Guideline Impact Analysis Statement

Guideline on Minimum Continuing Capital and Surplus Requirements (MCCSR) Draft Chapter 9 on the Capital Requirement for Segregated Fund Guarantees

I. Background

In 2000, OSFI amended the MCCSR Guideline to include a capital requirement for the risk associated with investment or performance-related guarantees on segregated funds. This requirement was based on recommendations contained in a report produced by the CIA's Task Force on Segregated Fund Investment Guarantees.

II. Problem Identification

The factors contained in the current requirement were calibrated to the returns of the Toronto Stock Exchange Index between 1956 and 1999. Thus, they reflect the large increase in stock prices that occurred from 1996 to 1999, but do not reflect the subsequent declines that occurred in 2000 and after. Since higher stock returns decrease the likelihood that a company will be required to make a payment under an investment guarantee, the calculation underestimates the capital required.

In addition, an error has been identified in the margin offset adjustment (factor D). The table for this factor was constructed based on the issue date of a contract instead of the time remaining to maturity. This error could lead to required capital being further underestimated.

III. Objectives

The objective in revising the Guideline is to correct the error and update the requirement for segregated fund guarantees so that companies maintain levels of capital that are sufficient, in the current market environment, to cover all of the associated risks.

IV. Identification and Assessment of Options

Option 1 *– Retain the segregated fund capital requirement as currently written.*

In the short term, retaining the status quo would be the least costly option for both the industry and OSFI. However, keeping the status quo could lead, over time, to some companies holding capital that would not be sufficient to cover their guarantee obligations if markets did not return to their previous levels. This could potentially result in increased levels of risk and costs to both the industry and OSFI as they would have to take steps to ensure sufficient capital was available where a shortfall had occurred due to segregated fund guarantees.

***Option 2** – Adopt a new methodology*

A new methodology would not offer significant benefits as the current method is still considered the best practice for analysing investment guarantees. Further, the development of a new methodology would be time consuming and costly for both OSFI and the life insurance industry, as it would likely involve extended consultations.

***Option 3** – Update the factors in the existing requirement to reflect recent market movements and correct the margin offset adjustment.*

While this would appear to be the simplest way of addressing the issues with the current Guideline, OSFI determined that the amount of time and expense that would have been required to update the factors was prohibitive, because OSFI would have had to calibrate factors for individual variables to produce a reliable approximation under all combinations of variables.

***Option 4** – Implement a new format for the requirement while retaining the current methodology.*

This option involves calculating a separate factor for each possible combination of product type, fund class, and policy characteristics. This case-by-case approach is costly for companies to implement, as it requires the creation of a database to contain the large number of factors, along with software to access it. Notwithstanding, producing the factors under this approach is still simpler than under Option 3 because the requirement for each combination of variables can be modeled separately. Furthermore, this approach would also be less costly and time consuming for OSFI than Option 2.

V. Recommendation

In an effort to reduce the time and expense required for the necessary guideline revisions, OSFI has chosen Option 4. This approach will provide companies with the following advantages:

- each factor will be based on specific product characteristics and, therefore, the requirement will be more precise;
- there will be less potential for human error;
- companies will no longer be required to use manual interpolation or extrapolation;
- the calculated requirement will be easier to audit.

VI. Consultation

The draft amendment has been circulated to the relevant industry associations for comment. Providing notice of this draft amendment to the MCCSR Guideline now should give the industry sufficient time to adjust its systems for year-end 2005, when this amendment is planned to come into effect. In addition, OSFI is providing the software needed to access the factor database, which will help companies significantly in making the transition.