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Educational Note

Guidance for the 2011 Valuation of Insurance Contract Liabilities and DCAT for Property and Casualty Insurers

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Guidance for the 2011 Valuation of Insurance Contract Liabilities and DCAT for Property and Casualty Insurers

Committee on Property and Casualty
Insurance Financial Reporting

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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: Phil Rivard, Chair
Practice Council
Pierre Dionne, Chair
Committee on Property and Casualty Insurance Financial Reporting

Date: November 4, 2011

Subject: **Educational Note – Guidance for the 2011 Valuation of Insurance Contract 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, the 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 November 3, 2011.

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 the 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.

PR, PD

INTRODUCTION

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 actuaries in several areas affecting the valuation of insurance contract 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 CIA 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 – Insurance Contract Valuation: All Insurance,
- Section 2200 – Insurance Contract Valuation: Property & Casualty Insurance,
- Section 2400 – The Appointed Actuary, and
- Section 2500 – Dynamic Capital Adequacy Testing.

Subsections 2260 and 2270, which address margin for adverse deviations (MfAD) for P&C insurance, were revised January 2011. The revision addresses the issue of selecting a margin below the low end of the range. The previous Standards of Practice related to MfAD derived from both deterministic and stochastic analyses were very specific in not allowing for an MfAD less than the low end of the range. The revised Standards of Practice make it clearer to members that selection below the low margin may be acceptable in unique circumstances. Reference to the final Standards of Practice on MfAD is

[Final Standards – Practice-Specific Standards for Insurers \(P&C Insurance\) – Subsections 2260 and 2270](#) (January 2011).

In June 2011, the Actuarial Standards Board published Revised Exposure Draft to Revise the Standards of Practice – Dynamic Capital Adequacy Testing – Section 2500. The intent of the revised exposure draft is to ensure consistency with the Office of the Superintendent of Financial Institutions (OSFI) Guideline E-18 Stress Testing as well as changes arising from the adoption of International Financial Reporting Standards (IFRS). Reference to the revised exposure draft is

[Revised Exposure Draft to Revise the Standards of Practice – Dynamic Capital Adequacy Testing – Section 2500](#).

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 Property and Casualty Insurance](#) (December 2009),

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

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

[Notice of Intent to Revise the Standards of Practice – General Standards – Subsequent Events \(Subsection 1520\)](#) (April 2009),

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

[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: [Discounting](#) (November 2010),

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 2005), and

Educational Note: [Evaluation of the Runoff of P&C Claims Liabilities When the Liabilities are Discounted in Accordance with Accepted Actuarial Practice](#) (June 2011).

REGULATORY GUIDANCE

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

OSFI Requirements

OSFI issues a memorandum for the Appointed Actuary on an annual basis. AAs would consult this memorandum for the latest instructions from OSFI.

The calculation of the Minimum Capital Test/Branch Adequacy of Assets Test (MCT/BAAT) for 2011 differs from that of 2010, and OSFI expects that the changes would be incorporated into the AA's DCAT analysis. Originally, OSFI intended to include an annual audit of the 2011 MCT/BAAT. This audit requirement was postponed until fiscal year-ends beginning on or after January 1, 2012 and will not apply to the prior year. Draft changes to the MCT/BAAT calculation for 2012 were published for industry consultation in May 2011. This guideline was published in its final form in October 2011, and AAs are expected to incorporate the changes into their DCAT analyses, or, if not practical, comment on the effect thereof.

With the implementation of IFRS, consolidated reporting will be required within P&C regulatory returns. For capital purposes, the consolidated entity includes the parent company and all subsidiaries that carry on business that the parent could carry on directly pursuant to the *Insurance Companies Act*. The above rule does not apply to life insurance company subsidiaries, which are to be reported using the equity method. OSFI anticipates that most AAs will continue to prepare non-consolidated Appointed Actuary's Reports (AARs); however, an additional exhibit and commentary must be provided that reconciles the information within the AAR to the consolidated opinion. AAs will be expected to value non-federally-regulated subsidiaries in

accordance with accepted actuarial practices in Canada and include these AARs as appendices or as a separate part of the AAR.

OSFI Guideline E-18 Stress Testing states that, from time to time, OSFI may ask institutions to carry out standardized scenario tests to assess system-wide vulnerabilities. A specific standardized test was requested from approximately 60 companies and branches with a deadline of June 30, 2011. Institutions that were not required to complete the stress test at that time were asked to consider the scenario and, if appropriate, include the test in their DCAT report. OSFI expects that all DCAT reports would contain this stress test or an explanation as to why it is not relevant. If the stress test was submitted previously, a comment to that effect would be sufficient; however, the AA may wish to include the results of the stress test in a summary table.

OSFI published Guideline A-4 Capital Targets in June 2011, 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 is to be clearly and formally documented, updated at least annually, and discussed with the insurer's board of directors or chief agent. OSFI expects that insurance companies will be compliant with Guideline A-4 on or before June 2012.

AMF Requirements

L'Autorité des marchés financiers (AMF) issues specific guidelines of interest to AAs of Québec-regulated insurers.

The AMF guideline regarding the mandatory insurance contract liabilities report is updated annually, usually in November, and covers regulatory requirements, the expected content of the report, and the prescribed layout of the report. The AMF guideline also mandates prescribed exhibits for reporting results of the A valuation. These include the unpaid claims and loss ratio exhibits for which specific instructions are also available. AAs who wish to opt for the filing of a simplified database should refer to the guideline. The guideline and appendices (in Excel format) can be found at <http://www.lautorite.qc.ca/en/policy-liabilities-report-pro.html>.

