MCT ADVISORY COMMITTEE

QUÉBEC CHARTERED P&C INSURERS

July 2009

KEY PRINCIPLES FOR THE FUTURE DIRECTION OF THE CANADIAN REGULATORY CAPITAL FRAMEWORK FOR PROPERTY AND CASUALTY INSURANCE

AUTORITÉ DES MARCHÉS FINANCIERS

MINIMUM CAPITAL TEST ADVISORY COMMITTEE

Since the current solvency framework was first put into place, Canada has been among the leaders in the development of risk-based capital adequacy tests for insurance companies. There is a great deal of interest both in Canada and abroad in developing new capital requirements to better measure risk and thereby facilitate improved risk management procedures within institutions.

Regulators and the Canadian property and casualty (P&C) insurance industry are working together through the Minimum Capital Test (MCT) Advisory Committee (MCT Advisory Committee) to develop more advanced risk measurement techniques (internal models) for incorporation into the solvency formula. These techniques will include the development of risk management and disclosure criteria for risk-sensitive methodologies for use by companies that have the commitment and resources to implement them.

The MCT Advisory Committee is co-chaired by Chris Townsend, P&C representative of the Canadian Institute of Actuaries' ("CIA") Risk Management and Capital Requirements Committee, Chris Walton, Insurance Bureau of Canada's ("IBC") Financial Affairs Committee, and Bernard Dupont, Director, Capital Division at the Office of the Superintendent of Financial Institutions ("OSFI"). Its members are senior representatives from the IBC, the CIA, the Property and Casualty Insurance Compensation Corporation ("PACICC"), the Canadian Council of Insurance Regulators ("CCIR"), OSFI, the Autorité des marchés financiers ("AMF") and representatives from the industry.

This note is the first in a series of regular updates on the MCT Advisory Committee's progress in developing a new framework for assessing P&C insurance capital adequacy.

The MCT Advisory Committee plans to develop and recommend to the AMF and OSFI changes to the current capital framework in stages. Its first priority is to develop an approach to measure the insurance risk.

As the MCT Advisory Committee completes its work, the AMF intends to consult the industry before any changes are made to the framework. An important collateral benefit of this work will be stronger conceptual and analytical bases. This will ensure that the current approach based on factors and formulas remains appropriately risk-related for that majority of companies that will not be using their own models.

While a definitive timetable has yet to be approved, the implementation of a measure for insurance risk for regulatory capital purposes is expected by 2014. The development of models to measure the other risks will follow thereafter.

The AMF is now releasing for comments a draft of high level key principles, as developed and proposed by the MCT Advisory Committee in "Key Principles for the Future Direction of the Canadian Regulatory Capital Framework for Property & Casualty Insurance", which is consistent with the AMF regulatory framework. The key principles are set out in the attached paper.

The AMF welcomes comments you may have on the attached document. Please send your comments no later than August 31, 2009.

Request for comments

Comments may be made in writing to:

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Additional information

Further information concerning this matter is available from the following:

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JULY 2009

DRAFT FOR COMMENTS

Background

This paper has been prepared by the Minimum Capital Test (MCT) Advisory Committee (MCT Advisory Committee) to outline the key principles for a new capital framework for Canadian P&C insurers. These principles are intended to encourage the use of improved risk-based business decisions and better reflect each insurer's risk profile and risk management practices.

Key stakeholders in the Canadian P&C insurance industry are working together through the MCT Advisory Committee to:

- build consensus on the direction the new capital adequacy regime will take;
- establish priorities and timing;
- provide expert feedback on high level principles;
- identify resources available to develop technical standards;
- assign work to appropriate working groups; e.g., the Canadian Institute of Actuaries (CIA) or others;
- assess recommendations on modification to the capital framework from the technical groups;
- review and provide expert feedback on criteria developed by OSFI, or other regulators;
- recommend elements of a new internal models capital framework to the AMF and OSFI.

Key principles

The New Capital Framework should:

1. Encourage good risk management

- Internal model approaches should recognize companies that manage their risks properly in accordance with minimum standards and to prudent levels.
- The models, techniques, parameters, inputs and assumptions that are used for calculating capital requirements should normally be used internally for managing risks.
- Standards for the use of models will be established.
- When an internal model approach is used for one risk, it should apply to all occurrences of that risk for all companies in a group (i.e., cherry picking is not allowed), except when a risk is immaterial.
- A leverage ratio or other relevant measure may be useful to complement a risk-based capital test.

2. Encourage capital planning and avoid pro-cyclicality

- The capital framework should encourage appropriate capital planning and the creation of high quality capital buffers during times of profitable growth – such buffers should be sufficient to withstand unexpected loss scenarios and to carry an insurer through adverse circumstances.
- Where practicable, the capital framework should minimize pro-cyclicality (i.e., the tendency of a rule, such as a capital requirement, to exacerbate the effect of a market phenomenon such as a business cycle) and its macro-prudential impact (e.g., the effect the rules have on the strength of the financial system as a whole) should be considered.
- The capital framework should, in the aggregate, create sufficient capital in the P&C industry to encourage systemic stability.

