

RE THINK REINSURANCE



THE 55TH ANNUAL CANADIAN
REINSURANCE CONFERENCE



CANADIAN REINSURANCE / CONGRÈS CANADIEN DE
CONFÉRENCE / RÉASSURANCE

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AGENDA

1. Regulatory (and Supervisory) Convergence

- Why and How?

2. Global Regulatory Convergence Themes

- Global Supervision, Solvency Standards, ORSA, Economic Balance Sheet, Eligible Capital

3. Canadian Implications and Views – Selected Issues

- **Balanced approach adopting International “Standards”**
- **Supervision, Solvency Standards, Reinsurance**



Regulatory Convergence – Why?

International

- Financial Crisis
 - G20 / Finance Ministers / Financial Stability Board (FSB)
- Global comparability
- Trend to more risk-based/ principles based standards
- Convergence among Sectors

Canada

- Member of G20 and FSB
- IAIS Adherence/Cooperation
- Advances in actuarial and capital theory; increased complexity and globalization of products
- Consistency: insurers and banks



Regulatory Convergence – How?

International

➤ **IAIS Insurance Core Principles, Standards, Guidance**

➤ **Supervision**

➤ IAIS , Solvency II

➤ **Solvency Standards**

➤ IAIS, Solvency II, NAIC

➤ **Reinsurance**

➤ IAIS, Solvency II, NAIC

Canada

➤ **Acts and Regulations, Guidelines, Advisories, Application Guides, Consultations, Supervisory Practices, Industry Notices**

➤ **OSFI's Feb 2011 revision to Supervisory Framework**

➤ **“Life Insurer Solvency Assessment” Framework (Standard and Advanced Approaches)**

➤ **“Reinsurance Response Paper”; Guideline B-3; Guidance on RSAs**



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Regulatory Convergence – How?

IAIS Insurance Core Principles (ICP's) – Feb 2011 - 396 pages!

Introduction

ICP 1 Objectives, powers and responsibilities of the supervisor

ICP 2 Supervisor

ICP 3 Information exchange

ICP 4 Licensing

ICP 5 Suitability of Persons.

ICP 6 Changes in control and portfolio transfers

ICP 7 Corporate Governance

ICP 8 Risk Management and Internal Controls

ICP 9 Supervisory review and reporting

ICP 10 Preventive and corrective measures

ICP 11 Enforcement

ICP 12 Winding-up and exit from the market

ICP 13 Reinsurance and Other Forms of Risk Transfer

ICP 14 Valuation

ICP 15 Investment

ICP 16 Enterprise Risk Management for solvency purposes

ICP 17 Capital Adequacy

ICP 18 Intermediaries

ICP 19 Conduct of Business

ICP 20 Public Disclosure

ICP 21 Countering fraud in insurance

ICP 22 Anti-money laundering and combating the financing of terrorism (AML/CFT)

ICP 23 Group-wide supervision

ICP 24 Macroprudential supervision and market analysis

ICP 25 Supervisory cooperation and coordination

ICP 26 Cross-border cooperation and coordination on crisis management

Assessment methodology

“Solvency Standards”

Reinsurance

Supervision (excerpts)



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Regulatory Convergence – How?

IAIS Insurance Core Principles (ICP), Standards and Guidance *

ICP 17 Capital Adequacy** - the (Insurance Core) Principle

The supervisor **establishes capital adequacy requirements** for solvency purposes so that insurers can absorb significant unforeseen losses and **to provide for degrees of supervisory intervention.**

* ICP's and Standards are “mandatory”, Guidance is not

** Supported by 18 Standards and within each of these 18 Standards many Guidelines



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Regulatory Convergence – How?

ICP 17 – Standard (#4)

17.4 In the context of insurance legal entity capital adequacy assessment, the **regulatory capital requirements establish:**

- (i) a solvency control level above which the **supervisor does not intervene on capital adequacy grounds. This is referred to as the Prescribed Capital Requirement (PCR)**. The PCR is defined such that assets will exceed technical provisions and other liabilities with a specified level of safety over a defined time horizon.
- (ii) a solvency control level at which, if breached, the **supervisor would invoke its strongest actions, in the absence of appropriate corrective action by the insurance legal entity. This is referred to as the Minimum Capital Requirement (MCR)**. The MCR is subject to a minimum bound below which no insurer is regarded to be viable to operate effectively



Regulatory Convergence – How?

