POLICY RATIONALE FOR RECOMMENDED CHANGES TO TRINIDAD AND TOBAGO'S INSURANCE (CAPITAL ADEQUACY) REGULATIONS, 2020

BACKGROUND

Trinidad and Tobago's current asset and liability valuation requirements and capital adequacy framework were updated in 2021. The new regime includes:

1. a consistent method of valuation of policy liabilities;
2. regulatory minimum capital requirements based on a factor driven risk-based formula;
3. a requirement to hold adequate capital in excess of the regulatory minimum to support the insurer's risk profile and business plan;
4. actuarial certification of the adequacy of capital and satisfactory future financial condition to be demonstrated through stress testing of the business plan over a period of five years for long term insurers and three years for general insurers.

Moreover, Sections 144 and 145 of the new Insurance Act and the Central Bank of Trinidad and Tobago's (CBTT's) policy that financial statements and financial returns should be aligned (using IFRS) are in keeping with ICP 14.0.1[1]. This policy recognizes the benefits of aligning supervisory assessments of capital adequacy and earning trends and aligning supervisory solvency control levels with:

- the national corporate insolvency regime;
- metrics underpinning performance management and decision making at insurers; and
- risk assessment and capital management at insurers

However, once IFRS 17 is effective in January 2023, the current CPPM Regulation dealing with the valuation of policy liabilities, will **conflict** in fundamental ways with IFRS and with Sections 144 and 145 of the new Act requiring use of IFRS for regulatory reporting.

To rectify this, and to maintain compliance with IFRS, it is anticipated that the CPPM regulation will need to be rescinded. No replacement may be needed as IFRS 17 prescribes a consistent economic based approach to the valuation of insurance contract assets/liabilities (including reinsurance contracts).

Also, upon transition to IFRS 17, insurers must restate their balance sheets. This will impact insurers' available capital, regulatory required capital and capital ratios. The impact may be quite significant particularly for life insurers. Accordingly, revisions to the Capital regulation and recalibration of risk factors and target regulatory capital ratio and net tier 1 ratio and ultimately additional risk charges may be required. CBTT's goals for the revision and recalibration are to:

- adapt the capital regulation for IFRS 17 while maintaining compliance with fundamental elements of ICP 14, Valuation[2] and ICP 17, Capital Adequacy[3]
- minimize potential industry-wide regulatory capital impacts in the short and medium term
- minimize implementation burden by the industry

COMPATIBILITY OF IFRS 17 WITH THE PRINCIPLES AND STANDARDS OF THE ICPs

IFRS 17 is a major step forward in achieving high quality accounting, a significant policy measure intended to improve global transparency and comparability of financial statements produced using IFRS. It improves comparability by introducing a consistent approach[4] to all insurance contracts in jurisdictions applying IFRS. All insurance contracts must be valued as the total of:

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[1] ICP 14.0.1: "The IAIS considers it is most desirable that the methodologies for calculating items in general purpose financial reports can be used for, or are substantially consistent with, the methodologies used for regulatory reporting purposes, with as few changes as possible to satisfy regulatory requirements."

[2] ICP 14 Valuation: "The supervisor establishes requirements for the valuation of assets and liabilities for solvency purposes."

[3]"ICP 17 Capital Adequacy: "The supervisor establishes capital adequacy requirements for solvency purposes so that insurers can absorb significant unforeseen losses and to provide for degrees of supervisory intervention."

[4] A simplified approach approximating the general model may be used for some simpler insurance products such as ones for which the coverage period is less than a year.

1. realistic current estimates (incorporating the time value of money) of amounts that the company expects to collect from premiums and pay out for claims, benefits and expenses;
2. an adjustment for the timing and risk of those amounts ("risk adjustment"); and
3. the contractual service margin ("CSM") which is the unearned profit expected to be recognized over the remaining period of insurance coverage.

The ICPs provide that a proper assessment of an insurer's true financial strength/capital adequacy requires appraisal of its total balance sheet on an integrated basis under a system that depends upon realistic **economic values**, consistent treatment of both assets and liabilities and where all **margins are transparent** and catered for within the capital adequacy regime[5].

The current estimate component of the IFRS 17 valuation substantially meets the criterion of an economic valuation required by the ICPs. The risk adjustment and CSM components can be considered to be margins in excess of the economic values. Under IFRS 17, these margins will be transparently reported and they are **entity specific** since:

- the risk adjustment is to "reflect the compensation **that the entity requires** for bearing the uncertainty about the amount and timing of the cash flows that arise from non-financial risk"
- the CSM represents the insurer's unearned profit which will depend on, inter alia, the mix of business, age profile and profitability of the insurance portfolio

Reported capital is determined from an insurer's financial statements as the difference between the value of its assets and liabilities. The strength of the capital is dependent on the level of margins included in the valuation of the liabilities. Therefore a liability valuation framework based on entity specific margins has the potential to distort the relative strength of the capital positions of otherwise similar insurers.

