Letter

Title	Final Life Insurance Capital Adequacy Test (LICAT) 2023 – Letter (2022)
Category	Capital Adequacy Requirements
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Sector	Life Insurance and Fraternal Companies

To: Federally Regulated Life Insurance Companies & Fraternal Benefit Societies

Today, OSFI is publishing the final Life Insurance Capital Adequacy Test (LICAT) 2023 guideline, reporting forms and instructions that will come into force on January 1, 2023. This final version of the LICAT 2023 guideline is the result of extensive engagement with stakeholders to define regulatory capital requirements under the new International Financial Reporting Standard 17 – *Insurance Contracts* (IFRS 17). This marks the final milestone announced in the September 30, 2020, Letter to Federally Regulated Insurers.

While a great deal of effort has gone towards a robust implementation, IFRS 17 is a new standard, and we expect insurers to act conservatively when making decisions that would result in changes to their levels of capital.

Key revisions to the LICAT 2023 guideline include:

- Adapting the LICAT for *IFRS 17 - Insurance Contracts*, including the use of concepts and measurements of insurance liabilities and also,
  - Recalibrating certain elements of the test to minimize industry-wide capital impacts, including reducing the Base Solvency Buffer scalar from 1.05 to 1.0; and
  - Introducing a two-year optional volatility measure to dampen the volatility introduced by the market consistent valuation on Cost of Guarantees under IFRS 17.
- Incorporating the OSFI Advisory Supplementary Guidance for the Treatment of Participating Insurance issued in November 2020; and
- Specifying credit risk requirements in a manner consistent with *IFRS 9 - Financial Instruments* terminology.

For life insurers with segregated fund guarantee (SFG) business, OSFI is developing a new approach to determine capital requirements for SFG risk to replace the current method. In June 2021, OSFI announced that it was deferring the implementation date of the new approach to January 1, 2025 (from January 1, 2023). In the interim period, the current method for the capital treatment of SFG risk has been retained, updated to accommodate IFRS 17. A public consultation of the revised methodology is planned for February 2023.

Appendix 1 provides a summary of consultation comments received during the June 2021 public consultation, along with OSFI responses. LICAT reporting forms and instructions have been updated to reflect changes to the LICAT guideline.

In addition, the Own Risk and Solvency Assessment (ORSA) Key Metrics Report form and instructions, as well as Guideline A-4 Regulatory Capital and Internal Capital Targets and OSFI's Advisory Revised Guidance for Companies that Determine Segregated Fund Guarantee Capital Requirements Using an Approved Model received minor consequential updates as a result of the changes made to the LICAT 2023 guideline.

OSFI would like to acknowledge the extensive engagement with the insurance industry throughout this multi-year project to update the LICAT framework for IFRS 17. We believe that we have achieved our commitment of capital neutrality while maintaining the integrity of the test.

Should you have any questions, please contact Michelle John, Director, Life Insurance Capital, Capital Division by email at michelle.john@osfi-bsif.gc.ca.

Sincerely,

Amar Munipalle

Executive Director, Risk Advisory Hub

Appendix 1 – Summary of Public Consultation Comments and OSFI Responses

General comments

Capital Neutrality

Comment

To counteract the capital impact from changes related to the removal of C-3 provisions from Surplus Allowance, negative reserves and reinsurance in the LICAT guideline, OSFI should consider the following:

a. Reduce the Base Solvency Buffer (BSB) scalar to below 1.0 since a large part of financial risks are now provisioned for in the present value of Fulfilment Cash Flows.
b. Reduce the Minimum and Supervisory Targets for the Core Ratio.
c. Increase the credit given for Surplus Allowance in the Core Ratio, from 70% to 80%.
d. Include a portion of the liability for options and guarantees of the Participating Insurance product within the Surplus Allowance.
e. The calibration of the solvency buffer could be lowered to recognize prudence in the market consistent valuation. This could be in the form of revising both the gross (non-participating and participating) interest rate risk (IRR) buffer and the 10% par interest rate risk floor.

For a change as significant as IFRS 17, a transition period is appropriate.

