



Introduction of IFRS in Canada - a regulatory view

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OSFI
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Canada

Agenda

- **A single financial reporting system for insurance enterprises**
- **The introduction of IFRS in Canada**
- **A new approach - the Total Asset Requirement**
- **Fair value and the use of models**



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A single financial reporting system

- **Canadian insurance legislation specifies that insurers will prepare financial statements prepared according to GAAP**
- **Legislation came into force in 1992**
 - For life insurance, a new valuation method was introduced, the Policy Premium Method, which is the basis for proposals in the IFRS4 Phase II discussion paper
 - At the same time, capital requirements and Dynamic Solvency Testing were introduced
 - This change was preceded by a long period of collaboration between industry, regulators, the actuarial and accounting professions and the insurance consumer protection funds
 - Later, the valuation method was expanded to the Canadian Asset Liability Method (CALM)



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Why do Canadian insurance regulators approve of a single financial reporting system?

- **Two different sets of statements for the same insurer in the same year create confusion**
- **GAAP statements provide a better measure of profit than do traditional conservative regulatory statements**
 - Profit is a leading indicator of future solvency
- **Regulators' solvency concerns can be met through capital requirements and risk-based supervision**



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Why do Canadian insurance regulators approve of a single financial reporting system?

- **Legislation, accounting standards and operating agreements between the regulators and the actuarial and accounting professions provide the regulator with the ability to influence developments so that the system continues to provide satisfactory results**
- **A single system does not require the regulator to invest resources in maintaining its own system**



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Margins

- **Assumptions for valuation of liabilities are the actuary's best estimate**
- **These best estimate assumptions are adjusted by margins (Provisions for Adverse Deviations)**
- **Actuarial standards specify an explicit range for the margins for each assumption**
 - The minimum value is to satisfy actuarial and regulatory concerns that experience can be worse than the best estimate
 - The maximum value is to assure that the resulting measurement of income remains appropriate



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Introduction of IFRS in Canada

- **Effective 1 January 2011**
- **For insurance contracts, IFRS4 (Phase I) will apply**
- **For insurance contracts, little or no change is expected**
- **Major issues:**
 - Investment contracts
 - Bifurcation of contracts; separation of embedded derivatives
- **Alterations to capital requirements**



Introduction of IFRS in Canada

- **Based upon the IFRS Phase II discussion paper released by the IASB, we are, at present. Concerned with the following issues:**
 - Asset default risk
 - Asset / liability mismatch risk
 - Own credit recognition
 - Treatment of participating insurance
 - Definition of fair values
- **In addition, we cannot expect the same degree of cooperation with accounting standard setters that we have enjoyed in the past**



Introduction of IFRS in Canada

- **OSFI desires to maintain important aspects of our financial and regulatory system for insurers:**
 - A single set of financial reports
 - Reliance upon the Appointed Actuary
 - Reliance upon the external auditor
 - Risk-based supervision
 - Strong risk management within insurance companies