On risk measurement

3. Consider all risks

- The capital framework should consider all risks within the consolidated group:
  - including Insurance (including Catastrophe), Market, Credit, Liquidity and Operational risks.
  - the methodology and process for inclusion may vary depending upon the practical precision with which a risk can be measured.
- Capital requirements should, within a risk category, reflect risk mitigants, reinsurance, interrelationship and diversification/concentration taking account of effectiveness under normal and stress scenarios.
- Risks should be aggregated. No diversification between risk categories is permitted until evidence confirms diversification will hold in a stress situation.

4. Determine assets, liabilities and the capital requirement on a consistent basis for risk measurement purposes

- Off balance sheet items have to be considered.

5. Be practical, yet technically sound

- There should be a standard approach to every risk
- A framework for determining regulatory capital requirements for P&C insurance companies should have two basic components:
  - a standard approach, which is to be used by all companies to determine the company's minimum capital requirement and by companies without approval to use internal models to determine supervisory and company target required capital amounts, and
  - an internal models approach, which is to be used by companies with approval to use internal models to determine supervisory and company target required capital amounts subject to AMF-defined floors.
- The internal model approach should be developed, subject to insurers meeting regulatory defined parameters for the various risk categories, with freedom to choose some but not necessarily all model inputs, and with both quantitative and qualitative conditions around the inputs. Generally, standardized assumptions should be used where they are not dependent on company-specific circumstances.
- Standardized approach may need to be recalibrated based on testing from an internal model approach.
- Capital requirements for immaterial risks could be based on a standardized approach, even for P&C insurers that have otherwise elected to use an internal model approach for regulatory capital purposes.

6. Reflect existing risks on going concern basis and consider winding-up and restructuring

- Risks should be measured on a going concern basis and should consider winding-up and restructuring costs.
- Regulatory capital available has two key functions: it allows institutions to absorb losses during ongoing operations and it protects policyholders and creditors from loss in the event of liquidation.
- In defining available capital and required capital, risks should not be double counted.
- Existing risks include all current commitments, whether on- or off-balance sheet.
- Future new business and renewals have to be considered.

7. Use measures that are comparable across risks and products (e.g., Value at Risk (VAR) or Conditional Tail Expectation(CTE))

- Consistency of measurement between risks should be maintained if possible.
- The risk measure should be based on statistically credible data.
- The risk measure should establish a time horizon (combined with an appropriate measure of terminal liabilities) that is common to institutions.
- The minimum capital framework should be based on a risk measure level (e.g. VAR or CTE 99) that is common to institutions.
- Companies should hold capital above the regulatory capital target because of economic cycles, desired ratings and differences in risk management; an internal capital target ratio should be established by companies.

8. Use a Total Asset Requirement (TAR) approach

- The current capital level and the reserve margins should be considered on an integrated basis.
- The measurement process should be comprehensive.
- Expected losses under the total assets requirements approach should include margins for misestimation and deterioration.

On capital adequacy

9. Ensure that capital is prudent

- To allow market discipline, the meaning and methodology for, and the factual disclosure related to, regulatory capital and capital requirements should be transparent.
- Regulatory capital covers unexpected losses on both sides of the balance sheet in stress conditions; unexpected losses will include those coming from volatility (statistical fluctuations) as well as from catastrophes and other unforeseen events.
- Although using a total assets requirements approach, capital is independently set at a prudent level above liabilities as capital should provide a cushion against unexpected losses.

10. Consider international principles and best practices

- The insurance market is global and Canadian risk management should reflect international best practices.
- International principles and best practices should be adapted to reflect the market, risks and products of Canadian companies.
- Capital requirements should be risk-based.

On risk monitoring

11. Allow comparison of similar risks across financial institutions

- Banks, life insurers and P&C companies should hold comparable levels of capital for similar products and risks, taking into account the level of conservatism in their business and balance sheet.
- While respecting the need for a level playing field, the capital framework should recognize differences in the nature of business and operating environments across the sectors.

12. Be transparent, validated and based on credible data

- The model, as well as its assumptions and inputs, must be disclosed in sufficient detail so that it can be analyzed by users of financial statements and compared to the models of other companies.
- Minimum standards for data and inputs to models are necessary.
- Credible data can be audited.
- Where relevant, professional standards (e.g., the CIA standards), both current and to be developed in the future, should be considered to develop these criteria.
- The data should reflect the company's own experience and practices and where data needs to be supplemented with external data, such data must be relevant for the company's business strategy and risks.

13. Use reliable processes with assumptions sustainable in times of stress

- Rules for using models should be clear.
- A process should be in place to make sure model applications are appropriate.
- A review process should be implemented.
- The results of models should be replicable.
- Material changes to models (e.g., parameters, assumptions, methods) will be subject to approval.

14. Be part of intervention levels for supervisory action

- The minimum and target capital levels should be part of the evaluation of the risk profile as a tool among series of control levels that define possible supervisory interventions when, among others, the available capital falls below a predetermined level.
- The capital ratio level for intervention should be sufficiently high to allow supervisory action at an early stage.