OSFI Response

OSFI communicated its intention to minimize industry-wide capital impacts on implementation of IFRS 17 while maintaining the integrity of the test. To that end, the following levers have been adopted to mitigate the impact of IFRS 17:

1. Reduce BSB scalar from 1.05 to 1.00.
2. Made adjustments to the IRR calculation for the par credit and the requirements for non-participating, non-segregated fund products as follows:

   a. Exclude the incremental market consistent value of Cost of Guarantees in the IRR buffer calculation for non-participating products (non-segregated fund);
   b. Reduce the factor applied in the IRR buffer for the participating credit floor calculation from 10% to 5%.
3. Increase the limit to 130% of the sum of items 1 through 6 in section 2.1.2.9 of the LICAT guideline.

OSFI gave consideration to other adjustments but did not believe they were necessary to achieve our goal.

LICAT 2023 will not include a transition adjustment. Based on our analysis, it is not needed. LICAT 2023 is expected to result in a capital neutral outcome at the industry level, and while there will be some variance in results across federally regulated insurers, this variance is generally not material and will be managed according to our principles-based supervisory approach.

Capital Volatility

Comment

IFRS 17 may increase the volatility of the LICAT ratios, relative to IFRS 4. This is in addition to LICAT volatility related to prescribed rates used to calculate required capital versus market rates used on Available Capital.

In addition, the market consistent cost of guarantee under IFRS 17 for products such as Par and Universal Life can change materially from quarter to quarter with market movements, leading to increased volatility of the LICAT ratios.

OSFI Response

OSFI reviewed the LICAT sensitivity under different economic scenarios to understand the change in capital volatility from IFRS 4 to IFRS 17. At industry level, OSFI did not observe material increases in volatility.

One exception is volatility introduced through the market consistent cost of guarantee (CoG) under IFRS 17. Generally and where possible, OSFI expects insurers to take measures to address volatility introduced with IFRS 17. However, in the short-term, modelling of CoGs may not be fully developed for some insurers. Because of this, OSFI introduced a temporary volatility mitigation measure to the test, which will be in place for two years. Insurers will have a one-time option to decide whether to implement this measure.

References to Liabilities

Comment

OSFI should clarify that references to liabilities apply to net obligations regardless of whether they represent a net asset or net liability, and whether the direct and reinsurance components are presented in the balance sheet as assets or liabilities.

OSFI Response

OSFI believes that it is clear from the context whether any particular liability referred to in the guideline can be negative. In the case of reinsurance, the guideline distinguishes clearly between reinsurance contract held assets, reinsurance contract assumed assets, reinsurance contract held liabilities, and reinsurance contract assumed liabilities. When necessary, the guideline specifies whether a liability or requirement is to be calculated gross, net of registered reinsurance only, or net of all reinsurance.

Clarifications and Corrections

Comment

A number of clarifications and corrections were suggested to the guideline and forms.

OSFI Response

OSFI made clarifications and corrections throughout the LICAT guideline and forms to assist with calculations and to promote a consistent interpretation of the methodology.

Comments on specific sections of the LICAT guideline

Adjustment to Surplus Allowance – Risk of Non-Performance by Reinsurer

Comment

The surplus allowance should include the effect of the risk of non-performance by the reinsurer for reinsurance contracts held (which in effect is reflected in the estimates of future cash flows), since this new charge in the financial statements serves the same purpose as the 2.5% charge for reinsurance contracts held that is included in the Base Solvency Buffer.

OSFI Response

The 2.5% charge for registered reinsurance contracts held, along with all of the other risk charges in section 3.1, reflects the risk of unexpected credit losses. It does not cover the risk of expected credit losses, which are covered by balance sheet credit risk provisions. Both the balance sheet provision and the 2.5% capital charge provide for potential credit risk losses arising from reinsurance.

Surplus Allowance – Net of All Reinsurance

Comment

The LICAT 2023 guideline requires that the risk adjustment that is included in the Surplus Allowance (SA) should be calculated net of all reinsurance. This is different than the LICAT 2019 guideline for which the provisions for adverse deviation (PfADs) in the SA are net of registered reinsurance only. As a result, the SA will reduce for all unregistered reinsurance arrangements.

