 2009, the AA estimated the provision for HST on claims incurred on or before year-end 2009 and expected payments to be made on or after July 1, 2010. Since HST is now implemented, the AA would need to understand how HST is reflected in the data underlying the valuation of policy liabilities (paid claims and case reserves). As of year-end 2010, the AA will re-evaluate the provision for HST based on this information.

In addition, Nova Scotia increased its HST from 13% to 15% effective July 1, 2010, while Québec has announced modifications to its PST. The PST in Québec will be increased from 7.5% to 8.5% on January 1, 2011 and to 9.5% on January 1, 2012. The AA would consider the implications of those changes in valuing liabilities.

In their DCAT analyses, AAs would also consider the effect of the expected increase in future claim costs as a result of the tax changes.

### **International Financial Reporting Standards**

Since International Financial Reporting Standards (IFRS) will be adopted in Canada on January 1, 2011, AAs would be expected to understand the effect thereof for their respective companies.

IFRS 4, which applies to insurance contracts, is an interim standard that allows insurers to mostly retain their current accounting policies for those contracts that meet the definition of insurance (Phase I).

Although Phase I is expected to have little effect on most P&C companies, two areas of immediate concern to the AA follow.

**Contract Classification:** 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. The CIA’s Practice Council has issued an educational note, [Classification of Contracts under International Financial Reporting Standards](#), which summarizes considerations relevant to the classification of insurance contracts.

**Disclosures:** IFRS 4 requires enhanced disclosures in financial statements. The notes to the 2011 financial statements will include data for accounting years 2011 and 2010 (the prior year for comparison purposes). Thus, many insurers will begin to gather information for disclosures during 2010. The CIA has recently published a research paper, [Disclosure Requirements IFRS 4 – Insurance Contracts for P&C Insurers](#), to assist actuaries who will be working with insurers in the information-gathering process and drafting of disclosure notes. The research paper identifies the disclosures that are relevant to P&C insurers, analyzes the considerations of the disclosure requirements and provides guidance for disclosure.

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

Research Paper: [Disclosure Requirements IFRS 4 – Insurance Contracts for P&C Insurers](#) (October 2010).

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), and

[‘Impact of IFRS on Canadian Property & Casualty Insurers’](#), KPMG LLP (on the syllabus of CAS exam 6C).

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, Phase II will introduce substantial changes in the measurement of policy liabilities and the presentation of the financial statements. In July 2010 the International Accounting Standards Board (IASB) published the exposure draft Insurance Contracts for comments. Although this document is not the final version of the Phase II standards, the AA would review it to anticipate the changes to come. The PCFRC refers you to the following IASB documents.

Exposure Draft: [Insurance Contracts](#), July 2010, and



Basis for Conclusions Exposure Draft: [Insurance Contracts](#), July 2010.

**Guidance to Members on Specific Situations**

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 CIA Standards of Practice, educational notes, Rules of Professional Conduct, 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 CIA Standards of Practice and the Rules of Professional Conduct. Guidance provided by the PCFRC is not binding upon the member.

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## APPENDIX

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

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

<http://www.actuaries.ca/members/publications/2010/210067e.pdf>

Educational Note: Margins for Adverse Deviations for P&C Insurance (December 2009)

<http://www.actuaries.ca/members/publications/2009/209138e.pdf>

Rules of Professional Conduct

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

Standards of Practice

[http://www.actuaries.ca/sop/sop\\_e.cfm](http://www.actuaries.ca/sop/sop_e.cfm)

Educational Note: Classification of Contracts under International Financial Reporting Standards (June 2009)

<http://www.actuaries.ca/members/publications/2009/209066e.pdf>

Exposure Draft to Revise the Standards of Practice – Practice-Specific Standards for Insurers (P&C Insurance) – Subsection 2250 – Margin for Adverse Deviations (September 2009)

<http://www.actuaries.ca/members/publications/2009/209087e.pdf>

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: Maturity (November 2007):

<http://www.actuaries.ca/members/publications/2007/207099e.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>