P&C Insurance Capital Rules – The Times They Are A-Changin'

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Regulator initiatives over the past couple of years herald significant changes to the way P&C insurers will calculate and manage their capital. This multi-year process has been accompanied by an unprecedented degree of research by the regulators as they try to gauge the impact of their proposed changes. The first phase of the evolution to a new capital test has been introduced in the first quarter of 2012. We will outline the nature and impact these first changes and discuss at a high level what may be expected in the future. Many in the industry are actively engaged in trying to help the regulators understand the impact of their proposed changes.

OSFI has stated their objective for undertaking revisions to the Capital guideline in 2012 as a wish to adopt more appropriate risk-based guidance by:

- Introducing an interest rate risk capital requirement.
- Recognizing certain hedging instruments for interest rate risk.
- Introducing greater granularity to credit risk factors for invested assets based on credit rating and term to maturity.
- Removing the margin factors on the provision for adverse deviation portion of the claims liability.
- Introducing a capital factor on collateral held as security for unregistered reinsurance.
- Removing the capital factor on balances due from OSFI registered affiliated reinsurers.

They have also introduced a requirement to obtain an auditor's opinion on the MCT page of the 2012 P&C annual return and have consolidated the MCT (Minimum Capital Test for Canadian companies) and BAAT (Branch Test of Adequacy of Assets for foreign companies) in one document. OSFI has stated that the changes were motivated by the desire to ensure that the guidelines continued to accurately reflect the risks in the P&C insurance industry and a desire to bring greater consistency between P&C insurance capital requirements and those of other financial sectors.

Industry-Wide Capital Ratios:

In Exhibit 1 we have calculated the industry wide MCT and BAAT at the end of the first quarter of each of the last three years with the most recent quarter reflecting the new rules.

Exhibit 1							
Comparison of Industry wide MCT under 2010, 2011 and 2012 rules	**Companies (P&C-1)**				**Branches (P&C-2)**		
	Capital available	Capital required	Capital adequacy		Assets available	Asset margin	Margin
	($'000)	($'000)	%		($'000)	($'000)	%
2012 Ratios based on new capital rules and accounting	24,857,848	10,186,465	244.03		6,416,689	1,945,953	329.75
2011 Ratios based on old capital rules and accounting	22,088,713	9,215,796	239.68		5,977,615	1,885,072	317.10
2010 Ratios based on old capital rules and accounting	22,871,617	9,378,836	243.86		5,635,830	1,695,729	332.35

Only 6 of 157 companies in the Q1 2012 MSA Research database reported ratios below 200, including, interestingly, the largest subsidiaries of two of the largest publicly listed insurance organizations, Intact and Genworth, demonstrating in part the need to demonstrate capital efficiency to the analyst community. Genworth's unique mortgage insurance product mix and Intact's recent investment activity has strongly influenced and explains in part their ratios. Only one of 78 Branches had a ratio below 220 in Q1 2012.

Following is a brief discussion of some of the more significant changes in 2012.

Interest Rate Risk:

The new interest rate risk capital requirement is designed to address the risk of changing interest rates on the value of interest rate sensitive assets and liabilities. As noted in an article in last quarter's MSA Report, Canadian companies at 2011 year end had accumulated $2.28 billion of interest rate related unrealized net gains on bonds and debentures. Premium liabilities and unpaid claims liabilities are also sensitive to interest rate changes as they are discounted under accepted actuarial practice. The interest rate risk margin is calculated using either modified or effective duration matching to calculate the net impact of interest rate changes on these assets and liabilities. In 2012 a 0.5% change in rates must be modeled, moving to 0.75% in 2013.

Of total required capital for Canadian companies at Q1 2012 of $10.2 billion, $0.49 billion came from the Interest Rate Risk calculation. Companies are allowed to recognize certain hedging instruments for interest rate risk calculation.

Credit Rating and Term to Maturity for Investments:

Previously investments were assigned risk factors based on whether they were investment grade or not. The 2012 rules now assign specific factors based on a range of credit ratings and also the term to maturity of the investments. This will provide a significantly enhanced granularity to the investment margins. Using total industry Canadian company data reported to MSA Research we calculated the credit risk margin percentage carried in Q1 2011 using the old factors and the credit risk margin percentage in Q1 2012 using the new factors. Exhibit 2 displays the results for the Term deposits, bonds, and debentures category and for Preferred Shares.