For unregistered modified coinsurance arrangements (modco), it seems counterintuitive to not get credit for the risk adjustment in the LICAT ratio numerator even though all the assets and liabilities are retained on the ceding company's balance sheet.

OSFI Response

This was already corrected for in the version of the guideline that was issued for public consultation in June 2021 through the new credit given in section 10.2.3/10.3.1. For modco, the credit will be the ceded best estimate liability plus risk adjustment.

Since the requirement in section 10.2.1 is only the ceded best estimate liability, this will leave risk adjustment as a credit that can be recognized as an Eligible Deposit, leaving overall requirements unchanged.

Non-attributable Expense (NAE)

Comment

Under IFRS 17, expenses that are not directly attributable to the fulfilment of insurance obligations are no longer provisioned for. NAE are recognized in profit or loss each period as incurred, and CSM and Available Capital are implicitly increased. NAE should be deducted from the CSM amount included in Available Capital.

OSFI Response

No change was made to the LICAT 2023 guideline regarding CSM.

Deferred Taxable Asset (DTA) recognition as Tier 1 Available Capital and credit risk charge for DTA included in capital

Comment

LICAT temporary DTAs are expected to increase with higher IFRS 17 liabilities. Therefore, capacity of the 10% Net Tier 1 limit may reduce, resulting in further deductions to the Available Capital. OSFI should consider increasing the limit.

Also, it would also be helpful if OSFI can provide a rationale for maintaining a 25% credit risk capital charge applied to DTA admitted in capital and consider reducing this risk charge to be more aligned with an average long government bond.

OSFI Response

OSFI's current DTA limit of 10% reflects the uncertain realizability of DTAs in times of stress. Although having a value greater than zero does reflect that DTAs may provide some economic benefits in certain scenarios, at the same time it supports the quality of capital resources.

The 25% risk charge applied to DTAs is comparable to that of other assets of similar quality/riskiness. DTAs differ from government bonds as they are not an obligation of the taxing government as of the reporting date. Instead, they are a potential future obligation of the government that may become payable if the insurer reports future taxable income.

Deduction of Negative Reserves in Tier 1 Capital

Comment

The LICAT tier 1 capital requirement is incongruous with the LICAT total capital requirement, and the source of this incongruity is the deduction for negative reserves.

LICAT gross tier 1 capital requirement assigns a disproportionate weight to lapse risk, which implicitly means a higher risk aversion for this risk. The arrival of IFRS 17 is a good opportunity to review the concept of this deduction for negative reserves.

OSFI Response

Negative reserves are deducted from tier 1 due to the fact that, like goodwill, intangibles, and other assets deducted from tier 1, negative reserves are not real property and are not a financial obligation of any entity or person, making their value highly uncertain in stress.

To respect OSFI's commitment that, to the extent possible, in updating the LICAT for IFRS 17, OSFI intends on maintaining current capital policies, OSFI is not revisiting the general concept behind the negative reserve deduction for the 2023 guideline.

Use of Best Estimate Cash Flows in Negative Reserves Calculation

Comment

Under LICAT 2019, PfADs are included in the calculation of the negative reserve deductions, whereas for LICAT 2023 they are not.

Negative reserves should continue to be calculated using padded/risk-adjusted cash flows in LICAT 2023. Alternatively, OSFI should introduce other adjustments so that the deduction is neutral to what it is under LICAT 2019.

OSFI Response

In LICAT 2023, the negative reserve deductions are done on a best estimate basis instead of calculating using padded/risk-adjusted cash flows. This change was necessitated by the fact that post-IFRS 17, OSFI cannot be assured that every insurer will calculate risk adjustment by policy (for example, some risk adjustment methodologies will incorporate diversification). If the risk adjustment does include diversification, then allocating the risk adjustment for a group to individual policies within the group will underestimate the amount of negative reserves deducted.

In order to mitigate the impact of the change, OSFI increased the limit to 130% of the sum of items 1 through 6 in section 2.1.2.9 of the LICAT Guideline.

Limit on Amounts Recoverable on Surrender (Section 2.1.2.9)

Comment

Changes in section 10.2.5 tax credit for unregistered reinsurance would affect this limit causing a double impact to come through.

