Memorandum

To: All Fellows, Affiliates, Associates, and Correspondents of the Canadian Institute of Actuaries and other interested parties

From: Conrad Ferguson, Chair
Actuarial Standards Board

Marco Fillion, Chair
Designated Group

Date: November 24, 2017

Subject: Notice of Intent to Review the Standards of Practice to Incorporate Changes to section 2500 – Dynamic Capital Adequacy Testing

Comment Deadline: March 20, 2018

Document 217120

Introduction

The Actuarial Standards Board (ASB) has established a designated group (DG) on the harmonization of Dynamic Capital Adequacy Testing (DCAT) and Own Risk and Solvency Assessment (ORSA). The DG’s mandate is to propose revisions to Standards of Practice (SOP) section 2500 Dynamic Capital Adequacy Testing that will

- Provide a more robust approach to satisfy federal and provincial insurance acts’ requirements to report on the expected future financial condition of an insurance entity; and

- Allow for a better alignment with ORSA regulatory requirements as it relates to work needed to report on the expected future financial condition of an insurance entity.

Background

The ORSA is a requirement for insurers in Canada. The Office of the Superintendent of Financial Institutions (OSFI) published guideline E19 on ORSA in November 2013, and concurrently revised Guideline A-4: Internal Target Capital Ratio for Insurance Companies for federally regulated insurers. The first ORSA report from insurers was required in 2014.
In May 2015, the Autorité des marchés financiers (AMF) published its Capital Management Guideline which introduced its expectations specifically for insurers licensed to transact insurance business in Québec to set up an ORSA mechanism.

In early 2015, the Canadian Institute of Actuaries (CIA), through the Committee on Risk Management and Capital Requirements (CRMCR), assisted by the Joint Risk Management Section of the Casualty Actuarial Society, the CIA and the Society of Actuaries, developed a survey for insurers to review and assess the implementation of ORSA in Canada. One of the conclusions presented in the report indicated that “A majority of respondents (70%) believe that DCAT and ORSA processes should be integrated (Q23)” and “The development of updates to the standards of practice and educational notes was identified as a high priority by many respondents (Q34)”.

In light of this survey’s conclusions, the CRMCR established a working group that looked at the different regulatory requirements behind DCAT and ORSA, how they had been operationalized as a result, and compared their similarities and differences. The working group presented a discussion paper on the possible integration of DCAT and ORSA to the Committee on the Appointed/Valuation Actuary, the Committee on Property and Casualty Insurance Financial Reporting, the Committee on Life Insurance Financial Reporting, the CIA Practice Council, the AMF, and OSFI. The general feedback from all stakeholders was that integration of DCAT and ORSA at a level to be defined was desirable, and that the ASB should establish a designated group to lead that work.

The high-level observations from the discussion paper were that

- The status quo of having completely independent DCAT and ORSA processes is not desirable.
- DCAT has interpreted the requirement of the Insurance Companies Act by applying a relatively narrow view of what reporting on the financial condition means, and needs to be modernized. The adverse scenarios can lack robustness and be static (year-to-year) and the Appointed Actuary’s (AA) recommendations, if any, may lack depth given the narrow view.
- The industry’s current operationalization of DCAT and ORSA can result in important differences in processes and expectations such that the current reporting of one cannot be used to satisfy the reporting requirement of the other (i.e., the DCAT report would not be satisfactory as an ORSA report and vice versa).

Although there are a number of differences between the two requirements, when comparing the DCAT SOP and the ORSA guidelines, their ultimate objectives are essentially the same. Both are concerned with insurance entities requirement to hold an appropriate level of capital for the security of its policyholders. The discussion paper also found that, other than being the product of different regulatory triggers (Insurance Companies Act for DCAT and OSFI/AMF guidelines for ORSA), the key differences between DCAT and ORSA are the following:
• Level of guidance – CIA standards prescribe certain aspects of the DCAT (e.g., number of scenarios, definition of satisfactory financial condition, etc.) while ORSA cannot be prescribed, otherwise it is not the insurance entity’s own view.

• Scope – DCAT focuses on a capital sufficiency analysis relative to regulatory capital requirements, while ORSA is much broader, including all aspects of risk management from risk identification, assessment, appetite, and integration into operations, the approach of relating risk to capital, and the feedback loop into the decision-making process of senior management.

• Ownership – DCAT is owned by the Appointed Actuary (as per the Insurance Companies Act the actuary must report on “the financial position of the company and, where so specified in such a direction\(^1\), the expected future financial condition of the company”) while ORSA is owned by the Board.

