Regulatory Updates

2015 MCT Guideline (Draft) and other regulatory reporting changes

Agenda

1. **Draft 2015 MCT Guideline**
   i. Conceptual changes
   ii. Significant changes and additions
      - Capital available
      - Capital required
      - Diversification credit
      - MCT Calculation
      - BAAT
   v. Transition
   vi. Impact analysis
2. **Other notable reporting changes**

2015 MCT Guideline (draft)
Conceptual changes

- Update risk factors that have not been changed since the initial MCT Guideline was issued in 2003
- Includes the introduction of additional risks
- Thought to be a more robust risk-based capital test
- Better align with capital frameworks across other financial sectors

2015 MCT Guideline (draft)
Conceptual changes

- Capital requirements at the target level, as opposed to the minimum level
- MCT risk factors are developed at a pre-determined confidence level
- OSFI has elected 99% of the expected shortfall over a one-year time horizon as a target confidence level

2015 MCT Guideline (draft)
Significant changes and additions

- Key changes to capital framework:
  - Definition of capital –*revised composition and qualifying criteria*
  - Insurance risk – *amended risk factors and use premium liabilities rather than UPR*
  - Credit risk – *more granularity for off-balance sheet exposures and unregistered reinsurance*
  - Market risk – *introduction of foreign exchange risk*
  - Operational risk – *more explicit risk charge*
  - Diversification credit – *provide a benefit for diversification across risk categories*

2015 MCT Guideline (draft): Capital Available

- Four primary considerations for defining the capital available :
  - Availability
  - Permanence
  - Absence of encumbrances and mandatory servicing costs
  - Subordination

- Significant changes in presentation (30.xx MINIMUM CAPITAL TEST: CAPITAL AVAILABLE) as a result of changes or further clarification with respect to:
  1. Capital components (Category A, B and C Capital and non-controlling interests)
  2. Qualifying criteria
  3. Capital composition limits
  4. Regulatory adjustments to capital

2015 MCT Guideline (draft): Capital Available

Capital Components & Qualifying Criteria:

1. Category A Capital (common equity):
    i. Common shares meeting the category A qualifying criteria
    ii. Share premium resulting from instruments issued and included in common equity capital and other contributed surplus
    iii. Retained earnings
    iv. Earthquake, nuclear and general contingency reserves
    v. Accumulated other comprehensive income

- For an instrument to be included in Category A it must meet all of the qualifying criteria

2015 MCT Guideline (draft): Capital Available

Capital Components & Qualifying Criteria:

2. Category B Capital
   i. Instruments issued that meet Category B qualifying criteria and do not meet the criteria for classification as Category A (subject to limits)
   ii. Contributed surplus (share premium) resulting from the issue of instruments meeting the qualifying criteria for Category B

- For an instrument to be included in Category B it must meet all of the qualifying criteria

2015 MCT Guideline (draft): Capital Available

Capital Components & Qualifying Criteria:

3. Category C Capital
   i. Instruments issued that meet Category C qualifying criteria and do not meet the criteria for classification as Category A or B (subject to limits)
   ii. Contributed surplus (share premium) resulting from the issue of instruments meeting the qualifying criteria for Category C

- For an instrument to be included in Category C it must meet all of the qualifying criteria
- Amortization requirement in the final five years prior to maturity

2015 MCT Guideline (draft): Capital Available

Capital Components & Qualifying Criteria:

4. Non-controlling interests
   i. Capital instruments meeting the qualifying criteria under categories A, B and C
   ii. Capital in subsidiary is not excessive in relation to the amount required to carry on the subsidiary's business
   iii. Level of capitalization of the subsidiary is comparable to the insurance company

2015 MCT Guideline (draft): Capital Available

Capital composition limits:

- Category B and C instruments included in capital available are subject to the following limits:
  - Sum Category B and C qualifying instruments will not exceed 40% of total capital available, excluding accumulated other comprehensive income
  - Category C qualifying instruments will not exceed 7% of total capital available, excluding accumulated other comprehensive income
- Excess Category B and C instruments will be treated as follows:
  - Excess in either Category B or C will not be considered capital available
  - Excess in both Category B and C requires insurers to exclude the greater of the 2 excess amounts from capital available

2015 MCT Guideline (draft): Capital Available

Regulatory adjustments to capital available:

1. Cumulative gains and losses due to changes in own credit risk on fair valued liabilities
    - Apply to all unrealized net after-tax fair value gains (losses) and not just those classified as held for trading
2. Earthquake premium reserve not used as part of financial resources to cover earthquake risk exposure
3. Deferred policy acquisition expenses for A&S business
    - Deduction only applies to A&S business
    - Includes all other DPAE other than commissions and premium taxes for A&S business
4. Goodwill
    - Deduction is now net of eligible deferred tax liabilities