It is unclear why such a limit is needed and what situations the limit is meant to address. It is recommended that OSFI considers the removal of such limit.

OSFI Response

The tax credit in section 10.2.5 is substantially the same as the credit that exist in LICAT today, which is the amount of taxes applicable on offsetting reserves ceded. OSFI has reviewed the limit in section 2.1.2.9 on amounts recoverable on surrender, and has increased it as part of a series of measures to maintain industry-wide neutrality upon implementation of IFRS 17 (please refer to comment #1 above).

IRR Scenario Rates

Comment

OSFI should consider aligning the LICAT IRR discount rates with those in IFRS 17, also considering the guidance from the Committee on Life Insurance Financial Reporting. Changes could include:

- a longer observable period; and
- a lower ultimate risk-free rate.

Also, the timing and magnitude of LICAT IRR stress scenarios should also be reviewed to ensure appropriate incentives for managing assets backing insurance liabilities and capital.

OSFI Response

OSFI will consider these comments for a future version of the LICAT framework, and at such time, will perform a holistic policy review the IRR buffer.

Mortality Volatility Calculation

Comment

In Section 6.2.4, “Net Amount At Risk/Face Amount” was replaced by “1 – Best Estimate Liability/Face Amount” in the mortality volatility calculation. Instead, “1 – Fulfilment Cash Flows/Face Amount” (which incorporates risk adjustment) should be used as it is more consistent with the LICAT 2019 guideline requirements.

OSFI Response

This change in Section 6.2.4 was made to ensure internal consistency between the calculation of the marginal insurance risk requirements in subsection 2.1.2.9.2, which requires the calculation of the mortality volatility risk component at the policy level.

Discount Rate used for Lapse Risk BSB Calculations

Comment

It is observed that the lapse risk component of the BSB for interest sensitive products (e.g. universal life) can increase significantly. This is because the cashflows used to determine the capital are now based on universal life credited rates that are much lower than current rates (e.g. based on IFRS 17 rates instead of, for example, equity returns), but still discounted at 5.3% in the LICAT calculation. To compensate for this impact, OSFI should consider adjusting the requirements for insurance risk by allowing insurers a choice between crediting at equity returns instead of IFRS 17 discount rates, for the purpose of this calculation.

OSFI Response

In the LICAT, cash flows used to determine required capital for insurance risk are calculated using Best Estimate Assumptions. Under IFRS 4, Best Estimate Assumptions are those used in the IFRS 4 valuation (i.e. in the CALM base scenario). When moving to IFRS 17, Best Estimate Assumptions used will be those used in the IFRS 17 valuation. Allowing different fund projection rates to be used in LICAT would be misaligned with our policy methodology to use valuation Best Estimate assumptions as the base scenario for insurance risk required capital calculation. The prescribed discount rate (i.e. 5.3%) was introduced to the LICAT framework to minimize volatility of the Insurance Risk Buffer.

Credits for Special Policyholder Arrangements for Group Life & Health Business

Comment

The Marginal Insurance Risk Requirements (MIRR) formula in section 2.1.2.9 has been revised in the draft LICAT 2023 guideline. This change results in higher credits for special policyholder arrangements as provided in sections 6.8.2 and 6.8.3 for Group Life & Health business. OSFI should confirm their expectations on whether the credits for special policyholder arrangements should increase as a result of the MIRR revision.

OSFI Response

Credits for special policyholder arrangements may increase under sections 6.8.2 and 6.8.3 based on the higher marginal insurance risk requirements in section 2.1.2.9.

Segregated Fund Standardized Approach

Comment

Section 7.3.1 states that the total gross calculated requirement (TGCR) cannot be negative. The IFRS 17 total net actuarial liability (including CSM and RA) could be negative (i.e. the addition of the CSM may not bring the liability back to zero). If the net actuarial liabilities held are negative, then the net required capital could be higher than the TGCR. As such, either the TGCR should be allowed to go negative, or the net actuarial liabilities held should be floored at zero.