ICP 17 – Guideline (#2) to support Standard (#4)

17.4.2 In broad terms, the highest regulatory capital requirement, the **Prescribed Capital Requirement (PCR)**, will be set at the level at which the supervisor would not require action to increase the capital resources held or reduce the risks undertaken by the insurer. **However if the insurer's capital resources were to fall below the level at which the PCR is set, the supervisor would require some action by the insurer** to either restore capital resources to at least the PCR level or reduce the level of risk undertaken (and hence the required capital level).



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Global Regulatory Convergence Themes

Global Supervision

- ICP 23 (Group wide supervision)
- ICP 3 (refers to Supervisory Colleges)
- IAIS's "Com Frame" for Internationally Active Insurance Groups
- Solvency II (e.g. Equivalence)
- OSFI (revised Supervisory Framework)



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Global Regulatory Convergence Themes

Solvency Standards

- ICP 14 (Valuation) and ICP 17 (Capital Adequacy)
- Solvency II (Pillar 1)
- NAIC's Solvency Modernization Initiative
- OSFI – transition to “Life Insurer Solvency Assessment”



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Global Regulatory Convergence Themes

Own Risk and Solvency Assessment (ORSA)

- ICP 8 Risk Management and Internal Controls
- ICP 16 Enterprise Risk Management
 - Primary purpose of ORSA is to assess whether insurer's risk management and solvency position is currently adequate and is likely to remain so in the future
- Solvency II (Pillar 2)
- OSFI's Supervisory Framework



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Global Regulatory Convergence Themes

Economic Balance Sheet

- ICP 14 Valuation
 - Reflect total balance sheet approach on an economic basis
- Solvency II
 - Assets: exchanged between knowledgeable, willing parties
 - Liabilities: amount they can be transferred (“exit value”)
- OSFI’s transition from MCCSR to “Life Insurer Solvency Assessment” (Standard and Advanced Approaches)



Global Regulatory Convergence Themes

Eligible Capital

- Capital Targets
 - ICP 17, Capital Adequacy
 - OSFI's (Draft) Guideline A-4
- Basel III
 - OSFI Guidelines for Deposit Taking Institutions (DTIs)
 - Importation to insurers – discussions will start soon



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Global Regulatory Convergence Themes

Reinsurance

- ICP 13 Reinsurance and other forms of risk transfer
- NAIC “Reinsurance Modernization Act”
- OSFI
 - Response Paper, Guideline B-3, Guidance on RSAs



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Canadian Implications and Views

"Balanced Approach" adopting International "Standards"

1. Level of adoption

- Avoid adopting
 - only the more "onerous" international guidance
 - a more "onerous" version of other international guidance

2. Pace of adoption

- Overall neither
 - lead implementing the more "onerous" international guidance
 - follow implementing the more "onerous" international guidance



Canadian Implications and Views

Supervision

Group-wide supervision – Multiple IAIS sources

- Establish an effective and efficient framework – ICP 23.6
 - Reliance on foreign regulators to supervise foreign subsidiaries
 - Reliance on the group supervisor of foreign parent to properly supervise group



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Canadian Implications and Views

Solvency Standards

Capital adequacy and establishing regulatory capital - ICP 17.1 and 17.2

- Total balance sheet approach – ICP 17.1
- Meet obligations under adversity – ICP 17.2
 - Confidence levels; Diversification credits

Solvency control levels/triggers of intervention - ICP 17.3 and 17.4

- Solvency Control Levels – ICP 17.3
 - Various considerations
- PCR; MCR – ICP 17.4
 - Below MCR/PCR, supervisor invokes strongest action/requires action



