Reference: Guideline for Federally Regulated Life Insurance Companies and Fraternal Benefit Societies

October 10, 2018

To: Federally Regulated Life Insurance Companies & Fraternal Benefit Societies

Subject: 2019 *Life Insurance Capital Adequacy Test* (LICAT)

After completing a public consultation process, OSFI is issuing the final version of the 2019 LICAT guideline. In addition to minor edits and clarifications, key changes made to the guideline include:

- apply the same capital treatment to all leases that will be reported on the balance sheet as a result of IFRS 16 – *Leases*;
- create consistency with the upcoming revised Guideline B-5: *Asset Securitization*;
- add three credit rating agencies to the list of recognized agencies;
- specify that mortality risk components apply to group life insurance products; and
- introduce additional conditions for funds withheld reinsurance arrangements.

Appendix 1 summarizes consultation comments received, organized by theme, along with OSFI responses. We thank those who provided comments.

Should you have any questions, please contact Lisa Peterson, Acting Managing Director, Life Insurance Capital at lisa.peterson@osfi-bsif.gc.ca or at (613) 990-7282.

Sincerely,

Carolyn Rogers
Assistant Superintendent
Regulation Sector

Attachment

Appendix 1 – Summary of 2019 LICAT Public Consultation Comments and OSFI Responses

Issue	Stakeholder Comment	OSFI Response
Adjustments applicable to negative reserve deduction	Consider adjusting the negative reserve deduction to reflect that operational risk would generally decrease when a policy lapses.	OSFI agrees that there may be a reduced amount of operational risk when policies lapse and has, therefore, adjusted the reduction to the negative reserve for a policy in the 2019 LICAT guideline.
IFRS 16 - *Leases*	a) As there are differences in the risks of owning versus leasing a property, the same capital charge should not apply to both cases.	a) OSFI does not believe that there is sufficient justification to warrant a different risk factor for owned property versus leased property. The current LICAT framework reflects this by having the same capital treatment for owned properties and (finance) leases.
	b) Since IFRS 16 does not introduce new risks, there should be no impact on capital requirements. For example, the change in accounting treatment does not imply that a right of use asset has market risk.	b) Prior to IFRS 16, lease exposures were underrepresented (on the balance sheet) and, in OSFI's opinion, so were the capital requirements. OSFI supports the IFRS 16 approach whereby, from a lessee's perspective, no distinction is made between assets that are leased ("operating leases") and assets that are financed to be owned ("finance leases"). The 2019 LICAT reflects this approach by applying the same capital treatment to all leases captured under IFRS 16. Accounting standards appropriately adjust for differences in risk exposure for leases whereby only a portion of a property's economic life is reflected on the balance sheet (excluding the property's residual value). Capital requirements pick up the carrying amount of property (i.e., the risk exposure), whether leased or owned. They also capture market risk associated with leases (e.g., early cancellation penalties, fluctuating market lease rates, costs associated with renegotiating or finding a new lease, as well as uncertainty in the realizable value of right of use assets in times of stress).

Guaranteed coverage period	The definition of guaranteed coverage period is confusing and adjustments are needed to align the wording with the term of the liability used for CALM valuation purposes.	OSFI aligned the guideline wording with its policy intent, which is to apply level and trend shocks over the period during which insurers are assuming risks. In cases when this period extends beyond the term of the liabilities projected in the CALM valuation, OSFI clarified a footnote to reflect its expectation that the insurer should hold capital to cover the risk exposure.
Treatment for bonds that are both puttable and callable, as well as for preferred shares	a) OSFI's prescribed treatment for callable/puttable bonds and preferred shares assumes not only perfect rationality on the part of the issuer and the holder, but also perfect knowledge of future interest rates. This seems to be an "uneconomical" exercise, due to imperfect knowledge of future interest rates. In the end, the most significant indicator of an early exercise will be the exercise price. With this is mind, an alternative simplification is to project the cash flows dependent on the exercise price and the interest rate scenario. b) OSFI's proposed treatment is complicated and requires onerous calculations that may not have a material impact on the results.	a) The LICAT methodology assumes that interest rate volatility is zero in the prescribed scenarios so that future rates will be equal to those implied by today's forward rates. This assumption is correct for derivatives that do not contain options (e.g., swaps), and becomes correct for options in the limiting case as interest rate volatility approaches zero. The option exercise price is not the only determinant of whether an option will be exercised. For example, while a call at 200% of par will never be exercised, a call at 100% of par might or might not be exercised, depending on the interest rate scenario. Hence the need to test the value of exercising each option under each scenario. The fact that interest rates are volatile and future rates are not known with certainty does not imply that a call option will be exercised at the first opportunity. All other things being equal, a bond with two embedded call options will always be worth less than a bond that has only one of the embedded options; therefore, it is appropriate for the interest rate risk methodology to take both options into account. b) The prescribed treatment for bonds and preferred shares with both embedded put and call options is simpler than other methods that an insurer might use to measure the interest rate sensitivity of such instruments, and is suitable for a standardized approach.

		Also, as per section 1.4.5 of the LICAT guideline, immaterial approximations may be used in the determination of the LICAT ratio.
Methodology to determine net open currency positions	Section 5.6.1 includes a list of structural positions and related hedges that are excluded from the calculation of net open currency positions. Exclusion #2 does not allow insurers to include positions that are hedges of net investments in foreign operations in the net open position.	OSFI deleted this exclusion from the 2019 LICAT guideline.
Credit for funds held under a funds withheld reinsurance arrangement	The proposed wording should be modified to acknowledge the “natural” movement of funds withheld (i.e., payments contractually in proportion to the movement of underlying liabilities reinsured should be excluded from the condition).	The wording reflects the intent, which is to ensure that if an insurer is taking credit for funds withheld, it should never make a payment when the funds withheld balance is equal to or less than the liabilities reinsured. If the funds withheld balance is higher than liabilities reinsured and the insurer is not applying the excess to other components, then the LICAT wording allows for the excess to be paid to the reinsurer.