2015 MCT Guideline (draft): Capital Available

Regulatory adjustments to capital available:

5. Intangible assets, including computer software
    - Computer software now considered an intangible asset and is fully deductible from capital available
    - Deduction is now net of eligible deferred tax liabilities
6. Deferred tax assets excluding those arising from temporary differences
    - Exclude items that qualify for 10% risk factor
    - Include the amount of DTAs arising from temporary differences that are in excess of the amount that could be recoverable from income taxes paid in the three immediate preceding years.
    - Deduction is now net of eligible deferred tax liabilities

2015 MCT Guideline (draft): Capital Available

Regulatory adjustments to capital available:

7. Investments in own shares
    - Includes investments in its own common shares, held directly or indirectly and any own stock that they may be contractually obliged to purchase
8. Reciprocal cross holdings
    - Also known as back-to-back holdings and are designed to artificially inflate the capital position

2015 MCT Guideline (draft): Capital Required at Target

Minimum capital required =capital required at target / 1.5

- Grouped into 4 categories

  1. Insurance risk
  2. Market risk
  3. Credit risk
  4. Operational risk

2015 MCT Guideline (draft): Capital Required at Target

Insurance Risk:

- Broken into 4 categories:

    1. Unpaid Claims
    2. Premium Liabilities
    3. Catastrophe
    4. Reinsurance ceded to unregistered reinsurers

2015 MCT Guideline (draft): Capital Required at Target

Insurance Risk:

1. Unpaid claims
   - Unpaid claims margin is net of PfAD's
   - Revised risk factors to adjust to the target level
   - OSFI also undertook a variability analysis to come up with the revised factors
   - The data for **property** class and **liability** class demonstrated more volatility than expected and thus increased risk factors
   - The expected losses for **automobile liability and personal accident** class were not far from actual losses and thus reduced risk factors

2015 MCT Guideline (draft): Capital Required at Target

Insurance Risk:

2. Premium liabilities *(significant changes)*
    - Premium liabilities vs unearned premiums
    - Premium liabilities margin is net of PfAD's
    - No longer a capital charge for deferred policy acquisition expenses
    - Risk factor applied to the greater of net premium liabilities and 30% of NWP
    - Class of insurance has been updated (reduced detail in Auto and a much more granular split within property, liability and surety)
    - *30.xx – MCT INSURANCE RISK: CAPITAL REQUIRED FOR UNPAID CLAIMS AND PREMIUM LIABILITIES*

2015 MCT Guideline (draft): Capital Required at Target

Insurance Risk:

3. Catastrophes
   - Earthquake – Guideline B-9
5. Reinsurance ceded to unregistered insurers
   - Risk factor changed from 10% to 15%
   - Adjustment of 1.5 eliminated to bring the margin required to the target level

2015 MCT Guideline (draft): Capital Required at Target

Market Risk:

- Broken into 5 categories:

1. Interest rate risk
2. Foreign exchange risk
3. Equity risk
4. Real estate risk
5. Other market risk exposures

- 30.XX – MCT MARKET RISK CAPITAL REQUIREMENTS

2015 MCT Guideline (draft): Capital Required at Target

Market Risk:

1. Interest rate risk

    - Methodology consistent with current calculation
    - Interest rate shock factor increased by 50 bps to 1.25%
    - Interest rate sensitive liabilities includes an additional row for 'Other as approved by OSFI'

2015 MCT Guideline (draft): Capital Required at Target

Market Risk:

2. Foreign exchange risk
   - Covers the risk of loss resulting from fluctuations on currency exchange rates
   - Currently exists in the BAAT, however is new to the MCT
   - Risk factor (10%) applied to greater of the aggregate net long position and the aggregate net short position in each currency
   - Adjustment for plain vanilla foreign currency hedges permitted
   - Carve out of up to 25% of liabilities (only for insurers holding a net open long position in the same currency)

2015 MCT Guideline (draft): Capital Required at Target

Market Risk:

2. Foreign exchange risk

Capital Required for Foreign Exchange Risk						
		Net open long position[1] in CAD, before carve-out (xx)	Carve-out[2] in CAD (xx)	Net open long position in CAD, less carve-out (xx)	Net open short position[3] in CAD (xx)
U.S. Dollar	xx				
Euro	xx				
U.K. Pound	xx				
Swiss Franc	xx				
Danish Krone	xx				
Swedish Krona	xx				
Australian Dollar	xx				
Hong Kong Dollar	xx				
Singapore Dollar	xx				
Japanese Yen	xx				
China Yuan Renminbi	xx				
Chilian Peso	xx				
Indian Rupee	xx				
Other (specify)	xx				
Total net position	**xx**				
Net exposure = MAX (Total net open long positions, Absolute value of total net open short positions)				xx	
Total foreign exchange risk margin				**xx**	

2015 MCT Guideline (draft): Capital Required at Target

Market Risk:

