Advisory

Title	Supplementary Guidance for The Treatment Of Participating Insurance in Guideline A: Life Insurance Capital Adequacy Test
Category	Capital Adequacy Requirements
Date	November 30, 2020
Sector	Banks Trust and Loan Companies
Effective Date	January 1, 2021

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Guidance to be rescinded

As a result of OSFI's policy review, this guidance was identified as outdated, redundant, or no longer fit-for-purpose. It will be rescinded and removed from the website by April 1, 2025.

This Advisory applies to all federally regulated life insurance companies and societies, holding companies and companies operating in Canada on a branch basis, and updates and complements Guideline A: *Life Insurance Capital Adequacy Test* (LICAT). It implements a smoothing mechanism for the calculation of interest rate risk for participating blocks of insurance, and clarifies the capital treatment of certain participating insurance liabilities.

This Advisory will remain in effect until January 1, 2023, at which time the guidance contained herein will be incorporated into the LICAT guideline.

Definition

For the purpose of this Advisory, the term "**DSR**" means a dividend stabilization reserve or other similar experience levelling mechanism that is reported as a liability on the financial statements. This term encompasses additional reserves or other similar experience levelling mechanisms referred to in section 9.1.1 of the LICAT.

1. Smoothing Of Interest Rate Risk Requirements For Participating Insurance

OSFI is implementing a smoothing mechanism to reduce unwarranted volatility that could occur in the interest risk requirements for participating blocks of insurance. The smoothing will be effected by substituting rolling average amounts for certain components of the LICAT Base Solvency Buffer calculation, as specified below.

For each separate participating block within an insurer's LICAT calculation, the following new quantities are defined:

- $IRR_{i\ par}$ is the six-quarter rolling average of $IRR_{i\ par}$, as defined in LICAT section 5.1.2.2, for the block.

- $IRR_{i\ par\ npt}$ is the six-quarter rolling average of $IRR_{i\ par\ npt}$, as defined in LICAT section 5.1.2.2, for the block.

- $C_{i\ adverse}$ is the six-quarter rolling average of $C_{i\ adverse}$, as defined in LICAT section 9.1.2, for the block.

All of the rolling averages above should be calculated as the simple average over the current quarter and the previous five quarters. Once these averages have been determined, they should be substituted for the current quarter amounts in the formulas occurring in the following places in the LICAT:

- Within the calculation of the participating credit CP_i for the block in section 9.1.2:

- All three of the averaged quantities should be used in place of the current quarter amounts in the calculation of the intermediate components K i , K i reduced interests , and K i floor .

- The amounts I R R i par and C i adverse should be used in place of I R R i par and C i adverse in the remaining components of CP i . However, the amount C i initial should be that for the current quarter.

- Within the calculation of the standalone requirement K par i for the block in section 11.3, the amount I R R i par should be used in place of I R R i par .

All other components of the LICAT interest rate risk requirement calculation, including the determination of the most adverse scenario for a geographic region, and the calculation of the requirements for non-participating business, should follow the methodology specified in LICAT without modification.

For new participating blocks, no averaging should be used for the first quarter a block is reported. For the second quarter, all averaged quantities should be calculated using half of the sum of the first quarter and second quarter amounts. For the third quarter, the averages are one third of the sum of the first, second, and third quarter amounts. The averaging continues in this manner until the block is reported for six quarters.

Any participating block that is divested should be excluded completely from the LICAT calculation, and should not have a requirement reported for it.

If an entire participating block is coinsured by a reinsurer, the cedant should treat the transaction as a divesture, and the reinsurer should treat the assumed block as a new participating block. If only a portion of a participating block is coinsured, then:

- the cedant should reflect the change in the components of the smoothing calculation as if the reinsurance arrangement has been in place for the prior five quarters, and

- the reinsurer should treat the assumed portion as a new participating block, provided it had not assumed any portion of the block previously.

2. Negative DSRs

If a DSR is negative, then it is not available to absorb experience shortfalls within a participating block, and if it is material, it is itself an experience shortfall that must be recovered through dividend reductions. The recovery of negative DSRs will be subject to the same requirements as for recovery of other experience shortfalls (i.e. dividend reductions to effect recovery of a material negative DSR must be made within two years from when the negative reserve becomes material). In addition, irrespective of materiality, all negative DSRs should be deducted from Tier 1 Available Capital, with no corresponding add-back to Tier 2.

For the purpose of determining whether a negative DSR must be recovered, materiality should be assessed taking into consideration the insurer's internal management policies for participating insurance, and all relevant OSFI guidance related to participating insurance.

The DSRs contemplated in the LICAT guideline are those relating to actual experience. However, in applying the above guidance, an insurer may elect to use either DSRs resulting from actual experience within each participating block, or the total DSR reported on the financial statements for each participating block. Once this choice has been made, it should be applied consistently throughout the LICAT guideline and in subsequent quarters, and should be used consistently for all of the participating blocks of an insurer.