Canadian Implications and Views

Reinsurance

“Strategies” and Transparency – ICP 13.1, 13.2

- Supervisor requires cedant to have “strategies” appropriate to nature, scale and complexity (plus systems and procedures) – ICP 13.1
 - OSFI’s Guideline B-3: Risk management “policy” (Key Principle #1)
 - OSFI’s Guidance on Reinsurance Security Agreements
- Supervisor requires that cedants are transparent – ICP 13.2
 - OSFI’s “Response Paper”: Adopted “View 2” (comprehensive regulation) instead of View 1 (little, if any regulation)
 - OSFI’s Guideline B-3: Due diligence of reinsurers (Key Principle #2)



Canadian Implications and Views

Reinsurance (continued)

Supervisory Recognition and Binding Documentation – ICP 13.3, 13.4

- Supervisor takes into account nature of supervision of reinsurers (unilateral, bilateral, multilateral) – ICP 13.3
 - OSFI’s “Response Paper”: Premature to consider “mutual recognition”
- Supervisor requires prompt documentation of principal economic and coverage terms and conditions in a timely fashion – ICP 13.4
 - OSFI’s Guideline B-3: binding summary agreements, reinsurance contracts, clarity and certainty of terms (Key Principles #3 and #4)





Office of the Superintendent of
Financial Institutions Canada

Bureau du surintendant des
institutions financières Canada

Regulatory Convergence: Some International Themes

Canadian Reinsurance Conference Session 6

Michael Bean
Director, Capital Division

April 7, 2011



OSFI
BSIF

Canada 

Focus of this Presentation

- **Consider three themes in insurance regulation and their implications for Canadian companies:**
 - Greater expectation for companies to assess and manage their own risks
 - Use of internal models for risk measurement, risk management and the determination of regulatory requirements
 - Movement toward the use of more market-based methods of valuation and capital determination



Company-Specific Risk Measurement

- **Greater expectation for companies to:**
 - assess the risks they actually have on their balance sheets
 - hold appropriate amounts of capital for those risks
 - actively manage those risks
- **versus:**
 - relying solely on regulatory capital as a measure of risk
 - using regulatory capital to manage their businesses



Company Specific Risk Measurement

- **Catalysts:**
 - More sophisticated products (e.g., variable annuities with complex guarantees)
 - More sophisticated risk management techniques (e.g., dynamic hedging)
- **Rationale:**
 - Companies better placed than regulators to understand all the risks in their business
 - “One size fits all” risk measurement not sufficiently granular to capture all the risks in sophisticated products



Company Specific Risk Measurement

- **Canadian context:**
 - OSFI has always encouraged companies to conduct their own analyses and develop appropriate risk and capital management plans
 - Recent developments:
 - Guideline A4 – Capital Targets
 - Guideline B3 – Sound Reinsurance Practices & Procedures
 - Future developments:
 - Own Risk and Solvency Assessment (ORSA)



Use of Internal Models

- **Context:**
 - Company-specific risk measurement requires the use of company-specific models
 - Internal models have the potential to better capture the risks in sophisticated products than standardized models
- **Applications:**
 - Regulatory capital
 - Economic capital



Use of Internal Models

- **Economic capital models:**
 - Intended to allocate a company's capital commensurate with risk to enhance shareholder value, subject to the constraints posed by regulators and rating agencies
- **Regulatory capital models:**
 - Intended to protect policyholders / depositors, but not necessarily shareholders
 - Capital needed to continue to write new business not considered



Use of Internal Models

- **Canadian context:**
 - Internal models used to calculate regulatory capital requirements for segregated fund guarantees since 2002 (subject to OSFI approval)
 - Recent developments:
 - Comprehensive review of capital requirements for segregated fund guarantees
 - Future developments:
 - Project to expand the use of internal models for regulatory capital (both life and P&C)



Market-Based Methods of Valuation & Capital Determination

- **Move toward the use of more market based methods for market risks**

versus

- **Use of methods based primarily on historical experience**



Market-Based Methods of Valuation & Capital Determination

- **“Market-based methods” can mean:**
 - methods based on arbitrage-free principles
 - “risk neutral” calculation techniques
 - methods based on replication
 - methods based on financial economics
 - methods in which parameters are market observed values



Market-Based Methods of Valuation & Capital Determination

- **Rationale:**
 - Market risk has non-diversifiable components
 - Law of large numbers doesn't hold
 - Traditional actuarial techniques insufficient
 - Market risk has become a more material component of the risk on insurance company balance sheets
 - Products with embedded guarantees (e.g., variable annuities)