3. Equity risk

- To reflect the increased variability experienced in global equity market and also to harmonize the risk factors applied in the life insurance sector and to be consistent with international trend
- Includes investments in common shares and joint ventures with less than or equal to 10% ownership interest
- Risk factor increased to 30% from 15%

2015 MCT Guideline (draft): Capital Required at Target

Market Risk:

4. Real Estate Risk

- Includes investments in investment properties and own use properties
- Risk factors increased to 20% and 10%, respectively (currently 15% and 8%)

5. Other market risk exposures

- Includes investments in equipment and other items not included in other risk categories
- 10% risk factor applied

2015 MCT Guideline (draft): Capital Required at Target

Credit Risk:

- Exposure to both on and off-balance sheet items including:
  1. Counterparty default risk for balance sheet assets (30.71 & 30.73)
  2. Counterparty default risk for off-balance sheet exposures (new page)
  3. Counterparty default risk for unregistered reinsurance collateral and SIR's (new page)
- Effective maturity is now a permitted method for calculating capital required for instruments that are subject to a determined cash flow schedule (currently, nominal maturity is used)

2015 MCT Guideline (draft): Capital Required at Target

Credit Risk:

1. Counterparty default risk for balance sheet assets:

- 30.71 and 30.73 used to determine capital required for balance sheet assets net of exposures for collateral/guarantees

EXAMPLE:

$100,000 bond rated AAA due in 10 years that has a government guarantee of 90%

		Remaining Term to Maturity				
		Greater than 5 years				
Rating		Balance Sheet Value (09)	Redistribution of Exposure for Collateral/ Guarantees (10)	Net Exposure (11)	Risk Factor (12)	Capital Required (03x04)+(07x08)+(11x12) (13)
Government Grade	01		90,000	90,000	0.00%	0
AAA	02	100,000	(90,000)	10,000	1.25%	125

2015 MCT Guideline (draft): Capital Required at Target

Credit Risk:

1. Counterparty default risk for balance sheet assets:

- Increase in risk factors
- Cash other – includes demand deposits, certificates of deposit, drafts, cheques, acceptances and other similar obligations with a maturity of less than three months (0.25%)
- Mortgages – removed government grade and added a new row for mortgages secured by undeveloped land (15%)
- Deferred tax assets - arising from temporary differences where the insurer could recover income taxes paid in the three immediate preceding years (10%)

2015 MCT Guideline (draft): Capital Required at Target

Capital Risk:

Example – Capital charge on DTA's

Deferred Tax Asset	$	2,000	
Less: Eligible associated Deferred Tax Loss	$	500	
Adjusted DTA	$	1,500	
Less: income taxes paid in 3 immediate preceding years	$	1,200	A
DTA in excess of income taxes paid in 3 immediate preceding years	$	300	B
A. Subject to 10% risk weight on page 30.71			
B. Full deduction from capital available			

2015 MCT Guideline (draft): Capital Required at Target

Credit Risk:

2. Counterparty default risk for off-balance sheet exposures:
   - Include Type 1 structured settlements, derivatives and other exposures
   - Risk factors updated to a more granular level based on credit rating of the issuer and term to maturity
   - Capital required is calculated in a manner similar to on-balance sheet assets in that the credit risk exposure is multiplied by a counterparty risk factor
   - 30.xx – MCT CREDIT RISK: CAPITAL REQUIRED FOR OFF-BALANCE SHEET EXPOSURES

2015 MCT Guideline (draft): Capital Required at Target

Credit Risk:

2. Counterparty default risk for off-balance sheet exposures:

EXAMPLE

A $300,000 Type 1 structured settlement rated BBB+ or lower, backed by collateral of $200,000 from a counterparty rated A- or higher

Capital Required for Type 1 Structured Settlements						
Rating of the counterparty	**Credit equivalent amount** (01)	**Redistribution of Exposure for Collateral/ Guarantees** (02)	**Net exposure** (03)	**Credit conversion factor** (04)	**Risk factor** (05)	**Capital required** **(03x04x05)** (06)
Rated A- and higher xx		200,000	200,000	50%	2.00%	2,000
Rated BBB+ and lower xx	300,000	(200,000)	100,000	50%	8.00%	4,000

2015 MCT Guideline (draft): Capital Required at Target

Credit Risk:

3. Counterparty default risk for unregistered reinsurance collateral and SIR's :

- Concepts and application are consistent with the current guideline
- Risk factors updated and applied at a more granular level based on credit rating of the issuer and term to maturity
- Page 70.38 has been updated to include the calculation for excess collateral
- 30.xx – MCT CREDIT RISK: CAPITAL REQUIRED FOR COLLATERAL HELD FOR UNREGISTERED REINSURANCE EXPOSURES AND SELF-INSURED RETENTIONS

