OSFI DEVELOPMENTS TOWARD A NEW LIFE INSURANCE CAPITAL FRAMEWORK

Posted on February 3, 2015

Categories: Insights, Publications

Introduction

Over the past several years, the Office of the Superintendent of Financial Institutions (OSFI) has been working with life insurers and other industry stakeholders to develop a revised life insurance regulatory framework that is modern and effective. Certain milestones in this overall process have already been achieved, including updated requirements for corporate governance practices that are risk-based, in tune with and reflective of emerging international best practices, and the requirement for insurers to conduct and report on their Own Regulatory Solvency Assessment (ORSA). The corporate governance requirements are set out in OSFI's updated *Corporate Governance Guideline* which applies to other OSFI-regulated entities in addition to life insurers, such as banks and P&C insurers, and the ORSA requirement is contained in OSFI's *Guideline E-19*, which also applies to P&C insurers.

An aspect of the evolving life insurance regulatory framework that is exclusively tailored to the business of life insurance is the initiative to create a new standardized approach to setting capital requirements for life insurers. This life insurance capital framework initiative has involved specific processes, including quantitative impact studies (QISs) – the most recent being Quantitative Impact Study #6 of November 2014 – designed to test the impact of potential changes to capital requirements. On January 5, 2015, OSFI issued a paper[1] entitled *Life Insurance Capital Framework Standard Approach* summarising the rationale and basis for the methodologies tested in the 6th QIS. This practice note touches on the approaches OSFI is currently considering in the development of a new life insurance regulatory capital framework, as described in the paper.

Total Asset Requirement

A technical analysis of the paper is outside the scope of this practice note. Stated simplistically, the revised standard approach outlined in the paper is based on the concept of a total asset requirement (TAR) designed to quantify the insurer's ability to meet its obligations in light of its total financial position.

The TAR is calculated by starting with a best estimate of the insurer's liabilities (BEL), using specified discount rates and cash flows, to which is applied an aggregate solvency buffer calculated separately to take into account credit, market, insurance and operational risk. The paper defines *credit risk* as "the risk of loss arising from the potential default of parties having a financial obligation to the insurer." *Market risk* is "the risk that changes in the financial markets will adversely affect the value of assets and liabilities." Insurance risk is defined as "the risk of loss caused by obligation to pay out benefits and expenses in excess of what was expected", and *operational risk* is "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events."

Within the individual solvency buffers a reduction in the buffer (or credit) is taken for reinsurance and hedging, as risk mitigation measures. The aggregate solvency buffer is further reduced to take into account diversification within and between risks and for discretionary risk sharing features in participating and adjustable business.

The paper graphically illustrates the 6th QIS components for the determination of TAR, starting with the BEL and adding the net individual solvency buffers for credit, market, insurance and operational risk, and deducting the specific credits for diversification and participating and adjustable business.

Solvency Test

The paper also discusses approaches OSFI is considering for solvency testing measures. Currently, life insurers are subject to a solvency test that is based on a ratio of qualifying regulatory capital (required to available) called the Minimum Continuing Capital and Surplus Requirements (MCCSR) ratio. The target is 150% MCCSR and OFSI can take control of the life insurer if the MCCSR drops to 120%. OSFI will collect information in the 6th QIS toward the development of potential new solvency measures and several options include capital ratios, total requirement ratios and excess assets ratios.

Conclusion

OSFI's ultimate objective in conducting QISs is to produce a revised capital guideline for life insurers that takes into account emerging developments in the areas of financial reporting, actuarial methodology, economic capital and financial theory and thereby better assesses life insurers' solvency risk. However, as OSFI states in the paper, the described approaches taken in the 6th QIS are "subject to further review, consultation and calibration" and industry stakeholders are invited to continue to provide input in order to assist with the framework's development.

by Carol Lyons

1 Prepared by the Standard Approach Advisory Group, a joint committee of OSFI, Autorité des marchés financiers (the Quebec provincial insurance regulator) and Assuris (the Canadian life insurance compensation association for policyholders).[ps2id id='1' target=''/]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.