

October 8, 2021

Office of the Superintendent of Financial Institutions (OSFI)
QISLICAT@osfi-bsif.gc.ca

Subject: Draft LICAT 2023 Guideline

The Canadian Institute of Actuaries (CIA) thanks OSFI for the opportunity to comment on the draft LICAT 2023 Guideline (QIS3 version).

The attached comments and suggestions are in order of their appearance in the guideline. We have kept our comments to those driven by IFRS 17 updates. Our most significant concerns are in:

- treatment of negative reserves;
- treatment of unregistered reinsurance;
- treatment of deferred tax assets (DTAs);
- guidance on treatment of contractual service margin (CSM) non-deductibility; and
- neutrality and volatility of the LICAT ratios, capital implications, and financial results. Additional data points up to 2023 can be used to assess the reasonableness of results.

Our comments are summarized by section below. Further details and other comments are included in the appendix.

General volatility

The disconnect between fair value of assets under IFRS 9 and insurance contract liabilities under IFRS 17 may increase the volatility of the LICAT ratios, relative to IFRS 4. This is in addition to LICAT volatility related to prescribed rates used to calculate required capital versus market rates used on available capital.

We also have noted that the market consistent cost of guarantee (COG) under IFRS 17 for products such as Par and Universal Life can change materially from quarter to quarter with market movements. This, in turn, may lead to increased volatility of the LICAT ratios.

General wording

It should be clear that references to liabilities apply to net obligations regardless of whether they represent a net asset or net liability and whether the direct and reinsurance components are presented in the balance sheet as assets or liabilities. This is a general matter that extends through the LICAT 2023 Guideline and OSFI may wish to address it somewhere in Chapter 1.1.

Chapter 1

We believe that the surplus allowance should include the effect of the risk of non-performance by the reinsurer for reinsurance contracts held (which in effect is reflected in the estimates of future cash flows) since this new charge in the financial statements serves the same purpose as the 2.5% charge for reinsurance contracts held that is included in the base solvency buffer.

Chapter 2 – Deferred Tax Assets

As in QIS1 and QIS2, we continue to encourage OSFI to review the limit on DTA recognition as Tier 1 Available Capital. Currently, the DTA temporary included in available capital is recognized up to the limit of 10% of net tier 1. However, there is a 25% credit risk capital charge, and any excess over the 10% limit is not recognized.

Depending on the final outcome of the Department of Finance’s consultations on the taxation implications of international accounting rules for insurance contracts (IFRS 17), and in particular, the non-deductibility of the CSM for tax purposes, this may be an additional reason for OSFI to revisit the 10% limit on DTA recognition. In addition, it would be helpful if OSFI could provide a rationale for maintaining a 25% credit risk capital charge applied on DTA related to CSM.

Further, it would be helpful if OSFI could encourage the Department of Finance to expedite the expected timeline to reach its decision on the non-deductibility of the CSM for tax purposes. This decision will impact the level of gross capital.

Chapter 2 – 2.1.2.9 General Concept

We disagree with the general concept of the deduction for negative reserve in the LICAT 2019 and LICAT 2023 Guidelines.

Since the arrival of IFRS 17 is a good opportunity to review the concept of this deduction for negative reserves, we would like to present a simplified analysis that shows that the LICAT tier 1 capital requirement is incongruous with the LICAT total capital requirement and that the source of this incongruity is the deduction for negative reserves.

The conclusion of this analysis detailed below and in the appendix is consistent with the observation that this deduction for negative reserves is not conceptually justified and that it deteriorates the significance of the core ratio that should measure the real financial strength of insurers. Our concern is also supported by the fact that Solvency II and Insurance Capital Standard (ICS) do not have such a deduction.

As of December 31, 2020, the industry (“Total Canadian Life Companies” as per OSFI’s website) would need, respectively, \$78.0B and \$78.6B in gross total capital (equity and debt capital instruments) and gross tier 1 capital (equity only) to meet supervisory targets (100% for total ratio and 70% for core ratio). This result is counterintuitive as the gross tier 1 capital should be lower than gross total capital. This result is caused by the deduction for negative reserves.

Chapter 2 – 2.1.2.9 Changes to Best-Estimate Basis

Currently, provisions for adverse deviations (PfADs) are included in the calculation of the negative reserve deductions. Using best estimate liabilities may have a neutral industry impact

overall; however, the impact at a company level is uncertain. We suggest further reviewing the implications of negative reserve treatment since impacted companies are continuing to see significant impacts despite the changes already made.

For this section, where risk adjustments at the policy level are available or can be allocated, the deduction/structure, as in the LICAT 2019 Guideline, can be maintained and is preferred over the excessive complexity added in the draft LICAT 2023 Guideline.