Market-Based Methods of Valuation & Capital Determination

- **Rationale:**
 - Market-based methods enable companies to better capture the economics of the risk in products such as variable annuities
 - Companies are using more market-based techniques to manage market risk
 - Accounting (IFRS)



Market-Based Methods of Valuation & Capital Determination

- **Canadian context:**
 - Development of market consistent approach to determining regulatory capital requirements for segregated fund guarantees (2011-2013+)
 - Increased use of financial instruments and/or dynamic strategies to manage risk in segregated fund guarantee products
 - Financial instruments have a market value
 - Desirability of having consistency between asset and liability valuations
 - Potential for the use of more market-based approaches to market risk in other products



Questions?



OSFI
BSIF

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Lessons Learned

QIS 5

- Background, Results, Impact

PwC Solvency II Survey

- Preparedness, Critical Success Factors

Impact of Solvency II

Lessons for Canada

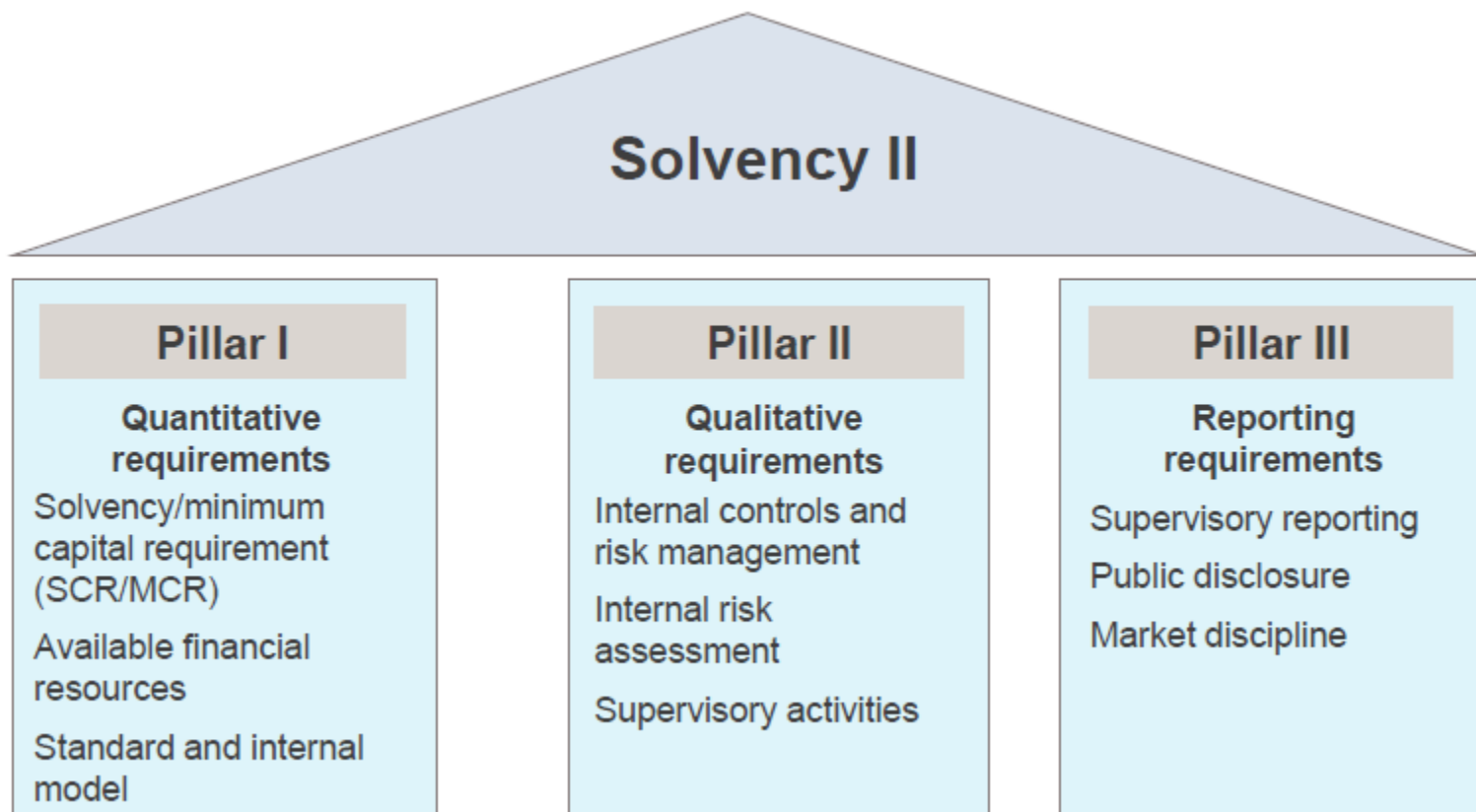


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Pillars



QIS 5 - Background

- Fifth (and last) quantitative impact study for European insurers
- “Dry-run” for Solvency II (SII)
- Measure solvency standards using standard formula for SCR
- EIOPA (formerly CEIOPS) requested information on model results
- Over 2500 insurers – 70% participated (QIS 4 ~ 30%)



QIS 5 - Results

- Mixed
- German Insurers blast SII as complex (especially for smaller insurers)
- Denmark– Six failed SCR, push for simplification
- Italy/Austria – Most better off than prior regime
- 15% fail SCR across Europe (20% within U.K.)
- Overall results show industry is healthy
- Highlight some weaknesses (both in measures and preparedness)



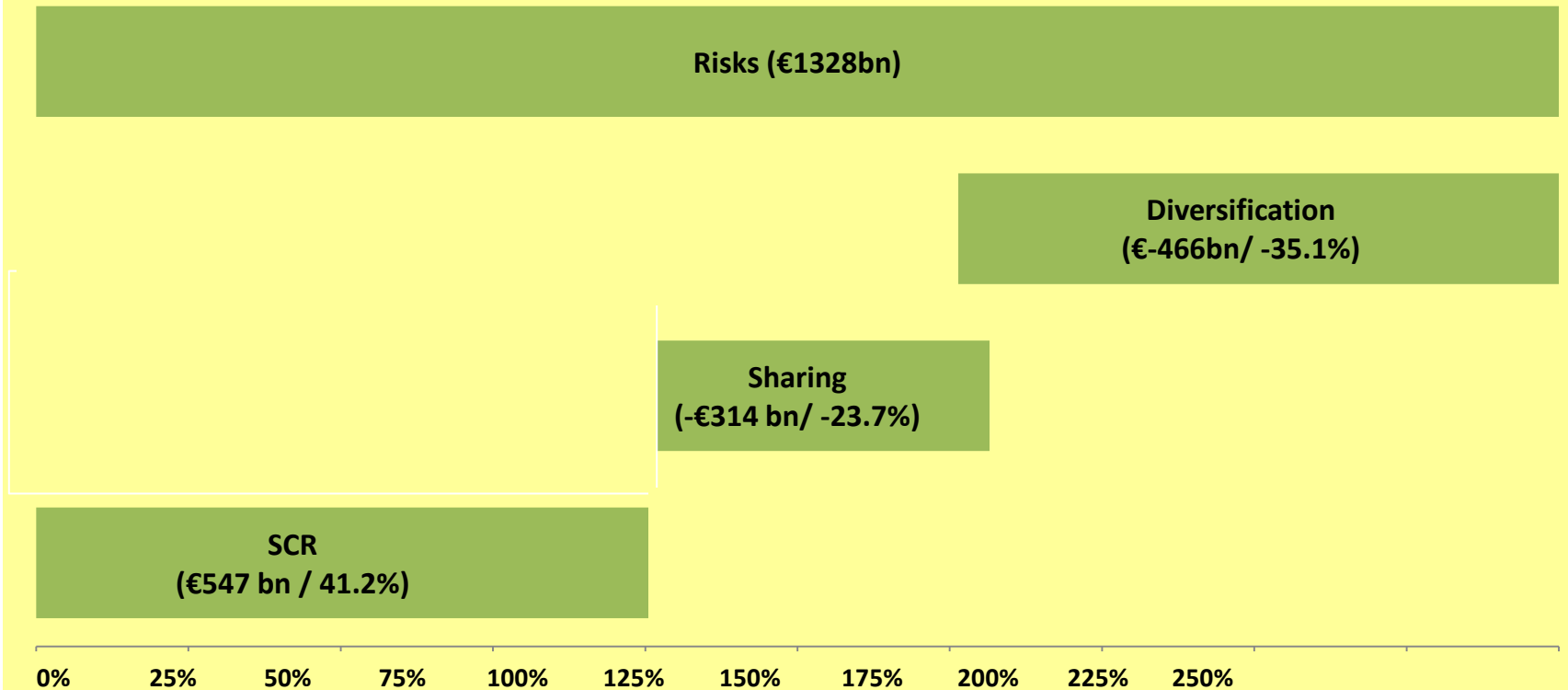
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QIS 5 Results