Exhibit 2			
Comparison of Interest Sensitive Investment Margins in 2011 and 2012			
	Total	**Margin**	**Margin**
	($'000)	($'000)	%
Bonds, debentures and term deposits			
2012	48,500,215	394,458	0.81
2011	47,131,462	475,755	1.01
Preferred shares			
2012	3,472,868	212,748	6.13
2011	3,311,056	192,114	5.80

Removing the margin factors on the PfAD portion of the claims liability:

The industry has long argued that applying a capital risk factor to claims PfADs represented a margin on a margin. The regulators have agreed and removed this additional margin in 2012.

Reinsurance:

The new capital factor on collateral held as security for unregistered reinsurance does not significantly affect a great many companies but will require new discipline and rigour to the process of negotiating security for unregistered reinsurance placements. OSFI has also removed another long term irritant by removing the factor on registered affiliated reinsurers.

Future Changes:

As mentioned at the outset of this article, there has been an extensive consultation process related to the future direction of the P&C insurance capital tests. A partial list of OSFI capital related releases over the last two years includes:

- April 2010 – Data request for 2012 changes and draft guideline
- December 2010 – Discussion Paper on 2013 MCT changes
- June 2011 - Guideline A-4 Internal Target Capital Ratio for Insurance Companies
- October 2011 - Guideline A 2012 revision
- December 2011 – Canadian Vision for Property and Casualty Insurer Solvency Assessment (Property & Casualty Minimum Capital Test (MCT) Advisory Committee – P&C MAC)
- May 2012 - Data request for 2014 changes including Foreign Exchange rules (update of 2010 request)
- June 2012 - Draft 2013 Guideline A including employee benefit related accounting changes
- July 2012 – OSFI Position Paper on Proposed Changes to the Definition of Capital under the MCT: Qualifying Criteria, Capital Components, Limits and Regulatory Adjustments

It would take an entire issue to try to summarize the hundreds of pages of material in these documents, but several significant items on the horizon are summarized below. The December 2011 Vision paper produced by the P&C MAC should be considered essential reading for all with an interest in the direction of capital measurement in Canada as should the very recently released Position Paper which addresses the components of capital, among other items.

Internal Models:

Many other jurisdictions and financial services sectors have or are in the process of moving to a system which allows companies to incorporate internal capital models into the solvency measurement process. These models are being used increasingly for capital allocation, risk management and ratings agency assessments and are designed to help monitor all risks faced by an insurer. With appropriate data controls, model approval processes, governance and other model controls, the P&C MAC believe that internal models can be used as a substitute or supplement to standard solvency tests.

Impact of New Employee Benefits Accounting in 2013:

OSFI has very recently issued a draft of the 2013 Guideline A which contains significant changes intended to respond to the implementation of IAS 19 – Employee Benefits accounting on January 1, 2013.

Foreign Exchange Risk in 2014:

A controversial new margin being proposed by OSFI for 2014 involves significant additional capital charges for net foreign currency exposures. Several commentators have expressed a view that these new tests may preclude insurers from diversifying their portfolios into non-Canadian investment markets. See May 2012 OSFI Data Request for a copy of the draft rules.

Impact of Potential New Lease Accounting on Branch Capital:

A bit of a sleeper which is now keeping some Branch CFOs up at night is the potential impact of new IFRS lease accounting rules on the BAAT. Operating leases may soon be required to be shown on a gross basis similar to the way capital leases are currently reported. If the asset portion of the

accounting is not considered a vested asset and capital relief is not provided for the liability half of the equation, significant damage could be done to BAAT ratios.

Summary:

Never before has the there been so much activity related to the future direction of capital measurement for Canadian P&C insurers. The regulators have some fairly clearly stated objectives and are pushing forward aggressively. It is incumbent on all industry participants to remain current on these fast moving developments and insert themselves as much as possible into the dialogue with the regulators in order to help manage the outcome.