Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

Guideline

Subject: **Minimum Capital Test**
For Federally Regulated Property and Casualty Insurance Companies

No: **A** **Effective Date:** **January 1, 2016**

Subsection 515(1) of the *Insurance Companies Act (ICA)* requires Federally Regulated Property and Casualty Insurance Companies (property and casualty companies) to maintain adequate capital. Subsection 608(1) of the *ICA* requires foreign property and casualty companies operating in Canada on a branch basis (foreign property and casualty companies) to maintain an adequate margin of assets in Canada over liabilities in Canada. The Minimum Capital Test (MCT) Guideline is not made pursuant to subsections 515(2) and 608(3) of the *Act*. However, the minimum and supervisory target capital standards set out in this guideline provide the framework within which the Superintendent assesses whether a property and casualty company maintains adequate capital pursuant to subsection 515(1) and whether a foreign property and casualty company maintains an adequate margin pursuant to subsection 608(1). Notwithstanding that a property and casualty company may meet these standards, the Superintendent may direct the property and casualty company to increase its capital under subsection 515(3) or the foreign property and casualty company to increase the margin of assets in Canada over liabilities in Canada under subsection 608(4).

This guideline outlines the capital framework, using a risk-based formula, for target and minimum capital/margin required, and defines the capital/assets that are available to meet the minimum standard. The MCT determines the minimum capital/margin required and not the level of capital/margin required at which property and casualty companies must operate.

Foreign property and casualty companies are reminded that the MCT is only one element in the determination of the required assets that must be maintained in Canada by foreign property and casualty companies. Foreign property and casualty companies must vest assets in accordance with the Adequacy of Assets in Canada test as prescribed in the *Assets (Foreign Companies) Regulations.*

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Table of Contents

Page

Chapter 1. Overview and General Requirements....4

1.1. Overview....4

1.2. General Requirements....6

Chapter 2. Definition of Capital Available....9

2.1. Summary of Capital Components....9

2.2. Capital Composition Limits....17

2.3. Regulatory Adjustments to Capital Available....18

2.4. Capital Treatment of Interests in and Loans to Subsidiaries, Associates and Joint Ventures....21

Appendix 2-A: Information Requirements for Capital Confirmations....24

Chapter 3. Foreign Companies Operating in Canada on a Branch Basis....26

3.1. Branch Adequacy of Assets Test....26

Chapter 4. Insurance Risk....29

4.1. Diversification Credit within Insurance Risk....29

4.2. Margins for Unpaid Claims and Premium Liabilities....29

4.3. Risk Mitigation and Risk Transfer - Reinsurance....30

4.4. Self-Insured Retention....36

4.5. Catastrophes....36

4.6. Accident and Sickness Business....40

Worksheet – Capital Required: Accident and Sickness Business 45

Chapter 5. Market Risk....46

5.1. Interest Rate Risk....46

5.2. Foreign Exchange Risk....51

5.3. Equity Risk....55

5.4. Real Estate Risk....59

5.5. Other Market Risk Exposures....59

Chapter 6. Credit Risk....60

6.1. Capital Requirements for Balance Sheet Assets....60

6.2. Capital Requirements for Off-Balance Sheet Exposures....66

6.3. Capital Treatment of Collateral and Guarantees....71

Chapter 7. Operational Risk 75

7.1. Operational Risk Formula 75

7.2. Components of Operational Risk Margin 75

Chapter 8. Diversification Credit 79

8.1. Risk Aggregation and Diversification Credit 79

Chapter 1. Overview and General Requirements

The Minimum Capital Test (MCT) Guideline applies to Canadian property and casualty insurance companies and foreign property and casualty companies operating in Canada on a branch basis, collectively referred to as P&C insurers. Chapter 3 of this guideline, *Foreign Companies Operating in Canada on a Branch Basis,* defines assets available for foreign property and casualty companies operating in Canada on a branch basis (foreign companies). The MCT Guideline uses generic expressions that are meant to apply to both Canadian P&C insurers and foreign companies; e.g., capital available also refers to assets available for Branch Adequacy of Assets Test (BAAT) purposes, capital required refers to margin required for BAAT purposes and capital adequacy refers to margin adequacy for BAAT purposes.

This chapter provides an overview of the MCT Guideline and sets out general requirements. More detailed information on specific components of the capital test is contained under subsequent chapters.

Further guidance concerning some of the requirements of the MCT Guideline may be found in other guidelines and advisories available on OSFI's website under the Property and Casualty Insurance Companies section.