Impact of Diversification and Loss-absorbing Capacity



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QIS 5 – Next Steps

- Found areas of weakness (QIS 6?)
- SII framework in place in 2011
- Models – not a panacea
- 1-2 year transition period



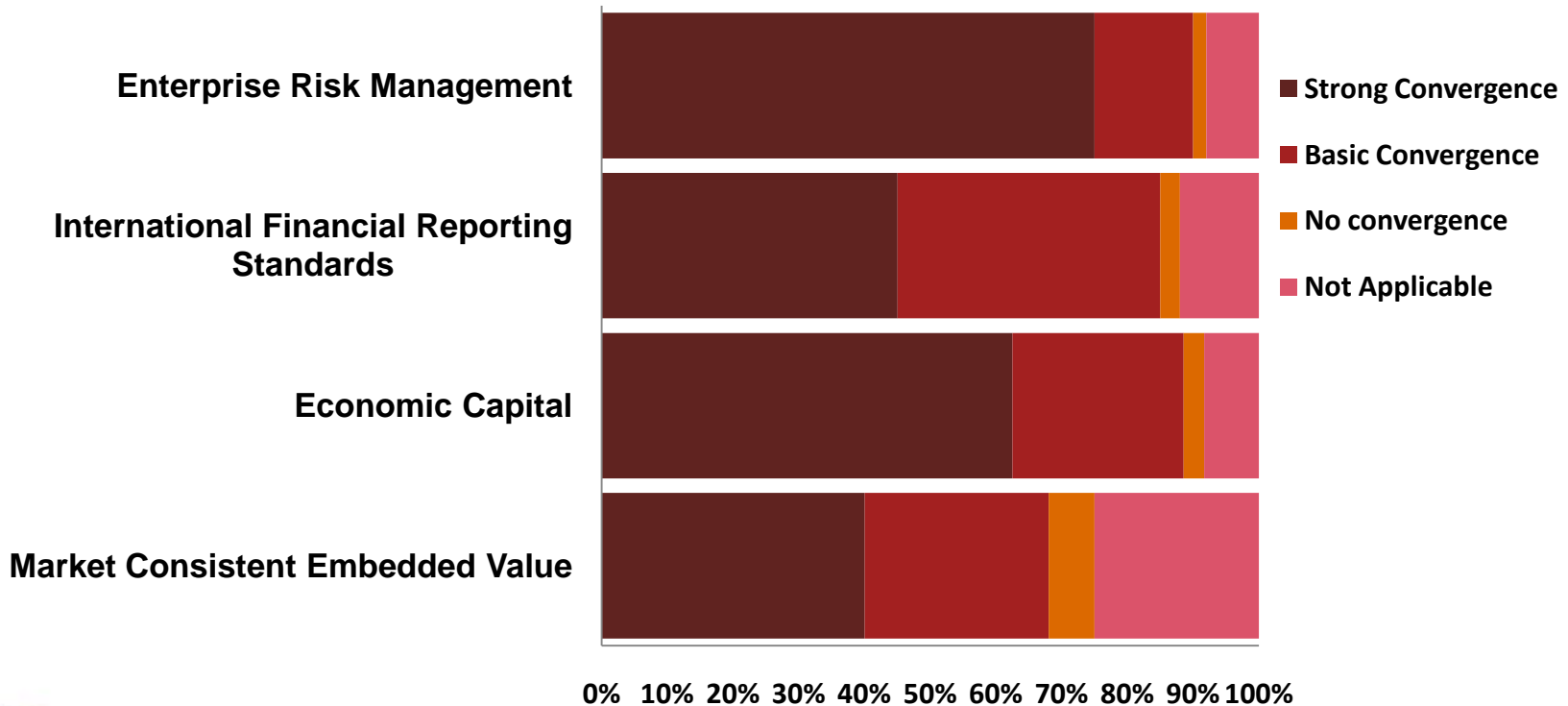
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PwC Survey