• Opinion – required only for DCAT.

• Independence – The AA’s ownership of DCAT comes attached with its independence from management. There is no such requirement for ORSA, other than a requirement for an independent review, with a similar requirement for DCAT (external peer review).

The discussion paper further discussed how regulators require insurance entities to set internal capital targets (internal targets\(^2\)) that are forward-looking and in line with their capital needs, governance, integrated risk management, stress testing and capital adequacy guidelines. By definition, internal targets are set at a level that gives reasonable assurance of the satisfactory financial condition of the entity. This, in the DG’s view, could form the foundation of the framework harmonizing DCAT and ORSA. Under this framework,

• The AA’s opinion would be kept in order to promote an appropriate level of accountability and independence sought by stakeholders of both processes.

• The opinion could be centered on the appropriateness or the use of internal targets in the AA’s assessment of the entity’s satisfactory financial condition.

• The AA would not own the overall ORSA in order to provide his/her opinion on the “satisfactory financial condition”; however, the ORSA would be used as input.

• CIA guidance (standards, educational notes, etc.) would need to be revised to reflect the change in focus and provide new guidance of what constitutes satisfactory financial condition. More specifically, SOP section 2500 would be renamed Financial Condition Analysis.

From a more practical point of view, this framework would also allow the AA to perform further capital sufficiency testing to supplement the ORSA capital quantification so that

\(^{1}\) Direction that may be made by the Superintendent.

\(^{2}\) As defined in OSFI’s Guideline A-4: Internal Target Capital Ratio for Insurance Companies for federally regulated insurers, and in the AMF’s Capital Management Guideline.
important financial condition reporting and analysis components can be integrated. One could also conceivably extend the AA’s responsibility to the quantification of the ORSA capital for some entities, where for others it may still reside with the chief risk officer (CRO).

The DG recognizes that other differences (such as the DCAT requirements on timing of reporting vs. ORSA, report content, etc.) and operational changes would need to be addressed, but in the context of trying to harmonize DCAT and ORSA for the purpose of bringing better efficiency and value to stakeholders, these should not be fundamental issues.

Questions for Feedback

The ASB is soliciting feedback on the following questions:

1. Conceptually, the ORSA should be sufficient to provide the AA the necessary information to report on the financial condition of the insurance entity. How prescriptive should the SOP be in harmonizing the work of the AA with the ORSA process (scenarios, stress tests, internal targets setting, reporting, etc.)? Should it allow flexibility to have a fully separate process? Why?

2. What changes to the current SOP section 2500, including the definition of satisfactory financial condition, can be made to make it more robust (e.g., inclusion of stress testing and integrated scenarios, etc.), effective (e.g., not a compliance exercise), and value-added to management and the Board (e.g., why analyse and report the same risks through different processes)?

3. Are internal targets the appropriate focal point in harmonizing DCAT and ORSA? If so, should the AA review, assess, or use the determination of the internal targets set by ORSA in his/her assessment of the satisfactory financial condition?

4. What currently works with the DCAT process and should remain part of the supporting work done by the AA?

5. What does the DCAT process bring that the ORSA process does not, and vice versa?

6. What revisions should be made about the opinion of the AA regarding future financial condition? (What should stay? What needs to change? The current opinion is based on how DCAT defines satisfactory financial condition. That definition may change under a new standard and your views on the opinion should not be constrained by that definition.)

7. Other issues that should be discussed?

Members of the DG

The group responsible for the development of the revisions to these standards of practice consists of Marco Fillion (chair), Hélène Baril (Life), Pierre Bernard (P&C), Wally Bridel (Reinsurance), Kevin Gray (Life), Pierre Lepage (P&C), Tim Watson (Mortgage Insurance), Diane Gosselin (OSFI observer), Sylvain St-George (AMF observer), Alexis Gerbeau (ASB liaison), and Tony Williams (observer).
Proposed Timeline

The DG hopes to publish an exposure draft of SOP section 2500 in the summer of 2018 after considering feedback on this notice of intent.

Your Feedback

The DG is soliciting feedback on this notice of intent from interested CIA practice committees, the regulatory authorities, members of the CIA, and other stakeholders, as appropriate. Feedback is requested on both the questions raised in this notice of intent and any other aspects related to the harmonization of DCAT and ORSA that may be in need of change. Parties wishing to comment on this NOI should direct those comments to Chris Fievoli at chris.fievoli@cia-ica.ca and Marco Fillion at marco.fillion@pwc.com by March 20, 2018.

The ASB’s due process has been followed in the development of this NOI.

CF, MF