OSFI Response

OSFI revised the TGCR floor in OSFI's Advisory: *Revised Guidance for SFG Capital Requirements Approved Model* December 2010 (Revised Apr 2022). The floor will be reduced to the negative of deferred acquisition costs. As is the case in the LICAT 2019 framework, required capital continues to be floored at zero.

Simplification of Chapter 10 - Reinsurance

Comment

Understanding the principles and goals underpinning Chapter 10 would be helpful for all stakeholders. There are concerns that Chapter 10 (reinsurance) is very complicated to understand and to explain to senior management or Board level audiences.

It would be clearer if Chapter 10 were written as a standalone chapter, with limited cross-referencing (e.g. to section 2.1.2.9) and, therefore, with less risk of misinterpretation. For ease of readability, calculations from previous sections can be stated again in Chapter 10.

OSFI Response

OSFI's general goal is to maintain parity between retained and ceded business. Taking into account comments received from industry and other stakeholders, OSFI has reworked Chapter 10 to simplify the methodology, while ensuring this goal continues to be achieved.

OSFI has not reproduced the formulas for amounts recoverable on surrender in section 2.1.2.9 in order to keep the guideline, and Chapter 10, to a reasonable length.

Tax Credit for Unregistered Reinsurance

Comment

The 10.2.5 tax credit for unregistered reinsurance should be based on all negative reserves ceded to an unregistered reinsurer, instead of just the offsetting liabilities (i.e. carveout of ceded positive reserves). This ensures consistent and fair capital treatment between retaining the business or ceding the business to an unregistered reinsurer.

OSFI Response

Parity is maintained due to the fact that the ceding company will report a taxable loss, and therefore receive a tax refund, when it cedes business having an aggregate negative reserve. The reason for setting the tax credit based on the offsetting liabilities is that, if all negative reserve policies lapse after the business is ceded, the only additional taxable loss will be that arising from offsetting liabilities ceded.

Negative Reserve Adjustment for Non-Canadian Business Ceded to Unregistered Reinsurer

Comment

For non-Canadian policies, section 2.1.2.9 allows for a 10% decrease in the negative reserve deduction for retained business, whereas section 10.2 does not allow for a similar adjustment if the policy is ceded to an unregistered reinsurer. OSFI should amend section 10.2 to introduce the same credit. This will align with the principle that the capital position for business retained should be similar before and after an unregistered reinsurance transaction.

OSFI Response

OSFI does not believe further adjustments are required to section 10.2. For retained business, in addition to the 10% decrease in the negative reserve deduction, there is a 30% deduction of risk adjustment from the LICAT core ratio that is not applicable to business ceded to an unregistered reinsurer. Considering these two adjustments, the LICAT guideline does not favour retained business over ceded business.

Between-risk Diversification

Comment

In 2019 LICAT guideline, only 50% of level and trend insurance risks are considered in the between-risk diversification. One possible justification for this would be that 50% level and trend would roughly represent the "PfAD requirement" embedded in the Base Solvency Buffer (also known as the "terminal provision") and that no diversification is generally assumed in the determination of PfADs under the Canadian Asset Liability Method (CALM).

To recognize the fact that IFRS 17 requires risk adjustments to be diversified, OSFI should consider higher level and trend insurance risks in the between-risk diversification in the LICAT 2023 guideline.

OSFI Response

The carve-out of 50% of level and trend insurance risks in the between-risk diversification calculation is to recognize that only a proportion of these risks are diversifiable. This is independent of the level of PfADs or risk adjustments. Therefore, the change to IFRS17 does not necessitate a change to this calculation.

Recognition of Deferred Tax Assets (DTAs) under LIMAT

Comment

There is currently no recognition of DTA in the LIMAT ratio. This non-recognition is inconsistent with the treatment under LICAT ratio and puts Branches at a disadvantage. Given the non-deductibility of the CSM, which results in a more material DTA, it is recommend that a portion of the DTA is included in Other Admitted Assets to minimize the potential IFRS 17 transition impacts.

OSFI Response

Branch DTAs are not recognized in the LIMAT ratio in either LICAT 2019 or LICAT 2023. This is because they are not vested and are easily transferable to the parent. As such, their availability to Canadian policyholders is highly uncertain.