What level of convergence do you hope to achieve with other significant initiatives?



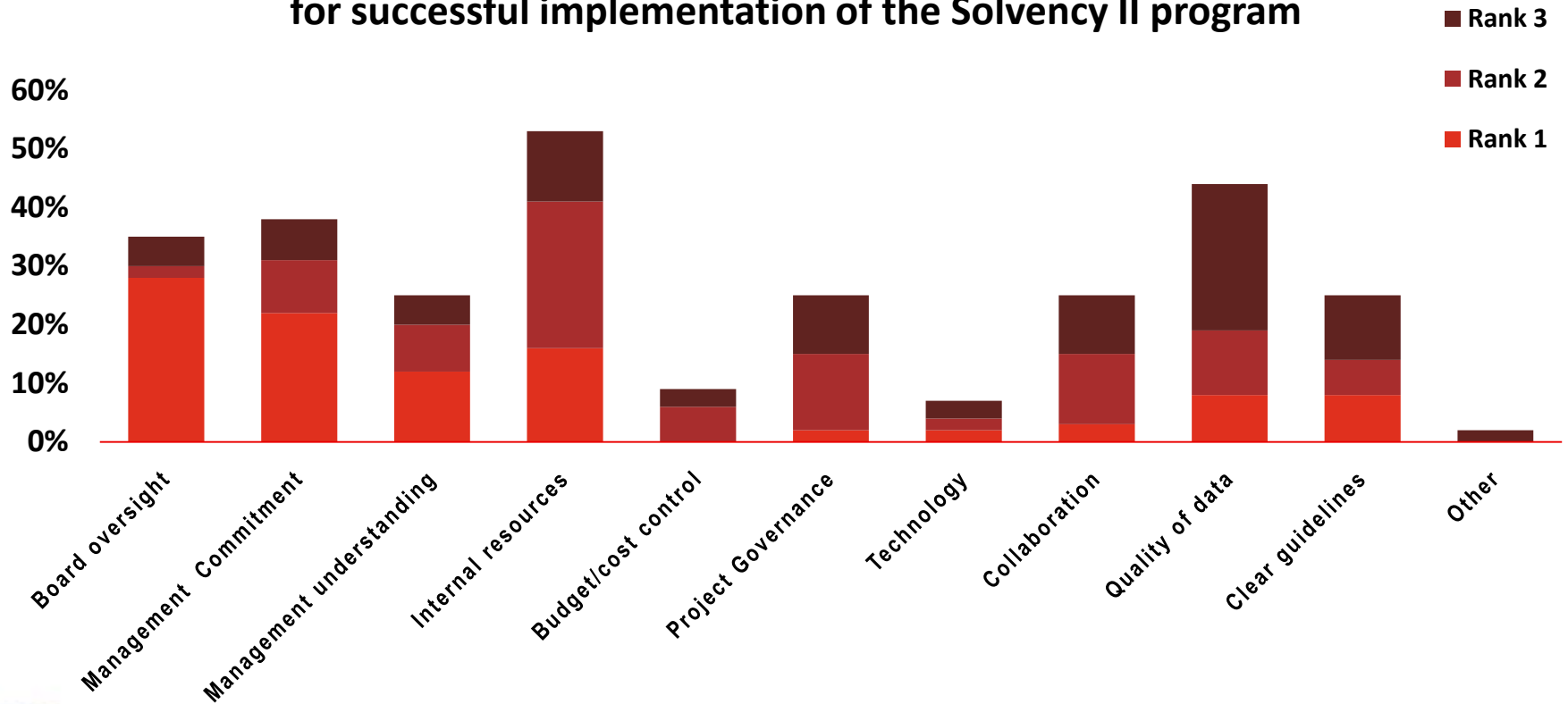
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PwC Survey