- Table of OSFI Guidelines
- Guidelines and Related Advisories – Capital
- Regulatory and Legislative Advisories

1.1. Overview

1.1.1. Minimum and target capital requirements under the MCT

Under the MCT, regulatory capital requirements for various risks are set directly at a pre-determined target confidence level. OSFI has elected 99% of the expected shortfall (conditional tail expectation or CTE 99%) over a one-year time horizon as a target confidence level.[1]

The risk factors defined in this guideline are used to compute capital requirements at the target level. The resulting MCT capital requirements are then divided by 1.5 to derive the minimum capital requirements. The MCT ratio is expressed as the capital available over the minimum capital required.

1.1.2. Risk-based capital adequacy

P&C insurers are required to meet the MCT capital requirements at all times. The definition of capital available to be used for this purpose is described in chapter 2 and includes qualifying criteria for capital instruments, capital composition limits, and regulatory adjustments and

[1] As an alternative, a value at risk (VaR) at 99.5% confidence level or expert judgement was used when it was not practical to use the CTE approach.

deductions. The definition encompasses capital available within all subsidiaries that are consolidated for the purpose of calculating the MCT ratio.

P&C insurers' minimum capital requirements are calculated on a consolidated basis and determined as the sum of the capital requirements at the target level for each risk component, less the diversification credit, divided by 1.5.

The minimum capital requirements are calculated as follows:

Sum of:

i.) Capital required for insurance risk (reference chapter 4):
   a. Capital required for unpaid claims and premium liabilities;
   b. Catastrophe reserves;
   c. Margin required for reinsurance ceded to unregistered reinsurers.

ii.) Capital required for market risk (reference chapter 5):
   a. Capital required for interest rate risk;
   b. Capital required for foreign exchange risk;
   c. Capital required for equity risk;
   d. Capital required for real estate risk;
   e. Capital required for other market risk exposures.

iii.) Capital required for credit risk (reference chapter 6):
   a. Capital required for counterparty default risk for balance sheet assets;
   b. Capital required for counterparty default risk for off-balance sheet exposures;
   c. Capital required for collateral held for unregistered reinsurance and self-insured retention (reference section 4.3.3).

iv.) Capital required for operational risk (reference chapter 7).

Less:

v.) Diversification credit (reference chapter 8).

Divided by 1.5.

1.1.3. Scope of consolidation

The capital adequacy requirements apply on a consolidated basis. The consolidated entity includes the P&C insurer and all of its directly or indirectly held subsidiaries, which carry on business that the parent could carry on directly in accordance with the *Insurance Companies Act* (ICA), including holding companies (e.g. P&C insurance and ancillary businesses such as agencies, brokerages and mutual funds). It therefore excludes:

- life insurance subsidiaries,

- other regulated financial institutions carrying on business that the parent would not be permitted to carry on directly under the *Insurance Companies Act* (ICA).

Whether a subsidiary should be consolidated is determined by the nature of the subsidiary's business (i.e. whether it carries on business related to P&C insurance), not the location where the subsidiary conducts its business (e.g. a U.S. P&C insurance subsidiary). All other interests in subsidiaries are considered "non-qualifying" for capital purposes and are excluded from capital available and capital required calculations.

1.1.4. Foreign companies

The margin requirement for foreign companies is set forth under the BAAT in chapter 3. The BAAT covers each of the risk components, and is determined using risk factors and other methods that are applied to assets under the control of the Superintendent, to specific assets under the control of the Chief Agent, and to liabilities in Canada.

The BAAT is only one element in the determination of the required assets that must be maintained in Canada by foreign companies. Foreign companies must vest assets in accordance with the Adequacy of Assets in Canada test, as prescribed in the *Assets (Foreign Companies) Regulations.*

1.1.5. Interpretation of results

The MCT is a standardized measure of capital adequacy of a P&C insurer. It is one of several indicators that OSFI uses to assess an insurer's financial condition and should not be used in isolation for ranking and rating insurers.

1.2. General Requirements

1.2.1. MCT supervisory capital ratio for federally regulated P&C insurers

The MCT ratio is expressed as a percentage and is calculated by dividing the P&C insurer's capital available by minimum capital required, which is derived from capital required calculated at the target level for specific risks.

Federally regulated P&C insurers are required, at a minimum, to maintain an MCT ratio of 100%. OSFI has established an industry-wide supervisory target capital ratio (supervisory target) of 150% that provides a cushion above the minimum requirement and facilitates OSFI's early intervention process. The supervisory target provides additional capacity to absorb unexpected losses and addresses capital needs through on-going market access.

