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Alert

Insurance sound bytes

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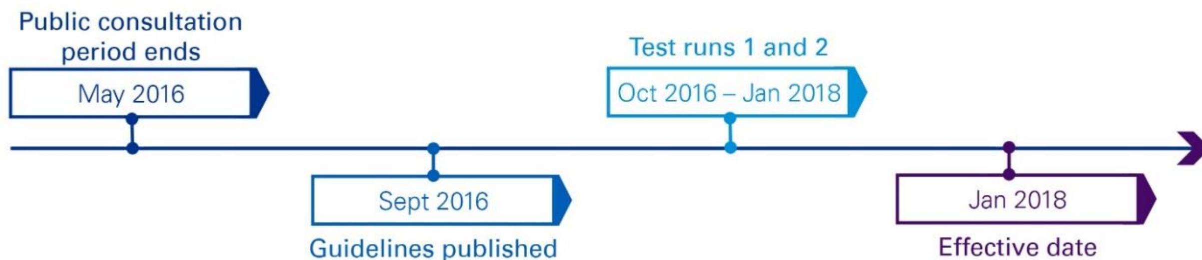
Canadian life insurers encounter an additional challenge as OSFI's Life Insurance Capital Adequacy Test scheduled to become effective in 2018

Closing in on a final guideline

The Life Insurance Capital Adequacy Test (LICAT), an evolution in the Canadian standard regulatory capital model for life insurers, has been developed by OSFI in close collaboration with stakeholders. The LICAT will replace the current Minimum Continuing Capital and Surplus Requirements (MCCSR). In the case of foreign insurers operating in Canada on a branch basis, the Life Insurance Margin Requirements and Adequacy of Assets in Canada Test (LIMAT) within LICAT will replace the current Test of Adequacy of Assets in Canada and Margin Requirements (TAAM). The LICAT is expected to be finalized in the summer of 2016, with an effective date of January 1, 2018. Two test runs are also scheduled in 2016 and 2017 for final calibration prior to implementation.

This diagram outlines OSFI's steps to a final guideline.



After LICAT becomes effective, OSFI will re-assess the approach for segregated fund guarantees and any revisions required to respond to forthcoming accounting changes (e.g. IFRS 16 *Leases*, IFRS 9 *Financial Instruments* and IFRS 4 Phase II *Insurance Contracts*).

Comparing apples to oranges

The table to the right provides a high-level comparison of MCCSR to LICAT:

MCCSR	LICAT
Total ratio Available Capital (AC) Required Capital (RC)	Total ratio AC + Surplus Allowance[1] Base Solvency Buffer (BSB)[2]
Tier 1 ratio Tier 1 AC RC	Core ratio Tier 1 AC Base Solvency Buffer
Supervisory target 150%	Supervisory target 100%
Minimum ratio 120%	Minimum ratio *90 – 95% [under review by OSFI]*

[1]Selected provisions for adverse deviation (PfADs)

[2]Aggregate capital requirements, less credits, multiplied by a scalar of *1.15 [under review by OSFI*

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More complex than MCCSR, and with different risk sensitivities

While MCCSR was primarily a factor-based approach, LICAT is a mix of factor-based and shock-based approaches in which a life insurer's capital requirements are set to a supervisory target level that is intended to align with a conditional tail expectation (CTE) of 99% over a one-year time horizon, including a terminal provision.

More risk-sensitive measures are used to determine capital credits for risk-sharing products (e.g. segregated funds, universal life and traditional participating products) and new credits for risk diversification were introduced. The new LICAT model will respond differently than MCCSR to changes in a life insurer's risk profile, and insurers will need to understand how this will affect a wide range of business decisions and capital planning.

> "While the level of capital in the insurance industry is not expected to change significantly because OSFI will use a scalar to calibrate to the same level as the old MCCSR, changes in the risk sensitivities under LICAT may significantly increase or decrease capital for individual insurers. Management and directors will want to understand the impact and start developing their strategy."
>
> – Stéphane Lévesque, Partner

System and process changes

Changes to systems and processes necessitated by the introduction of LICAT will need to be designed and implemented with sufficient time incorporated into the schedule to adequately test impacts. When planning system changes, insurers will want to consider:

- Addressing any system constraints (e.g. processing capacity, software functionality, etc.) which may impact an entity's ability to execute the prescribed shock scenarios required to determine the Base Solvency Buffer;
- Upgrading valuation platforms to access LICAT-facilitating enhancements (e.g. AXIS's update to enhance the lapse cross-over functionality needed for the lapse volatility shock), including associated staff training, model testing and validation;
- Developing robust methodologies (modelling approach and associated inputs) to perform the LICAT shocks and sensitivities;
- Reviewing modelling approach for adjustable and participating product features in the context of determining LICAT capital credits;
- Designing and implementing internal controls over new judgments, inputs and calculations introduced (e.g. by the more advanced techniques to measure various risks under LICAT); and
- Re-designing period-end reporting and timelines to accommodate additional steps and calculations.

> "The new capital framework reflects several rounds of consultations and quantitative impact studies involving Canadian life insurers, and is also aligned with the most recent developments in international solvency standards and best practices in other jurisdictions"
>
> – Mary Trussell, Partner

Interaction with forthcoming accounting changes

Plans to implement LICAT should be considered in tandem with plans to implement forthcoming accounting changes (e.g. IFRS 4 Phase II, IFRS 9 and IFRS 16). As a result, insurers will want to spend some time:

- Educating internal stakeholders, identifying any projects underway which may impact the availability of scarce actuarial, information technology or accounting resources and soliciting feedback on proposed changes.
- Considering the impact of forthcoming accounting changes on key metrics under LICAT, for example:
  - The treatment of IFRS 16's 'right-of-use' asset; and
  - The elimination of interest and asset-related PfADs and transition adjustment under IFRS 4 Phase II.
- Baking in opportunities to future-proof any system and process changes, in particular where an insurer intends to make changes to information technology systems.
- Identifying and capitalizing on opportunities to stream-line period-end processes.

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