The AMF also publishes a guideline for the preparation of the report on the financial condition (DCAT report). This guideline is updated annually, usually in March, and covers the same general aspects as the insurance contract liabilities valuation guideline. When completing their DCAT report, AAs are advised to be aware of the latest developments in the calculation of the MCT ratio, <http://www.lautorite.qc.ca/en/report-financial-condition-pro.html>.

In March 2011, the AMF published a revised guideline on the capital adequacy requirements (MCT Guideline). The changes were the results of the new IFRS requirements that came into effect on January 1, 2011. However, a slightly modified version of the guideline will come into effect before the 2011 year-end. The guideline also provides information on the AMF's expectations on the determination of the insurer target capital ratio. It is expected that AAs would also note that a major revision of the MCT Guideline, in line with OSFI's own 2012 MCT guideline, will be published in the fall of 2011 or early 2012 for consultation. The guideline is expected to be published in a final form later in 2012, <http://www.lautorite.qc.ca/en/guidelines-insurers.html>.

AUTO REFORMS

Ontario

On September 1, 2010, a new Statutory Accident Benefits Schedule (SABS) became effective in Ontario. As a result, new standard auto insurance policies began to apply on or after September 1, 2010. However, some of the reform changes also applied 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 2011, the AA would be expected to consider the effect of the Ontario auto reforms on the valuation of insurance contract liabilities. The AA would consider the

limitation of accident benefit claims which is expected to result in an increase in tort claims and the effect on the pure incurred but not reported (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 transitional rules is available on the Financial Services Commission of Ontario's (FSCO) [website](#).

Other Jurisdictions

On April 1, 2010 the Nova Scotia government introduced reforms to regulations limiting non-pecuniary damages for minor injuries. For accidents occurring after April 1, 2010, the limit on pain and suffering awards was increased to \$7,500 from the previous limit of \$2,500 which had been in place since the introduction of the cap in November 2003. The 2010 reform also narrowed the definition of minor injuries compared to the previous legislation.

At year-end 2011, the AA would be expected to consider the effect of this increase on the valuation of insurance contract liabilities. AAs would also consider the expected effect in future claim costs resulting from the Nova Scotia auto reforms in their DCAT analyses.

In late September 2010, the province of New Brunswick elected a new government. A campaign promise of this government was to initiate a six-month review of the minor injuries regulation limiting non-pecuniary damages for minor injuries to \$2,500 that has been in place since 2004. The review is currently underway.

If appropriate, the AA would consider any implications that exist in New Brunswick depending on the outcome of the working group's recommendations.

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. Provincial regulators may have different definitions of "insurance of risks in Canada". AAs of branches would take this into consideration in their work.

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.)

The British Columbia provincial government conducted a referendum on whether to keep the HST or reinstate PST and GST. The result of the August 2011 referendum was to reinstate the PST and GST. The AA would consider the implications of those changes in valuing insurance contract liabilities.

The AA would need to understand how HST is reflected in the data underlying the valuation of insurance contract liabilities (paid claims and case reserves). As of year-end 2011, the AA will re-evaluate the provision for HST based on this information.

In addition, changes to the level and application of the PST in Québec are expected in 2012. It is expected that the impact will be minimal, but the AA would consider it if appropriate.

The AA would make appropriate provisions in the valuation of insurance contract liabilities and the DCAT analysis for these changes in taxes.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

Since International Financial Reporting Standards (IFRS) were 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, there are two areas of immediate concern to the AA:

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). The CIA 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 CIA 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), and

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

Phase II of IFRS 4 is intended to result in a single international standard for all insurance contracts. In July 2010 the International Accounting Standards Board (IASB) published the exposure draft Insurance Contracts for comments. The exposure draft introduced substantial changes in the measurement of insurance contract liabilities and the presentation of the financial statements. Currently the IASB is deliberating on issues raised in response to the exposure draft. The date for the adoption of Phase II is not yet finalized. Although the exposure draft is not the final version of the Phase II standards, the AA would review it in order to remain aware of 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.

APPENDIX

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

Rules of Professional Conduct

<http://www.actuaries.ca/members/publications/2011/211033e.pdf>

Standards of Practice

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

Final Standards – Practice-Specific Standards for Insurers (P&C Insurance) – Subsections 2260 and 2270 (January 2011)

<http://www.actuaries.ca/members/publications/2011/211005e.pdf>

Revised Exposure Draft to Revise the Standards of Practice – Dynamic Capital Adequacy Testing – Section 2500 (June 2010)

<http://www.actuaries.ca/members/publications/2011/211062e.pdf>

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

<http://www.actuaries.ca/members/publications/2010/210063e.pdf>

Educational Note: Margins for Adverse Deviations for Property and Casualty Insurance (December 2009)

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

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

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

Draft of Educational Note: Subsequent Events (October 2008)

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

Notice of Intent to Revise the Standards of Practice – General Standards – Subsequent Events (Subsection 1520) (April 2009)

<http://www.actuaries.ca/members/publications/2009/209043e.pdf>

Educational Note: Dynamic Capital Adequacy Testing (November 2007)

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

Task Force Report: Materiality (October 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 (November 2010)

<http://www.actuaries.ca/members/publications/2010/210079e.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 P&C Claims Liabilities When the Liabilities are Discounted in Accordance with Accepted Actuarial Practice (June 2011)

<http://www.actuaries.ca/members/publications/2011/211064e.pdf>

Educational Note: Accounting for Reinsurance Contracts under International Financial Reporting Standards (December 2009)

<http://www.actuaries.ca/members/publications/2009/209125e.pdf>

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