OSFI expects each P&C insurer to establish an internal target capital ratio (internal target) per Guideline A-4 Regulatory Capital and Internal Capital Targets, and maintain on-going capital, above this target. However, the Superintendent may, on a case-by-case basis, establish an alternative supervisory target (in consultation with a P&C insurer) based upon the P&C insurer's individual risk profile.

P&C insurers are required to inform OSFI immediately if they anticipate falling below their internal target and to lay out their plans, for OSFI's supervisory approval, to return to their internal target. OSFI will consider any unusual conditions in the market environment when evaluating P&C insurers' performance against their internal targets.

P&C insurers are expected to maintain their MCT ratios at or above their established internal targets on a continuous basis. Questions about an individual P&C insurer's target ratio should be addressed to the Relationship Manager at OSFI.

1.2.2. Audit requirement

P&C insurers are required to engage their auditor appointed pursuant to section 337 or 633 of the ICA to report annually on the MCT or BAAT prepared as at fiscal year-end, in accordance with the relevant standards for such assurance engagements, as promulgated by the Canadian Auditing and Assurance Standards Board (AASB).

The annual audit report of the MCT or BAAT must be prepared separately from the audit report for the financial statements, and is to be filed no later than 90 days after the P&C insurers' fiscal year-end. The annual audit opinion provided must be with respect to the current fiscal year-end, for page 30.61 of the P&C quarterly return.

1.2.3. Transitional arrangements

P&C insurers are required to phase-in the capital impact of the revised MCT framework. The phase-in should be done on a straight-line basis, over twelve quarters, starting with the first quarter ending in 2015.

The capital impacts to be phased-in must be computed separately for capital available and capital required. The net capital impact is equal to the difference between capital available (old framework versus new framework) and minimum capital required (old framework versus new framework). In order to do so, P&C insurers are required to calculate two sets of MCT requirements as at December 31, 2014 (or October 31, 2014): one under the old framework, and another one under the new framework. The MCT requirements under the old framework are the same as those prepared and filed with OSFI for regulatory compliance purposes. The MCT requirements under the new framework as at December 31, 2014 (or October 31, 2014) do not need to be filed with OSFI.

In order to ensure that all companies are treated equally, the phase-in is mandatory for all insurers whether they are affected positively or negatively.

For example, a P&C insurer with a December 31 year-end must file with OSFI its MCT as at December 31, 2014 under the old framework and must calculate an additional MCT under the new framework as at the same date. The difference in capital available and the difference in capital required are the capital impacts to be amortized evenly over the next twelve quarters. The amortization of capital available and capital required impact amounts must be reported each

quarter until December 31, 2017. Insurers with an October 31 year-end must calculate the capital impacts (old versus new) as at October 31, 2014. The amortization of capital available and capital required amounts must be reported each quarter until October 31, 2017.

The phase-in amounts for capital available and capital required are a one-time impact based on December 31, 2014 (or October 31, 2014) which will uniformly unwind to zero over the next twelve quarters and are to be calculated using the following formulae:

Phased-in Capital Available = Capital Available under the New MCT - n*/12 x (Capital Available under the New MCT at December 31, 2014 – Capital Available under the old MCT at December 31, 2014)*

Where *n* declines from 11 in the first quarter 2015 to 0 in the fourth quarter 2017

Phased-in Capital Required = Capital Required under the New MCT - n*/12 x (Capital Required under the New MCT at December 31, 2014 – Capital Required under the old MCT at December 31, 2014)*

Where *n* declines from 11 in the first quarter 2015 to 0 in the fourth quarter 2017

Equity Derivatives, Common Shares Held Short and Eligible Hedges

P&C insurers are required to phase-in the capital impact of the capital treatment for equity derivatives (futures, forwards, and swaps), common shares held short and eligible hedges that are already in place at the time of issuance of this guideline whether the capital impact is positive or negative. The capital impact should be phased-in over eight quarters starting with the first quarter ending in 2016.

The capital impact is equal to the market risk capital treatment for equity derivatives, common shares held short and eligible hedges as per section 5.3 and must be calculated and reported at the end of each quarter. Therefore, the capital impact to be phased-in will vary by quarter. The capital impact must be phased-in using 1/8 of the new capital charge (or credit) in the first quarter 2016 increasing to 8/8 or full recognition in the fourth quarter 2017 (the end of the phase-in period will be October 31, 2017 for insurers with an October 31year-end).

Phase-in = Capital Required for Market Risk for equity derivatives, common shares held short and eligible hedges as at the quarter end x n/8

Where *n* increases from 1 in the first quarter 2016 to 8 in the fourth quarter 2017