Rank the top three factors you believe are the critical success factors for successful implementation of the Solvency II program



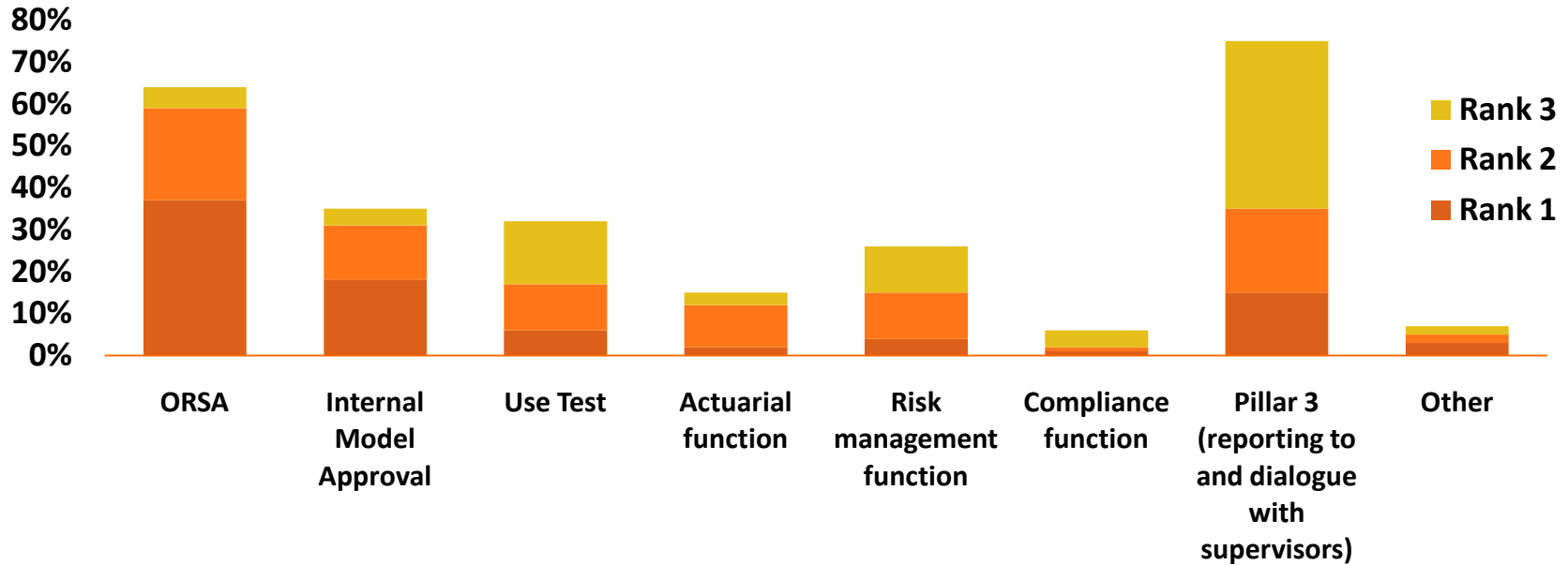
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PwC Survey

Rank the top three elements which present significant challenges to the implementation of the Solvency II program



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SII – Impact/Comments

- Solvency II will create an “illusion” that crisis will be avoided
- Small/med. size insurers overwhelmed by Pillar II requirements
- Complexity of standard model
- Impact on those who have limited access to capital and those who operate with a minimal capital base (captives)



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SII – Impact/Comments

- Monoline Insurers (no diversification)
- Cost of SII carried by policyholders
- Innovative tailored reinsurance solutions and corporate structures
- Benefits:
 - Common platform
 - State of the art ERM
 - Documentation/transparency



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Lessons for Canada

➤ For Regulators:

- Too much and too fast can cause significant market disruption issues

➤ For Insurance Companies:

- Convergence will happen in time
- Convergence has benefits but regulatory overhead will not decrease any time soon
- European issues illustrate our potential future challenges



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