Chapter 2 – 2.1.2.9 Higher Risk Aversion for Lapse Risk

As per the analysis detailed in the appendix, the deduction for negative reserves (about \$16.2B) represents about 20% of the gross tier 1 capital of \$78.6B. While the remainder of the gross tier 1 capital requirement represents a rather balanced risk assessment, the deduction for negative reserves only reflects lapse risk.

As such, LICAT gross tier 1 capital requirement assigns a disproportionate weight to lapse risk, which implicitly means a higher risk aversion for this risk. It would be helpful for OSFI to explain if the presence of the deduction for negative reserves is the result of a higher aversion to lapse risk (or to provide another explanation).

Chapter 5 – Interest Rate Risk

OSFI could consider aligning the LICAT IRR discount rates with those in IFRS 17, also considering the guidance from the Committee on Life Insurance Financial Reporting.

Changes could include:

- a longer observable period (30 years instead of 20)
- a lower ultimate risk-free rate

In creating this improved link between IFRS 17 and LICAT, there would be less volatility and better comprehension/communication of risk to all stakeholders, where such an alignment of capital and liability measurements promotes better risk management. OSFI would need to ensure proper calibration to achieve the objective of capital neutrality at transition, and to avoid introducing unwarranted volatility into capital ratios.

We suggest that the timing and magnitude of LICAT IRR stress scenarios also be reviewed to ensure appropriate incentives for managing assets backing insurance liabilities and capital.

Chapter 5 – Scalar

We suggest that OSFI consider the total balance sheet requirement in assessing required capital levels, as the underlying risks should not change with the move to IFRS 17.

We believe a risk-based capital framework should not require scalar adjustments; however, if an interest rate risk scalar is used, it should be differentiated by major product lines, notably par and non-par. A single scalar may create unwarranted cross-subsidization between product lines.

Chapter 6 – Mortality Volatility

We continue to believe the replacement of “NAAR/FA” by “1 – Best Estimate Liability/FA” in the mortality volatility calculation could lead to an increase in capital. We recommend using “1 – Fulfilment Cash Flows/FA” as it is more consistent with the LICAT 2019 Guideline requirements.

Chapter 7 – Segregated Funds

With the implementation of the new standard approach postponed by two years to January 1, 2025, the existing segregated fund guarantee (SFG) approach in Chapter 7 of the LICAT 2019 Guideline has been adapted for IFRS 17 in QIS3.

Section 7.3.1 states that the total gross calculated requirement (TGCR) cannot be negative. The IFRS 17 total net actuarial liability (including CSM and RA) could be negative (the addition of the CSM may not bring the liability back to zero). If the net actuarial liabilities held is negative, then the net required capital could be higher than the TGCR. As such, we recommend that either the TGCR be allowed to go negative, or the net actuarial liabilities held also should be floored at zero.

Chapter 9 – Cost of Guarantee

Under IFRS 4, the quantification of the participating policy liabilities for options and guarantees is reflected in the PfADs and is included in the numerator of the LICAT ratios. IFRS 17 requires a market consistent measurement of these options and guarantees and includes a significant margin over the best estimate liabilities. As a result, the cost of options and guarantees increases liabilities from IFRS 4 to IFRS 17 and therefore increases the total asset requirement.

The calibration of the solvency buffer could be reassessed (lowered) or a surplus allowance credit given, in view of the increased total asset requirement to recognize the market consistent valuation prudence. For the solvency buffer calibration, this could be in the form of revising both the gross (non-par and par) interest rate risk buffer and the 10% par interest rate risk floor. Non-par is referenced in this section for completeness.

Chapter 9 – Adjustable Credit Example

On page 185, there is an error in the example:

“This example builds on the example presented at the end of section 11.2.4, where the requirement $K_{\text{non-par}}$ for a non-participating block of business within a geographic region is determined to be 1,517,987,653”

As such, the resulting adjustable credit page 186 should be 189,268,035

Chapter 9 – Par Adjustable Credit

\bar{C}_{adverse} is defined as the six-month rolling average gross adjustable credit. We suggest that OSFI include similar guidance for newly acquired blocks per footnote 110.

Chapter 10 – General

Understanding the principles and goals underpinning Chapter 10 would be helpful for all stakeholders. It would also help to understand how OSFI believes credit for unregistered reinsurance is appropriate, such that neither too little nor too much credit is recognized.

It would be clearer if Chapter 10 were written as a standalone chapter, with limited cross-referencing (e.g., Section 2.1.2.9) and therefore with less risk of misinterpretation. For ease of readability, calculations from previous sections can be stated again in Chapter 10.

Chapter 10 – Pools

For consistency between actuarial areas of practices, OSFI should ensure alignment of LICAT and MCT reinsurance treatment of industry pools (for example *CDIPC* pool, high-cost drug pools).