2015 MCT Guideline (draft): Capital Required at Target

Operational Risk:

- Risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events
- New calculation links two risk drivers using a prescribed calculation
- Risk drivers include:
  1. Capital/margin required
  2. Premium level (direct, assumed and ceded), subject to cap
- 30% cap on operational risk charge based on capital/margin required at target before operational risk and diversification credit
- 30.xx – MCT OPERATIONAL RISK CAPITAL REQUIREMENTS

2015 MCT Guideline (draft): Capital Required at Target

Operational risk:

$$\boxed{\textit{Operational risk margin} = \textit{MIN}\ \{30\%\ CR_0,\ (10\%\ CR_0 + 3\%\ P_w + 2\%\ P_a + 3\%\ P_c + 3\%\ P_\Delta)\},}$$

where:

CR_o is total capital required for the reporting period, before the operational risk margin and diversification credit

P_w is direct premiums written in the past 12 months

P_a is premiums assumed in the past 12 months

P_c is premiums ceded in the past 12 months

P_Δ is growth in premiums in the past 12 months

2015 MCT Guideline (draft): Diversification credit

- Risk aggregation is the approach used to calculate the total of all individual risk elements
- Diversification credit occurs when the method of aggregation of risks produces results that are less than the sum of the total individual risk elements
- Based on various analysis and data review the MCT will include a diversification credit within the following risk categories:
  1. Diversification within insurance risk – diversification credit has been implicitly built into the risk margins applied to unpaid claims and premium liabilities
  2. Diversification between insurance risk and the sum of credit and market risks – prescribed formula

2015 MCT Guideline (draft): Diversification credit

➢ Diversification between insurance risk and the sum of credit and market risks:

$$Diversification\ credit = (A + I) - \sqrt{(A^2 + I^2 + 2 \times R \times A \times I)}$$

A is the asset risk margin, which is the sum of capital required for:

- credit risk, including requirements for balance sheet assets and off-balance sheet exposures; and
- market risk, including interest rate risk, foreign exchange risk, equity risk, real estate risk and other market risk exposures.

I is the insurance risk margin, which is the sum of capital required for:

- unpaid claims and premium liabilities;
- margin required for unregistered reinsurance exposures; and
- catastrophe risk.

R is the correlation factor between *A* and *I*, equal to 50%

2015 MCT Guideline (draft): MCT Calculation

- **Total capital available/Total minimum capital required**
  - Total capital available as calculated on the new MCT page and adjusted for the phase-in of capital available
  - Total minimum capital required is determined by dividing Total capital required at target (insurance risk + market risk + credit risk + operational risk – diversification credit) by 1.5 to reach the minimum level of capital required and adjust for the phase-in of capital required

2015 MCT Guideline (draft): BAAT

- Net assets available
  - Changes in presentation consistent with the MCT pages
  - 30.92 – NET ASSETS AVAILABLE is now the equivalent page to Capital Available for Canadian companies
  - Excess vested assets over net liabilities consistent with current application with the following changes:
    1. Deduction for DPAE – only applies to A&S business
    2. SIR recoverables not deducted from assets available is a new adjustment to total liabilities
  - Adjustments to excess vested assets over net liabilities consistent current guideline with the addition of an add-back of DPAE excluding A&S (no longer a deduction from net vested assets)
- Net required margin is consistent with the MCT (excluding items which are not applicable to Foreign Branches)
- BAAT calculation is consistent with the MCT

2015 MCT Guideline (draft): Transition

- Phase-in the capital impact of the revised MCT framework
- Straight-line basis, over 12 quarters, starting with the first quarter ending in 2015
- Phase-in calculated separately for capital available and capital required
- Calculate two sets of MCT requirements as at December 31, 2014 (or October 31, 2014):
    1. Under the old framework
    2. Under the new framework
- Mandatory

Impact analysis: Implications of the new guideline

- **Quantitative impact:**
  - OSFI QIS:

	2012 MCT	Draft MCT (May QIS)	Updated Draft MCT
MCT	246%	240%	250%
BAAT	311%	281%	298%

  - 50% will experience an increase and 50% will experience a decrease
  - Property insurers will experience greatest impact on insurance risk due to the increase in risk factors

Impact analysis: Implications of the new guideline

- **Qualitative impact:**
  - Increased granularity of information
  - Greater demands on resources
  - Increased amount of actuarial information and demand on resources
- **Audit implications:**
  - Audit report due 90 days (changed from 60 days) from year-end
  - Revised audit opinion (2 pages vs 1)
  - Possible decrease in materiality due to granularity
  - Increased reliance on actuarial expertise and resources

Other notable regulatory reporting changes

- Regulatory Reporting System
- Combined company and branch return
- Annual reporting changes
  - Annual supplement (filed with Q4 interim return)
  - Interim return (filed quarterly for all 4 quarters)

Thank you

Questions?