This issue can be addressed under the total balance sheet approach by reframing the test of capital adequacy as a test of adequacy of assets backing both liabilities and capital. Assets should be sufficient to ensure:

- with a high degree of confidence, that an insurer can withstand adversity emerging over a defined regulatory control time horizon (e.g. might be deemed to be one year)
- that there are sufficient assets at the end of the defined time horizon to provide for the:
  - transfer of the remaining obligations to another insurer or
  - run-off of the remaining obligations.

Equivalently, since IFRS 17 requires current estimates to be computed using unbiased estimates of the expected value of possible outcomes:

- assets backing the current estimates would be expected to cover expected experience; and
- assets backing the margins in the accounting liabilities in excess of current estimates **plus** assets backing available accounting capital are available as a buffer to absorb adverse deviations from expected experience[6].

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[5] ICP 14.4: "The valuation of assets and liabilities is an economic valuation."
ICP 14.4.1: "An economic valuation is a valuation such that the resulting assessment of an insurer's financial position is not obscured by hidden or inherent conservatism or optimism in the valuation. Such an approach is appropriate in the context of risk-based solvency requirements which satisfy these ICPs and standards and shares their objectives of transparency and comparability."
ICP 17.1: "The supervisor requires that a total balance sheet approach is used in the assessment of solvency to recognise the interdependence between assets, liabilities, regulatory capital requirements and capital resources and to require that risks are appropriately recognised."

[6] In this regard the following guidance of ICP 17.2.6 is relevant:
"Capital resources protect the interests of policyholders by meeting the following two objectives. They:
• reduce the probability of insolvency by absorbing losses on a going concern basis or in run-off; and/or
• reduce the loss to policyholders in the event of insolvency or winding-up."

REVISIONS TO THE CAPITAL REGULATION

The revisions to the Insurance (Capital Adequacy) Regulations, 2020 (the "amended capital adequacy regulation") reflect the total balance sheet approach. The CSM is added to retained earnings and the risk adjustment is added as an additional capital buffer in the numerator of the capital ratios. Certain components of required capital are to be based on best estimate liabilities computed using the same assumptions as the IFRS 17 current estimates.

APPENDIX 1 gives additional detail about the more significant amendments proposed. Other minor amendments which do not relate to the implementation of IFRS 17 were made in order to tidy up the existing wording and for clarity.

QUANTATITIVE IMPACT STUDY

To calibrate the possible new risk factors, minimum regulatory capital ratio and net tier 1 ratio a quantitative impact study (QIS) will be needed. The purpose of the QIS is to:

- cater for IFRS 17/IFRS 9 impacts so as to mitigate industry-wide regulatory capital impact while revising the framework:
    - to allow for calibration independent of the entity specific level of risk adjustments established by insurers in accordance with IFRS 17; and
    - using a total balance sheet approach
- Assess the need for transition arrangements at an individual insurer level

These objectives are proposed to be transparently articulated to the industry. It must also be made clear to the industry that revisions to the framework were kept to a minimum to limit implementation burden and as far as possible be consistent with standard functionality of actuarial software systems

APPENDIX I - Rationale behind Material Amendments made to the Insurance (Capital Adequacy) Regulations, 2020

Material Amendments	Tab	Treatment for Capital Adequacy -IFRS 17	Rationale
Adjusted Retained Earnings	40.011, 40.012	The Contractual Service Margin (CSM) included in insurance contract liabilities under IFRS 17 will be counted as available capital. This is to be achieved by adding the CSM to retained earnings and is stated as follows in the revised regulation: *"7.1 The amount of adjusted retained earnings shall be the sum of retained earnings and all contractual service margins in the financial statements that are reported as liabilities minus all contractual service margins that are reported as assets."*	IFRS 17 requires a significant change in how profits are recognized. Under the current CPPM regulation, negative reserves are permitted. This means that a large portion of the future unearned profits are recognized at issuance of a policy. Under IFRS 17, future unearned profits must be deferred and are only recognised as the insurer provides insurance services[1]. The CSM is the component of the liability that represents the unearned profit to be recognized in the future. Under IFRS 17, this change is to be applied retrospectively. Therefore retained earnings will be reduced on transition because it no longer includes any unearned profits as that amount, the CSM, is included as a component of insurance contract liabilities (added as a margin to the current estimates under IFRS 17). The treatment as a component of available capital under the amended capital adequacy regulation parallels the current treatment of negative reserves at issue and run off of those negative reserves, albeit at a different rate. This change is: • also in keeping with the total balance sheet approach as described in the policy document above; • the approach taken by OSFI in its adaptation of its LICAT framework for IFRS 17 • the approach being taken by FSC-Jamaica in its adaptation of its capital framework for IFRS 17