Chapter 10 – 10.2.3

There seems to be a misalignment between Section 10.2.3's new title "Differences between reinsurance contracts held and direct liabilities" and its content.

Chapter 10 – 10.2.5

Our view is that the tax credit should be based on all negative reserves ceded to an unregistered reinsurer as was the case under LICAT QIS2. This would lead to the same results as retaining the business, which is aligned with the guiding principles that have been previously articulated by OSFI.

For non-Canadian policies, Section 2.1.2.9 allows for a 10% reduction in the tier 1 deduction for a direct writer, whereas Chapter 10 does not allow for a similar adjustment if the policy is ceded to an unregistered reinsurer.

Chapter 10 – 10.2.6 and 10.2.7

The change in Section 10.2.5 also affects the limit in Section 10.2.6, doubling the negative impact of this QIS3 change on Chapter 10. It would be useful to have a brief note on the limit's logic. Tying to an earlier point, how does OSFI get comfortable that the results produce neither too little nor too much credit? What principles/constraints are applied?

Chapter 11 – Between-risk Diversification

In the LICAT 2019 Guideline, only 50% of level and trend insurance risks are considered in the between-risk diversification. One possible justification for this would be that 50% level and trend would roughly represent the "PfAD requirement" embedded in the base solvency buffer (also known as the "terminal provision") and that no diversification is generally assumed in the determination of PfADs under the Canadian asset liability method.

To recognize the fact that IFRS 17 requires risk adjustments to be diversified, we suggest that higher level and trend insurance risks be considered in the between-risk diversification in the LICAT 2023 Guideline.

If OSFI's intent is to continue carving out risks before determining the between-risk diversification credit and since the impact of this carve-out is significant, we believe that a

rationale should be provided in the LICAT 2023 Guideline, in accordance with the objective of transparency set by the IAIS.¹

The CIA appreciates the opportunity to provide feedback on these issues, and we would welcome further discussion with you throughout this process.

If you have any questions, please contact Chris Fievoli, CIA Staff Actuary, Communications and Public Affairs, at 613-656-1927 or chris.fievoli@cia-ica.ca.

Sincerely,

[original signature on file]

Michel St-Germain, FCIA
Immediate Past President, Canadian Institute of Actuaries

The Canadian Institute of Actuaries (CIA) is the qualifying and governing body of the actuarial profession in Canada. We develop and uphold rigorous standards, share our risk management expertise, and advance actuarial science for the financial well-being of society. Our more than 6,000 members apply their knowledge of math, statistics, data analytics, and business in providing services and advice of the highest quality to help ensure the financial security of all Canadians.

¹ International Association of Insurance Supervisors (IAIS)'s Insurance Core Principles (ICP), standard 17.6: "The regulatory capital requirements are established in an open and transparent process, and the objectives of the regulatory capital requirements and the bases on which they are determined are explicit."

APPENDIX – COMMENTS ON CHAPTER 2

Details of the analysis

Here is a summary of data obtained from OSFI's website (see full data below):

LICAT data as of December 31, 2020, for "Total Canadian Life Companies"

	\$B
Tier 1 available capital (A)	77.8
Gross tier 1 capital	120.9
(Tier 1 deductions)	-43.1
Tier 2 available capital (B)	22.8
Tier 2 capital instruments	7.0
Tier 2 elements other than capital instruments (mostly negative reserves*)	16.2
(Tier 2 deductions)	-0.4
Total available capital (A + B)	100.6
Surplus allowance ("SA") and eligible deposits ("ED")	75.8
Base solvency buffer ("BSB")	126.5

* Tier 2 add-back of the deduction for negative reserves represent most of the tier 2 elements other than capital instruments at the industry level.

The supervisory target total and core ratios (100% and 70%) could be translated in terms of gross capital requirements (i.e., how much actual equity and debt capital instruments, as measured in the financial statements, is needed):

Gross total capital requirement = 100% x (BSB – SA – ED) + tier 1 deductions
+ tier 2 deductions – tier 2 elements other than capital instruments

gross tier 1 capital requirement = 70% x (BSB – SA – ED) + tier 1 deductions

From these formulas and the data above, we conclude that, to meet the supervisory targets as of December 31, 2020, the industry must hold:

- \$78.0B² in gross total capital (equity and debt capital instruments); and
- \$78.6B³ in Gross tier 1 capital (equity only).

Below is a reconciliation of these two gross capital requirements:

	\$B
Gross total capital requirement	78.0
30% x (BSB - SA - ED)	-
	15.2
Tier 2 deductions	-0.4

² 100% x (126.5 – 75.8) + 43.1 + 0.4 – 16.2

³ 70% x (126.5 – 75.8) + 43.1

Tier 2 elements other than capital instruments (mostly negative reserves*)	16.2
Gross tier 1 capital requirement	78.6