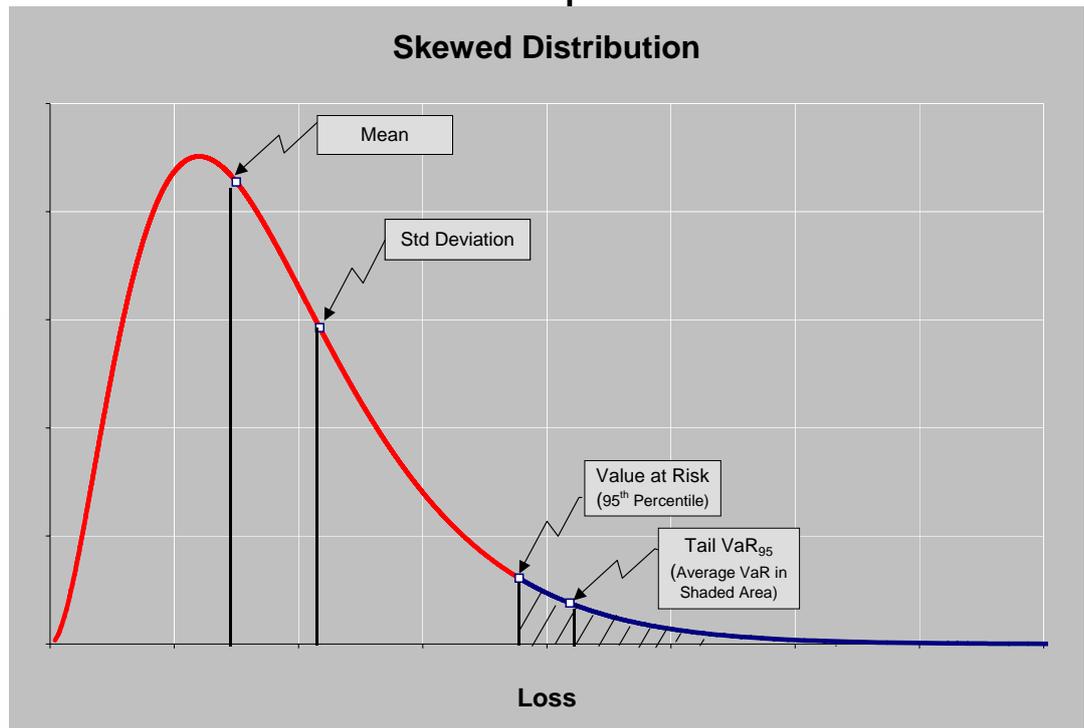


Total Asset Requirement

- **The traditional financial structure to monitor solvency is to *add* policy liabilities to required capital**
 - The total of liabilities and capital provides the required financial strength
- **The new Canadian approach is to determine the total assets required for financial strength and then *subtract* policy liabilities to determine required capital**



Total Asset Requirement



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Total Asset Requirement

- **Allows the supervisor to maintain a fixed degree of financial strength without having to change capital requirements whenever accounting standards or methods change**
- **Allows an automatic adjustment through capital for those elements of IFRS4 that are not acceptable to the supervisor**

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Total Asset Requirement

- **Minimum Capital Requirement**
- **Standard Approach**
 - Applies to all companies
 - Use company's own data and standard risk parameters or models
- **Advanced Approach**
 - Based upon internal models
 - Only for technically sophisticated companies
 - Requires pre-approval by OSFI



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Total Asset Requirement

- **Two workstreams**
 - Standard Approach
 - Working in cooperation with Assuris, the life insurance consumer protection plan (guarantee fund)
 - Advanced approach
 - Advisory Committee with representation from
 - Life insurance industry
 - Supervisors
 - Assuris
 - Actuarial profession (CIA)



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Total Asset Requirement

- **Some risks will be covered within the Total Asset Requirement but not at all in liabilities**
 - Credit (asset default) risk
 - Market risk
 - Including asset /liability mismatch
 - Operational risk



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Margins in Policy Liabilities

- **The Phase II Discussion Paper for IFRS4 contained several possible methods for choosing margins**
- **The Cost of Capital Method (CoCM) seems to be gaining popularity internationally**
 - Adopted in Europe under Solvency II and in Switzerland
- **It is not clear whether different methods will produce significantly different values**
 - Test calculations are being undertaken



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Margins in Policy Liabilities

- **Neither OSFI nor the Canadian Actuarial Standards Board have done much work yet with respect to the method of selecting margins**
- **The CoCM method will be difficult to apply under the Total Asset Requirement due to potential circularity in the calculations**
- **Approximate methods are being investigated**



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OSFI's interest in IFRS

- **If OSFI adopts the Total Asset Requirement, will it continue to be interested in insurers' public financial statements under IFRS?**
- **YES!**
 - Profit remains a leading indicator of future solvency
 - Firms will likely manage to an IFRS income target
 - Concerns under Pillar 3 (Market Discipline) include the quality of financial information being received by the public



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Fair Value and Models

- **IFRS is based upon fair values for financial assets and liabilities**
- **Fair values are usually based on market values where deep and liquid markets exist**
- **For many financial instruments, these markets do not exist and fair value becomes “mark to model”**



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Fair Value and Models

- **Financial regulators, particularly in the Basel Committee, have been concerned that they may not be able to depend on these models**
- **The reasonableness of their concern has been shown by our experience with various forms of securitized assets over the past year**
 - Markets collapsed, assumptions used in pricing models became very uncertain and fair values were extremely difficult to determine, causing uncertainty about some institutions' financial condition



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Fair Value and Models

- **In the insurance sector, OSFI continues to have confidence in the use of models**
- **This is due to models being used in conformity with actuarial professional standards of practice and guidance**
- **The IAIS and IAA have prepared guidance on the use of models**
- **There is no comparable development in the banking sector**



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Fair Value and Models

- **Models have been used successfully for many years in Canada in the valuation of life insurance policy liabilities**
- **Models have been used in some areas for the determination of capital requirements**
- **This will be extended under the new advanced approach to TAR**



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Fair Value and Models

- **The use of models for financial valuation and capital assumes**
 - A sound program of risk management within the insurance company
 - A sound system of controls around the use of the model
 - Regular audits of the model and supporting data
 - Competent personnel to operate the model
 - Pre-approval by the supervisor



Questions and Discussion

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