Accumulated Other Comprehensive Income (AOCI)	40.011	AOCI specifically identified as a component of Tier 1capital. IFRS 17 allows insurers to include insurance finance income or expenses for the period in profit or loss or to disaggregate the insurance finance income or expenses between profit or loss and other comprehensive income. (paragraphs 88-89 and B129-B133 of IFRS 17)	AOCI is a part of net equity. The current regulation does not separately identify AOCI as to be included in Tier 1 Capital. Insurers would have included in "Other reserves". This change has been made for clarity.
Deferred acquisition costs (DAC)	40.011	The excess, if positive, DAC asset for any policy (including DAC for policies for which coverage has not yet become effective) over its termination or surrender charges are now required to be deducted from Gross Tier 1 Capital and added to Tier 2 Capital	The DAC asset is new under IFRS 17. The excess over surrender or termination charges does not meet the criteria of Tier I Capital i.e. permanent capital that is fully available to cover losses of the insurer at all times on a going concern and a wind-up basis (ICP 17.11)
Risk Adjustment	40.010, 40.011	The risk adjustment is added to available capital in computing the redefined Regulatory Capital Ratio and Net Tier 1 Ratio: The risk adjustment is the amount included in insurance contract liabilities determined in accordance with IFRS 17, stated as follows in the revised regulation: *"The risk adjustment in relation to a specific block of business, refers to the risk adjustment for non-financial risks reported in the financial returns that is associated to the block of business. The risk adjustment excludes all provisions for credit risk and counterparty default, as these are financial risks. The amount of risk adjustment used in the calculation of the regulatory capital ratio and net tier 1 ratio is equal to the risk adjustment net of all reinsurance reported in the financial statements in respect of all insurance contracts other than segregated fund contracts."*	As described in the policy document above, this change is needed because risk adjustments are entity specific margins. Reported capital is determined from an insurer's financial statements as the difference between the value of its assets and liabilities. The strength of the capital is dependent on the level of margins included in the valuation of the liabilities. Therefore a valuation framework based on entity specific margins has the potential to distort the relative strength of the capital positions of otherwise similar insurers. This change where the risk adjustment is added as an additional capital buffer in the numerator of the capital ratios rather than treating as a component of liabilities: • ensures comparability by removing the distortion created by entity specific margins in the liabilities; • is in keeping with the total balance sheet approach as described in the policy document above; • is the approach taken by OSFI in its LICAT framework for IFRS 17; and • the approach being taken by FSC-Jamaica in its adaptation of its capital framework for IFRS 17

Receivables	40.011, 40.020	1) Capital Available Deductions: Removal of the deductions for outstanding premiums and outstanding agent or broker debit balances 2) Asset Default Risk Charge: Removal of the capital requirement calculation for the outstanding premiums and outstanding agent or broker debit balances not deducted from available capital 3) Asset Default Risk Charge: Description for Other Receivable changed to Balance Sheet Receivables	Under IFRS 17, distinct investment components of an insurance contract must be separated and treated under applicable standards such as IFRS 9. However cash flows from insurance receivables and policy loans are interdependent with other insurance contract cash flows and consequently do not meet the IFRS 17 definition of distinct investment components that are separated. Therefore, the policy loan and premium receivable cash flows are included in fulfilment cash flows for insurance contract measurement under IFRS 17 and are hence valued as part of the insurance contract liability recorded in the financial statements. Therefore under IFRS 17, policy loan balances and premium receivable balances will not be not recorded as separate assets within the IFRS 17 financial statements. Looking into adding them back under certain circumstances but will reassess this approach when the pro-forma statements are received
Lapse Risk Charge Description	Schedule 11 of the Regulations	The policy liabilities are to be determined in accordance with IFRS using the best estimate assumptions (i.e. excluding risk adjustment, CSM and time value of guarantees.	Approach updated for consistency with IFRS 17 and total balance sheet approach described in the policy document above.
Asset Liability Mismatch Description	Schedule 9 or the Regulations	The policy liabilities are to be determined in accordance with IFRS using the best estimate assumptions.	Approach updated for consistency with IFRS 17 and total balance sheet approach described in the policy document above.
Claims Liabilities descriptions	40.040, 40.041	1) Premium Adequacy Risk Charge renamed to Margin for Unexpired Coverage 2) Outstanding Claims Risk Charge renamed to Margin for liability for incurred claims	Descriptions updated for consistency with IFRS 17 terminology.